

Corporate Tax - Ukraine

Labour taxation: considerations for businesses

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When starting and running a business in Ukraine, investors should prepare for the formalities of Ukrainian legislation. In many cases, form prevails over substance, including with regard to taxation issues. This update considers the various methods of structuring labour remuneration payments in order to be tax deducted.

Tax deduction for labour remuneration expenses

It is common practice to accrue payments related to the remuneration of labour based solely on the orders of company management. This means that the grounds for payment accrual and the procedure for payment calculation are not set out in any other local document. It can be argued that such payments are deductible on the following grounds:

- According to Paragraph 142.1 of Article 142 of the Tax Code, a taxpayer may deduct labour remuneration expenses, which include:
 - accrued basic and additional salary;
 - incentive payments in the form of bonuses, other rewards and/or compensation; and
 - any other expenses in monetary form or in kind, made on the "agreement of the parties".
- According to Paragraph 2 of Article 97 of the Labour Code, provisions on the remuneration of labour, including the conditions on establishment and amount of bonuses, rewards and other incentives, compensation and guarantee payments must be stipulated in a collective agreement. If a collective agreement has not been concluded at the enterprise, the employer must agree these issues with the elected body of the trade union or – if one has not been established – another authorised representative of the work collective. In the latter case, issues on the remuneration of labour may be agreed in the form of a separate regulation on the remuneration of labour or other document agreed with the work collective.

Moreover, the phrase 'agreement of the parties' also means a labour agreement – that is, according to Ukrainian law, a taxpayer may regulate issues on the remuneration of labour either in the collective agreement (or equivalent document) or directly in the labour agreement.

The initial version of the Tax Code (effective until August 2011) stipulated that a taxpayer could exclusively deduct labour remuneration expenses stated in the collective agreement (and not in a labour agreement). Considering that many employers do not conclude collective agreements, this requirement essentially reduced the amount of labour remuneration payments that could be deducted.

In short, pursuant to the Labour Code, the company management's order on the accrual of labour remuneration payments is not considered a document that can legally set forth the conditions governing the establishment and amount of such payments. Such an order can be the basis only for its accrual.

Structuring labour remuneration

As mentioned, a taxpayer can regulate issues regarding the remuneration of labour in the collective agreement or separately in individual labour agreements with employees. The general rule is to envisage payments made to most employees in the collective

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agreement (or equivalent document). Grounds for the accrual of payments, the payment calculation procedure (with respective coefficients and percentage ratios) and the frequency and terms of payment are thus also to be set out in the collective agreement.

In addition, it is advisable to stipulate in the collective agreement that the payment of incentives (eg, bonuses and rewards) is the obligation – not the right – of the employer if employees meet all conditions for payment. The tax authorities are of the position that if the payment of incentives is the employer's right (and not an obligation), the employer should make such payments at the expense of profits. Employers may regulate the specific amount of the incentive payment to be paid to each employee by using several indicators.

It is better to establish 'occasional' payments – that is, those that are not systematic and paid only to individual employees – in the labour agreement with the employee (or a supplementary agreement).

A separate issue arises in respect of structuring compensation payments to employees. Sub-paragraph 164.2.17 of Article 164 of the Tax Code states that compensation to the employee for any expenses or losses other than those that should be reimbursed in accordance with the law is considered a fringe benefit for the employee. Such compensation may be regarded as financing the personal needs of the employee and is thus not tax deductible. Therefore, the word 'compensation' should be avoided when drafting collective/labour agreements.

Tax disputes over labour remuneration expenses

Disputes with the tax authorities regarding the lawfulness of tax deductions for labour remuneration expenses are common. One of the most frequent issues that arise regards payments made in kind. For example, when the employer provides certain employees with assets or services free of charge (eg, accommodation or a car), whether such expenses are tax deductible depends on the grounds on which the employee has been provided with the asset or service (ie, whether it is provided as a bonus due to the employee's position or connected to the employee's job functions).

If such assets or services are provided to facilitate the execution of job functions (eg, a sales manager who requires a car in order to perform his or her job obligations), the relevant costs incurred (eg, car rental fees) are tax deductible as either the taxpayer's administrative expenses pursuant to Article 138 of the Tax Code (Clause B, Sub-paragraph 138.10.2) or as other expenses, depending on their purpose. The main requirement is that such expenses are connected to the business activity of the enterprise and supported by respective documentation (eg, the enterprise's car policy and route sheets).

If the employee is provided with certain assets or services as a bonus that is envisaged in the labour or collective agreement, such assets or services are tax deductible as labour remuneration expenses pursuant to Paragraph 142.1 of Article 142 of the Tax Code. However, giving the employee certain assets as a bonus means that the taxpayer does not itself use the asset, but rather passes the right to use the asset to the employee, who uses it for personal purposes. Therefore, such a transfer of right may be recognised as a business operation. In such case, a sale of services is deemed to have occurred. The question then arises as to whether such a business operation is considered a source of income for the enterprise. However, the legislation on this issue (in particular, transfer pricing) is undergoing changes. Therefore, due to the ambiguity of the existing law, and because a procedure to determine taxable income in the given case has not been established, such business operations are not presently considered taxable income.

However, court practice shows that any payment in favour of an employee that is made to a third party triggers tax risks in terms of deductions. Therefore, it is recommended that enterprises avoid providing any benefits in kind and making payments directly to third parties, rather than to the employee.

Issues with the tax authorities may also arise with respect to severance pay. The tax authorities' stance is that since severance pay is not intended to provide incentives to the employee and is made merely due to the termination of labour relations, it does not constitute the wages fund and therefore is not tax deductible. In order to reduce the risk of a dispute with the tax authorities, severance pay can be stipulated as a bonus for long-term cooperation in the collective or labour agreement.

Comment

Considering the above, the collective agreement (or equivalent document) and the labour agreement can be used as an effective mechanism for tax planning and optimisation. With the proper structuring of payments on the remuneration of labour, the taxpayer may considerably reduce its taxable profits with deductions on such expenses.

Another aspect that the taxpayer should keep in mind is whether it is beneficial to deduct such expenses, as the remuneration of labour is subject to unified social

contribution. By deducting for labour remuneration expenses, the taxpayer saves on corporate profit tax at a rate of 19% (for the current year), against unified social contributions at a rate of more than 36%. However, the maximum basis for accrual of unified social contribution is 17 times the minimum subsistence level for employable persons per month (at present, approximately \$2,440). Where an employee's total monthly income equals or exceeds the maximum basis, the taxpayer will save on tax by deducting labour remuneration expenses; but if the employee's total monthly income is below this amount, deduction for labour remuneration expenses may not be beneficial, since the accrual of these expenses leads to additional social contributions.

However, the above does not concern cases where payment was already made on the sole basis of the company manager's order and the unified social contributions as also paid (which happens often in practice). In this case, the payment is still not definitively tax deductible if it is not stipulated in the collective and/or labour agreement in accordance with the Labour Code and the Tax Code.

Most payments that fall within the fund on 'remuneration of labour' are included when calculating average monthly allocation of sick leave days and vacations. As such, structuring payments as part of the remuneration of labour may significantly affect the amount of sick leave payments and vacations given.

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