

# Taxation in Ukraine - THE JOURNEY

*towards a more effective system*

by Michael Kharenko and Mykola Orlov, Shevchenko Didkovskiy & Partners.

**After its independence, Ukraine had to develop from scratch a new tax system sufficient to sustain the needs of a market economy and stimulate attraction of capital to Ukraine. While there are considerable achievements in this area, these successes have not come easy.**

Presently, Ukraine is undergoing a major tax reform aimed at lightening the tax burden on businesses and individuals. The most recent changes include the reduction of the corporate profits tax rate to 25% and the individual income tax rate to 13% from 2004.

Recent tax legislation has also established further safeguards against fiscal abuses. For example, it has clarified the procedure for obtaining official interpretations of tax laws from the tax authorities, provided for suspension of fiscal penalties during court proceedings on disputed tax indebtedness, and modified the procedure for the application of double tax treaties by allowing outright reduction or elimination of the tax obligation under the treaties instead of the previously existing refund procedure.

---

## TAX SYSTEM OF UKRAINE

The Constitution of Ukraine requires that any taxes or similar obligatory payments be introduced, amended or cancelled only by the laws of Ukraine, i.e. statutes passed by the Parliament of Ukraine. The Ukrainian tax system

includes 24 national and 16 local taxes and obligatory payments. On the national level, the principal taxes and obligatory payments are the business profits tax, individual income tax, value added tax (VAT), excise tax, import and export customs duties, state duties (fees for notarial services, court proceedings, etc.), land tax and fees for exploration and production of natural resources, as well as various social security payments. It should be noted that to date Ukraine does not have real estate tax (although there have been a number of attempts to introduce it).

On the local level, the most widely encountered taxes and obligatory payments include the advertising tax, local council tax, hotel duty, parking fee and market duty. Local taxes and duties generally have low tax rates and do not have any significant impact on the taxpayer.

---

## BUSINESS TAXATION

The major taxes paid by businesses in Ukraine, including by foreign companies and their representative offices, are the business profits tax (profits tax), value-added tax

(VAT), excise tax and import (export) customs duties, as well as social security payments. Special (privileged) tax treatment is available for certain small businesses and individual entrepreneurs.

---

## PROFITS TAX

### Taxpayers and tax base

The profits tax is payable by all resident business entities (excluding individual entrepreneurs), as well as by non-business entities, including governmental agencies and NGOs, on certain parts of their income. Resident taxpayers are taxed on their worldwide income (although credits for taxes paid abroad are generally available).

Non-residents, both individual entrepreneurs and legal entities, pay profits tax only on their income from Ukrainian sources.

### Calculation

Generally, the tax base is calculated as the difference between the gross income and tax-deductible business-related expenses plus allowable depreciation deductions. It should be noted that the Ukrainian tax authorities have traditionally applied a very restrictive interpretation of business-related expenses and have often required confirmation that certain expenses incurred by taxpayers were related to their business activities (e.g. long-distance telephone calls and advertising).

There are also many local peculiarities for deductibility of expenses ordinarily not encountered in many other countries. For example, deductibility of interest payments made by a Ukrainian company 50% of which is owned or controlled by non-residents to a foreign creditor is limited generally to 50% of the company's taxable profit during an accounting period; deductibility of expenses on presentations, receptions, promotion campaigns involving free distribution of goods is limited to 2% of the taxable profit for the previous fiscal year.

From January 1, 2003 all fixed assets are divided into four groups subject to depreciation with separate maximum depreciation rates for each group. For example, the quarterly depreciation rate is 1.25% (2% from 2004) for buildings, 6.25% (10% from 2004) for automobiles and office equipment, 15% for computer hardware and software, and 3.75% (6% from 2004) generally for other fixed assets. The previously existing accelerated depreciation rates are no longer available.

The profits tax is accounted for and paid on the quarterly basis, and carry-forward of losses is permitted for an indefinite period of time. The losses incurred after January 1, 2003 are accounted for as tax-deductible expenses.

### Taxation of certain transactions

Special rules are provided for taxation of certain business transactions and types of income. Such special rules cover, *inter alia*, barter transactions, contractual joint venture activity, receipt of interest-bearing and non-interest-bearing loans, payment of dividends and trade in securities.

