

Comparative Analysis of Tax Systems: Some Evidence from CEE Countries

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Abstract—During last decades is widely discussed the international harmonization of financial reporting. This harmonization is also affected by national tax systems in analyzed countries. This paper provides some evidence on current national tax systems in selected countries in Central and Eastern Europe. The linkage of accounting profit as a tax base might decrease the administrative burden for majority of SMEs, which are the most important engine of each national economy.

Keywords—International harmonization, tax system, SMEs, Czech Republic, Slovakia, Estonia, Latvia

I. INTRODUCTION

SECTOR of SMEs plays a crucial role in national economies; it is a driving force of business, of growth, innovations and competitiveness. It plays a decisive role in job creation and, in general, is a factor of social stability and economic development. On the other hand, SMEs have often difficulties to obtain capital or credits which are caused by the continuing unwillingness of financial markets to take the risk and through insufficient guarantee which SMEs can offer to banks. Limited sources of financing can also make the approach to more information difficult, especially information on new technologies and potential markets.

European Union divides SME companies onto following three groups:

- micro entities
 - with less than 10 persons employed
 - annual turnover of up to 2 million EUR or a balance sheet total up to 2 million EUR
- small enterprises
 - with 10-49 persons employed
 - annual turnover of up to 10 million EUR or a balance sheet total up to 10 million EUR
- medium-sized enterprises
 - with 50-249 persons employed
 - annual turnover of up to 50 million EUR or a balance sheet total up to 43 million EUR

Together with these indicators, SMEs should also fulfill a criterion of independence, which means that no other subject

should participate in its basic capital or voting rights by more than 25 %.SMEs sector forms as much as 99 % of business entities around the world. Table 1 provides European evidence on the share of SMEs.

TABLE I
SHARE OF SMEs AMONG ALL ENTERPRISES (YEAR 2007, IN %)

| | Enterprises | Value added | Persons employed |
|---------------------------------|-------------|-------------|------------------|
| Mining & quarrying | 98.9 | 34.6 | 33.8 |
| Food & beverages | 99.1 | 47.7 | 62.8 |
| Tobacco | 79.4 | 6.2 | 15.5 |
| Textiles & leather | 99.5 | 73.9 | 76.2 |
| Wood & wood products | 99.8 | 76.2 | 84.1 |
| Pulp & paper products | 97.1 | 41.1 | 54.1 |
| Publishing & printing | 99.7 | 61.9 | 72.5 |
| Coke, petroleum & nuclear fuel | 91.5 | 10.0 | 15.3 |
| Chemicals & man-made fibres | 95.7 | 26.2 | 35.5 |
| Rubber & plastics | 98.5 | 57.3 | 63.8 |
| Other non-metallic minerals | 99.1 | 52.0 | 62.6 |
| Basic metals | 95.3 | 24.7 | 33.2 |
| Fabricated metal products | 99.7 | 78.2 | 82.8 |
| Machinery & equipment | 98.7 | 49.7 | 56.4 |
| Office machinery & computers | N/A | 32.5 | 47.4 |
| Electrical machinery | 98.4 | 36.9 | 43.2 |
| Radio, TV & telecoms equipment | 98.5 | 24.3 | N/A |
| Instruments, watches & clocks | 99.4 | 48.8 | 63.9 |
| Motor vehicles | 93.9 | 11.6 | 18.1 |
| Other transport equipment | 98.3 | 20.4 | 28.6 |
| Manufacturing | 99.6 | 74.8 | 76.7 |
| Electricity, gas & steam | 97.6 | 23.9 | 18.6 |
| Water supply | 96.6 | 33.6 | 37.5 |
| Construction | 99.9 | 82.8 | 88.0 |
| Motor trades | 99.9 | 78.9 | 87.5 |
| Wholesale trade | 99.8 | 76.8 | 81.3 |
| Retail trade | 99.9 | 55.2 | 63.7 |
| Hotels & restaurants | 99.9 | 75.9 | 82.2 |
| Land transport; pipelines | 99.9 | 60.2 | 65.1 |
| Water transport | 99.4 | 65.2 | 58.2 |
| Air transport | 96.2 | 18.1 | 8.9 |
| Support. transp.; travel agents | 99.4 | 43.7 | 54.2 |
| Communications | 99.2 | 6.9 | 12.8 |
| Real estate | 99.9 | 87.7 | 86.4 |
| Renting | 99.9 | 74.9 | N/A |
| Computer services | 99.8 | 58.5 | 69.0 |
| R&D | 99.4 | 43.1 | 54.2 |
| Other business activities | 99.8 | 69.3 | 62.8 |

Source: [3]

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Majority of labor force is employed in SMEs. Following tables (Table II and Table III) provides evidence about the labor productivity with respect to the size of entity, and employment breakdown with respect to the size of entity in the European Union.

