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SHIFTING FROM TAXATION OF CORPORATE INCOME TO DISTRIBUTED PROFIT: THE CONCEPT FOR LATVIA

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Abstract

Work productivity, competitiveness and the generation of investments are indices, in which Latvia trails behind other countries. The need for economic growth is evident. It can be done, by establishing a tax regime, which would serve as incentives to particular investments.

The aim of this paper is to develop a concept for Latvia on corporate income tax in future. The objectives of this paper are: compare different corporate income tax principles, assess impact of corporate income tax on investments, productivity and other economic indicators and prepare suggestions for optimal taxation in case of Latvia. The method of this research is based on an expert survey and desk research, as well as on data analysis of economic activities.

In order to promote Latvian competitiveness, enhance productivity, attract investment, increase state budget revenues in the long term, to simplify the payment of tax and reduce the administrative burden, it is proposed to introduce zero corporate tax regime for reinvested profit. This will encourage investment and productivity growth, develop the economy; it will lead to higher tax revenues (medium and long term) and will increase GDP. The solution will improve the company's financial indicators (liquidity, solvency), simplify tax administration, reduce opportunities for tax optimization, and improve the financial performance of companies.

Keywords: corporate income tax, taxation of distributed profit, taxation of capital, personal income tax

Introduction

In the World Economic Forum "Global Competitiveness Index Report 2016–2017" Latvia was ranked in the 49th place among 138 economies surveyed worldwide (Word Economic Forum, 2016). Labour productivity and macroeconomic environment is one of the factors which Latvia lags behind the European and North American region. Latvian labour productivity is one of the lowest in the EU. (European Commission, 2016)

Competitiveness and productivity increase is needed to promote national economic development, to increase the gross domestic product (GDP) growth and income convergence with the EU average. Development of new technologies, innovations and investments in human capital (education, competence and skills training) will increase each company's competitiveness and productivity, thereby it will have positive impact on the general economic situation.

Increasing competition is one of the preconditions for increasing the productivity of the economy. It also stimulates the concentration of resources in companies with potential to export. It is necessary to improve access to capital (credit conditions) especially for exporting companies. Therefore, it is worth considering to create an additional mechanism for support to new and innovative companies. (Beņkovskis, 2016)

In the European Commission's strategic development plan "Europe 2020" one of the priorities is support for innovations. The aim is to increase competitiveness of Europe in the global market. By 2020 it is planned to support more investment in research and development sector, accordingly it will reach at least 3% of each country's GDP (European Commission, Europe 2020). Latvian investment activities, as well as the EU as a whole has been moderate in recent years, and investment volumes have still not reached pre-crisis levels. Low level of investment and the weak dynamics in foreign direct investments is greatly affected by weak lending, relatively low demand, relatively high private and public debt levels, as well as the current economic situation and uncertainty of political situation in the external environment of Latvia. Low levels of investment in fixed assets hinder renewal and modernization, which may undermine the country's competitiveness and growth potential. (Ministry of Economics of the Republic of Latvia, 2016)

From 2004 till 2015 foreign direct investments grew in the Baltic States. As it is seen in Figure 1, the level of foreign direct investments in Estonia is more than 30% above the level in Latvia and more than 50% in Lithuania. (Ministry of Economics of the Republic of Latvia, 2016)

