INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/25

UKRAINE

January 2016

TECHNICAL ASSISTANCE REPORT—REDUCING SOCIAL SECURITY CONTRIBUTIONS AND IMPROVING THE CORPORATE AND SMALL BUSINESS TAX SYSTEM

This paper on Ukraine was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on October 2015.

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International Monetary Fund
Washington, D.C.

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INTERNATIONAL MONETARY FUND

Fiscal Affairs Department

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REDUCING SOCIAL SECURITY CONTRIBUTIONS AND IMPROVING THE CORPORATE AND SMALL BUSINESS TAX SYSTEM

Roberto Schatan, Selcuk Caner, Christophe Waerzeggers and Victor Thuronyi

October 2015

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Contents **Page**

Preface 6
Executive Summary 7
I. Introduction 10
II. Social Security Contributions 10
A. Background 10
B. Deficits in social security funds 12
C. SSC reform: recent changes in the law and new proposals 15
D. Pensions and welfare through the social security system 19
E. The continuing allure of a flat PIT 21
F. SSC rates and formal employment 23
G. The social security regime for the self-employed 29
H. Revenue effects of proposed SSC reforms 31
I. Other tax measures to compensate SSC reform 35
III. Simplified Taxation regimes for small taxpayers 38
IV. Excise taxation 50
A. Room for increasing rates 50
B. The special case of alcoholic beverages 56
V. Corporate Profit Tax Corporate Profits Tax 59
A. Revenue performance 59
B. Replacing the CPT by a tax on distributed profits 61
C. Inflation adjustment 61
D. Other design issues with the Corporate Profits Tax 62
E. Drafting issues 63

Tables

1. Social Funds Operations 13
2. Pension Fund of Ukraine Operations, 2007-15 14
3. Comparative Labor Regulations: Rigidity in Hours/Difficulty in Redundancy 26
4. Social Security Contribution Rates 30
5. Distribution of Income and SSC Payments, 2014 31
6. Revenue Impact of Changes to the SSC Rates, 2014 32
7. Revenue Effect of Merging the SSC and the PIT Systems with a Single PIT 33
8. Distributional Impact of a flat 29 percent PIT Rate, 2014 34
9. Revenue Impact of a 3 Change in PIT Structure, 2014 36
10. Summary Revenue Effects of Tax Measures 37
11. The ST Regime Taxpayers' Income and Taxes, 2014 40
12. VAT registration thresholds (selected countries) 45
13. Comparison between normal GAAP and proposed cash flow taxation 47
14. Revenue Estimates of Moving Individuals from Single Tax 48
15. Estimated Social Security Contributions of Single Tax Groups 2 and 3 49
16. General Government Revenue from Excise Taxes, 2008-2015 52

17. Comparison of Excise Tax Rates in Ukraine and Neighboring 53
18. Tax Burden of Selected Products 54
19. Excise Tax Revenue under Different Scenarios 55
20. Excise Tax Rate Changes and Revenues 56
21. Corporate Income Tax Revenues 60

Figures

1. Tax Revenues as percentage of GDP, 2003-2014 14
2. Monthly SSC Revenues – excluding Crimea 15
3. Average Wages and Inflation 24
4. Social Security Contribution Rates and informality 24
5. Changes in SSC rates and informality 25
6. Change in tax wedge and informality 25
7. Financial Deeping and Informality 28
8. Excise Tax Revenue in Central and Eastern Europe and CIS 51

Boxes

1. Amendments to the SSC reform, 2014 -2015 17

Appendixes

A. Inflation adjustments 64
B. Other design issues with the CPT 72
C. Drafting issues 79

Annexes

1. Illustration of proposed rules for Provisional Payments and ACT 83
2. Stylistic example 84

Acronyms

CPT	Corporate Profit Tax
EU	European Union
EUR	Euro
FAD	Fiscal Affairs Department
FAT	Fixed Agricultural Tax
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
IT	Information Technology
MoF	Ministry of Finance
MW	Minimum Wage
MSW	Minimum Subsistence Wage
OECD	Organization for Economic Co-Operation and Development
PAB	Producers of Alcoholic Beverages
PIT	Personal Income Tax
SBA	Stand-by Arrangement
SSC	Social Security Contributions
SFS	State Fiscal Service
ST	Single Tax
STS	Simplified Tax System
TA	Technical Assistance
TC	Tax Code
TCR	Thin Capitalization Rule
UAH	Ukrainian Hryvnia
USD	United States Dollar
VAT	Value-added Tax
WHO	World Health Organization

PREFACE

In response to a request from the Deputy Minister of Finance, Ms. Olena Makeieva, a technical assistance mission from the International Monetary Fund's (IMF) Fiscal Affairs Department (FAD) visited Kiev July 20–August 1, 2015 to review selected tax policy issues and advise on specific tax reform proposals. The mission comprised Messrs. Roberto Schatan (mission head), Selcuk Caner (both from FAD) and Christophe Waerzeggers (Legal Department) and Mr. Victor Thuronyi, external expert. The mission was also assisted by David Amaglobeli (FAD) and from Headquarters in Washington, D.C. by Mr. Ricardo Fenochietto (FAD) and Csaba Feher (Expenditure Department).