TABLE II
LABOR PRODUCTIVITY BY ENTERPRISE SIZE (YEAR 2007, EUR 1000 PER
PERSON EMPLOYED)

| | micro | small | medium | SMEs | large |
|-----------------------------------|-------|-------|--------|-------|-------|
| Mining & quarrying | 257.0 | 85.3 | 125.7 | 134.8 | 130.2 |
| Food & beverages | 24.1 | 30.4 | 39.7 | 32.5 | 60.0 |
| Tobacco | 10.3 | 80.2 | 62.7 | 61.7 | 172.1 |
| Textiles & leather | 17.2 | 25.2 | 24.2 | 23.0 | 26.1 |
| Wood & wood products | 21.7 | 31.4 | 36.5 | 29.3 | 48.5 |
| Pulp & paper products | 28.3 | N/A | 51.9 | 43.9 | 73.3 |
| Publishing & printing | 34.2 | 45.7 | 54.2 | 44.8 | 80.0 |
| Coke, petroleum & nuclear fuel | 58.0 | 134.3 | 120.1 | 117.9 | 191.7 |
| Chemicals & man-made fibres | 75.4 | 61.5 | 83.5 | 77.0 | 119.1 |
| Rubber & plastics | 32.3 | 39.8 | 45.3 | 41.9 | 54.9 |
| Other non-metallic minerals | 26.2 | 44.1 | 52.6 | 43.7 | 68.3 |
| Basic metals | 31.6 | 54.9 | 65.2 | 59.8 | 90.4 |
| Fabricated metal products | 31.5 | 43.2 | 46.4 | 41.3 | 53.0 |
| Machinery & equipment | 35.7 | 48.5 | 54.2 | 49.3 | 64.6 |
| Office machinery & computers | 36.8 | 47.7 | 54.2 | 43.3 | 80.8 |
| Electrical machinery | 31.1 | 44.0 | 48.9 | 44.5 | 53.0 |
| Radio, TV & telecoms equipment | 35.7 | 54.4 | 50.0 | 48.7 | 83.3 |
| Instruments, watches & clocks | 31.1 | 47.8 | 58.7 | 47.1 | 79.6 |
| Motor vehicles | 34.1 | 44.8 | 45.3 | 44.2 | 74.4 |
| Other transport equipment | 29.3 | 42.5 | 45.3 | 41.9 | 65.6 |
| Manufacturing | 22.9 | 35.1 | 37.4 | 34.1 | 37.9 |
| Electricity, gas & steam | 327.0 | 152.6 | 142.9 | 211.1 | 153.4 |
| Water supply | 87.0 | 67.0 | 48.3 | 56.1 | 72.5 |
| Construction | 30.2 | 39.4 | 43.9 | 35.8 | 54.4 |
| Motor trades | 26.9 | 38.4 | 52.9 | 35.6 | 66.7 |
| Wholesale trade | 39.2 | 57.1 | 67.6 | 52.5 | 68.8 |
| Retail trade | 18.1 | 26.9 | 27.8 | 21.3 | 30.4 |
| Hotels & restaurants | 16.3 | 20.7 | 25.7 | 19.0 | 27.8 |
| Land transport; pipelines | 27.2 | 36.2 | 37.3 | 32.4 | 39.8 |
| Water transport | 135.1 | 133.7 | 123.6 | 130.4 | 96.7 |
| Air transport | N/A | 151.5 | 198.0 | 155.4 | 68.8 |
| Support. transport; travel agents | 45.6 | 53.1 | 56.0 | 52.2 | 75.0 |
| Communications | 42.8 | 53.3 | 52.5 | 44.5 | 89.0 |
| Real estate | 96.8 | 86.6 | 103.7 | 95.8 | 86.0 |
| Renting | 110.6 | 93.2 | 162.3 | N/A | N/A |
| Computer services | 43.8 | 60.6 | 73.2 | 56.6 | 92.5 |
| R&D | 34.1 | N/A | 59.9 | 41.7 | 65.2 |
| Other business activities | 40.3 | 50.4 | 39.9 | 42.8 | 32.0 |

Source: [3]

This paper provides evidence on tax system in selected CEE countries (Czech Republic, Slovakia, Estonia and Latvia) with the purpose to point out the difference in tax systems of these countries.

