Tax Trends

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Legislation Update

The countries of Central and East Europe have all undertaken major overhauls in their systems of taxation in the last year or so. Western-style profit and income taxes were unheard of in these countries only a few years ago when the state merely appropriated the "profits" of enterprises which it owned. Now, as privatization is gaining speed in the region, almost all of these countries have adopted Western-style taxes in order to beef up government revenue which is no longer received from the dwindling state sector. In general, tax authorities in these countries are few and under trained. Laws are changed and updated frequently, especially in the former Soviet Union (FSU), where the high rates of wage inflation render tax brackets obsolete very quickly.

What follows is primarily a discussion of aspects of corporate taxes, income taxes, value-added taxes and tax incentives of interest to foreign investors that have been adopted in several countries in Central and East Europe. As always, prospective investors should pay close attention to the evolving taxation systems, and regulatory environment generally, in the region.

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The Czech and Slovak Federal Republic

The current corporate tax rate of 55% will be lowered to 45% under a new law passed in April 1992 and effective 1 January 1993. However, the current 40% rate for joint ventures with more than 30% foreign ownership will also be set at the new 45% rate. Employers will also have to contribute 34% of wages for social security (employees will pay 14%). Tax holiday rules, which have not yet been finalized, should include incentives for investment in priority areas, depressed areas, and badly polluted areas. There are no specific incentives for foreign investors. The new tax regulations are closer to Western norms and will make it easier for Western firms to operate. Firms will be able to carry forward losses for five years and two depreciation systems are offered (straight line or accelerated); the lists of deductible and nondeductible items coincide with Western lists. Withholding tax rates vary from 25% on dividends and profit shares to 1% on financial lease payments.

The personal income tax rates will also change as of 1 January 1993. The current top rate of 17% will be raised to 47% (on incomes over K1,080,000, about $37,250) with rates varying down to the lowest bracket set at 15%. All forms of compensation, in cash and in kind, will be taxed, and a foreigner who resides in the CSFR for more than 183 days will be taxed on his or her worldwide income.

A new value-added tax (VAT) of 23% will also be introduced in 1993; it will apply to most goods and services with a 5% rate applying to most foods and essential services including heat and electricity. [The VAT, used throughout West Europe, has been adopted by East European countries to replace their Soviet-style turnover tax. The VAT is paid on the "value-added" at each stage in the production process based on the selling price. It is recoverable by each payer in the process except by the consumer of the final product.] A consumer goods tax will also come into effect in addition to the VAT on hydrocarbon fuels, alcohol, and tobacco products. These two taxes will replace the turnover tax, which has been abolished. The VAT should cause an overall consumer price increase of 6-8%.

The individual Czech and Slovak republics still have the right to change these taxes (the republics are permitted to add up to 5% to the corporate rate) since they still must work out the laws on collection of taxes. Variations between the republics after the end of federation, if it occurs, should also be considered.

A tax treaty with the United States is being negotiated, but it should not be effective until 1994.

Hungary

Hungary levies a corporate profit tax at a uniform 40% rate under a law enacted 1 January 1992. Employers also make contributions equal to 50.5% of wages to social programs; social security need not be paid for foreign employees of foreign owned firms. The withholding tax rate is 20% and is levied on royalties, interest, rent, and some capital gains. Hungary recently added charitable contribu-

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tions to the list of acceptable deductions and the loss carry-forward was extended from two to five years. The tax law provides for straight-line depreciation of capital assets.

The personal income tax rates vary from 25% to 40% (reduced from at top rate of 50%). Foreign employees are now taxed at the regular Hungarian rates on 70% of their Hungarian salary and on all of their salary earned outside Hungary. Officials in Hungary are emphasizing their new focus on enforcement, particularly on payment of income taxes by foreigners.

Many republics of the ex-USSR have taken Russia's lead in introducing a VAT.

Hungary has a General Turnover Tax (GTT) which is similar to VAT. It is paid on goods and services at a 25% rate; imports are taxed but exports are not.

