Unblocking the bottlenecks of the Estonian wealth-management scene for private foundations

Katrin Sepp*, Urmas Kaarlep† and Turgay Kuleli‡

Abstract

The purpose of this article is to present proposals to the Estonian legislator for removing the bottlenecks in the law that may hinder the establishment of private foundations in Estonia. These include the current double taxation of private foundations, the taxation of non-resident beneficiaries, public accessibility of documents, and the number of people involved in the administration of foundations. The authors propose a new, special type of foundation—a private foundation with limited economic activity, non-public documents, compulsory annual review by an auditor, relaxed requirements for the formation of the supervisory board and last, but not least, a special tax regime.

Introduction

In our previous articles, we came to the conclusion that the Estonian Foundation Act[1] permits the establishment of private foundations.[2] However, as there is no specific regulation covering private foundations only, there are some bottlenecks in Estonian law which in fact may hinder the establishment of private foundations.[3] The following were identified as the most critical:

- Double taxation of private foundations
- Taxation of non-resident beneficiaries
- Public accessibility of documents
- The number of people involved in the administration of foundations

Therefore, the Estonian legislator would be well advised to make changes to its existing regulations governing private foundations. The purpose of this article is to present solid proposals for amendments to the Estonian legislator, the implementation of which would lead to the solution of the aforementioned issues.[4] For each problem, we will follow three steps: a brief description of the current relevant provision; our reasoning for an amendment; a proposed wording of a new provision(s).

* Katrin Sepp, Notary candidate, Tiit Sepp, Merle Saar-Johanson, Tarvo Puri et al, Rävala 3 / Kuke 2 (V floor), 10143 Tallinn, Estonia; Tel: +372 534 881 91; E-mail: katrin.sepp@notar.ee; www.notarnet.ee.

† Urmas Kaarlep, Lecturer and Researcher, Finance and Tax consultant, Estonian Business School, Lauteri 3, 10114 Tallinn, Estonia; Tel: +372 562 469 99; E-mail: urmas.kaarlep@ebs.ee; www.ebs.ee.

‡ Turgay Kuleli, TEP, LL.M., M.B.A., Head of Wealth Planning, Sirel and Partners Attorneys at Law, Tartu mnt 43, 10128 Tallinn, Estonia; Tel: +372 606 9600; Fax: +372 606 9601; E-mail: turgay.kuleli@sirel.com; www.sirel.com.

1. *Sihtasutuste seadus,* RT I 1995, 92, 1604; RT I 1995, 92, 1604. English text available at <https://www.riigiteataja.ee/en/eli/ee/Riigikogu/act/515012018008/consolide> accessed 16 January 2018.

2. T Kuleli and U Kaarlep, 'Is the Estonian Foundation Act Ready for Private Purposes?' (2017) 23 Trusts & Trustees 653–57.

3. T Kuleli and U Kaarlep, 'What makes Estonia an Attractive Jurisdiction for Global Non-Charitable Private Foundations?' (2017) 23 Trusts & Trustees 263–72; K Sepp and U Kaarlep, 'The Estonian Foundation – what is Missing for it to be a well-designed Wealth Management Vehicle for Local and Foreign High-net-worth Individuals?' (2016) 24 Juridica International 96–104.

4. Only the most important proposed amendments are listed in this article. Other, related amendments are not examined here in the interest of brevity, but have also been presented to the Ministry of Justice of Estonia by Finance Estonia. Urmas Karleep and Katrin Sepp were members of this working group of Finance Estonia.

 doi:10.1093/tandt/tty093

Necessary Amendments regarding the foundation act and other related acts

Definition of Private Foundations

Subsection (1) of section 1 of the Foundation Act (FA) contains a general definition of a foundation: a foundation is a legal person in private law which has no members and which is established to administer and to use assets to achieve the objectives specified in its articles of association.

In order to draw, as well as to simplify the distinction between private foundations and other foundations, it is necessary to give a separate definition of a private foundation as a new special type of foundation.

