Proceedings of the 2015 International Conference "ECONOMIC SCIENCE FOR RURAL DEVELOPMENT", No37
Jelgava, LLU ESAF, 23-24 April 2015, pp. 201-210

ASSESSMENT OF CORPORATE INCOME TAX IN THE BALTIC STATES

Irija Vitola[1], Dr.oec.[+]; **Atrjoms Antonovs[2]**, Ms.oec.
[1,2] Faculty of Economics and Social Development, Latvia University of Agriculture

Abstract. A favourable and stable tax policy, predictability of taxes and well-structured taxes are the key drivers for the development of new enterprises and the attraction of investment as well as a significant driver for the sustainability of existing enterprises and economic growth in the country. The aim of the research paper is to identify how some elements of the corporate income tax of Lithuania and Estonia might be applied in Latvia. Both in Latvia and in Lithuania, taxable income is adjusted for the depreciation of fixed assets. In Latvia and in Lithuania, the taxable income is also adjusted for fines and penalties paid in the reporting year. Lithuania's enterprises are entitled to more favourable tax adjustments for costs unrelated to economic activity, as theses costs do not have to be added to their pre-tax profit. In Latvia, undistributed profit has to be taxed as in Estonia, setting a 0% enterprise income tax rate on undistributed profit.

Key words: corporate income tax, tax calculations, tax adjustments

JEL code: H2

Introduction

Stabile, predictable and well-structured tax policies not only in Latvia but also in a greater region, like in the Baltics, are one of the factors for sustainable economic growth in the country. Every country's sustainable development depends on planning the country's development, the government's revenues and expenditures, developing priority industries as well as efficient government budget management. Every country can plan its development only based on its government budget revenues, most of which are composed of taxes collected in the country.

Presently Latvia, Lithuania and Estonia have stabilised their government budget revenues from taxes. In each country, the corporate income tax (CIT) rate is different; yet, given that any state's key purpose is to ensure preconditions for its economy's sustainable development, the elements and rates of the corporate income tax and its payments to their Treasury are very important.

[+] Corresponding author. Tel.: + (630 24214); fax: + 371 630 84987.
E-mail address: Irija.Vitola@llu.lv.

Hypothesis: the elements of Lithuania's and Estonia's corporate income tax systems may be applied in Latvia as well.

Research aim: to identify how some elements of the corporate income tax of Lithuania and Estonia might be applied in Latvia.

To achieve the aim, the following tasks are set:

1) to examine the theoretical aspects of corporate income tax;
2) to perform a comparative analysis of corporate income taxes in the Baltic States;
3) to perform a comparative analysis of corporate income tax calculations in the Baltic States.

The following **research methods** were employed in the paper: abstract and logical analysis; the monographic and descriptive methods; the graphic method; and statistical analysis methods.

Materials used

The theoretical part was based on findings and perspectives of various authors, information available in statistical databases as well as documents produced by the Cabinet of Ministers on the tax system.