TABLE III
EMPLOYMENT BREAKDOWN BY SIZE OF ENTERPRISE (YEAR 2007, IN %)

| | Size of enterprise | | | | |
|-----------------------|--------------------|-------------|-------------|-------------|-------------|
| | micro | small | medium | SMEs total | large |
| <i>European Union</i> | 29.5 | 20.6 | 17.0 | 67.1 | 32.9 |
| Austria | 25.0 | 23.2 | 18.9 | 67.1 | 32.9 |
| Belgium | 29.5 | 21.4 | 15.5 | 66.4 | 33.6 |
| Bulgaria | 26.0 | 23.3 | 24.0 | 73.3 | 26.7 |
| Cyprus | 39.3 | 24.1 | 20.0 | 83.4 | 16.6 |
| <i>Czech Republic</i> | 28.9 | 18.5 | 20.1 | 67.5 | 32.5 |
| Denmark | 19.7 | 25.2 | 21.0 | 66.0 | 34.0 |
| Estonia | 24.6 | 27.6 | 26.3 | 78.5 | 21.5 |
| Finland | 23.0 | 19.1 | 17.7 | 59.8 | 40.2 |
| France | 24.3 | 20.4 | 15.8 | 60.5 | 39.5 |
| Germany | 19.1 | 21.6 | 19.6 | 60.4 | 39.6 |
| Greece | 57.5 | 17.4 | 10.7 | 85.6 | 14.4 |
| <i>Hungary</i> | 35.1 | 19.3 | 16.7 | 71.2 | 28.8 |
| Ireland | 19.4 | 25.7 | 24.1 | 69.3 | 30.7 |
| Italy | 46.6 | 22.1 | 12.4 | 81.1 | 18.9 |
| <i>Latvia</i> | 22.1 | 28.4 | 26.6 | 77.2 | 22.8 |
| <i>Lithuania</i> | 23.6 | 25.6 | 26.2 | 75.4 | 24.6 |
| Luxembourg | 18.4 | 24.2 | 23.7 | 66.3 | 33.7 |
| Malta | N/A | N/A | N/A | N/A | N/A |
| Netherlands | 29.3 | 21.7 | 17.2 | 68.3 | 31.7 |
| <i>Poland</i> | 37.9 | 11.4 | 18.8 | 68.1 | 31.9 |
| Portugal | 41.4 | 22.9 | 16.5 | 80.9 | 19.1 |
| <i>Romania</i> | 22.0 | 20.9 | 22.5 | 65.4 | 34.6 |
| <i>Slovakia</i> | 14.7 | 20.4 | 21.6 | 56.7 | 43.3 |
| Slovenia | 28.1 | 18.2 | 20.7 | 67.0 | 33.0 |
| Spain | 38.3 | 24.5 | 14.8 | 77.6 | 22.4 |
| Sweden | 24.4 | 21.0 | 18.3 | 63.7 | 36.3 |
| United Kingdom | 21.5 | 17.4 | 15.2 | 54.1 | 45.9 |

Source: [3]

II. LITERATURE REVIEW

The separation of tax statements and financial statements is common practice in many countries, e.g. USA. European countries have discussed abolishing book-tax conformity. E.g. Spain has relaxed the strong link between tax accounting and book accounting; France and Austria are discussing clearer separations of their accounting systems in the future [2, 16, 26].

A large strand of literature has examined the connections between tax and financial accounting. Many authors identify increasing divergence in reported financial and taxable income [1, 25]. [5, 8, 15, 19, 20, 23, 24] discuss costs and benefits of a possible book-tax alignment. All of them emphasize disadvantages of such a development. [10] identify a strong tax influence on financial accounting regulations in Germany. Compared to other countries, [4] describe a (implicit) strong emphasis on the conservatism principle in German financial accounting regulations, which is partly due to its closeness to tax accounting. [9] discuss investment incentives caused by a one-book or a two-book accounting system. [12, 13] provide an overview of the literature dealing with the developments in national financial reporting systems.