For that, we are proposing a new subsection (1^1) to section 1, which would set out the most important difference between a private foundation compared to other types of foundations: namely that the documents of a private foundation—in contrast to all other foundations should not be publicly available. In order to reduce the number of business relations and creditors that could be affected by not having access to the foundation's documents, the new definition should also set out that a private foundation is not allowed to engage in economic activities that are not directly related to the maintenance and accumulation of assets in the interests of its beneficiaries. Thus, a private foundation must meet the following conditions: (1) the foundation operates on behalf of private interests and in accordance with the purpose specified in its bylaws; (2) the foundation is established for the purpose of administering assets obtained from its founders or other persons; (3) the foundation does not receive income from active business activities, i.e. it does not provide services, sell goods etc to earn profit. Hence, the private foundation may, eg, invest in securities or conduct some real estate transactions, but not open an online store 'in the interest of the beneficiaries'. Currently, the FA does not directly prohibit that a foundation's primary activity is direct economic activity, thus private foundations may also be used for commercial purposes (if such activity seems reasonable, taking into account, *inter alia*, the taxation aspect).

We are also proposing a new subsection (3^1) to section 3 FA, which provides rules for naming a foundation. The name of a private foundation should clearly indicate that it is a special type of foundation. In this way, the name of a private foundation alone would make it clear to possible creditors of the foundation (as well as others related to or engaged in the activities of the foundation) that, with this type of foundation, not all documents related to the foundation are publicly accessible as is the case with all other foundations.

Thus, the following wording should be added as subsection (1^1) to section 1:

> (1^1) A private foundation is a foundation established on behalf of private interests with its activities being the maintenance or accumulation of assets in the interest of the beneficiaries or a class of persons designated in the articles of association, and conducting no other economic activities. The documents to be submitted by a private foundation to the register are not public, unless otherwise provided by law

The following wording should be added as subsection (I^I) to section I of FA:
"(I^I) A private foundation is a foundation established on behalf of private interests with its activities being the maintenance or accumulation of assets in the interest of the beneficiaries or a set of persons designated in the articles of association, and conducting no other economic activities. The documents to be submitted by a private foundation to the register are not public, unless otherwise provided by law"

Concerning the name, subsection (3^1) needs to be added to section 3 in the following wording:

> (3^1) The name of a private foundation shall include the addition 'private foundation'.

Mandatory review and auditor's opinion

In order to ensure that a private foundation does not in fact engage in unauthorized economic activities (in the meaning of the proposed subsection (1^1) to section 1 FA), some type of external control seems to be unavoidable.

Under current law, every foundation must prepare and submit an annual report at the end of a financial year (section 34 FA), but an auditor's review[5] or audit of the annual accounts is compulsory only under the conditions specified in section 91(4)[6] and section 92 (2^1)[7] of the Auditors Activities Act.[8] We suggest that the annual account of all private foundations should be subject to review by an auditor, and, in addition, that the auditor should issue an opinion on whether the activities of the foundation comply with our proposed subsection (1^1) to section 1 FA. If the auditor comes to the opinion that the activities of a private foundation do not comply with the proposed section 1 (1^1) of the FA, this would constitute the basis for compulsory dissolution[9] according to section 46 FA and/or section 40 of the General Part of the Civil Code Act.[10]

Thus, we propose to amend subsection 92 (2^1) of the Auditors Activities Act and phrase it as follows:

> (2^1) The review of annual accounts is mandatory for a private foundation. Review of the annual accounts is also compulsory for a foundation not mentioned in subsection 91 (4) of this Act in whose annual accounts at least one of the indicators of the financial year exceeds the following conditions: 1) return on sales or revenue - 15, 000 euros; 2) total assets as of the balance sheet date – 15, 000 euros.

Regarding the aforementioned auditor's opinion, we propose adding subsection (5) to section 34 FA in the following wording:

> (5) The annual report of a private foundation must be accompanied by an auditor's opinion on whether the activities of the private foundation comply with subsection 1 (1^1).

Information privacy

All Estonian foundations are registered in a public register, and the documents submitted to the register are included in the so-called 'public file' available to everyone online (for a fee of two euros).[11] These documents include information concerning the objectives of the foundation, its (class of) beneficiaries, the conditions for distributions and the assets to be used, the procedure for appointment and removal of members of the management/supervisory board,

5. An audit is an engagement by the auditor that provides assurance to the public that financial statements are free of material misstatements. The outcome of an audit is a report that expresses positive assurance by stating whether the financial statements accurately represent in all material aspects the financial position, financial performance, and cash flows of the legal person. Compared to an audit, a 'review' is a simpler form for evaluating the financial statements. The purpose of a review is to provide reasonable assurance that no significant misstatements were detected in the annual report—it is expressed in the form of a 'negative opinion'. Due to the character of the work and the amount of time required, a review usually costs less than an audit.

