Taxation of distributed profits: International Experience

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Introduction

Background

- Ongoing discussion about replacing the Corporate Profit Tax (CPT) by a tax on distributed profits („Exit Capital Tax“) Ukraine
  - CPT tax base: Financial profit of companies
  - Distributed profit tax base: Transactions in which capital leaves the domain of the tax system (dividends, surcharges on transfer prices etc).
- German Advisory Group has published a Policy Study (PS/01/2017) on this study including a comparison of the two systems and recommendations

Content of this Policy Briefing:

- International experience with taxes on distributed profits
  - Estonia: Original implementation distributed profit tax, still in place
  - Macedonia: Distributed profit tax implemented, but reversed
  - Moldova: Failure of a reform
  - Georgia: Distributed profit tax introduced in 2017
- Basic design features, economic and fiscal effects, implications for UA

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Estonia: First case of tax on distributed profits

History

- 2000: Change from a conventional CPT to a tax on distributed profits of companies
- Still in place
- Original instance of a tax on distributed profits

Motivation

- Strengthen equity base of companies to stimulate investments
- Discourage the use of tax havens
- Reduce compliance and administration costs

Key features

- Applies to resident companies and permanent establishments
- Tax rate of 20%
- Tax base: Distributed profits or disbursements equalized with profit distributions (e.g. expenses related not to business activities, large donations, related party transactions)
- No double taxation of dividends
- No thin-capitalization rules
- Monthly tax returns are filed and the tax is paid on the 10th of each month

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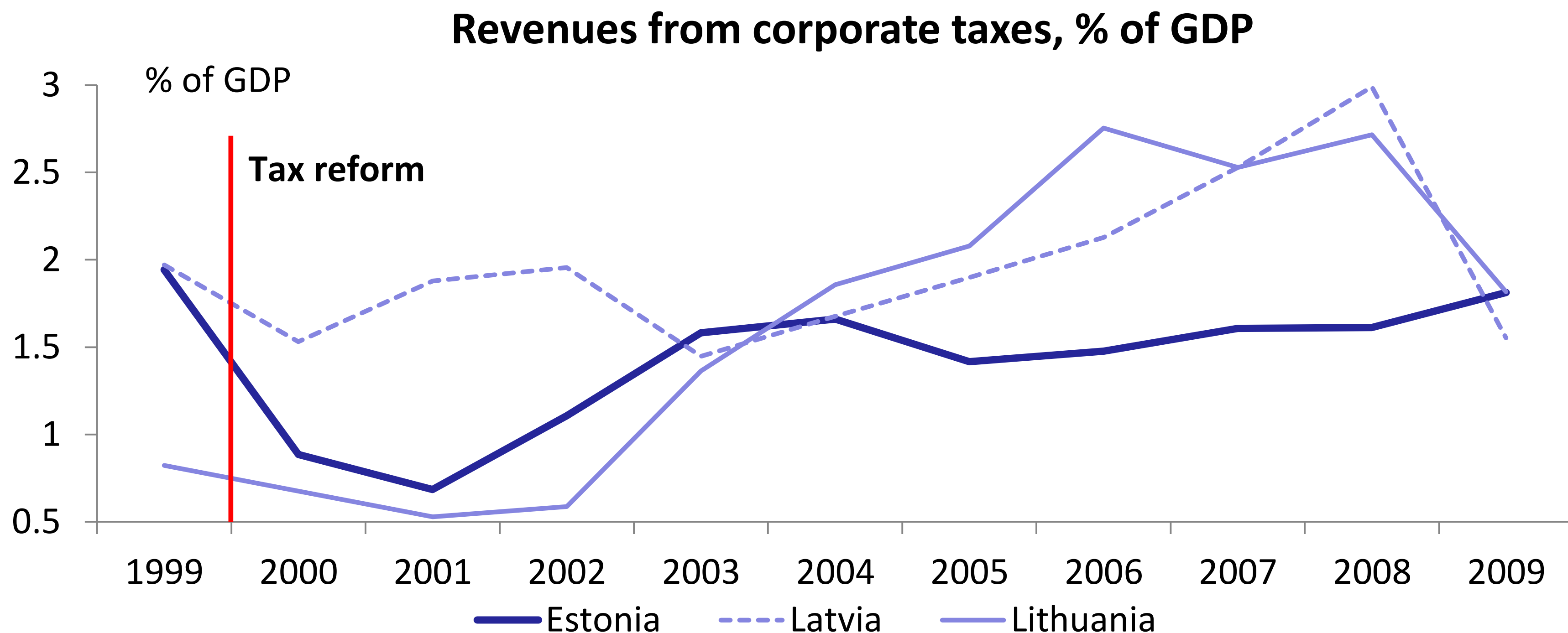
Estonia: Fiscal impact