[18] provide a framework for measuring tax rate and tax-

base effects and discuss the optimal complexity of taxable income. [17] empirically measures the complexity of the tax systems of US states. [7] find that nonuniformity among US states' tax systems increases corporations' compliance cost burdens; [11] identifies ongoing nonconformity and concludes that compliance costs will remain "needlessly high". Transferring these findings to the current German situation, one might argue that reporting three parallel income statements as it is required induces high compliance costs.

We can find a number of qualitative papers dealing with possible new determinations of taxable income for German companies. However, analyses quantifying the effects of alternative tax bases on the tax burden of companies are rare. Quantitative evidence is provided by [2, 6, 14, 21]. [6] analyzes differences between US GAAP and the current German tax base and finds that German companies would save taxes if German taxable income was connected to US GAAP. [21] finds that the tax burden of companies would decline if uniform accounting based on IFRS was implemented. In Austria, [2] uses a business model simulation to analyze various tax bases, including the IFRS and US GAAP. But according to the most recent publications, there will be no uniform accounting based on IFRS or US GAAP either in Austria or in Germany.

III. COUNTRY STUDIES

A. Czech Republic

According to Czech tax system, we can identify three groups of taxes there:

- *direct taxes*
 - income taxes
 - individuals
 - legal entities
 - capital levies
 - property tax (land, buildings)
 - road tax
 - other
 - legacy duty
 - gift tax
 - estate tax
- *indirect taxes*
 - VAT
 - consumer taxes (petroleum, alcohol, tobacco, duty)
 - green taxes (electricity, gas, solid fuel)
- *other taxes*
 - municipal taxes
 - social insurance

Value added tax (VAT) is treated by VAT Act, which was harmonized to the requirements of 6th E.U. Directive. Currently there are valid following rates:

- basic rate (20 %)
- reduced rate (10 %)

Due to the reform of pension system, there is expected that

from 2012 on all goods and services will be applied the basic rate, with the exception of seven basic consumables (bread, milk, potatoes, selected vegetable, selected fishes, milk-based baby foods, dietary consumables). The new flat rate is still under negotiation.

All companies have to pay their income tax based on Income Tax Act. Current rate of income tax for companies is 19 %.

Calculation of the tax is based on the accounting profit. The adjustments of accounting profit to reach the tax base are following [22]:

| | |
|---|--|
| | Revenues |
| - | Costs and expenses |
| = | Accounting profit before tax |
| + | Tax ineffective costs and expenses <ul style="list-style-type: none"> • travel allowances higher than the limit defined in Labour Code • representation costs • other social expenses • donations • penalties • shortage of stocks (exceeding the compensation), • calculation of provisions not based on Act on Provisions • calculation of impairment not based on Act on Provisions • positive difference between accounting and tax depreciation (amortization) |
| - | Tax ineffective revenues <ul style="list-style-type: none"> • uncollected penalties |
| = | Tax base I |
| - | Loss from previous years |
| = | Tax base II |
| - | Donations <ul style="list-style-type: none"> • minimum amount of 1 donation = 2,000 CZK, • maximum amount of all donations = 5 % of Tax base II |
| - | Other deduction based on Income Tax Act |
| = | <i>Tax base</i> |
| | Rounded tax base (on thousands of CZK lower) |
| * | Tax rate (19 %) |
| = | Income tax of the company |
| - | Tax allowances |
| = | FINAL INCOME TAX OF THE COMPANY |

Individuals have to pay income tax of 15 %. As individuals are taxable all partnerships

Income tax also discussed the tax depreciation of fixed assets. They are divided onto 6 groups. Assets in group 1 are depreciated for 3 years, in group 2 for 5 years, in group 3 for 10 years, in group 4 for 20 years, in group 5 for 30 years, and in group 6 for 50 years. There is possible to use two methods for tax depreciation, i.e. linear method and regressive method.

B. Slovakia

The Slovak tax system includes the following taxes:

- personal income tax,
- corporate income tax,
- value added tax,
- excise tax,
- property tax,
- vehicle tax,
- local taxes, and
- administrative fees.

