Major tax reform in Ukraine includes important changes to corporate tax rules

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In brief

The tax laws in Ukraine have been changing rapidly. Several new laws introduce significant amendments to the Ukrainian Tax Code. These laws, which affect the corporate income tax, the value added tax, the personal income tax, transfer pricing rules, and other key issues, entered into force January 1, 2015.

These amendments are designed to (1) simplify Ukrainian tax administration to ease the conditions of doing business in Ukraine and improve the country's investment climate, and (2) raise revenue to finance government expenses. Thus, these measures could have both positive and negative impacts on Ukrainian taxpayers.

This *Tax Insight* focuses on the most significant changes to the Ukrainian corporate profits tax rules, including:

- a shift from the direct method of calculating tax profit to an indirect method of adjusting accounting profit for tax differences
- new thin capitalization rules
- liberalization of some expense deductions, including payments to non-residents (other than those in low-tax jurisdictions)
- an unlimited loss carryforward period, and
- cancellation of certain tax incentives.

In detail

Tax base and rate

The standard corporate tax rate remains 18% for 2015. Reduced rates of 0% or 3% are available for qualified insurance activities.

Beginning with reporting for 2015, each taxpayer's annual tax base is Net Profits Before Tax (NPBT) as determined under an appropriate accounting method, either Ukrainian statutory or International Financial Reporting Standards (IFRS), adjusted for 'tax differences' (see below).

Taxpayers with prior-year annual income of UAH 20 million or less (net of indirect taxes) may opt not to make the adjustments. They remain eligible for the loss carryforward allowance.

Tax differences

NPBT should be adjusted for tax differences, including the following:

Depreciation of assets

Depreciation of fixed and intangible assets should be recalculated in accordance with the tax rules. These rules provide a list of expenses not subject to tax depreciation, the minimum useful lives of assets, and minimum values of assets subject to amortization. Any reduction in the value of assets due to their impairment is disregarded for tax purposes. There are special rules for calculating the residual value of fixed or intangible assets at their liquidation or disposal.

Provisions

Provisions for vacation and salary payments are allowed, while other provisions for future costs (i.e., warranties and contingent liabilities, etc.) are disallowed, as are provisions for doubtful debts.

Actual expenses covered by these provisions, except for vacation and salary payments, are deductible when incurred. There are special rules for banks and financial institutions.

Thin capitalization rules

The thin cap rules apply to taxpayers whose debts to non-resident related parties are more than 3.5 times greater than their equity (more than 10 times greater for financial institutions and leasing companies). The interest expense deduction for these taxpayers is limited to 50% of earnings before interest, taxes, depreciation and amortization (EBITDA). Nondeductible interest can be carried forward indefinitely, but with an annual reduction of 5% of the residual amount. Under the old rules the interest deduction was limited to the taxpayer's interest income, plus 50% of EBIT.

Loss carryforward allowance

Losses can be carried forward without limitation. The prior rules restricted the use of tax losses accumulated as of January 1, 2012. This restriction has been removed — the residual amount of unused losses from January 1, 2012, now can be deducted in full.

Investment income

Dividends received from other Ukrainian corporate profits taxpayers are not taxable to the shareholder.

Amended rules for deductibility of payments to non-residents

Only 70% of payments for goods or services to residents of low-tax jurisdictions are deductible. The list of low-tax jurisdictions is established by Ukraine's Cabinet of Ministers.

The new laws eliminate the restrictions on the deductibility of consulting, marketing, and advertising fees paid to non-residents (other than those in low-tax jurisdictions).

The deduction of royalties paid to non-residents is limited to the taxpayer's royalty income received in the current tax period plus 4% of the taxpayer's net income of the previous year (the previous limit was 4% of the taxpayer's net income for the previous year). Royalties are not deductible if paid to non-beneficial owners, low-tax jurisdictions, non-residents that are exempt from tax on royalties in their country of residence, or non-residents for trademarks originating in Ukraine.

These limitations can be waived if a taxpayer confirms the market level of payments in accordance with the transfer pricing rules, even if the transactions are not subject to those rules.

The term 'royalty' has been redefined to exclude payments for the use of a computer program by the end user and for purchasing electronic copies of intellectual property for final consumption.

Liberalization of tax deductibility rules

The new laws have eliminated a number of restrictions on the deductibility of costs. This includes costs related to special clothing, insurance, training, waste, hospitality, business trips, and advertising.

