

Ukraine: New year with the brand new Tax Code

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Early in December 2010 the Ukrainian Tax Code was signed by President Yanukovich and officially published. On 1 January 2011, this document - which has sparked heated debates in the Parliament and drawn healthy criticism from the international business community as well as small domestic businesses - will become law, with the following exceptions:

- Profits tax chapter, one of the most debatable, will come into effect on 1 April 2011;
- Real estate tax for individuals will be introduced from 2012;
- New transfer pricing rules will come into effect in 2013, and
- Taxation of interest income earned by individuals from deposits is deferred until 2015.

The logical question is whether this brand new Tax Code is a good or bad thing for international businesses that operate in Ukraine or have Ukraine in mind for potential expansion.

Earlier in 2010, in the days following the presidential elections in Ukraine, the new Ukrainian Government publicly declared its intention to reform the tax system. In light of this declaration, it was, in our professional view, a good thing for both Ukraine and Ukrainian and international businesses, to have codified tax rules that would replace the hundreds of currently existing laws, regulations and interpretations, which are in many cases inconsistent with one another.

Does this really mean the end of the tax reforms to which Ukraine has been committed? No, in fact, this probably means only the start of these reforms. It matters a great deal for the business community what the Tax Code looks like now, but no less important is what will happen with the implementation and changes of this document in the first couple of years after its enactment. Much will depend not only on the new rules of law, but on the approach that the Ukrainian authorities will take in monitoring the impact of the changes on business and adjusting the new rules in a way that makes the Ukrainian economy attractive to new foreign investment.

PwC in Ukraine was actively involved in discussions of the proposed new tax rules, concerns of the international business community and their suggestions on ways forward with the Ukrainian Government and Parliament. Based on these discussions, we would like to offer the foreign business community the following food for thought.

KEY POINTS OF THE NEW TAX CODE AND ITS IMPACT ON UKRAINIAN BUSINESSES

The Ukrainian Government presents the new Tax Code as a very progressive document that, among other measures, reduces the rates of major taxes (Corporate Profits Tax and VAT), eliminates a number of small but burdensome local taxes that currently exist in particular regions or towns of Ukraine, unifies statutory and tax accounting rules and simplifies the VAT recovery procedures, the latter of which is currently a major tax issue for exporters in Ukraine.

It should be noted, however, that the tax rates are not the major tax issue for Ukraine; they are quite comparable with other European tax rates. Tax administration is the real issue, given that Ukraine is currently ranked by PwC, World Bank and IFC as one of the least attractive countries when it comes to ease of paying taxes.

Initially, Ukrainian business was shocked by the version of the draft Tax Code, passed by the Ukrainian Parliament in the first reading in June 2010, which was largely based on the assumption that the taxpayer is always wrong and guilty. Inconsistent compilation of existing tax laws with significant revision of rules for tax audits, tax assessments and appeals against them in the favour of the tax authorities, in combination with the proposal to give the tax office almost unlimited powers to control business and collect taxes at own discretion, were the reasons why business said a clear “no” to that document. The business community expressed a clear view to the authorities that that version of the Tax Code would never ease doing business in Ukraine.

Now, reading the Code, we are glad to say that the voice of business was heard by the authorities. Most disputable and arrogant administrative rules were taken out of the draft and the following key principles were introduced into the Code:

- **Unification and simplification of tax rules.** The terminology of the document is much more consistent than the one in the original draft. The first steps are taken toward unifying statutory financial and tax accounting, which eases the lives of accountants and finance personnel.

Currently multinational corporations keep three sets of accounts in Ukraine: IFRS, statutory financial and statutory tax. Unification of the last two is clearly a positive factor. Examples of unification include same rules for recognition of revenues and costs, same depreciation rates and same approach to recognition of exchange rate differences, allowance of accelerated depreciation of machinery, equipment and transport vehicles.

Still, many other things need to be done in this area after the enactment of the Tax Code, i.e. unification of statutory accounting rules with the international financial reporting standards, simplification of the procedures to prepare the tax returns, etc.

The Code has also reflected the concept of stability of tax rules, i.e. at least 6 months prior notice to business is required to introduce any future significant changes in this document.

In addition, the Code contains a “conflict of interest” clause, stating that if tax rules are inconsistent, they should be interpreted in favour of a taxpayer

- **Simplification of tax administration.** As mentioned above, tax administration rules are, at least, no worse than the current rules. In addition, the authorities have agreed to introduce less frequent and more simplified tax reporting for relatively small businesses.

This is only the first step in the improvement of tax administration in Ukraine. What goes beyond the Tax Code is the qualitative improvement of tax audits. The tax authorities must understand the industries they are auditing, market trends and the financial indicators of these industries at a particular point of time, so that the tax audits are focused on the identification and understanding of deviations from these trends and indications for a particular taxpayer, as well as discussing their rationale with the taxpayer prior to tax assessment.

Another positive example of the improvement of tax administration is the introduction of a single personal income tax rate for both Ukrainian tax residents and non-residents alike. Currently, non-residents are subject to tax at a double rate and to establish Ukrainian tax residency is a long and burdensome process, requiring lots of time and effort for both individuals and their employers.

