SLOVAK EXPERIENCE WITH MINIMUM CORPORATE INCOME TAX[1]

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Skúsenosti Slovenska s minimálnym zdanením firiem

Abstract: *Minimum corporate taxation has been an issue for international tax research as well as for political tax discussions around the world. It was initially designed to prevent undesired but legally permitted tax avoidance. Over time many countries start to use these concepts to ensure or stabilize their tax revenues. With the aim to tackle widespread presence of corporate income tax non-payers, Slovakia as of 2014 introduced simple minimum corporate tax, domestically called "tax license". Government defended that it will make the tax system fairer on the ground of horizontal equity and it will help to clean up Business register with possible positive effects on audit efficiency. As of 2018 the minimum corporation tax was repealed, and we have four years of its experience which allows us to do research in this area and evaluate its success. Results of our research suggest that introduction of minimum corporate income tax improved horizontal equity of the corporate income tax, where part of the companieshasnot paid any income tax for a long time.*

Keywords: *tax avoidance, corporate taxation, minimum income tax, effective tax, tax equity*

JEL Classification: H 2, H 21, H 25, H 26

[1] The contribution is an outcome of research conducted at IFP (Institute for Financial Policy) where both authors work(ed).

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1 Introduction

CIT evasion in Slovakia has been widespread. Every year within the period of 2004 – 2013, more than half of the corporations did not pay corporate income tax (CIT). Indeed, the share of non-payers in Slovakia never got below 50%, even in times of strong economic growth. Moreover, a non-negligible amount of companies operating its business as of 2004 did not pay any tax for 8 consecutive years or more [6, p. 35]. In addition, long lasting tax-induced incentives for the self-employed to incorporate exacerbate this issue even more.[4]

The short-term loss position with declared zero tax is a natural phenomenon in business, however substantial number of companies which repeatedly declared zero tax liability came to the government attention. The basic goal of the business is to maximize profits for its owners by creating value added for a company [2, p. 133][5]. Long-term presence of zero or loss making private companies can be explained either by non-compliant behavior which exacerbates the violation of horizontal equity[6] or just by dormant and zombie firms. Non-compliant entities participate in the benefits of public infrastructure without their contribution and "at the expense" of compliant ones[7]. Given that, evasion as well as equity is a significant issue in corporate income tax in Slovakia.

To tackle with the relatively high level of CIT non-compliance, as of 2014, Slovakia introduced a minimum income tax for the incorporated sector[8]. Its main objective was to increase tax revenue through a more even distribution

[4] Increasing gap between CITs and PITs as well as other "tax" induced motivation (exemption of company's owner from social security) led to ongoing increase of share of private companies without employees on the total number of private companies from 15% in 2006 to 35% in 2013 [6, p.49].

[5] There are other modern theories of companies' goals - for example corporate social responsibility, innovation as a goal, stakeholder theory, however the most prevalent aim is to just generate the profit.

[6] Individuals in equal positions should be treated equally.

[7] Corporations do not bear the tax burden, only people could bear the tax burden, so economic burden of tax must be borne by workers, customers and investors – while the specific incidence of CIT is contentious issue – that rising share of incorporations of self-employed to private companies without employees are just individuals who "bear the tax burden" sheltered behind company's structures.

[8] Similarly, in 1969, Treasury Secretary informed US Congress that 155 high-income individuals paid no federal income tax what subsequently caused political firestorm and induced introduction of alternative minimum tax (AMT). Original purpose of AMT was to catch wealthy individuals who were sheltering most or all of their income [7].

of the tax liability among firms, especially to force long-term tax avoiding entities to contribute to public services. To enhance horizontal equity, the measure was accompanied by a reduction in the CIT rate from 23% to 22 %. The idea was to increase relative benefits of compliant companies to non-compliant ones at approximately neutral fiscal cost as well as increase country's investment potential.[9] The second, publicly claimed goal [5], was to clean up the business register from inactive and dormant companies, thus, contribute to the increased efficiency of the tax administration's auditing activities and possibly to potential growth of productive firms [4, p.25][10].

The amount of the minimum CIT depends on the company's turnover and value added tax (VAT) registration status. Three levels of minimum corporate tax - for small corporations, not registered to VAT (EUR 480), small corporations registered to VAT (EUR 960) and large corporations with turnover above EUR 500,000 (EUR 2,880) are employed[11]. If the tax calculated based on actual taxable income using standard CIT rate is lower, then relevant tax license must be paid. Non-profit organizations, social enterprises are fully exempt as well as every company in the first year of its existence. The difference between the minimum tax and the tax calculated based on taxable income may be carried forward and credited to tax liability up to following three years, what mitigates its potential distortive effect. For companies that will pay CIT in the future, the current tax license can be seen as a pre-payment of the regular CIT.

