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Exit Capital Tax:
Technical suggestions on the draft law

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The German Advisory Group on Economic Reforms, which has been active in Ukraine since 1994, advises the Ukrainian Government and other state authorities such as the National Bank of Ukraine on a wide range of economic policy issues and on financial sector development. Our analytical work is presented and discussed during regular meetings with high-level decision makers. The group is financed by the German Federal Ministry for Economic Affairs and Energy.

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Exit Capital Tax: Technical suggestions on the draft law

Executive Summary

The Ministry of Finance of Ukraine is currently preparing a draft law on introducing an "Exit Capital Tax" (ECT), which would replace the current Corporate Profit Tax (CPT). This Technical Note makes technical suggestions and comments for improving the current, non-official version of the draft law, prepared by lawyers Alexander Shemiatkin and Tetiana Shevtsova, which is used by the Ministry of Finance as the base for preparing the official draft law. Key recommendations are:

Tax introduction and enforcement

- Postponing the coming into force of the law until 2020 to allow businesses, state authorities and banks to prepare for this significant change in the tax system
- Fully implementing authorities' access to summary bank data on transactions of ECT payers with non-payers of ECT. Without this access, ECT enforcement would be severely restricted. Without implementing access to bank data, we strongly advise against introducing the ECT

Tax rates

- Setting two ECT tax rates of 20% and 25%, with the former being applied to dividend payments ("transactions with capital exit") and the 25% rate being applied to payments economically equivalent to dividends such as surcharges on transfer pricing transactions, royalties or interest payments
- Keeping the PIT rate at 18%, striking the currently included reduction to 13%

Taxation of payments economically equivalent to dividends

- Not applying usual prices for identifying ECT taxability of transactions with residents that are not payers of ECT and instead identifying and prosecuting private entrepreneurs used for ECT evasion via implementing a list of criteria for determining fake entrepreneurship
- Amending the ECT tax base to include transactions with private entrepreneurs under the SST if they simultaneously meet two or more of the criteria of fake entrepreneurship
- Including agricultural entities under group 4 of the simplified system of taxation (SST) in the list of ECT taxpayers and completely eliminating the SST for agricultural producers from 2020
- Using the arm's length principle for defining ECT taxable interest paid to non-residents in controlled transactions instead of relating it to maximum NBU rates
- Making royalties paid under typical avoidance schemes fully ECT taxable
- Including non business-related expenses as taxable under the ECT

Tax reporting periods

- Introducing annual ECT reporting for small companies and quarterly reporting for all other companies. Annual reporting should be used for all transactions with surcharges above arm's length level (transfer pricing etc.)

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1 Introduction

The Ministry of Finance of Ukraine is obliged to submit a draft law on introducing an "Exit Capital Tax" (ECT) by July 2017 through the Tax Code amendment law passed by Parliament in the end of December 2016. Introducing such a tax would be a major departure from the conventional Corporate Profit Tax (CPT) system in operation now in favour of a rather rarely used method of corporate taxation, using distributed profits of companies – and economically similar payments – as the tax base rather than the financial profits of companies. This system of corporate taxation is currently used by Estonia and Georgia, although the latter country has only introduced this tax in the beginning of 2017.

The German Advisory Group has analysed the proposed tax reform comprehensively in PS/01/2017, "Corporate Profit Tax vs. Exit Capital Tax: Analysis and recommendations" and has reviewed international experience in PB/03/2017, "Taxation of distributed profits: International Experience". Our analysis finds that introducing such a system, although in principle feasible, risks major short-term fiscal losses for an uncertain impact on investment and economic growth, although the tax would probably have a positive long-run impact on the business environment through reducing the administrative complexity of corporate taxation.

As the Ministry of Finance is required to submit a draft law on this proposed tax reform, in this Technical Note, we make technical suggestions towards improving the existing draft law on the Exit Capital Tax (DLECT) by lawyers Alexander Shemiatkin and Tetiana Shevtsova, which will form the base for the draft by the Ministry of Finance. The suggestions made in this paper follow the line of recommendations developed in our analysis in PS/01/2017 and result from discussions with members of the working group on the Exit Capital Tax chaired by the Ministry of Finance. Making these technical recommendations does not imply that the German Advisory Group recommends introducing an ECT system. Instead, these technical recommendations are intended to ensure that, if an ECT introduction is desired, the ECT would be set up in the best way possible.