Research results and discussion

Theoretical aspects of corporate income tax

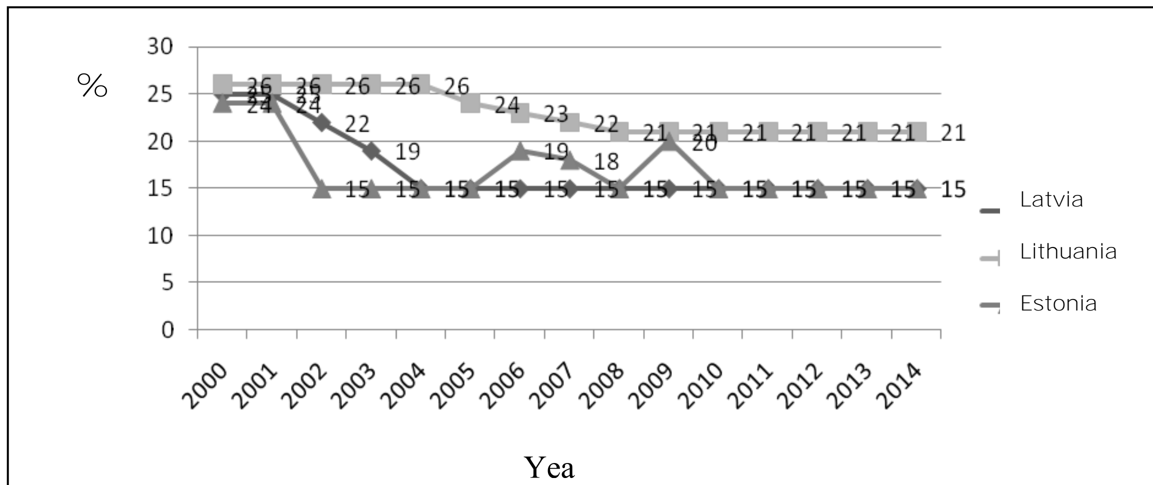
When doing accounting, any enterprise, in line with its field of economic activity, has to calculate its estimated tax payments. Any enterprise has to make all tax payments in accordance with the laws and rules being in effect in the country, for instance, excise, customs, value added tax payments.

Corporate income tax is one of the taxes that, in accordance with a country's legislation, has to be calculated and paid into the government budget.

The government policy document Guidelines for the Development of the System of Taxes and Duties stipulates that the problems to be tackled with regard to the enterprise income tax are as follows: optimisation of the tax reliefs and strengthening of the tax base (Guidelines for the Development…, 2003).

Any enterprise, when calculating its corporate income tax, has to take into consideration the terms of the law passed in a country – criteria, tax reliefs and other important factors. The way how genuinely enterprises keep records of all their revenues and expenses and calculate their payable taxes as well as make tax payments cannot be traced by any institution. Accordingly, it is very important that owners of an enterprise understand the need to keep correctly records of all the enterprise's assets, revenues and expenses and would not perceive the corporate income tax as a penalty.

Stable corporate income tax rates are important both for businessmen to be able to budget the costs of future periods and for the government to budget tax revenues.



Source: authors' construction based on KPMG data

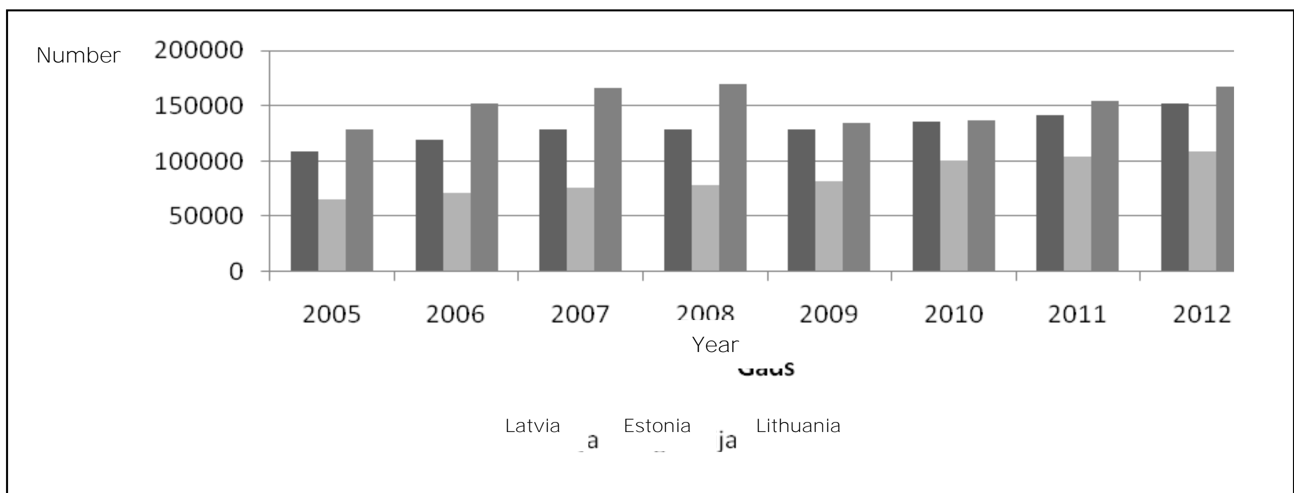
Fig.1. Corporate income tax rates in the Baltic States in the period 2000-2014, %

Since the year 2000, the corporate income tax rates have changed many times in the Baltic States – in Latvia and Estonia the rates only decreased, while in Lithuania, after the rate was reduced to 15% in 2002, it was raised and reduced again until 2010 when it stabilised at 15% (Fig.1).