For example, a non-interest bearing loan received from a non-resident by a Ukrainian company shall be included into its taxable income if not repaid within the tax period when received. Contrary to the practice existing before 2003, the amount of such non-interest-bearing loan can be later included into the tax deductible expenses upon its repayment to such non-resident.

A Ukrainian company must prepay the 30% profits tax on dividends either prior to or during the distribution of dividends. Such prepayment is not deducted from the amount of dividends (as was the case previously) and reduces the tax liabilities of the payer of dividends for the respective tax (accounting) period. Dividends distributed to non-residents are also subject to further 15% withholding (referred to as 'repatriation tax'). Interestingly, under the existing practice only the repatriation tax may be reduced by the application of the double tax treaties.

Separate tax accounting is established for transactions with securities (including derivatives) and corporate rights. From January 1, 2003, such accounting is conducted as per groups of securities and corporate rights. The positive balance in each group is added to the taxable income of the taxpayer, while the negative balance is carried forward to reduce future earnings in the respective group.

### Tax rates

The general profits tax rate is 30% (from 2004 – 25%). However, special tax rates are provided for the taxation of certain types of income, mainly income of Ukrainian insurance companies and non-residents.

Ukrainian companies or permanent establishments of foreign companies in Ukraine making payments to non-residents must withhold Ukrainian profits tax from such income at the general rate of 15%. The income subject to withholding includes dividends, royalties, interest, rents and profit from trade in securities. Ukrainian tax law allows upfront reduction of such withholdings based on the provisions of double taxation treaties concluded by Ukraine. To date, Ukraine has signed and ratified such treaties with more than fifty countries, including all of the leading world economies.

### Taxation of representative offices

All representative offices of foreign companies are presently required by the tax authorities to be registered as payers of profits tax. The representative offices of the companies resident in the countries having double tax treaties with Ukraine may then be exempted from taxation to the extent allowed by the tax treaties. (Most of the tax treaties are based on the OECD model and have exemptions for marketing, advertising and other auxiliary activity). The representative offices of the companies resident in the other countries are treated as permanent establishments even if they are not engaged in business activities.

### Anti-avoidance rules

A number of anti-tax avoidance rules are applied. For example, transactions with related entities, not-for-profit organisations and non-residents are subject to the arms-length pricing rules drafted in accordance with the OECD guidelines. There is also a limitation on the deductibility of expenses incurred by Ukrainian companies in transactions with companies registered in certain tax havens (only 85% of such expenses may be deducted for tax purposes). The list of such tax havens, annually reviewed by the Cabinet of Ministers of Ukraine, generally targets the low- or no-income tax havens such as, the Bahamas, Barbados or Bermuda. At the same time, Ukrainian tax law does not have any CFC rules or provisions against treaty shopping or the use of conduit or base companies in tax haven jurisdictions.

---

## VALUE-ADDED TAX

### Taxpayers

In accordance with the Law of Ukraine 'On Value-Added Tax' of April 3, 1997 (the VAT Law), VAT taxpayers generally include:

- any legal entity or individual entrepreneur the total amount of whose taxable transactions exceeds 3,600 non-taxable individual incomes (about US\$11,500) over the most recent 12-month period;
- any legal entity or individual entrepreneur that imports goods into Ukraine or receives services from a non-resident for their use and consumption in Ukraine; and
- any legal entity or individual entrepreneur trading in Ukraine for cash, irrespective of the amount of its taxable transactions.

(A taxpayer may choose not to pay VAT if it pays the single tax, as described below).

### Tax base

VAT is payable on the majority of trading transactions in Ukraine. The important exceptions are provided for:

- issue and placement of and trade in securities (provided that securities are sold or purchased for cash or in exchange for other securities);
- transfer of leased or pledged (mortgaged) property and financial lease payments;
- transfer of funds and assignment of bank loans (with the exception of factoring transactions);
- provision of insurance services; and
- transfer of assets to the authorised capital of a Ukrainian legal entity (including for importation of such assets into Ukraine).

Furthermore, a number of transactions are presently exempted from VAT, in particular:

- sale of periodicals and books (including study materials) produced in Ukraine;
- sale of medicines and medical appliances registered in Ukraine;
- provision of health services;
- privatisation of State-owned or communal assets; and
- sale of goods for use and consumption by the diplomatic missions in Ukraine.