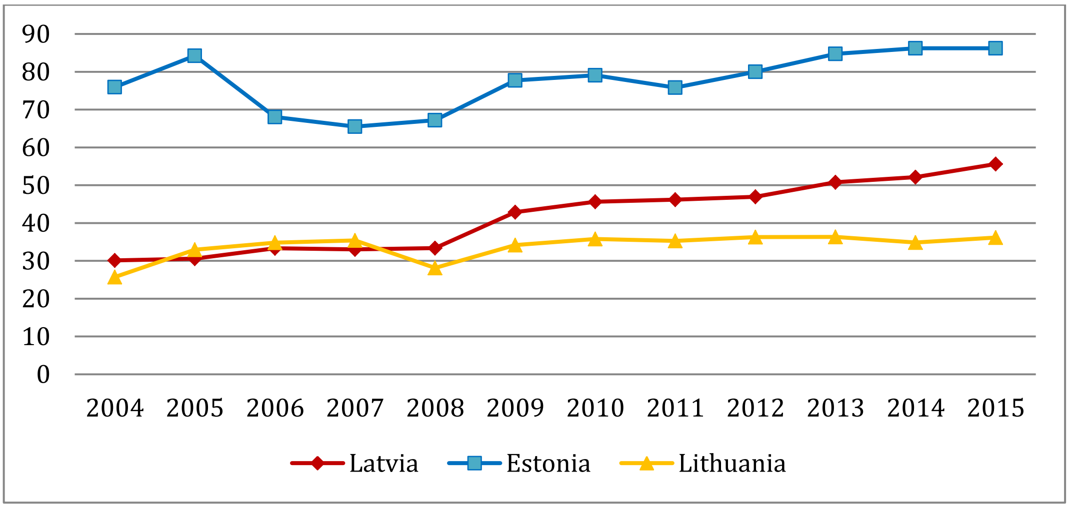

Figure 1. **Foreign direct investments in % of GDP**

Source: Eurostat (2016)

Taxation is one of the main national mechanisms, which may affect the increase of competitiveness and productivity. This can be done by setting the corporate tax regime to facilitate adequate investment.

Latvian tax system is not competitive compared to neighbor countries – Estonia and Lithuania. Latvian companies have a higher tax burden on labour. The corporate income tax (hereinafter – CIT) system in Latvia is the least competitive. Lithuania provides favourable conditions for entrepreneurs by offering a lower effective CIT rate corresponding to the tax actually paid (Domnīca Certus, 2016).

Estonian tax system has been assessed as the most competitive in the OECD countries for the second year in a row, and the most important and most competitive Estonian feature is the CIT system (Pomerleau & Cole, 2015).

In the global competition for attraction of investment CIT is being used as a tool for attraction of investment. Over the past decade there has been a tendency to reduce the nominal CIT rate in almost all parts of the world – in the OECD countries as well as the European Union. Latvian neighbor countries have a very aggressive CIT regime, they provide a significant competitive advantage, and especially Estonia stands out with its zero corporate tax regime on reinvested profit.

Although implicit tax rate in the Baltic countries has changed in recent years, they are similar (see Figure 2). However, the Estonian income tax system is better evaluated.

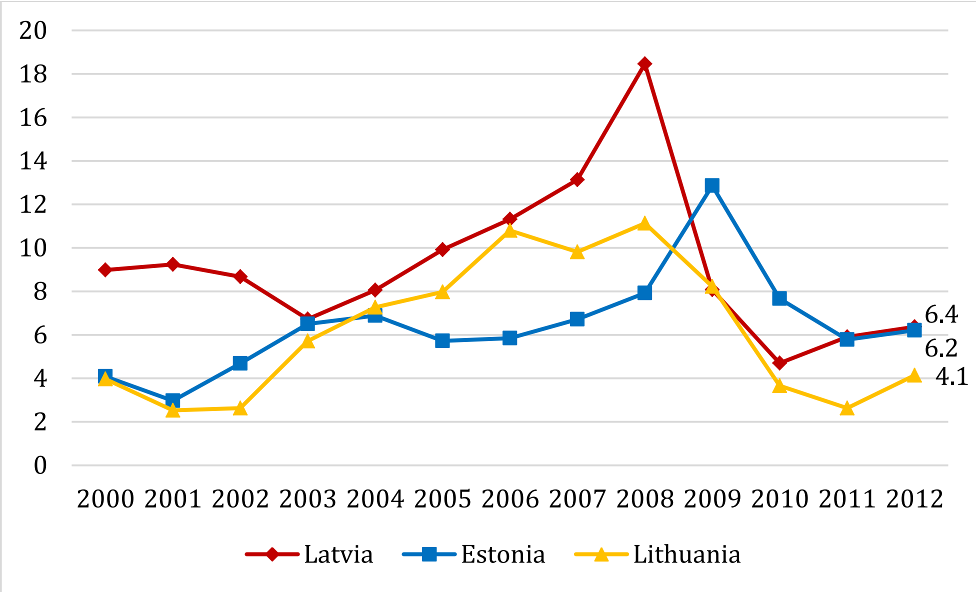

Figure 2. **Implicit tax rate in the Baltic countries, %**

Source: TAXUD (2016)

Moreover, taking into account the different CIT systems (for example, in Estonia there is no personal income tax on income from capital) it shall be evaluated as a whole by comparing taxed profit (at the company level) as well as taxed income on capital (at the individual level) because for investors it is important to know total tax burden on income from capital. There is no separate personal income tax on dividends in Estonia, however, Latvia has such a tax – 10 per cent and Lithuania – 15 per cent. So, Estonia is in a better position than Latvia, comparing the total tax burden on income from capital, because Latvian residents (individuals) on income from capital has to pay the CIT as well as personal income tax of 10%.