Overall analysis of business activity

The purpose of reforming the corporate income tax in the Baltic States is to foster the development of enterprises and to attract investors.

As shown in Figure 2, among the Baltic States, the greatest number of active enterprises was observed in Lithuania in the period 2005-2012; according to the Statistics Lithuania, the greatest number of enterprises was registered in 2008, reaching 169159 units.



Source: authors' construction based on Eurostat data

Fig.2. Number of active enterprises in the Baltic States in the period 2005-2012

The trends in the Baltic States are similar; there are just a few exceptions. Increases in the numbers of active enterprises were observed in the period of analysis in all the Baltic States.

Efficient attraction of investment is the determinant factor that creates favourable conditions for overcoming an economic crisis, for structural changes in the national economy and for fostering regional development and technological progress, which, in its turn, is a basis for stable economic growth (Titarenko D., 2006).

Until 2008, a strong inflow of foreign investment was observed in Latvia. In 2008, compared with the previous year, the weakest increase in the inflow of foreign investment was recorded, only 11.69%. In 2005, too, an increase was insignificant, 10.01%, which may be explained by the fact that on 1 May 2004 Latvia, just like the other Baltic States, was not a member of the European Union.

Table 1

Foreign investment in Latvia in the period 2004-2010, mln EUR

Year	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Investment	1679.1	1847.3	2362.3	3142.3	3509.8	4687.7	5284.4
Annual increase, %	-	10.01	27.87	33.01	11.69	33.56	12.72
Increase from 2004, %	-	10.01	40.69	87.14	109.02	179.17	214.72

Source: authors' calculations based on CSB data

According to the Central Statistical Bureau of the Republic of Latvia, most of the foreign investment in Latvia originated in the European Union countries. Of the total foreign investment in 2010, 73.68% was from the European Union. In Latvia, least foreign investment came from the CIS countries.

Table 2

Foreign investment in Lithuania in the period 2004-2010, mln EUR

Year	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Investment	4698.69	6920.69	8377.14	10282.65	9190.6	9206.19	10030.97
Annual increase, %	-	47.29	21.04	22.75	-10.62	0.17	8.96
Increase from 2004, %	-	47.29	78.29	118.84	95.60	95.93	113.48

Source: authors' calculations based on* the *Statistics Lithuania

In Lithuania, an annual increase in foreign investments ranged from 10.62 to 47.29% in the period 2004-2010. The fastest increase in foreign investments was observed in 2005 when, compared with the previous year, they grew by 47.29%. In 2008 and 2009, the amount of foreign investment, measured from the base year of 2004, was the same, with a slight increase of 0.17% in 2009. The number of registered enterprises also declined in Lithuania in these years.

As shown in Table 3, the situation with foreign investments in Estonia is similar to that in Lithuania. In the period of analysis, an increase in foreign investments, on an annualised basis, ranged from 0.89 to 29.65%. Just like in Lithuania, in Estonia, too, the fastest annual increase was observed in 2005, reaching 29.65%. The next fastest increase was recorded in 2007, which was 18.07% in comparison with the previous year. During the period 2007-2009, the amount of accumulated foreign investment in Estonia was steady. At the end of the period of

analysis, compared with the base year, the amount of investment had increased by 69.45%, which was the lowest growth rate among the Baltic States.

