IMPLEMENTATION OF ESTONIAN CIT MODEL IN GEORGIA

LEGISLATIVE ASPECTS AND COMPARATIVE ANALYSIS

USAID GOVERNING FOR GROWTH (G4G) IN GEORGIA

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ABSTRACT

The objective of this report is to deepen the understanding of GoG on the legal aspects of Estonian CIT model. The report explains the legislative aspects of Estonian CIT model, including comparison with Georgian legislation, and provides recommendations on the possible amendments to the Georgian legislation.

ACRONYMS

CFC	Controlled Foreign Companies
CIT	Corporate Income Tax
G4G	Governing for Growth in Georgia
GoG	Government of Georgia
MoF	Ministry of Finance
NGO	Non-Governmental Organization
OECD	Organization for Economic Cooperation and Development
OECD BEPS	OECD Base Erosion and Profit Shifting
PE	Permanent establishments
RS	Revenue Service
USAID	United States Agency for International Development
WHT	Withholding tax

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EXECUTIVE SUMMARY

The USAID Governing for Growth (G4G) in Georgia project is designed to support the Government of Georgia (GoG) to create a better enabling business environment in which legal and regulatory reforms are fairly and transparently conceived, implemented and enforced through consultative process. To achieve this goal, G4G focuses on strengthening capacity of both, public and private sectors, to effectively cooperate on policy and legislation of key reforms, including tax enforcement and administration.

GoG is considering a package of policy measures to stimulate economic growth. The package includes the reform of the Corporate Income Tax (CIT) system.

The existing CIT rate in Georgia is 15% and dividends are subject to 5% withholding tax. In order to stimulate investment in Georgian economy, GoG considers the possibility of implementation of the Estonian system of CIT. Estonian model is unique. Introduced back in 2000, when the current Income Tax Act came into force, the main difference of the Estonian system from traditional systems is that profits are not subject to tax at the moment when they are earned. Instead, taxation is deferred until the distribution of profits. The Estonian CIT system is easier to comply with both for taxpayers and for the tax administration. The main goal of the CIT reform in Estonia was to facilitate the development of enterprises and attract investors.

The Georgian Ministry of Finance (MoF) approached G4G with a request to provide assistance in better understanding of the Estonian CIT model and analyzing the consequences of its potential implementation in Georgia. G4G supports MoF by hiring Estonian consultants to conduct 1) legal analysis and 2) cost-benefit analysis of Estonian CIT model and the possible impact of its adaption to Georgia. Besides, G4G awarded a grant to local organization to conduct regulatory impact assessment (RIA) on Estonian CIT model implementation in Georgia.

The objective of this report is to explain the legislative aspects of Estonian CIT model, including comparison with Georgian legislation, and provide recommendations on the possible amendments to the Georgian legislation.

As a pre-work, the Estonian CIT expert worked with the following materials:

a. Estonian Income Tax Act;
b. Tax Code of Georgia;
c. Relevant other Estonian and Georgian normative acts.

The Estonian CIT expert made detailed overview of Estonian CIT model in the course of the one workshop and several meetings (held in Tbilisi, Georgia):

a. Workshop with the representatives of MoF and Revenue Service (RS);
b. Meeting with Georgian tax experts of BIG 4 and other audit companies (E&Y, Deloitte, PWC, KPMG, BDO);
c. Meeting with representatives of Government of Georgia (Economic Council, Business Ombudsman);
d. Meeting with G4G grantee Young Economists Association of Georgia (NGO working on the Regulatory Impact Assessment).

During the workshop and meetings, the Estonian CIT expert discussed different practical aspects of the Estonian and Georgian tax systems. Conclusions and recommendations of this report are based on the meetings and workshop mentioned above.

APPENDICES

A. FINDINGS

1. GENERAL FEATURES OF CIT MODEL

	Georgia (current law)	Estonia	Changes required?	Comments (if any)
Tax residency for legal entities	Based on incorporation and place of management	Based on incorporation. European Company (SE) or European Cooperative Society (SCE) whose headoffice is registered in Estonia is also considered to be Estonian tax resident.	No	The Georgian and Estonian definitions of tax resident differ but there is no inevitable need to change the Georgian law for implementing the Estonian CIT law.
Taxable period	Calendar **year**	Calendar **month**	The calendar month shall be introduced as taxable period.	Technically, under the Estonian CIT model, the taxable period can be calendar year but this is not advisable for cash flow and tax compliance purposes. It is easier for companies to declare and settle any CIT amounts together with payroll taxes on a monthly basis.
Territorial scope	Worldwide income	Worldwide income	No	

2. TAX EXEMPTIONS

	Georgia (current)	Estonia	Changes required?	Comments (if any)
Tax exemption for **dividends received** from resident and non-resident companies (participation exemption for dividends).	Yes	Yes	No principle changes required. Only wording of the law and tax declaration forms needs to be adjusted.	
Interest income (incoming)	Various exemptions.	No special rules (taxable as part of distributed profit).	Need to consider taxation under general rules.	Exemptions for various types of income (including interest income from certain sources) would reduce the transparency of tax system and it would make the CIT model more complex. The postponement of CIT liability partly compensates the negative effect of tax incentive abolishment.
Capital gains from securities	Several exemptions (e.g. government securities, free trade securities, non-resident issuer's securities, etc.).	Taxable under general rules. Estonia is considering the exemption but no draft law published.	Georgia needs to consider whether such capital gains should be exempt or not.	Exemption for capital gains from securities would generally increase the attractiveness of Georgia as holding company location. On the other hand, it would reduce the transparency of tax system and it would make the CIT model more complex. The postponement of CIT liability partly compensates the negative effect of tax incentive abolishment. If Georgia decides to have exemption on capital gains then it should be applicable to the gain part (not to the entire amount of sale proceeds).

