Corporate Profit Tax vs. Exit Capital Tax: Analysis and recommendations - Summary of results -

David Saha, Thomas Otten, Oleksandra Betliy, Ricardo Giucci

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Corporate Profit Tax vs. Capital Exit Tax

Ukraine currently operates a Corporate Profit Tax (CPT)

- Tax base: Essentially financial profits: accounting entity

Proposal to replace with Exit Capital Tax (ECT)

- Estonian model, tax base: Transactions with capital exit (e.g. dividends)
- Ministry of Finance has to submit draft law by July

Purpose of this paper:

1. Should Ukraine go for fundamental change towards an ECT system?
2. If ECT system installed in Ukraine, how should it best be designed?

Present CPT: Tax base and tax rate

Tax base

- Since 2015: Financial profit according to IFRS or Ukrainian Accounting Standards
- Adjustments for tax purposes include: Value adjustments, minimum depreciation according to the Tax Code, provisions/accruals, thin-capitalisation adjustments etc.
- Profit can be positive, but cash flows negative => still positive tax burden

Tax rate

- CPT rate: 18 %
- However, witholding tax and military duty on dividends received by natural persons
- Effective tax rate hence 23.3%

Taxation of corporate profits in Ukraine

Company profit		UAH 100
CPT	18%	UAH 18
Dividend		UAH 82
Withholding tax	5%	UAH 4.1
Military duty	1.5%	UAH 1.23
Profit received by owner		UAH 76.67
Effective tax rate	23.33%	

Source: Own calculations

Present CPT: other aspects

Anti-avoidance rules

- Thin capitalisation: Deductible interest on related party loans limited 50% EBIT
- Transfer pricing (TP): Since 2015, according to OECD guidelines
- Minimum terms on depreciation (reduces company discretion in accounting)
- Adjustment of provisions/accruals and value corrections (also reduces discretion)

Simplified system of taxation (SST)

- Parallel tax system intended for small companies, private entrepreneurs
- Four groups of companies, the 3rd group can have up UAH 5 m turnover p.a., 4th group for agricultural companies
- Pay a unified tax of 5% on turnover in lieu of CPT, other duties (some pay unified tax of 3% + VAT)

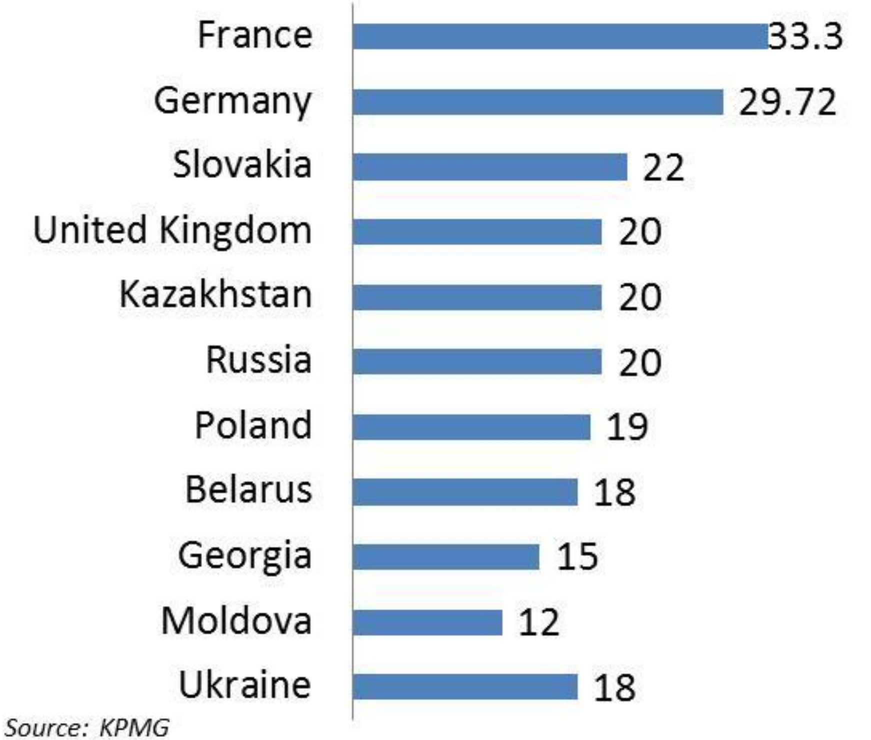
Administration

- Conducted by State Fiscal Service of Ukraine (SFS)
- Tax audits concern entire financial accounting, complex procedure