Table 3

Foreign investment in Estonia in the period 2004-2010, mln EUR

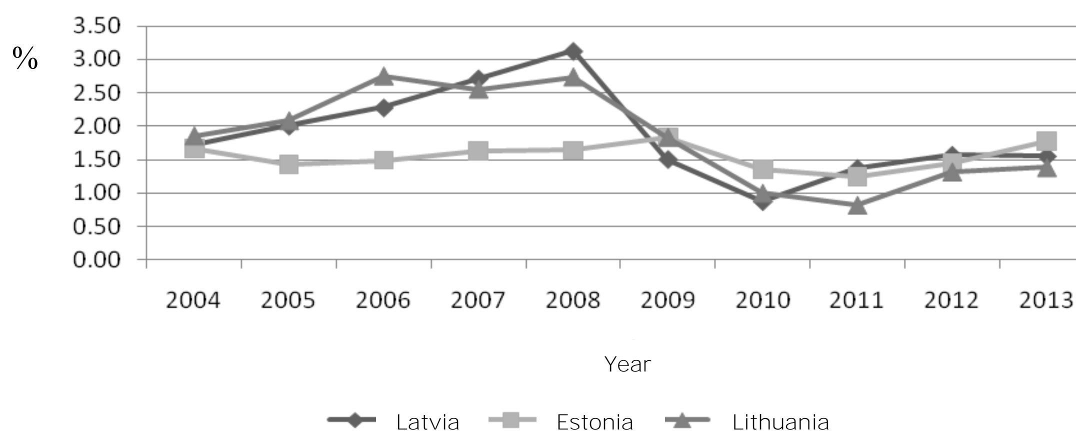
Year	2004	2005	2006	2007	2008	2009	2010
Investment	7374.30	9560.50	9643.80	11386.40	11774.60	11670.20	12495.40
Annual increase, %	-	29.65	0.87	18.07	3.41	-0.89	7.07
Increase from 2004, %	-	29.65	30.78	54.41	59.67	58.26	69.45

Source: authors' calculations based on Eesti Pank data

Even though the fastest increase in foreign investments was registered in Latvia in the period of analysis, compared with the base year, the total amount of foreign investments in Latvia in 2010 was smaller than in Lithuania in 2005 and Estonia in 2004. The greatest amount of foreign investments was in Estonia regardless of the facts that in Estonia the number of enterprises was smaller and the number of non-resident enterprises was considerably smaller than in Latvia and in Lithuania. Estonia is attractive to investors due to the 0% corporate income tax rate for undistributed profit, while Lithuania's enterprises are entitled to more favourable tax adjustments for costs unrelated to economic activity, as theses costs do not have to be added to their pre-tax profit.

Corporate income tax burdens in the Baltic States

The key tax policy indicator is usually a tax burden expressed as a percentage of gross domestic product (GDP), which shows the share of GDP to be redistributed by means of the country's tax policy (Ketners K., Lukasina O., 1993).



Source: authors' construction based on Eurostat data

Fig.3. CIT revenues as a percentage of GDP in the Baltic States in the period 2004-2013

The CIT revenues paid into the government consolidated budget, expressed as a percentage of GDP, characterise a tax burden in a particular country. As shown in Figure 3, until 2009 the lowest CIT burden among the Baltic States was observed in Estonia, being quite steady within a range from 1.43 to 1.66% of GDP. In 2010, CIT revenues in the consolidated budget of Estonian's government decreased by 24.41%, compared with the previous year; this was the

reason why CIT revenues declined in terms of percentage of GDP. Over the entire period of analysis in Estonia, the CIT burden was quite steady, varying between 1.24 and 1.88%.

The trends in CIT burdens in Latvia and Lithuania were similar. The highest CIT burden among the Baltic States was observed in Latvia in 2008, accounting for 3.13% of GDP, followed by a sharp decline up to 1.51% of GDP in 2009 and 0.88% of GDP in 2010. Over this period, in Latvia, too, just like in Estonia, CIT revenues in the government consolidated budget declined, which might be explained by the global economic crisis and decreases in the profits of enterprises, as the number of enterprises did not grow in the period concerned. In 2009 in Lithuania, the number of active enterprises sharply declined; consequently, CIT revenues, in terms of percentage of GDP, also decreased. However, despite the fact that the number of active enterprises rose in Lithuania over the next years, the CIT burden fell to 1.00% of GDP in 2010 and to 0.82% of GDP in 2011. This is explained by decreases in profits made by enterprises and a CIT rate cut from 20% to 15% in 2009.