Poland

Under the Polish corporate tax law passed 15 February 1992 but effective 1 January 1992, the corporate tax rate is set at 40%; this should be reduced to 35% in 1993 and to 30% in 1994. Companies operating in depressed areas receive reduced rates. Employers pay 47% of gross salary as a contribution to social insurance. Losses can be carried forward three years. The withholding tax on income from dividends and shares is 20%.

The personal income tax, effective 1 January 1992, has rates ranging from 20% to 40%. People residing in Poland for more than 183 days are considered residents and are taxed on their worldwide income; otherwise they are taxed only on their Polish-source income.

Poland should be introducing a VAT sometime during 1993 which will replace the high sales (or turnover) taxes. There is a 5% sales tax on processed foods and some commodities; luxury goods are also subject to high sales tax effective 1 April 1992.

Poland does have a tax treaty with the United States, but a new one should be negotiated after the tax situation settles.

Former Soviet republics

Prior to the break-up of the Soviet Union, the individual republics imposed their own taxes in addition to those of the Union, although these taxes did not differ greatly between republics. Even now, the republican tax laws are very similar, the biggest differences coming in the area of tax holidays and incentives granted to foreign investors (discussed below).

Corporate profit taxes vary slightly from republic to republic. In general, the tax is on the gross income of businesses, less specified deductions; wages paid over a certain norm are normally not deductible but social insurance costs are. Effective 1 January 1992, Russia imposes a standard rate of 32%, while investment institutions and brokerage firms must pay 45%. There are also withholding taxes of 15% on income such as dividends and interest and gains on equity holding, but profit from live entertainment with large audiences, for instance, is taxed at 70%. Five year loss carryforwards are available under certain circumstances. Ukraine sets a basic rate of 28%, but sets much higher rates on brokering operations and casinos; Ukraine also has a withholding tax rate of 15%.

Income taxes are levied in most of the former republics on both the nationals and foreigners resident in the republic (residing in the republic for more than 183 days of the year). In Russia, the rates vary from 12% to 40%, where most foreigners would fall in the 40% category. The top Ukrainian income tax rate is 30%, but is levied at a lower wage than is Russias top rate.

Many of the republics of the FSU have taken Russia's lead in introducing a VAT. The Russian VAT is different from EC-style VAT in that Russian law does not permit recovery of VAT on any fixed asset purchases. The VAT is payable in the currency of sale. In Russia in 1992, the VAT is 28% on most goods; the rate will lowered in 1993 to 20% (the VAT on children's clothes will fall to 10%). Certain basic food products are taxed currently at a 15% rate; this rate will also be 20% in 1993. Imports and exports are exempt from VAT. Ukraine's VAT is similar to Russia's but instead imposed a rate of 22% on goods and services with deregulated prices and 27% on those with regulated prices. Russia also introduced excise taxes on 19 different goods such as cigarettes, alcohol, and gasoline; because of the high rate of inflation, the duties are fixed as a percentage of the price (ranging from 10% to 90%). Ukraine levies excise taxes on alcohol, chocolate, caviar, tobacco, private automobiles, jewelry, china, carpets, and leather clothing.

All of the former Soviet republics continue to abide by the U.S.-Soviet tax treaty of 1973 (the status of the Baltics, however, is questionable) until treaties signed with the individual countries can go into effect. The United States signed a tax treaty with Russia in June, but it will probably take at least a year before it enters

into force. Ukraine and Kazakhstan are also on the verge of signing a tax treaty with the United States.

Tax incentives for foreigners

It should be stressed that just about all Central and East European governments are very willing to negotiate concessionary tax arrangements with individual foreign firms despite any lack of tax incentives in their laws. Foreign investors operating in so-called "priority areas" are especially needed by these countries and would probably receive tax holidays if there are not laws that already grant them.

The Czech Republic issued special rules early in 1992 giving a one year tax holiday to companies, including joint ventures, whose taxable profits do not exceed K1 million (about $35,000). The rules apply to firms registered between 1 January 1991 and 31 December 1992. In addition, a two year tax holiday is received by firms whose activities are at least 75% in priority sectors, such as environmental protection (such as hazardous waste management and environmental clean-up). The new Czech and Slovak tax legislation, effective 1 January 1993, will eliminate special incentives for joint ventures, though there should still be incentives, in general, for operating in depressed areas, priority areas, and heavily polluted areas. The Czech and Slovak parliaments will most likely also pass laws making tax holidays possible in their respective republics.

