

Peculiarities of the “Estonian” Tax Model in Taxation System of Georgia

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Abstract

Georgia is a country of a transitional economy, one of the most important financial determinants of which is the tax system, which is constantly undergoing the changes to different directions in terms of perfection and development. Taxes somehow create a peculiar "bridge" between the macrofinance and microfinance, among which the corporate income tax gains the function of the crucial important tax in terms of efficient operation of the business sector. Among the reforms carried out in the economy of Georgia, one of the most topical directions among the economic reforms is establishment of the so-called “Estonian” model and its further implementation. The present paper deals with the relative aspects of traditional and Estonian models of taxation and substantiates the necessity of determination of the main directions of its perfection.

Keywords: Taxation System; Corporate Income Tax; The Traditional Tax Model; Tax Deduction; The “Estonian” Tax Model; Taxable Expenses; Distributed Profit; Retained Profit.

1. Introduction

One of the most innovative reforms implemented in transitional economy of Georgia, namely in its tax system is the implementation and operation of the so-called “Estonian” model (hereinafter: The Estonian model) since 2017, aimed to promote the economic growth on the basis of increasing business reinvestment in terms of proper tax administration. That’s why implementation of the model in the practice has been preceded by the significant macroeconomic (i.e. fiscal) and microeconomic (i.e. reinvesting) analysis (4). Due to the fact that the corporate income (profit) tax is the basic tax for any business entities, it is important to emphasize the main features that distinguish the Estonian model from the traditional one. The principal peculiarity in the new model is the fact that the corporate income taxation of the company is prolonged by the period of profit distribution which allows companies to save funds from the day of gaining the profit till the day of distribution of the profit and direct the mentioned funds to the reinvestment, or carry out its transformation into capital of the financial resources.

It is important to emphasize that the classical and imputation systems of corporate income taxation are used in the worldwide taxation systems. In the classical system, the distributed dividends are subject to taxation in parallel to corporate income taxation, while in the imputation system, the corporate income taxation excludes the moment of taxation of the profit distributed as dividends. There are also the half-imputation taxation systems, which provide partial exemption of the dividends from taxation or deduction in order to avoid the double taxation (James, Nobes, 2009, pp. 258-260). In Georgian reality, the Estonian model can be considered as a peculiar modification of the half-imputation system of taxation in which the profit distributed as dividends are taxable if it is aimed to reinvestment of the business subject as well as in other specific cases.

It should be noted that the results obtained using the Estonian model should be considered in the short-term and medium- and long-term periods of time. In the short term period, the tendency of decreasing the corporate income tax in the budget revenues is remarkable, while the expected trend of revenue, investment and economic growth - in medium and long-term periods. For the economy of Georgia, which seeks to attract foreign investments, it is especially important to carry out the qualitative and quantitative analysis of the Estonian model, where the above mentioned model was introduced in 2000, and the results of its effect on investment activity and, overall, on economic growth was observed from the medium-term (approximately after 2-3 years). The following table gives a clear highlight

Table 1. Investment Characteristics of Estonia (Million Euros)

	1999	2000	2001	2002	2003	2004
Foreign Direct Investments	284.3	424.7	602.7	306.8	822.2	838.0
Share Capital	163.1	250.9	232.7	52.5	340.6	296.5
Reinvested Profit	46.1	116.0	247.9	215.4	409.5	573.0
Miscellaneous	75.0	50.9	123.1	67.0	94.2	-40.9
Foreign Investments Abroad	-79.2	-66.7	-225.5	-139.9	-137.4	-216.5
Net Foreign Investments	205.0	358.0	377.2	166.9	685.0	621.5

Source: http://pbo.parliament.ge/media/k2/attachments/Profit_Tax_Reform.pdf

2. Comparative analysis of traditional and Estonian tax models

The main distinguishing features between the traditional and Estonian models of corporate income taxation can be summarized as follows:

The traditional model focuses primarily on the formation of financial results of the business, or on getting profit (result), while the Estonian model focuses on the distribution of financial results (process), which represents a peculiar "starting point" of the corporate income taxation;

According to the traditional method, all economic subjects (resident enterprise and permanent establishment of non-resident enterprise) are tax payers if it is not subject to exemption from the appropriate taxation, while according to the Estonian model, the taxation doesn't apply to commercial banks, micro financial organizations, credit unions, insurance companies, pawnshops (before the deadline defined by the transitional provisions of the Tax Code), system-electronic forms of totalizers and enterprises defined by the law on "Oil and Gas";

The difference between the gross income and the deductible expenses is the object of corporate income taxation in traditional model, or the taxable profit [(Gross Income - Deductions) x 15%], therefore, the focus is on the full taxation of income and the correct mechanism for the deduction of the expenses, while the Estonian model is fully focused on the mechanism of taxable disbursements/expenses, and offset/deductible funds [Taxable disbursements: 0.85 x 15% - offset and deductible funds].

