CORPORATE INCOME TAXATION IN THE NEW MEMBER STATES OF THE EUROPEAN UNION

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Corporate income in the new Member States of the European Union is generally taxed in accordance with international tax standards. Companies resident in new Member States are subject to corporate income tax on worldwide income, while the resident is defined according to its domicile or the place of actual management.

Corporate tax systems in new Member States are similar to those introduced in the original EU-15.

The following figure denotes the three main categories of tax systems in regard to the extent of integration of corporate income tax into personal income tax of the individual shareholder, i.e. tax on distributed profits.

Classical system

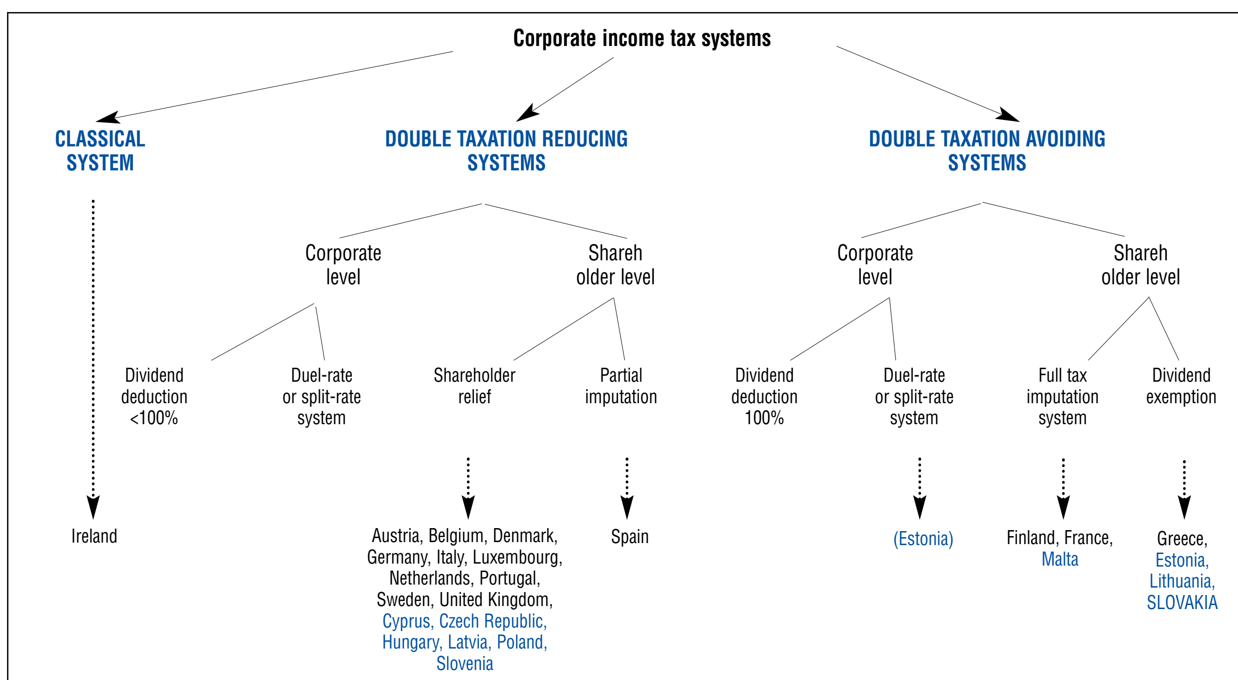
The classical system results in a double taxation – at the level of corporate profits and at the level of shareholder dividends. Within the Europe, the classical system is only applied in Ireland and a majority of Swiss cantons. It is not applied in any of the new Member States.

Double taxation avoiding systems

In contrast to the classical system, double taxation avoiding systems exclude double taxation. In the new Member States, they ensure that profits are only taxed once either at the corporate level (dividends at the shareholder level are exempt from taxation) or at the shareholder level (full imputation system). Malta is the only new Member State that applies a full imputation system. Dividends received by shareholders are grossed-up by the underlying corporate income tax on the distributed share of profits and taxed progressively. At the same time, corporate income tax on dividends is credited or set off in favour of the individual shareholder against his personal income tax. Distributed profits are therefore taxed only once, through personal income tax at the shareholder level.