Comparison of corporate income tax calculations in the Baltic States

To illustratively show the key differences in corporate income tax among the Baltic States, the paper shows the corporate income tax calculated in accordance with each country's legislation and tax declarations, taking into consideration taxable income adjustments – increases or decreases in the tax – as well as applicable tax deductions (Table 4).

Both in Latvia and in Lithuania, taxable income is adjusted by adding the depreciation of fixed assets. As regards depreciation, in both countries it is calculated in the same way – by means of the straight-line method – the purchase value of fixed assets is spread over three years, thus, obtaining a depreciation value of EUR 300 per year.

In Latvia and in Lithuania, penalties and fines paid in the reporting period have to be added to taxable income.

As regards representation costs, Latvia's Law on Enterprise Income Tax states that in calculating the enterprise income tax, 60% of the representation costs have to be added to the taxable income. It turns out in this case that if an enterprise has spent EUR 500 for representation in the reporting period, EUR 300 have to be added to its taxable income. In Lithuania, enterprises are allowed to incorporate in their costs up to 75% of their representation cost, meaning that enterprises have to adjust their taxable income by adding 25% of their representation cost, which, in this example, amounts to EUR 125.

In both countries, the taxable income has to be also adjusted by adding the increase in the allowance for doubtful receivables, which, in this case, is assumed to be EUR 200.

In total, given all the mentioned tax adjustments, the taxable income in Latvia increases by EUR 830, while in Lithuania this amount is only EUR 655, which is EUR 175 less than in Latvia.

Table 4

Calculation of the corporate income tax in Latvia and Lithuania, EUR

	Latvia	**Lithuania**
Taxation period profit before the tax	10000	10000
Expenses unrelated to economic activity	650	-
Taxable income	**10650**	**10000**
Additions to taxable income		
Sum of the depreciation of fixed assets and the write-off of intangible investment reported in an annual report	300	300
Sum of penalties and fines	30	30
Representation costs	300	125
Increase in the allowance for doubtful receivables	200	200
Total increase in taxable income	**830**	**655**
Deductions from taxable income		
Sum of the depreciation of fixed assets and the write-off of intangible investment	(630)	(600)
Cost for providing a new special job for physically or mentally disabled individuals	(350)	-
Total deduction from taxable income	**(980)**	**(600)**
Taxable income	**10500**	**10055**
Total loss reducing the taxable income	1500	1500
Adjusted taxable income	**9000**	**8555**
Tax on adjusted taxable income	**1350**	**1283,25**
Tax deductions	(270)	(513,3)
Estimated CIT	**1080**	**769,95**

Source: authors' calculations based on each country's legal acts

The next adjustment of taxable income, according to any enterprise profit and loss statement, refers to deductions from taxable income.

Just like there are additions to taxable income, there are also deductions from taxable income; taxable income is adjusted for depreciation. In Latvia, Section 13 of the Law on Enterprise Income Tax stipulates five depreciation categories; computer equipment and programs are included in Category 3 with a depreciation rate of 35% which is multiplied by a coefficient of 2.

In Lithuania, no certain depreciation categories with certain depreciation rates are set for enterprises; however, the law states that depreciation has to be calculated using the straight-line method and spread over 3 years (for computer equipment) applying a coefficient of 2.

Latvia's Law on Enterprise Income Tax also provides that an enterprise which has created a new special job for a physically or mentally disabled individual and employs such an individual for at least two years may deduct from its taxable income the cost of creating this job. The authors assume that if an enterprise incurs such costs, they are deducted from its taxable income at a full extent.

After the taxation period, given the additions to and deductions from taxable income, an enterprise's taxable income in Latvia would be equal to EUR 10500, while in Lithuania it would be EUR 10055, which is significantly less than in Latvia.

