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Corporate Profit Tax vs. Exit Capital Tax: Analysis and recommendations

David Saha, Thomas Otten, Oleksandra Betliy, Ricardo Giucci

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Institute for Economic Research and Policy Consulting
Reytarska 8/5-A,
01030 Kyiv, Ukraine
Tel: +38 044 / 278 63 42
Fax: +38 044 / 278 63 36
institute@ier.kiev.ua
www.ier.com.ua

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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
info@beratergruppe-ukraine.de
www.beratergruppe-ukraine.de

Corporate Profit Tax vs. Exit Tax: Analysis and recommendations

Executive Summary

A Corporate Profit Tax (CPT) System fairly normal by international standards is currently in operation in Ukraine. However, there is discussion whether this system should be replaced by a Exit Capital Tax (ECT), following the example set by Estonia in 2000.

Under the current CPT system, the tax base is constituted by the adjusted financial profits of companies, taxed at a rate of 18% plus a further personal income tax of 5% plus military contribution of 1.5% on dividends disbursed to private persons. With a tax base and tax rate that are fully within the range of normal international practice, this system is unlikely to have particularly harmful effects on investment, however, the taxation of retained profits may reduce available equity for financing investments. Fiscally, the CPT in 2016 only provided 7.7% of consolidated fiscal revenues, corresponding to 2.5% of GDP, very low in international comparison. The low revenues appear due to massive losses accrued by taxpayers in previous years, legal tax avoidance instruments such as FX debts, transfer pricing and other optimisation schemes and due to large enforcement problems of the tax, originating in widespread manipulation of financial statements by companies and inadequate institutional capacity of the State Fiscal Service of Ukraine. Indeed, the compliance burden with the present system is relatively high due to large documentation needs and audits often focusing on formal issues rather than the financial accounting of the audited companies.

The proposed ECT system involves changing the tax base to transactions involving dividends or other forms of "capital exit" from the tax system. Under the unofficial draft law on the ECT,[1] taxable transactions shall be taxed at 15% for dividends or 20% for other forms of capital exit such as surcharges on transfer prices or inflated interest rates for credits from related parties that effectively constitute attempted tax avoidance. This system is significantly different from the present CPT system as the tax base is made up of transactions with non-ECT payers rather than the much more complex tax base rested in financial accounts. Most key anti-avoidance concepts such as transfer pricing control remain relevant in the new tax base, but the treatment of these concepts is now transaction-based instead of affecting adjustments to the financial result as before.

Economic effects on investment and economic growth from introducing an ECT system would probably be limited. The present system does not generate large tax revenues and hence can have little negative impact on investments. Accelerated depreciation of equipment investments has been recently introduced in the present CPT system. However, the fiscal effect of the ECT is likely to be negative in the short run due to tax deferral in the system, necessitating a comprehensive strategy for financing this reform if it is to be undertaken. In the long run, however, an ECT system appears able to generate fiscal revenues as well as a CPT and, due to reduced enforcement, would contribute to a significant decrease of administrative burden both on the sides of companies and tax authorities.

Introduction of an ECT system can lead to an overall systematic improvement in the long run, but this improvement is not expected to be radical. Crucially, negative short-run fiscal implications of the reform must be fully compensated to avoid clearly negative spillover effects in the short run. And reform of the tax system does not at all alleviate the much more important need for a comprehensive overhaul of tax administration, especially the institutional capacity and soundness of the SFS.

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[1] We base our analysis of the ECT proposal on the draft suggested by Oleksandr Shemiatkin and Tetyana Shevtsova available at: http://kmp.ua/wp-content/uploads/2016/06/ECT-comparative-table_10_2016_EN.pdf

Authors

David Saha	saha@berlin-economics.com	+49 30 / 20 61 34 64 0
Thomas Otten	th.otten@otten-consulting.de	+380 / 44 / 492 77 08
Oleksandra Betliy	betliy@ier.kiev.ua	+380 / 44 / 278 63 42
Ricardo Giucci	giucci@berlin-economics.com	+49 30 / 20 61 34 64 0

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1. Introduction

The taxation of corporate profits in Ukraine is currently subject to intensive discussion. The most important element of this discussion is the question, whether Ukraine should fundamentally change its Corporate Profit Tax (CPT) in favour of an "Exit Capital Tax" (ECT). The Tax Code amendment law passed by Parliament in the end of December 2016 obliges the Ministry of Finance to submit a draft law containing a fundamental change of corporate taxation towards an ECT by July. An unofficial draft law, prepared by lawyers Олександр Шемяткін та Тетяна Шевцова, already exists and serves as the basis of discussion. This draft is supported by a group of people deputies involving Chairperson of the Verhovna Rada Committee on Taxation and Customs Policy, Ніна Южаніна, and some further experts.

An ECT effectively taxes dividends or distributed profits, rather than the financial profits of companies, according to the so called "Estonian model" as Estonia replaced its previous CPT with its form of a ECT in 2000. This tax concept enjoys some popularity in the region. Georgia has introduced a ECT with the beginning of 2017 and Moldova conducted a reform inspired by the Estonian model in 2008 (but has subsequently reversed it).The key difference between a conventional CPT such as that operated by Ukraine and most other countries and a ECT is that the object of taxation changes from the financial profit to actual transactions of companies. Due to this difference, proponents of the ECT claim that the ECT has a range of advantages over conventional CPTs, including positive effects on corporate equity and investments and a decrease of the administrative burden faced by companies and tax administrations. Critics of the approach doubt the beneficial effects on investments and administrative burdens and voice concern about possible fiscal losses and the transition costs imposed by yet another tax reform.

With respect to corporate taxation, Ukraine hence faces two overarching question that this policy study aims to shed light on:

1) Should Ukraine go for fundamental change towards an Estonian model / ECT system?
2) If an ECT system is to be installed in Ukraine, how should it best be designed?

The structure of this paper will be as follows: In chapter 2, the present CPT system in Ukraine is described. In chapter 3, the CPT system is analysed regarding its economic, fiscal and administrative burden effects. In chapter 4, the current proposal of an ECT is described. In chapter 5, the CPT and ECT systems are compared and the effects of fundamental change in corporate taxation by introduction of an ECT system are analysed. In chapter 6, recommendations are given on whether fundamental change should be undertaken and how an ECT or CPT system should best be designed in Ukraine.