In Lithuania and Slovakia, corporate profits are only taxed once, at the corporate level. Double taxation in these countries has been eliminated through a system of dividend exemption at the shareholder level. Therefore, the corporate income tax rate determines the tax burden

Corporate income tax systems in EU Member States (2004)



Source: Finkenzeller, M. – Spengel, Ch.: Measuring the Effective Levels of Company Taxation in the New Member States: A Quantitative Analysis; Luxembourg: Office for Official Publications of the European Communities 2004, p. 14.

of both retained and distributed profits. The tax-exempt status of dividends in Slovakia is based on the tax reform that entered into force on 1 January 2004. Even so, the dividends of 2003 profits, distributed in 2004, were still taxed at the shareholder level.

In Estonia, however, a combined system has been introduced. This includes elements of a split rate system, as well as elements of a dividend exemption system. At the corporate level, retained earnings are exempt from taxation and distributed profits are subject to a tax rate of 26%. Tax is payable only on distributed profits, not undistributed profits. At the shareholder level, dividends are exempt from taxation.

Double taxation reducing systems

These systems are based on the provision of various forms of relief aimed at the mitigation or reduction of double taxation. Most of the new Member States grant only partial relief. The shareholder relief system does not conflict with fundamental freedoms arising from treaty obligations with the European Community (for example, free movement of capital) and it does not give domestic dividends preference over cross-border dividends. Discrimination against cross-border dividends results from the imputation system, with the deduction of tax restricted to domestic dividends. That is why, a couple of years ago, the United Kingdom, Germany and Italy dispensed with the imputation system and introduced the shareholder relief system. Finland and France followed suit from 2005.

In Poland, Slovenia, Hungary, Latvia, the Czech Republic and Cyprus, shareholders receive – compared to other sources of personal income – preferential treatment for their dividend income.

In Slovenia, 40% of the dividends are deductible from the personal income tax base. Consequently, only 60% of the dividend is subject to personal income tax at the shareholder level. In Poland, dividends are subject to a final withholding tax of 19%. This is also, in effect, a preferential treatment since the tax rate in the first (lowest) tax bracket is set to 19%. The same applies to Hungary where dividend are subject to a final withholding tax of 20% corresponds to the lowest tax rate (first tax bracket) of personal income tax. In the Czech Republic, Latvia and Cyprus, a final withholding tax of 15% is imposed on distributed profits at source. This final withholding tax of 15% reflects a preferential treatment for shareholders because it corresponds to the lowest personal income tax rate in these countries.

As regards the most efficient taxation (for multinational investors), it is not generally the case that the type of corporate taxation system is a relevant factor when selecting the most advantageous locality for a subsidiary. Since corporate tax relief is only granted to domestic shareholders, the type of corporate taxation system is only of relevance when the subsidiary has domestic shareholders. The tax burden imposed on multinational investors at the subsidiary level therefore depends mainly on the tax base and tax rate in the source country, while also taking into account the withholding tax on dividends as well as method for mitigating international double taxation in the home country of the parent company.

Tax rates

The nominal statutory corporate income tax rates in the new Member States vary between a lowest rate of 15% (Lithuania, Latvia, Cyprus) to a highest rate of 35%, imposed in Malta. Except for Cyprus, the new Member States have proportional tax rates. The standard rate of income tax in Cyprus is 10%, and for the fiscal year 2003 and 2004 an additional 5% tax was imposed on taxable income in excess of an amount corresponding to EUR 1.7 million. In Estonia, profits used as an internal source of financing (i.e. not distributed to shareholders) are exempt from taxation, while distributed profits are taxed at a rate of 26%.

The trend of nominal income tax rate reduction in new Member States is indicated in Chart 1, which clearly shows the tax rates for 2004 and 2003. Through tax reforms, five of the ten countries reduced the statutory tax rates for 2004. The most substantial tax cuts were made in Poland (by 8%) and Slovakia (by 6%). As many as six of the ten new Member States have a corporate tax rate of less than 20%. The average tax rate fell from 23.8% in 2003 to 21.5% in 2004. This may be compared with the average nominal tax rate in the EU-15, which went from 31.7% in 2003 to 31.6% in 2004. The rate in 2004 was almost 10% lower in the new Member States. Malta remains the only country imposing a tax rate above the average of the EU-15 countries.