6. The text (official translation) of s 91(4) reads as follows: 'An audit of the annual accounts is compulsory for a foundation established by the state, a legal person in public law, a local government, a political party or a company in which the state has at least discretion for the purposes of the State Assets Act, as well as a foundation established on the basis of a will or a foundation that is subject to audit pursuant to the Statutes or the Supervisory Board decision or which is in correspondence with the conditions provided for in subsections (1) or (2) of this section.'

7. The text (official translation) of s 92(2^1) reads as follows: 'Review of the annual accounts is compulsory for a foundation unspecified (i.e. not mentioned, emphasis added) in subsection 91 (4) of this Act in whose annual accounts at least one of the indicators of the financial year exceeds the following conditions: 1) sales revenue or income 15,000 euros; 2) total assets as of the balance sheet date 15,000 euros.'

8. *Audiitortegevuse seadus*. RT I 2010, 9, 41; RT I, 17 November 2017, 25; English text available at: <https://www.riigiteataja.ee/en/eli/516112017003/consolide> accessed 16 January 2018.

9. Compulsory dissolution cannot be decreed by the registrar (assistant judge), but must be referred to a judge (s 595 s 2(5) of Code of Civil Procedure (*Tsiviilkohtumenetluse seadustik* - RT I 2005, 26, 197; 15 January 2018; English text available: <https://www.riigiteataja.ee/en/eli/515012018001/consolide> accessed 24 January 2018). To decide on a dissolution, the court also hears the members of the managing bodies (s 629(2) of Code of Civil Procedure). According to s 40(2) of the General Part of the Civil Code Act (note 10), if a deficiency or other circumstances which constitute the basis for the compulsory dissolution can clearly be eliminated, the court shall, beforehand, give the legal person a term for elimination of the deficiency or circumstances. A ruling on compulsory dissolution is subject to appeal (s 629(5) of Code of Civil Procedure).

10. *Tsiviilseadustiku üldosa seadus*. RT I 2002, 35, 216; RT I, 20 April 2017; 21. English text available: <https://www.riigiteataja.ee/en/eli/509012018002/consolide> accessed 16 January 2018.

11. s 77(1) and s 85 of Non-profit Associations Act (*Mittetulundusühingute seadus*. RT I 1996, 42, 811; RT I, 9 May .2017, 21; English text available: <https://www.riigiteataja.ee/en/eli/515012018007/consolide> accessed 16 January 2018, s 217 (1)2)3) of the rules of procedure of the court registration department (Kohtu registriosakonna kodukord. RT I, 28.12.2012, 10; RT I, 23.12.2017, 11), s 14 (3) of FA.

etc.[12] In addition to this, annual reports containing information on the foundation's income and assets etc are publicly available through the information system of the commercial register.[13]

However, confidentiality is a very significant and attractive advantage for people wishing to establish a private foundation. Thus, for Estonia, it is important to make an exception for private foundations regarding the public accessibility of these documents. In fact, with the newest amendments to the Money Laundering and Terrorist Financing Prevention Act[14] that were enacted to implement the 4th Anti-Money Laundering Directive,[15] an exception has already been made regarding the registration of ultimate beneficial owners of private foundations,[16] but this regulation will not be complete unless the following changes are made too.

With the newest amendments to the Money Laundering and Terrorist Financing Prevention Act that were enacted to implement the 4th Anti-Money Laundering Directive, an exception has already been made regarding the registration of ultimate beneficial owners of private foundations, but this regulation will not be complete until the Foundations' Act is changed too

First of all, subsection (6) should be added to section 14 FA and worded as follows:

> (6) With regard to the documents to be submitted to the register by a private foundation, the following specifications apply:
>
> 1. The documents submitted to the register by a private foundation are kept in a registry file instead of a public file. Any person wishing to view the documents must first establish a legitimate interest in doing so.
> 2. Only a person with a legitimate interest may have access to the annual report of a private foundation and the documents to be submitted with such report.