Hungary will eliminate all tax holidays for new foreign ventures by 1 January 1994. Until that time, joint ventures having at least 30% foreign ownership, deriving more than half of their income from production, and having an equity capital of at least 50 million forint

Taxes in the former Soviet Republics

Country	Date of Enterprise Tax Law	Enterprise tax rate	Personal Income tax rate (top)	VAT	Excise taxes?	Tax incentives for foreign ownership?
Armenia	23 Jan 92	25%	na	28%	yes	yes
Azerbaijan		35%	55%	na	na	yes
Belarus	March 92	30%	50%	28%	yes	yes
Estonia	15 Oct 91*	35%	50%	18%	yes	yes
Georgia		na	na	28%	yes	na
Kazakhstan	4 Feb 92	35%	30%	28%	yes	yes
Kirghizstan	Spring 91	35%	na	28%	yes	yes
Latvia	11 July 92	35%	35%	12%	yes	yes
Lithuania	6 Feb 92	see note**	33%	18%	na	yes
Moldova	Oct 90	48%	na	28%	yes	yes
Russia	27 Dec 91	18%	40%	28%†	yes	no
Tadzhikistan	27 Feb 91	45%	na	28%	na	yes
Turkmenistan		negligible	na	28%	na	na
Ukraine	21 Feb 92	18%	30%	22%	yes	yes
Uzbekistan	15 Feb 91	45%	50%	30%‡	na	yes

* Most taxes were increased to the levels listed in amendments of June, 1992.
** Rates vary from 10% to 30% and frequently more when a combination of rates is used; rates depend on sector, amount of profits used for investment, number of handicapped employees, etc.
† Rate will decrease to 20% in 1993, 10% for children's clothing.
‡ Rate does not apply to retail trade and services.

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In Poland, foreign investors should negotiate with government officials for any tax concessions for which they may be eligible.

(about $650,000) qualify for a 60% tax holiday for the first five years and 40% for the next five years. In addition, these same joint ventures, if operating in priority sectors such as electronics or machine tools, receive a 100% tax holiday for the first five years and 60% for the next five years. Tax breaks are also offered to firms operating in depressed areas. Hungarian companies receive tax credits for profits reinvested in Hungary by foreign shareholders. Again, these credits will end beginning in 1994. Firms qualifying for any of these benefits prior to the end of the 1993 will continue to receive them for the indicated period of time even after the start of 1994. Companies considering investing in Hungary should therefore keep this date in mind.

Poland does offer tax holidays for investments in depressed areas and for large investments that provide for technology transfer or export-oriented production. Joint ventures with foreign participation had qualified for three year tax holidays, but it is unclear whether these holidays are still available. Individual foreign investors should negotiate with government officials in any case for any tax concessions for which they may be eligible.

Foreign investors still receive many tax breaks in several of the former Soviet republics, although Russia has eliminated tax holidays for foreign investment. For instance, in Ukraine, joint ventures with more than 20% foreign share and fully owned subsidiaries are exempt from profit tax for five years (three years if in the wholesale or retail trade sector and two years if engaged in brokering). Thereafter, the base tax rate is reduced by 50% for enterprises engaged in production (30% if engaged in other activities). Ukraine grants many other concessions to foreign investors.

Kazakhstan grants five-year tax holidays to joint ventures with more than 30% foreign share and fully owned subsidiaries engaged in nine priority areas of production (consumer goods, food processing, electronics, biotechnology, medical equipment, pharmaceuticals, construction materials, resource recovery and recycling, and production based on Soviet inventions). Their tax rates are reduced by 50% for an additional five years thereafter. Belarus offers joint ventures with more than 30% foreign ownership and fully owned subsidiaries three-year tax holidays; thereafter, the authorities may grant, on a case-by-case basis, a reduction in the base tax rate of 50% for an additional three years. Lithuania offers a reduction in taxes paid on the share of profit paid to the foreign investor ranging from 70% to 50% depending on when the joint venture is registered. ◊

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