As well as in other countries, the introduction of minimum corporate tax in Slovakia spurred enormous public debates with many varying views and perceptions. Four years of experience[12] with corporate minimum tax in Slovakia allows us for tax research in this area. The ambition of the authors is to analyze if the initial goals of tax license have been successfully reached. The basic two research questions are: did it improve horizontal equity of the tax system and did it help to clean up the registry from dormant companies?

[9] Statutory CIT rate has strong impact on incentive to invest in country [1, p. 673].

[10] Increasing survival of low productivity zombie firms at the margins of exit congests markets and constrains the growth of more productive firms.

[11] For a reference, minimum gross (net) wage in Slovakia was equal to EUR 435 (EUR 377 approximately) in 2017, monthly gross (net) average earning of single person was EUR 944 (EUR 722 approximately).

[12] Only data for two years of minimum tax existence is at our disposal (2014 and 2015), but results can be extrapolated for overall period.

1.1 Methodology

We carried out the analysis of anonymous individual corporate tax return data between 2004 and 2015. With the notion of profit maximization company objective, we used arbitrary time test to assess the impact of tax license on horizontal equity. It serves as a simple tool to split overall sample of companies liable to CIT to three relevant categories: “responsible”, “noncompliant” and “uncategorized” companies (Table 1).We assume minimum CIT to be effective in improving horizontal equity if it just succeeds to hit predominantly “noncompliant” companies.

The time test we apply to the tax base adjusted for tax losses, which after the introduction of a tax license represents a “true”[13] proxy level of taxation. The time test is applied to all companies existing in 2015 and back to 2004. Companies that ceased doing their business before 2015 are excluded from the analysis. The final step is the division of companies in every year based on their final tax liability up to EUR 3,000 and above to allow analyze control group without the impact of minimum CIT.

The first condition of the decision tree is based on the notion of causality between overall economic development and final tax revenues. Years 2009 to 2012 have been a period of unfavorable CIT development (crisis and post-crisis period with offsetting previous losses). The remaining eight years (2/3 of the observed period) are periods in which one could expect companies' efforts to meet their main goal of generating profits. This period of favorable economic years with increasing corporate tax revenues is finally arbitrarily reduced by half (4 years). The goal is to check for relevant facts (such as investment activities) that can lead to economic loss and zero tax liability.

To consider relevant factors (short period of existence or start of doing business in the period of economic stagnation) which could affect company possibility to meet the first arbitrary condition we do not apply it effectively to all companies. Active companies that emerged during the period of unfavorable economic development (from 2009 to 2012) and do not meet the first condition are automatically attributed to “uncategorized”. We suppose these companies to face more challenging business conditions that could lead to more frequent zero tax liability. For this purpose, we apply the second condition of time test - eight years of existence, which covers also corporations that originated between 2013 and 2015 and could not meet the first condition per se.

[13] The adjusted tax base for tax loss does not consider foreign-tax credit to avoid double taxation and tax breaks, however results are robust even after inclusion of these items.

Table 1

Decision tree for attribution of companies to relevant categories

1. condition	Did the company pay in observed period (from 2004 to 2015[14]) CIT at least 4 times (does not matter inwhich year)?		
	Answer: No		Answer: Yes
2. condition	Did the company do business for at least 8 years?		"responsible"
	Answer: No	Answer: Yes	
	"uncategorized"	"noncompliant"	

Source: Authors.

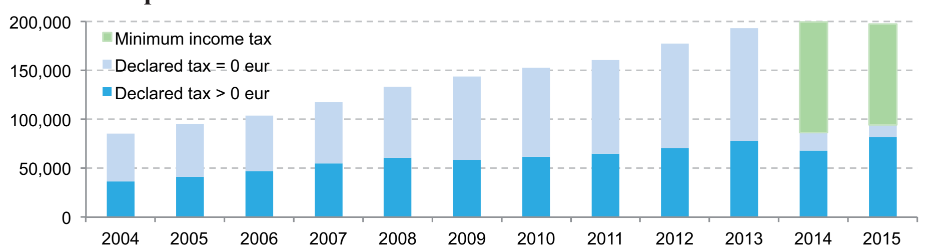
We also devoted a special focus to the analysis of companies which closed their business during the introduction of minimum CIT. Regarding of corporations which ceased to exist, we look at specific characteristics as a number of employees, average revenues, age or based on the categorization of applied time test.

