Core principles of Estonian corporate tax system (2/20/17)

The Latvian Cabinet of Ministers' decision of 9 May 2017 to support the draft national tax policies for 2018–2021 has made it clear that the next six months will see significant changes to the Latvian tax system. Confirming the intention announced earlier to move the Latvian corporate income tax (CIT) regime closer to the Estonian model, the proposed policy solutions provide for reforming the CIT system from 1 January 2018 to charge a 0% tax on reinvested profits and a 20% tax on gross profits at the time of distribution. With the proposals still at a developmental stage, this article explores the Estonian model to discover how the so-called 20/80 tax rate principle works.

The 20/80 tax rate principle

With the implementation of its CIT reform in 2000, Estonia started a unique tax policy based on the main principle of not charging tax until profits are distributed to encourage long-term investment in companies and promote economic growth. The Estonian regime gives a full CIT exemption on undistributed profits (including income from business activities and company share sales as well as passive income such as dividends, interest and royalties). The mass media often call it the "0% reinvested profit model."

At the same time, the CIT calculation principle requires that the 20/80 rate be applied to the net amount of distributable profit, i.e. 20% on gross profit or 25% on net profit. To understand how the 20/80 principle works, let's look at a practical example.

A company reports a profit of €100 for the year. €80 is available for a dividend payment, and €20 must be paid in tax at the time of profit distribution:

Although technically the gross profit for the year (€100) attracts a 20% tax, the actual tax on the net profit received (€80) is 25% (€20 = 80 x 25%).

Tax compliance

While this calculation may initially seem complicated, Estonian taxpayers stress the simplicity of this system. According to PwC's 2016 *Paying Taxes* survey, the Estonian taxpayer annually spends an average of 81 hours on tax compliance. This ranks Estonia fourth among the EEA countries whose tax regime creates one of the lowest administrative burdens in Europe.

Administering the Estonian tax regime is based on the following calculation principles:

- Accounting profit doesn't need adjusting for tax purposes because there are no capital allowances, taxes losses or any other taxable income adjustments;
- Tax is charged on profits distributed in the tax period, including dividends (and surplus assets on winding-up), equity reduction payments or share repurchase, transfer pricing adjustments, taxable gifts, donations etc;
- The 20/80 tax rate applies to all non-business expenses that aren't eligible for a tax deduction (such as fines, securities purchased from tax-haven entities, staff and client entertainment expenses, and so-called representation expenses over a certain threshold);

- The tax period is one calendar month.

The reinvested profit regime outlined in this article applies to Estonian tax residents: Estonian-registered entities and permanent establishments. Certain structures such as pension funds and investment funds attract a special tax regime based on different principles from those described above.