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TAXATION OF FOREIGN INVESTORS IN LITHUANIA

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Session III Review of the corporate income tax policies including incentives for FDI in the Baltic States

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Lithuania is very interested in attracting foreign investors to bring their capital and know-how to Lithuania. We are acutely aware that foreign investment is one of the fundamental keys to the economic future of Lithuania. Creating the appropriate legal and tax environment for foreign investment has been one of the principal goals in the reforms we have undertaken in our laws and regulations. In this discussion, my focus is only on the measures we have taken and that we plan to take with respect to the taxation of foreign investment.

We believe that there are at least two basic approaches to take with respect to establishing a good foundation for foreign investment: (1) adopting special tax incentives that apply exclusively to foreign investments; and (2) creating a tax system that is solid, stable, and that is conducive overall for business, whether the enterprise be financed by domestic or foreign capital.

Our tax laws take both approaches. The Lithuanian tax system began with a number of different tax holidays. These tax holidays, special exemptions, and reduced tax rates for foreign investment seemed the easiest solution at first. However, administering the laws and rationalizing the difference in treatment between foreign investors and our own business ventures was not as simple as the original idea to simply grant holidays. We think these tax holidays were useful in their time, since they certainly attracted foreign capital, and provided predictability in taxation to foreign investors who were unfamiliar with the Lithuanian system. The Lithuanian tax system, during the 1990s, we must admit, has gone through many changes, as have the tax systems of our neighbors. The tax holidays helped to bridge this period of great change, by guaranteeing a certain stability to our foreign investors.

Over the years, our emphasis has shifted. While we still have tax benefits specially aimed at foreign investors, we are concentrating more on creating a stable tax system. We cannot neglect our domestic businesses, and we believe that sophisticated, serious foreign investors will appreciate a tax system that is rational, that is neutral, that does not create burdens against repatriating profits, that permits the deduction of normal expenses, with a possibility of carrying forward net operating losses. This is the system we are intending to set in place. We hope to attract foreign investors who will bring in their capital to Lithuania as a natural extension of their activities in the global market.

In combination with particular tax benefits specially targeted for foreign investments, a stable tax system should make Lithuania an attractive place for foreign investors. Please bear in mind that we do not intend that Lithuania become some tax haven for foreign investors seeking to evade taxes from their home countries. Rather, we want Lithuania to be an honorable member of the world economic community. Foreign investors will have to decide for themselves whether the other conditions present in Lithuania, such as our labor force, our market, and our resources, will make investment worthwhile. Taxes are only part of the picture. Our intention is that taxes be designed so as to stimulate and not hinder investment.

Special Tax Incentives for Foreign Investors

1. The Law on Investments into Lithuania of July 7, 1999 – "Strategic Investors"

The Law on Investments of July 7, 1999, provides that when a foreign investor invests no less than 200,000,000 litai and meets certain other criteria, the investment may be considered a "strategic investment", and the Government of Lithuania may enter an agreement with the investor that the tax rates in effect as of the time the threshold investments is committed, will not be changed for a period of five years (with a possibility of extending the term for an additional five years). In other words, tax benefits may be granted to substantial investors, at the discretion of the Lithuanian government.

We believe that this tax benefit is preferable to the granting of outright tax holidays. Our strategic investor plan is a more flexible mechanism. The tax relief may be designed especially for the investor and the particular business involved. For instance, the Government can refuse to grant incentives if it finds that there are elements of tax avoidance motivating the investment.

The Government will consider whether the investor is a bona fide "foreign investor." We need to ensure that the company organized under the laws of a foreign country is a "genuine" foreign company. Perhaps local, Lithuanian businessmen formed a company in another country simply for the purpose of investing in Lithuania as a foreign investor and thereby gain the benefit of the extraordinary tax benefits for foreign investment.

Also, we need to consider carefully exactly what constitutes an "investment" for purposes of this benefit, as well as the point at which we will consider that the threshold investment has been reached to qualify as a potential strategic investment.

Indeed, the granting of the status of a strategic investor, then, is not always as obvious as it might seem. But we believe that fact that each case is determined on its own merits is a good way to avoid the problems that make broad, automatic tax incentives for foreign investors so difficult to administer.

