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NEWSLETTER

German Economic Team

UKRAINE

Amendments to the Tax Code in 2020: The "BEPS law"

The "BEPS law" containing changes to the Tax Code of Ukraine came into force in May of this year. This law implements anti-tax-avoidance and tax transparency measures recommended by the OECD's BEPS project to combat tax base erosion and profit shifting. Important changes combat tax-avoidance schemes that exploit loopholes in double-taxation agreements with complex international constructions and unregistered permanent establishments. The law also contains general changes to improve the tax system.

The changes constitute an important step ahead towards strengthening Ukraine's tax receipts and improving the business environment. Whilst companies will benefit from many fixes to existing problems in the tax system, the use of complex international tax avoidance schemes will be significantly discouraged. The law also represents a much-needed shift in the philosophy of tax administration from "form over substance" to "substance over form". For this shift to translate from legislation to actual practice, however, implementation will play a key role and solid training of tax authorities' staff will be required.

The "BEPS law" (No. 466-IX "On amendments to the Tax Code of Ukraine) was adopted on 23 May 2020 after Ukraine ratified the multilateral convention to "implement tax treaty related measures to prevent base erosion and profit shifting" (BEPS) in 2019. The main purpose of the BEPS initiative, led by the OECD, is to combat the abuse of international tax treaties for tax avoidance and hence to strengthen the revenues of participating countries from corporate taxation.

The law contains changes related to BEPS-implementation as well as other changes to improve the tax system in general. In the following, we distinguish between measures on BEPS implementation that will come into force on January 1st, 2021 and other changes, which mostly came into force starting May 23, 2020.

Main measures implementing BEPS

Permanent establishments

The definition of permanent establishments in the Tax Code was amended to correspond to BEPS requirements and to the OECD "Model Tax Convention on Income and on Capital". This is important in combating the existing practice of tax avoidance by not registering permanent establishments with the tax office (e.g. staff employed as "individual entrepreneurs" and payed directly from abroad).

Tax authorities will commence audits of unregistered permanent establishments from 2021 onwards. Audits can result in a compulsory registration with the tax office, tax assessment, seizure of property and penalties of UAH 100k. Also, new rules for determining the tax base of permanent establishments have been introduced, applying the principle of „arm's length" used also for transfer pricing. The possibility of applying the "indirect method", assuming a fixed profitability of 30%, was cancelled.

Transfer pricing

The threshold in order to qualify a company as a related party has been raised from 20 to 25% of direct or indirect ownership. Also, three-level transfer pricing (TP) reporting for international groups of companies with annual consolidated income above EUR 750 m has been introduced, which will include Master file, Local TP documentation and Country by Country (CBC) Reports. Companies with income above EUR 50 m but below EUR 750 m will need to submit a Master file on request of the Ukrainian Tax Office. Furthermore, the concept of business purpose will now be applied in TP.

Withholding tax

As withholding taxes on passive income (such as dividends) are often avoided using international structures and effectively abusing multiple double taxation agreements (DTAs), several measures are undertaken to combat this practice:

When income is not paid directly to the beneficiary but to a nominal recipient, the DTA for the country of the beneficiary shall now be applied. Also, DTA tax exemptions will not be applied to transactions which do not have a business purpose and whose main purpose is to exploit DTA tax reliefs. And non-residents purchasing shares of companies owning property in Ukraine will now be required to withhold income taxes for the non-residents selling the shares (and must register with Ukrainian tax authorities).

Controlled Foreign Companies (CFC)

Such companies have often been used with the sole purpose of hiding beneficiaries. Starting in January 2021, residents (legal entities and natural persons) owning shares of foreign companies or having control over such companies, are deemed their controllers for tax purposes. If the controller of CFC is a resident natural person, that person is obliged to declare their share of profits from the company in their annual income declaration, to be taxed under the PIT.

Other changes to tax legislation

Corporate profit tax

"Thin capitalisation" rules have been amended to exclude interest payments during construction phases (where no revenue and profit is made from the respective assets), if the accrued interest is capitalised and hence treated as costs once the asset is put into operation. Furthermore, international financial institutions (IFIs) have been excluded as potential related parties.

The threshold for obligatory application of tax adjustments to financial results (e.g. minimum depreciation terms, thin capitalisation rules etc.) was shifted from UAH 20 m to UAH 40 m annual income. The same threshold applies for obligatory quarterly CPT-reporting. Also, the threshold of low-value assets has been increased from UAH 6k to UAH 20k for the purpose of tax accounting. The production method of tax depreciation is now allowed.

Value added tax

VAT payers using the "cash method" for VAT accounting can now claim a VAT credit even when a payment is made later than 1095 calendar days after a purchase. Also, it has been clarified that both contractors and subcontractors in construction have the right to use the "cash method" for VAT accounting. And for the export of soybeans and rape seeds, a 0% VAT rate has been re-established, such that VAT paid on inputs can be accounted as VAT-credit.

Personal income tax (PIT)

"Usual prices" will be applied to income and expenses from selling or purchasing investment assets with non-resident related parties or any non-residents in "low tax countries". Profits from operations with foreign investment assets shall be taxed with PIT according to the same rules as the profit received from operations with investment assets on the territory of Ukraine. Hence, only the financial result of such operations will be taxable (not the gross income as before).

Tax administration

A new concept of responsibility has been introduced, which requires authorities to prove malicious intent in order for a taxpayer to be guilty of a tax offence. Special appeals commissions must be created by the tax office, which will have to consider attenuating circumstances. Also, tax authorities are restricted being able to change the scheduling of pre-announced tax audits only twice a year: Once in the first and once in the second quarter of the year. The range of previous tax years that a tax audit may concern is increased from 3 to 7 years for PIT and military contribution (MC) payments from employees' wages as well as other labour-related payments.

Assessment

This law represents a genuine step forward. Apart from solving a number of problems in the tax environment, it achieves substantial progress on two important fronts: The fight against tax avoidance using and abusing international constructions and tax treaties as well as a philosophy shift from the Soviet legacy of "form over substance" to the modern "substance over form" in tax administration.

The BEPS-related measures will contribute to strengthening the tax revenues of Ukraine. At the same time, they will only harm companies willfully abusing the possibilities of financial globalization – not good "corporate citizens". Companies operating in Ukraine stand to substantially by the improvements contained in this law: Fixes to some problems in the tax environment and especially the shift to "substance over form" will improve the business environment. However, for this shift of philosophy in tax administration to succeed, legal reform alone is necessary but not sufficient: Tax authority and judicial staff need to be trained in new concepts such as intent of a transaction or methods to determine "arm's length" prices for the reform to fully succeed.

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