Present CPT: Economic effect

- Possible impact: Negative incentive for investment due to tax on capital
- Effective rate of 23.33% slightly higher but similar to PIT + military duty => no large distortion
- CPT discriminates against equity financing (interest costs can generally be deducted)
- Accelerated depreciation (in force 2017-2018) reduces this effect
- International tax competition: Ukrainian rate not excessive

International average CPT rates in comparison



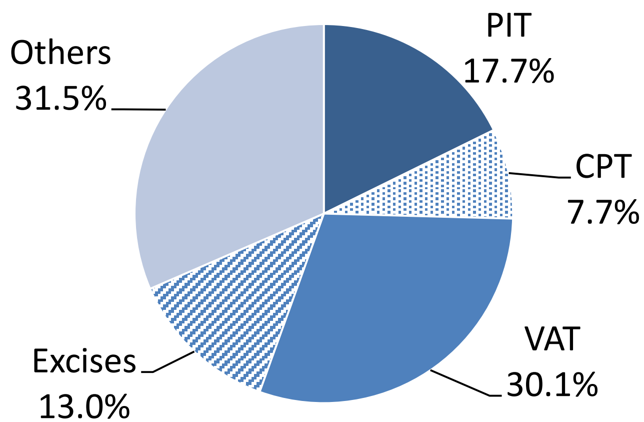
Source: KPMG

Note: CPT Germany consists of the statutory CPT rate of 25% and a variable municipal component, which is averaged here

➢ **Mild economic effect. No strong incentives against investment, competitive rate**

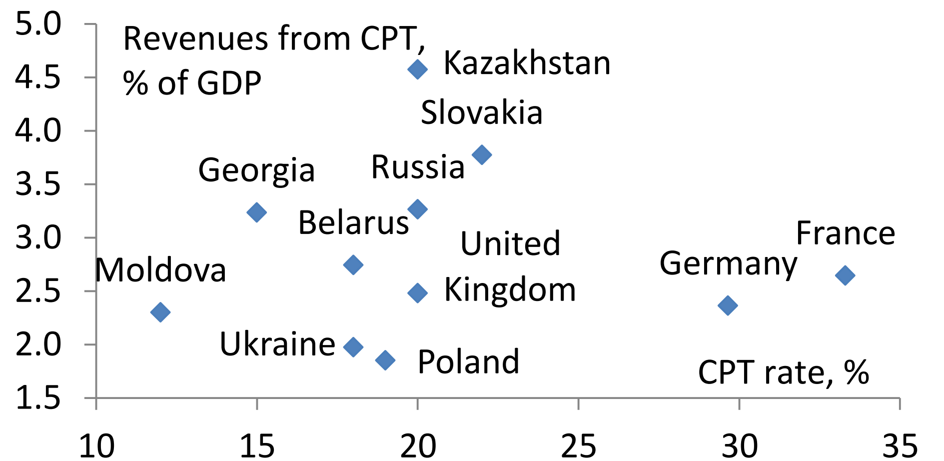
Present CPT: Fiscal effect

Share of revenue sources in consolidated fiscal revenues, 2016



Source: Ministry of Finance of Ukraine

CPT rates and revenue shares of GDP in different countries, 2015



Source: KPMG, IMF (Government Finance Statistics)

- Relatively low CPT revenues, UAH 60.2 bn (2.5% of GDP) in 2016
- Reasons on top of legal avoidance:
  - Large losses of companies from FX debt carried forward
  - Profit shifting to loss making CPT payers and SST payers (limited)
  - Large enforcement problems at SFS (lack of qualified experts)
- Low revenues in international comparison for this tax rate

➢ **CPT fiscally not successful. 1000 taxpayers pay 90% of revenues**

Present CPT: Administrative burden

Administrative burden on companies and tax authority

- **General** issues of CPT system:
  - **Complexity** of financial accounts
  - **Discretion** for companies in valuations, provisions
  - Implies **need for high competence** of tax authority
  - Often relatively large **documentation needs**
  - **Approximation of tax/financial accounting** should reduce administrative burden
  - Need for a **cooperative tax** culture (taxpayer honesty, light inspection burden)
- **Specific** issues of Ukraine’s CPT
  - Large **shadow economy** (35% of GDP), hence much tax evasion
  - **Low capacity and high corruption at SFS**: Audits result in arbitrary taxes, hard to challenge in courts, focus on form rather than substance
  - Consequence: **Tax audits cause immense burden** (administrative and financial), often cause work stoppages at HQs