According to the traditional method, the declaration is due to the annual declaration resulting from the consequences of the last year, while the Estonian model envisages a monthly declaration based on taxable disbursements, (accordingly, in case of absence of taxable disbursement, there will be no necessity of submitting the declaration);

The calculation of corporate income tax rate with respect to tax base considers on the one hand the standard ad valorem tax rate (15%), on the other hand it comprises the so-called "gross up" taxation (0.85 x 15%);

The traditional model is primarily focused on tax accounting, while the Estonian model is interlinking the financial and tax accounting systems (e.g. permanent and temporary differences caused by the depreciation and other similar moments are ignored);

The traditional model uses the so-called loss scheduling (prolongation) mechanism in the form of deduction of the losses of the previous years from the profit to be gained in the following years that is not familiar for the Estonian model due to its content;

According to the traditional approach, the expenses incurred by the company were ranged as deductible and non-deductible expenses and consequently, the fully or partially deductible taxes, allowed by legislation were considered to be tax expenses, while the non-deductible expenses were covered by the net profit received after taxation.

As for the new approach, according to which the very non-deductible expenses turned into the main deductible disbursements, except for separate exceptions (e.g. according to the traditional model, the financial sanctions paid in the budget in the form of the fines and penalties were not deducted while according to the Estonian model, they are not taxed unlike the other non-deductible expenses);

In the case of traditional taxation, the exemption from profit taxes in case of reinvestment concerned only agricultural enterprises and medical institutions, while the Estonian model due to its content, exempts the reinvestment activities of all enterprises;

The Estonian model provides a certain “asymmetrical taxation” with respect to organization which implies taxation of organizations in case of economic activity according to traditional rules of taxation, unlike the enterprises, representing the business entrepreneurs.

Table 2. Comparison of Traditional and Estonian Tax Models in Georgia

	Criterion	Traditional Model	Estonian Model
1.	Emphasis on financial result	Getting of financial results	Distribution of financial results
2.	Taxpayer	Each enterprise	Each enterprise (Except of financial institutions and other business entities)
3.	Objectives of taxation	Taxable profit	Taxable expenses
4.	Period of declaration	Each year	Each month
5.	Tax rate	15%	15% by „gross up” (15/85)
6.	Oriented	On tax accounting	On proximity of financial and tax accounting systems
7.	Loss scheduling (prolongation)	Is allowed	Does not exist
8.	Non-deductible expenses	Do not enrolled in deductions and were so levied	Belongs to deductible expenses and are so levied
9.	Exemption	In reinvestment cases belonged only to agriculture enterprises and medical clinics	In reinvestment cases belonged to each enterprises
10.	Taxation of organizations	Envisaged (In certain cases)	Is not equalized with enterprises (i.e. is levied according to the early rule)

Source: Author’s own; based on the tax legislation of Georgia.

3. The main characteristics of the Estonian tax model

According to the Estonian tax model, the object of taxation is to actually carry out the following disbursements: 1. Distributed profit (including differences between prices); 2. Expenses and other payments not related to economic activities; 3. Free of charge supply of goods/services and/or transfer of funds; 4. Representative expenses exceeding the maximum amount defined in the Tax Code.

The distributed profit (2, Article 98¹) is the profit of an enterprise that is distributed by the enterprise to its partners, in the form of dividends, in monetary or non-monetary form. The distributed profit also includes the so-called differences between prices (difference between the transaction price and the market price). The distributed dividends shall be taxed at the moment of payment, if it is distributed to a natural person, non-commercial (non-entrepreneurial) legal entity, non-resident or an enterprise exempted from the profit tax. Dividend is not subject to taxation if it is distributed to the enterprise, using the Estonian model of taxation. The essence of such mechanism of taxation is that the funds distributed in the form of dividends are not subject to taxation if remains in business and creates the relevant added value (enterprise), while the funds, distributed “out” of the business (natural person, non-commercial legal entity). Funds that will be distributed outside the country as repatriation of capital (non-resident entities) and funds, the distribution of which is potentially connected with such economic subjects with which the enterprise may have some “transactions” for avoiding taxation (the enterprise exempted from the profit tax), such disbursements are subject to relevant taxation.

