

Romanian tax system – opportunities and failures

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Abstract: - During the years, Romania suffered many changes related to its fiscal system. Starting with 2007, since we've joined European Union, Romania committed to respect the EU legislation. In the following article we will try to underline some of the advantages and disadvantages for investors that decide to start a business in Romania. From the fiscal point of view, Romania is the land of many possibilities. Doing business in Romania has definitely advantages but also disadvantages, as we will see.

Key-Words: - Romanian taxation system, profit tax rate, income tax rate, permanent establishment, tax on nonresidents' income, tax on dividends, tax on royalties, VAT, Romanian IRS

1 Introduction

During the years, Romania suffered many changes related to its fiscal system. Starting with 2007, since it have joined European Union, Romania committed to respect the EU legislation. In the following article we will try to underline some of the advantages and disadvantages for investors that decide to start a business in Romania. From the fiscal point of view, Romania is the land of many possibilities. Doing business in Romania has definitely advantages but also disadvantages, as we will see. Every year many of the old fiscal opportunities or facilities disappear,

but new ones are introduced by the Fiscal Code. Perhaps this is the reason for a new profession to start in Romania, from 2006, meaning the Tax Consultants.

2 Incorporated businesses

First we must appreciate the profit tax rate which is pretty small – 16% - as compared to those from other countries (for example UK or Germany) and that it is unique and not established progressive. Fiscal losses can only be reported in the future and

starting with 2009, fiscal losses can be deducted from future fiscal profits for 7 years. For fiscal losses encountered before 2007, the carried forward period is only 5 years.

Unlike most of the European countries, fiscal losses can not be used in case of mergers or unions. In case a company that reported fiscal losses is bought by another, the fiscal losses are permanently lost. Also there is no possibility to claim back fiscal losses.

Beside the tax rate which is pretty small, Romanian Fiscal Code allows another way of taxing, meaning tax on income for the so called micro –enterprises. The tax of income is 3% computed on the income reported by the company (some income is exempted according to the law) but there are some conditions a company should fulfilled in order to be considered a micro-enterprise. According to the Fiscal Code, a micro-enterprise is a Romanian legal person that cumulatively satisfies the following conditions on December 31st of the preceding fiscal year:

- a) obtain incomes other than those from consulting services and management, of more than 50% of total incomes;
- b) has from 1 to 9 employees including;
- c) obtained incomes that have not exceeded the equivalent in lei of 100,000 euros;
- d) the social capital of the legal person is owned by persons other than the state, local authorities and public institutions.

A newly incorporated company may declare itself a micro-enterprise but it must hire an employee in at least 60 days. Once a company broke the mandatory rules, it can never be again a micro-enterprise. The big punch starting with 2007 was the alteration of Fiscal Code. According to the Fiscal Code available for 2004 – 2007, in case a micro-enterprise excided the 100,000 euro income threshold rule, it became a profit tax payer starting with 1st of January of the following year. Starting with 2007, in case the micro-enterprise that exceeded the equivalent in lei of 100,000 euros; the company become a profit tax payer starting with the year in course. This implied a big loss for companies that wanted to tax with lower rates some gains and form for this purpose a newly enterprise, declared as a micro-enterprise.

There are some special rules applied for some business, such as night-bars, night-clubs, discotheques, casinos and sports betting. Taxpayers that carry out activities in the nature such as those described above, including the legal persons which realize these incomes based on a contract of association, and for which the profit tax owed for

the activities provided in this article is less than 5% of the respective incomes are required to pay a tax equal to 5% of such realized incomes. Even if such taxpayer must pay a minimum tax, as we see the level is not very high and that explains the large number of casinos in Romania.

As mentioned before, the tax rate and the taxable base are unique, meaning that there are not special rules or rates for income from capital gains, from donation, inheritances, bank's turnover or investment gains.

As for the tax payers, starting with May 2009, Romanian taxpayer - irregardless if they pay tax on profit or on income (like micro-enterprises)- have to pay a minimum profit tax, in spite of they fiscal losses. Those kind of changes are very frequent, even if the Fiscal Code contains articles that require the Romanian authorities to modify or complete the Fiscal Code with at least 6 months before the date of its entry into force and to allow Romanian tax payer to accommodate with changes (since any modification or completion to the code should enter into force starting with the first day of the year next to the year of its adopting by law).