3. SPECIAL TAXPAYERS

	Georgia (current)	Estonia	Changes required?	Comments (if any)
Tax exemption for profits derived by companies that provide **medical and agricultural services** that are reinvested for a period of 3 years from the end of the relevant tax year.	Yes	N/A	In principle, it may be possible to maintain the tax incentive but then it would be necessary to make separate calculation for such income and relevant expenses. Increases admin burden.	Exemptions for various types of income or various types of taxpayers would reduce the transparency of tax system and it would make the CIT model more complex. The postponement of CIT liability partly compensates the negative effect of tax incentive abolishment.
Profits of **Special Trade Companies** from certain permitted activities	Exempt	N/A	Need to consider taxation under general rules or the necessity to keep separate regulations.	Exemptions for various types of income or various types of taxpayers would reduce the transparency of tax system and it would make the CIT model more complex. The postponement of CIT liability partly compensates the negative effect of tax incentive abolishment.
Profits derived by **free industrial zone entities** from permitted activities	Exempt	No special rules.	Need to consider taxation under general rules or the necessity to keep separate regulations.	Exemptions for various types of income or various types of taxpayers would reduce the transparency of tax system and it would make the CIT model more complex. The postponement of CIT liability partly compensates the negative effect of tax incentive abolishment.
Grants and membership contributions received by **agricultural cooperatives**	Exempt	No special rules.	Need to consider taxation under general rules or the necessity to keep separate regulations.	Exemptions for various types of income or various types of taxpayers would reduce the transparency of tax system and it would make the CIT model more complex. The postponement of CIT liability partly compensates the negative effect of tax incentive abolishment.
Tax exempt reserves	Banks, credit unions, insurance	No	To be abolished.	Georgia may decide to take the tax exempt reserves into account in the

	and leasing companies may have tax-exempt reserves.			transitional provisions. For example the amount of tax exempt reserves may reduce right to pay out “old” profits as tax exempt dividends (see p 7.1. in the table below).
Income from **hydrocarbon resources**	Preferential 10% tax rate.	No	Georgia should consider whether to maintain special tax rate. In case of multiple activities, distinguishing the activities may cause significant administrative burden.	Exemptions for various types of income or various types of taxpayers would reduce the transparency of tax system and it would make the CIT model more complex. The postponement of CIT liability partly compensates the negative effect of tax incentive abolishment.
Permanent establishments (PE) of non-resident companies	Profit earned by a non-resident through its Georgian PE.	Special regulation but generally CIT is payable under the same principles as for Estonian tax resident companies (distributed profit).	Some adjustments and practical guidance to taxpayers will be required (i.e. guidance on which transfers between the PE and foreign headoffice are considered to be taxable distributions).	
Non-profit organizations	Income from commercial activity is subject to CIT.	CIT base: 1) Expenses not relating to the activities specified in the Articles of Association of a non-profit organization. 2) Payments made on the basis of missing or non-compliant source document; 3) Fines and penalties	Some adjustments are required.	

		imposed on the basis of law; 4) Late tax payment interest; 5) Value of assets confiscated from the taxable person; 6) Environmental charges paid or damage compensation charges paid pursuant to elevated rates; 7) Bribes granted to other organizations or individuals.		

4. TAX ADMINISTRATION

	Georgia (current)	Estonia	Changes required?	Comments (if any)
Calculation of annual profit for tax purposes	Yes	No	To be abolished.	For practical reasons no need to calculate tax profit.
Deadline(s) for CIT return	31 March next year	10th of month following to the taxable period	Yes	It is easier for companies to declare and settle any CIT amounts together with payroll taxes on a monthly basis.
Deadline(s) for CIT payment	Advance payments by 15 May, 15 July, 15 September and 15 December.	10th of month following to the taxable period	Yes	