It should be mentioned that in case of distribution of profit in the form of dividends, the year of profit gained doesn't matter for taxation but for avoidance of double taxation, the enterprise is entitled to set off accrued and paid the amounts of corporate income taxes during distribution of the net profit as well as the during 2008-2016, if the profit gained in these periods are distributed. In addition, the profit tax paid is calculated using a special formula that significantly facilitates the establishment of a tax base in similar cases.

For the purpose of corporate income taxation, the differences between the prices are equal to the transaction price and the market price for the operations carried out by the enterprise: 1. With interdependent person; 2. Offshore company (controlled operation); 3. With the person exempted from corporate income tax. Important nuance is also, that the difference between the prices is not subject to corporate income taxation if the party of the operation in case of the interdependent entity is the enterprise using the Estonian model, while in case of the entity exempted from the corporate income tax is the budget organization.

For accurate definition of the distributed profit as the main object of taxation and accurate calculation of the corporate income tax to be paid it's principally important to state what is not considered to be a distributed profit for the business entities. Such directions include: Amount equal or less than the amount paid in the equity capital of the partner when redeeming the share or for the liquidation of the enterprise (as such kind of disbursement is not considered as the dividend for the tax purposes); The dividends distributed as shares or by transferring into the ownership (while distribution of dividends in this manner, the funds are "not flowing" from the business, despite the enterprise is obliged to tax the paid dividends at source); The dividends distributed on entrepreneurial entities (except the individual entrepreneur and persons exempted from the corporate income tax, e.g. the company with a status of high-mountainous enterprise; agricultural company, the income of which received by the supply of agricultural products before the industrial processing does not exceed 200,000 GEL; organization, etc.); Transfer of assets to the state and / or local self-government through capital reduction, if most of shares belong to them; Distribution of dividends received from foreign enterprises (excluding offshores) (if dividends are derived from foreign enterprises and the profit gained from the local activities is distributed, then the profit gained as the dividends from abroad will be excluded and the profit remained from the difference will be subject to taxation).

Expenses and other payments not related to economic activities (2, Article 98²), together with the distributed profit, are another large group subject to corporate income taxation, including such expenses and payments which are not related to its economic activity. Such as: Expenses that are not documented (for example, the enterprise has acquired the supplies of the certain value however it can't be properly substantiated by bill of lading. Also, if the person accountable to the enterprise was given some funds by which he has made a purposeful procurement, but failed to submit the relevant document, which will be deemed as documented and will be relevantly taxed, etc.). Expenses which are not intended to gain profits, income or compensation (for example, the enterprise transferred a certain amount of money to the company with which no business connection is confirmed or some assets were acquired by the document written out on under the name of the company, e.g. furniture and it was used for private purposes, etc.); Expenses incurred from the goods purchased from a person with microbusiness and fixed taxpayer status (e.g. the enterprise has purchased stationery items from a person with microbusiness status on which the relevant document of expenditure is available but such expenses would not be deducted according to the traditional model, analogically, according to the Estonian model, such expenses are deemed to be the taxable disbursement); The interest paid on the loan higher than the established interest rate (this is regulated by the subordinate act, namely the relevant order of the Minister of Finance). Furthermore, if the traditional model implied the taxation by using the accrual principle, the new model implies taxation of the existing financial expenses above the norm at the moment of paying); The mentioned group of taxation also include expenses in the amount exceeding the customs value of the goods purchased from the special foreign trade company; Payment for the purchase of the capital contribution, share of the non-resident or the entity exempted from the corporate income tax and other analogical taxable disbursements; The following payments carried out by the persons registered in the offshore country and persons exempted from the profit tax are also equated with non-economic costs and payments: for purchase of the loan securities; financial sanctions derived from contractual relations; advance payment; loan issuance; purchase of demands on them and the loss incurred by the transfer of the right of demand and others (the corporate income tax reduction with appropriate amount will be made in the relevant monthly declaration in case of return of loans, paid advance payments and other above listed payments). Expenses that are not related to the economic activity of the enterprise, also include provide loans to individuals and non-resident individuals, because in both cases, the usage of resource goes beyond business activity.

Free of charge supply of goods/services and/or transfer of funds (2, Article 98³) – according to the Estonian model of corporate income taxation, donation of the funds is subject to taxation, as well as the free of charge supply operations and loss of goods. In particular, the supply of goods or services are considered free of charge if it does not aim to gain profit, income or compensation from this point of view, as well as the loss of inventories and/or fixed assets at the moment of their identification. According to the traditional model, the identified loss of goods would be included in gross incomes and taxed on the basis of the annual declarations, in case of the Estonian model the identified loss of goods will be considered as free of charge supply of goods and taxed in the same year of the loss identification.

