German Advisory Group Ukraine

NEWSLETTER

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Tax on Withdrawn Capital: Economic and fiscal effects

Introduction of a Tax on Withdrawn Capital would be a fundamental change of Ukraine's corporate tax system. The proposed tax is an internationally unusual corporate tax based on profit distributions rather than on the financial profits of companies. Although the effect on investment in the short run is likely to be limited, the new tax has potential to improve business climate in the long run. Fiscally, introduction of the new tax will lead to a significant annual fiscal shortfall of 1.2% to 1.5% of GDP in the first years following the tax reform, which should be fully compensated in the budget. Also, the potential for improvement of the business climate can only be realised if the tax reform is combined with a substantial reform and improvement of the tax authority.

Fundamental change of corporate taxation

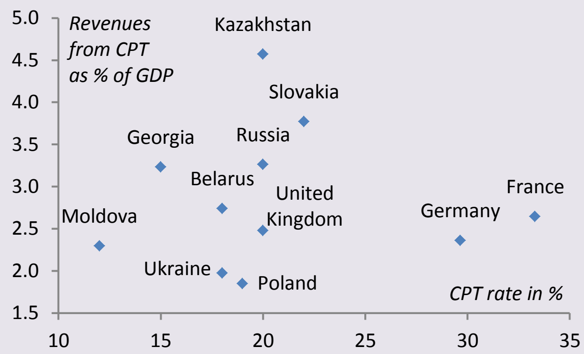
A substantial change of corporate taxation is currently discussed in Ukraine. A draft law for introducing a "Tax on Withdrawn Capital" (TWC, earlier referred to as "Exit Capital Tax") to replace the present Corporate Profit Tax (CPT) has been adopted by the Cabinet of Ministers and is supported by the President but has not yet been submitted to the Verkhovna Rada. A large public debate has erupted about the possible reform, especially because of concerns of the International Monetary Fund (IMF) about fiscal losses.

Introducing the TWC would amount to a fundamental reform of corporate taxation in Ukraine. The TWC taxes dividends and equivalent transactions, in which profits of companies are distributed to any physical person or legal entities outside Ukraine and capital is withdrawn from a company. The present CPT in contrast taxes the financial profits of companies. Whereas the CPT is an internationally common system in terms of tax base and tax rate, the TWC is a non-standard type of corporate taxation that was first introduced in Estonia in 2000. Since then, similar tax reforms were undertaken by only a very small number of countries, including Macedonia and Moldova (which subsequently reversed these tax reforms) and Georgia, where the tax was introduced in 2017.

Current state of corporate taxation in Ukraine

It is often claimed that corporate taxation in Ukraine is facing severe problems. Fiscal revenues from the CPT in Ukraine were relatively low in recent years. However, this was largely due to two factors: Firstly, the economic crisis of Ukraine led to large losses of companies, which can be "carried forward" to offset the CPT burden for years. Secondly, capacity, know-how and institutional problems at the tax authority, the State Fiscal Service of Ukraine (SFS) led to imperfect tax enforcement, causing reduced tax revenues and sometimes very high administrative burdens to taxpayers, especially with regard to questionable auditing practices.

CPT rates and revenue shares of GDP in different countries



Source: KPMG, IMF (Government Finance Statistics), data for 2015

None of these issues are directly linked to the tax system, however. Companies indicate in surveys that they face difficulties mainly with regard to tax administration, not the taxes themselves.

Limited effects on investment

The first main motivation brought forward for the proposed tax reform is to increase investment. As retained and reinvested profits of companies would not be taxed under the TWC, proponents argue that investments of companies should increase. Our analysis indicates that the positive impact of the TWC on investments will probably be limited in the short run. As the present tax system is not unusual by international standards and is not perceived by companies as a major impediment to investment, changing it can only have limited impact.

Furthermore, the difference between TWC and CPT with regards to the tax treatment of investments is smaller than appears at first sight due to accelerated depreciation rules in place already and due to the tax losses carried forward by many taxpayers. International experience, although limited due to the small number of countries running a tax similar to the

TWC, is in tune with this expectation of limited positive investment impact.

Potential for administrative facilitation

The second key motivation stated for the tax reform is to reduce the administrative burden of corporate taxation. It is claimed that a transaction based tax rather than an accounting based tax gives rise to lower administrative burdens for companies and tax authorities alike. This would contribute to a better business climate and would also lead to increased investments in the medium to long term.

Our analysis confirms this potential. Enforcement and auditing of the TWC could be simpler and less demanding on both companies and SFS. Some particularly contentious topics such as fair-value assessments for assets or provisions for liabilities would no longer play a role. However, other challenging aspects of enforcement such as controls on transfer pricing and related-party operations would remain present.

Fiscal shortfall in the short run

Although the tax base of the TWC is in principle conceptually sound, implementation of the new tax would lead to a severe reduction of revenues from corporate taxation in the short run. We calculated the resultant annual fiscal shortfall for the first few years following introduction in 2018 (as was originally intended), but relative results would be the same for later years. According to our calculations, the reduction in fiscal revenue would be between 1.2% and 1.5% of annual GDP.

Fiscal impact of the TWC, UAH bn

	Optimistic result	Pessimistic result
Foregone revenues from CPT system	74.7	74.7
- TWC Revenue	36.9	27.4
= Fiscal shortfall	37.8	47.3
% of GDP	*1.2%*	*1.5%*

Source: Own calculations
Note: Calculation assumes introduction in 2018

Our calculations include positive (revenue-raising) as well as negative (revenue-decreasing) reactions to the new tax, such as deferment of taxation by retaining and possibly reinvesting profits instead of distributing them immediately. We do not expect a large and immediate de-shadowing as a result of the tax reform.

Recommendations

Despite limited positive investment or growth effects and negative fiscal effects in the short run, the TWC is in principle a valid option for tax reform and has the potential for positive economic effects in the medium to long run. If the reform goes ahead, its long-run success depends on two key conditions.

Firstly, the significant fiscal shortfall caused by TWC introduction must be fully compensated in the budget. Despite recent improvements, Ukraine's fiscal situation remains vulnerable, especially in view of repayment obligations on debt in foreign currency amounting to almost USD 12 bn in 2018 and 2019. Secondly, tax reform does not replace the need for a comprehensive reform and overhaul of the tax authority. Increased capacity, transparency and accountability of the SFS are vital to ensure that the tax authority can manage proper implementation and application of the new tax and can deal with the complexities in corporate taxation that will remain even after possible tax reform.

Author

David Saha, saha@berlin-economics.com

Editors

Dr Ricardo Giucci, Robert Kirchner

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A more comprehensive analysis is provided by the Policy Study PS/01/2017 "Corporate Profit Tax vs. Exit Capital Tax: Analysis and recommendations".

German Advisory Group Ukraine
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The group advises the Government of Ukraine on economic policy issues since 1994. It is funded by the German Federal Ministry for Economic Affairs and Energy and implemented by the consulting firm Berlin Economics.

Berlin Economics

BE Berlin Economics GmbH | Schillerstraße 59 | 10627 Berlin
+49 30 / 20 61 34 64 - 0 | info@berlin-economics.com | Impressum