

Tax reform: new corporate tax calculation model (1/32/17)

On 28 July 2017 Parliament adopted amendments to the Corporate Income Tax (CIT) Act in their final reading, significantly changing the principles of CIT treatment. The new CIT model largely resembles the one Estonia adopted 17 years ago ([see our Flash News edition of 18 May 2017](#)) which provides for paying tax at the time any profit is distributed (including deemed profit distributions). This article explores some of the new principles for calculating CIT.

How is the new CIT model different from the existing model?

The current CIT payment procedure involves calculating taxable income on the basis of a financial profit or loss after statutory adjustments for non-deductible expenses or non-taxable revenues on the accrual basis. The new model means that tax will be payable on the distribution of financial profits (the cash flow basis).

Under the new model, fixed assets are no longer eligible for capital allowances, which were seen as tax relief at the beginning of an asset's useful life but represented a deferred tax liability on the balance sheet. Any accounting adjustments made after 2017 (such as revaluations and general provisions) will not affect the taxable base, yet writing off provisions on the balance sheet as at 31 December 2017 will be governed by a set of transition rules (we'll be writing about those soon).

The concept of tax loss is being abolished. However, a five-year period of transition will apply to any losses accumulated before 2018. Unfortunately, those tax losses can be offset only if the company pays dividends in the next five years.

What items will be taxed?

As stated above, only profit distributions and deemed profit distributions will be taxed. Profit distributions include –

- declared dividends, including interim dividends;
- deemed dividends (any portion of profit being added to share capital), including any surplus assets on winding-up; and
- payments treated as dividends (a cooperative society's profit payments to its members, a sole trader's profit distributions, a partnership's profit share-outs,¹ and certain payments a permanent establishment makes to the non-resident entity).

Examples of deemed profit distributions, which will also attract CIT, include –

- non-business expenses,
- fines and penalties,
- excess costs incurred on so-called representation and staff sustainability events,
- donations,
- non-arm's length transactions with related parties,
- loans to related parties,
- doubtful debts, and
- excess interest payments.

Many of these expenses will be taxed each month, while certain items, such as transfer pricing differences

and excess interest payments, will be taxed once a year through the CIT return for the last month of the financial year.

The rate

The new rate of CIT is 20% of the taxable base. However, before applying the statutory rate to the taxable base for the tax period, this should be divided by a coefficient of 0.8. Since the taxable base is increased, the effective rate will be 25%.

Anti-avoidance rules

The amendments include a number of rules aimed at preventing tax avoidance, for example:

- Loans to related parties will be treated as deemed profit distributions (there are several exceptions, which we'll be writing about soon);
- CIT will be payable on doubtful debts failing to meet exemption criteria, by directly expensing a bad debt, and on provisions for any debts that remain uncollected within three years;
- CIT will also be payable on excess interest payments.

Transition rules

A set of transition rules have been adopted to prescribe ways of distributing pre-2018 profits without charging the new CIT, ways of utilising accumulated tax losses, making provisions for doubtful debts, how the new CIT treatment will affect operators in special economic areas or free ports and companies enjoying large investment relief, and steps to be taken by entities whose financial year does not end in December.

(to be continued)

¹ Except for a profit share-out from an alternative investment fund set up as a partnership