➢ **Large administrative burden on companies, enforcement difficulty by SFS**

➢ **Main problem is low SFS capacity and integrity, not the tax system per se**

Present CPT: Conclusion

- **Relatively standard design of CPT in int. Comparison**
- **No large negative economic effects**
- **Fiscally ineffective due to large losses carried forward and inadequate enforcement capacity by SFS**
- **Main problem: Large administrative and financial burden caused by tax audits due to inadequate enforcement**
- **Main problems not caused by the nature of the tax system but by specific issues, especially institutional capacity**

ECT: Current proposal

- Our analysis is based on the current version of the unofficial draft law proposed by Oleksandr Shemiatkin and Tetiana Shevtsova

Motivation for an ECT

1. Increasing investments due to taxation of distributed profits only
2. Administrative facilitation due to transactions forming the tax base

Tax Base

- Conceptually: Dividends and transactions in which capital exits tax system, e.g. equated payments (interest to related parties), surcharges (TP)
- Hence: Only a limited number of transactions
- Financial accounting no longer the base for taxation, instead a limited number of *transactions*
- All flows *between* ECT payers are not taxed
- Flows *out* of the system such as dividends, royalties financial aid, interest rates are in principle taxable according to specific rules

ECT: Current proposal (2)

Tax rates

- 15% on transactions with capital exit, e.g. dividends, payments by state and municipal entities
- 20% on equated payments (e.g. related party interest) or surcharges on prices

