Overview of the taxation of income earned from investment funds

The overview has been prepared by AS SEB Pank (hereinafter: SEB) to provide its clients with primary information on the taxation of income earned from investment funds in Estonia. The principles and data contained in the overview are presented as at 2 November 2021.

We advise you to consult a professional tax adviser to clarify the circumstances surrounding the taxation of income from investment funds. The overview only describes the most general principles of taxation and may not address aspects that are important for the taxation of the income of a particular unit holder.

SEB does not act as an advisor to the unit holder in tax matters, and this also applies if specific tax behaviour is referred to in this overview, investment fund documents, or other information materials. Tax legislation may change in the future.

Further information on the investment funds mediated by SEB, including the terms and conditions of investment funds, public offer prospectuses, financial statements, and other relevant information, is available on the website at https://www.seb.ee/eng/savings-and-investments/investments/investment-funds.

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Introduction

Taxation of income earned from an investment fund depends on the residence and legal form of the investor, as well as the type of fund and income and several other circumstances. In addition, the legislation provides some investors with a number of significant tax incentives or imposes different tax conditions on certain types of funds.

In order to apply the tax rules, it is first necessary to know whether the income of the investor has arisen from so-called growth units or income units. There are tax differences for income earned from both mandatory and voluntary pension funds as well as foreign investment funds.

In the case of **growth units**, the income earned or loss received by the fund is reflected in the change in the net asset value of the units or shares (hereinafter: units) of the fund: the net asset value of a unit either increases or decreases. The investor has received income from the fund if the redemption price of their unit exceeds the acquisition cost.

In the case of **income units**, the fund distributes all or part of the income earned to the investors as disbursements without redeeming the units. Disbursements are usually made in cash, but they can also be made to the investor by issuing additional units (free of charge) at the expense of the income of the fund.

Income of a natural person is taken into account for income taxation in the tax period in which the income was received. Deductions from taxable income are taken into account in the tax period in which they were paid. The tax period for the types of income covered by this overview is the calendar year.

Investment account

When investing through the investment account system, a natural person has the opportunity to defer the payment of income tax on the income earned from the fund until the moment the income is taken into consumption. An investment account is a regular current account used only for making financial investments. **Therefore, it is reasonable to have at least two accounts: one for day-to-day transactions (wages, card payments, loan commitments, invoices, credit cards, etc.), the other account for transactions in financial assets (if necessary, money can be transferred from the account for day-to-day transactions)**. Payment of income tax can be deferred if financial assets as defined in the Income Tax Act are purchased for the money in the investment account and if income from the sale of that asset or other income related to the asset (such as interest) is received directly or is transferred, as soon as possible, to the investment account. **In order to defer income tax liability arising from income received from financial assets that could not be acquired for cash due to the content of the transaction, the acquisition cost of these financial assets must be declared in the income statement as an investment account contribution (financial assets received as inheritance, gift, liquidation distribution, share option, etc.)**.

Therefore, the investor must

- define a separate current account (investment account) through which they make transactions with financial assets;
- assess whether the financial products acquired by them are considered financial assets within the meaning of the Income Tax Act;
- keep records of investment account contributions and disbursements.

A person can have several investment accounts. Income tax liability arises when the amount of disbursements made by a person from all their investment accounts exceeds the balance of contributions made to all of their investment accounts. The balance of the contributions is calculated after each contribution and disbursement by adding the contribution to the previous balance or subtracting the disbursement from the previous balance.

More detailed information on the possibilities, features and conditions of the investment account can be found on the website of SEB at https://www.seb.ee/en/private/savings-and-investments/investments/investment-account[1].

Taxation of income earned from growth units

Resale of growth units

A fund with growth units does not make disbursements to the unit holders from the earned income; instead, the income earned from investing the assets of the funds is reinvested and accumulated in the fund. The increase or decrease in the value of the assets of the fund achieved via investment activity is reflected in the increase or decrease of the net asset value of the unit. The unit holder may realise the profit or loss obtained thereby from their investment by reselling the units.

1 We also recommend that you read the overview prepared by the Estonian Tax and Customs Board at https://www.emta.ee/eng.