Companies registered or having headquarters in the Slovak Republic are subject to Slovak corporate income tax. A permanent establishment may be registered in the Commercial Register in the Slovak Republic as an organizational component of a foreign subject, or may be registered only for tax purposes. A permanent establishment arises if the performance was provided in the Slovak Republic for more than six months in a period of twelve consecutive months. A permanent establishment is also created if a certain place is available from which a foreign company carries out business activities in the Slovak Republic. A permanent establishment must be registered not earlier than thirty days after the foundation. The foundation of permanent establishment is dependent on the provisions of existing agreements on abolishing double taxation. All employees of a permanent establishment are subject to Slovak income tax. The registration of companies liable to tax must follow within thirty days after obtaining a trade license for business activity in the Slovak Republic. Each company is required to inform the tax authorities of any changes in registration data within fifteen days. Agreements on abolishing double taxation concluded between the Slovak Republic and the western states correspond to the OECD model agreement.

Corporate income tax is levied on legal entities with establishment or headquarters in the Slovak Republic. They are required to tax income derived from Slovak and foreign sources. Other legal entities are obliged to tax income derived from Slovak sources. The incomes from the distribution of company profit (e.g. dividends) are basically not subject to taxation. The tax base is composed principally of gross income after deduction of expenses, but must be reduced or increased by certain prescribed statutory items. The tax rate is 19% of the tax base. Expenses on achieving, securing and maintaining taxable income are tax deductible if not specifically mentioned as non-deductible or partly deductible. Loss incurred in the year, which passed the recognition of income, may be deducted from the tax base during a maximum of five consecutive years. A company, which was dissolved without liquidation, is usually able to transfer the tax loss deduction to the successor. The tax loss deduction is to be assessed for each year separately. Depreciation is a tax deductible expense. Even and accelerated depreciation is permitted. In accounting, it is possible to use different depreciation rates. Intangible assets are depreciated for tax

purposes in accordance with accounting regulations. In case of the finance lease, the lessee depreciates the leased property.

Taxable persons are registered for *VAT* in Slovakia when the total turnover for the preceding twelve months exceeds 35 000 Euros. The general tax rate is 19%; the reduced rate 10% is applicable to certain products (e.g. books, medical goods). A taxpayer has the right to deduct input VAT relating to the provision of its own taxable fulfillment. Under certain circumstances, the foreign person is entitled to a refund of Slovak VAT.

From 1.1.2011 the temporary increase in the VAT rate from 19% to 20%.

C. Estonia

Estonian taxation system is considered to be simple and liberal. A basic act for all other tax Acts is Taxation Act. It specifies Estonian tax system, requirements for tax Acts, rights, duties and liability of taxpayers, withholding agents, guarantors and tax authorities, and procedure for resolution of tax disputes and main definitions used in all tax acts. Taxation Act provides precise regulation of carrying out administrative procedures of tax authorities and creates stronger sense of reliability for taxpayers. The tax system of Estonia consists of state taxes provided for by relevant taxation acts and local taxes imposed by a rural municipality or city council in its administrative territory pursuant to law.

State taxes are:

- income tax,
- social tax,
- land tax,
- gambling tax,
- value added tax (VAT),
- customs duty,
- excise duties (levied on tobacco, alcohol, electricity, some packaging materials and motor fuel),
- heavy goods vehicle tax,
- unemployment insurance contributions, and contributions to mandatory funded pension.

Local taxes are:

- sales tax,
- boat tax,
- advertisement tax,
- road and street closure tax,
- motor vehicle tax,
- animal tax,
- entertainment tax, and
- parking charges.

Compared to most European countries, the major difference is that income tax has only one general flat rate.

Corporate income tax is 21%, and there is a monthly unemployment insurance tax of 2.8%, which is deducted from salary by employer. An individual's income is taxable at the rate of 21% as well. The tax does not apply to accumulated undistributed profits. The tax applies to an actual distribution

of profits by the company, mainly to a dividend or to gifts and benefits that have been distributed. The tax payable is at the rate of 21/79 of the actual payment (21% of the gross profit).

Estonian resident companies and permanent establishments of the foreign entities (including branches) are subject to income tax only in respect of all distributed profits (both actual and deemed), including:

- corporate profits distributed in the tax period;
- gifts, donations and representation expenses;
- expenses and payments not related to business.

The following taxes are of most importance to an employee: income tax, social insurance, unemployment insurance contributions and contributions to mandatory funded pension.

The standard rate of VAT is 20% (increased in 2009 from 18%). Certain supplies attract a reduced rate of 9%, including books, some periodicals, and certain medicines and medical equipment supplies. The provision of accommodation also qualifies for the reduced rate. International services, international transport services and exports are all zero-rated. VAT returns must be submitted monthly and there are severe penalties for late submission of the returns. Exemptions from VAT include insurance, postal services, financial services, health and education.