In addition to this, a second sentence must be added to section 217(2) of the rules of procedure of the court registration department,[17] as in the following highlighted wording:

> An annual report is a public document that is not included in the public file, and it may be examined through the information system of the commercial register. Only a person with a legitimate interest may have access to the annual report of a private foundation and the documents to be submitted with such report.

The following subsections (3) and (4) should be added to section 217 of the rules of procedure of the court registration department:

> (3) In the case of a private foundation, the documents provided for in subsection (1) of this section shall be kept in the registry file. Persons wishing to view the documents shall be required to establish a legitimate interest in doing so.
>
> (4) To identify a legitimate interest in viewing the documents, the members of the management board and the supervisory board of a foundation shall also be heard, if possible.

Amendments concerning supervisory board

Another thing that needs to be changed is the number of persons required to run a private foundation. Currently, a founder has to find at least three trustworthy persons (in addition to himself) to set up a private foundation—one to be a member of the

12. K Sepp and U Kaarlep (fn 3), 98.
13. s 217(2) of the rules of procedure of the court registration department, s14(5) FA.
14. *Rahapesu ja terrorismi rahastamise tõkestamise seadus*. RT I, 17.11.2017, 2; RT I, 17 November 2017, 38; English text available: <https://www.riigiteataja.ee/en/eli/521122017004/consolide> accessed 16 January 2018.
15. Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC. 5 June2015, L 141/73.
16. See s 76 (3)4).
17. See fn 11.

management board and two for the supervisory board.[18] This may be excessive for a small family wealth protection vehicle, and we therefore suggest that, in the case of private foundations, the supervisory board requirement be relaxed to specify a minimum of one member. Removing the supervisory board completely would significantly lessen the internal control system, and this is not desirable. We also considered the (greater) involvement of external bodies, but this role would be inconsistent with the scope of responsibilities that auditors currently have in Estonia, and the imposition of more extensive judicial supervision would at this point also be too great a burden for the Estonian courts.

Currently, a founder has to find at least three trustworthy persons (in addition to himself) to set up a private foundation. This may be excessive for a small family wealth protection vehicle

In this context, we propose replacing the current wording of subsection (1) of section 26 FA with the following highlighted wording:

> (1) The supervisory board shall have three members, unless the articles of association prescribe a greater number of members. The supervisory board of a private foundation may have one or several members. A member of the supervisory board must be a natural person with active legal capacity.

Necessary amendments regarding the income tax act

Removal of double taxation

Currently, private foundations are double taxed in Estonia when it comes to holding shares of a company and passing through the dividends to the foundation's beneficiaries, as the exemptions provided for holding companies by the Income Tax Act (ITA)[19] do not apply to foundations.[20]

At the moment, private foundations are doubly taxed in Estonia when it comes to holding shares of a company and passing through the dividends to the foundation's beneficiaries. We strongly recommend that this double taxation be abolished

We strongly recommend that this double taxation be abolished. First of all, as a distribution is regarded as a gift under current rules, a provision excluding such treatment must be included in section 49, worded as follows:

> (6^2) Distributions to beneficiaries by private foundations are not considered gifts or donations, except when such distributions are made contrary to law or to the objectives set out in the articles of the foundation.
> Currently, private foundations are double taxed in Estonia when it comes to holding shares of a company and passing through the dividends to the foundation's beneficiaries, as the exemptions provided for holding companies by the Income Tax Act (ITA) do not apply to foundations.
> We strongly recommend that this double taxation be abolished

Hence, the taxation of distributions would take place at the level of the beneficiary, but the private foundation would act as a withholding agent for income tax (section 41 ITA). To avoid double taxation of dividends, we propose to amend section 19 ITA by adding subsections (6^1) and (6^2)[21] phrased as follows:

18. K Sepp and U Kaarlep (fn 3), p. 100.

19. Tulumaksuseadus (Income Tax Act). – RT I 1999, 101, 903; 28 December 2017, 74 (in Estonian). English text <https://www.riigiteataja.ee/en/eli/ee/504092017017/consolide/current> (most recently accessed on 17 January 2018).