Income earned from the sale of growth units is taxed as profit received from the transfer of property in accordance with section 15 of the Income Tax Act.

The profit or loss on the transfer of property is the difference between the acquisition cost and sales price of the sold property. The taxpayer has the right to deduct from the profit or add to the loss the documented costs directly related to the sale or exchange of the property. The acquisition cost also includes the documented expenses of the taxpayer for the acquisition of the property and for their improvement and supplementation, such as transaction fees and other similar expenses.

No cash disbursements are made upon the exchange of the units of the investment fund and the income is taxed only upon the resale of the units received during the exchange. In this case, the acquisition cost also includes the costs incurred for the acquisition of the initially acquired units.

Income of a resident investor

A resident natural person has the right to deduct any loss suffered from the transfer of securities during the period of taxation from the profit earned from the transfer of securities during the same period of taxation. If the amount of loss suffered from the transfer of securities during the period of taxation exceeds the amount of profit earned from the transfer of securities during the same period of taxation, the taxpayer may deduct the amount by which the loss exceeds the profit from the profit earned from the transfer of securities during subsequent periods of taxation.

In accordance with the currently valid Income Tax Act, income earned from the transfer of securities (including the sale of investment fund units) by a resident natural person is taxable with the 20% tax rate. It is the responsibility of the investor to declare income and pay income tax on it.

Income received by a resident natural person from exchanging the units for the units of another investment fund of the same fund manager or income earned from the exchange of units or other holdings of an investment fund in the course of a merger of investment funds.

The income earned from the sale of units to resident legal persons is not subject to taxation. Such income is included in their profit and taxed upon the distribution of the profit pursuant to the regular procedure.

Income of a non-resident investor

Generally, if the investor is a non-resident, the income from the sale of units is not subject to income tax in the Republic of Estonia. As an exception, a non-resident investor is taxed on the income earned from the transfer of fund units or shares if at least 50% of the assets of the fund comprise or comprised at a certain period within two years prior to the transfer an immovable property or buildings located in Estonia as a movable and if the non-resident owned at least 10% of the fund at the time of the transfer.

The income earned from the growth units could still be taxable in the resident country of the non-resident investor.

Under the same conditions as a natural person resident in Estonia, a non-resident natural person may deduct from the taxable profit received in Estonia during the tax period the loss received from the transfer of securities taxable in Estonia during the same period. If the amount of loss suffered from the transfer of securities during the period of taxation exceeds the amount of profit earned from the transfer of securities during the same period of taxation, the taxpayer may deduct the amount by which the loss exceeds the profit from the profit earned from the transfer of securities during subsequent periods of taxation. If a non-resident has suffered a loss on the transfer of securities, the income of which is taxable in Estonia, they must declare the amount of the loss in the period when the loss occurred to transfer it.

Taxation of income earned from income units

Cash disbursements

If the income of the fund is distributed as cash disbursements, the cash disbursements made to investors from the income units are taxed as interest in accordance with section 17 of the Income Tax Act or as dividends[2] in accordance with section 18 of the Income Tax Act. For income units, the income of the investor is created when the respective disbursement is made and the exact taxation of the income depends on the residence, legal form, and other similar circumstances of the investor.

The disbursement made to a resident natural person which is considered interest is subject to a 20% tax rate. The fund manager or a person authorised by them withholds the income tax on the disbursement made to the investor. The residence of the investor is determined on the basis of the relevant data entered in the unit register. The fund manager assumes the accuracy of the data entered in the register.

2 A disbursement is taxed as a dividend if the payer is a fund established as a public limited company and if the disbursement complies with the provisions of subsection 18 (2) of the Income Tax Act

The residence of the investor is determined on the basis of the relevant data entered in the unit register. The fund manager assumes the accuracy of the data entered in the register.

A 7% income tax is withheld on a disbursement to a natural person treated as a dividend if the part of the profit on which the disbursement is based is taxed at the dividend level at a 14% income tax rate. In the case of a disbursement made to a non-resident natural person, the rate of withholding tax may not exceed the rate of income tax agreed in the conventions[3] concluded between the country of residence of the person and Estonia.

