

## CONCERNS IN BUILDING AND USING INCENTIVE CAPITAL BY MOLDOVAN UNDERTAKINGS

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**Abstract:** *The Article tackles the key legal, accounting and economic aspects of building and using incentive capital. In compliance with the Moldovan legislation in force, such capital is built by limited liability companies at the expense of their net profit. Incentive capital is intended for financial reward of workers, fostering their interest in increased work efficiency, active engagement in creative initiatives to the benefit of the limited liability company.*

**Key words:** incentive capital, net profit, workers, dividends, other reserves, limited liability companies.

The effective operation of economic agents directly depends on the qualifications of their workers, their knowledge, skills and the level of competence. As it has been objectively proved, the work effectiveness is much higher when work remuneration is oriented towards achieving strong results. In this process an important role belongs to regulatory measures, which have a great impact on workers' motivation, being a fundamental component of undertaking strategic management. Incentive capital is one of the workers' tangible encouragements governed by the Moldovan legislation.

Enacted in 2023, incentive capital is an innovative mechanism to motivate the staff, targeting long-term increase of professional activity and work effectiveness. Unlike the traditional remuneration systems, incentive capital is built at the expense of the limited liability company (LLC) net profit as a special reserve to pay stimulating compensations to workers. Such approach provides flexibility in managing staff motivation, contributes to the development of results-based corporate culture, and increases undertaking competitiveness through attracting and retaining qualified professionals. Being a form of workers engagement in profit distribution, incentive capital significantly increases the staff interest and commitment, to ensure long-term competitive advantages for the company.

The main rules for building and using incentive capital in the Republic of Moldova are governed by the provisions of Law on limited liability companies No. 135/2007 (hereinafter referred to as Law No. 135/2007) [1]. Pursuant to Art. 31<sup>1</sup> of this Law, upon building and using incentive capital, it is necessary to comply with certain criteria and constraints, the main ones being displayed in the table below.

**Table 1. Incentive capital building criteria and constraints for its use**

No	Criterion	Description
1	<b>Co-ordinating mechanism</b>	The decision to build incentive capital is taken by all undertaking participants unanimously.
2	<b>Building source</b>	Incentive capital is built at the expense of the undertaking net profit.
3	<b>Targeted use</b>	Incentive capital is allocated to pay rewards to workers in compliance with the established requirements. It can be used for making one payment or several payments in the foreseeable future.
4	<b>Requirements towards the recipients</b>	Incentive capital is intended for the workers employed on an individual contract basis who meet the following requirements: <ul style="list-style-type: none"> <li>• have the resident status;</li> <li>• work at the LLC for at least 12 months by the date of making the payments.</li> </ul>

No	Criterion	Description
5	Payment constraints	The payment amount shall not exceed the 100% of the worker's annual payroll.
6	Capital size constraints	The amount of incentive capital shall not exceed 25% of the net profit.
7	Internal regulation	Incentive capital building and use, identification of recipients and payment conditions are approved by the LLC regulation.
8	Rights of recipients	Recipients do not acquire rights and liabilities of LLC participants, but can have access to financial reporting and other information.
9	Nature of payments	Incentive capital is used to pay rewards to workers who are not LLC participants. Such rewards are dividend-equivalent, but are paid once a year.

Source: developed by the Authors based on Law No. 135/2007 [1, Art. 31<sup>1</sup>].

To comply with the requirements displayed in the table above it is necessary to pay attention to the following key matters:

- according to the provisions of the Tax Code [2, Art.5], resident – natural person is any individual who has his/her permanent residence in the Republic of Moldova (including those who travelled abroad for treatment/leisure/studies/business trip and/or are Moldovan public officials on duty abroad) or stays in the country for at least 183 days during the tax year. Pursuant to the cited provision, the resident status does not depend on the Moldovan citizenship. At the same time, if the undertaking decides to pay rewards at the expense of incentive capital to a worker who is a foreign state citizen, it would be necessary to determine the length of his/her stay in Moldova. If the length of stay is less than 183 days during the tax period, such income is not treated as dividends but as labour activity income and is subject to income tax in line with Articles 73 and 88 of the Tax Code;