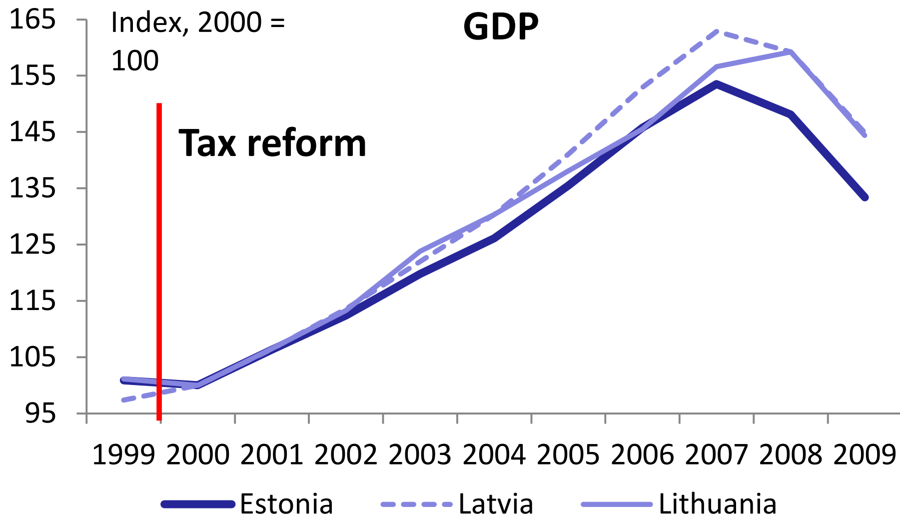


Source: IMF Government Finance Statistics

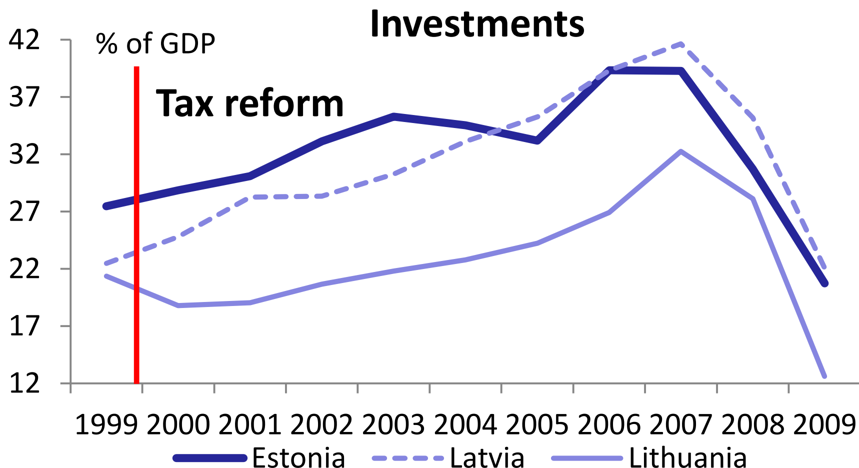
- Corporate tax revenues in Estonia declined from 2% to 1% of GDP during the reform
- In later years, revenues from distributed profit tax around 1.5% of GDP
- Larger fiscal contribution of corporate tax in other Baltic states up to 2.5% of GDP