During its visit, the mission had several rounds of productive discussions with Ms. Olena Makeieva and her staff and participated in a session of the Task Force on Tax Reform led by Ms. Natalie Jaresko, Minister of Finance. Discussions were held with a number of officials from the Ministry of Finance (MoF), including Mr. Mykola Chmeruk, Director of Department for Tax, Customs Policy and Accounting Methodology, and Yuriy Romaniuk, Deputy Head of the same Department, among a long list of other officials. The mission met with several officers from the State Fiscal Service (SFS), including Mr. Aleksandr Rekhchuk, Director of Department of Taxes on Individuals, and Mr. Sergei Naumov, Deputy Director.The mission also met with Mr. Valeriy Yaroshenko, Deputy Minister, Ministry of Social Policy and his staff. Meetings were held as well with Ms. Nina Yuzhanina, new Chair of the Tax and Customs Policy Committee in Parliament and separately with the Mr. Andrii Zhurzhii, First Deputy of the same Committee. The mission also held useful discussions with representatives of civil society organizations, the Director of USAID Leadership in Economic Governance Program and academics associated with this program. The mission met with tax experts from EY and PwC and representatives of the private sector, including spokesmen for the information technology industry (IT), from the European Business Association, and the Ukrainian Association of Investment Business. The mission separately met with officials from the World Bank and the European Union.

The team acknowledges the excellent support that it received from Mr. Ihor Shpak (senior economist, IMF Kiev office). Finally, the mission would also like to express its sincere appreciation to Mss. Valentina Kukhtik and Anna Burlay for their outstanding interpretation and collaboration.

EXECUTIVE SUMMARY

Social Security Contributions (SSC) in Ukraine need urgent attention. If nothing is done, the budget is poised to lose 4.5 percent of GDP in revenues in 2016 due to a legally mandated SSC rate reduction adopted in March 2015. The Ministry of Finance (MoF) is studying a number of options to find a responsible, revenue neutral, approach to lowering SSC rates, which at 40 percent of payroll are above all countries in the OECD. At the same time, Ukraine hosts a very large informal sector which stands as a difficult obstacle to developing its social and economic potential. However, there is no fiscal space to forgo tax revenues. The shift of the tax burden away from labor (as recommended by previous FAD missions) cannot jeopardize the integrity of public finances; it needs compensation from reliable sources of tax revenues.

Some of the plans gaining traction do not meet this standard. For example, the plan to merge SSC, the Military Tax and PIT in a single income tax at, initially, a 29 percent rate on a gross-up wage (adding SSC and the Military Tax to the base) does not seem feasible. There is no guarantee that wages would in fact be grossed-up for everybody; the switch to the new scheme would be optional and individuals with higher pay will be more heavily taxed under the proposed scheme, so they would probably stay in the old system. Inevitably, the plan would lose any pretended simplification benefits, as two SSC regimes would coexist. Also, the simplification gained by having one income tax is largely illusory as long as pensions are part of social security, since they are correlated with contributions and the monthly payroll of each individual taxpayer would continue to be the base of the pension. Reporting requirements and administrative procedures would remain fundamentally unchanged. The possibility of financing social security entirely from the budget should only be considered in the context of a simultaneous and comprehensive review of the benefits that the system should deliver.

A closely connected issue is the Single Tax System (STS) originally designed for small entrepreneurs, but which has become very porous to others. The regime allows qualifying taxpayers to pay a very low tax on income and a symbolic SSC fee, and offers ample opportunities for avoidance by employers who contract their workers as independent entrepreneurs. To restore horizontal equity with regular employees, the STS requires fundamental reform, addressing: a (turnover) cap for the STS that is too high, a system that effectively overrides the VAT threshold, unnecessarily admits legal persons and offers important tax and SSC incentives for employees to reclassify as independent entrepreneurs – a practice that is currently very difficult to combat due to poor rules and enforcement practices. However, the revenue potential here should not be exaggerated given the difficulty in taxing this segment of the population.

This report endorses lowering SSC rates (as a separate payroll tax in its current form) and tightening significantly the regime for small (true) self-employed taxpayers, but argues that it is uncertain that lowering rates alone will significantly push back the informal sector. International evidence indicates that this requires a comprehensive approach, involving the regulatory

environment, access to financial services and providing quality social security benefits. The mission strongly believes that foregone revenues from a reduction in SSC rates should be recouped from no uncertain sources; any resulting expansion of the tax base from lower SSC rates should not be relied upon upfront.