Latvian CIT is one of the most complex in terms of tax administration. Latvian CIT application is similar to countries such as Austria, Denmark, Finland, France, Germany, Greece, Italy, Portugal, Sweden, Spain, Czech Republic, Hungary, Lithuania, Poland, and Slovakia. It is based on the profit (or loss) by generally accepted accounting principles (GAAP) and for a suitable taxable income determination and correction in accordance with the tax regulations and restrictions. Corrections create a lot of confusion, errors and tax penalty surcharges. For example, the calculation of profit tax is adjusted for both the taxable base (income, expenses, losses, depreciation of fixed assets, etc.) and tax credits (donations, agriculture, etc.) and the amount of tax due (advance payment, deferred tax, etc.).

By contrast, the CIT system in Estonia is unique in the EU and even estimation of profit (loss) in Estonia should be done according to International Financial Reporting Standards (IFRS) (QC Giannini, Klemm, Oestreicher, Parascandola & Spengele, 2005).

CIT simplification gives Estonia the advantage of reducing the tax burden on the administration and payment time. As a result of this Estonia (with 84 minutes) ranks in 6th place in Paying Taxes Index 2017 (among the EU / EEA countries), but Latvia (with 169 minutes) is below the average (164 minutes) (World Bank Group & PricewaterhouseCoopers, 2016).

Literature review

Although the effective rates in the Baltic countries are similar (see Figure 2), Estonia has managed to attract more investment in comparison with Latvia, and has better competitiveness therefore. This indicates that the zero corporate income tax on reinvested profit has been a successful policy in Estonia. (Domnīca Certus, 2016)

This is confirmed by the study of Gorter and Mooj, namely, capital income taxes reduce the net rate of return on savings. In particular, a lower net rate of return has a substitution and an income effect that work in opposite directions. This effect, induced by the average (effective) tax burden on capital income, implies an increase in savings. The evidence on the compensated elasticity of aggregate savings is inconclusive: with elasticities ranging from 0.2 to 0.4. (Gorter & Mooj, 2001)

Comparing the Estonian company performance from the economic and financial point of view to Latvian and Lithuanian companies' performance during the period from 1996 to 2003, the introduction of zero corporate tax for reinvested profit in Estonian companies has increased investments and productivity of Estonian companies. Particularly there has been a positive effect change for smaller companies (Masso, Meriküll & Claimant, 2013). Even in 1963 Sandberg indicated that the net profits tax has such a deleterious effect on investment and therefore on growth that it should be replaced by some kind of gross profit taxation despite the effects on the distribution of the tax burden and the price level. (Sandberg, 1963)

Gruveski and Gaber mentioned that an increase in corporate and dividend tax will increase liabilities and the burden on investment, while an increase in interest income tax will decrease tax obligations and vice versa (Gruvevski & Gaber, 2015). It is evidenced by the example of Estonia. Namely, Estonian companies' demand for debt tends to be lower under zero corporate taxation system in comparison to the classical gross profit taxation system (average share of liabilities in total capital appears to be 8.2% lower and the share of loan liabilities in total capital of the sample companies is 3.7% lower). Profits retained in the company due to the effects of distributed profit taxation appear not to lead to additional business related investments, but to the accumulation of liquid assets instead (average share of cash in total assets of the sample companies is 3.9% higher). (Hazak, 2007)

Also the introduction of zero corporate tax for reinvested profit in Estonia starting from 2000 has been marked by the growing difference between the investment equity in Estonian and Latvian companies. During the period from 2000 to 2014, Estonian company equity increased and was on average 3.5 times higher than in Latvian enterprises. (Prokhorov, Fainglozs, & Yongin, 2016)