➢ **Fiscal impact of reform negative, 0.5% - 1% revenue shortfall due to tax reform**

Estonia: Economic impact



Source: World Economic Outlook database, April 2017



Source: World Economic Outlook database, April 2017

GDP

- Rapid growth of Estonia's economy in 2000s
- However, no significant difference in growth rates from neighbours after introduction of tax on distributed profits

Investments

- Higher investments in Estonia than in Lithuania and Latvia already pre-2000
- Investments accelerated after reform, but grew even faster in Latvia
- However, low debt-equity ratio of firms in Estonia due to retained earnings

➢ **No obvious economic effect of distributed profit tax visible**

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Estonia: Overall assessment

<u>Effects of the reform</u>

- Fiscal effect: Negative until 10y after reform
- Economic effect: No clear effect
- However: Despite no clear evidence of positive economic effects, companies and the government are confident that the tax reform further improved the business climate

<u>Special features of the Estonian implementation</u>

- EU compatibility
  - During reform, there were concerns that the tax may be a withholding tax on dividends (prohibited by parent-subsidiary directive)
  - Since the ECJ “Burda” decision in 2008, it is clear that this is not the case
- Estonia effectively became a “corporate bank” for multi-national companies’ profits
  - Profits stored tax-free in Estonia, no tax on interest payments
  - This approach is not suitable for a larger country such as Ukraine
- Avoidance issue: Credits to related parties given by Estonian companies
  - Unless credit is repaid, effectively an untaxed profit distribution
  - Currently under discussion: A “collateral income tax” on the credit, to be refunded when the debtor repays the credit

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Macedonia: Tax reform as a temporary measure

History

- Macedonia introduced temporary tax on distributed profits in 2009 to revive growth
- Returned to old CPT system in 2014 in order to increase fiscal revenues again