Some operations are not considered free of charge, ones which are related to the supply of the goods and services and cases after the transfer of funds: Free supply of goods, transfer of services or transfer of money (donation), which was taxed at the source of payment with income tax; Donations issued to charity organization not more than 10% of the net profit in previous calendar year (it should be taken into consideration that the donation shall be taxed not according to the relevant months of the charitable expenditure, but only from the reporting period when the total amount of donation paid in the current year exceeds the net profit margin of the previous year); Free of charge supply of goods and services to the state, local self-governance and/or public law entity (LEPL) or transfer of funds and free delivery of the bail or easement envisaged by the Civil Code; Delivery of real estate to a charitable organization if the recipient organization of this property carries charity at least in the last three calendar years to persons with disabilities.

Representative expenses exceeding the maximum amount defined in the Tax Code (2, Article 98⁴) are also taxable expenses, the margin of which consists of 1% of the income received during the previous calendar year, and if the expenditure exceeds the income received – then 1% of the expenditure (it should be taken into consideration that like charitable donations, representative expenses are taxed not according to expenditure of all months but only from the reporting period when the total expenditure incurred during the current year exceeds the corresponding marginal indicator). The amount of representative expenses incurred during the year of establishment of an enterprise shall be determined by 1% of the expenditure incurred until the end of the current year. In the latter case, the following circumstance should be considered: in particular, if the annual expenditure will be more than 1% of the total expenditure incurred by the end of the year, or exceed the permissible norm, the enterprise must specify the declaration based on the appropriate correction.

Thus, based on the comparative analysis of the traditional model to the Estonian model and the detailed characteristics of its taxation objects, we can evaluate the positive and negative aspects of the Estonian model functioning. In particular: within the terms of tax administration, an ambivalent attitude is observed, i.e. the tax administration is relatively simplified in accordance with the convergence of financial and tax accounting systems and it's complicated because of the monthly declaration in terms of "labor-intensiveness"; The model incites the reinvestment of the business entities, but at the same time creates preconditions for reducing operating liquidity (monthly outflow of funds in the form of corporate income tax); The model stimulates the companies to save the financial resources from profit generating till it's distribution, but in some cases, vice versa, aggravates the tax burden (in relation to controlled and similar operations); From the position of business, the annulment of the mechanism of current payments can be considered as a positive moment, while the automatic dysfunction of the loss prolongation can be considered as negative; The possibility to set off the corporate income tax paid in the last years (2008-2016) can be considered as the positive side, too, while the negative side is an "asymmetric" taxation of organizations as compared to enterprises.

Table 3. The Positive and Negative Sides of Estonian Tax Model in Georgia

Positive Sides	Negative Sides
Simplifying of tax administration (in terms of financial and tax accounting systems proximity)	complicated tax administration (in terms of monthly declaration procedure)
Encouraging and stimulating of reinvestment	Reducing of operating liquidity (Monthly cash outflow in the form of corporate income tax)
Saving of financial resources from profit generating till its distribution	Growing of tax burden in some cases (Offshore dealings and others)
Annulment of current payments	Cancellation of loss rescheduling mechanism
Possibility of offsetting of corporate income tax payed in previous (2008-2016) years	"Asymmetric" taxation of organizations compared to enterprises

Source: Author's own; based on the tax legislation of Georgia.

4. Conclusion

Therefore, all of the above-mentioned allow us to assess the following key directions for the improvement of Estonian tax system-model: For the purpose of improving the efficiency of the taxation mechanism, it is necessary to establish and permanently update the unified registry of enterprises exempted from profit tax payment (like the registry of the offshore countries); In terms of taxation of the non-economic expenses, it is expedient to review the legislative norm regarding entities with micro business and fixed taxpayer status in terms of equal conditions with other entities; Transition to the Estonian model of financial institutions will only be based on adequate analysis and macroeconomic and microeconomic trends and a thorough assessment of the current situation; Assess the efficiency of model operation in terms of state-payer administrative relations; Implementation of qualified complex-detailed intermediate empirical research by the state, from the point of view of study of the expectation of Estonian model (the impact on the medium term budgetary revenues, internal and foreign investments and economic growth) as a possible increase of business reinvestment potential in terms of the macroeconomic consequences, which will enable the appropriate policy-makers to carry out a balanced and effective corporate taxation policy aimed to the long-term prospects.

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