Social insurance is a financial obligation which is imposed on taxpayers to obtain revenue required for pension insurance and state health insurance. Social insurance contributions are paid by employers and self-employed persons on their business income and by the state for persons who are enumerated in the Social Insurance Act. The rate of social insurance in Estonia is 33% of the taxable amount. Social tax is paid by employers on all payments made to employees for salaried work performed, as well as 1.4% unemployment insurance. Social tax is not part of the salary number; it is calculated on the basis of the agreed (gross) salary. 13% of the social tax goes to the Health Insurance Fund and 20% goes to pension insurance.

Estonia has been able to maintain a liberal taxation policy. This has ensured the country's rapid development and economic success. Taxation policy is an important instrument for promoting investment and attracting foreign capital. Taxation rules and regulations in Estonia have less influence on general-purpose financial statements than in most EU Member States. This can have a two-fold impact:

- reduced incentives to understate reported net income, and
- reduced enforcement of accounting guidelines in SMEs.

First, in most EU Member States, the option to use either IFRSs or national accounting standards would require tax authorities to ensure that companies that adopt IFRSs for their legal entity financial statements receive broadly equivalent tax treatment as companies that continue to use national accounting standards. For example, tax authorities would have to ensure that financial statements prepared in accordance with either IFRSs or national accounting standards are an

acceptable starting point for computing taxable profits, and ensure specific tax rules continue to allow the special relief and credits, whatever the accounting treatment. Since 2000, the payment of corporate income tax in Estonia is deferred until the moment of distributing the profits, and reinvested profits are not taxable. Therefore, companies in Estonia are less pressured to satisfy the accounting requirements of taxation authorities than in most EU Member States. Second, many EU member states currently have a strong linkage between accounting and taxation. Consequently, tax authorities have traditionally played a significant accounting enforcement role in carrying out tax audits to the point that commercial bankers have often used tax returns more than financial statements in their assessment of SMEs' creditworthiness. Estonian tax rules largely removed the need for tax audits that indirectly contribute to enforcing accounting standards. Hence, compliance with accounting standards in unregulated enterprises merely rests on two pillars (i.e., the auditing profession, if the entity is subject to a statutory audit, and corporate managers, who prepare financial statements). Therefore the weaknesses regarding corporate management and the audit profession are of particular importance to enhance the quality of financial reporting in unregulated enterprises, which account for the larger portion of GDP.

D.Latvia

Taxes and fees system in Latvia consists of

- state taxes, object and rate of which are set by the Parliament – Saeima;
- state fees (over 55 types) which are applicable according to Law "On Taxes and Fees", other laws and regulations of the Cabinet of Ministers;
- local government fees which are applicable according to Law "On Taxes and Fees" and binding regulations issued by the council of local government;
- directly applicable taxes and other obligatory payments set in the European Union regulatory enactments.

The Law on Personal Income Tax and the relevant Cabinet of Ministers regulations govern personal income tax. The law covers tax on private individuals. An individual is a resident of Latvia (and thus fully taxable) in any of the following situations:

- they permanently reside in Latvia;
- they stay in Latvia for 183 days or more in a twelve month period;
- they are Latvian citizens employed in a foreign state by the Latvian Government.

Individual (int. al., who derive his/her income from a business of which he/she is a sole proprietor, i.e. self employed person or individual entrepreneur, or a partner in a partnership) is a subject to personal income tax at a flat rate of 25%. A 10% tax applies to dividend and interest income and a

15% tax applies to capital gains. Under certain conditions, the sale of an individual's primary residence may be exempt.

Corporate income tax is governed by the Law on Corporate Income Tax and the related regulations issued by Cabinet of Ministers. The law applies to domestic and foreign businesses, private individuals and other people (non-residents) who have earned income in Latvia, as well as to permanent representative offices of non-residents. Residents are taxable on worldwide income, non-residents are taxed on income earned in Latvia. Permanent establishments of foreign companies are taxed in the same way as resident companies, but certain restrictions apply to payments made to the head office.

In general, the corporate taxation system incorporates EU Directive requirements. From a flat rate of 25% on January 1, 2002, the Latvian corporate income tax rate was progressively reduced to a flat rate of 15% as of January 1, 2004. The starting point for determination of taxable income is the final result of the annual profit and loss account of the company and making specified taxation adjustments to this figure. During the following years of operations the company should pay every month advanced income tax payments based on its previous year's taxable income. The advanced income tax payments will be taken into account in process of determination of the actual income tax.