Ukrainian law also provides special exemption from both VAT and import customs duties for tolling schemes.

### Tax rates

The general VAT rate is 20%. Ukrainian Parliament recently attempted to reduce the rate to 17%, but the bill was vetoed by the President of Ukraine.

The privileged 'zero' VAT rate is provided for the exportation of goods and services from Ukraine which are "sold for use and consumption outside" of its customs territory. It should be noted that the Ukrainian tax authorities have been unwilling to permit the application of the 'zero' rate to the exportation of services when it is not proven that such services were physically rendered outside of the customs territory of Ukraine. Furthermore, certain services provided to non-residents have been traditionally viewed by the tax authorities as intended solely for use and consumption in Ukraine and generally denied any privileged tax

treatment (e.g. marketing services). However, the situation is, albeit slowly, changing and fewer disputes arise in connection with the application of the 'zero' rate to the exportation of services.

### Calculation

The VAT Law provides that the amount of VAT paid by a taxpayer for goods or services in connection with its business activity (referred to as 'tax credit') can be used to offset its VAT liabilities during the same tax period. Any tax credit not used in the respective tax period can be either refunded by the state or applied to offset the future VAT liabilities. In practice, the procedures for obtaining cash refunds for the overpaid VAT are extremely complicated and allow a lot of discretion. This resulted in the increasing state debt to VAT taxpayers, in particular to exporting companies. Today, this is considered one of the most acute problems for Ukrainian economy by the major international financial institutions working with Ukraine.

### Tax periods

VAT is paid on either monthly or quarterly basis depending on the volume of sales of a taxpayer.

---

## SOCIAL SECURITY PAYMENTS

Any employment-related income is subject to a number of taxes and obligatory payments in Ukraine. Some of them are paid by employers at their own expense, while others are withheld from the income of employees prior to disbursement. The taxes and obligatory payments paid by employers on salaries include:

- payment to the State Pension Fund of Ukraine at the rate of 32% (this obligatory payment is expected to change in 2004);
- payment to the State Social Security Fund for Unemployment at the rate of 1.9%;
- payment to the State Social Security Fund for

Occupational Accidents and Professional Diseases at the rate from 0.2% to 13.8%, depending upon the type of business (most of the businesses are taxed at the rates not exceeding 3%); and

- payment to the State Social Security Fund for the Temporarily Disabled at the rate of 2.9%.

The taxes and obligatory payments withheld from the employment-related income of the employees include:

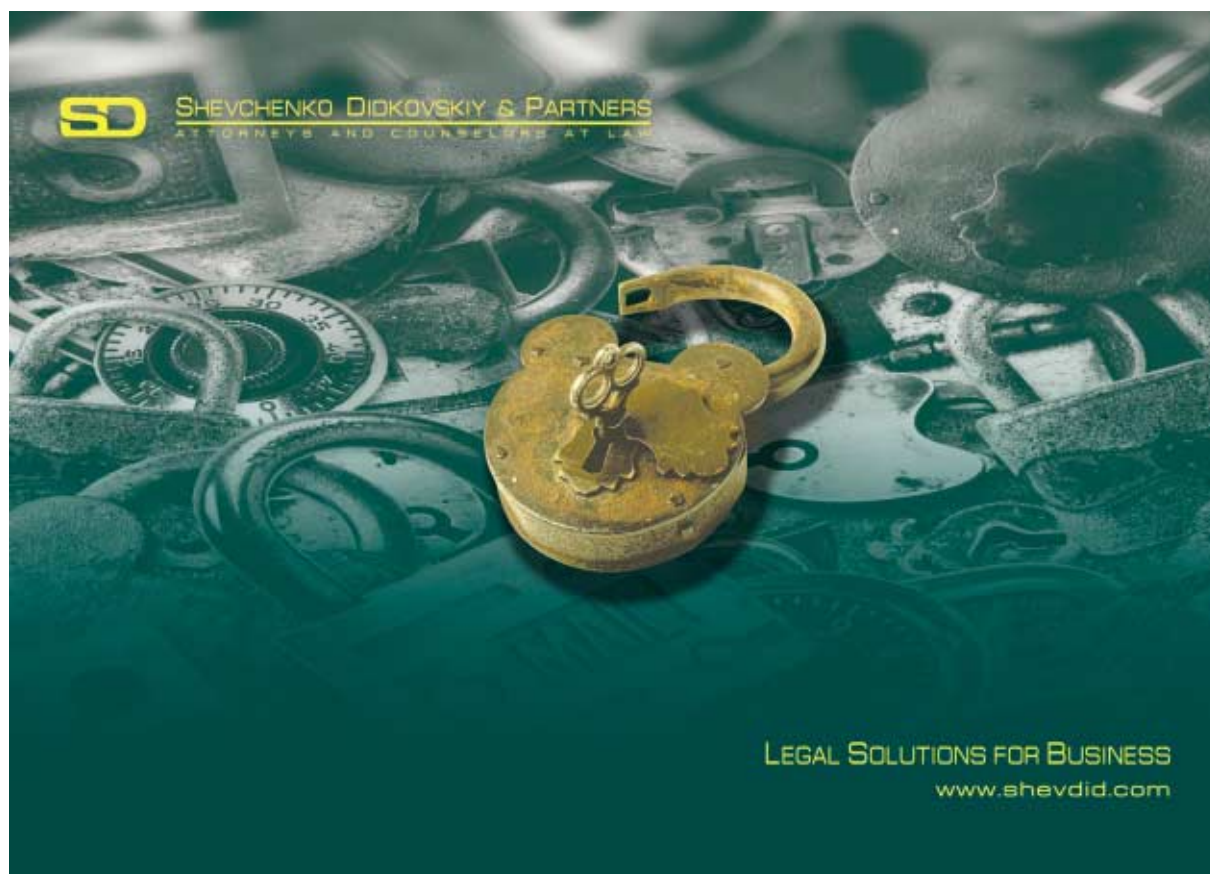
- individual income tax (at the rate from 10% to 40%, depending on the amount of income; from 2004 flat rate of 13%(15%));
- payment to the State Pension Fund of Ukraine at the rate of 1% or 2%, depending on the amount of employment-related income (this obligatory payment is expected to change in 2004);

- payment to the State Social Security Fund for Unemployment at the rate of 0.5%; and
- payment to the State Social Security Fund for the Temporarily Disabled at the rate from 0.25% to 0.5%, depending on the amount of employment-related income.

---

### EXCISE TAX

The application of the excise tax is regulated by the Decree of the Cabinet of Ministers of Ukraine 'On Excise Duty' of December 26, 1992 (which has the force of law). The goods subject to this tax and the respective tax rates are provided for separately in various Ukrainian laws.



The present list of taxable goods primarily includes alcohol and tobacco products, gasoline and certain other fuels, vehicles and jewellery. The rates are calculated either as a percentage of the sale price or as a fixed amount in euro based on the type and quantity, volume or weight of the goods.

Taxable transactions include the sale or other transfer of ownership of any goods subject to the excise tax produced in Ukraine or the importation of such goods to the territory of Ukraine. The tax is paid by both resident and non-resident legal entities and individuals that produce or import taxable goods.

---

## IMPORT (EXPORT) CUSTOMS DUTIES

### Import customs duties

Import customs duties are imposed on the goods imported into Ukraine. The import customs duties can be paid either as a percentage of the value of goods, or as a fixed amount based on the quantity of goods or as a combination of the percentage and a fixed amount. There are three types of import customs duty rates: preferential, privileged and full. Goods from most countries are subject to privileged rates ranging from 5% to 10%.

### Export customs duties

Ukraine still retains export customs duties on several types of goods aimed at restricting their export. Such export customs duties presently apply to oilseeds (mainly sunflower seeds), livestock, livestock hides, and scrap black metals. Although the existence of the export customs duties has caused a lot of debate over the recent years, it has proved impossible to abolish them.

### Protective customs duties

Ukrainian law also provides for the imposition of the protective customs duties, i.e. anti-dumping, compensatory and special duties. These customs duties can be used to protect the economic interests of

Ukraine and its producers. Over the recent years such protective measures have been used against several foreign companies on allegations of dumping and unfair competition.

The Ukrainian authorities are presently preparing for an overhaul of the present customs regulations, including the application of the customs duties, following the planned Ukraine's accession to the World Trade Organisation.