We would separately like to mention that the Tax Code has introduced the concept of “automatic” VAT refund, which is one of the key tax issues for exporters in Ukraine. In the last several years Ukraine has consistently failed to refund VAT to business in cash. The procedure for the refund introduced by the Code is very straightforward; it allows transparent businesses to get cash from the Government in a few weeks, compared to months and years of waiting which has been the case to date. However, for this new rule to work, the Government still has to develop an electronic register for all VAT invoices in the country and make this register work efficiently. This is no easy task and may take time to complete.

- **Mutual responsibilities of businesses and the Government in the tax sphere.** Given that the Ukrainian tax system is still developing, tax penalties on bona fide companies should be fair. International businesses are glad that the Government heard their concerns on this issue and significantly reduced tax penalties in the Tax Code.

Another positive change is that the Government has agreed to be financially liable for late refund of VAT. Late payment interest payable by the Government is introduced for each day of delay of the refund.

Given that the Tax Code is a brand new document that was made a law less than a month before the start of new fiscal year, it will give very little time to businesses to adapt to the changes, i.e. read the document, adjust accounting policies and procedures, make necessary changes into accounting software and reorganize tax-compliance and tax-planning functions. The authorities have agreed to set a “grace period” of 6 months after the introduction of the Tax Code. A nominal penalty of 1 Ukrainian Hryvna will apply to tax violations committed during this period. In addition, for corporate profits tax, no penalties will apply during second and third quarters of 2011.

IMPACT OF THE CODE ON FOREIGN INVESTMENT INTO UKRAINE

The proposed improvements of the tax rules will clearly lead to a reduction of state budget revenues in the short term. It is our understanding that in trying to compensate for this, the Ukrainian authorities have introduced in the Tax Code several significant limitations for businesses that negatively impact foreign investors in Ukraine. They include, for example:

- Prohibition for businesses, except for those operating in IT area, to deduct costs of goods, works and services purchased from individual entrepreneurs that pay Unified Tax;
- Limitations for business to deduct royalties, consulting, advertising, marketing and engineering fees payable to non-residents, unless such non-residents create permanent establishments in Ukraine and tax the above fees in Ukraine;
- Absence of costs for promotion of goods, works, services and trademarks in the list of tax deductible expenses. While this list is not closed, absence of direct indication of the tax deductibility of these costs in the Tax Code may lead to tax disputes;
- Non – deductibility of VAT payable by new businesses at start-up phase. New businesses that invest in, for example, manufacturing facilities, are not recognized as VAT payers until they make first sale, and thus are not able to recover VAT paid on construction works, purchased equipment, etc
- Unfair VAT treatment of several industries, for example grain traders, auditors, consultants, accountants, lawyers, software developers. Operations of these industries will not be subject to VAT. As a result, VAT that these businesses pay to their suppliers becomes extra cost for them.

We understand that the Government's rationale for these limitations is to prevent tax schemes used by non-transparent businesses in order to reduce their Ukrainian tax liabilities. Transparent international businesses fully support this intention, but the format of the limitations is unacceptable to them.

Take services payable to non-residents for example. Recharge of group costs as a service fee is a generally accepted business practice for multinational groups. It is aimed at the allocation of relevant costs to the entities that obtain economic benefits from services, and therefore tax deductibility of such fees should be economically justified. While the Government has heard the voice of business and rejected the original idea to completely prohibit tax deduction of such fees, limitations introduced by the Tax Code are still not good for investment image of Ukraine in the eyes of foreign investors. As a result, further foreign investments in Ukraine may not be attractive for international businesses compared to opportunities in neighbouring countries. In addition, Ukrainian subsidiaries of international businesses will compensate their additional tax costs (corporate profits tax, VAT, excise tax if applicable) via increases in the prices of their goods, works and services in Ukraine. As a result, Ukrainian consumers will suffer from higher prices on high quality products.

The Ukrainian authorities need to further revisit this and other rules that discriminate against international businesses. In our view, the best way to balance the interests of both the Government and businesses is to follow best international practices. For example, it is well known that no developed countries prohibit the deduction of service fees payable to foreign suppliers. As a rule, service fees payable to unrelated foreign suppliers are fully tax deductible. When such payments are made to a related party, other countries allow tax deduction to the extent that the payments do not exceed the level of similar payments to unrelated parties (the "arm's-length" principle). Other countries have developed their transfer pricing legislation that defines "arms-length" and Ukraine should introduce the same rules and apply them consistently.

A final aspect worth mentioning when discussing the new Tax Code is that it does not offer any specific tax incentives for foreign investments. While the incentives as such should not be a decisive factor for an investor to make a decision to invest or not, they may serve to differentiate Ukraine from neighbouring countries in the eyes of a particular investor. We believe that Ukraine need to revisit its approach to stimulating foreign investment activity.

To conclude this short summary of the Tax Code, it is important that the Ukrainian authorities are prepared to stay in active dialogue with the business community on any issues that businesses experience after the enactment of the Code and further amend this document to stimulate business activities in Ukraine. Therefore, businesses should not miss their chance to voice their issues and concerns during this dialogue.