20. More details available in K Sepp and U Kaarlep (fn 3), 101–103, but note that the discussion therein is based on an earlier version of the ITA. Nevertheless, the situation is essentially the same.

21. This corresponds to s $18(1^3)$ that entered into force on 1 January 2018, and is related to the new tax rate (14%) that is applied if profit distributed in a calendar year is smaller than or equal to the average distributed profit of the previous three calendar years (s 50^1); everything above that will be taxed at a rate of 20%; in case that the company distributes profit taxed at the preferential rate to a shareholder who is a natural person, an additional 7% withholding income tax shall apply. As a result, total taxation for a beneficiary would be the same as on dividend income received from a personal holding company.

(6[1]) Income tax shall not be charged on distributions made by a private foundation if income tax has been paid on the share of profit on the basis of which the distributions are made, or if income tax on the dividends has been withheld in a foreign state.

(6[2]) Income tax shall be charged on distributions made by a private foundation if the distribution is made on the basis of dividends or other profit distributions received by the private foundation from a resident company in monetary or non-monetary form if they are subject to taxation pursuant to 50[1] at the level of the company that is paying the dividend or at the level of the company that distributed the profit that served as a basis for payment of the dividend and if they are not subject to taxation pursuant to subsection 50 (1).

Taxation of non-residents

At present, non-resident beneficiaries of private foundations are taxed comparably to residents (including the aforementioned double taxation).

To compete with other private foundation jurisdictions, we suggest applying the principle of source-based taxation for distributions to non-resident beneficiaries of private foundations. Income originating from non-Estonian sources would thus not be taxable, while income from Estonian sources such as real estate or royalties would trigger Estonian taxation—as is presently the case for non-residents. The taxation of non-residents is addressed in sections 29–31[1] ITA.

We suggest applying the principle of source-based taxation for distributions to non-resident beneficiaries of private foundations

We propose to amend section 29 by adding subsection 14 in the following wording:

(14) Income tax is charged on distributions paid by a private foundation, if such a payment is based on income that would be taxable if derived by a