---

## SINGLE TAX

Ukrainian tax law provides for the privileged taxation of certain small businesses and individual entrepreneurs. These tax privileges have been introduced over the years in order to boost the development of small business in Ukraine and, at least partially, to relieve entrepreneurs of excessive tax and accounting burden. The biggest success proved to be the single tax arrangement.

The single tax is paid in substitution of a number of taxes and obligatory payments levied on businesses, in particular: profits tax or individual income tax, VAT, land tax, payment for the special use of natural resources, payment to the State Pension Fund, social security payments, and local council tax.

### Taxpayers

The option to pay the single tax is open to companies employing not more than 50 individuals whose annual proceeds do not exceed Hrn1m. Ukrainian hryvnias (about US\$190,000), and individual entrepreneurs employing not more than 10 individuals whose annual proceeds do not exceed Hrn200,000 Ukrainian hryvnias (about US\$38,000).

### Tax base and rates

A qualifying company can choose to pay the single tax either at the rate of 10% of its proceeds, in which case it does not pay VAT, or at the rate of 6% of its proceeds,

in which case it has to pay VAT. Individual entrepreneurs pay the single tax as a fixed monthly sum ranging from about US\$3.8 to US\$38. The single tax is not available to certain businesses, in particular banks, insurance companies and companies more than 25% of whose authorised capital is owned by the non-qualifying companies.

---

## FREE ECONOMIC ZONES

Over recent years, the Parliament of Ukraine has created more than 20 free economic zones on its territory. Each of these free economic zones is established for a limited period of time in order to stimulate the development of certain branches of local economy and thus offers privileged taxation to the qualifying investment projects. Such tax privileges usually include exemptions from the profits tax, VAT, import customs duties and excise tax, which are open to both Ukrainian and foreign investors.

Despite the growing criticism concerning the effectiveness of free economic zones, it appears that the majority of these zones will be allowed to continue in accordance with the laws governing their establishment and operation. Therefore, it is advisable for foreign investors to check on the availability of tax privileges in Ukrainian free economic zones for the intended investment projects in the target geographical area.

---

## INDIVIDUAL INCOME TAXATION

One of the major tax reforms has recently occurred in the area of individual income taxation. From January 1, 2004, Ukraine is introducing the new rules for taxation of individual income that represent the major overhaul of the out-dated income tax system established back in 1992.

### Taxpayers

Resident individuals are subject to the income tax on their worldwide income. Non-resident individuals are taxed only on the income derived from Ukraine.

Until 2004, an individual is deemed to be resident in Ukraine for tax purposes if he or she spent at least 183 days on the territory of Ukraine. The new tax procedures provide that the main criterion to determine the individual's state of residency for income tax purposes will be the country where he or she is permanently resident and, failing that, the centre of his or her vital interests (e.g. country of permanent residency of family members or the place of his or her registration as an individual entrepreneur). Only if these residency tests fail will the residency be determined on the basis of the number of days spent by an individual in Ukraine.

### Tax base

The new tax procedures have changed the calculation of the tax base. From 2004, the tax base will be determined as the difference between the taxable income of an individual and the sum of available tax credits and the non-taxable amount (the so-called 'social exemption'). The tax credit will be available only to the resident taxpayers and will consist of the allowable expenses on education, charitable contributions, and the health service, etc.

### Tax rates

While the existing individual income tax rates range from 10% to 40% (20% for the Ukrainian source income of non-residents), beginning from 2004 the tax will be charged at a single rate of 13% (15% from 2007) for most of the individual's income. Lower tax rates are established, *inter alia*, for the interest payments on deposits with banks and non-banking financial institutions (effective from January 1, 2005) and higher tax rates – for winnings and prizes and certain income of non-residents.

---

## CONCLUSION

In recent years, Ukraine has made noticeable progress towards creating a more effective tax system. Ukrainian tax laws and practice are steadily developing to ensure further business development and sustainable growth of the national economy. Starting from 2004, Ukraine will become one of the few countries at the lower end of the

corporate profits and individual income taxation, thereby facilitating investment activity.

**Michael Kharenko is a Partner and Mykola Orlov is an Associate at Shevchenko Didkovskiy & Partners in Kyiv.**

**For further information, please telephone +380 (44) 230 6000 or e-mail: [kharenkom@shevdid.com](mailto:kharenkom@shevdid.com) or [orlovm@shevdid.com](mailto:orlovm@shevdid.com)**