- according to the labour legislation, the wage includes the main component (tariff rate, salary), additional payments (supplements and premiums) and other incentives and compensations [3]. Meanwhile, such accruals like leave pay and health benefits, material aid and other similar payments are not taken into account when counting the limit/constraint. It is worth noting that if the worker failed to work the whole year due to various reasons (temporary inability to work, parental leave, etc.), the amount due would be significantly less. Therefore, the undertaking shall keep analytical records in the incentive capital account in terms of reporting periods of its building and state it in the decision on accrual of such stimulating payments;

- when determining the size of incentive capital, Law No. 135/2007 comprises no guidance on what profit to be taken into account – retained earnings (taking account of outstanding losses) of past years or the net profit for each reporting period. Besides, there are no provisions on building incentive capital if errors are committed and corrected upon mirroring the profit or when events occur after the reporting date.

Hence, when performing operations related to incentive capital building and use, questions arise regarding their mirroring in accounting. Nowadays, accounting of such operations is not governed in accordance with the regulatory acts. Therefore, the LLC keeps records for such operations differently and not always properly. To ensure unified mirroring of incentive capital we suggest introducing some amendments to the National Accounting Standards, as well as to the General Chart of Accounts. The proposals on making such amendments are contained in the articles published in the periodical press where the Authors presented their views on this matter [4, 5].

Having ascertained the aforementioned, we note that prior to making such amendments, the agent is entitled to independently develop accounting rules for incentive capital and consolidate them into its accounting policy. In our opinion, the operations on building and using incentive capital by the LLC can be mirrored in a separate sub-account “*Incentive Capital*”, opened to the synthetic account intended for accounting of other reserves. In this case, incentive capital building shall be accounted for as a decrease in retained earnings for the past years or used profit for the current reporting period and increase of liabilities towards workers for other operations. The payment of incentive rewards shall be mirrored as concurrent decrease of liabilities towards workers and of cash amounts.

The information on the accrued and used amounts of incentive capital shall be mirrored in financial reporting and taken into account when calculating the overall size of other reserves, mirrored in the balance sheet and in the equity changes report.

In light of the above, the incentive payments are ranked as dividends, and, therefore, shall be taxed as dividends. According to the Tax Code [2, Art. 90<sup>1</sup>], final withholding of tax in the amount of 6% is done from the paid dividends. Neither social security, nor mandatory health insurance contributions shall be accrued on such payments. In its explanations published in the consolidated base of tax practice [6], the State Tax Inspectorate stated how incentive payments shall be taxed. The Ministry of Finance also tackled that matter in its letters addressed to some economic agents.

Upon incentive capital building and use, it is necessary to comply with the provisions of Law No. 135/2007 pertaining to the distribution of net profit [1, Art.39] and to constraints on its distribution or payment [1, Art.40]. To that end, the LLC is not entitled to adopt any decision on the distribution of its net profit among the company participants, if following such distribution the value of company net assets would be less than the sum of its share capital and reserve capital.

Besides, the provisions of the Tax Code [7, Art. 80<sup>1</sup> p. (1)] shall be taken into account, according to which the agents practicing the general tax regime when paying dividends during the reporting period have to pay in advance the income tax in amount of 12% of the current tax period profit, which covers the incentive capital.

In conclusion it is worth noting that the implementation of the mechanism aimed at stimulating and rewarding the deserving workers through their participation in the company profit, would contribute to the establishment of a transparent and effective reward system, raising the staff interest in the work results and enhancing financial durability of those economic agents, which use incentive capital as part of their financial strategy. Nonetheless, the regulatory acts in force have no clear explanations in terms of accounting of incentive capital building and use, while taxation matters need refinements. To avoid ambiguities, it is important that the undertakings follow any changes in the legislation and tax authorities' explanations so that they could timely adapt their practices and minimise the business risks. To do that they need to develop efficient in-house regulations, containing not only incentive capital building and use, recipients' identification and conditions for incentive capital payment, but also monitoring mechanisms of changes in the legislation, as well as quick response algorithms to those changes.

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