Determining the price and the taxation of fringe benefits

The **"Procedure for determining the price of fringe benefits"** is established by Regulation No. 2 of the Minister of Finance of 13 January 2011 (hereinafter *the Regulation*).

If the fringe benefit is the income obtained from the **transfer of a share option**, then **the difference between the market price of the share option and the option premium paid to the employer is considered the price of the fringe benefit** (**subsection 1 of § 7 of the Regulation**).

If an employee did not pay option premium to the employer, the market price of the share option is considered the price of the fringe benefit.

If the fringe benefit is the income received from the **acquisition of the holding underlying the share option**, then the **difference between the market price and the realisation price of the holding, minus the option premium paid to the employer, is considered the price of the fringe benefit** (**subsection 2 of § 7 of the Regulation**).

Therefore, if 3 years have not passed since the option was granted and the option is exercised (realised), the employer is obliged to tax as a fringe benefit

- the market price or
- the market price minus the exercise price (realisation price) of the option paid by the employee and/or the option premium

of the underlying holding acquired by the employee.

In practice, there have been situations where the entire holding (100%) in the employer is transferred (the so-called full exit situation) and the options are terminated and exercised (realised) before 3 years have passed, on the condition that **the employee no longer receives a holding** upon termination and realisation of the option, **but financial compensation pay-out corresponding to the value of the holding**. This is because the new owner (investor) acquires the entire holding (100%) and does not continue with the option program. Since the new owner does not include employees in the circle of owners, it is not justified to formalise the holding in the name of the employee(s) only to immediately transfer it to the new owner (investor). In such a situation, the tax authority is guided by the content of the transaction and takes the position that, as a fringe benefit, **the monetary pay-out is not taxed as a fringe benefit in the extent that corresponds to the time the option is held**. Monetary pay-out exceeding the time the option is held is taxed as a fringe benefit.

EXAMPLE

There have also been situations where a **partial holding** (less than 100%) in the employer is transferred and/or by agreement of the parties, the right to use the option and the obligation to exercise the option are waived and a monetary pay-out is made to the employee (compensation is paid). In this case, the **monetary pay-out is taxed in full as a fringe benefit.**

Fringe benefit is declared in Annex 4 of the form TSD at codes 4080–4083.

If an employee performs their duties in Estonia and their wages are taxed with both income tax and social tax and social payments in Estonia, then the fringe benefit given to the employee is also subject to taxation with income and social tax in Estonia.

If a non-resident employee performs their duties in a foreign country and their wages are taxed with both income tax and social tax and social payments in the foreign country, then the fringe benefit given to the employee is also not subject to taxation in Estonia. The employer may have a tax liability in a foreign country.

In the future, if the employee benefits from the transfer of securities (acquired holding), they have the right to take into account the amount taxed as a fringe benefit with income tax according to **§ 48 of the Income Tax Act** by the employer as the cost of acquiring securities (**subsection 8 of § 38 of the Income Tax Act**). The employer's certificate is the basis for determining the acquisition cost.

EXAMPLES OF CALCULATING THE PRICE OF FRINGE BENEFIT

There have been situations where, with an option contract, an employee has the right to exercise an option and acquire a holding before 3 years have passed since the conclusion of the option contract, and this on the condition that the employee pays (reimburses) the tax liability related to the acquisition of the holding to the employer when the option is exercised. In such situation, the price of the fringe benefit is calculated according to the agreement between the employer and the employee, and the acquisition cost of the holding paid by the employee to the employer. Two examples can be given from practice to calculate the tax liability and the acquisition cost of a holding.

Example 1

An agreement has been concluded between the employer and the employee that the employee pays the employer **the estimated** (so-called hypothetical) **tax amount** based on the price of the fringe benefit. For example:

- the market price of the acquired holding, i.e., the price of the fringe benefit, is 1,000 euros;
- the employee pays the employer the calculated tax amount of 662.50 euros from the price of the fringe benefit of 1,000 euros

- (1,000 × 20 ÷ 80 = 250 euros; 1250 × 33% = 412.50 euros; income tax 250 euros + social tax 412.50 euros = 662.50 euros);

- since the employee paid (reimbursed) 662.50 euros to the employer, the taxable fringe benefit for the employer is 337.50 euros (1,000 – 662.50 = 337.50);

- the employer declares and pays the actual tax amount of 223.60 euros from the fringe benefit of 337.50 euros
(337.50 × 20 ÷ 80 = 84.38 euros; 421.88 × 33% = 139.22 euros; income tax 84.38 euros + social tax 139.22 euros = 223.60 euros);

- the market price of the acquired holding, i.e., the price of the fringe benefit, is 1,000 euros.

The employee has the right to take into account 1,000 euros as the acquisition cost of the holding, i.e., 662.50 euros paid to the employer + 337.50 euros taxed as fringe benefit.

If the employee sells the holding in the future for, e.g., 2,500 euros, their gain will be 2,500 – 1,000 = 1,500 euros.

The acquisition cost of the holding must be documented, and it is important that the employer gives the employee a certificate indicating the amount taxed as a fringe benefit.

Example 2

An agreement has been concluded between the employer and the employee that the employee pays the employer **the actual tax amount** based on the price of the fringe benefit. For example:

- the market price of the acquired holding, i.e., the price of the fringe benefit, is 1,000 euros;

- the taxable fringe benefit of 586.47 euros for the employer can be found as follows: 1,000 euros is the total amount of the fringe benefit and tax expense, or 170.513% in percentage terms (fringe benefit price of 1,000 euros, i.e. 100%, + tax amount on the fringe benefit of 705.13 euros, i.e. 70.513%); therefore the fringe benefit (100%) for the employer is 1,000 euros × 100% ÷ 170.513% = 586.47 euros;

- taxable fringe benefit for the employer is 586.47 euros and the tax amount on it is 413.53 euros (586.47 × 22 ÷ 78 = 165.41; 751.88 × 33% = 248.12; income tax of 165.41 euros + social tax 248.12 euros = 413.53 euros);

- the employee pays (reimburses) the employer the actual tax amount of 413.53 euros from the price

- of the fringe benefit of 1,000 euros (tax liability calculated from 586.47 euros out of 1,000 euros: 586.47 × 22 ÷ 78 = 165.41; 751.88 × 33% = 248.12; income tax 165.41 euros + social tax 248.12 euros = 413.53 euros);

- since the employee paid (reimbursed) 413.53 euros to the employer, the taxable fringe benefit for the employer is 586.47 euros (1,000 – 413.53 = 586.47);

- the employer declares and pays the actual tax amount of 413.50 euros from the fringe benefit of 586.47 euros.

The employee has the right to take into account 1,000 euros as the acquisition cost of the holding, i.e., 413.53 euros paid to the employer + 586.47 euros taxed as fringe benefit.

Like the first example, if the employee sells the holding in the future for e.g., 2,500 euros, their gain will be 2500 – 1,000 = 1,500 euros.

The acquisition cost of the holding must be documented, and it is important that the employer gives the employee a certificate indicating the amount taxed as a fringe benefit.

Both examples and calculations are possible in practice.

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