2. The present corporate profit tax system in Ukraine: Description

Ukraine currently operates a corporate profit tax that, in terms of its basic design, can be considered as a fairly standard system in international comparison. In order to provide an overview of the tax system, we first look at the tax *base*, then the tax rate and two further important aspects of the tax system, anti-avoidance rules and the parallel, simplified tax system for corporate taxation before describing key administrative aspects of the current system.

Tax base

In the CPT, the tax base (or taxable income), on which the tax rate is applied, is formed by the profits of companies, the difference between income, operational and financial expenses. Since 2015, the tax base for profit taxation is the financial profit in statements of companies, according to International Financial Reporting Standards (IFRS) or the Ukrainian Accounting Standards, which methodologically base on international accounting standards. For companies with a turnover larger than UAH 20 m p.a., financial profits are then adjusted for tax purposes on a number of terms. These include, inter alia: Value adjustments, minimum depreciation according to the tax code, provisions/accruals, thin-capitalisation adjustments etc.

As the CPT is a source tax, the object of taxation is any profit made by companies through business activity in Ukraine. Taxable entities are both resident and non-resident companies. Resident companies pay taxes on their global income[2]. Non-resident companies (e.g. permanent establishments) pay taxes on profits generated from their activities in Ukraine.

Tax rate

The CPT rate is 18% in Ukraine. However, when profits are disbursed as dividends to private persons, a personal income tax (PIT) of 5% plus the military duty (a surcharge to the standard personal income tax) of 1.5% is also levied. Effectively, profits have been taxed at a rate of 23.3% when they are received by the actual owners of companies. This is slightly higher, but still corresponds quite closely to the personal income tax rate for other sources of revenue (maximum rate: 18% PIT plus 1.5% military duty), hence not constituting a distortion for or against income from business ownership. For dividends disbursed to other CPT paying companies, an advance CPT payment of 18% applies (which can be credited against future CPT burdens of the payer and the recipient reduces his taxable income accordingly in order to avoid a double taxation). Dividends disbursed to non-resident legal entities are also subject to an 18% advance CPT payment and a 15% withholding tax unless a relevant double taxation agreement stipulates a lower withholding tax rate[3].

[2] Taxes paid abroad can be credited against the Ukrainian CPT burden

[3] The withholding tax rate is limited in most OECD-based treaties to 5% for major shareholders

Table 1

Taxation of corporate profits when disbursed to private persons

Company profit		UAH 100
CPT	18%	UAH 18
Dividend		UAH 82
PIT	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 calculation

Anti-avoidance rules, simplified tax system and administrative enforcement

Ukraine applies *anti-avoidance rules* that are relatively normal for a CPT system. These rules centre on the key methods for tax avoidance used internationally:

- Thin-capitalisation rules
- Reporting of transfer prices
- Minimum terms on depreciation
- Adjustment of provisions/accruals and value corrections

Thin capitalization rules limit the (deductible) interest on loans from related parties to 50% of profit before tax in Ukraine. On *transfer prices*, used to lower the tax burden by manipulating prices in international transactions when delivering or receiving goods or services from related parties, Ukraine applies rules based on the OECD guidelines on transfer pricing. In past years, transfer pricing rules, which were only introduced in 2013 had been seen as difficult to enforce. Minimum terms on depreciation and the adjustments of provisions etc. limit the scope for corporate discretion in financial/tax accounting.

The “simplified system of taxation” (SST) is a particularity of the Ukrainian system. Taxpayers under the SST only pay a “unified tax” instead of different tax rates including the CPT and pay a minimum level of social security contributions (SSC). Four groups of eligible taxpayers are defined in the simplified tax regime, with different tax rates. Most important from the perspective of the CPT system are the third and fourth groups under the SST. The third group contains companies of unlimited numbers of employees, provided that annual income is less than UAH 5 m. These companies pay a unified tax of 5% on their income[4]. The fourth group contains agricultural

[4] If companies opt to pay VAT separately, this rate drops to 3%. However, the opt-in to VAT happens rarely in practice

companies with an agricultural production share of at least 75% of turnover, paying taxes of ca. UAH 240 per ha of land. Through interactions with companies in the simplified system, profit shifting from the CPT regime into the (de-facto low-tax) simplified tax regime is possible. No transfer pricing rules exist on such transactions.

Tax administration and enforcement is conducted by the State Fiscal Service of Ukraine (SFS). In general, documentation requirements for companies are quite large in Ukraine. In case of suspected irregularities, the SFS can perform scheduled or unscheduled audits of taxpayers. These audits are relatively demanding as the object of a regular audit will be the entire accounting of a company, involving discussion of complex issues including the transfer prices for related party operations, valuations of assets and provisions for liabilities (both of which can be a crucial driver of IFRS profits). In the case of discovered tax evasion, different administrative penalties (25-50% of the underpaid amounts) and criminal sanctions exist.

3. Analysis of the present CPT system

We structure our analysis of the effects of the current tax system into three components: 1. The economic effects: What effect does the tax system have on the economic development of Ukraine, for example by inducing companies to invest more or less or shift business activity out of the country. 2. The fiscal effect: How effective is the tax system as a source of revenues. 3. Administrative burdens on companies and public administration.

