German Advisory Group Ukraine

NEWSLETTER

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Tax reform 2016: Positive aspects prevail

On 24 December 2015, once more a tax reform has been passed and came into force by 1 January 2016. The most important measure is the reduction of social security contributions from formerly over 40% to 22%. In order to compensate for the respective loss in public revenue, the contribution assessment ceiling has been raised and public expenditure - measured as a percentage of GDP - has been reduced. Consequently, there is a significant redistribution of an estimated 3% of the GDP from the public to the private sector. Furthermore, this measure strengthens the competitiveness of Ukrainian firms. Therefore, this measure is judged positively.

Moreover, progressive taxation, which had been introduced in 2011, has been abolished and a flat income tax rate at 18% has been implemented. With respect to the financial reporting, there have also been drawbacks; corporations with more than EUR 650,000 in revenues have to file their corporate income tax returns on a quarterly basis, which increases the bureaucratic burden.

The now well-functioning VAT refund can certainly be assessed positively. Although it only accounts for input tax credits which have been accumulated in the course of the newly introduced administrative system, this measure can surely be welcomed.

Overall, the tax reform can be judged as a suboptimal compromise. Nevertheless, positive aspects prevail.

Background

This reform compromise had been forced by the two competing tax proposals of the Parliament and the Ministry of Finance. Once more the statutory suspension period of 6 months had been ignored given the adoption on 24 December 2015 and the commencement, only about one week later, on 01 January 2016. Although these issues of lacking constitutionality have long been criticised and were said to receive highest priority among the issues to be solved, this leaves the impression that talk is cheap.

The IMF was certainly concerned whether the tax proposal of the Parliament would have been revenue-neutral, thereby causing the delay in the reform adoption. That proposal was designed to tackle the shadow economy by massively reducing social security contributions, which was in turn supposed to increase legal employment instead of quasi-self-employment and irregular salary payments. The IMF doubted the sustainability of the proposal regarding budget neutrality, and therefore it saw the progress in Ukraine´s fiscal consolidation threatened, which is one of the central goals of the IMF programme.

Social security contributions: Significant reductions

Social security contributions were reduced significantly from 3.6% to zero for the employee´s contribution and from on average of 36.5% to 22% for the employer´s contribution. In order to retain budget neutrality, the contribution assessment ceiling has been raised from 17 minimum salaries (end of 2015: UAH 23,426) to 25 minimum salaries (UAH 36,250). Equivalently, public expenditures as a percentage of GDP have been reduced. Thus, the tax reform implies a significant reallocation from the public to the private sector of an estimated 3% of the GDP. Given the inefficiency of the public sector, this reallocation might certainly carry positive spill-over effects for the overall economic performance.

The reduction in social security contributions simultaneously reduces overall production costs and increases competitiveness among Ukrainian firms. The extent to which this can actually improve the trade balance is an important factor and is currently evaluated by the German Advisory Group.

Income tax: Abolishment of progressive taxation

The progressive income taxation of 15% and 20%, respectively, which had been introduced in 2011, has been abolished. Now, there is a flat income tax with a rate of 18%. The special duty for military expenses of 1.5%, which had been introduced in August 2014, remains.

Corporate income tax: Drawbacks

Generally, the corporate income tax remains unchanged: the tax rate remains at 18%, the taxable base remains to be the commercial statutory financial statement – as it was introduced at the beginning of last year – only that large corporations have to adjust for changes in depreciation, retained earnings as well as provisions and losses. The profit tax exemption for large agricultural companies remains as well. The originally planned inclusion of those companies into the standard taxation is not part of the reform.

A step backwards has been taken regarding the reporting standards: Until the end of 2015, profit tax returns only had to be filed annually and tax prepayments were determined on the basis of the financial reporting results of the last business year. For large corporations, profit tax returns now have to be filed quarterly, which surely increases the administrative burden and is therefore judged negatively in the reform package. Further, tax instalments are not only based on the quarterly profit before tax results, but also 2/9 of the tax to be paid for the third quarter are required as a prepayment.

Although there is some progress regarding the VAT refund, the statutory refund of profit tax surplus remains an issue. Such surpluses amount to UAH 25 bn and the budget for 2016 does not consider any means regarding their refund. Thus, any improvements on this remain unlikely in the near future.

VAT: Refunding appears to work out

The reform of the VAT administration, which came de facto into force in early July 2015, persists. It can certainly be judged positively that VAT refunds of input tax credits are functioning well. Thus, one the major obstacles to investments has gradually been tackled. Still, no solution has been found on how to administer input tax credits from previous (business) years. This remains to be seen.

The automatic VAT refund for exporters has been abolished. VAT refund requests now have to be explicitly declared in the monthly VAT return, in which case only cameralistic audits are intended, fully substituting the former special VAT audit.

The special VAT accounting system for commercial farms will be abandoned by 2017. In the former system, commercial farms were allowed to deduct invoiced VAT and to invest the amounts for production purposes instead. During 2016, an interim solution is provided according to which invoiced VAT may only be deducted for certain agricultural products.

Taxation of small businesses

Regarding the lump-sum taxation of small businesses, the annual turnover limit has been reduced from UAH 20 m to UAH 5 m with a tax rate increase of 1% to 3% or 5%, respectively, depending on whether the business had opted for the VAT or not. Different estimations suggest that up to 20% of small business owners are quasi-self-employed. Therefore, this measure together with the significant reduction in social security contributions is supposed to foster regular employment.

Also due to the reduction in social security contributions, a containment of the shadow economy is expected. However, whether these expectations are going to be fulfilled in the short term remains to be seen as well since the approximate, commercial rate for money laundering is at 10%, which is still much lower than the income tax rate at 40% plus social security contributions. Thus, it is more likely that the reduction of the annual turnover limit from UAH 20 m to UAH 5 m rather triggers an increase in the number of small businesses for distributive purposes, than reducing the shadow economy.

Comparisons of major tax rates

Type of tax	Old	New
Social security contributions	> 40%	22%
Income tax	15/20%	18%
Corporate income tax	18%	18%
VAT	20%	20%

Conclusion: Positive aspects still prevail

The 2016 tax reform is certainly a suboptimal compromise. The fact that there are only marginal changes in the lump-sum taxation of small businesses, which is quite critical in terms of fiscal aspects, and that due to lobbyism there are quite a few exemptions for agricultural firms as well as a very low tax rate for dividends of only 5%, can certainly be judged negatively.

Still, the German Advisory Group can conclude that the positive aspects and changes outweigh those that can be judged negatively. The reduction in social security contributions certainly represents a milestone, with positive spill-over effects for the Ukrainian economy, regarding the growth and the trade balance, to be expected. In the medium term, this is also likely to contribute to the containment of the shadow economy.

Another milestone is represented by the, in the meantime well-functioning, VAT refund, which used to be a major obstacle for the attraction of foreign direct investment (FDI). For both cases, long requested reform efforts have finally been implemented.

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German Advisory Group

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