

# *Tax Newsletter*

## Tax Code: key changes related to Corporate Profits Tax

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# Tax Code

*Following the adoption of the Tax Code by the Ukrainian Parliament in December 2010, this Newsletter summarises key changes related to Corporate Profits Tax (CPT).*

## I General provisions

### • *Implementation date*

The provisions related to determining CPT liabilities are governed by Part III of the Tax Code, which enters into force on 1 April 2011.

For 1Q 2011 the taxpayers will be required to prepare the corporate tax return under the “old” CPT Law provisions and from 2Q 2011 onwards the new rules established by the Tax Code will apply.

### • *Tax rate*

The tax rate will be 23% in 2-4QQ 2011 and will gradually decrease further to 21% and 19% in 2012 and 2013 respectively. From 2014 onwards the tax rate should be 16%.

### • *Tax and financial accounting*

The overall approach adopted by lawmakers in respect of CPT liability computations may be viewed as an attempt to make tax accounting closer to the statutory bookkeeping rules.

In a significant change the “first event” rule will be cancelled. Rules for the recognition of items of income/expense for tax purposes will be based on financial accounting rules, but with certain restrictions (refer below).

Specifically, terms not defined by the Tax Code should be interpreted according to the definitions provided in the Law “On the Statutory Accounting and Financial Reporting in Ukraine”, national and international accounting standards.

### • *Transfer pricing*

New transfer pricing rules are expected to come into effect from 1 January 2013.

In the meantime, contractual prices should be used for tax purposes, but arms-length provisions will apply to transactions with related parties and non-standard payers of CPT.

## Highlights

- *Corporate profits tax changes are effective from 1 April 2011. Two final returns are required for 2011.*
- *Reduced rate of 23% applies from 1 April 2011 and will gradually decrease to 16%*
- *Tax accounting is unified to financial accounting (but some modifications)*
- *A 4% limitation of the previous year’s net revenue is placed on the deductibility of royalties paid to non-residents*
- *The deduction of the cost of consultancy, marketing and advertising services purchased from a non-resident is restricted to 4% of the previous year’s net revenue*
- *Cost of goods and services purchased from individuals on a simplified tax system will not be tax deductible*
- *Tax depreciation methodology is now closely aligned to financial accounting with transitional provisions*
- *The beneficial ownership concept will make tax planning more difficult*
- *The concept of service PE is added*
- *Penalties for the violations in 2Q11 and 3Q11 will not apply*
- *Tax holidays may be available for small businesses*

The Code has introduced ‘safe harbour’ threshold whereby no adjustments to the tax records are required provided the contractual price in the transactions with related parties and non-CPT payers is within a 20% deviation from the market (usual) price.

### • *Tax losses*

Tax losses can be carried forward indefinitely, including those recognized prior to 1 April 2011.

### • *Penalties*

Penalties for violations of the tax rules in 2Q11 and 3Q11 do not apply. However, there will still be a risk of tax assessment and criminal prosecution.

Penalties are set at 25% of tax underpaid for the first violation detected by the tax authorities. 50% penalty applies for the second violation and 75% starting from the third violation onwards, if revealed by the tax authorities within a 1095-day period.

- *Tax holidays*

Tax holidays may be available for small businesses, but unlikely to impact international business.

- *Simplified tax regime*

The simplified tax regime continues for eligible entities with no significant changes.

## II Income

- *Income recognition*

Although tax accounting for CPT will generally follow financial accounting rules, there are specific rules for income recognition.

Income arising from the sale of goods is recognized for tax purposes upon transfer of the title to such goods to the customer. Income from the provision of services is recognized at the date when the service acceptance act is signed.

Income should not be recognized for the price of goods/services shipped after 1 April 2011 up to the amount of their value prepaid before this date and taxed under previous regime.

- *Financial aid*

Refundable financial aid continues to be taxable if received from a non-standard CPT payer and not returned within the quarter.

However, as an exception, refundable financial aid received from a founder/shareholder (a non-standard CPT payer, including non-residents) is not taxable if returned within 365 days.

## II Expenses

- *General restrictions*

The Tax Code establishes two major categories of expenses: those related to the cost of goods/services sold and 'other' expenses.

Although expenses should be recognised in accordance with accounting standards, it is likely that significant restrictions in respect of deductibility of expenses will apply (accruals for example).

- *Expense recognition*

The cost of goods/services sold is deductible when revenue from their sale is recognized.

A taxpayer is entitled to adopt any of the methods of inventory valuation prescribed by the national accounting standards.

Other expenses should be deducted in the period when they are actually 'incurred' and the documentary evidence is available (signed acceptance acts).