2 Analysis of minimum corporate income tax in Slovakia

Updated figures of anonymized tax return data from 2004 to 2015[15] confirm the ongoing trend of widespread CIT non-payers in Slovakia, which never got below 53 % (Table 2). Until the introduction of minimum CIT in 2014, the trend of CIT non-payers share has been stabilized at the level of 60 %. This number seems to be quite high, however comparable data for relevant benchmarking, except for Austria where corporations declaring zero tax account for 40% [8], are not available.

Table 2

Breakdown of corporations based on declared CIT



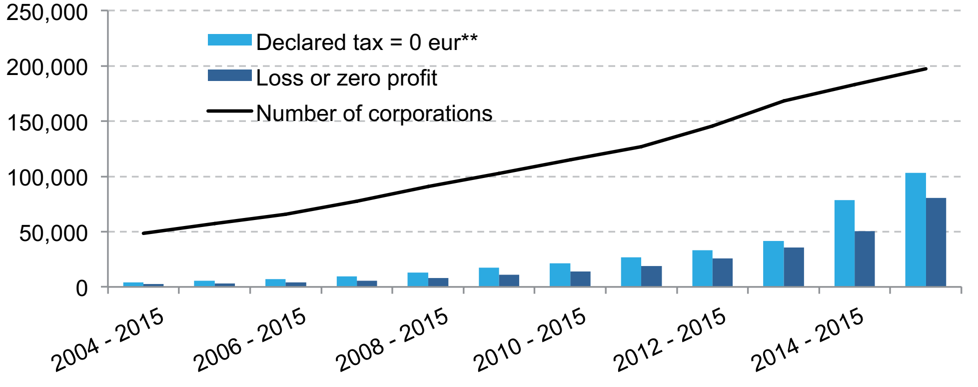
Source: CIT returns, author's calculations.
*Notes:*Corporations established for profit making subject to tax license.

14 Determined by the availability of tax return data.
15 The effect of minimum CIT in 2014 and 2015 is hypothetically eliminated.

Further analysis of updated corporate tax returns reveals that there is still a substantial number of companies which repeatedly declare zero taxable income. In the years 2004-2015, around 9 % of total companies doing business within this period declared zero tax liability and did not pay any tax in twelve consecutive years (Table 3). Given main goal of doing business such a long time without paying taxes raises many concerns.

Table 3

Companies with consecutive zero CIT liability (distribution to overall number of companies with zero declared tax and those of which were moreover in loss or zero profit)



Source: CIT returns, author's calculations.

*Notes:*Horizontal axis shows consecutive period when the company declared a zero tax and loss or zero profit respectively. Percentage above each column indicates the proportion of non-payers in the total number of companies which performed their business within this period. ** Figures in 2014 and 2015 do not consider effect of minimum CIT (declared tax matter).

Aggregate figures from corporate tax return data show that the tax revenue collected from the tax license amounted to EUR 109 mil. in 2014 (initial year). Therefore, more than 50% of companies contributed to additional non-negligible CIT revenues amounted to 4.6% of total CIT yield. As of 2015 the share of minimum tax on overall CIT has stabilized on the level of 3.2%. This decline is attributable to carry forward of previously paid minimum CIT as well as favorable economic conditions which led to more than two-digit increase of total CIT revenues. Additional revenues from the minimum CIT thus also contributed to the increase in the CIT-efficiency ratio[16].

[16] The ratio of declared CIT liability to gross operating surplus multiplied by the statutory rate. It indicates the overall efficiency of the CIT system [3, p.61].

Because of minimum corporate tax introduction, the declared corporate tax liability clustered close to three levels of minimum tax in years 2014 – 2015, which was not observable before. Observed clustering of declared tax liability represents the significant reaction of taxpayers in terms of adjusting their reported tax, while ensuring not paying more than the minimum tax in tax returns after 2013 [9, p. 2].These agents used to pay very low tax or declared zero tax liability. However, after the introduction of minimum CIT, the motivation of agents to optimize the tax base up to zero significantly diminished. In particular, taxpayers declared higher profit corresponding to the particular level of minimum CIT or close to that level.

Assessment of tax license impact on the improvement of horizontal equity is based on the above-mentioned methodology and assumptions. The aim is to reveal if the corporations bunching around minimum tax were just those that used to pay almost no taxes in their history. The result of applied times-test confirms that tax license has improved the horizontal equity of the tax system, especially at the level of "non-compliant" companies (Table 4).There is bulk of approximately 34 thousand of companies doing Business register for 8 years or longer; however, they paid tax just three times or less. The overall liability of this group increased more than 30 times, what is much higher than it was observed in control group which was not affected by the tax license (Annex 1). Improvement in horizontal equity is also observable within "responsible"category as the amount of their paid tax more than doubled and its increment is higher compared to its control group.

