Tax incentives fall short

Taxation is one of the tools used by central and eastern European countries to stimulate foreign investment. But, in most cases these have failed to achieve the desired results as Gabriella Erdös of KPMG's International Tax Centre reports

At the end of the 1980s economic priorities drastically changed in central and eastern Europe. The newly declared aims, such as transformation to a market economy, joining up to the EU or making the branches of economy competitive on the international market made the stimulation of investments an inevitable question for all the countries of the region.

As the resources of these countries were insufficient to realize these aims (or even to dream about their realization) special attention was paid to attracting foreign investors.

Mistaken incentives

Most of the tax laws have introduced generous tax incentives (eg lower rates and tax holidays of five to 10 years) for joint ventures.

But, because of a lack of experience and the lack of understanding of investors' motives, these measures were often introduced in an inappropriate way without examining interactions with other regulations. In many cases they could not fulfil their intended stimulation function.

Probably the most common example exists where tax holidays are granted from the date of the start of the activity, not taking into consideration possible start-up losses. Sometimes a loss carry-forward provision is in force. This may mean that the company will not have a positive taxable base in the first few years. It would, therefore be unable to benefit from the incentive.

Tax incentives granted to joint ventures have also led to unexpected results. Many joint ventures have been registered with the minimum amount of capital required by law (usually only a few hundred dollars for the foreign person involved). The company is then able to benefit from the tax incentives granted to joint ventures, achieving competitive advantages in this way over other domestic companies.

Countries have also realized the existence or non-existence of tax incentives is not a point of primary importance for making investment decisions. Many other considerations such as stability, infrastructure, and breaking into new markets have priority over taxation.

Another problem is that the first wave of investments were directed primarily towards sectors which gave a quick turnover and not to sectors which had a major importance for the economy of the country.

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Meanwhile, these countries have had to face wider problems such as growing unemployment, a deepening gap between developed and underdeveloped areas, dwindling hard currency resources, increasing foreign debt obligations and negative economic growth.

Targeted incentives

These and similar experiences have changed the emphasis away from incentives for joint ventures towards incentives for companies investing in certain branches of the economy and in certain geographic areas.

The remaining incentives granted exclusively to foreign investors have aimed at encouraging only large scale investments and have been granted on a case-by-case basis.

There are significant differences in the practice of each region of central and eastern Europe. Therefore it is logical to form groups on a geographic basis (which, in most cases indicates a common historical, cultural and legal background) and examine the trends and the individual tax incentives within the group.

This first of two articles gives an overview of tax incentives in Hungary, the Czech Republic, Slovakia and Poland. Countries of the central European group have a relatively long experience with tax reform. They are the so called 'leading reformers', those countries which first decided to open their economies to foreign investment.

All of them granted a large scale of tax incentives in their early corporate income tax and foreign investment laws, most directed exclusively to foreign investors. However, they have now begun to reduce the number of tax incentives during the recent years and change from investor specific incentives to activity specific ones.

By now these countries have made tax incentives exceptional instruments for encouraging specific projects and creation of employment. The trend of granting fewer and fewer tax incentives was almost uniform until the end of last year.

The Czech Republic declared neutrali-

ty as a main principle in its new income tax code introduced in 1993. Hungary has decided to withdraw tax incentives for foreign investors as of the beginning of 1994. Poland grants tax exemption only exceptionally, for large scale investment.

Only Slovakia, which suffered from insufficient foreign investment after the split from the Czech Republic, has decided to give up the principle of competition neutrality and introduce a number of tax incentives in 1993.

This year Hungary has broken the trend by introducing the possibility of tax incentives for large-scale investors and offshore companies. The Czech Republic has also introduced some allowances for dividend distributions and assets other than those purchased for lease.

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The Czech Republic

The only tax holiday available under Czech laws is a five year tax exemption for certain energy producers from the start of their activities.

The 1994 amendments to the Income Tax Code have introduced several new rules to reduce the overall tax burden on distributed dividends.

As a result of the amendments, dividend distributions are now subject to a final withholding tax only once, even if they are redistributed again.

For example, in the case of a parent-daughter-granddaughter company chain, the distribution from the granddaughter to the daughter is subject to withholding taxation, while the redistribution from the daughter to the mother is exempt. In addition, 50% of the tax withheld by the payor is deductible from its corporate income tax liability.

A recently-enacted provision of the income tax code is intended to encourage companies to invest in new assets: a tax allowance amounting to 10% of the purchase price of machinery and equipment is granted to the first owner of the assets if they are not sold or leased on within three years.

Slovakia

Slovakia has voted for another solution. The country gave up the policy of tax neutrality and introduced several types of incentive for legal entities established after December 31 1992.

These incentives depend on the activity, the headquarters and the extent of foreign investment in the company. The major incentives can be summarized as follows:

- commercial companies are entitled to a tax holiday in the first year of their income tax liability;
- commercial companies other than banks and financial institutions with a foreign participation of at least 30% or at least Dm1 million (US$570,000) foreign capital are, in addition, entitled to a reduced rate of income tax not exceeding 30% in the following two years;
- if at least 75% of the employees of a company are employed in an underdeveloped area as described in the regulation, and either the headquarters of the company is in that area or the profits saved through the tax incentives are reinvested in the area, a tax holiday of two years is granted;
- if such a company has foreign participation (under the conditions described above) the tax rate of two periods following the tax holiday may not exceed 20%;
- banks are also entitled to the initial tax holiday of one year and the tax rate applicable to them may not exceed 30% in the next two years (five years in the towns of Banska Bystrica and Zvolen); and
- banks with at least 75% foreign capital qualify for an additional 75% reduction of their taxable base in the next nine years provided the foreign capital contribution is deposited in Slovak financial institutions and loaned to Slovak companies.