A possible scenario is to reduce the average SSC more moderately than currently contemplated, for example, to 28 percent (keeping very few of the current 67 risk specific rates), increasing the cap on the payroll tax to 25 minimum wages (MW), and compensating revenues primarily from indirect taxes.

The STS should be simplified and most of its concessional nature eliminated by excluding all legal persons as well as all VAT taxpayers. There should be a single threshold that applies to both the VAT and the STS, which could be raised to 2 million hryvnias. General personal income tax rates should apply but to a simplified cash flow accounting base, except for the very small income self-employed individuals who would continue to pay a small fee (as in current treatment for Group 1 in the STS). Normal SSC rates should apply, except for the smallest taxpayers which are currently in Group 1 of the ST.

Despite recent reforms the current general tax system is complex, but this arises mostly from the TC's intricate and sometimes vague language, leading to disparate and arbitrary interpretations of the law. This breeds a severely antagonistic relationship between taxpayers and the SFS, aggravated by the absence of effective dispute resolution mechanisms (either administrative or legal). Thus, proposals for simplifying the tax system often aim in fact at tying SFS's hands, or introduce schemes that permit taxpayers to side-step the tax authority. Other simplification schemes being discussed are mostly illusory: not much simplification is gained, for instance, by merely reducing the number of PIT rates, by introducing a flat tax, or by replacing the CPT by a tax on distributed dividends (the Estonian model). Corporate profits will still need to be calculated, but with the added downside that corporate tax collection may be deferred for potentially an indefinite period of time.

The mission agrees that the TC needs to be simplified by gaining clarity and improving technical legal drafting, but some important policy amendments are required. To this effect the report reviews in some detail the Corporate Profit Tax (CPT) and identifies a number of tax design issues that could be improved in the short term. Furthermore, the integrity of the tax system would also benefit from equating the CPT rate with the top PIT rate of 20 percent to eliminate the incentive to arbitrage between both regimes, considering too that CPT revenues are noticeably low for international standards.

Recommendations	Timing: Short Term (ST); Medium Term (MT) and Long Term (LT)
Chapter II: Social Security Contributions	
Take a comprehensive approach to informality, do not rely only on reducing SSC rates	LT
Do not combine SSC and PIT into a single tax	ST/MT
Reduce the total number of SSC rates according to risk class (67) to a handful	ST
Consider reducing SSC rates gradually but as part of a revenue neutral package	MT
Do not rely on potential dynamic effects of SSC reduction in employment for achieving fiscal neutrality	ST/MT/LT
Do not contemplate an initial reduction below a 28% average SSC rate	ST/MT
Find compensating measures primarily in indirect taxation and property taxes	ST/MT
Eliminate horizontal inequity in SSC between employees and sole proprietors	ST
Strengthen regulatory definitions of employee	ST
Do not introduce presumptive taxation except for exiting rule applying to part-timers	ST/MT/LT
Consider substituting SSC with full budgetary resources only in strict coordination with comprehensive reform of SS system	LT
Chapter III: Single Tax System	
Eliminate legal persons from the STS	ST
Eliminate VAT payers from the STS	ST
Keep a concessional low fee contribution only for current Group 1	ST/MT/LT
Combine Groups 2 and 3 and tax them at general income PIT tax rates on cash flow basis	ST
Set upper limit for new simplified tax regime at 2 million hryvnias per year	ST
Increase the VAT registration threshold to the same level (conditional to STS reform)	ST
Chapter IV: Excises	
Increase substantially excise on alcoholic beverages, especially beer and spirits	ST
Levy the excise at point of first sale of ethyl alcohol and permit subsequent credit for manufacturers	ST
Continue to increase excises on tobacco nearer to EU standards	MT
Introduce an excise credit system in the supply chain of fuels to combat extensive evasion	ST
Chapter V: Corporate Profit Tax	
Disallow deductions for non-business expenses, and identify specific categories of non-deductible expenses	ST
Introduce a mechanism for inflationary adjustment for tax purposes that is triggered when inflation reaches a specified level	LT
Tighten the thin capitalization rule	ST
Change the base of the provisional payments to refer to previous year profit margin	ST
Permit crediting ACP against provisional payments	ST
Limit exemption for investment funds only to those that are regulated	ST
Increase the CPT rate to 20%, same as top PIT marginal rate	ST

I. INTRODUCTION

1. **This report discuses four topics on tax policy in Ukraine**. Two of them are currently being intensively debated among policymakers and stakeholders, namely, Social Security Contributions (SSC) and the simplified tax regime for small taxpayers, which are closely related, and the Corporate Profit Tax (CPT) and excises, which need attention as well. These issues are discussed in the same order in the four Chapters that comprise this report.