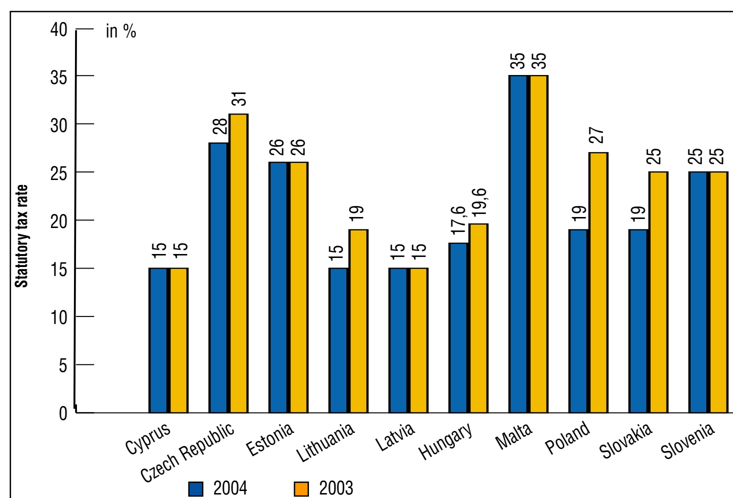
Tax base

The income liable to taxation is determined on the accrual principle. This means that the effects of transactions and other events are recorded at the moment of their occurrence, and not when cash or its equivalent is received or paid. The calculation of the tax base is based upon Generally Accepted Accounting Principles (GAAP), to which each new Member State made whatever adjustment was deemed appropriate. In general, the primary basis for setting the tax base is the book profit determined in accordance with national accounting standards. Cyprus and Estonia implemented International Financial Reporting Standards (IFRSs).

For the purposes of establishing the tax base, profits determined from accounts in all new Member States are adjusted by various items. Moreover, differences in establishing the tax base exist within in each country. The most important items affecting the tax base are set out lucidly in the table.

In all new Member States, purchased intangibles (for example, brands and patents) have to be capitalized and

Nominal statutory tax rates on corporate profits in the new Member States



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depreciated over the useful economic life (Cyprus, Hungary and Malta) or the depreciation method stated in the tax law has to be applied. The legally stipulated depreciation period for intangibles is five years in Lithuania, Slovakia and Poland, and six years in the Czech Republic. The depreciation of intangibles is treated most favourably in Lithuania, where the declining-balance method is used (intangibles are amortized at a rate of 66.67%) and the amount of depreciations is gradually reduced over the period of useful economic life.

Constructions (buildings) may be depreciated for tax purposes in all new Member States. The depreciation periods vary between 20 and 40 years. The declining balance method is used in Lithuania and Latvia. In Slovakia and the Czech Republic, it is possible to use not only the straight-line method[1] but also an accelerated method based on coefficients. Moreover, depreciation may be interrupted in one period and continued in another as if it had not been interrupted at all. In the event of a loss (excluding deduction of depreciations) in one year, it would be more advantageous to carry forward the depreciation to a period of expected profit and therefore to reduce the tax base. In the other countries, the straight-line method is compulsory. In Malta, an initial allowance of 10% in addition to the annual rate of 2% is allowed.

Tangible fixed assets (such as machinery and office equipment) may be depreciated in all new Member States, and a majority of the countries allow the declining-

Most important item affecting the tax base (2004)

Country	Depreciation of intangibles	Depreciation of buildings	Depreciation of machinery	Valuation of inventories	Reserves for bad debts	Deduction of losses
Cyprus	straight-line 12.5 years	straight-line 25 years	straight-line 10 years	FIFO	–	unlimited
Czech republik	straight-line 6 years	straight-line/declining--balance 30 years	straight-line/declining--balance 6 years	weighted arithmetic average, FIFO	allowed	5 years
Estonia	IFRS	IFRS	IFRS	IFRS	IFRS	retained earnings are tax exempt
Hungary	straight-line 12.5 years	straight-line 25 years	straight-line 14.5%	LIFO	–	unlimited
Latvia	declining-balance 66.67%	declining-balance 25%	declining-balance 40%	LIFO	allowed	5 years
Lithuania	straight-line 5 years	declining-balance 10%	declining-balance 40%	weighted arithmetic average, FIFO	–	5 years
Malta	straight-line 12.5 years	straight-line 45 years	straight-line 5 years	FIFO	–	unlimited
Poland	straight-line 5 years	straight-line 40 years	declining-balance 10%	LIFO	allowed	5 years
Slovakia	straight-line 5 years	straight-line/declining--balance 20 years	straight-line/declining -balance 6 years	weighted arithmetic average, FIFO	allowed	5 years
Slovenia	straight-line 5 years	straight-line 20 years	straight-line 4 years	LIFO	–	5 years

Source: Act No. 595/2003 Coll. on income tax, as amended; Act No. 586/1992 Coll. on income taxes. Jacobs, H.O. et al.: Company Taxation in the New Member States, Survey of the Tax Regimes and effective Tax Burdens for Multinational Investors. Study by Ernst & Young and the Center for European Economic Research (ZEW), Frankfurt am Main 2004, page 13.

balance method to be applied. Besides straight-line depreciation, in Slovakia and the Czech Republic it is possible to apply the accelerated depreciation method. As with buildings, the depreciation may be interrupted in one period and continued in another one. Companies in the Czech Republic which meet the statutory conditions benefit from a first year deduction of 10% in addition to the annual allowances for the acquisition of new assets classified in depreciation groups 1, 2 and 3. In Cyprus, Hungary, Malta and Slovenia, straight-line depreciation is the statutory method.