Nevertheless, starting with May 2009 a minimum tax is to be paid and the amount is computed based on the previous turnover reported by the company from which some incomes are to be deducted. The tax is settled based on a progressive system. Useless to say that the system is not fair-play for most of the Romanian companies which had a good year in 2008, but an awful one in 2009, because of the financial crisis. A minimum tax paid according to the current income would have been fairer to most of the companies. Even if the minimum tax is not that high (the range is between approximately 500 euro and 10,000 euro per year) the number of Romanian companies that decided to suspend their activity for 2009 (during the period of suspension no taxes are to be paid) increased by eight times!

There are many special rules related to non-deductible expenses or taxable base. For instance there are rules which a company must respect in order to deduct interest expenses, depreciation or provisions.

Also starting with May 2009, reserves related to revaluations of fixed assets, including land, performed after 1 January 2004, which are deducted for corporate income tax purposes through fiscal depreciation or through expenses with write-off of assets, will be included in the taxable income for corporate income tax purposes upon deducting the fiscal depreciation, respectively upon the disposal of fixed assets. In other word no more tax advantages from revaluation, unlike before.

3 Income tax for natural persons and social security contribution

The tax rate on such income is only 16% but most of the companies complain about the social security contributions that are pretty high. Social security (pension) contribution is 20.8 % for the company and 10.5 % for the employee. Health assurance contribution is 5.2% for the company and 5.5 % for the employee. Beside that contribution, another 0.85% is to be paid monthly by the company and is directed to a fund designated to support payments for medical leaves. Unemployment contribution is 0.5% for the company and 0.5 % for the employee. Beside that contribution, the company must support another mandatory one, computed at 0.25%, in order to guarantee the payment of wages. In Romania the employee's evidence is based on labor books. This implies other costs for the company that must pay usually 0.75% monthly for the labor office commission. Another special contribution is to be paid monthly, with a variable rate, and is directed to a fund designated to support payments for medical leaves due to work accidents. As we can see, the company pays almost 30% social security contribution and the employee pays 32.5 % tax. Unlike other countries, in Romanian is almost impossible to find a way to lower the taxes paid on salaries. All the deductions allowed by the fiscal code (such as luncheon tickets, holiday tickets under certain conditions) are insignificant. Social security contributions are a permanent conflict between the Romanian government and companies.

Romanian Fiscal Code accepts the idea of "freelancer". Usually, the free lancer only have to pay 16% based on the net income, 5.5 % health assurance and under certain conditions social security contributions and unemployment contribution. For certain professions a fixed tax according to their activity is due annually.

There are special rules for taxing certain incomes obtained by physical persons. For example, incomes from pensions are taxed with 16% on the amount that exceeds 230 euro (1,000 lei). By the way, Romanian pensions are known as being very small.

The income in the form of prizes is to be taxed by withholding at source at a rate of 16% applied to the net income for each prize. The incomes from gambling are to be taxed by withholding at source, using a quote of 20% applied to the net income not exceeding the quantum of 2,350 euro approximately (10,000 lei) and a quote of 25% applied to the net income exceeding the quantum of 2,350 euro approximately (10,000 lei). It is easy to conclude that it is better to win more frequently small prizes

then once a higher one!

Incomes from the transfer of real estates from the own patrimony are taxed according to the period of time the asset was own - the reason being that the Romanian government wanted to discourage speculation with real estate - as follows:

a) for the constructions of any kind with their related lands as well as for the lands of any kind without constructions on them, appropriated 3 years ago, inclusive - 3% up to the amount of lei 200,000 inclusively and 2% computed for the amount exceeding 200,000 lei inclusive;

b) for the real estates, appropriated in a period exceeding 3 years ago - 2% up to the amount of lei 200,000 inclusively; and 1% computed for the amount exceeding 200,000 lei inclusive.

Romania was well known as being the paradise for investors in real estate. The prices were probably the highest from Europe and the most dynamic.

The net income from the grant of the use of goods is taxed with an effective rate of 12 %, which makes it the most used alternative for the company in stead of paying salaries.

Income from intellectual property rights is taxed with 16% standard rate based on net income, but the net income is determined by subtracting from gross income a deductible expense equal to 50% for creation of monumental works of art, and 40% of the gross income for the other entire situation and the social security contributions paid. The effective rate, as we can see, is either 9.6% or 8%.

Income from investments (such as dividends, interest, transfer of shares of listed or unlisted companies, gains from derivatives and exchange rates, liquidation), are taxed at a 16% flat tax rate.