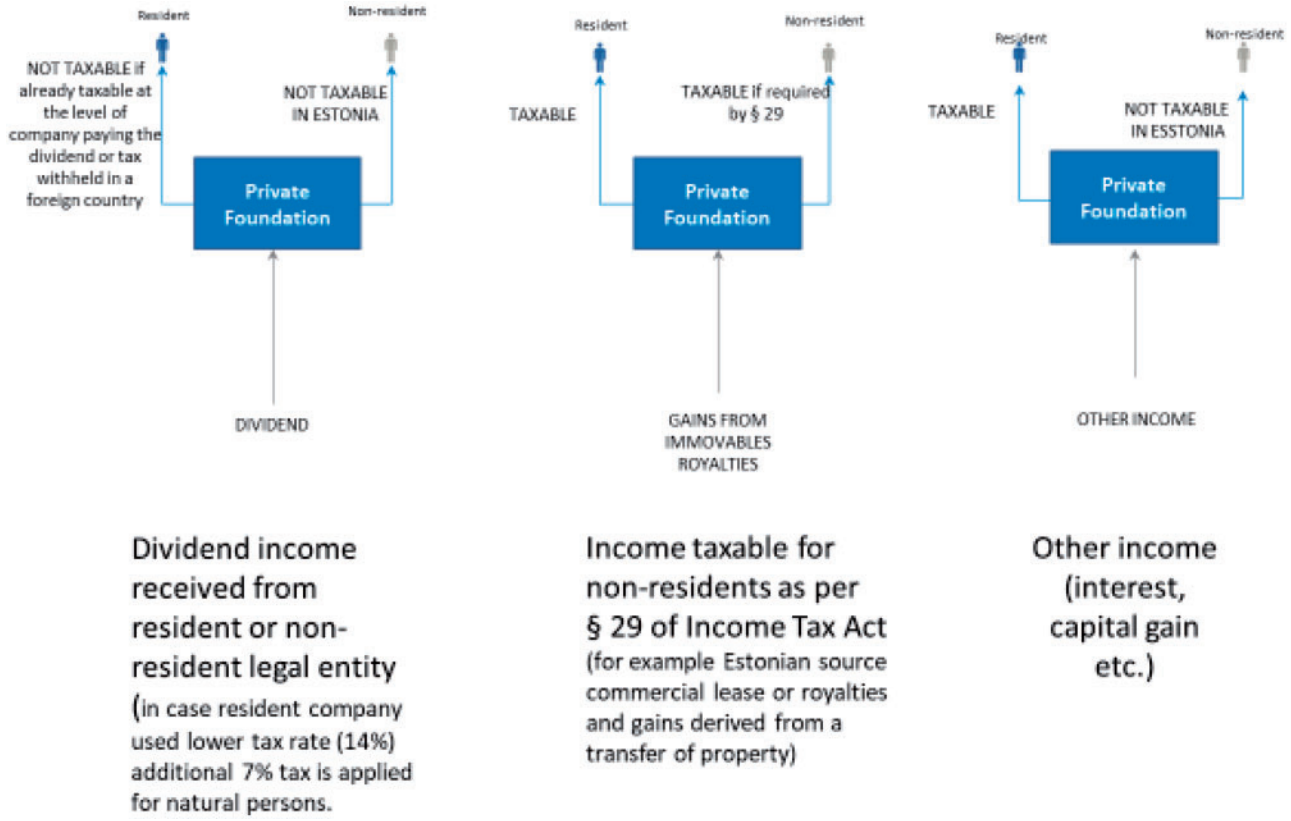

Figure I. Taxation of private foundations after the amendments.

non-resident in accordance with section 29 of this Act. With regard to the income tax rate, the rates established in this Act for corresponding income shall apply.

After the implementation of the amendments described above, the taxation of private foundations would be in principle as shown in Figure 1.

Conclusion

The proposals made in this article can be summarized as follows:

First of all, we propose a new, special type of foundation—the private foundation. The biggest difference between private foundations and other foundations is that the documents of the former should not be publicly accessible.

To reduce the number of business relations and creditors that could be affected by not having access to the foundation's documents, this new special type of foundation may engage in commercial activities only to fulfill its main purpose: the maintenance and accumulation of assets in the interests of its beneficiaries.

To ensure that the private foundation is not engaged in unauthorized economic activities, all private foundations shall be subject to a review of their annual accounts by an auditor, and the auditor shall additionally give an opinion on whether the activities of the private foundation comply with the law.

For the sake of objectivity and transparency and considering the value of the assets that might be involved in a public foundation's (eg a hospital's) activities, it may be justified that the administration bodies of public foundations—which operate in the public interest—be required to include a large number of members. However, as confidentiality, effectiveness, and privacy regarding asset are in the foreground when it comes to private foundations, reducing the minimum number of members of the supervisory board to one person would be would be beneficial.

To ensure competitiveness with other well-known foundation jurisdictions, Estonian legislators should abolish double taxation of private foundations and establish rules similar to those applicable to holding companies. Regarding non-residents, we strongly suggest that it be clarified that the taxation of distributions made by private foundations applies only for Estonian source income.

We believe that the thoughts put forward in this article will be helpful for Estonian legislators during the coming process of amending the regulations governing private foundations.

Katrin Sepp *is a notary candidate with the Estonian Chamber of Notaries and a PhD student at the Law Faculty of the University of Tartu, where her area of research is trust law, specifically the necessity and the possibilities for implementing the institution of the trust into Estonian law. Her main field of experience as a notary candidate is private law advising clients on property law, contract law, family law, succession law, and commercial law matters. E-mail: katrin.sepp@notar.ee.*

Urmas Kaarlep *is a lecturer at the Estonian Business School and a professional independent board member. At the university, his research interest focuses on intergenerational wealth transfers of HNWIs. Mr. Kaarlep draws on international finance and tax expertise from 21 years' experience with PwC in Estonia, the Ukraine, and Slovakia. E-mail: urmas.kaarlep@ebs.ee.*

Turgay Kuleli *has expertise in international wealth and tax planning, corporate law, international trust law, cross-border transactions, foreign private foundations. He coordinates business demands of non-Estonian clients doing or wishing to do business in Estonia with the team of Sirel Attorneys at Law. He regularly publishes in international journals on selected topics in the above areas. E-mail: turgay.kuleli@sirel.com.*