Inventories are valued at their production costs. The amount at which inventories are carried in the accounts depends on the extent that operating costs are attached to the products. The valuation of changes, i.e. movements in finished goods and stock of unfinished goods, depends on various alternative methods. In Cyprus and Malta, the FIFO[2] method is compulsory. The Czech Republic, Lithuania and Slovakia provide the option to use the weighted average cost method. Moreover, Hungary, Latvia, Poland and Slovenia permit the LIFO[3] method. As far as tax is concerned, this method is advantageous in the context of increasing prices (inflation effect) since the decreases in inventory are valued at the latest, highest price and therefore reduce the income tax base to a significant extent.

Among the new Member States, the statutory treatment of provisions in terms of their tax deductibility is extremely comprehensive. In all ten countries, provisions for bad debts are treated in a similar way. In Cyprus, Malta, Hungary, Lithuania and Slovenia, provisions for these claims are not tax deductible. Companies in the Czech Republic, Latvia, Poland and Slovakia may deduct provisions for bad debts from their tax base only under strictly defined conditions, and Lithuania allows the deduction of such claims only by financial institutions (banks, insurance companies).

As regards the amortization (deduction) of losses, none of the new Member States allows a loss carry-back; however, all the countries grant a loss carry-forward. In the Czech Republic, Lithuania, Latvia, Poland and Slovakia[4], the deduction of losses is limited to five consecutive fiscal years. Only in Hungary, Cyprus and Malta is the deduction of losses permitted for an unlimited number of consecutive years. In Poland, the amount of the loss which may be deducted in each year is limited to 50% of the loss. A unique tax system prevails in Estonia, where the tax base is not linked to book profits and retained or undistributed profits are exempt from taxation. Taxable income equals the profit distributed to shareholders. Given that profit distributed in this way is determined (assessed) according to IFRS, there are no special accounting methods leading to an assessment of the tax base. Since retained earnings are not taxed in Estonia, there is no reason to deduct losses.

Additional taxation

The overall tax burden of corporate entities may be further affected by additional taxes on income or assets. These include, for example, real estate taxes, property taxes, and local business taxes.

None of the ten new Member States imposes a property tax on companies. Real estate tax is imposed on companies in all the new Member States except for Estonia, Malta and Slovenia. The tax applies to land and buildings and the tax base is derived either from the market price of the real estate, the amounts laid down by law, or from the area of the land. Hence, the tax base varies from country to country. Real estate taxation is different in each country, but it does not have a significant impact on the effective tax burden since real estate tax rates are relatively low and all the countries allow this tax to be a deductible item for the calculation of corporate income tax.

Only Hungary imposes an additional local income tax. The tax base includes net sales revenues and 50% of the interest income. Costs of goods sold, costs of services (subcontractor fees) and costs of materials are tax deductible from income, though neither depreciation nor income deductibility is allowed. The maximum rate for local business tax may not exceed 2%. Given that the local business tax is up to 125% deductible from the corporate income tax base, the effective tax burden of the local income tax is substantially lower than the nominal rate of this tax.

Summary

A comparison of the tax regimes for companies in the new Member States shows that corporate income tax may be regarded as the most important tax. Additional profit-related taxes and other taxes imposed on companies are less important, as is also the case in the older Member States.

Corporate income tax rates, as well as the tax bases affected by various items, differ substantially between EU Member States. The effective tax burden of companies is, however, also determined by various individual circumstances, for example, the type and profitability of investments, the source of financing, and so on. It is therefore not possible to reach an unequivocal conclusion about the effective tax burden of companies located in the new EU Member States.

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[1] The straight-line method ensures the same amount of depreciations for the duration of the asset's useful life.
[2] The first decrease in inventory is valued at the price of the first gain in inventory, i.e. First In, First Out.
[3] The first decrease in inventory is valued at the price of the last gain in inventory. i.e. Last In, First Out.
[4] In Slovakia each tax loss may at present be deducted during the immediately subsequent five years, and the deduction may be even or uneven depending on the amount of the reported tax base.