



UKRAINE

TECHNICAL ASSISTANCE REPORT—DISTRIBUTED PROFIT TAX; VOLUNTARY DISCLOSURE OF ASSETS; AND BEPS IMPLEMENTATION

November 2019

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Ukraine

Distributed Profit Tax; Voluntary Disclosure of Assets; and BEPS Implementation

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Technical Report

July 2019

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ABBREVIATIONS AND ACRONYMS

AL	Arm's Length
ALP	Arm's Length Principle
AEOI	Automatic Exchange of Information
AML	Anti-Money Laundering
APA	Advance Pricing Agreement
BEPS	Base Erosion and Profit Shifting Work Program Organized by the OECD
CbC	Country-by-Country
CD	Capacity Development
CFC	Controlled Foreign Corporation
CPT	Corporate Profit Tax or Corporate Income Tax
CUP	Comparable Uncontrolled Price
EBITDA	Earnings before Interest, Tax, Depreciation and Amortization
FAD	Fiscal Affairs Department of the IMF
FATF	Financial Action Task Force
GDP	Gross Domestic Product
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IP	Intellectual property
LLC	Limited-liability Company
LOB	Limitation of Benefits
MAP	Mutual Agreement Procedure
MLI	Multilateral Instrument
MNE	Multinational Enterprise
MoF	Ministry of Finance
NBU	National Bank of Ukraine
OECD	Organization for Economic Cooperation and Development
PE	Permanent Establishment
PIT	Personal Income Tax
PPT	Principal Purpose Test
R&D	Research and Development
SFS	State Fiscal Service
TC	Tax Code
TP	Transfer Pricing
UAH	Ukrainian Hryvnia
VAT	Value-added Tax
VD	Voluntary Disclosure
WHT	Withholding Tax

PREFACE

In response to a request from the Minister of Finance, Ms. Oksana Markarova, a capacity development mission from the International Monetary Fund's (IMF) Fiscal Affairs Department (FAD) visited Kiev from May 20 – June 3, 2019 to review selected tax issues and advise on specific tax reform proposals. The mission comprised Messrs. Roberto Schatan (mission head), Martin Grote (both from FAD) and Mr. Lee Burns (external expert).

The mission presented the aide memoire and explained its recommendations to the Minister of Finance, Ms. Oksana Markarova. During its visit, the mission had several rounds of productive discussions with technical staff of the representatives of the Ministry of Finance (MoF), the State Fiscal Service (SFS), and the National Bank of Ukraine (NBU), including Messrs. Roman Goptsii and Yevhen Kozlov, senior tax managers in the Reform Support Team (MoF), Ms. Liudmyla Palamar, Head of the International Taxation Division, Victor Orcharenko, Deputy Head of the Tax Policy Department, Ms. Oleksandra Betliy, Chief Economist and Advisor to the Minister, Iryna Syvolap, Head of Transfer Pricing (SFS) and Oleksander Lepetiuk, Deputy Head of the Large Taxpayer Office (SFS). The mission also met with Ms. Kateryna Rozhkova, Deputy Governor of the NBU and her staff. The mission held discussions with Ms. Nina Yuzhanina, Chair of Rada's Tax and Customs Policy Committee, and with a number of representatives of civil society organizations that closely follow taxation issues in Ukraine, including the Institute of Social and Economic Transformation. The mission met with representatives from the private sector, including the European Business Association, the American Chamber of Commerce, the Ukrainian Chamber of Commerce and Industry, Baker McKenzie, KPMG, EY, PwC and Cargill.

The team acknowledges the excellent support that it received from the IMF Resident Representative Office, in particular Mr. Ihor Shpak (senior economist, IMF Kiev office). Finally, the mission would also like to express its appreciation to Mr. Iouri Loutsenko and Mr. Dmytro Yakubousky for their interpretation and collaboration.

EXECUTIVE SUMMARY

The mission examined the latest proposal to substitute the current Corporate Profit Tax (CPT) for a Distributed Profit Tax (DPT), in Ukraine also referred to as the Exit Capital Tax (ECT). The mission did not find any new elements to change the position expressed in FAD's previous technical report on tax policy (May 2017): the proposal is bad tax policy, detrimental for Ukraine on several fronts.