The list of expenses available for deduction specified by the Tax Code is not exhaustive. Other expenses related to a taxpayer's business activity may also be deducted, unless specifically restricted by the Tax Code.

It is clear that having primary documentation to substantiate the deductibility of expenses remains an essential requirement. It is unlikely that the tax office will accept a deduction for accrued costs.

- *Specific deductions*

The Code specifically permits the deduction of the following expenses:

- maintaining the company's cars (including lease), purchase of fuel, car parking without restrictions;
- expenses for mobile networks services and Internet;
- sales expenses, such as cost of advertising, market studies (marketing), pre-sale preparation of goods;
- warranty repairs (no limitations);
- insurance (no percentage limitation).

- *Specific restrictions*

The Tax Code places an individual 4% limitation of the previous year's net revenue on the deductibility of the following expenses:

- cost of consultancy, marketing and advertising services purchased from a non-resident, unless it was provided by its PE in Ukraine and was taxed accordingly;
- royalty payments in favour of non-residents (but royalties related to the IP rights that originated in hands of a Ukrainian resident are not deductible).

These limitations will have a major impact in initial years of operations.

Cost of goods and services purchased from an individual on a simplified tax system are not tax deductible (this does not apply to payments to IT entrepreneurs and payments to legal entities under simplified tax system).

The deduction of per-diems is capped at 20% and 75% limit of the minimum salary at the beginning of the calendar year for business trips within Ukraine and abroad correspondingly.

### • Long-term contracts

The Tax Code does not shed more light on the tax regime of the long-term contracts. These rules have not undergone any significant changes compared to the previous legislative provisions and remain rather ambiguous.

## III Tax depreciation

Tax depreciation rules are now aligned to financial accounting rules with some modifications.

Taxpayers are entitled to choose the depreciation methods per class of assets. There are a number of depreciation methods available, including straight-line and reducing balance. Accelerated depreciation is also available in respect of machinery, equipment and motor vehicles.

Although, there are now 16 asset classes, most are not relevant for majority of taxpayers. The table below explains the most relevant classes and the relevant depreciation rates per year under most common methods.

Asset class*	Straight line	Reducing balance	Accelerated
Buildings	Up to 5%	Up to 16%	-
Plant and equipment, including computers	Up to 20% Up to 50%	Up to 50% Up to 80%	Up to 100% Up to 100%
Motor vehicles	Up to 20%	Up to 50%	Up to 100%
Returnable containers	Up to 17%	Up to 40%	-

\*This is indicative only based on the nominal residual value. Actual rate will depend on the estimated residual value of an asset at the end of useful life

The Tax Code provides for the transitional provisions to move from the existing rules of tax depreciation computation to newly adopted ones.

## IV Specific considerations

### • Dividends

The Tax Code specifically exempts taxpayers from the advance CPT on dividends in case they are paid to individuals.

Dividends paid by fixed agricultural tax payers to their shareholders are also exempt from advance CPT.

### • Operations in foreign currency

Income and expenses in foreign currency should be recognized at the forex rate effective either at the date of income/expense recognition or the payment date, whichever occurs first.

Forex differences arising on unsettled debt balances and foreign currency account balances are computed according to the accounting standards. Realized and unrealized forex gains are taxable while losses are allowed for deduction.

In case of foreign currency sale, the difference between income realized from the sale and the balance value of the disposed foreign currency is taxed/deducted accordingly.

In case of a foreign currency purchase, the difference between the purchase price of the foreign currency and its balance value is taxed/deducted accordingly.

### • Interest restrictions

Tax deduction of interest payable by subsidiaries of foreign companies to related entities is effectively limited to the taxpayer's interest income plus 50% of EBIT (previously EBITDA).

The Tax Code explicitly provides the possibility to deduct excessive interest in future tax periods within the limit stated above.

### • Beneficial ownership concept

The Tax Code introduces the beneficial ownership concept, although there is no clear definition.

Nominees / agents / intermediaries may not be considered as beneficial owners and will therefore not be entitled to use the benefits of tax treaties, including reduced rates. It is unclear how the tax office will enforce this provision, but they are likely to be aggressive.

### • Advertising tax

The 20% tax in respect of payments for advertising services rendered by non-residents will apply, irrespective of whether such services were provided within the territory of Ukraine or abroad.

### • Permanent establishment

The Tax Code introduces the concept of a service permanent establishment (PE) whereby the provision of services (apart from the provision of personnel), including consultancy services, by a non-resident through its employees in Ukraine, shall constitute a Ukrainian PE of this non-resident, provided such activities (within the frames of one project) last for more than 6 months in any 12-month period.

Moreover, a construction site in Ukraine may also give rise to a taxable presence of a non-resident in Ukraine in the form of a PE, provided the length of the construction activities exceeds 6 months.