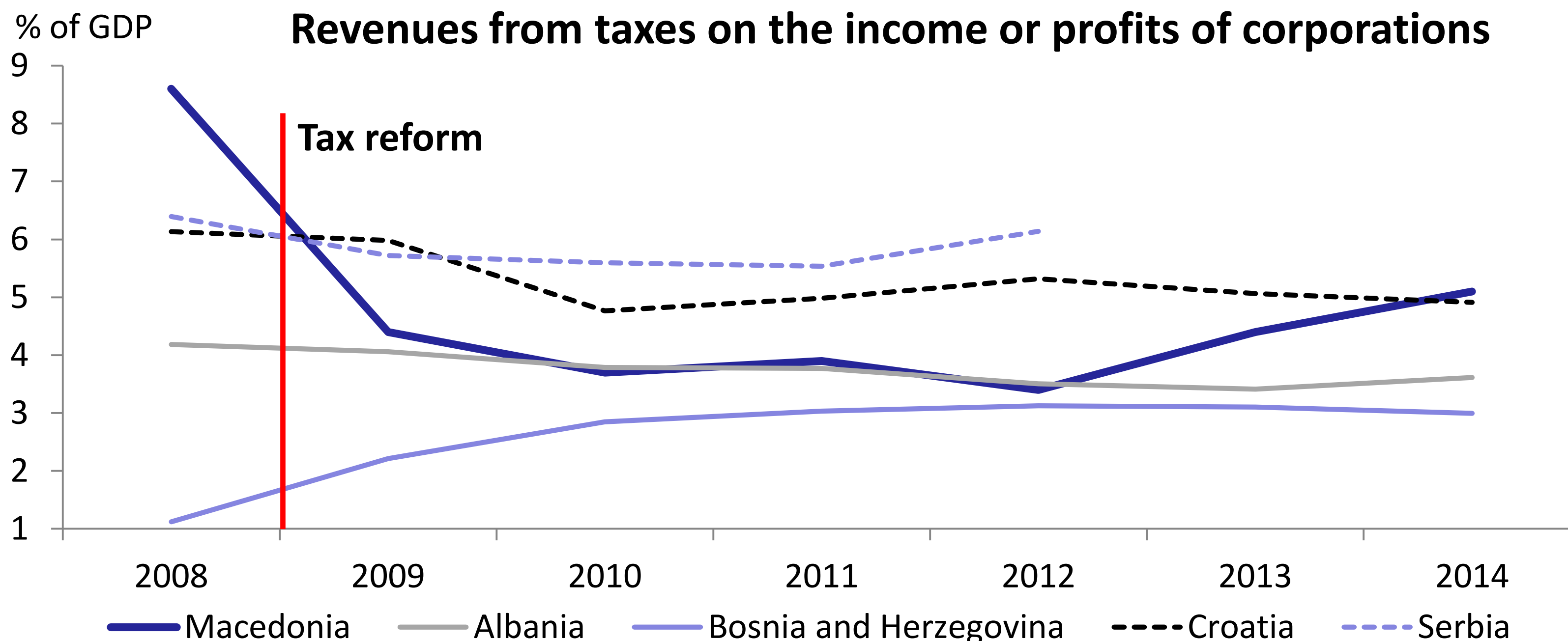
Motivation

- Counteracting the effects of the global economic downturn in 2008/2009
- Attracting investment by a business-friendly corporate tax

Key features

- Tax rate of 10%
- Tax base: Dividends paid by resident companies to non-resident companies or individual shareholders, disbursements equalized with profit distributions
- Thin capitalisation and transfer pricing rules were in place
- Profit distributions declared and taxed immediately
- Annual tax returns in addition, declaring taxable, non-deductible items such as interest subject to thin cap., transfer pricing adjustments, non-business expenditures
- Exempted from tax: SMEs below annual turnover of MKD 6 m (EUR 97,500) subject to a simplified tax system, companies operating in free industrial zones