The CIT reform in Estonia had a statistically significant effect on investment growth. Concerning the effect on investments, the investment growth rate rose in Estonia after the reform by 0.37 percentage points more than it did in Latvia and Lithuania as a cumulative impact over the four years following the reform. Regarding the impact of the reform on labour productivity measured as turnover per employee, labour productivity grew in Estonia by 13 percentage points more than it did in Latvia and Lithuania during the four years following the reform. (Maaso, Meriküll, & Vahter, 2011)

It is clear that under zero corporate tax for reinvested profit regime companies retain more profits undistributed than they would under the classical gross profit taxation system. And decreasing trend in the share of liabilities in total capital may be explained by the tax costs associated with dividend payment having led companies to retain more profits undistributed under distributed profit taxation, thus providing an alternative to external liabilities as a source of financing. (Hazak, 2009)

After the CIT reform in Estonia businesses improved their financial performance – liabilities in the balance fell, the share of cash in the balance sheet increased and other financial analysis ratios (liquidity, solvency, etc.) improved because the companies were provided with incentives not to distribute profits, but to invest in the company to improve their operations. Thus, such a reform has been worth it and considered also in other countries, which took the initiative to change the capital structure (Masso, Meriküll, & Claimant, 2011). The results on productivity imply stronger effects of the reform on productivity in the manufacturing industry. The most affected group again appears to be micro-firms with less than 10 employees. (Masso, Meriküll, & Claimant, 2013)

Investors' decision to invest in any of the countries may be dependent on several factors. CIT rate is the most important factor. In addition, the tax rate reduction may not result in revenue decline, but they may even grow. (Guziejewska, Grabowski, & Bryndziak, 2014)

Structural reforms and improvements in the business environment are important factors to attract foreign direct investment. So far, Estonia has most successfully coped with it, also thanks to the corporate income tax zero rate policy. (Irandoust, 2016)

There are some researches (Prohorovs, Fainglozs & Jonina, 2016) that shows negative impact on CIT revenues by EUR -142,5 million in first year of introduction of the new system, however, the revenues could become positive in the following year (fours year) by EUR +95,1 million. Moreover, the growth of revenues form value added tax, personal income tax and state social contribution could be a compensation (Prohorovs, Fainglozs & Jonina, 2016). The Ministry of Finance estimates even higher amount of loses of revenues of the CIT in first period (about EUR -300 million). To avoid potential losses in revenues, the requirement about advance payment could be integrated in the new model of taxation.

According to Ministry of Finance estimates the tax reliefs in recent years (2010–2013) had a big negative fiscal effect (Ministry of Finance of the Republic of Latvia, 2015). The most reduction in revenue are from option of loss forwarding. The option of loss forwarding should be kept also in new system, however, corrections might be adjusted to some extent.

Besides that one of the problem in taxation of income is double taxation of company income and dividends distributed to shareholder. The solution for this problem is changing principle of taxation, then only one type of tax for a period might be applied (Nasyrov & Shtyrlyaeva, 2015). The changes can be done by integration of the corporate and individual income taxes. In can be done in different ways, for example, by providing shareholders a credit for corporate taxes paid with respect to corporate earnings distributed as dividends. (Graetz & Warren, 2016)

Concept

In order to attract investment, promote competitiveness, enhance productivity, increase corporate tax revenues in the long term, to simplify the payment of tax and reduce the administrative burden, Latvia should also consider the introduction of zero corporate tax regime for reinvested profit.

The CIT would be charged only in the case of distribution of profit. This option will contribute to the development, because the company will remain at the disposal of assets, which can be used for operating, for example, modernization of equipment. Unfortunately, the existing system does not contribute to it to a great extent. A new CIT system with a common rate of 20 per cent on distributed profits should replace both current CIT as well as the personal income tax (hereinafter – the PIT) otherwise it will be taxed twice.

Moreover, some other arrangements should be adjusted, including tax reliefs, corrections etc. Any tax relief at the same time is difficult to administrate and it raises the costs for tax administration. All reliefs could be reviewed in context of its economic and social importance (Ministry of Finance of the Republic of Latvia, 2014). The most substantial tax relief are those which have led to investment promotion. Such incentives are used in many EU countries. Latvia has two significant tax reliefs for investments: tax relief for investment in large investment projects as well as tax relief for investment in free ports and special economic zones. Both should be integrated in the new system, too, example by providing transitional period.