The structure of this paper follows the paragraphs of the DLECT in chapters 2-9:

- ECT taxpayers
- Objects of ECT taxation
- Tax base of the ECT
- Surcharges on transactions equivalent to capital exit
- Tax rates
- Reporting and disclosure requirements
- Deductions
- Authorities' access to ECT payer bank data

As the ECT also interacts with other types of taxation, relevant recommendations for the laws on the PIT and VAT are made in chapter 10. Chapter 11 makes recommendations on ordering the transition from a CPT to an ECT regime. The annex, available only in Ukrainian language, includes a comparison table of the original draft law with our suggested amendments.

2 ECT taxpayers

2.1 Cancellation of simplified taxation for agricultural entities of Group 4

Refers to: Par.133 (133.4) of the current draft law on the Exit Capital Tax (DLECT).

Agricultural entities under group 4 of the simplified system of taxation (SST) shall be included in the list of ECT taxpayers.

Simplified taxation for legal entities in group 4 may result in abolishing taxation of their profits. Under the curent Tax Code of Ukraine (TCU), these entities pay CPT advance payments when paying dividend even though they are not CPT payers and cannot claim such advance payments back or offset with obligations on other taxes. So such entities are currently paying the equivalent of Exit Capital Tax and excluding them from the list of ECT taxpayers as foreseen in the DLECT would lead to abolishing taxation of their profits distribution after the CPT is replaced by the ECT.

We recommend the following changes to the TCU regarding the simplified taxation of agricultural producers:

- To keep the SST only for really small agricultural producers (< 200 ha, < UAH 5 m) that correspond to criteria defined with the art.291.4 subpar.4) of the Tax Code for simplified system of taxation of Group 4 (whose share of agricultural production for the previous tax (reporting) year equals or exceeds 75 percent) and only for 2 years (2018 and 2019)
- The simplified taxation system for agricultural producers should be eliminated completely from 2020 onwards

Our proposal on how the wording of TCU might be changed is included in the Ukrainian-language annex of this Technical Note.

3 Object of ECT taxation

3.1 Bad debts with non-payers of ECT

Refers to: Par.134 (134.1.2 e) of the DLECT.

The wording of the norm shall refer to the definition of bad debt as it is stipulated in par.14.1.11 of the Tax Code. In addition, we support the comments of the ECT Working Group to amend the provision with the following limitations for ECT taxation:

- Bad debts shall be ECT taxable if the taxpayer did not apply to court against the non-payer of ECT for repayment of the debt or for fulfillment of an obligation to deliver goods, perform works, render services within the limitation of action period; on the other hand, there shall be no need to involve a court in case of instances as foreseen by par. 14.1.11 of the Tax Code in par. 14.1.11 in which debts can be written off finally (e.g. debtor died, force majeure etc.)
- Bad debts taxable under the ECT shall be exempt from ECT up to amounts not exceeding 1 minimum wage set by Law at the January 1st (per 1 year per 1 debtor)

3.2 Transfer pricing operations

Refers to: Par.134 (134.1.2 i) of the DLECT.

The DLECT cover as objects of ECT taxation transfer pricing operations that are controlled according to par.39 of the Tax Code and do not correspond to the arm's length principle as defined in art.138 of the DLECT. We support the norm, but we also agree with the ECT Working Group members that par. 39 should be adjusted in a way that both protects against ECT avoidance while at the same time reducing administrative pressure on businesses. This should be done by:

- Cancelling the limitation of controlled operations per counterparty. This would protect from ECT avoidance via decreasing of contractual amounts with 1 counterparty and creation of a lot of counterparties (currently the minimum limit is UAH 10 mn)
- Keeping the threshold of annual income of taxpayers for being subject to transfer pricing control. This will help small companies under the present threshold of UAH 150 m to not become subject to transfer pricing controls, unless they undertake transactions with non-residents from low tax countries. If they undertake such transactions, these shall be stated in the ECT declaration. Transfer pricing control would then apply to them, but without the need to submit specific transfer pricing reports. Such companies would then prepare a simplified variant of the transfer pricing documentation only on request of tax authorities

3.3 Usual prices for non-payers of ECT

Refers to: Par.134 (134.1.2 k) of the DLECT.

The DLECT requires applying usual prices in order to define transactions taxable under the ECT in operations with residents not subject to ECT (i.e. taypayers under the SST): ECT shall be applied if the contractual price does not correspond to the usual price. The usual price method is defined in the provisions of the DLECT.