Macedonia: Fiscal impact

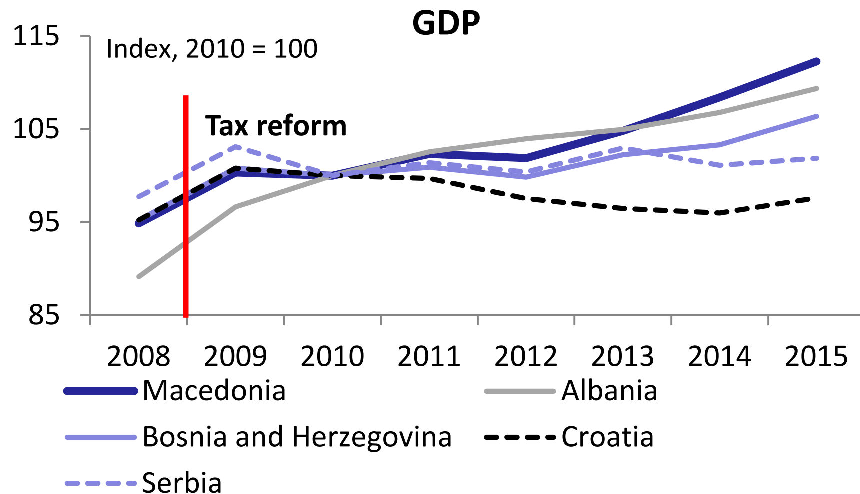


Source: GFS IMF

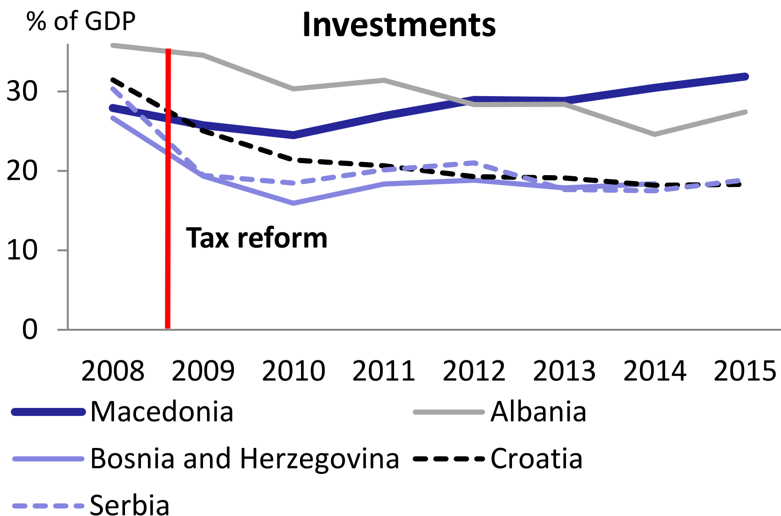
- Fiscal contribution almost halved from 8.6% to 4.4% in the 2009
- Partly due to economic downturn in 2008, but GDP recovered in 2009 and corporate tax revenues performed better in neighbouring countries
- Increasing fiscal revenues was main motivation for reversing reform in 2014

➢ **Clearly negative fiscal effect of reform**

Macedonia: Economic impact



Source: World Economic Outlook database, April 2017



Source: World Bank

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GDP

- Economic growth of Macedonia between 2008 and 2010 was very similar with benchmark countries in region
- Quicker growth of Macedonia and Albania after 2010
- Experts attribute growth to other factors as corporate tax pre- and post-reform was too low to be a significant factor

Investments

- Business representatives claimed the new system was good for investments by improving their liquidity
- Investments in Macedonia outperformed other countries in the region
- Tax however only one factor for this (also other pro-business reforms)

➢ **Potentially positive effect on long-term growth through investments**

➢ **But tax reform only one of multiple factors**

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Macedonia: Overall assessment

Effects of the reform

- Fiscal effect: Sharply negative, halved contribution of corporate tax to fiscal revenues
- Economic effect: Probably positive effect through increased investments
- Business in favour of the reform due to positive effect on their liquidity

Reasons for reversal

- Economic recovery in 2013 reduced perceived need for additional stimulation
- Negative fiscal effect perceived as stronger than positive effect on investments
- Free industrial zones already existed as a tax incentive and remained
- Conventional CPT was seen to raise chance of gaining EU membership

Special features of the Macedonian implementation

- Transition to distributed profit tax : It was hard to establish whether distributed profits had already been taxed under the previous CPT
- Reversal: Although it was planned as a temporary measure only, reversal came unannounced. This created problems for companies' tax and financial planning
- Temporary nature of distributed profit tax gave rise to possibilities for tax avoidance: Wait with profit distribution until return to CPT (also reason for unannounced reversal)

Moldova: Zero-rate CPT for reinvested profits

History

- CPT rate for reinvested profits was set to 0% in 2007 in context of wider reform
- This implied *technically* a CPT system, but due to zero rate on reinvested profits, it is *economically* a highly similar tax base as in a distributed profit tax system
- In 2012, CPT rate for reinvested profits was raised to 12%
- Hence an economically similar (CPT) system to an ECT between 2008 and 2011

Motivation

- Increase attractiveness of Moldova for foreign investors
- Together with other tax reform measures, de-shadow the economy
- Also domestic, purely political motivations involved (reduce tax revenue for Chisinau local government)

Key features

- Technically, Moldova still operated a CPT with a 15% rate
- Economic equivalence with distributed profit tax as reinvested profits no longer taxed, hence a tax incentive for equity financing of investments
- No simplification of administrative procedures: Companies still had to provide IFRS-based annual tax statements with all the consequent compliance cost