2. **These four topics are closely connected.** Ukraine has very high SSC rates, which are associated with an oversized informal sector that erodes the tax base. The simplified tax regime for small taxpayers provides inordinate benefits which weakens the tax system and is prone to abuse. The difficulties of the social security system cannot be understood without examining the special regime used by the self-employed under the single tax regime for small taxpayers. Lowering SSC rates is a starting point to resolving the problem, but this should be a revenue neutral initiative—for which the report discusses different options. Specifically, Chapter II reviews the policy debate on SSC; Chapter III looks in detail at the simplified tax regime for small businesses; Chapter IV explores the fiscal space in excises and, finally, Chapter V discusses improvements to the CPT.

II. SOCIAL SECURITY CONTRIBUTIONS

A. Background

3. **There is consensus in Ukraine that the Social Security System needs reforming**. It runs with a large public deficit (over 5 percent of GDP – see Tables 1 and 2) despite very high contribution rates. At the same time, high informality rates imply that the coverage is poor and that both employers and employees have a strong incentive to opt out of the system. Also, the system is further weakened by generous and sometimes lax regulations governing the self-employed. The government of Ukraine is considering different options to simplify the system, strengthening its finances and simultaneously lowering contribution rates. This Chapter of the report discusses these options.

Previous FAD recommendations

4. **A previous FAD tax policy mission report[1] pointed out that Social SSC in Ukraine are high for international standards.** At approximately 40 percent of the wage base, they are above all countries in the OECD. At the same time, it argued that it was reasonable to assume that this high tax burden on labor was associated with a large informal sector. Indeed, informality

[1] IMF, *Restoring a Strategic Approach to Tax Reform,* March 2015.

in Ukraine is very large, one of the highest in the world.[2] The system is also complex, with nearly 70 different rates depending on the production activity risk class.

5. **The recommendation in that report was to reduce the average SSC rate, possibly by as much as 40 percent, to 25 percent of the wage bill.** This represented a smaller reduction than proposed by some participants in the policy debate in Ukraine at the time, but it would have implied limiting the amount of revenues surrendered to a level which could be compensated for the most part with a more progressive personal income tax (PIT) structure. The overall strategy recommended in that report was to shift the tax burden away from average income employees towards higher income individuals, expanding the base of property taxes, higher marginal rates in the PIT, and eliminating exemptions and privileged tax regimes, such as the Flat Agricultural Tax (FAT).[3]

The policy challenges ahead

6. **Ukrainian authorities share the concern about high SSC and informality.** These impose a high cost on a reduced base of taxpayers while limiting the delivery of mandated social benefits. FAD's recommended strategy, however, was not adopted. The legislation was changed to reduce SSC rates (though not the number of rates), albeit no consensus has been found on how to mitigate the impact on revenues. In the last semester alone the strategy in this regard has changed directions a number of times, as reflected by Rada amendments to proposed and approved bills (see Box1). The discussion on SSC reform continues among stakeholders, led by the Ministry of Finance and its ad hoc advisory bodies.[4]

7. **The status quo is not tenable.** The law as it stands today mandates a reduction in SSC rates without taking into account some vital contextual facts: the social security funds in Ukraine

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[2] According to F. Schneider, A. Buehn & C. Montenegro, *Shadow economies all over the world*, Policy Research Working Paper 5356, World Bank, July 2010 (pp.27-30), Ukraine ranked 140 among 151 countries, with an informal sector representing nearly 50 percent of GDP for the period 1999-2007. Basic indicators for the labor market by the State Statistics Service of Ukraine show that in 2010 – 2014 the proportion of payroll employees has decreased below 50 percent with respect to the total employed population. Although this may not be a very accurate estimate of the informal sector (payroll employees defined as those employed in entities with 10 or more employees), the data indicate that informality has probably worsened in recent years.

[3] The March 2015 report also recommended that the cap on SSC be increased from 17 to 80 monthly minimum wages. The estimated cost of reducing the SSC rate by 40 percent under that condition was 1.08 percent of GDP (p.25); almost 95 percent of that amount could be recouped by introducing additional marginal rates of 20 and 25 percent in the PIT (p.31). The report also recommended reducing drastically the number of SSC rates.