If the part of the profit on which the dividend disbursement is based is taxed at the dividend level at the income tax rate of 20%, then the natural person does not pay additional income tax and therefore, income tax is not withheld on the disbursement.

Disbursements made in cash from a fund to resident legal persons and non-residents are not subject to income tax in Estonia. Such income of a resident legal person is included in their profits and is taxed in accordance with the regular procedure upon the distribution of profits. In the case of a non-resident investor, disbursements made from the fund may be taxable in their country of residence.

Disbursements in additional units

If the income of the fund is not paid out in cash but in additional units, the disbursement will not be taxed separately. In case of resale of issued additional units, the income earned from their sale is taxed in accordance with the rules of taxation of income received from the transfer of property (see 'Taxation of income earned from growth units').

Sale of income units

When reselling income units, the principles of taxation of income received from the transfer of property must be followed. This means that if the redemption price of a particular unit exceeds its acquisition cost, the investor has earned income from the fund and must pay income tax on that income in accordance with the rules for taxing income from the transfer of property (see 'Taxation of income earned from growth units').

Taxation differences when investing in units of mandatory pension funds (second pillar)

Only a resident natural person for whom a social tax payer is required to pay social tax or who pays social tax for themselves and who pays a mandatory funded pension from the fees provided for in section 7 of the Funded Pensions Act can invest in mandatory pension funds.

Tax incentives for making contributions

Disbursements of the mandatory funded pension withheld from the fees paid to a resident natural person are deducted from their income for the tax period. Thus, when the tax is withheld, the gross salary of a person is smaller in the amount of the withheld tax (usually 2%), but its effect on the net salary is smaller by the income tax component. If the income tax rate is 20% and the withholding tax rate is 2%, the payment of the mandatory funded pension reduces the net salary by an amount equal to 1.6% of the gross salary.

Taxation on disbursements

In order to receive disbursements from the mandatory pension fund, a person must generally enter into a pension agreement. From 1 January 2021, a person who has joined the second pillar can suspend their contributions and, if desired, also withdraw money directly from the pension fund without concluding a pension agreement.

Disbursements made directly from the fund are generally taxed at a rate of 20% (section 20^1 of the Income Tax Act).

Disbursements from the fund to a person of **retirement age**[4] or up to 5 years before reaching that age are taxed at the income tax rate of 10%.

All disbursements to a person who has a document certifying no work ability are tax-free.

The money of a mandatory pension fund can be withdrawn tax-free by concluding a pension agreement with lifetime

3 Conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital: Maksulepingud ja teabevahetuslepingud | Maksu- ja Tolliamet (emta.ee)

4 The retirement age is calculated based on the year of birth (more information on the website of the Social Insurance Board: Pension, types of pensions and benefits | Government installation profile (sotsiaalkindlustusamet.ee)

payments or a fund pension, the disbursement period of which corresponds to the **life expectancy**[5] or is longer than it.

If the length of the concluded pension agreement is shorter than the officially established **life expectancy**[5], the disbursements are subject to a 10% income tax rate.

Income tax is withheld upon disbursement. Income tax is levied on the entire disbursement, regardless of whether the person has earned income from their investment or not. Income from investments in mandatory funded pensions does not affect the general calculation of tax-free income (up to 6,000 euros per year).

Taxation on the exchange of units and other special cases

The exchange of units of a mandatory funded pension fund for units of another mandatory funded pension fund, redemption of units upon the conclusion of a pension agreement or the introduction of a pension investment account, as well as the transfer of units to the pension account of the heir is exempt from income tax because no disbursements are made to the unit holder or the heir in these cases.

Tax differences when investing in units of voluntary pension funds (third pillar)

Only natural persons, including non-resident natural persons, can invest in voluntary pension funds.

However, given the specificities of taxation when investing in voluntary pension funds, we recommend that non-resident natural persons thoroughly assess the impact of taxation on the proposed investment and, if possible, consider more suitable options for investment.