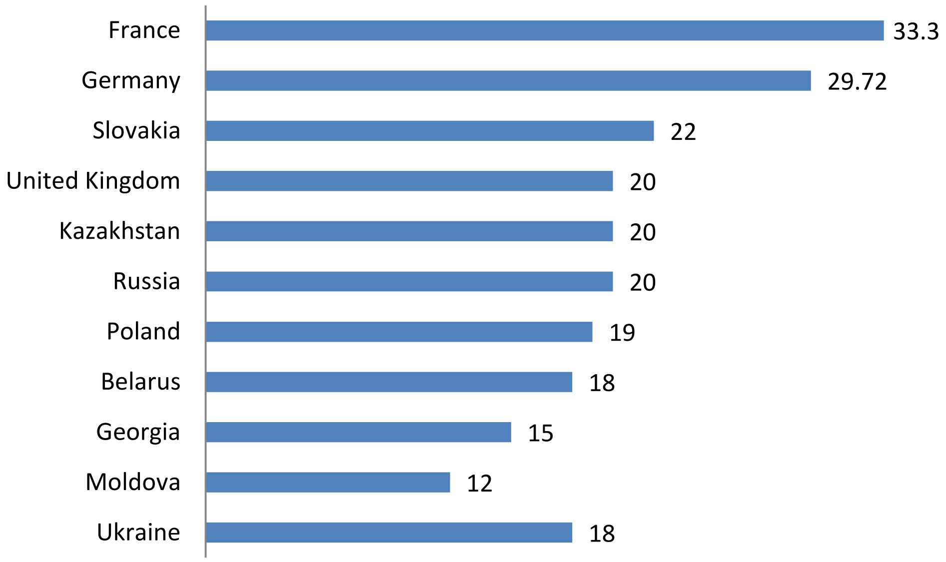
<u>Economic effects</u>

As a tax on profits of companies owned by individuals, the CPT is effectively a tax on capital. People's decision to invest saved money in companies or to consume it will be affected by such a tax. If the effective tax rate on capital invested in business is very high, investment in a country may be negatively affected. In Ukraine, the present effective tax rates on income from capital invested in companies is 23.3% as shown above. This tax rate is reasonably similar, albeit slightly higher, than the Personal Income Tax (PIT) rate of 18% plus, again, the military duty of 1.5%. Although the relation of capital taxation versus other tax types remains a hotly discussed topic in economics, the Ukrainian system does at present not seem to excessively tax capital income.

However, it is a feature inherent in CPT systems that equity financing is less attractive from a perspective of taxation rather than credit finance: Whereas the cost of interest for credit (unless it falls under thin capitalisation rules) can be deducted, for financing from retained profits, no such deduction applies. Some approaches exist in order to mitigate this effect, ranging from accelerated depreciation rules to an "allowance for corporate equity", ACE system. In 2017, accelerated depreciation have been temporarily introduced (expiring in 2019) that allow depreciating equipment investments within two years in Ukraine, leaving the discrimination of equity finance in place only for investments in non-equipment assets such as real estate. If desired, such an instrument could be prolonged or made permanent as it only changes the timing, not the final magnitude of the tax burden. Hence, although many Ukrainian companies are highly leveraged[5] and access to credit is perceived as difficult, the CPT probably does not pose a significant hindrance to investment.

Finally, corporate taxation should be seen in the context of international tax competition. An excessive tax rate would lead companies to move to other countries. However, from Fig. 1 it is obvious that Ukraine's rate of 18% is not excessive in an international perspective.

Figure 1
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

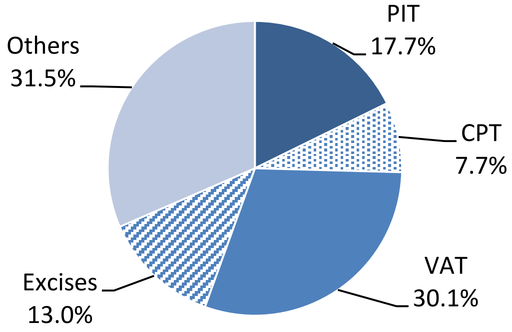
In conclusion, the economic effects of the Ukrainian CPT at present can be seen as mild: No strong incentives against investments exist and the tax rate is competitive in international comparison.

Fiscal effects

The CPT is a relatively small source of tax revenue in the Ukrainian budget. In 2016, CPT revenues amounted to UAH 60.2 bn, corresponding to 7.7% of total consolidated fiscal revenues and 2.6% of GDP. There are several reasons for this relatively low revenue contribution of the CPT.

[5] German Advisory Group Ukraine, "Improving SME Access to Finance in Ukraine", Policy Paper 02/2016

Figure 2
Share of revenue sources in consolidated fiscal revenues 2016



Source: Ministry of Finance of Ukraine

Apart from the legal tax avoidance methods used by companies internationally (e.g. through valuations, provisions, transfer prices etc.), there are several reasons for this relatively low revenue contribution of the CPT.

1. Many companies have run up large losses, largely generated by sharp exchange rate losses on foreign-currency-denominated debt during the last period of Hryvnia depreciation. This loss is carried forward and offsets present tax obligations. At the end of the first quarter of 2016, 8,000 companies with a turnover of more than UAH 20 m were reporting losses and the sum of accrued declared losses reached UAH 1.68 tr at the end of the first quarter of 2016[6]. A large share of these losses appear to have been made in operations with related parties, however this is extremely difficult to challenge via tax audits. The problem of accrued losses carried forward is likely to reduce CPT revenues for some years to come, as losses can be forwarded indefinitely.
2. There may be some profit shifting to loss-making CPT payers and taxpayers under the SST[7], although fraud with group 3 of the simplified tax system is probably much larger with regard to PIT and Social Security payments than CPT evasion. Nevertheless, it is possible to evade a large share of the 18% CPT by making contracts for (non-existing) services rendered by a simplified taxpayer who then taxes his revenue at 5% and pays back the remainder, minus his margin for the fraud, in black cash money. However, the extent of this is likely to be relatively limited. Total transactions between CPT payers and group 3 of the simplified tax system totalling only a relatively limited UAH 50 bn[8] per year, which also includes real and legitimate transactions as well as PIT and SSC evasion through fake entrepreneurs.

[6] Oleksandr Shemiatkin, Exit Capital Tax: Real Reform for Ukraine, Kyiv Post 21/29, 2016

[7] IMF, "Ukraine – Technical Assistance Report – Reforming the State Fiscal Service", 2016

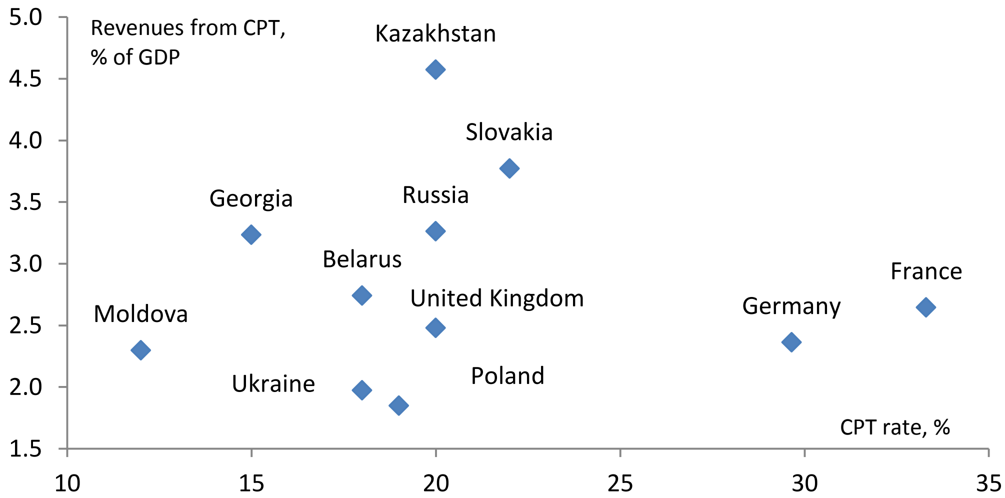
[8] The exact magnitude is not entirely clear, the cited UAH 50 bn are to be taken as a maximum estimate