There are no special rules for tax accounting of repair costs. Ukrainian statutory or IFRS rules should apply.

The new rules abolish the tax accounting rules for the receipt (provision) of financial aid. Under the old rules, the receipt of financial aid triggered negative tax consequences for taxpayers. In particular, financial aid recipients were required to include in taxable income notional interest if the financial aid came from a corporate profits taxpayer or the total financial aid amount if it came from an entity that is a not a corporate profits taxpayer, including a non-resident.

Transition provisions

There are several transition provisions related to tax depreciation (accumulated as of January 1, 2015), provisions, overdue debts, payables, receivables, etc.

Cancellation of tax incentives

Effective January 1, 2015, the new laws cancel tax incentives for the following taxpayers:

- producers of gas (methane), bio-energy fuel, electric and heat energy generated from bio-energy fuel, and domestic equipment powered with bio-energy power
- manufacturers of certain consumer goods (the so-called 'light industry')

- ship and aircraft-builders
- enterprises that produce machinery for the agricultural industry
- publishers and cinematographers
- investors in qualifying large investment projects (those resulting in job creation) in qualifying industries
- IT companies.

Advance tax payments

Taxpayers with annual income exceeding UAH 20 million (approximately USD1.25 million) must make monthly advance tax payments (MATP). There is an exception for newly established companies, non-profit organizations, collective investment arrangements, and agricultural producers.

The rules in effect before January 1, 2015, apply to MATP from January 2015 through May 2016.

MATP from March 2016 through May 2016 should be no less than 1/12 of the taxpayer's 2014 corporate profits tax liabilities.

Beginning in June 2016, MATP for the period from June of the current year through May of the following year should equal 1/12 of the previous year's tax liabilities.

Taxpayers with a loss (i.e., no taxable profit) in the first quarter of the reporting year no longer may choose quarterly tax reporting and payment.

Taxpayers with a loss in the previous year but generating profits in the first quarter of the current reporting year must file half-year, nine-month, and annual returns, if their annual income exceeds UAH 20 million.

Generally, the rules for advance tax on payment of dividends (ATD) remain the same. However, the ATD now applies only to the portion of dividends that exceeds the profits of the respective dividend year for which corporate profits tax has already been paid, and ATD reduces the amount of MATP for the next year.

Other tax law changes

The latest round of Ukrainian tax reform is quite extensive, changing almost every Ukrainian tax.

These significant changes are beyond the scope of this *Tax Insight*, but in summary the reform:

- increases the maximum personal income tax rate from 17% to 20%
- introduces significant changes to VAT legislation with respect to the electronic VAT administration system, minimum VAT base, VAT refund and VAT credit rules
- adds a new excise tax on wholesale supply of electric power
- provides an extra 5% excise tax on retail sales of excisable products, such as alcoholic drinks, beer, fuel, and tobacco products
- abolishes the excise tax on transactions involving securities
- retains the military tax (1.5% on personal income), which was supposed to be abolished effective January 1, 2015 and
- abolishes the special 0.5% pension duty on purchase of foreign currency by legal entities.

The takeaway

The effects of these changes on Ukrainian taxpayers will vary widely. Some of the new rules simplify tax administration, thereby easing the burden for corporate taxpayers. In particular, such taxpayers will no longer have to maintain separate tax accounting and perform complex tax profit calculations for entities whose profit does not exceed UAH 20 million (approximately USD1.25 million).

The changes also eliminate numerous restrictions on expense deductions, including limitations on deductions for consulting, marketing, and advertising services fees to non-residents (other than those in low-tax jurisdictions). Further, the changes liberalize the rules on deductibility of royalty payments to non-residents.

Other changes, however, may increase the Ukrainian tax burden of US multinationals. For example, the deductibility of payments for goods or services to residents of low-tax jurisdictions has been reduced from 85% to 70% of eligible expenses. The reform also introduces more sophisticated thin capitalization rules and cancels numerous tax incentives for certain industries.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

International Tax Services, United States

Svitlana Kozhushko
+1 (646) 335-4262
svitlana.m.kozhushko@us.pwc.com

Elena Liaskovskaia
+1 (646) 471-5515
elena.liaskovskaia@us.pwc.com

International Tax Services, Ukraine

Ron Barden
+380 44 354 0404
ron.j.barden@ua.pwc.com

Slava Vlasov
+380 44 490 6782
slava.vlasov@ua.pwc.com