Tax incentives for making contributions

A resident natural person and a natural person of a contracting state of the European Economic Area has the right to deduct up to 15% of the taxable income of the person in Estonia during the tax period (but not more than 6,000 euros) of the amounts paid for the acquisition of units of a voluntary pension fund established in Estonia and a voluntary pension fund operating on an equivalent basis in a contracting state of the European Economic Area[6] from the taxable income of a person in Estonia. This means that the Estonian state refunds income tax on amounts invested as a voluntary funded pension (including additional money placed in both the pension fund and the funded pension insurance agreement) that do not exceed 6,000 euros or 15% of the annual taxable income of the person in Estonia.

For example, if said individual, whose taxable income in Estonia is 1,000 euros per month (12,000 euros per year), invests 75 euros (900 euros per year in total) in the pension fund each month, the state will return the money from the contributions made to the pension fund to the extent of the income tax rate. If the income tax rate is 20%, the state refunds 180 euros (which is 20% of 900 euros).

Amounts paid for the acquisition of units of a voluntary pension fund operating outside a contracting state may be deducted from the income of the tax period only in the case provided for in subsection 28 (1^2) of the Income Tax Act.

Taxation on disbursements

A unit holder has the right to demand the redemption of units of a voluntary pension fund at any time. Upon the redemption of units of a voluntary pension fund, the disbursement made to the unit holder is taxed pursuant to section 21 of the Income Tax Act. Disbursements are generally taxed at a rate of 20%.

Disbursements are subject to a 10% income tax rate if they are made to the investor after they reach the age of 55[7] and if at least five years have elapsed since the initial acquisition of the units.

The appropriate tax rate is **levied on the entire disbursement from the voluntary pension fund, regardless of whether or not the investor has earned a return on their investment**. By concluding a supplementary funded pension insurance agreement, the amounts accumulated in the voluntary pension fund can also be received tax-free. Disbursements made on the basis of an insurance agreement are exempt from income tax after the policyholder reaches the age of 55[7], provided that the disbursements are made by the insurer at least once in three months until the death of the policyholder. In essence, this is an exchange of units for a lifetime annuity pension, which is subject to a tax incentive through an income tax exemption.

5 Life expectancy – the average number of years lived by men and women published by Statistics Estonia is used. Information on the website of Statistics Estonia Life expectancy | Statistikaamet

6 As at 1 February 2020, the contracting states of the European Economic Area are Austria, Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, the Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain and Sweden.

7 For persons who have joined the third pillar after 1 January 2021, instead of the age limit of 55, the retirement age or the age up to 5 years before reaching retirement age is calculated.

The 10% tax rate applies to disbursements made under a pension agreement if at least five years have elapsed since the initial acquisition of the units and the agreement period is shorter than the **life expectancy**[5] and to disbursements made in the liquidation of a voluntary pension fund.

All disbursements, both from the fund and under a pension agreement, to a person who has a document certifying no work ability are tax-free.

It is important to remember that income taxed at a rate of 20% on voluntary funded pension disbursements affects the general calculation of tax-free income (up to 6,000 euros per year).

Tax differences when exchanging units

The exchange of units of one voluntary pension fund for units of another voluntary pension fund is not subject to income tax because no disbursements are made to the unit holder. In addition, the redemption of units of a pension fund upon concluding a supplementary funded pension insurance agreement is not subject to income tax.

Tax differences when inheriting units

In the event of the death of a unit holder of a voluntary pension fund, an heir who is a natural person has the right to demand the transfer of some or all of the inherited units to the securities account of the successor or the redemption of units.

If a disbursement is made to the heir upon redemption of the pension fund units without the units of the bequeather being transferred to the securities account of the heir, the disbursement made to the heir is taxed at the rate of 20%.

Upon transfer of the units to the securities account of the heir, the heir acquires the respective units and the redemption disbursement is taxed in accordance with the circumstances related to the unit holder (age of the unit holder, time of initial acquisition of units, etc.) on the same principles as other disbursements to the unit holder (see 'Taxation on disbursements' above).

Taxation of income earned from foreign investment funds

Income earned from foreign investment funds through a fund manager, SEB Pank, or other intermediary operating in Estonia is declared and taxed as securities income earned in Estonia in the same way as income earned from Estonian investment funds.

Additional information

For more information on the taxation of income earned from investment funds,

please contact SEB's customer support at **665 5100**

or call **seb.eesti** via Skype.