hot issue

Entrepreneurs Under the Unified Tax Regime (Under the New *Personal Income Tax Act*)

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Currently, almost 2.5 million Ukrainian citizens are registered as private entrepreneurs and a considerable number of them are engaged in rendering works or services on the basis of civil law contracts. Most of the said entrepreneurs use the so-called *unified tax regime* (under which the level of applicable taxes is limited by a unified tax with a cap of UAH 200 per month, where regular personal income tax and payroll-related mandatory remittances are not applied).

Undoubtedly, taxation issues are quite important both for them and for the entities to which they render services (hereinafter — customers).

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Proceeding from the above, it is appropriate to investigate some possible implications of the new *Personal Income Tax Act* (which comes into effect on 1 January 2004) in respect of the scheme involving private entrepreneurs rendering works or services to customers.

We would like to note that, in fact, the new *Personal Income Tax Act* dated 22 May 2003 envisages some cases when the engagement of private entrepreneurs is treated in the same way as if they were employees of the customer.

Namely, the second paragraph of Article 1.8 of the *Personal Income Tax Act* stipulates that remuneration paid to a private entrepreneur by a company for provision of works or services[1] shall be taxed as if it were a wage (salary) of an employed person, if *the agreement with the entrepreneur establishes* that:

1. the services for which the payment is made are rendered (works provided) on a continuous and regular basis for a period exceeding one monthly tax period;

and/or

2. the customer enjoys all the benefits and bears all the risks related to rendering or not rendering the above services.

If a case falls into the scope of the second paragraph of Article 1.8 of the said Act, then personal income tax shall be held back from the sum of remuneration at 13 % rate by the customer, which is recognized a tax agent pursuant to Articles 1.15 and 8.1 of the said Act. In addition to the above, the sum of remuneration shall be subject to pension and social security remittances as if the remuneration were a wage or salary (Article 4.4 of the Act).

Therefore, when a case falls into the scope of the said provision, engaging entrepreneurs compared with using employees really has no benefit from the cost perspective.

In such cases, engaging entrepreneurs might be sensible from the cost perspective[2] if it is tailored in a way as not to allow it to fall into the scope of the above provision.

In the latter case the remuneration of such an entrepreneur shall be taxed under special rules, which are not directly provided by the said Act. That is, the Act refers such cases to special regulations on the taxation of private entrepreneurs. Such a conclusion follows from the analysis of paragraphs 9.12 and 22.10 of the Act. Respective special regulations shall be the ones contained in:

- Chapter IV of the current *Decree On Personal Income Tax*, which remains valid until the new Act on taxatixon of income of private entrepreneurs is adopted;
- Presidential *Decree No.727/98 of 3 July 1998* (with subsequent amendments) on the unified tax for small businesses. When applied this Act will replace the above Decree in respect of incomes falling into the scope of the Decree.

The discussed Act (sub-paragraph 4.3.25 of the Act) also specifically stipulates that income derived by a private entrepreneur, who has chosen a special (simplified) tax system under the respective Act, is fully exempt from personal income tax. And even if the tax authorities challenge the applicability of the above exemption[3] by saying that the Decree is not formally the Act even though it has the force of the Act, the Decree shall nevertheless be applied as a part of *special regulations* in accordance with paragraph 9.12 of the Act[4].

In the latter case the remuneration paid to the respective entrepreneurs shall be not treated similarly to a salary (wage) under the *Personal Income Tax Act* and the customer shall, respectively, not be regarded as a person responsible for withholding personal income tax (because the tax does not apply to such cases). Pension and social remittances are not applicable in such cases either.

The crucial issue is in which cases would contracting a private entrepreneur for provision of works or services not trigger taxation of the remuneration paid to such entrepreneur as if it were a salary.

One clear exemption is provided directly by the last paragraph of the discussed Article 1.8 of the new *Personal Income Tax Act*. This paragraph states that salary-like tax treatment shall not be applicable if the engaged natural person assigns (delegates) the actual performance of an appropriate service to third persons (regardless of whether such delegation is done with the permission of the *employer* or without it). Yet, in such cases the *intermediary* becomes the tax agent as such for the purposes of the *Personal Income Tax Ac*t and *downstream* compensation payments become fully taxable merely at the other levels. Therefore, the real benefits of using this approach in practice are at least limited.

As such, the only approach to be on the safe side with contracting entrepreneurs for works or services without triggering excessive taxation, is to tailor the relationship with such entrepreneurs in a way in line with which none of the qualifying features stipulated by the second paragraph of the Article 1.8 is matched[5]. That is, that the terms of the contracts[6] for works and services with such entrepreneurs shall neither envisage continued and regular service (works) for a period exceeding one month nor envisage that the customer enjoys all the benefits coming out of such works (services) and bears all the risks related to rendering or not rendering the above services.

In our view this may be achieved in the case under consideration by restructuring the relationship between the customer and the private entrepreneurs from continuous contracts into contracts for specific tasks with the respective works (service) period for each contract being within one calendar month. It is also stated that all the risks related to the provision of respective services (e.g., related to compliance with legislation on advertising, on protection of consumers' rights etc.) are with the entrepreneur.

As a matter of practice one may consider implementing shorter terms and a non-permanent way of rendering services with clear interruptions. For example, services may be rendered by an entrepreneur on the basis of a direct contract with a customer (and by delegating a part of work to other individual entrepreneurs under the same tax regime) for 20 days, while during the following 40 days the entrepreneur doesn't render any services *directly* to the customer, acting as a subcontractor of the other entrepreneurs. This will allow for simultaneous use of two legal grounds (non-permanent service for a short period plus subcontracting for work by other persons), which shall exempt the entrepreneur's income from excessive taxation.

It may be wise to start implementing this scheme even before the new *Personal Income Tax Act* comes into effect in order to present such reshaping as some kind of normal evolution rather than as a change caused entirely by the relevant changes in tax legislation. ■

1 That is, this rule does not apply in the event of payments for goods.

2 We limit our analysis here merely by the cost factor. Other aspects of contracting entrepreneurs compared to using employees are beyond the scope of this analysis.

3 That is quite unlikely from the practical perspective in our view.

4 It is worth noting that the *Decree On Personal Income Tax* is also not formally an Act even though it has the force of an Act. Applicability of the Decree as a part of the special regulations cannot be challenged without undermining the applicability of the Decree as well.

5 We considered the approach whether the link 'and/or' between these two qualification requirements may be treated in a way that at least one of the said two qualification requirements (namely, the first one) may be considered as not being self-sufficient for the qualification, but we do not feel comfortable in recommending such an aggressive approach.

6 We note that the Act literally refers to the terms of respective contracts rather than to a relevant factual pattern. As such, the Act still demonstrates the approach under which the formal side is given some priority over the actual substance.