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The Baltics - a new tax heaven?

As calls for more taxation harmonization by some EU member states increase, the Baltic states, and especially Estonia, have been in the international limelight due to their low corporate income tax.

However, the general discussion at the European level is riddled with misconceptions about the Baltic states? taxation systems that should be corrected.

Estonia employs a rather unusual income tax for corporations. Instead of annual taxation of profit, the corporate income tax is based on payments out of the corporation, while reinvested profits are left untaxed. Thus in Estonia the corporate income tax is paid when payments are made out of the corporation by way of dividends (dividend tax), most fringe benefits to staff, hospitality costs, donations, etc. The current rate of the tax is 26/74 of the net amount paid ? i.e., 26 percent of the gross amount. The Estonian government plans a general tax reduction that would bring the tax rates in Estonia down to 20 percent by the year 2007.

It should be noted that changes to Estonian tax systems are anticipated by the end of the year 2008, when the Estonian transition period for the Parent-Subsidiary Directive ends. The directive provides a participation exemption whereby taxation based on distribution of profit to parent companies is prohibited, making it impossible for Estonia to levy the current dividend tax. Whether this forces Estonia to return to a more traditional model of corporate income tax or if the Estonian Ministry of Finance comes up with yet another novel tax system remains to be seen.

Latvian and Lithuanian corporate income taxation follows more traditional models. However, both use a rather low ? 15 percent ? tax rate. While receipt of dividends incurs an additional tax, the participation exemption required by the Parent-Subsidiary Directive will remove the tax on dividends in most cross-border investment situations.

None of the Baltic countries fits into the traditional concept of a tax haven. The tax rates, while low, can hardly compete with the tax rates of offshore tax havens. Another traditional tax haven, benefit of anonymity and secrecy, is also absent in the Baltic states. Baltic tax authorities would no doubt cooperate fully with other EU member state tax authorities. However, as an advantage for a company interested in tax optimization, the Baltic states do have a growing network of tax treaties.

Even though not tax havens per se, Estonia, Latvia and Lithuania may be caught in the ?anti-tax haven? legislation of some countries. This has been a problem in Finland, where in principle any Finnish controlled foreign company with an annual corporate income tax less than 17.4 percent may allow the tax authorities to tax the income of the foreign company as the income of the Finnish shareholders. In practice, however, the Finnish tax authorities seem to be rather hesitant in the use of this possibility as regards Finnish controlled Baltic corporations. Still, the uncertainty of the situation makes it difficult for Finnish controlled companies to utilize the tax benefits offered by the Baltic states in full. Ironically, Estonia faces a similar problem in Lithuania.

In conclusion, while the tax level in the Baltic states may look like a tax heaven compared withmuch of the rest of the EU, the Baltic states can hardly be described as such in the traditional sense. And while the beneficial tax systems in the region may offer some tax optimization possibilities for corporations present in the region for other business purposes, it is unlikely that the tax benefits are sufficient to warrant the use of a region solely for tax optimization purposes on a bigger scale. o

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