2. Former Tax Incentives (repealed after 1997)

Just for your information, we would like to summarize quickly some of the former tax incentives granted to foreign investors in Lithuania. You will see that Lithuania too has tried very broad tax benefits, but we were discouraged by the difficulty of their administration and of preventing their abuse.

Foreign investment made before December 31, 1993 --

29% tax rate reduced by 70% (i.e., special rate of 8.7%) applied for the first 5 years after registration of a corporation in which foreign capital was invested before December 31, 1993, but the special rate only applied to that proportion of taxable income that was the same as the proportion of foreign capital in the business's total capital, and only to the extent such income was not used for wages and is reinvested in the business of the enterprise.

29% tax rate reduced by 50% (i.e., special rate of 14.5%) applied for the 6th through 8th year after registration of a corporation in which foreign capital was invested before December 31, 1993, but the special rate only applied to that proportion of taxable income that is the same as the proportion of foreign capital in the business's total capital, and only to the extent such income was not used for wages and was reinvested in the business of the enterprise.

Foreign investment made from January 1, 1994-August 1, 1995 --

29% tax rate reduced by 50% (i.e., special rate of 14.5%) applied for the first 6 years after registration of a corporation in which foreign capital was invested, but the special rate only applied to that proportion of taxable income that is attributable to the foreign investment.

Foreign investment of 2 million USD or more (before April 1, 1997) --

(except oil products wholesalers and retailers if proceeds from oil products are >30% sale revenues)

29% tax rate reduced to 0% for the first 3 years after first quarter during which the level of foreign capital investment of a foreign investor reached 2 million USD.

29% tax rate reduced by 50% (i.e., special rate of 14.5%) applies for the 4th -6th years after 2 million USD threshold reached.

The complexity and difficulty in interpreting and administering these tax benefits, even though we had the best of intentions, made them too inefficient to continue.

We learned another important lesson: that it was important to attract serious, sophisticated investors who valued Lithuania and would contribute to Lithuania's economic development. Investors who could afford to ignore the conditions of their investment, other than the tax benefits, were precisely those who invested only for so long as the tax benefit lasted. They quickly pulled out their investments and moved to another advantageous location as soon as the need arose (i.e. the tax break ended). We learned to place greater emphasis on developing a coherent and neutral tax system to help both foreign as well as domestic investors.

3. The Lithuanian legislation relating to free economic zones and related tax measures

The creation of free economic zones in Lithuania has been accomplished through the special law on the basic principles governing free economic zones, the specific laws setting up free economic zones in areas such as Siauliai, Klaipeda, and Kaunas, and the provisions of the tax laws that grant special tax incentives to companies organized in such zones.

Under the provision of the current corporate income tax law, the regular tax rate of 24% reduced by 80% (i.e., a special rate of 4.8%) applies for the first 5 years after the registration of a corporation in a free economic zone. The regular rate of 24% reduced by 50% (i.e., a special rate of 12%) applies for the 6th through the 10th years after the registration of a corporation in a free economic zone.

Special provisions apply to corporations that are registered in free economic zones and that are at least 30% (in value) owned by foreign investors that have invested no less than 1,000,000

USD. That is, a 0% tax rate applies for the first 5 years after registration, and the regular 24% tax rate reduced by 50% (i.e., a special rate of 12%) applies for the 6^{th} through 10^{th} years after registration.

For all businesses in free economic zones, taxable income is reduced by expenses incurred for the acquisition of essential fixed assets, research costs, technology costs, and for investment and capital investment.

Our free economic zones have been criticized by the European Commission. They are considered to have created special privileges for enterprises to attract them to Lithuania rather than the enterprises' home countries. The free economic zones, according to EU experts constitute harmful tax competition, as well as unacceptable state aid. The EU tolerates some tax privileges as part of a strategy for regional development, but we are still debating with the Commission as to whether the benefits to be offered in the Lithuanian free economic zones exceed those tolerated by the EU principles.