3. There appear to be large enforcement issues with the tax. After changing the tax base to results of financial statements, SFS capability to properly apply the system has been lacking. Relatively large attempts at improving SFS capacity and improving the tax system for easier enforcement such as implementation of transfer pricing rules have been made, hence a gradual improvement of CPT revenues should be expected. However, capacities of both SFS officers and court judges to properly understand and critique IFRS or Ukrainian Accounting Standards based financial statements are perceived to remain inadequate at present.
4. Tax payers with less income than UAH 20 m do not have to apply tax corrections such as provisions, minimum amortization terms, devaluations, thin capitalisation etc. Due to this, they can use a wide range of legal accounting tools to reduce their financial result to minimise their CPT burden.

Internationally, tax avoidance, especially by large multinational companies remains a highly discussed topic. The ability to legally or at least quasi-legally shift profits (e.g. Starbucks or Apple shifting profits to tax havens by using royalties on intellectual property) has somewhat eroded CPT tax bases. Revenue issues with the CPT are not necessarily only a Ukrainian difficulty. Fig. 3 shows that the relationship between CPT rates and revenues is not at all clear internationally. However, with CPT revenues of only 2% of GDP (in 2015), Ukraine is at the bottom end of countries with similar tax rates (although 2015 figures may be particularly subdued due to recession and CPT revenues have risen above 2.5% again in 2016). Also, the fact that only 5% of the total 270,000 CPT payers pay CPT at present, indicates severe enforcement issues[9]. Hence, there appear to be some problems especially plaguing the Ukrainian CPT at present, rendering it fiscally quite ineffective in international comparison. These problems are probably largely related to issues already mentioned.

Figure 3

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



Source: KPMG, IMF (Government Finance Statistics)

[9] However, the figure of 270,000 total companies is overstated as this includes many dormant companies effectively no longer in operation.

In conclusion, the CPT is not fiscally successful at present. Around 1,000 taxpayers of a total of around 270,000 taxpayers contribute around 90% of CPT revenues. This is due to a combination of carry-forward losses accrued in earlier years, legal tax avoidance strategies through methods inherent in the system and remaining enforcement problems due to administrative capacity. As corrections of the system have been undertaken, the fiscal contribution of the CPT should rise in coming years, but room for more reform exists especially with regard to a) SFS institutional strength and capacity and b) better controlling related-party transactions.

Administrative burden

The administrative burden caused by the Ukrainian CPT, both on the tax authority and on companies, is often heavily criticised. Indeed, the administrative burden imposed by the CPT appears high in Ukraine. This can be due to a combination of factors inherent in a CPT system or due to specifics of the Ukrainian system and related practices.

One factor that is much criticised, but is a general characteristic of a CPT system is the complexity and discretion in the calculation of financial profits, which gives rise to a difficult interaction between companies and tax authorities. Transfer prices, the fair value principle in determining asset values and provisions can have a strong impact on the taxable profit of companies. Companies have to run financial accounts in any case, which includes the necessity to formally deal with a number of these concepts. Since taking financial accounts as the base for tax accounting in 2015, the administrative burden for companies caused by the CPT has decreased. Nevertheless, using financial accounting as the base for taxation gives company an incentive to use these concepts in order to reduce the burden. In consequence, asset valuations and provisions can be the subject of intensive arguments between companies and tax authorities. In most countries, companies and tax authorities manage to deal with this complexity in a cooperative way, provided that in general, a culture of tax honesty exists that permits some degree of trust between authorities and companies. Hence, from a systematic point of view, the administrative burden of a CPT system appears manageable.

However, there are specific circumstances in Ukraine that magnify the administrative burden:

- Ukraine has a large shadow economy of around 35% of GDP and hence a culture of tax evasion, especially in locally owned companies. This implies the need for a relatively large amount of tax audits, which in turn place large administrative burdens on both the companies and the SFS.
- The institutional capacity of the SFS is only slowly improving and is still described by many actors as inadequate. The complex nature of accounting requires a sufficient number of experts at the tax authorities, able to match the qualifications of companies' accountants. Also, credible rumours about widespread corruption in the SFS persist. According to a poll conducted by Transparency International in 2015, the SFS was perceived as the most corrupt

state entity of Ukraine[10]. Concepts such as valuations etc. in financial accounting give discretion to companies and tax authorities for applying rules. This discretion provides a space in which corruption can exist, however, rather than by using discretionary leeway, abuse of power by SFS inspectors in practice tends to take more crude forms such as arbitrary imposition of taxes.

- The institutional culture of the SFS is still influenced by the Soviet heritage, in which rules existed and were applied for every detail. Using a dynamic accounting system such as IFRS, which UA-GAAP is based on, such a pure rules-driven approach is not possible, but needs to be replaced by a pragmatic approach focusing on moderating between legitimate business interests of companies and the fiscal interest of the state. Tax audit practice shows tax officers applying a sharp fiscal approach via twisting norms, even if an obvious interpretation of the norm's goals would not give room for such discretions.
- As a result of the above factors, tax audits cause an immense burden on companies. They are, as appears factually necessary, conducted with high frequency, but due to insufficient qualifications of tax inspectors, cannot function well. Tax audits often led to complete work stoppages at company HQs. Corruption issues much compound the problem. Audits often focus on form rather than substance (the correctness of the accounting) due to lack of capacity for checking their substance and rules are applied too rigidly due to an outdated approach to taxation. There are even credible reports that in many cases, tax inspectors imposed taxes without any legal grounds. Rectifying such problems is costly as especially 1st and 2nd level courts are hardly independent and the threat of criminal sanctions on company representatives has been used to coerce companies into submission to otherwise unjustified tax claims. In consequence to this, the tax police has recently been abolished because of widespread abuse of power, a list of planned audits is to be published and a methodology for deciding unplanned audits has been defined. Nevertheless, uncertainty and risks remain present concerning how tax enforcement will be handled in future.