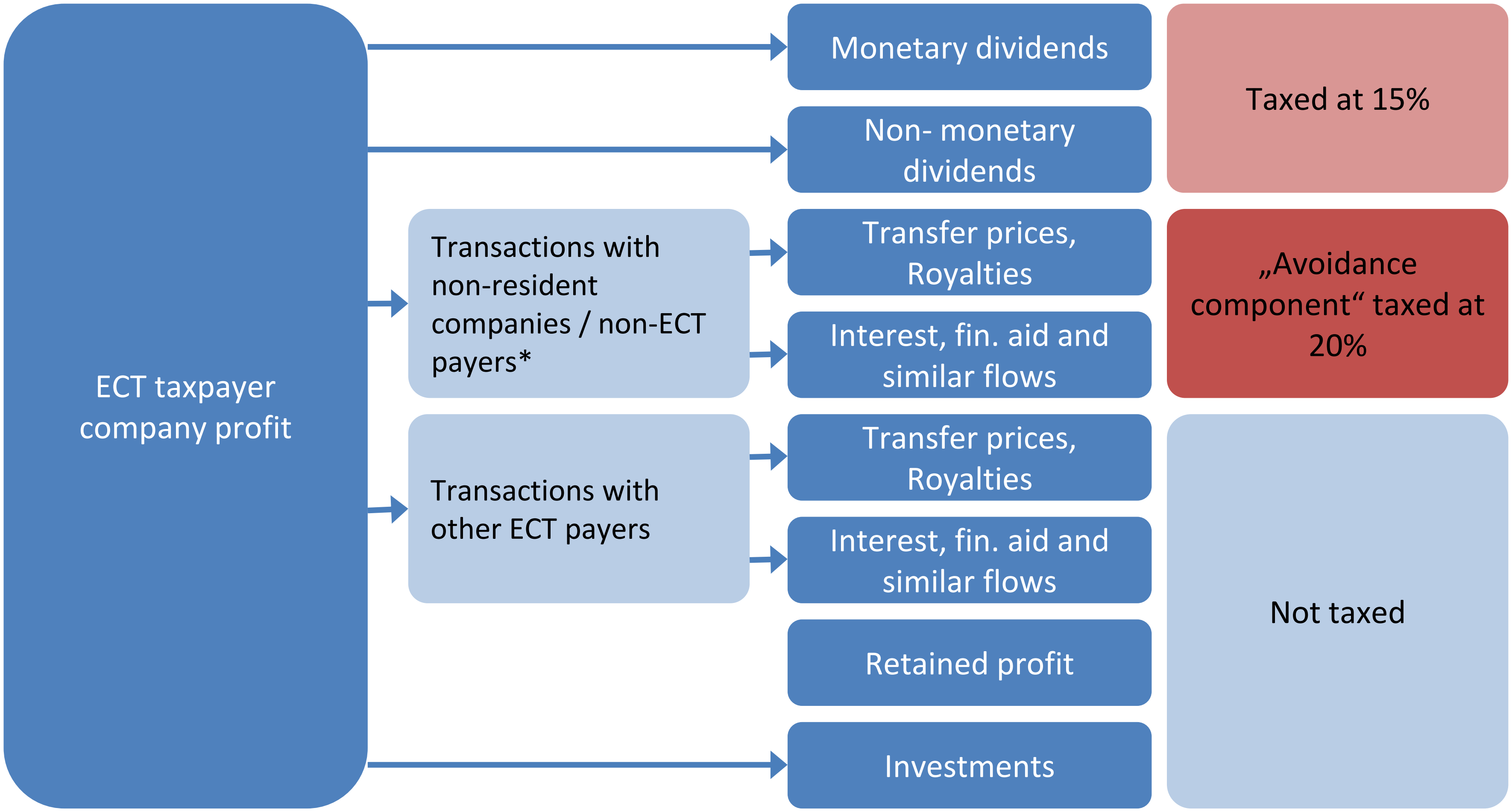
Anti-avoidance

- Key: 20% tax rate on “avoidance transactions”
- Interest to related parties: 20% on interest above max NBU rate
- Royalties to non-CPT payers: Taxable above 6% previous year revenue
- TP: Applies to controlled transactions. Usual price method applies for transactions with resident non-ECT payers

Administration

- Companies only report taxable transactions to SFS
- Dividends and equated payments reported monthly, annual report of controlled transactions for TP

ECT: Transactions and their tax treatment



Source: Berlin Economics

**For transactions with resident non-ECT paying companies, not all rules apply (usual price method instead of transfer prices), for details see annex 1*

Comparison of CPT and ECT systems

Key differences

- Radical difference in tax base: Financial accounts vs transactions
- Tax rate would change from 23.33% to 15%/20%
- Concepts such as valuations, provisions no longer relevant for tax

Similarities

- However, many concepts remain, just change heading
- TP, related party interest, royalties now treated under taxable transactions instead of within financial accounts
- For these concepts, little changes

Compliance of ECT with international obligations

- ECT is in principle compliant with BEPS, EU approximation and double tax treaties

ECT: Economic effects

Conceptually

Investment should be strengthened by retained profits no longer being taxed

- More cash available for reinvestment, equity finance strengthened
- No incentive to fabricate loss-making statements: Improves access to credit
- Taxation of disbursed profit beneficial for start-ups who often lack liquidity

In practice

- Few companies pay CPT anyway, so little practical effect of ECT introduction
- Without massive losses in system, effect would be stronger, but losses will probably remain in system, as dubious as they may be
- Accelerated depreciation (on equipment investment) counters most harmful CPT effects on investment, can be extended
- Difference remains for real estate, other non-equipment investment

➢ **Economic effect of ECT system on investments likely to be limited**

➢ **Direct linkage of positive economic to negative fiscal effect**

ECT: Fiscal Effects

Tax deferral and rate

- Due to tax *deferral* to distributed profits, possibility of deferment of profit distribution, hence short run revenue shortfall
- Also, envisaged 15% rate below current CPT effective rate

Immediate effectiveness of TP and anti-avoidance

- Anti-avoidance strategies appear appropriate
- Controlled transactions can no longer be offset with illegitimate earlier losses
- Some doubt remains about the usual price method

Estimates of short run fiscal revenue shortfall, importance

- First year shortfall estimates range from UAH 11bn (0.5% of GDP, KM Partners) to UAH 39 bn (1.6% of GDP, SFS)
- Important that any short run revenue loss fully compensated in budget!

➢ **ECT introduction likely to cause fiscal losses in first years, no negative effect expected for later years**

➢ **Crucial that any possible negative fiscal short run effect is fully compensated**

ECT: Administrative burden

Change of tax base to transactions

- Several complicated concepts (valuations, provisions) no longer relevant
- Reduces documentation needs, less material to be reviewed by SFS
- Verification on basis of bank summaries of transactions with non-ECT payers
- Financial accounting must still be conducted – just not for tax
- Here, audits can become much lighter burden, real potential for simplification, positive effect on investment climate

Remaining difficulties

- Key anti-avoidance measures still relevant, difficulties with them will persist
- TP, royalties remain subject of SFS-company interaction and difficulty
- Some transition costs likely, especially regarding SFS capacity to enforce new system and ensure revenues/anti-avoidance in early stages