The provisions for limitation of tax avoidance should be in place in the new system of the CIT. The main recommendation of the OECD guidelines on BEPS (Juruss, Kuma, 2016) shall be covered, too. To improve tax enforcement further actions could be examined, example, more cooperation or creating of common data base or registers. (Zucman, 2014)

For implementation of new solution a SWOT analysis was done by the authors (Table 1).

Table 1

SWOT analysis for zero corporate income tax for reinvested profit introduction in Latvia

Strengths	Weaknesses
1) Improvement of corporate financial indicators 2) Simplified tax system and administration 3) Cost reduction for tax administration (also for reliefs)	1) There will be changes in existing CIT incentives. In particular, this could affect already existing tax reliefs for investments. It is necessary to evaluate existing incentives for investments in free ports or special economic zones. Therefore the transitional provisions might be provided. 2) It is necessary to make changes and investments in tax administration systems (declarations, calculation, etc.)
Opportunities	**Threats**
1) Increase of tax revenue (middle and long term) 2) Improvement of business environment (investments, competitiveness, productivity) 3) Improvement of macroeconomic situation (growth of GDP) 4) Increase the visibility of Latvia and attractiveness for foreign investors	1) In short term there is a risk for decrease of tax revenue. Transitional provisions may include the advance payment 2) Taxpayer may not invest in business effectively 3) Compliance and accounting for small and medium enterprises may still be difficult 4) The European Commission continue to develop Common Consolidated Corporate Tax Base (CCCTB). For now it is unclear, how the CCCTB will impact CIT at the national level 5) Tax avoidance and tax evasion. Anti-avoidance measures should be in place

Source: By authors

Discussions

Whether the changes from current CIT 15 per cent to introduction of zero corporate tax regime for reinvested profit will have an impact on economic situation is an empirical question and can only be estimated by using empirical techniques. To estimate the impact accurately, one must necessarily take into account several factors. This can be done by using standard multiple regressions. The model would identify the factors that determine profit and investments and test the degree of influence of those factors.

Particularly, to evaluate potential impact of introduction of zero corporate tax regime for reinvested profit on economic situation and revenues the following should be analysed: correlation of profit of companies before and after taxes with equity and evaluated impact of the changes on the investments and share of liabilities in total capital. The impact on the overall growth of business, possibility to attract new external financing can been assessed on the basis of trend in potential investments and growth of equity as well as the costs saved for tax administration . Zero corporate tax regime for reinvested profit contributes to accumulation of companies' capital for investments; therefore such kind of model creates more favorable conditions for business growth. Weak financial operation result is an important reason for credit institutions to reject loans for companies. Thereby, after the tax regime reform companies would not be motivated to hide income, and companies would show the true financial results. Attraction of fund will allow companies to increase their competitiveness and it will create opportunities for additional income. Increasing turnover will increase productivity, and it will reflect in the growth of GDP.

At the end, potential tax revenues from distributed profit can be estimated. In addition, this will allow for Latvia to rank higher in the competitiveness evaluation index. It will improve the tax system assessment of the OECD group of countries. Thus, it will contribute to Latvian visibility and attractiveness to foreign investors. The changes would have multiplication effect and an impact on the growth of GDP. Also the change will improve the corporate financial indicators (liquidity, solvency) and thus also the assessment of businesses in application for access to financing and credits. In addition, it will lead to the simplification of the income tax system, tax accounting, payment and administration, reduction of the resources and time for administration as well as improvement of rating of Latvia in Paying Taxes Index, reduction of tax avoidance (adjustments, planning, and optimisation) as well as tax evasion.

Conclusions

The main task for the tax policy is to promote dynamic and sustainable development of the country, therefore the tax policy shall be competitive, fair, stable and with incentives to engage taxpayers in business activities.

The proposed solution to change theCIT system in Latvia from thecurrent CIT 15 per cent to introduction of zero corporate tax regime for reinvested profit should be evaluated. While there would be increase of investment, competitiveness and productivity, there shall be increase of corporate profits and also of distributed profits. All companies will not always reinvest, therefore, the profit will paid and the tax payment will be due.

Although in the short-term there could be additional expenses (tax administration system change), in the long-term it would reduce the administrative burden and costs of tax administration.

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