

Nation will start 2011 with two tax codes; transition expected to cause confusion

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Ukrainians will wake up on Jan. 1 next year with double vision – not necessarily as a result of New Year parties, but because there'll be two tax systems operating.

The new tax code, adopted by parliament and signed into law by President Viktor Yanukovich this month, will come partially into force at the beginning of next year.

Businesses will have three months to adjust to rules that take effect immediately, while several more months will be granted before other changes envisioned in the recently adopted tax code take effect.

This all means that two tax systems will be working side-by-side for a while. This transitional period, experts say, could lead to confusion, which state tax administration officials could use to their advantage.

"This will be a nightmare for accountants because during one calendar year, two laws will work, giving room for tax officials to abuse their powers," said Oleksandr Minin from KM Partners, a law firm.

To stay safe in this situation, businesses should follow the new legislation that is clearly defined, for instance related to value-added tax. They should follow old rules in instances in which the new rules are not clear or require more explanation, such as for social payments – akin to a payroll tax – that are yet to be defined by a separate law.

The code itself has been widely criticized for benefitting larger businesses and not smaller firms.

"The tax code will benefit large businesses but effectively limit business-to-business activity between them and small entrepreneurs," said Olena Bilan, chief economist at Dragon Capital. "Amendments to the tax legislation introduced by the document are likely to produce a minor affect on budget revenues."

Small business

The privileged tax breaks for small business have been left untouched. As a result, a variety of business activities performed by individuals will continue to be registered as individual business entities paying a small privileged tax rate. Their single tax will remain low – between Hr 20 to Hr 200.

But there was one blow for small businesses. Big businesses will no longer be able to include the costs of goods and services purchased from these private entrepreneurs and deduct the cost from their tax bills.

The old tax system allowed medium and large enterprises not only to hire entrepreneurs to perform certain work or services, but also to take advantage of this system to reduce tax payments. Many companies employed a large number of full-time staff this way. The schemes allowed many businesses to avoid paying high payroll taxes, leaving the pension fund short of badly needed revenue. Meanwhile, the employees also got away by paying much less taxes than had they registered as full time employees.

"Now when payments to individuals registered under this system will not be tax deductible for corporate tax purposes, this will increase the cost of doing business with such entrepreneurs for companies," said Ron Barden, partner for tax and legal services at PricewaterhouseCoopers.

Key changes in new tax law

Tax	Current status	Adopted changes
Corporate profit tax	25 percent	23 percent from 2011 21 percent from 2012 19 percent from 2013 16 percent from 2014 10-year tax holidays for the light industry, hotels, aircraft makers, shipbuilders and producers of agricultural machinery; 5-year tax holidays for small businesses and startups
VAT	20 percent	17 percent from 2014; automatic VAT refunding for eligible companies; the government faces fines in case of delaying refunds; ; zero rate for agro producers and exporters (excluding trading companies)
Personal income tax	15 percent	15 percent for monthly incomes below 10x minimum wage (Hr 9,220 as of Dec. 1); 17 percent for monthly incomes above 10x minimum wage
Excise taxes on oil products		No changes in Tax Code but parliament earlier approved 38-40 percent hikes effective 2011
Excise taxes on alcohol and tobacco		No changes in Tax Code but parliament earlier approved a 7 percent increase effective 2011 (not applied to beer producers)
Oil royalties		40 percent hike from 2011
Gas royalties		18.5 percent hike from 2011
Simplified Taxation Regime (STR) for small businesses		No changes in rates and thresholds; costs of goods and services purchased from entrepreneurs using STR (except IT services) by companies subject to general taxation regime are no longer tax deductible
Fixed agricultural tax, special VAT regime for agro producers*		No changes
Tax on interest earned on bank deposits		5 percent from 2015
Property tax		Progressive rate ranging from 0 percent to 2.7 percent of the minimum wage per square meter applied depending on taxable property area from 2012

Note: *agro producers retain VAT in their bank account to use for CAPEX and production needs.

Source: Dragon Capital

Meanwhile, earnings of small business that indeed worked with big companies will significantly fall, because they will share the income tax, explained Minin from KM Partners.

Big business

The tax code introduces new tax rates on profits that will be reduced from the current 25 percent to 23 percent in 2011 and further to 16 percent in 2014. However, experts said the nominal tax rate does not reflect the so-called effective tax rate, which is considerably higher.

The effective rate depends on how a company defined its gross business expenses and what amount of income is left for taxable profit. The list of expenses that can be credited to the total gross costs was never identified clearly, allowing lots of room for maneuver for entrepreneurs, as well as tax administration.

"Regulatory authorities and businesses had different ways to determine the list and amount of expenses that may be tax deductible," said Volodymyr Kotenko, partner and head of tax and legal practice at Ernst & Young in Ukraine.

While firms could artificially increase their gross costs, so as to declare a smaller profit to be taxed, tax authorities could at any time and for any reason disagree with the declared data.

The tax code now provides for limited deductibility for a range of service payments to non-residents – up to 4 percent of prior year net revenues and a 4 percent limit on royalty payments to non-residents.

"These two issues were of major concern for investors and the limits may still impact the overall cost of doing business, but not excessively, especially with the reduction in the corporate tax rate from 25 percent to 23 percent," Barden said.

Social payments

Social payments on salaries, the so-called payroll payments made by employers, which largely go to the state pension fund, remain high. It is expected to be addressed in upcoming pension reform efforts, but officials have not said if they plan on reducing the current rates charged, which can reach 40 percent. As a result, many employers will in the near term continue to prevent employees from revealing their true salaries, keeping them in the shadows.

"Currently every wage (up to an established cap) the employer pays triggers roughly at least 40 percent (or more, depending on the industry) of social contributions to the revenue. Add 15 percent personal income tax that the employer is liable to withhold from the salary and you will see how expensive it is to pay 'white' wages", said Kotenko.

"Also consider that starting January 1 2011 17 percent will apply to the salary exceeding 10 minimum wages," he added.

This all makes it very expensive to pay wages legally, concluded Kotenko.

Handling taxes

The relationship and powers of tax administration and taxpayers remains unchanged by the new tax bible.

That's hardly good news, given that the World Bank's annual Doing Business report confirms that Ukraine's tax environment is far from friendly. In 2001 Ukraine ranked 181 out of 183 countries for ease of its tax system.

The World Bank counted 135 tax payments per year in Ukraine, which take up 657 hours per year, almost 56 days. The total amount of taxes paid reach 55.5 percent of a business's profit.

Barden from PricewaterhouseCoopers said the consolidation of financial and tax accounting should reduce the administrative burden. This change, along with the consolidation of pension payments and filings, should significantly improve Ukraine's ranking.

"All things being equal, Ukraine could be one of the most improved countries in 2011," he added.

Other experts are less optimistic. In particular, requirement to provide documentary support for accounting remains in force. This means that you will need to provide proof of payment of all taxes and charges, documents and agreements on reporting.

Also the tax code leaves unclear in what cases tax officials can refuse to accept declarations and reports and doesn't set the responsibility for abusing this.

"The requirement of documentary proof for accounting, like payments, charges, reports and agreements, makes the bureaucracy of reporting taxes more complicated," said Minin from KM Partners.

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