Thus, the CPT indeed creates a large administrative burden especially for companies. However, as other countries successfully apply CPT systems, there is no clear systematic defect in CPT systems with regard to administrative burden. In principle, the approximation of financial and tax accounting should reduce the administrative burden in a CPT system. However, due to inadequacy of the present tax authority, the administrative burden is high, especially due to extremely problematic tax audit practices. Resolving these problems will not be trivial. Capacity building at the SFS will be difficult. A CPT system is demanding on tax authorities insofar as they require qualified staff in order to effectively and cooperatively engage with companies. However, fully (not just formally) qualified accounting staff remains scarce and is unlikely to be attracted by the wages at the SFS. Also, a cultural shift from the Soviet heritage to a solution-oriented approach to resolving disputes must be

[10] Transparency International, Corruption as viewed by business: Anti-rating headed by tax services, customs, agency for land lots http://ti-ukraine.org/en/research/corruption-as-viewed-by-business-anti-rating-is-headed-by-tax-services-customs-agency-for-land-lots/

completed, which is likely to take several years. Only if tax audits are conducted accurately and in a pragmatic, solution-oriented manner, is a cultural shift towards more accuracy in tax statements by companies likely, permitting a decrease of audit frequency.

Conclusion

At present, the CPT in Ukraine is a relatively standard design of a CPT, both in terms of rate and tax base. It is unlikely to have any particularly harmful economic effects; however, its fiscal impact is severely limited at present. The key problems of the present system with regard to its fiscal revenue generating capacity are large, probably illegitimate, but existing losses carried forward and inadequate enforcement capacity by the tax authorities. The problematic aspects of this system do not per se necessitate a fundamental change of the system but appear in principle capable of solving through incremental reform of the system and its institutions.

The main deficiency of the current system is the administrative and financial burden caused for companies through frequent tax audits. These audits tend to be conducted inaccurately, often focusing on form rather than substance and often resulting in work stoppages at company headquarters and the imposition of unjustified tax burdens that are then hard to challenge due to inadequacies of the courts system. This problem arises not due to inadequacy of a CPT system per se, but principally due to lack of institutional capacity, corruption and an outdated approach to tax enforcement at the SFS.

4. Proposed reform

It is now discussed to fundamentally change the tax system according to the "Estonian model". The discussion currently centres on a draft law elaborated by lawyers Oleksandr Shemiatkin and Tetiana Shevtsova (the Shemiatkin/Shevtsova draft). This draft is supported by some members of parliament including the chairwoman of the Verhovna Rada committee on tax and customs, Nina Yuzhanina. This draft is likely to become the basis also for a draft law that the Ministry of Finance is required to submit to Parliament by July. In the following, the Shemiatkin/Shevtsova draft will be the basis for our descriptions of specifics of the approach and for our comparison and analysis.

Motivation

The proposed "Exit Capital Tax" (ECT) is a completely different concept from the present CPT. Two main motivations exist for the proposed fundamental change of the system:

1. Increasing investments. In an ECT system, profits are only taxed once they are effectively disbursed to natural persons or capital leaves the scope of the tax system (e.g. to related companies in another country). Hence, retained profits used for investments are not taxed as in the present system, which should favour investment.
2. Administrative facilitation. As the tax base shifts from the financial profits to transactions, it is claimed that a transaction based tax rather than an accounting based tax gives rise to lower administrative burdens for companies and tax authorities alike.

Tax base

The principal difference between the proposed ECT and the present CPT is that the tax base is no longer made up by the adjusted financial profits, but by single transactions. In principle, the ECT is still a tax on profits, but the notion of profits changes from the financial accounting definition of profits to actual flows of money. The idea is that only profits disbursed from a company should be taxed as in the end the objective of any for-profit company is to pay dividends to its shareholders. The idea is hence to change the tax base from an accounting amount depending on complex valuations and depreciation to actual, measurable flows[11].

The original idea is that distributed profits, i.e. dividends paid out to shareholders are to be taxed. Apart from widening the tax base to include avoidance through disguised dividends (see the section on anti-avoidance measures), this original idea needs to be adapted to account for two issues: Firstly, holding constructions where dividends flow from one company to another (and hence only later to natural persons) and secondly, international ownership patterns, in which companies are related to

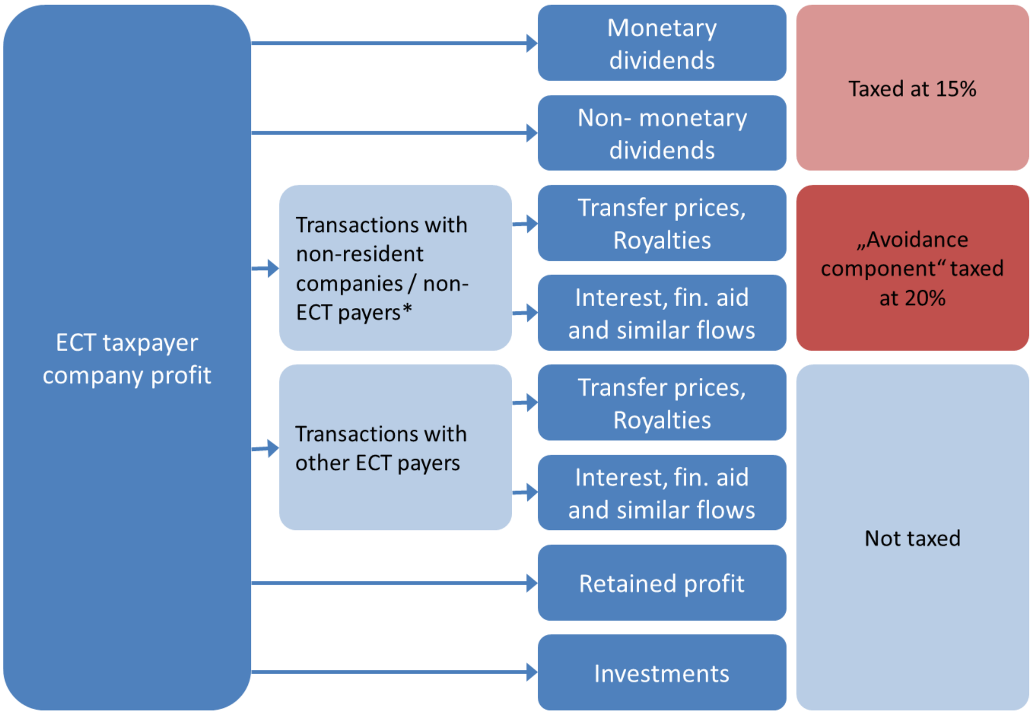
[11] Actually, it could be argued that an ECT is in fact already applied in Ukraine. When a simplified tax payer (e.g. Group 4, agricultural producer) pays dividends, she has to pay an advance CPT-payment though being formally exempted from CPT. Since this simplified tax payer cannot credit this CPT-advance against any other tax obligations, it in fact turns out to be a tax on capital exit in form of dividends.

companies in other tax jurisdictions. Accounting for these two factors is the reason why the tax concept is labelled Exit Capital Tax: Whenever capital *exits the tax system*, it is taxed.