➢ **Administrative burden likely to decrease due to transaction based tax**

➢ **Transition costs likely, but probably very limited**

CPT vs ECT: Conclusions

Expected short run and long run effects of ECT introduction over retention of CPT

	Short run	Long run
Economic effect	0	(+)
Fiscal effect	-	0
Administrative burden	(+)	+

Legend: - worsening; (-) slight worsening; 0 no effect; (+) slight improvement; + improvement
Source: Own assessment

- **ECT introduction will result in small but positive effects on investment**
- **Fiscal effect will be negative in short run, neutral in long run**
- **Clear reduction of administrative burden can be achieved, positive effect on investment climate**
- **ECT still depends on a functioning SFS for positive effects**

➢ **In long run, ECT appears a suitable system, but will not be a "big bang"**

➢ **Should only be introduced if fiscal effect fully compensated in short run!**

General recommendations

- **ECT introduction would on balance be sensible in the long run.**
- **However, positive impact would be rather limited.**
- **ECT should only be introduced, if the revenue shortfalls expected in the first years are properly compensated with expenditure cuts or tax rises.**
- **Without compensating measures, the overall impact of an ECT introduction would be clearly negative.**

- **The main problem of Ukraine's tax system is not the tax system, but deficient tax administration.**
- **Measures to improve the capacity and institutional culture of the SFS are crucial. The corruption at the SFS should be combatted.**
- **ECT would under no circumstances substitute the need for a comprehensive overhaul of the SFS.**
- **Without SFS overhaul, any possible benefits from ECT introduction are likely to be minimal.**

Recommendations in case of ECT introduction.

- **The existing draft is a good starting point from which to further refine and improve an ECT system for application in Ukraine if so desired**
- **The negative fiscal short-run effects of an ECT introduction must be fully compensated by offsetting revenue increases or spending reductions.**
- **Slightly higher ECT rates than in the current proposal could be used, the bottom rate should correspond to PIT (plus military duty) rate**
- **Sharpen transaction reporting requirements by companies in the ECT. A pragmatic middle ground between excessive reporting needs and too little information relayed to tax authorities should be found.**
- **Access for tax authorities to bank summaries on amounts and number of transactions between non-tax-payers and ECT-payers**
- **The usual price method to be used in determining prices on transactions between ECT and SST payers should be improved to strengthen its value as an anti-avoidance mechanism.**
- *Note: We will publish a Technical Note with detailed recommendations and concrete proposals for adapting the present draft in due course*

Annex: ECT treatment of transactions within Ukraine

Transactions	*Rate*	*Comments*
Any transactions with ECT-payers	0%	
Dividends to other ECT payers	0%	
Dividends to non-ECT-payers	15%	Tax applied if paid to private persons + legal entities on simplified taxation e.g. agricultural companies on simplified taxation
Surcharges on goods and services transactions with non-ECT-payers	20%	Usual price regulation applied: not less than purchase price, for fixed assets: not less than residual value, not less than weighted average selling price (alienation), not less than production costs; ECT only applied if alienation >20%
De-facto private expenses of businesses	0%	
Financial Aid to non-ECT-payers	20%	Unless repaid within 12 month: ECT-obligation directly at date of fin-aid payment; ECT-credit-recognition in case repaid within 12 months
Royalties paid to non-ECT-payers	20%	Threshold: 6% of previous year's revenue

Annex: ECT treatment of transactions with non-residents

Transactions	*Rate*	*Comments*
Dividends to legal entities	15%	
Dividends to private persons	15%	
Transfer pricing violations	20%	
Interest paid to related parties beyond market range	20%	Threshold: 50% of NBU-max-interest-rate for foreign currency lending (currently 11%)
Royalties beyond market range	20%	Threshold: maximum of royalties: 6% of previous years revenue
Non-refundable financial aid	20%	
Refundable financial aid	20%	Unless repaid within 12 months
Loans to related parties	20%	ECT-credit-recognition at the moment of repayment
Non-profitable investments abroad	20%	

Contact

Dr. Ricardo Giucci
giucci@berlin-economics.com

Robert Kirchner
kirchner@berlin-economics.com

German Advisory Group
c/o BE Berlin Economics GmbH
Schillerstr. 59, D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
www.beratergruppe-ukraine.de
Twitter: @BerlinEconomics