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Eligibility to use investment fund may be lost for three years

The Ministry of Finance has updated its tax explanations from 21 January 2022 on corporate income tax accounting of an investment fund that serves as an alternative to the so-called Estonian CIT.

I. Minister of finance has updated investment fund explanations

The updated explanations contain guidelines on the application of the provisions of the Corporate Income Tax Act of 15 February 1992 with respect to regulations that enable taxable persons to include in their tax-deductible costs the contributions they make to a separate reserve fund formed for investment purposes. It is a preferential solution that makes it possible to claim tax-deductible costs even before an investment begins. The explanations present key and practical matters associated with the operation of an investment fund, such as: the entities eligible to apply this preferential solution; the conditions for the formation of a fund, the method used to make contributions and the spending dates; references to accounting records and practical examples.

II. The minister explains new regulations on ineligibility to use the fund

The updated version of the explanations of 21 January 2022 reflects the changes to Article 15 par. 1hd point 1 of the CIT made by the Act of 9 December 2021 on amending the Excise Tax Act and certain other acts (2021 Journal of Laws, item 2427). The changes pertain to the consequences of an expense from the fund that has been financed or refunded to the taxable person in any form (the consequences will not include penalties in the form of temporary loss of eligibility to make contributions). The regulation provides that if in the course of a tax year a taxable person spent such funds for purposes other than investments, he will for a time lose eligibility to make tax-deductible contributions to the fund.

III. Withdrawal from the fund for purposes other than investments takes away preference

Where in the course of s tax year a taxable person uses the fund inconsistently with its purpose, i.e. for purposes other than investments, or there is a breach of the conditions with regard to the entity's eligibility to use the investment fund, or funds are not spent by the statutory deadline, then in addition to the obligation to account for the income and pay interest (special tax liability), the taxable person will lose eligibility to make tax-deductible contributions on terms specific to the fund for a period of 3 tax years, but no less than 36 months.

IV. Improper withdrawal results in 3-year ban on tax-deductible contributions

The 3 tax years are counted from the beginning of the year following the year in which the investment fund conditions were breached.
If, therefore, such a withdrawal is made in June 2022, the 3-year period will be counted from 1 January 2023 and will last until the end of 2025. Thus the taxable person will not be able to benefit from the fund until 1 January 2026 at the earliest (example based on the assumption that the tax year is concurrent with the calendar year). If the period of 3 tax years is shorter than 36 months, eligibility to make tax-deductible contributions will be lost for the next three tax years, until the end of the year in which those 36 months are up.

V. Formation of fund to be preceded with specific investment plans

Improper use or improper formation of the fund – for the sole purpose of overstating tax-deductible costs without realistic investment plans – will lead to a reversal of the tax benefit gained by the taxable person as a result of recognizing contributions to the fund as tax-deductible costs. This is meant to counteract the fund being treated merely as an instrument to lower CIT liabilities rather than for investment purposes. This is why the formation of such funds should be preceded with specific investment plans.

VI. If expenses are repaid, taxable person will not lose eligibility to make contributions

Eligibility to make contributions is not lost on account of an expense from the fund that has been financed or refunded to the taxable person in any form. In such cases, the taxable person will only be required to: firstly – add to his revenue the equivalent of the amounts deducted or paid out of the fund (at an amount equal to the improper expenses) that had previously been recognized as tax-deductible costs; secondly – declare in his tax return and pay interest accrued from the day on which contributions to the fund were recognized as tax-deductible costs to the date on which that revenue was formed, at the statutory late interest charge rate in effect on the contribution date.

VII. Withdrawal in error must be returned and explained

A withdrawal made in error from an investment fund account for a purpose other than investment will not result in a loss of eligibility to continue to make contributions to the fund, as long as it is properly documented and promptly corrected by refunding the incorrectly withdrawn amount. Thus to avoid the negative consequences, the taxable person should without delay make an “additional” contribution to the fund, as well as convincingly demonstrate that the withdrawal was an error rather than an intentional act consisting of, for example, temporarily financing oneself with the fund. As stressed in the explanations, the burden of proof as to the occurrence of an error that does not have the hallmarks of an intentional act is on the taxable person.

The previous version of the explanations was discussed extensively in our November 2021 tax alert, which may be found on our website.

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