We do not support applying usual prices for definition of ECT objects in operations with residents not subject to ECT. We understand the motivation for applying usual prices, as transactions with taxpayers under the SST might be used for ECT avoidance (e.g. paying for works/services provided by private entrepreneurs of Group 3 instead of paying dividends directly to the shareholders). However, the usual prices method is complicated, time-consuming and may not be helpful in case of work/services purchase when the entire contract, not only the amount exceeding the usual price, may be fake (i.e. fake works or services are rendered by the counterparty in return for the payment). Instead, we support introducing criteria of fake entrepreneurship in the DLECT, as we recommended in our previous Technical Notes TN/03/2016, TN/04/2016 on "Bringing changes to the Tax Code", that will help to:

- Identify and prosecute private entrepreneurs used for CPT/ECT evasion
- Tax under the ECT transactions with such private entrepreneurs that may be deemed fake under the citeria listed in DLECT (please also see par. 4.6. of the given Technical note)

3.4 Non-business related expenses

Refers to: Par.134 (134.1.2) of the DLECT.

We recommend amending Par.134 (134.1.2) of the DLECT by including non business-related expenses to the list of objects of ECT taxation as transactions equivalent to exit of capital guided by the following rules:

1. To be included as object for ECT: Expenses made by ECT-payers for the personal benefit of individuals (e.g. luxury goods, such as yachts, appartments, houses, etc.), purchased by an ECT-payer but used by non-ECT payers (e.g. shareholders-natural persons) for their personal benefit while still being booked to the balance of the ECT-payer
2. Non-business related expenses taxable under the ECT shall be exempt from ECT up to amounts not exceeding 100 minimum wages set by Law at the January 1st (per year, per luxury good)
3. Not to be included as objects for ECT: Expenses such as corporate events, mobile phone expenditures, private use of corporate cars, trips or fuel expenses thay may have double-purpose as well. Such expenses shall be subject for PIT in case being deemed as non-business related
4. For private use of corporate cars we recommend implementing a stricter PIT application: For the employee who uses the car, 1% of the initial price of the car is applied for monthly PIT, unless the car is not only formally but physically located every night and every weekend at the parking lot of the company. The currently applied formal order, that a car cannot be used for private purposes whould be not enough anymore

4 ECT taxable base

4.1 Interest limitation

Refers to: Par.137 (137.1.1.) of the DLECT.

We recommend that the ECT taxable base for taxation of interest shall not be related to the maximum NBU rate as foreseen in the present DLECT since maximum NBU rates do not exist for every type of loan and are not a permanent institution maintained by the NBU. The ECT taxable base for interest paid to non-residents in controlled transactions shall be defined according to the transfer pricing rules. In case the amount of paid interest doesn't correspond to the arm's length level, the exceeding over the arm's length level shall be the base for ECT taxation. The arm's length level for the interest rate will be based on the market range of interest rates in comparable uncontrolled operations that shall be a constitute measure for estimation of the interest surcharge paid over the arm's length level and to be taxable with ECT as a transaction equivalent to the capital exit.

4.2 Free of charge deliveries to non-payers of ECT

Refers to: Par.137 (137.1.3 b) of the DLECT.

We recommend that free of charge deliveries within advertising (marketing) campaigns shall be exempt from ECT.

We also recommend that this exemption for advertising (marketing) campaigns shall be limited to 0.5 percent of the net revenue from sales of goods (works, services), as reflected in the financial statements of the taxpayer for the previous reporting year.

We also recommend that the usual price of a separate unit of free distribution within a campaign shall be limited to 1 minimum wage set by Law on January 1st as foreseen in the current version of the draft law.

4.3 Financial aid to non-payers of ECT

Refers to: Par.137 (137.1.4, 137.1.5, 140.16) of the DLECT.

We recommend that, as stated in the current version of the draft law, a 12 months limitation period should apply for financial aid return by non-payers of ECT to ECT-payer in order for such financial aid to be exempt from ECT taxation.

We also agree to the proposal by ECT Working Group members to add an exemption for ECT taxation for non-purpose financial aid, provided to natural persons within the limit of income defined by par. 169.4.1 of the Tax Code.

We support the limitation in the current version of the draft law for financial aid paid to non-profitable organizations as 0.5% of the net revenue from sales of goods (works, services), as reflected in the financial statements of the taxpayer for the previous reporting year.