[4] The MoF created a Task Force for Tax Reform with the participation of representatives of different ministries, parliament, academics, independent advisors and experts, as well as private sector representatives and NGOs. Its task is to elaborate a fundamental tax reform proposal, including SSC, for the 2016 budget.

are already deep in deficit; the budget in fiscal year 2016 will face some additional pressure because some one-off revenue raising measures in 2015 are not renewable[5]; and supply side effects of lower rates are not sufficiently dependable to be the cornerstone of a prudent tax policy. Given these constraining elements, reforming SSC needs to be at least revenue neutral in a static sense. Hoping that an uncompensated drop in SSC will move the Ukrainian economy along the lower half of a Laffer curve and solve public revenue shortages is a heroic assumption and should not be the basis for tax policy in Ukraine at this point (positive dynamic effects may be factored in when, and whether, they materialize in the medium-term).

Recommendations

- Reduce the number of risk based SSC rates to a handful.
- Reduction of SSC rates should be revenue neutral.
- Revenue neutrality should not account for dynamic effects of SSC reduction

B. Deficits in social security funds

8. **Four different social benefits are financed with SSC: unemployment insurance, temporary disability, accident insurance and pensions.** Pensions are by far the most important of these benefits; revenues of the pension fund are about eight times the other three put together (see Table 1). The pension system has operated with a very significant deficit for a long time. Although this deficit has diminished over time (from 7 percent of GDP in 2009 to 5 percent in 2104), the projected deficit for 2015 (3.9 percent of GDP) is still a matter of concern. Also, the other funds for the first time are projected to add 1.4 percent of GDP to that deficit in 2015.

[5] These include a temporary one-off increase in import tariffs and central bank's profits transferred to central government.

Table 1. Ukraine: Social Funds Operations

Table 1.a. Unemployment Fund

	2007 Act.	2008 Act.	2009 Act.	2010 Act.	2011 Act.	2012 Act.	2013 Act.	2014 Act.	2015 Proj.
(in UAH billions)									
Revenue	3.7	4.8	5.8	7.2	8.1	9.2	9.7	6.2	5.9
Expenditure	3.6	4.7	5.9	6.8	8.1	6.9	7.9	6.9	8.3
Deficit	0.2	0.1	-0.1	0.4	-0.1	2.3	1.7	-0.7	-2.4
(in percent of GDP)									
Revenue	0.5	0.5	0.6	0.7	0.6	0.7	0.7	0.4	0.3
Expenditure	0.5	0.5	0.6	0.6	0.6	0.5	0.5	0.4	0.4
Deficit	0.0	0.0	0.0	0.0	0.0	0.2	0.1	0.0	-0.1

Table 1.b. Temporary Disability Insurance Fund

	2007 Act.	2008 Act.	2009 Act.	2010 Act.	2011 Act.	2012 Act.	2013 Act.	2014 Act.	2015 Proj.
(in UAH billions)									
Revenue	5.5	7.2	6.8	8.0	8.6	10.0	10.5	9.4	8.2
Expenditure	5.3	7.2	7.5	8.2	7.6	9.3	10.6	9.2	8.8
Deficit	0.3	0.0	-0.7	-0.2	1.0	0.8	-0.1	0.3	-0.6
(in percent of GDP)									
Revenue	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.6	0.4
Expenditure	0.7	0.7	0.8	0.8	0.6	0.7	0.7	0.6	0.4
Deficit	0.0	0.0	-0.1	0.0	0.1	0.1	0.0	0.0	0.0

Table 1.c Ukraine: Accident Insurance Fund

	2007 Act.	2008 Act.	2009 Act.	2010 Act.	2011 Act.	2012 Act.	2013 Act.	2014 Act.	H1, 2015 Proj.
(in UAH billions)									
Revenue	3.0	3.9	3.2	4.2	5.5	6.2	6.5	6.5	3.4
Expenditure	3.0	3.7	3.5	4.0	4.6	5.7	7.3	5.9	3.9
Deficit	0.0	0.3	-0.4	0.1	0.9	0.5	-0.7	0.5	-0.5
(in percent of GDP)									
Revenue	0.4	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.2
Expenditure	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.4	0.2
Deficit	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0

Sources: Ukrainian authorities and IMF staff estimates.