Creation of a Stable Business Income Tax Law

As mentioned in the introduction, we believe that extraordinary tax incentives are not the only reasons serious investors are attracted to a particular country. It seems to us that serious investors will consider also the economic and political stability of our country, our well-trained low cost labor, access to markets and materials, as well as the legal infrastructure. We believe it is critical for Lithuania to have in place a "normal" tax system. We are in the process of drafting a new business income tax law, which we believe will be fair and neutral to all businesses.

The new business income tax law will provide for a greatly reduced tax rate for all taxpayers – 15%. Taxable income will be determined after the deduction of most ordinary business expenses, including the possibility of accelerated depreciation of long-term assets. Of course, we will continue to permit the carryforward of net operating losses to the next succeeding five years. The taxation of shareholders and corporations will be coordinated so that double taxation of distributed profits will be minimized. We are also preparing laws to permit the tax-deferred reorganization and liquidation of business entities.

Foreign companies that operate a trade or business in Lithuania through a branch will be taxed on the income earned through this branch, after deduction of expenses allocable to these activities. Payments or transfers of assets from the branch to its home office outside of Lithuania will not normally be subject to tax in Lithuania, since the branch is considered part of the same legal entity as its home office.

Foreign companies that derive occasional profits from sources in Lithuania, that do not have a trade of business in Lithuania, will be subject to a withholding tax of 15%. As in all cases when taxes are withheld at the source, no deductions are permitted.

We intend to implement a neutral and reasonable policy that will not overly burden profits that are repatriated from Lithuania by our foreign investors.

However, we must note that there has been significant political pressure to eliminate the corporate income tax altogether in Lithuania. Persons arguing in favor of this say that this will stimulate the development of enterprises in Lithuania and that it will attract foreign investors. We have attempted to draft laws along these lines, but the Ministry of Finance has found it practically impossible to devise a satisfactory scheme that will ensure fair and efficient taxation of both Lithuanian residents and foreign investors. All drafts of an income tax law without a corporate-level income tax push the entire burden of taxation onto persons who receive payments from Lithuanian businesses. In fact, they end up discriminating against foreign investors, who repatriate their earnings from their tax-free businesses. Lithuanian business would not be taxed if they received similar payments. Of course, foreign investors can always repatriate profits in less direct ways, through, for instance, manipulative transfer pricing practices. But, this is not a situation we wish to encourage. The Ministry, for now, continues to support the goal of a neutral, efficient tax system. We believe a well-balanced and fair tax system will do more to stimulate investment than extraordinary schemes.

Lithuania's Tax Treaty Network:

Of course, the treaties that Lithuania has entered with other countries to eliminate the double taxation of profits earned in international operations will affect the taxation of investments made by residents of a treaty contracting state into Lithuania. It is obvious that tax treaties are very important to ensuring fair taxation of foreign investments in Lithuania, as well as providing reduced tax rates for repatriated profits. For that reason, we intend to pursue as actively as possible tax treaty negotiations with as many countries as we can, a policy we have followed throughout this last decade.

At the present time, Lithuania has entered tax treaties with the following countries:

Belgium	(signed 26 November, 1998)
Byelorussia	(signed 18 July, 1995)
Canada	(signed 29 August, 1996)
China	(signed 3 June, 1996)
Czech Rep.	(signed 27 October, 1994)
Denmark	(signed 13 October, 1993)
Estonia	(signed 13 September, 1993)
Finland	(signed 30 April, 1993)
France	(signed 7 July, 1997)
Germany	(signed 22 July, 1997)
Ireland	(signed 18 November, 1997)
Iceland	(signed 13 June, 1998)
Italy	(signed 4 April, 1996)
Kazakhstan	(signed 7 March, 1997)
Latvia	(signed 17 December, 1993)
Moldova	(signed 18 February, 1998)
Norway	(signed 27 April, 1993)
Poland	(signed 20 January, 1994)
Russia	(signed 29 June, 1999)
Sweden	(signed 27 September, 1993)
Netherlands	(signed 16 June, 1999)
Turkey	(signed 24 November, 1998)
Ukraine	(signed 23 September, 1996)
USA	(signed 15 January, 1998).