We suggest amending par. 137.1 by shifting the provisions of par. 140.16 and including it as an additional subpar. of par.137.1, since par. 140.16 says that any shortage or decrease of assets value revealed during an inventory taking (over the natural attrition norms) shall be deemed as financial aid provided to non-payers of ECT and shall be taxed under the ECT. We suggest to reduce the non-taxable limit for assets value decrease as a result of re-sorting from 10% to 5% and not to apply such a non-taxable share to shortages.

4.4 Investments abroad

Refers to: Par.137 (137.1.7 a) of the DLECT.

We support a comment from the ECT Working Group to the subpar. 137.1.7 a) that suggests applying a limit to payments of membership fees to foreign (international) organizations and institutions. We suggest it to be set as 500 minimum wages (ca. EUR 50,000) set by Law at the January 1st (instead of 1000 minimum wages (ca. EUR 100,000) foreseen by another member that in our opinion is too high) per taxpayer, per year.

4.5 Royalties

Refers to: Par.137 (137.1.11) of the DLECT.

In the current version of the draft law, royalties paid to non-payers of ECT and exceeding 6 percent of the net revenue from sales of goods (works, services), as reflected in the financial statements of the taxpayer for the previous tax (reporting) year are defined as taxable in the amount exceeding the 6% threshold.

We suggest defining the ECT taxable base here as the amount of royalties paid to (following the provisions 140.5.6 and 140.5.7 of the effective edition of the Tax Code):

a) non-residents during the tax (reporting) period in the amount that exceeds the amount of income from royalties increased by 4 % of net sales of products (goods and services) , according to financial statements of the taxpayer for the previous tax (reporting) year, except for entities engaged in the field of television and radio.

b) non-residents that are not beneficial (actual) recipient (owner) of royalties, except when the beneficiary (beneficial owner) provides those the right to receive royalties – subject to ECT in full amount

c) non-residents regarding objects of intellectual property in respect of which the resident of Ukraine obtained the intellectual property right first - subject to ECT in full amount

d) non-residents that are not liable to tax on royalty revenues in their country of residence - subject to ECT in full amount

e) resident legal entities not paying ECT - subject to ECT in full amount

f) residents natural persons on SST - subject to ECT in full amount

We support suggestions of ECT Working Group members that the base for the royalties threshold calculation shall be the previous tax (reporting) year's net revenue from sales of goods (works, services) whereas for newly established entities threshold shall be calculated based on the current year revenues. The revenues shall be subject to tax audits as long as they are being used as a threshold for calculation of royalties exempt from ECT taxation.

4.6 Combating fake entrepreneurship

Refers to: Par.137 (potential subpar.137.1.14) of the DLECT.

We agree to the proposal of ECT Working group members that the ECT taxable base shall include the amount of funds and/or the cost of goods (works, services) transferred (provided) to private entrepreneurs under the SST that simultaneously meet multiple criteria defined with the DLECT.

Moreover, in Technical Note TN/05/2015, we recommended the following changes to the Tax Code of Ukraine regarding combatting fake entrepreneurship:

- *To introduce a list of criteria to determine fake entrepreneurship of natural persons (based on German experience with under two or more of which the individual is deprived of the right to engage in entrepreneurship on Simplified system of taxation*

Thus we would like to support the proposal on introducing a list of criteria to determine fake entrepreneurship of natural persons. The criteria we recommended in TN/05/2015 are listed below:

a) perform work, services (including intermediary services for buying, selling, leasing and real estate evaluation), or are engaged in the supply of goods to one legal entity or several entities that meet criteria of related parties specified in p.p.14.1.159 of the Tax Code for a period exceeding six months, with the following works / services can be done (products supplied) on several projects or contracts simultaneously or sequentially

b) receive income from the supply of goods, works and services to one legal entity or several entities that meet criteria of the related parties listed in p.p.14.1.159 of the Tax Code, an amount of such income exceeds 85% of the income of such individual entrepreneur over a period lasting more than 6 months

c) perform work and / or provide services similar to the duties of staff of the legal entity to whom such an individual entrepreneur providing work / services

d) during the economic activities on supplying goods, works and services - subject to internal instructions and operating regulations of the legal entity to whom such an individual entrepreneur is supplying goods, providing work / services

e) do not have their own / leased space for economic activities on supplying goods, works, services and carry out their activities on the territory of a legal entity to which such individual entrepreneur supplying goods, providing work / services, or on the territory of another legal entities that are related to the given entity (p.p.14.1.159 Code)

f) perform economic activity on supplying goods, works and services using property (phones, computers, printers, fax machines, furniture, cars, stationery, gasoline, etc.), owned be the legal entity to which such individual entrepreneur supplying goods, providing work / services and / or use the property of other entities that are related to the given entity (p.p.14.1.159 Code)

g) prior to the registration as an individual entrepreneur on a simplified system of taxation such individual was a staff member of the legal entity to which such individual entrepreneur supplying goods, providing work / services or a staff member of another entities that are related to the given entity (p.p.14.1.159 Code)