But, in order to animate a little bit the Romanian capital market and the BVB (Bucharest Stock Exchange), interest income earned from deposits in Romanian banks or other savings instruments, which is tax free as of January 2009. Also tax free is for 2009 the capital gain from transfer of shares of listed companies, which might be a great opportunity for investors from Romania or outside Romania. These opportunities apply only for 2009, because starting with 2010 for income derived from transfers of listed securities the tax rate will be as follows:

- For securities owned for less than 365 days, 16%;
- For securities owned for more than 365 days, 1%.

Non resident physical persons became for the taxation purposes residents if one of the following conditions is met, according to the Fiscal Code:

- the person has his or her domicile in Romania;
- the center of vital interests of the person is located in Romania;

- the person is present in Romania for a period or periods that exceed in total 183 days during any period of 12 consecutive months ending in the calendar year in question;

If the non resident taxpayer satisfies at least one of the above conditions for a period of three consecutive years, then he or she is subject to the income tax for incomes obtained from any source, both from Romania and from outside Romania beginning with the fourth fiscal year.

Actually, the pretty small tax rate for personal income encourages foreign citizens that work in Romania to declare their fiscal residency in Romania for at least a year. And if the citizen is from UE, he or she will probably opt to keep its social security contribution back in its mother country (for at most 2 years according to the European directives) but to pay income tax in Romania, especially if Romania and his or her country of domicile are part of a double tax treaty.

4 Tax on dividends

The rate for tax on dividends is one of the smallest in Europe since it is 16%, and it is based on the accounting net value profit and not on the fiscal value. Rates of dividend taxation depend on the category in which the shareholder is caught. The tax on dividend for residents, natural persons, is 16% and it is withheld by the payer company.

Starting with 2007, the provisions of the Parent-Subsidiary Directive are applicable in Romania and, consequently, the dividends received by a Romanian company from another Romanian company are not taxed if the beneficiary has held at least 10% of the Romanian company's shares for a continuous period of at least two years by the date of dividends payment. Same rules apply if the beneficiary of the dividends is an incorporated business resident of another UE member state.

If the Romanian resident, beneficiary of the dividends, do not satisfy the above mentioned conditions, then the tax rate is 10%.

From 2009, in order to remove the discrepancy between the residents and non residents juridical persons, based in another EU member state, that receive dividends from Romania, the tax rate for non residents juridical persons, based in another EU member state, in case the above conditions for detention of shares were not met is 10%. Before 2009 the tax rate was 16%.

Under these circumstances we can talk about a positive discrimination in favour of non residents juridical persons. This is because if they do not meet

the 2 year period of holding they pay 10% tax on dividend, BUT in the year the condition is met, the tax paid is to be claimed back from the budget. Romanian companies do not benefit from the same fiscal treatment. Once they paid the tax rate it can not be claimed back.

5 VAT

Since Romania joined EU, almost entire legislation related to VAT was adopted. The standard VAT rate is one of the smallest from EU – 19%. There are also a large number of transaction that are exempted from VAT. The Fiscal Code settles reduced VAT rates in certain situations. Some supplies, such as hotel accommodation, books and museum tickets, are subject of a 9% reduced VAT rate.

In order to enliven the economy, starting from December 2008, the Romanian government changed the Fiscal Code by introducing a new reduced VAT rate, amounting 5%. This rate is to be applied only for delivery of buildings under certain circumstances (as part of social policy) such as old people's homes, retirement homes, orphanages, rehabilitation centers for children with disabilities.

The category also includes buildings and parts thereof supplied as housing with a maximum useful surface of 120 square meters, excluding outbuildings. The reduced rate applies if the value of the house acquired by any single person or family is less than RON 380,000 exclusive of VAT (which is in Euro approximately 70,000 and it is not a large amount for a house in Romania). The reduced VAT rate will also apply to the supply of the land beneath the housing on the condition that it does not exceed 250 square meters, including the footprint of the housing. The reduced VAT rate and some other facilities offered by the government for young people are expected to enliven the real estate market.

A big dispute among companies was generated by the latest change on the Fiscal code. Starting in may 2009 the fuel expenses and the VAT related can not be deducted for certain types of cars.