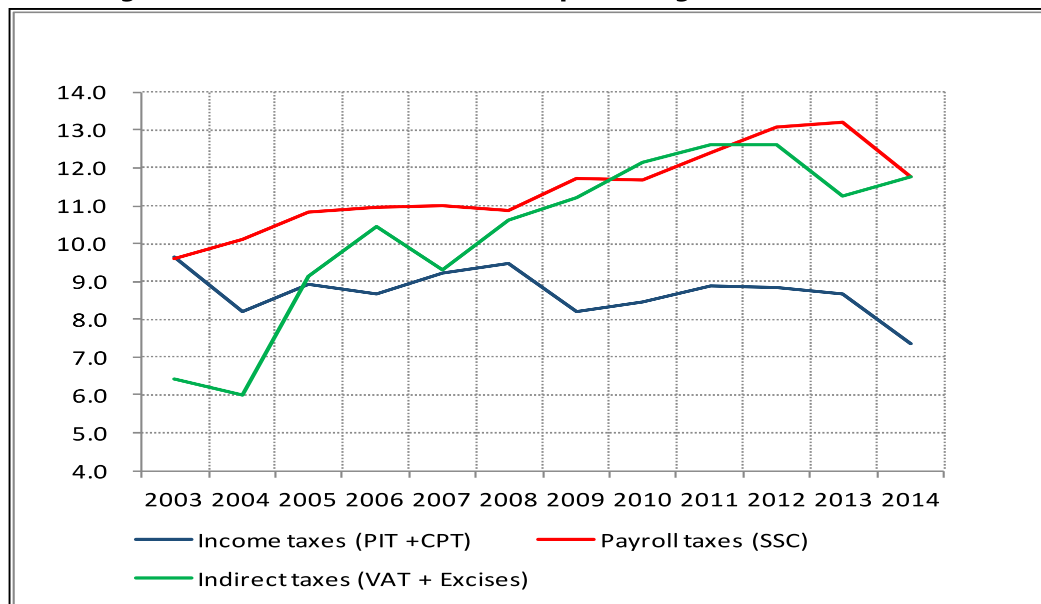
Table 2. Pension Fund of Ukraine Operations, 2007-15

	2007	2008	2009	2010	2011	2012	2013	2014	2015
	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Act.	Proj.
			(in UAH billions)						
Own revenue	75.5	102.0	99.8	119.3	139.1	158.0	166.9	165.9	172.5
Expenditure	99.9	150.3	165.7	191.5	210.7	233.7	250.3	243.5	249.5
Deficit	-24.4	-48.4	-65.9	-72.1	-71.7	-75.7	-83.5	-77.6	-77.0
			(in percent of GDP)						
Own revenue	10.1	10.3	10.5	11.1	10.7	11.2	11.4	10.6	8.7
Expenditure	13.3	15.2	17.5	17.7	16.2	16.6	17.1	15.5	12.6
Deficit	-3.2	-4.9	-7.0	-6.7	-5.5	-5.4	-5.7	-5.0	-3.9
Memorandum item:									
GDP (UAH billions)	751.1	990.8	947.0	1,079.3	1,300.0	1,404.7	1,465.2	1,566.7	1,980.7

Sources: Ukrainian authorities; and IMF staff estimates.

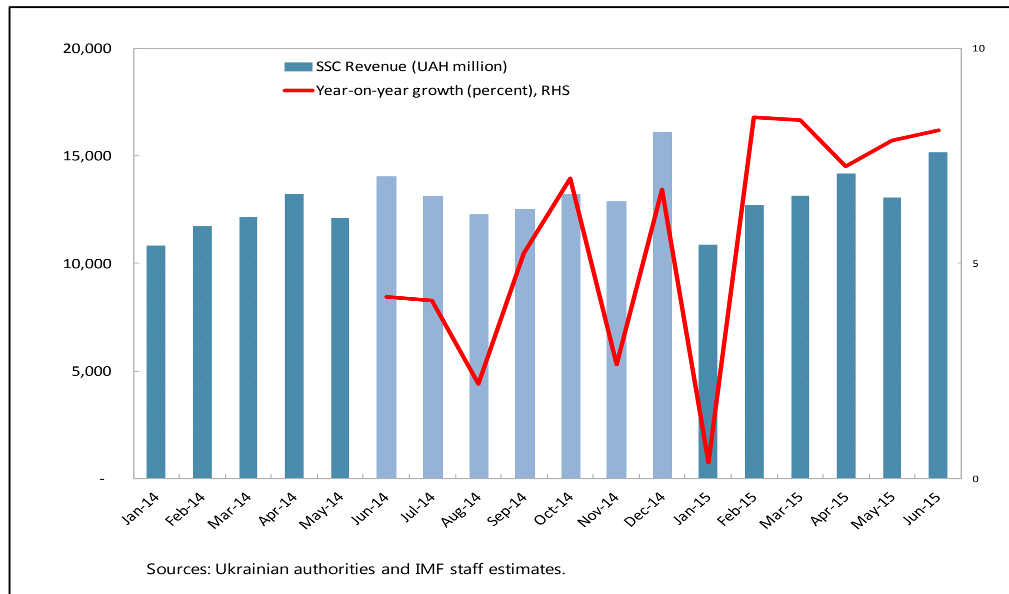
9. **SSC have been the most important and dependable source of tax revenues.** For most years SSC have been larger than revenues from all income taxes (CIT + PIT) or from indirect taxes (VAT + excises). Up until the beginning of the conflict in the East, SSC also showed a more stable growth trend than other taxes, though insufficient to close the expenditure gap (see Fig. 1).