Comments to the list of criteria stipulated in the DLECT and a comparison with German practice is provided in the Ukrainian language version of the Technical Note. In addition, we suggest amending the above list with one more criterion for fake entrepreneurship that may be used by shareholders to reduce taxation of capital exit:

h) Simultaneously with registration as an individual entrepreneur on SST such person is a shareholder (owner) of the legal entity that is paying such entrepreneur for supply of goods, works and services

However, we recommend that the ECT tax base shall include the amount of funds and/or cost of goods (works, services) transferred (provided) to private entrepreneurs under the SST if they simultaneously meet two (instead of four as foreseen in the present version of the draft law) or more of the criteria defined with the draft law.

The list of criteria can be added either in the ECT or the SST parts of the Tax Code and shall be used both for the ECT taxation purpose (ECT taxable base definition by ECT-payers that have transactions with such private entrepreneurs) as well as to deprive the private entrepreneurs of the right to engage in entrepreneurship on Simplified system of taxation if they simultaneously meet two or more of the listed criteria, with obligation to pay PIT from the amount of their income received during the period of being on SST, within the limitation of action period.

5 Surcharges for transactions equivalent to exit of capital

5.1 Sales/purchase of goods/services (controlled transactions)

Refers to: Par.138 (138.1.1) of the draft law.

We support the amendment suggested by ECT Working group members that the wording of subpar.138.1.1 shall be adjusted in the way that makes it clear that it shall be applied only to the controlled (transfer pricing) operations defined with the par.39 but not to the inland or other non-controlled transactions:

“The ECT taxable base for operations that do not meet the "arm's length" principle is defined as the sum of:

- The amount exceeding the price that corresponds to the "arm's length" principle, defined by the rules of par. 39 of the Code, over the contractual price of sold goods (works, services) for controlled transactions in cases stipulated by par. 39 of the Tax Code,
- Or the amount in excess of the contractual price of purchased goods (works, services) over the price that corresponds to the "arm's length" principle, defined by the rules of par. 39 of the Code, for controlled transactions in cases stipulated by par. 39 of the Tax Code”

5.2 Royalties

Refers to: Par.138 (138.1.2) of the DLECT.

In the current version, subpar. 138.1.2 of the draft law states: “*The ECT taxable base for operations that do not meet the "arm's length" principle is defined as the sum of:*

The amounts exceeding the prices that corresponds to the principle of "arm's length", defined by the rules in accordance with par. 39 of the Code, for royalties payable to:

a) non-residents registered in the low tax countries

b) non-residents regarding objects of intellectual property in respect of which the resident of Ukraine obtained the intellectual property right first

c) non-residents that are not liable to tax in respect of royalty in the country of their residence”

We recommend deleting subpar.138.1.2. The taxable base for royalties is already regulated by par.137.1.11 of the draft law. Furthermore, the royalties mentioned in subpar. 138.1.2 should be taxed with ECT in the full amount instead of taxing only the surcharges to arm’s length prices (see par.4.5 of this Technical Note).

5.3 Usual prices

Refers to: Par.138 (138.1.3) of the DLECT.

In the current version, subpar.138.1.3 of the draft law states: "*The ECT taxable base for operations that do not meet the "arm's length" principle is defined as the sum of:*

The amounts exceeding the usual price, defined according to the rules of this Tax Code, of the contractual prices of goods sold to resident non-payers of ECT."

We recommend deleting subpar.138.1.3. Consistent with our previous recommendations, usual prices (or surcharges to usual prices) shall not be applied to define the ECT taxable base in inland transactions with resident ECT non-payers (see chapter 3.3). Instead, we recommend applying criteria of fake entrepreneurship as a method of defining the ECT taxable base (please see par.4.6 of this Technical Note).

5.4 Period for surcharges taxation with ECT

Refers to: Par.138 (138.2) of the DLECT.

We agree with the proposal suggested by members of the ECT Working Group regarding applying taxation of surcharges at arm's length level annually. The period for ECT calculation based on surcharges shall correspond with the deadline for Transfer Pricing reporting (for more details please see chapter 7 of this TN).