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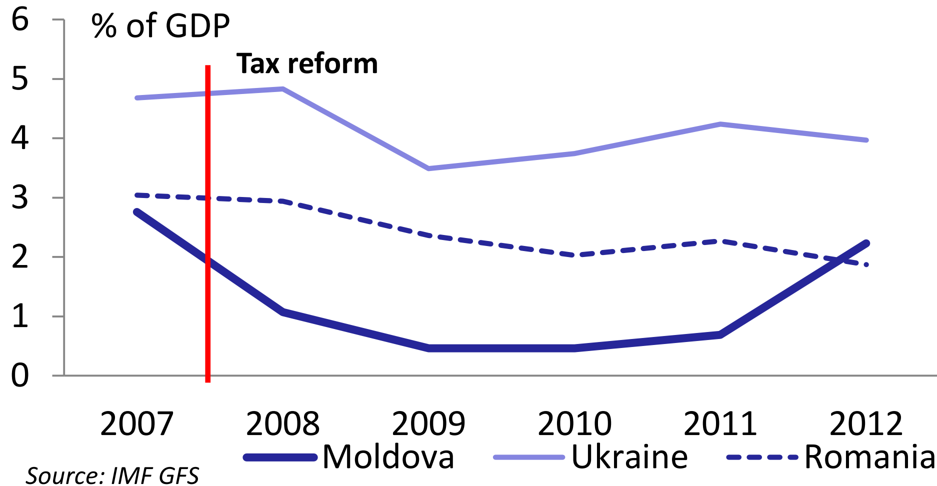
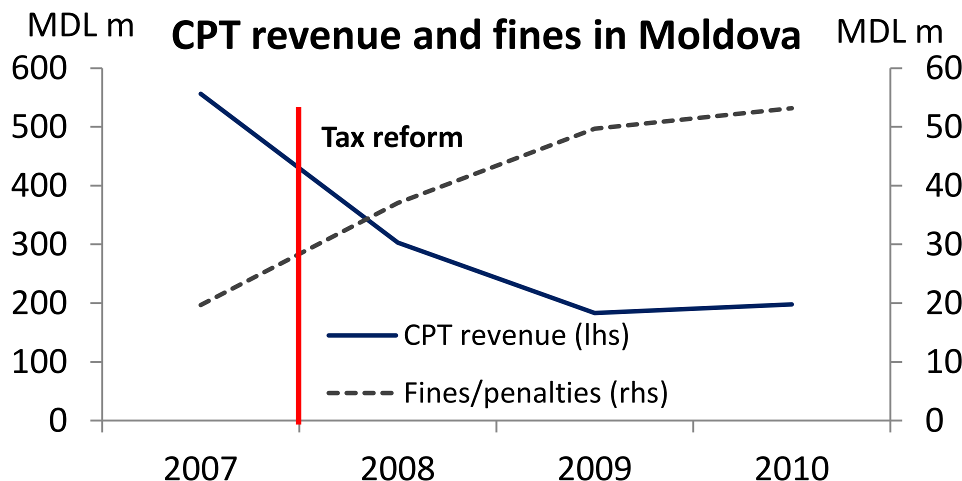
Moldova: Fiscal impact





Fiscal effect:

- Fiscal contribution of CPT collapsed from 2.8% to 1.1% of GDP in 2008
- In context of general deterioration due to global economic downturn
- Fiscal contribution of CPT recovered when zero rate was abolished 2012

Indirect effect through fines and penalties:

- Unexpected sharp fiscal effect and general economic deterioration led to sharp deficit increase
- Consequence: Revenue service tried “plugging the hole” by increasing the volume of fines and penalties levied
- Completely counteracted desired effect on investment attractiveness