Firstly, it would risk a sizable *loss in tax revenue* on a sustained basis, conservatively estimated at 1.7 percent of GDP (2020-21). This is the experience in countries that have adopted the DPT (Estonia, North-Macedonia, and Georgia). The revenue loss is probably underestimated because the calculation assumes optimistically that businesses would distribute half of their profits and does not consider spillover effects on the Personal Income Tax (PIT), whereby high-income individuals may incorporate to obtain the benefits of a DPT: i.e., deferral of the tax and a lower rate. Additionally, the plan does not offer credible options for compensatory measures for absorbing the loss of tax revenue: an increase of VAT or cutting public expenditures will adversely impact on low-income households, while imposing an asset tax on businesses seems particularly inefficient.

Secondly, the tax break that the DPT implies is *regressive*, for the incidence of the CPT is mostly on shareholders. Thirdly, the claim that the DPT increases *private investment* cannot be taken for granted; there is no evidence to that effect in countries that have adopted it. Fourthly, the DPT is *not simpler*. In fact, it introduces several complications as deemed dividend distributions must be verified, transaction by transaction, with reference to complex transfer pricing methods. Thus, it does not minimize taxpayers' interaction with the SFS and puts severe stress on its institutional weaknesses (e.g., transfer pricing enforcement).

The issues that concern DPT proponents can be addressed under the current CPT, for example, by adopting a more attractive accelerated depreciation regime and reforming the SFS administration to combat corruption. The government of Ukraine should resist the pressure of adopting the ECT, which would benefit only persons earning income from capital and do little to solve any real problems.

Instead, upgrading the current CPT should be pursued, especially regarding aspects of international taxation given the plan to relax currency exchange controls. These controls have traditionally led Ukrainian businesses and individuals to keep reportedly large amounts of resources abroad, which have not paid income taxes in Ukraine. The authorities' concern is that making worldwide income taxation effective in Ukraine, along the lines recommended by the new OECD (BEPS) standards, will require a one-off Voluntary Disclosure program (VD). The mission reviewed a concept note developed by the MoF, the NBU and the SFS describing the main features of such program. The key feature of the program is a 9 percent fee payable for non-declared assets in lieu of outstanding taxes, which would buy, in certain terms, immunity

against prosecution for having violated currency controls and related tax laws. The program would have the advantage of broadening the tax base by the annual returns of those assets.

If the Ukrainian authorities chose to adopt a VD, the reviewed draft program can be improved. For example, the proposed *0 percent fee* for repatriated assets reinvested in government securities should be eliminated, for it grossly violates the horizontal fairness principle. Also, self-declared assets must be valued by relying on bank statements and independent valuers in jurisdictions where these assets are located. Importantly, the program should be managed by a centralized independent Amnesty Unit, staffed by the NBU and SFS—as opposed to regional SFS adjudication—to decide VD applications and payment arrangements. Moreover, a VD program can only effectively be managed by reference to tight application of anti-money laundering (AML) and counter-terrorist financing (CTF) preventative measures.

The mission reviewed seven draft laws prepared by the MoF and the NBU for implementing BEPS actions on international taxation. The proposals are a positive initiative that will generally help protect Ukraine's tax base. However, there is a good number of technical improvements suggested in this report for the proposed draft laws, particularly in relation to Controlled Foreign Corporations (CFC), Permanent Establishment (PE), Transfer Pricing (TP) and Interest Deduction Limitation rules.

The recommendations largely favor simplifying rules, improving the definition of basic concepts, eliminating potential loopholes, and adhering more closely to international standards in some cases. Thus, for the sake of simplification, the report recommends that CFC rules should apply to the 'first onshore' person rather than having to trace them back to the ultimate beneficial owner in Ukraine. Also, it recommends that the proposed interest deduction limitation (30 percent of EBITDA) should eliminate the carry-forward currently permitted, limit deductions to net interest expense (rather than gross interest) and exempt the financial sector from this limitation.

Some key definitions can be improved too. For example, related parties and controlled transactions are overly and unnecessarily broad, potentially forcing many independent persons to comply with TP obligations. Also, the concept of PE should be designed to apply equally to on-shore and off-shore PEs. Further, the concept of a server PE is left entirely undefined; the report suggests a definition so that the concept may become operational. Moreover, there are loopholes that need correcting. The provision on indirect transfer of assets does not refer to mining and petroleum rights and the CFC rule allows for a lower tax rate on foreign sourced passive income, which creates for Ukrainian residents an incentive to invest abroad.

However, some of the complexity in the draft proposals arises inevitably from the BEPS framework itself. It is a problem inherent in the design of the international taxation system as it stands currently. Some issues are not well resolved in the BEPS framework, for example, how to accurately and objectively allocate risks among related parties, or how to safely apply a regime for low value-added services. Nonetheless, this report suggests some measures to strengthen the anti-abuse provisions.