5.5 Exceptions for surcharges

Refers to: Par.138 (138.3) of the DLECT.

We agree in general to the list of exceptions on transcations that shall have no surcharges for ECT taxation, as it is included in the DLECT (par.a) and b) as described below). However, we recommend to change the par.c) based on the amendments recommended in section 5.3 of this Technical Note (to exclude reffering to the usual prices). Thus, the operations shall have no surcharges for ECT taxation if:

a) an operation is controlled and its price corresponds to the "arm's length" level of price that is defined in accordance with par. 39 of the Tax Code, which is proved in the Transfer pricing report and transfer pricing documentation submitted in accordance with par. 39 of the Tax Code
b) an operation is not controlled and its price is confirmed by taxpayer in accordance with the procedure foreseen with par. 39 of the Tax Code, but without submission of the Transfer pricing report
c) an operation of selling the goods (works, services) to resident non-payers of ECT through public offers (retailers, shops, Internet sites, etc.) and to non-profitable enterprises, institutions and organizations referred to in paragraph 133.3 of the Tax Code

The reference to subparagraph 138.1.3 of the Tax Code in the provision 138.3 c) should be deleted as we recommend not using the usual price surcharge foreseen in subpar. 138.1.3.

6 ECT tax rates

Refers to: Par.139 (139.1) of the DLECT.

We support the differential tax rates foreseen by the current version of the draft law, but we strongly recommend higher rates. Under the present draft, the ECT rates will be still lower than the current rate. The present effective tax rate on profits paid out to shareholders (CPT + Personal income tax on dividends + military duty combined) is 23.3%. As a fiscal shortfall is to be expected if the ECT is introduced, there is no justification for applying lower rates than in the present CPT system. We therefore recommend tax rates of 20% and 25%:

- 20% - Tax rate on dividend payments ("transactions with capital exit");
- 25% - Tax rate applied to "equated payments" (payments equivalent to capital exit) such as interest, financial aid, surcharges on transfer pricing transactions. No further tax would have to be paid on dividends, as the withholding tax would be dropped with the proposal.

We do not support the proposals of some ECT Working Group members to set up one single ECT tax rate. In our opinion, applying the 25% tax rate on the "avoidance component" of those transactions most usually used for profit shifting (related party credits, transfer prices and royalties) is an important component of the anti-avoidance strategy to be used in the ECT.

7 ECT reporting/disclosure requirements

Refers to: Par.140 (140.2, 140.6, 140.9) of the DLECT.

We recommend the following reporting periods for ECT:

- Annual reporting period - for companies with annual income lower than the threshold of annual income foreseen with the par.39 of the Tax Code (currently the threshold is UAH 150 m):
    - If the company is not working with non-residents from low tax countries and thus has no surcharges for ECT purposes: Within 60 calendar days after the reporting (tax) year (approx. March 1st)
    - If the company is working with non-residents from low tax countries and thus is under transfer pricing control and will have to calculate surcharges for ECT purposes (to be stated in the ECT declaration): Until October 1st of the following year (the same deadline as for Transfer pricing reporting). Although such companies shall be released from the Transfer pricing reporting, but they will need to obtain the information required for arm's lengths prices definition and surcharges calculation, what is not possible to do before October of the next year, when the information about comparable uncontrolled operations of the previous year appears in the special databases (SPARK, Ruslana, etc.)

- Quarterly reporting period - for companies with annual income exceeding the threshold of annual income. Such entities shall submit the ECT reporting with the following deadlines:
    - If the company has no controlled transactions as defined by par.39 of the Tax Code and thus has no surcharges for ECT purpose: Within 40 calendar days after the reporting quarter for Q1-Q3 and within 60 calendar days after the reporting (tax) year for the Q4 report (approx. March 1st) to agree it with the deadline for annual

Financial reporting since some ECT indicators are still related to the Financial reporting of the company (income as a base for royalties etc.)

- If the company has controlled transactions as defined by par.39 of the Tax Code and so is under transfer pricing control and will have to calculate surcharges ECT purposes, it will have to separately submit reports for:
  - Exit capital tax transactions (and economically equivalent) that are not under transfer pricing control - quarterly within 40 calendar days after the reporting quarter for Q1-Q3 and within 60 calendar days after the reporting (tax) year for the Q4 report
  - Exit capital tax transactions (and economically equivalent) that are under transfer pricing control and may contain surcharges – annually, before October 1st of the following year (the same deadline as for transfer pricing reports).