Crucially, transactions *between* ECT taxpayers are not taxed. Only when the capital is finally distributed to a natural person or to a company outside the ECT's scope, it will be taxed (instead of being taxed twice or complex tax credits arising). The idea is hence a simplification of the tax base by only considering transactions involving an exit of capital from the tax system. The payers of the ECT are to be legal entities residents as well as permanent establishments of non-residents (except for diplomatic entities).

Figure 4

Schematic illustration of profit taxation under proposed ECT



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 table 2*

<u>Tax rate</u>

The Shemiatkin/Shevtsova draft envisages a tax rate on dividend payments ("transactions with capital exit"), in monetary and non-monetary form to owners of a company, of 15%. A tax rate of 20% would be applied to "equated payments" (payments equivalent to capital exit) such as interest paid to related parties above a threshold or financial aid and on *surcharges* on transactions including transfer pricing and royalties. No further tax would have to be paid on dividends, as the withholding tax and military duty would be dropped with the proposal.

Anti-avoidance measures

Key to the anti-avoidance strategy is applying the 20% tax rate on the "avoidance component" of those transactions most usually used for profit shifting – related party credits, transfer prices and royalties. Determining the avoidance component – that is, the surcharge on fair interest rates, transfer prices or royalties used to shift profits is done in accordance with several provisions:

- For interest paid to non-resident related parties, this avoidance/surcharge component is estimated by using the maximum interest rate defined by the NBU on foreign borrowings of residents for the relevant type of borrowing rate. All interest above 50% of this interest rate is deemed taxable.
- Royalties to non-CPT-payers locally and abroad: Taxable above the threshold of 6% of the previous year's revenue. Applicable transactions also include royalties on intellectual property rights which were first owned by a resident of Ukraine and on intellectual property held in countries where royalties are not taxable
- Transfer pricing: Rules will only apply to "controlled transactions" (transactions with related non-resident parties and with companies in tax havens).
- For prices for goods and intellectual property in transactions with resident non-ECT payers, the "usual price method" is to be used to determine the arm's length price (the price that would be used in a usual market transaction). The difference between the usual and the actual price is then taxable.
- However, no measures are foreseen for non-business related expenditures (deemed dividends through expenditures for private use). This problem exists in the present CPT system as well.

Administrative aspects

The principle underlying the administration of the tax is that companies are only to report taxable transactions. Dividends/transactions with capital exit and equated payments are to be reported monthly if specific transactions falling under this concept took place. "Controlled transactions" to which the rules on transfer pricing apply are to be reported annually. The amount of tax to be paid is to be defined independently by a taxpayer. The tax base estimation for the first object is straightforward. Tax liabilities under transactions with capital exit and provision of financial aid are to be reduced by: the paid property tax (in a particular month within two tax years); and by the amount of tax paid in preceding periods due to provision of financial aid (falling under "equated payments" taxation) in case if it is paid back fully or partially to the taxpayer.

The tax authorities shall have access to a range of data including the quarterly and annual financial reports of companies and are empowered to conduct tax audits on the basis of reports by taxpayers, financial reports and accounting reports and further documentation related to decisions on profit distributions and calculation of payments and transaction that equate to a capital exit.

Table 2

Treatment of transactions under the proposed ECT

Transactions	*Rate*	*Comments*
Payments within Ukraine		
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 and ltd. 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%	More of an issue for PIT and social security.
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
Payments abroad		
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%	

Source: Berlin Economics

5. Comparison of ECT with the present system and analysis of effects

In principle, the concept underlying the ECT – taxing flows only rather than accounting results – is sound. This type of source taxation of cash flows is also applied in indirect taxation and is generally perceived as a relatively robust source of income and less vulnerable to evasion and avoidance than more complex tax types such as the CPT using a complex tax base constituted by the financial accounts of companies. However, it has to be analysed whether the basic concept works in practice and how it compares to the present system that it is intended to replace. In the following, we first compare the two systems before analysing, in sequence the economic effect, the fiscal effect and the effect on administrative burdens of companies and tax authorities.

Comparison

At first glance, the difference between the CPT and the ECT appears radical. Indeed, several important differences exist. The tax base is changed from financial/tax accounts towards actual transactions and for most issues touched upon in this paper thus far, different treatment emerges. The effective tax rate (for profits disbursed to residents of Ukraine) would be changed from 23.33% to 15% for dividends and 20% for other controlled transactions.

However, it is important to notice that because of the different tax base in the ECT, the main difference emerging in the treatment of the important avoidance methods (related party credits, transfer price, royalties) is that these concepts change from being adjustments to the financial results – with no actual effect if losses are brought forward to cancel any positive tax burden – to being taxable transactions (for the surcharges above “arm’s length” prices). Table 3 presents a comparative overview of the approach to certain key concepts in the two tax systems.

One note on compliance of an ECT with international treaties and obligations: Worries about ECT compliance with the OECD Base Erosion and Profit Shifting (BEPS) strategy, with EU approximation and existing double tax treaties have been frequently raised. The Estonian experience can here be used to infer that no problematic or unsolvable compatibility are likely to emerge. An ECT is (or can at least quite easily and without substantial changes be made) BEPS compliant. As it remains a (deferred) tax on corporate profits, it is compatible with EU law in consequence of the European Court of Justice’s (ECJ) *Burda* ruling.