It is important to underline the fact that during the last years Romania had no restriction for deducting VAT related to car (except for the situation in which the car was to be used for personal purposes). This was one of the most exciting rules for non residents came to Romania, since they were used to several restriction when deducting VAT for car, such as for car used by administrative employees, for luxury cars and so on. According to the new rule, VAT related to the acquisition (i.e. either local purchase, intra-

community acquisition or import) of motorized road vehicles, as well as the one related to the acquisition of fuel destined for the vehicles having the characteristics mentioned below, owned or used by taxpayers, is non-deductible. The rule applies to motorized road vehicle that are exclusively used for passenger road transportation, weighing no more than 3,5 tones and with a maximum of 9 seats (including the driver's seat). However, vehicles used for commercial/resale purposes, used for paid passenger transport including taxi, the ones used for supply of services against consideration (e.g. rental to third parties, subject to financial or operational lease agreements, etc.), as well as those exclusively used for special destinations (e.g. for interventions, security and protection, courier services, transport of employees to and from the place of performing their activities, vehicles used by sales-agents, etc.) do not fall under the above VAT non-deductibility provisions.

Even if for a short period of time, VAT for imports was not to be paid, from April 2007, companies that imports goods in Romania must pay VAT, which may later deduct and claim back. The threshold for small companies is settled to the 35,000 euro and so is the threshold for remote sales.

Perhaps one of the biggest problems for Romania is the bureaucracy. It is pretty complicated especially for nonresidents to register for VAT purposes in Romania, to claim back and actually receive the VAT from the budget, there are many forms mandatory to submit monthly.

6 Taxation for non residents

There are two cases for taxation of non-residents depending on permanent establishment started in Romania or not. A Permanent Establishment is defined as being the place through which the activity of a nonresident is conducted, fully or partially, directly or through a dependent agent. Once a Permanent Establishment is created, Romania has the right to tax the profits of the foreign enterprise derived from the activity performed on its territory.

Romania adopted most from international legislation related to permanent establishment and transfer pricing. Still the procedure for setting advance price agreements or advance pricing arrangements are difficult, expensive and time consuming. Transactions between related parties should observe the arm's length principle. If transfer prices are not set at arm's length (or using another methods according to OECD legislation), the Romanian Tax Authorities have the right to adjust

the taxpayer's revenues or expenses, so as to reflect the market value.

When the non resident doesn't has a permanent establishment there are different rules that apply. If the foreign person, beneficiary of the income from Romania, doesn't have a certificate of residence from a country that previously signed a double tax treaty with Romania, then the income is taxable in Romania based on a 16% rate, except for certain situation when the income is exempted from taxation.

If the beneficiary owes a residence certificate and a double tax treaty exists, then the rules form double tax treaty are to be applied.

As Romania is an EU member state, the provisions of the Parent Subsidiary Directive are to be applied. Thus, dividends paid by Romanian companies to companies resident in one of the EU and EFTA member states are exempt from WHT if the dividend beneficiary has held a minimum of 10% of the shares of the Romanian company for a continuous period of at least two years by the date of dividends payment. Romania has also implemented the Interest and Royalties Directive with a transitional period for the application of this Directive until 2010. Until 31 December 2010, 10% WHT applies on payments of interest and royalties made by Romanian companies to companies resident in EU and EFTA member states and holding at least 25% of the share capital of the Romanian company for a continuous period of at least two years prior to the date of payment of interest / royalties. Such payments are WHT exempt from 1 January 2011, under the same conditions as stated above.

7 Conclusion

Even if it is not a tax heaven, Romanian taxation system allowed resident or non resident business to pay small taxes on their income. The Romanian Fiscal Code do not reveal any fiscal facilities (especially when compared with previous years) but small profit flat tax rates are pretty advantageous. A great advantage for 2009 is that both residents and non residents companies or physical persons may benefit from 0% tax rate in case of gains from transfer of shares or other investments listed to a Romanian Stock Exchange.

As a disadvantage we must not forget that social security contributions are considered very high, especially when compared with the rewards. But lately, Romania started to implement the second and the third pension pylons, meaning the state

pension plan privately administrated and the private pension plans.

Probably the most criticized problem related to Romanian tax system is that it is continuously changing, which makes it very difficult for both national and multinational company to pan their activities and cash flows.

An important facility is granted to small business that have a possibility to opt for taxation on income and not on profit. Yet a reason of permanent complain is the Fiscal Procedure Code and the lack of jurisprudence when taxes or unclear articles of Fiscal Code are involved.

Also, since Romania is part of more than eighty Double Tax Treaty and since it implemented the mandatory European Directives, money can be transferred in a tax heaven, under certain conditions, without taxes.

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