5. TECHNICAL ISSUES

	Georgia (current)	Estonia	Changes required?	Comments (if any)
Accrual vs cash basis	Accrual method is compulsory for VAT payers. Taxpayers who are not VAT registered can opt between accrual and cash accounting methods.	Cash	Cash method should be introduced for all taxpayers.	Cash-based method is more in line with the ideology of Estonian CIT model.
Equity calculations for tax purposes	No	Yes	Yes, to be established.	In order to avoid misuse of the Estonian CIT model, there shall be calculation of amounts contributed in to the equity and the amounts taken out from the equity. The calculation shall include transfers that increase or decrease the equity of company, e.g.: 1) monetary and non-monetary contributions; 2) share buy-back transactions; 3) share capital reductions (unless no payments are made to shareholders); 4) payment of liquidation proceeds to the shareholders etc. Dividend distribution is not part of the calculation because it is taxable under separate regulations.
Special regulation for self-employed persons (special bank account) for achieving similar result	N/A	Yes. Generally, the annual increase of special bank account is deductible from the taxable annual profit of a self-employed person. Any non-business transfers of such special bank account will be ignored for tax	Needs to be considered.	Due to the popularity of self-employment in Georgia, it may be necessary to introduce a special regulation (special account) for self-employed persons in order to achieve similar tax regime for self-employed persons. For Estonian self-employed persons certain minimum social tax liability exists even if the taxable profit is zero. The aim of such minimum requirement is to ensure the coverage by state health insurance. However, in Georgia this is not applicable, as Georgia does not

		calculation purposes.		have social taxes or contributions.
Tax depreciation and amortization regulations	Yes	No	To be abolished.	No amortization or depreciation regulations for tax purposes are required.
Carry-forward of tax losses	Yes	No	To be abolished.	No carry-forward rules because tax profit is not calculated.
Accelerated depreciation	Used in respect of certain assets, such as computers, electronic facilities, trucks and pipelines.	None	To be abolished.	No amortization or depreciation regulations for tax purposes are required.
Group taxation	No	No	No	Both in Estonia and Georgia, each company is considered to be a separate taxpayer. Estonia has not considered any group taxation regime under its current CIT model.

6. WITHHOLDING TAXES

	Georgia (current)	Estonia	Changes required?	Comments (if any)
WHT on dividends	5% on dividends paid to individuals and non-residents (without PE in Georgia)	No	No	The change of CIT model does not require the abolition of dividend WHT. Based on the Estonian previous experience (when Estonia also applied WHT on dividends together with the postponed CIT) simultaneous collection of two taxes may cause misunderstandings, particularly in the international taxation context.
WHT on interest	5% WHT irrespective of the recipient. 15% WHT if paid to a low tax territory. No WHT on	Only in specific case: interest paid by contractual investment fund to a non-resident who holds at least 10%	Minor changes required.	WHT deducted from interest payments made to Georgian resident companies can be credited against CIT payable by the interest recipient (when such company distributes profit or incurs other taxable events).

	interest paid by financial institutions.	participation in that fund only if more than 50% of the fund´s assets consist of (or any time during the 2 previous years consisted of) Estonian real estate.		
WHT on royalties	10% WHT if paid to non-residents. 15% WHT if paid to a low tax territory.	10% WHT if paid to non-residents. Exemptions applicable under the EU Interest-Royalty Directive.	No	

7. ANTI-AVOIDANCE

	Georgia (current)	Estonia	Changes required?	Comments (if any)
Restrictive rules for intragroup loans instead of dividends	N/A	No	Yes	Estonia currently does not apply any restrictive regulations against the misuse of Estonian CIT model. Estonian companies tend to grant loans to their related entities (instead of dividend distributions). Loan period in the contract is usually realistic (e.g. one year) but the loan agreements are renewed and the loan amounts are increasing. It is advisable for Georgia to have specific regulations in place from the beginning. Introduction of such limits at a later stage may cause negative feedback from taxpayers and may be technically and politically more sensitive.
Transfer pricing regulations	Yes	Yes	Minor changes required.	The potential changes only relate to the wording of the law (taxation of unearned profit or excess expense as hidden profit distribution).
Restrictive measures against the use of low tax territories	Partial	Yes	Need to be strengthened.	1. Estonia applies 20% WHT on service fees paid to a low tax territory (irrespective of the place of service); 2. Estonia taxes loans and

				prepayments to legal entities situated in a low tax territory (20/80 CIT on the top of full loan amount). Tax is refundable when loan is repaid to the Estonian lender. 3. Estonia taxes all acquisitions of shareholdings in low tax territory companies as non-business expense (20/80 CIT on the top of such cost).
Thin capitalization regulations	Planned entry into force from 2016.	No	No	It may be advisable to consider the OECD BEPS initiative and its developments.

8. TRANSITIONAL ISSUES

	Georgia (current)	Estonia	Changes required?	Comments (if any)
Transitional regulation for distribution of **profits earned under the old regime**.	N/A	Yes (expired by now)	Yes	Under the Estonian transitional regulations, the Estonian companies fixed their retained profit amount as at the end of previous CIT model. In addition, each company calculated its effective tax rate (actual rate under the previous CIT model). When distributing the "old" profits, only the difference between the general (nominal) tax rate and the effective tax rate was payable. Alternatively, Georgia may decide to allow tax-exempt distribution of "old" profits whereas such right is decreased by the amount of tax-exempt reserves. In any case Georgia may impose 5% WHT on dividends sourced from "old" profits.
Compensation of unused **tax losses** generated under the traditional CIT system.	Currently N/A	None	Georgia may decide to have a compensation mechanism.	Estonia did not have specific transitional regulations for unused tax losses and it did not cause any negative feedback from taxpayers.

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