➢ **Negative fiscal effect led to increased fines, worsened investment climate**

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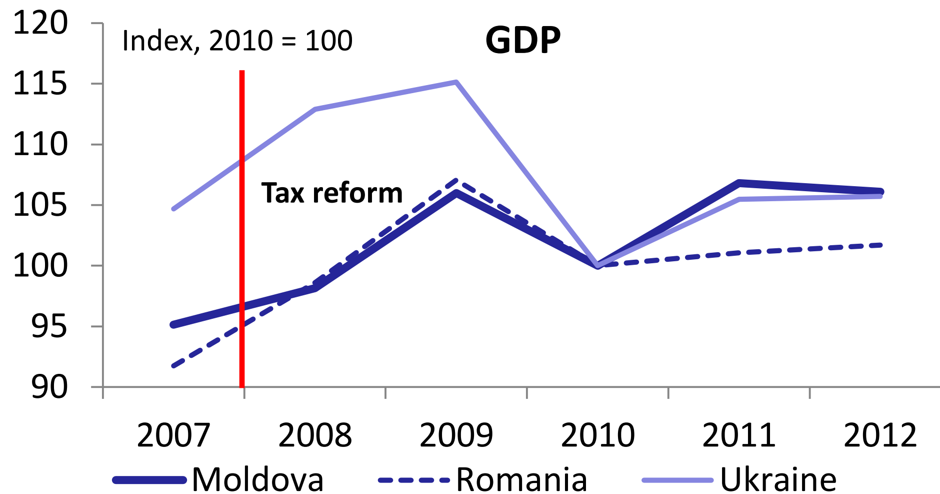
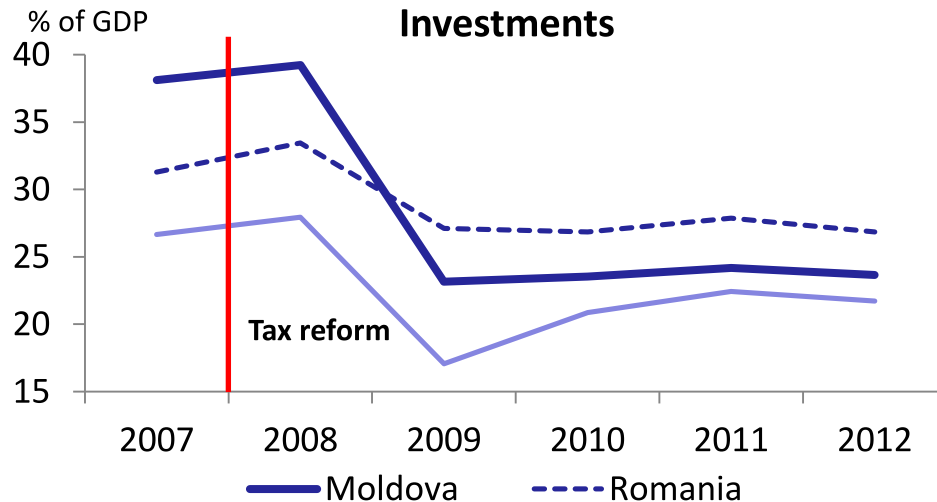
Moldova: Economic impact



Source: World Economic Outlook database, April 2017



Source: World Bank

GDP

- No difference between development of Moldova and Romania until 2010
- Stronger growth than Romania in 2011, but similar with Ukraine

Investments

- Sharp downturn of investments in 2009 after introduction of zero rate
- Decrease of investments in 2009 mainly due to global economic crisis
- After 2009 no improvement of investments visible
- Probably due to high compliance cost with Revenue Service (fines etc.)

➢ **No positive investment or GDP effect**

➢ **Increased fines deteriorated investment climate**

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Moldova: Overall assessment

Effects of the reform

- Fiscal effect: Sharply negative effect of zero rate on top of deterioration during global economic crisis in 2008 led to large pressure on revenue service to increase revenues. In consequence, fines and penalties were levied heavily on companies
- Economic effect: No positive effect, as investment climate deteriorated due to the activities of the revenue service

Assessment

- In balance, a highly counterproductive measure as fiscal revenues were lost without any positive impact on the economy
- Highlights need for solid budget planning in the context of an envisaged ECT reform
- Implementing a "surrogate tax on distributed profits" through a zero CPT rate on reinvested profits implies that no administrative facilitation arises: IFRS-based tax statements remain

Georgia: Recent introduction of tax on distributed profits

History

- Tax on distributed profits was introduced in January 2017
- Only partial tax reform: Financial institutions/companies excluded, remain on CPT for now