This approach will help reducing the administrative pressures related to ECT reporting and disclosure for small companies that do not have controlled transfer pricing operations. At the same time, the companies that are under the transfer pricing control will have sufficient time for analysis of information regarding arm's length level of prices and calculation of surcharges (if any).

8 ECT tax obligation deducting elements

Refers to: Par.140 (140.7) of the DLECT.

We agree to the following list of ECT obligation deducting elements (within the positive amount of ECT obligations defined according to the art.136 and 137.1.4 of the DLECT) foreseen by the Draft Law and supported by members of the ECT Working Group:

a) The amount of tax paid in the previous tax periods from the amount of financial aid provided in case of its return or partial return to the taxpayer
b) The amount of paid property tax (the provision shall be clarified according to the comments of the ECT Working Group members regarding what components of the property tax are deductible - tax on real property other than land, vehicle tax, payment for land)
c) The amount of tax paid in previous tax periods in connection on the transfer of funds and/or value of the property for the purpose of investing outside Ukraine, in case of a return or partial return of such funds and / or property to the taxpayer
d) The amount of tax paid in previous tax periods in connection on the transfer of funds and / or property value of the goods as a contribution of the founder and / or owner to the charter capital of legal entity non-payer of ECT; as a contribution to the joint venture entity - non-payer of ECT; in trust entities non-payer of ECT , in case of return or partial return of such funds and / or property to the taxpayer
e) The amount of taxes paid abroad in connection with the payment of dividends in favor of the ECT taxpayer. This tax amount shall be confirmed by a certificate issued by the competent authority of the State of residence of the dividends payer

In addition we recommend amending subpar.140.7 with some more deduction elements not included in the DLECT:

f) For controlled operations: The amount of tax paid in previous tax periods on surcharges, in case of receiving credit-notes (after sale discounts) from non-resident for imported goods (works, services) or after sale price increase provided to non-resident in export operations (if any), that will put the prices of controlled transaction back to the arm's length level, within the amount of surcharges in the relevant transactions calculated and taxed with ECT in the previous tax periods

g) For bad debt of non-payers of ECT: The amount of tax paid in previous tax periods on bad debts with non-payers of ECT, in case the payment for delivered goods (works, services) or goods delivery (in case of prepayment) is received from the non-payer of ECT after the limitation of the action period expired, within the amount of relevant bad debts that were already written off and taxed with ECT in the previous tax periods

h) For transaction with resident non-payers of ECT: The amount of tax paid in previous tax periods on goods/payments delivered to resident non-payers of ECT that correspond to the criteria of fake entrepreneurship, in case goods/payments have been returned by such resident non-payers of ECT, within the amount of relevant sales/payments to the resident non-payer of ECT taxed with ECT in the previous tax periods

9 Authorities' access to bank on transactions with non-payers of ECT

Refers to: Par.140 (140.14) of the DLECT.

We agree with the wording of the DLECT regarding the banking control over the transactions with non-payers of ECT:

"If a taxpayer committed a transaction that is a subject for ECT taxation with a person who can not be identified, it is believed that such transactions has been done with a non-payer of ECT.

During the transfer of funds by the taxpayer to another taxpayer the code of the taxpayer – recipient shall be indicated in payment documents.

The bank or financial institution shall submit a report to the tax authority that contains information about the total amount of funds transferred by the taxpayer in favor of non-payers of ECT during the tax (reporting) quarter - on a quarterly basis by the 20th of the month following the tax (reporting) quarter.

Information shall be provided in accordance with the procedure that shall be established by the Ministry of Finance and the National Bank of Ukraine, without identifying individuals non-payers of ECT to whom funds have been transfered.

If the amounts of operations declared by ECT-payers by results of the tax (reporting) quarter doesn't match the amounts stated in the information received by tax authority from the banking or financial institutions, reduced by the amounts reported by the taxpayer as a tax agent, the tax authority may send a request to the taxpayer to obtain an explanation for this discrepancy."

We support the idea of the ECT Working Group to amend the standard form of the payment order by adding a new obligatory field for ECT-payer's tax number, which will be assigned to ECT-payers by tax authorities when they include them into the register of ECT-payers. ECT-payers shall be responsible for the correctness and credibility of the ECT-numbers of their subcontractors mentioned in payment orders (or keeping it blank in case if a subcontractor is a non-payer of ECT). Cash transactions shall be controlled by banks as well (purpose of the cash use, etc.).