Table 4

Outcomes of time test - companies with CIT up to EUR 3,000 (in EUR mil.)

Year	"Non-compliant"		"Responsible"		"Uncategorized"	
	Number	Overall Tax	Number	OverallTax	Number	OverallTax
2010	34 898	1	48 374	24	11 036	1
2011	33 822	0,8	51 859	25	20 037	2
2012	34 284	0,7	55 396	27	33 883	2
2013	33 961	0,9	55 483	27	55 998	6
2014	34 459	30	53 278	64	66 567	43
2015	34 279	30	51 329	61	76 919	58

Source: CIT returns, author's calculations.

Table 5

Outcomes of time test - companies with CIT over EUR 3,000 (in EUR mil.)

Year	"Non-compliant"		"Responsible"		"Uncategorized"	
	Number	OverallTax	Number	OverallTax	Number	OverallTax
2010	402	10	19 754	1 659	368	6
2011	302	14	20 253	1 773	554	11
2012	293	16	20 829	1 775	756	13
2013	359	15	20 472	1 758	1 929	39
2014	1 030	37	23 051	2 013	4 674	105
2015	1 732	71	25 355	2 422	7 973	171

Source: individual CIT returns, author's calculations.

Opponents of the minimum tax in various public discussions stressed that even active corporations might cease to exist due to increased business costs after its introduction. Detailed analysis of Business Register (BR) data neither confirm these concerns, nay completely disprove them (Table 6). According to analyzed available data, during the period of its existence mainly companies without employees and no earnings closed their business. From the perspective of paid taxes, the "non-compliant" closed their business activities predominantly. Looking at the age of ceasing companies, mostly older ones have been eliminated, what supports the argument that tax license helped remove dormant companies from Business registry. This improvespotential of audit effectiveness as well as the potential growth of productive firms. Furthermore, the introduction of minimum CIT resulted in a reduction of new business establishments. We assume that the minimum CIT limits motivation of agents to establish business to avoid the tax system.

Table 6

Breakdown of closed companies* by selected characteristics

4 871		2013**		2014		2015	
		100 %	7 439	100 %	5 693	100 %	
Number of em- ployees	1***	2 932	50 %	5 419	73 %	4 546	80 %
	2 – 4	339	7 %	553	7 %	311	5 %
	5 andmore	1 600	33 %	1 467	20 %	836	15 %
Average business and financial rev- enues (2010 - 2013, in thousands of EUR)	0	2 795	57 %	3 521	47 %	2 303	40 %
	1 – 10	690	14 %	1 093	15 %	1 015	18 %
	10 – 100	646	13 %	1 262	17 %	1 016	18 %
	100 and more	740	16 %	1 563	21 %	1 359	24 %

Time test (based on the number of years in which paid taxes)	Non-compliant	3 873	80 %	5 400	73 %	3 993	70 %
	Responsible	548	11 %	1 070	14 %	901	16 %
	Uncategorized	450	9 %	969	13 %	799	14 %
Age of company (in years)	0 – 4	1 111	23 %	1 659	22 %	1 198	21 %
	5 – 9	1 551	32 %	2 243	30 %	1 977	35 %
	10 andmore	2 209	45 %	3 537	48 %	2 518	44 %

Source: Business Register, author's calculations

*Notes:** Companies established for profit making, subject to tax license.** Similar behavior was visible before 2013 which was influenced by anticipated introduction of minimum tax. *** Companies with zero, one and non-identified numbers of employee. We assume the sole employee is mostly the business owner.

3 Conclusions and policy implications

The result of our research suggests that introduction of minimum CIT improved equity (fairness) of the corporate income tax, where part of the companies have not paid any income tax for a long time. Perceived negative impact of minimum CIT on the active companies has not been confirmed yet. On the contrary, in the observed period mainly inactive dormant and zombie companies ceased to exist. Moreover, the analysis revealed behavioral response of companies which cluster their declared tax liability around and close to three levels of minimum corporate tax. Therefore, mitigating non-compliance by minimum tax should not be considered as the first-best tax policy option, especially as it may give the impression that avoiding CIT is acceptable as long as firms pay just the minimum CIT. However, until the effective audit system of financial administration will be in place, it is the very effective tool to force long-term non-payers force to contribute to public services. The tax license was repealed after for years of its existence without any additional countermeasures that would prevent taxpayers from re-reporting zero tax and hence repeatedly violate horizontal equity. Noncompliant taxpayers will likely to participate from benefits of welfare economics without proper contribution and at the expense of compliant ones.

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