Figure 1. Ukraine: Tax Revenues as percentage of GDP, 2003-2014



10. **Adjusting for Crimea and conflict-affected regions, SSC revenues in 2015 have not underperformed**. With these adjustments revenues in fact have risen 7 percent compared to the same period in 2014 (see Fig. 2). So, SSC continue to be a fundamental source of revenues for the budget.

Figure 2. Ukraine: Monthly SSC Revenues – excluding Crimea



Sources: Ukrainian authorities and IMF staff estimates.

C. SSC reform: recent changes in the law and new proposals

The initial proposal by the Ukrainian government

11. **In December 2014 the government of Ukraine proposed to the Rada a graduated reduction in the SSC for employees with an income above 2 MW.** The fall in revenues from the proposed rate reduction would have been partially compensated by: a) imposing a minimum base of one monthly MW on employees working less than 40 hours per month, i.e. having all part-timers paying SSC as if they were fully-employed and b) raising significantly the cap on SSC (see Box 1). According to mission calculations, the (static) cost of this initiative would have been UAH 17.5 billion (1.2 percent of GDP).[6]

The first reform adopted by the Rada

12. **The reform proposed by the government was not adopted.** Instead, the Rada voted for a conditioned reduction in SSC rates for 2015, followed by a smaller but unconditioned decrease in 2016, without increasing the income cap, nor keeping a high rate for individuals with income below two minimum wages. As approved, the 2015 reduction of 60 percent in the SSC rate would apply only if employers increased the payroll base of the tax sufficiently to compensate for it (combining new employment and increased wages). The cut in SSC rates was thus conceived as providing an incentive for employers to "de-shadow" their informal payroll and

[6] This estimate with 2013 data does not include the effect of lower employers' deductions for CIT purposes due to lower SSC.

expand the base sufficiently so that net revenues would not be affected. For 2016 the bill authorized a 40 percent cut in SSC rates without conditions.

13. **Some employers did apply the reduced SSC rates in 2015.** According to SFS, 7,000 employers applied the reduced SSC rate for 2015, covering almost 700,000 employees. This is not insignificant, but it is uncertain how companies complied with the conditions to apply the reduced SSC rate, whether (and how much) the payroll increased from legalizing wages previously paid underground or from increased employment that would have occurred anyway, or from wage inflation, or from company mergers, or any combination of the above.

14. **It is difficult to discern why employers would actually opt for this scheme.** It offered no reduction in their total tax bill, the only potential benefit would be regularizing past underground payments. However, there is no amnesty associated with this initiative, nor a credible (and imminent) threat that the law would be enforced to collect past due SSC. Remaining in the informal economy appears to be still be the safest option. Also, no conditions apply for 2016; it might seem preferable to taxpayers to wait a year to enjoy the benefit of the SSC cut.

The reform amended

15. **In March 2015 the Rada scrapped the previous text of the law and lightened conditions to apply reduced SSC rates**. Also, it would allow each company to adjust down its SSC rate according to the increase in the wage base it paid in 2015 as compared to 2014, without exceeding a reduction of 40 percent. The SSC rate reduction for 2016 remained unchanged, that is, without conditions or other compensating measures.

16. **In May 2015 the Rada initiated discussions to amend the bill approved in March**. A new initiative (originating on the legislative floor) was approved eliminating all conditions to decrease the SSC rate in 2015, and allowed an immediate reduction to 60 percent (lowering the current rate from 40 to 15 percent in 2015), with no compensating measures to recoup the revenues at stake.[7] The implicit argument is that a drastic cut is what it takes to provide a sufficient incentive for employers to formalize the wage bill that they pay underground. The risk is that formalization does not happen in any significant degree, or not sufficiently to compensate the cut, with severe effects on the budget. The bill was vetoed by the President in July.

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[7] Bill 2576, voted May 19, 2015.

Box 1. Amendments to the SSC reform, 2014 -2015

I. Initial proposal submitted to Rada in December 2014

- For wages below 1 MW (part-timers) the assessment base is 1 MW
- For wages up to 2 MW the current (40 percent average) rate applies.
- For wages exceeding 2 MW the SSC would be reduced to a marginal rate of 26 percent for 2015, 21 percent for 2016 and 16 percent for 2017.

II. The proposal adopted by Rada on December 28, 2014

In 2015 SSC may be reduced by a coefficient of 0.4 if the following conditions are concurrently met:

(i) The SSC base exceeds the average monthly base in 2014 by at least 2.5 times;
(ii) The average wage is higher by at least 30 percent compared with 2014;
(iii) The average payment per individual insured is at least UAH 700;
(iv) The company average wage is at least three minimum wages.