Motivation

- Improving the investment climate and increasing investments in Georgia
- Tax reform in context of wider measures aimed at improving infrastructure and business climate in Georgia

Key features

- Applies to resident companies and permanent establishments
- Tax rate remains at 15% as for previous CPT
- Tax base: Distributed profits, equated payments (non-business expenditures etc.)
- Arm‘s length principle for transactions with related parties

First results

- Business representatives welcomed the new tax
- Although many stakeholders had large reservations due to possible negative fiscal effects, first quarter revenues from new tax were higher than expected

Policy implications for Ukraine

Implications on whether tax on distributed profits should be introduced

- Distributed profit tax generally linked to at least short-term fiscal losses
- Unclear evidence on effect on economic growth
- ➢ International experience indicates that limited economic gains from distributed profit tax introduction may not justify the fiscal losses incurred

Policy implications in case of introduction of a distributed profit tax

- Moldovan experience highlights need for solid budgetary planning to account for fiscal revenue losses in the first years
- Necessity for clear and easy to enforce rules on taxation of profits already taxed under previous CPT regime
- A zero rate for reinvested profits as in Moldova instead of a full tax reform will lead to negative fiscal effects without simplifying tax administration
- Distributed profit tax not suitable as a temporary measure as this sets an incentive for not distributing profits while tax on distributed profits in place

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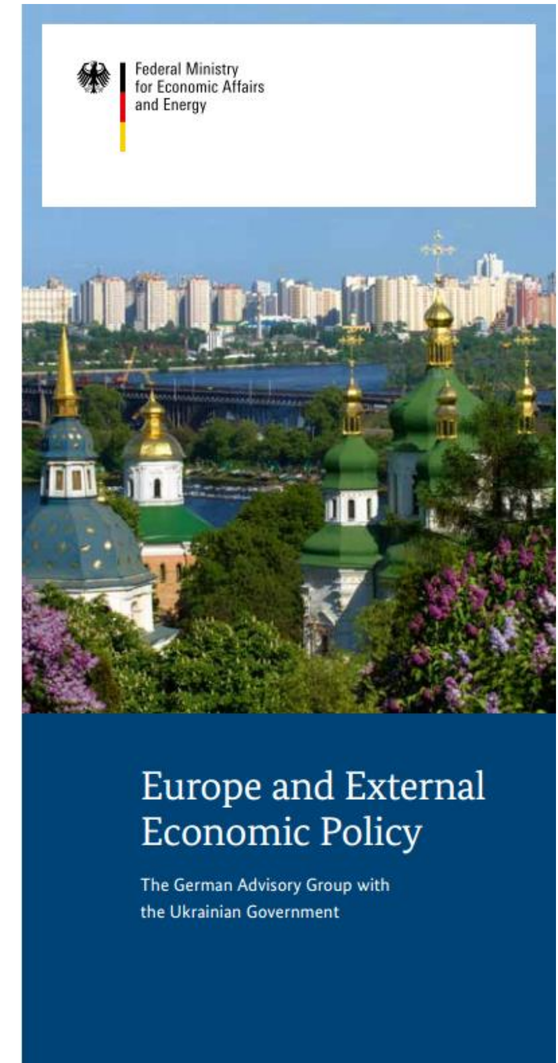

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Annex: Germany 1980s-1990s discussion about cash flow tax

- Discussion in the 1980s-90s: Cash-flow tax for companies.
  - Taxing operational profit minus investments, wages
  - Similar to an ECT: Tax base not financial profits but flows
  - Provisions, current value of assets not relevant, only flows
- Argument in favour of cash-flow tax:
  - Neutrality towards financing decisions (no distortion against equity finance or taxation of retained earnings as in CPT)
- Another proposal (Sinn, 1984):
  - Keep CPT, immediate full depreciation of investments, same tax on dividends as on retained earnings
  - ECT without system change, but depreciation/investment issue solved

- **Mainly academic discussion**
- **No political implementation**

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