We are aware of the position of the National Bank and the Banks Association that have suggested to delete subpar.140.14, however, we disagree with this position. Implementation of authorities' access to bank data on transactions with non-payers of ECT is a key instrument for enforcement of the ECT. Without this access, any stringent enforcement of the ECT stopping short of fully auditing financial statements and supporting documents of companies (which would negate any potential benefit of the ECT with regard to reduction of administrative burdens of the tax system on companies and authorities alike) is not possible. **If the current subpar. 140.14 on banking control and respective reporting on transactions with non-payers of ECT will be not implemented, we strongly recommend against introducing an ECT system.**

10 PIT and VAT changes

Refers to: Art. 13 – 17 (par.165 - 170) of the DLECT regarding PIT (personal income tax).

We agree with the following amendments on PIT foreseen by the DLECT in case the ECT rate will be increased to 20% (as we described in the par. 6 of the given Technical Note):

- To exempt from PIT taxation:
    - Dividends accrued (paid) in favor of the PIT taxpayer by the ECT taxpayer
    - Financial aid paid in favor of the PIT taxpayer by the ECT taxpayer

We disagree with the following foreseen by the Draft Law amendments on PIT:

- To reduce the PIT rate from 18% to 13% (including for passive income). Such a major step should not be taken in a law directed at corporate taxation and is furthermore entirely unreasonable given the expected deterioration of public revenues due to ECT introduction
- To release residents payers of ECT from the duty of tax agent when paying dividends to the natural person – we suggest that the information on paid dividends shall be disclosed by ECT taxpayers in the quarterly PIT reporting of tax agents (1-DF) although PIT taxation is not relevant for such personal income
- To cancel special taxation of dividends on shares or other corporate rights with the status of privileged (currently those are taxed as salaries)

We support the comments of the State Fiscal Service regarding the above mentioned amendments to PIT that may lead to significant revenues shortage in municipal budgets and may increase the scope for PIT avoidance schemes.

Comments to Art. 18 (par.181) of the Draft Law regarding VAT (value added tax).

We disagree with the following foreseen by the Draft Law amendments on VAT:

- To increase the threshold for VAT payers obligatory registration from UAH 1 mn to 1,600 minimum salaries (ca. UAH 5 mn).

We support the comments of the State Fiscal Service that VAT obligatory registration threshold shall stay without changes during the ECT reform, otherwise foreseen threshold increase will lead to reduction of number of VAT payers and as a result - to significant State budget's revenues shortage.

11 Transitional and final provisions

Refers to: Art.21 (par.XX) and par.II of the DLECT regarding transitional and final provisions on ECT

We support the following amendments included in the DLECT and supported by members of the ECT Working Group:

- CPT (corporate profit tax) overpayments, accumulated at the beginning of the fiscal year when ECT replaces CPT, can be used by ECT-taxpayers to reduce their tax obligations on ECT and /or can be returned to the taxpayer's bank account
- Interest that have been accrued by ECT-payers in the reporting periods before ECT replaces CPT, shall be exempt from ECT taxation when those are being paid in the period when ECT is effective
- Dividends that are being paid in the period when ECT is effective, accrued for the periods of 2014-2019 (before ECT replaces CPT), calculated separately per each year, in the amount:
    - That doesn't exceed together with previously paid dividends positive taxable result declared in CPT report of the relevant tax year – are not subject for ECT taxation;
    - That exceeds together with previously paid dividends for such years positive taxable result declared in CPT report of the relevant tax year –are subject for ECT taxation.

  In case if tax losses were declared for the relevant tax year, dividends paid for such tax year shall be ECT taxable in full amount.

We disagree with the following amendments foreseen by the DLECT:

- Taxpayers up to their own decision have the right to calculate their CPT tax obligations for the year of 2020 either according to the rules established by Chapter III of the Tax Code in edition effective during the year of 2019, or according to the rules established by Chapter III of the Tax Code in edition valid from 1 January 2020

We disagree with the following amendments supported by members of the ECT Working Group:

- 18% of the amount of tax losses, accumulated at the beginning of the year when ECT replaces CPT, can be used by ECT taxpayers to reduce their tax obligations on ECT.

In addition we strongly recommend postponing the date when the Draft Law on ECT comes into force until January 1st 2020, in order to provide time for business, state authorities and banks to prepare for this significant change of the tax system.