Table 3

Comparative table CPT and ECT systems in Ukraine

	Current CPT system	*Proposed ECT system*
Tax base	Financial profits of companies (IFRS / national accounting standards) with slight adjustments	Distributed profits (dividends) and other exists of capital from tax system, actual transactions only
Tax rate	18% CPT +5% of PIT + 1.5% of military fee (as a part of PIT) on dividends Effective tax rate of 23.33%	Monetary and non-monetary dividends: 15% ECT Transactions with equated payments / Surcharges under transactions: 20% ECT
Treatment of investments	Taxed at 18% if financed from retained profits, deductible if financed by credit. Accelerated depreciation rate for equipment: 2 years.	Not taxed
Treatment of goods/services/ intellectual property transactions with third parties	All business expenditures listed as costs/deductions when calculating of tax base, have to correspond to usual prices.	Only for controlled transactions (only goods) with non-CET payers, 'usual price' method shall be used, surcharge component taxed at 20%.
International transactions to which transfer pricing rules apply	**Transfer price adjustments to financial result.**	**Transaction taxed if TP adjustments necessary.**
Treatment of credits/interest on credits from third parties	Thin capitalization rules limit deductible interest taking into account the level of debt in relation to the size of statutory capital	Interest and commissions paid to related parties (non-residents) is taxed at 20% on the part that is above 0.5 times the maximum rate set by the NBU.
Effect of exchange rate changes	**Can significantly affect the tax base. Sharp hryvnia depreciation resulted in large losses reported by taxpayers, carried forward indefinitely.**	**No effect**
Treatment of non-business related expenditures	Non-business activities should be financed from profit. Checked in financial statements.	Taxed under PIT only

Source: Berlin Economics

Economic effects

Would introducing an ECT system contribute to increasing investments by companies as the proponents of such a system claim? In principle, such an effect on investment would stem from the fact that the retained profits of companies, from which the equity component of investments is financed, would no longer be subject to corporate tax. Hence, the cash reserves of companies would be larger, providing the opportunity for more investment (also improving access to credit). Indeed, access to credit would also be somewhat improved as companies no longer have an incentive to fabricate loss-making financial statements in order to reduce their tax burden, which at the same time harms their creditworthiness for financial institutions. Taxing only capital exits could be particularly helpful for start-ups, which are often experiencing difficulties when having to pay corporate profit taxes well before establishing a positive balance of cash flows and in the ECT would only pay when they decide to start disbursing profits.

A crucial feature of the present system is, of course, that due to the massive losses carried forward by companies and due to large suspected tax evasion and avoidance, many companies do not pay CPT at all and hence do not suffer from a taxation of retained (cash) profits. Generally, in the present system, retained profits are taxed at 18%, however, accelerated depreciation rules have recently been introduced (valid only for 2017 and 2018, but could theoretically be extended) for investment in equipment, which can be depreciated within two years, hence quite considerably reducing the difference in the taxation of retained earnings between the two systems. A difference however remains for investment in real estate or other non-equipment parts of compound investments.

Therefore, in practice, compared to the CPT system, the ECT would only significantly improve the investment possibilities of relatively few companies who are honest taxpayers, do not have large tax losses carried forward and have a large share of their investments in categories other than equipment. This may be especially beneficial for start-ups. Also, access to bank credits would be somewhat improved. In sum, compared to the present system, the effect on investment will probably remain very limited. When comparing the ECT system to a more perfect CPT system without the present enforcement difficulties and the losses carried forward, the effect would become stronger. However, favourable accelerated depreciation rules in a CPT system are in principle a way of reducing the difference between the systems. Furthermore, it is unlikely that the tax losses accrued by companies in their foreign exchange operations, as dubious as they may be, can be legally removed from the present system.

Concluding assessment: *The differential effect of introducing an ECT system on investments is likely to be limited. Furthermore, the main effect is intrinsically linked to the fiscal effect: The larger the (negative) fiscal effect, the larger the (positive) investment effect would be.*

Fiscal effects

Changing the tax base from financial profits to distributed profits or other forms of capital exit constitutes a form of tax deferral: Profits are basically taxed later, only when they are disbursed in some form. This is likely to create a negative effect on the fiscal revenues in the short run: If companies, after the possible introduction of an ECT would not pay many dividends (possibly to use untaxed retained profits for investments), this would result in a shortfall of financial revenues in the years following the introduction of this tax system. Indeed, in Estonia, after introduction of the ECT in 2000, tax revenues on the ECT were initially considerably lower than on the previous tax before fully recovering. Furthermore, the Shemiatkin/Shevtsova draft envisages a tax rate of 15% on dividends paid out to residents of Ukraine, which is a considerable reduction of the tax rate from previously 23.33%. Hence, in principle, tax deferral and a lower rate may lead to an adverse fiscal effect.

In practice, the fiscal effect of an ECT introduction must be compared with the imperfect present state of the CPT. CPT revenues are diminished in no small part due to the massive tax losses carried forward by CPT taxpayers. In the logic of an ECT, these losses play no role as companies are taxed if they distribute profits. If they are able to distribute profits, they therefore cannot be in a loss-making situation anymore. Controlled transactions will lead to immediate tax revenues that cannot be offset with earlier losses any longer, which at the moment would prevent the changes of transfer pricing rules in the present system from leading to substantial revenue increases. Hence, the ECT system would not inherit the legacy of these losses. Another driver of differential tax revenues could be tax enforcement. If enforcing the ECT system should really be considerably more practical for the tax authorities, this would lead to a better revenue performance of the ECT in the longer run. However, transitional enforcement problems are likely in the first years, in which companies and tax authorities need to fully adjust to working with a new system. This is likely to result in a short-term gain by companies and hence reduced ECT revenues in the first years.

The ECT proposal appears to appropriately address the major avenues for tax avoidance and evasion. Rules on taxing interest on related-party credits, “financial aid” to related parties (an otherwise new possibility for avoidance: Aid or non-repaid credit given to related parties abroad), transfer prices and royalties focus on the likely avenues for large-scale avoidance without cluttering the system by including other avenues that may be numerous in cases but small in fiscal importance. The usual price method, which, although simpler than transfer pricing, may often not be a very sharp instrument to prevent avoidance, remains in place for transactions with taxpayers under the SST, essentially preserving the status quo in this regard.

Current estimates of the negative short-run fiscal effect of the introduction of an ECT in the first year range from UAH 11 bn (estimate by KM Partners, who developed the ECT proposal), corresponding to 0.5% of 2016 GDP to UAH 39 bn (estimate by the SFS), corresponding to 1.7% of 2016 GDP. Due to the fiscal deficiencies of the present system, the estimate by the SFS appears very high, but can be taken as an upper boundary for the first year fiscal loss.

Such a short-run loss is not to be taken lightly in the present environment. Ukraine is on an IMF programme and has no free access to financing its public debt on the market. The reduction of the general government deficit to a manageable level was one of the greatest achievements of government after the Maidan. Full fiscal compensation of any such reform would hence be absolutely necessary. Moldova’s experience can serve as an illustration: When Moldova reduced its corporate tax rate to zero in 2008, reductions in revenues led to political pressure being exerted on the tax authorities. As a result, companies were showered with fines and penalties for minor transgressions, perverting the impact of the reform from a positive to an adverse effect on investment climate. Hence, if Ukraine decides to implement the fundamental change towards an ECT system, it should ensure a full and solid compensation of corresponding revenue losses up to an upper boundary estimate.