In both countries, the legislation allows transferring losses of previous periods to the next taxation period.

The corporate income tax is calculated from the adjusted taxable income, applying a 15% rate both in Latvia and in Lithuania. The tax from the adjusted taxable income in Latvia would be EUR 1353 and EUR 1283.25 in Lithuania, which is EUR 66.75 less than in Latvia.

In accordance with the legislation, tax reliefs may be applied to taxable income. Both in Latvia and in Lithuania, there are tax deductions for charitable contributions. In Latvia, its legislation strictly stipulates what charitable contributions may be made and whom they may be given, thus, restricting potential abusive tax avoidance instances. In Latvia, enterprises may be granted a tax relief of 85% for charitable contributions to governmental institutions and government capital companies fulfilling national cultural functions delegated by the Ministry of Culture as well as to associations, foundations and religious organisations registered in the Republic of Latvia; however, the total amount of this relief may not be more than 20% of the estimated corporate income tax. So, one can assume that if an enterprise, in a reporting period, has donated EUR 500 to a governmental institution or a religious organisation, 85% of this amount is equal to EUR 425 but this is more than 20% of the estimated corporate income tax. Since the tax relief may not exceed 20% of the estimated corporate income tax, the enterprise may be granted a tax relief of EUR 270 for its charitable contribution.

In Lithuania, enterprises may deduct from their taxable income a double amount of their donation but it may not exceed 40% of the estimated corporate income tax. This tax relief in Lithuania significantly affects the size of the corporate income tax calculated and presented in the example, as this tax relief reduces the corporate income tax in Lithuania by 40%, which is quite a lot, given the fact that in Latvia such a tax relief reduces the corporate income tax by only 20%.

After deducting the tax relief from the estimated corporate income tax, the authors conclude that in Lithuania, based on this example, EUR 769.95 have to be transferred to the government consolidated budget, which is EUR 301.05 or 28.7% more than in Latvia. The greatest difference between the sizes of corporate income tax calculated for both countries is made up of tax relief deductions. Enterprises in Lithuania may deduct 20% more tax relief related to charitable contributions than in Latvia, whereas in Latvia enterprises may deduct only 85% of their donations; however, in Lithuania, the amount donated have to be multiplied by 2 for the purpose of tax deductions.

To calculate the size of corporate income tax to be paid by an enterprise in Estonia, the amounts of profit distributed in a reporting period in the Baltic States have to be identified, as shown in Table 5.

In Estonia, the corporate income tax is paid only if profit is distributed. The tax rate on dividends paid is 21% of the gross dividends, which is equal to EUR 10000, as shown in the example in Table 5, or a 21/79 tax rate is applied to net dividends, which totals in this case EUR 7900.

Table 5

Distributed profit of an enterprise in the Baltic States in the period of analysis, EUR

	Latvia	Lithuania	Estonia
Pre-tax profit in a taxation period	**10000**	**10000**	**10000**
Estimated CIT on profit	1080	769.95	-
Undistributed profit in a reporting year	8920	9230.05	10000
Estimated IIT on dividends paid	892	1846.01	-
Estimated CIT dividends paid	-	-	2100
Total estimated taxes	**1972**	**2615.96**	**2100**
Net dividends paid	**8028**	**7384.04**	**7900**

Source: authors' calculations

Given the fact that when distributing a profit in dividends in Estonia, the profit is taxed by only one tax – corporate income tax – and individual income tax is not applied to the profit; the tax paid in Estonia is higher than in Latvia because the tax rate in Estonia is comparatively higher, yet, it is lower than in Lithuania, as dividends paid in Lithuania are taxed also by individual income tax, the rate of which for dividends is 20%. However, enterprises very often choose not to distribute all their profit made during a reporting period; in this case, Estonia's tax system has some advantages, as the estimated tax is smaller.