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Hungary

Corporate tax liability may be reduced by the use of five major types of tax incentives. These are the joint venture incentive; the incentives concerning certain economic policy priorities; the large scale investment incentives; the tax allowance for employing unemployed personnel; and the offshore company incentive.

The tax exemption for reinvested profits, the tax allowance concerning certain cultural and sport activities and the incentive granted to entities with foreign participation have been withdrawn as of January 1 1994.

However, companies which were entitled to the joint venture incentive may continue to benefit from it providing the conditions are met. Companies which have applied for court registration and began their investment in an activity of specific importance before the end of 1993 may also benefit from the joint venture incentive.

An enterprise with foreign participation of at least 30% may reduce its tax liability by 60% in the first five years of activity and by 40% in the following five years (the reduction is increased to 60% or 100% with respect to activities of specific importance and activities in underdeveloped areas) if more than 50% of its annual sales proceeds are derived from self-manufactured products, or from the operation of self-constructed hotels, and the share capital exceeds Ft50 million (US$485,000).

A tax allowance is granted in proportion to capitalized interest and deducted interest expenses for credits financing

investments or used for achieving certain economic policy priorities.

These priorities include expanding the marketability or increasing the volume of exportable commodities, water quality and environmental protection. Probably the most important from this group of incentives is a new tax credit granted to any company using credits for financing investment. The incentive is equal to 38% of capitalized interest or 25% of the deducted interest expenses.

By using this incentive the effective interest burden on investment credits may be reduced. Loans are expensive in Hungary. The average interest rate on commercial loans is around 35%.

New incentives

As of January 1 1994 two new types of large scale investment incentive have come into force. An incentive may be granted by the government to companies with a share capital of at least Ft100 million if an amount of at least Ft25 million from the distributed dividend is reinvested.

This incentive is available provided the whole amount or a part of it is used to increase the share capital and the share capital so increased is not reduced (nor is the company split or demerged) for five years following the reinvestment.

The government may also grant tax incentives to companies with a share capital of at least Ft500 million for investments of at least Ft200 million.

This incentive is available on condition that, as a result of the investment, at least half the company's turnover is derived from the production or sale of environment-friendly products produced with modern technology, and the sale increases export revenues or creates new jobs.

Both tax incentives may be granted for a maximum period of 10 years. The incentives may not exceed 100% of the tax liability in the first five years and 60% in the second five years. The actual period and rate is established by the government on an individual basis.

Offshore opportunities

Becoming an offshore centre is something of a recurrent dream of Hungarian legislators and appears again and again in Hungarian law. Some years ago the foreign investment law introduced the possibility of establishing companies in duty-free territories or granting a 'semi offshore' status to them.

The 1991 foreign investment law has abolished all the previously granted tax holidays in Poland. The only incentive still available for joint ventures is a discretionary one

At the beginning it had a lot of advantages but in the course of the next few years the advantages became less and less attractive.

The 1994 amendments to the corporate income tax law introduced a new form of offshore companies (the law also calls them 'foreign investors', which may be a bit misleading) and granted them a tax allowance of 85% by way of tax credit. This means that the effective tax rate for companies qualifying for the offshore company incentive is reduced to 5.4%.

A limited liability or joint stock company which is 100% foreign owned is treated as an offshore company for income tax purposes if it satisfies a number of conditions. First, the company must hold an off-shore permission granted by the Minister of Finance.

Secondly, it must be engaged solely in trading or providing services (excluding financial services) to third countries. In addition, the majority of its managing staff and personnel must be Hungarian, it must be represented by Hungarian lawyers, and the obligatory audit must be made by a licensed auditor (or firm) resident in Hungary.

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Furthermore, the company's operative bank accounts must be kept in Hungary. The owners (including indirect owners) of the company must all be foreign and neither the company nor its owners may have interest in other Hungarian entities or permanent representation in Hungary.

To encourage the employment of those previously unemployed, companies may deduct an amount equal to 70% of the social security contribution paid in the last 12 months from their taxable base provided the individual was registered as unemployed for at least nine months and no one having the same type of job was dismissed in the period beginning six months before the employment of the unemployed person.

Poland

The 1991 foreign investment law has abolished all the previously granted tax holidays. The only incentive still available for joint ventures is a discretionary one (the discretion is wielded by the Minister of Finance and companies must fulfil stringent conditions).

The amount of investment must exceed ECU2 million (US$1.8 million), the share capital may not be reduced for two years and at least 20% of the products must be exported to qualify for the incentive.

Poland now grants tax exemptions only for agricultural and forestry activities. Certain tax allowances are available for companies operating in areas of high unemployment and creating new workplaces or if 50% of the personnel was previously unemployed.

The 1994 tax proposals contain some new investment allowances. Qualifying entities may deduct purchase or leasing expenses of certain specified assets up to 25% of the taxable base. Entities deriving at least 60% of the turnover from export may deduct such expenses up to 50% of the taxable base.

If approved these incentives will be applicable with a retroactive effect from January 1 1994. ❑

Next month: Part II of the central and eastern European tax incentive survey. Developments in Bulgaria, Romania, Estonia, Latvia, Lithuania, Kazakhstan and Russia will be analyzed.