Depreciation for tax purposes is calculated on the basis of book value for each category of fixed assets doubled rate of depreciation prescribed in the Law on Corporate Income Tax (Table 2) is applied.

TABLE II
DEPRECIATION RATES FOR TAX PURPOSES

| Group No | Rate | Type of Fixed Assets |
|----------|-------|--|
| 1 | 5 % | Buildings and perennial plants. |
| 2 | 10 % | Railway rolling stock and technological equipment, sea and river fleet vessels, fleet and port technological equipment, power equipment. |
| 3 | 35 % | Computers and related office equipment (printers, software products and data storage equipment, means of communication, copiers etc.). |
| 4 | 20 % | Other fixed assets (except the fixed assets of the 5th category). |
| 5 | 7.5 % | Oil exploration and extraction platforms and ships together with related equipment. |

Revaluation of fixed assets is not allowed for tax purposes. The value of intangible assets for tax purposes is written off

- for concessions – within 10 years;
- for patents, licenses and trademarks – within 5 years.

Research and development costs (except costs of determining the location, quantity and quality of minerals)

should be written off in the year when they are incurred. Expenses directly related to the business activities are tax deductible.

Mandatory social insurance payments are governed by the Law on State Social Insurance and paid by insured persons and their employers. Social security payments cover old age pensions, social insurance in case of unemployment, and social insurance against work accidents, disability, maternity and illness. Total basic rate is 35.09% of an employee's gross salary (24.09% is paid by employer and 11% by employee). Reduced rates apply for certain categories of employees.

The Property Tax Law and the related regulations of Cabinet of Ministers govern the application of property tax, whose rate is currently from 0.1% till 1.5% of the cadastral value of real estate (land and buildings). A 3% tax is levied on agricultural land not in use. The property tax is calculated and collected by local municipalities which have the power to grant taxation reductions to specific categories of individuals.

Indirect taxes

The Law on Value Added Tax and the related regulations of Cabinet of Ministers govern the application of value added tax (VAT). The standard rate of VAT is 22%. Standard rate applies to almost all entities that are subject to VAT and reach or exceed a de minimis level of LVL 10,000 (excluding import) in a 12-month period. On some occasions VAT is applied at a reduced rate of 12% (for example to medical devices, infant food, various newspapers and magazines, public transport, utilities, and some other items). For some items (for instance, export) zero-rate is applied and other are exempt from VAT (for instance, financial and insurance services).

The Law on Excise Duties and the related regulations of Cabinet of Ministers govern the application of excise duties. Excise duty is imposed on oil products, alcoholic and non-alcoholic beverages, and tobacco products. The Latvian excise duty legislation is in line with EU rules.

Customs duty is paid by natural persons and legal entities and imposed on goods imported in Latvia from countries outside of the EU upon their release for free circulation. The duty is based on the common customs tariff applicable in all EU member states.

Other taxes

The Law on Natural Resources and the related regulations of Cabinet of Ministers govern the application of natural resource tax in Latvia. In Latvia natural resources tax is applied to extraction of natural resources, waste storage, air pollution and greenhouse effect gas emissions produced by stationary technological equipment not included in the emission quotas, as well as goods polluting water and environmentally harmful goods, e.g. lubricants and other goods and substances. The tax is paid by legal entities and natural persons if extracting natural resources, distributing or importing environmentally unfriendly goods or which are allowed to perform such activities. The basic rate and

additional rate are prescribed by the law.

Lottery and gambling tax is paid by lottery and gambling providers. The rate depends on the kind of gambling, gambling venue location, gaming equipment and number of participants.

A special tax regime (indirect tax payments and social contributions) applies to the commercial activity of free ports (Riga and Ventspils) and special economic zones (Liepaja and Rezekne) in Latvia. The application of special tax regime is regulated by law.

IV. CONCLUSION

Strength of SMEs (small and smaller medium enterprises in particular) consists in their higher flexibility and to a certain point also in their innovative creativity. Having financial information that is universally understood and comparable to other companies' information can improve relationships with customers, suppliers, investors and bankers. If these business partners have more confidence in the financial information being provided using harmonized reporting system, this can be a crucial factor in securing a new supplier, obtaining finance, reducing the cost of borrowing, and arriving at an acquisition or cooperation agreement.

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