The dividend systems in Latvia and Lithuania are similar: an estimated corporate income tax of a reporting period is calculated from the pre-tax profit after the taxable income has been adjusted, thus, obtaining an undistributed profit of the reporting period. When distributing this profit to the owners or shareholders of an enterprise, it is taxed by the individual income tax. In Latvia, the individual income tax rate on dividends is 10%, while in Lithuania this tax rate is twice as high at 20%.

Conclusions, proposals, recommendations

1. Latvia, Estonia and Lithuania offer a favourable tax system as well as low tax rates for foreign investors. Estonia is attractive to investors due to the 0% corporate income tax rate for undistributed profit.
2. In the period 2005-2009, the number of active enterprises in Latvia rose 18.12% or by 19791 units, while in the period 2009-2012 their number grew at a slightly slower rate, 17.83%; however, this number rose by 22934 units, which indicated that conditions for business were favourable in Latvia.
3. Despite the low tax burdens in all the Baltic States, foreign investments in Lithuania and Estonia are considerably greater than in Latvia, which indicates more beneficial and better-structured CIT systems there.
4. Lithuania's enterprises are entitled to more favourable tax adjustments for costs unrelated to economic activity (as these costs do not have to be added to their pre-tax profit, representation costs increase the taxable income by only 25%, while in Latvia it is 60% as well as tax reliefs for charity donors are greater in Lithuania).

5. **Latvia's enterprises, unlike those in Lithuania, are entitled to more favourable taxable** income adjustments. First, a taxable income is adjusted for the depreciation of fixed assets (because depreciation categories with certain depreciation rates are set for enterprises in Latvia, which are higher than if calculating using the straight-line method, as it is practised in Lithuania. Tax adjustments for costs of providing a new special job for physically or mentally disabled individuals in Latvia may be positively viewed).
6. Adjustments of taxable income and tax reliefs affect CIT revenues paid into the government budget only in Latvia and Lithuania, while in Estonia revenues paid into the government budget are influenced by the amount of profit distributed in a reporting period, as adjustments of taxable income and tax reliefs are not available in Estonia.
7. The government should perfect the PIT policy in Latvia by amending the Law on Enterprise Income Tax and introducing significant PIT reliefs for businessmen, thus, contributing to business development and competitiveness in Latvia.
8. **To maintain the competitiveness of enterprises, Latvia**'s legislators have to retain the PIT rate at 15%; this rate in Estonia is 21% and 15%, too, in Lithuania.

Bibliography

1. Cabinet of Ministers. (2003). Guidelines for the Development of the System of Taxes and Duties (in Latvian). Retrieved: http://likumi.lv/doc.php?id=76127. Access: 24.03.2013.
2. Central Statistical Bureau. Databases. Retrieved: http://www.csb.gov.lv/dati/statistikas-datubazes-28270.html. Access: 28.02.2014.
3. Eesti Pank. Databases. Retrieved: http://statistika.eestipank.ee/?lng=en#treeMenu/FINANTSKONTO. Access: 02.03.2014.
4. Eurostat. Databases. Retrieved: http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_database. Access: 28.02.2014.
5. Ketners, K., Lukasina, O. (1993). ***Taxes in the European Union and Latvi**a **(in Latvian)***. Riga: Merkurijs Lat. p. 237. Retrieved: http://ocw.e-learning.lv/EK1301/lv/Nodokli%20-%20gramata.pdf. Access: 19.12.2013.
6. KPMG. Corporate Tax Rates table. Retrieved: http://www.kpmg.com/global/en/services/tax/tax-tools-and-resources/pages/corporate-tax-rates-table.aspx. Access: 23.02.2013.
7. Saeima. (1995). Law on Enterprise Income Tax. Retrieved: http://likumi.lv/doc.php?id=34094. Access: 10.01.2013.
8. Statistics Lithuania. Databases. Retrieved: http://osp.stat.gov.lt/en/temines-lenteles40. Access: 28.02.2014.
9. Titarenko, D. (2006). ***Investment as a Growth Factor for the Economy of Latvia*** (in Latvian). Riga: Transport and Communication Institute. p.151.