Concluding assessment: *Introducing an ECT is likely to create fiscal losses in the first years, although there are good reasons to presume that the losses might be recouped in later years due to easier enforcement and inapplicability of carried-forward losses by companies. Due to the difficult state of Ukraine's public finances, if an ECT is introduced, care should be taken to assure that any possible fiscal losses up to 1.7% of GDP are compensated with expenditure cuts or tax rises.*

<u>Administrative burden</u>

One of the main arguments in favour introducing an ECT is reducing the administrative burden both for companies and for the tax authorities, leading to lower compliance costs and better tax enforcement. Indeed, there are several ways in which an ECT would reduce the administrative burden on both sides.

Firstly, changing the tax base from financial/tax accounts to individual transactions implies that only taxable transactions are to be documented by companies filing their taxes and that tax audits only concern a limited list of transactions with actors outside the ECT system. Companies still must perform financial accounting, but the large extra burden associated with this being the tax base is removed. This reduces the need for primary documentation by companies and somewhat eases the resource requirements at the SFS without alleviating the need for a massive strengthening of institutional capacity. In order for this to work, the SFS needs to be able to verify, which transactions were made by the taxpayers. However, this does not require full access to bank data (difficult under data protection rules). If the SFS gets only summaries on amounts and number of transactions between non-tax-payers and ECT-payers from banks, this will suffice. This kind of data collection is technically possible and would not violate data protection rules, however some legal changes may be required[12]. Based on this data there will be statistical indications for potential fraud, and following this a tax audit on site can be executed. It will be necessary to ensure that a pragmatic approach to this data collection is found in order to avoid having to conduct tax audits on the basis of financial accounts (as is the practice in Estonia). Doing this would cancel a large share of the administrative simplification provided by the ECT approach as the number of tax audits in Ukraine is expected to be large, given the lack of a culture of tax honesty.

Secondly, although related, the change of the tax base means that tax authorities and companies no longer need to discuss several accounting concepts that provide scope for disagreement or discretionary application of rules by the tax authorities. Such concepts include for example fair-value assessments for assets or provisions for liabilities. As these concepts are no longer part of the tax base, this would result in real and significant reduction of administrative burden on the side of both

[12] This would probably concern Article 62 of the law „On Banks and Banking Activity".

companies and the SFS. If an ECT is introduced, once it is running smoothly and the reductions of the administrative burden are clearly noticed by Ukrainian companies, the system could also become a prominent theme of Ukraine's investment attraction activities, showing that there is a real commitment to create a business-friendly environment.

Some difficult concepts remain subject for assessment by companies and the SFS. This concerns the key avoidance avenues that only change heading from possible deductions to taxable transactions. Determination of the taxability of related party credits (plus now financial aid to related parties), transfer prices for goods and services or royalties remain subject to company-SFS interaction. The proposals in the draft on targeted application and modification of these rules appear sensible, but could equally be used for improving the present system. However, as mentioned above, the problem of offsetting carried-forward losses would no longer be present.

Transition costs are a final issue to mention under administrative burdens. Indeed, any system change is likely to create adjustment costs in all affected parties. For companies, administrative adjustment costs are likely to be limited as primary documentation needs will shrink under the new system. On the side of the tax authorities, adjustment costs may imply certain revenue losses due to less than perfect knowledge of the system in the early period, but in principle, reduced demands on qualified staff under the ECT system should quickly compensate these costs.

Concluding assessment: *Administrative burdens on companies and tax authorities appear to be lower in an ECT system due to a smaller number of transactions being relevant for tax purposes and some difficult accounting concepts no longer being required to be audited. Transition costs will exist, but are likely to be small.*

<u>Overall conclusion</u>

Fundamentally changing the corporate taxation system in Ukraine from a CPT to the proposed ECT system is likely to result in small, but positive economic effects on investment. The fiscal effect in the short run is likely to be negative and should be fully compensated if the ECT is introduced. In the long run, the fiscal effect of the ECT is likely to be positive due to easier enforcement and the inapplicability of problematic legacy tax losses as well as indirect effects due to its positive impact on investment climate. The effect of an ECT introduction on the administrative burden on companies and tax authorities is likely to be beneficial. Whether an ECT system is to be introduced hence primarily depends on whether the short run fiscal shortfall can be compensated and whether the administrative and (small) economic effects are deemed large enough to engage in such a major legislative change. However, in the long run, the ECT system appears to be a suitable tax system for Ukraine with advantages, especially related to lower administration needs and hence better enforceability.

Table 4

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

6. Recommendations

General recommendations

Following our previous analysis, the following general recommendations on the choice between retaining the present CPT system or introducing the proposed ECT system emerge:

1. **The introduction of the proposed ECT as a substitute for the current CPT system would on balance have a positive impact on Ukraine in the long run.**
2. **However, this positive impact would be rather limited. A gradual improvement of the business environment through less burdensome company-state interaction is likely to result. No big bang, especially with regard to economic growth should be expected.**
3. **Furthermore, the 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.**
4. **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. Corruption at the State Fiscal Service should be combatted.**
5. **ECT introduction could be a complement to improving the tax administration, but 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 minimised.**

Recommendations in case of ECT introduction

If an ECT system is to be introduced, the following recommendations outline refinements and adaptions as well as more detailed investigation that should be undertaken. The German Advisory Group will publish a Technical Note with detailed recommendations and concrete proposals for adapting the present draft in due course.

1. **The existing draft law proposed by Oleksandr Shemiatkin and Tetiana Shevtsova is a good starting point from which to further refine and improve an ECT system for application in Ukraine if so desired.**
2. **The negative fiscal short-run effects of an ECT introduction must be fully compensated by offsetting revenue increases or spending reductions.**
3. **The fiscal shortfall generated by an ECT introduction in the short run could be reduced by choosing slightly higher rates of ECT than the current 15%/20%. The bottom rate should correspond to the Personal Income Tax (plus military duty).**
4. **Specifications on transaction reporting requirements by companies in the ECT should be sharpened. A pragmatic middle ground between excessive reporting needs and too little information relayed to tax authorities should be found.**
5. **The tax authorities should be legally given access to summaries on amounts and number of transactions between non-tax-payers and ECT-payers from banks such that no recourse to financial accounts is necessary in tax audits.**
6. **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.**