For 2016 on the reducing coefficient is set at 0.6 without conditions.

III. The proposal adopted by Rada on March 2, 2015

- Taxpayers can pay a lower SSC rate in 2015 if:
  (i) The 2104 monthly SSC base per employee increases 20 percent;
  (ii) The average SSC payment per employee is no less than 2014 average;
  (iii) Number of employees does not exceed 200 percent the 2014 average.

- The reduction in SSC rates will be set for each company and calculated as the ratio of average monthly salary in 2014 and the current reporting month salary. However, the reduction cannot be more than 0.4.

- The reducing coefficient from January 1, 2016 will be set at 0.6 without conditions.

IV. The proposal voted in Rada May19, 2015

- SSC are lowered using a 0.4 reduction coefficient beginning current year and no conditions apply.

- The President vetoed this bill in July, 2015

Discussion in the Task Force

17. **Discussions on SSC are ongoing and the policy aims remain unsettled.** Different stakeholders have presented new proposals to the Task Force on Tax Reform which advises the

MoF. One proposal which has gained some traction is merging SSC and the "Military Tax" [8] with the PIT at a flat 29 percent rate (higher than the current top marginal rate). Revenues would be allocated according to some proportion to the general budget and to funding social security benefits. The idea is that current SSC and Military Tax would be grossed-up to wages to increase the base of the new "combined" PIT. The PIT rate would then decrease gradually to ultimately 20 percent by 2018.

18. **Merging SSC with PIT entails some important risks for revenues.** The proposal now under review by the MoF considers different mechanisms to compensate for the loss of revenue that the 29 percent PIT rate on a grossed-up base would imply with respect to the current system. However, these compensators rely heavily on the assumption that employers will legalize a wage bill now paid underground and in taxing persons that qualify for a simplified regime for small taxpayers (see Chapter III) at a much higher rate. These are uncertain assumptions, which are not fully consistent: on the one hand it is expected that employers are very sensitive to a lower SSC rate, bringing a shadow payroll into the open, while on the other small taxpayers are expected to be very unresponsive to higher taxes, not migrating their activity to the shadow economy (estimations discussed in Section H of this Chapter).

19. **Ukraine has no fiscal space for a SSC reform that loses revenues**. A gradual reduction in SSC rates is justified as an element in a more comprehensive effort to combat informality—an effort that needs to encompass reforming labor regulations, rationalizing social security benefits and improving administrative efficiency. Any upfront reduction in revenues from lower SSC rates must be fully compensated by other revenue increasing measures from no uncertain sources.

Simultaneous changes in the PIT

20. **The December 2014 tax reform increased the top marginal PIT rate to 20 percent, shortly followed by pushback to shrink the tax base.** The increase in the top rate is a step towards a more progressive scheme, although FAD's recommendation was also to include an additional income bracket at 25 percent. However, an initiative presented to the Rada in May 2015 aimed at reversing course by increasing the lower bound of the income bracket to which the 20 percent rate applies, from 10 minimum subsistence wages (MSW) to 17 MSW.[9] Thus, all individuals with an income between 10 and 17 MW would pay only 15 percent, obtaining a tax cut as compared to the situation prior to the December 2104 reform, when they paid a

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[8] The Military Tax was introduced in 2014 as a temporary tax first, now indefinite, standing at 1.5 percent of gross income of all individual taxpayers.

[9] The reference to define income brackets with this initiative would change from subsistence wage to minimum wage, but they are practically identical.

17 percent tax.[10] Though the bill was vetoed by the President in July, it is indicative that there is still strong support for a quasi-flat tax structure in the PIT.

Recommendations

- Overturn the uncompensated SSC rate reduction coefficient of 0.6 projected for 2016.
- Reductions in SSC rates must be fully compensated by additional tax revenues.
- Do not include in expected revenues possible effects from reducing the informal economy.
- Do not decrease the base of the top marginal rate in the PIT.

D. Pensions and welfare through the social security system

21. **Traditionally social security systems have both a pension component and a welfare safety net for the old aged.** The second ingredient makes social security a distinct operation from a pure (even if government run) pension plan. The safety net provides a subsidy to a population in need, financed by high income social security contributors and all taxpayers (from the general fiscal budget), in varying proportions, depending on the deficit of the social security system.

22. **Social security in Ukraine, as in much of the world, is a defined benefit system financed through as 'pay as you go' scheme**. This means that the government acquires the obligation to pay retirees a specified benefit funded with SSC from current taxpayers, supplemented with revenues from other taxes as the system may require. The benefits are normally (above a certain level of income) a declining function of contributions, which will provide during retirement a replacement ratio of the salary earned at time of retirement. Thus, the pension element of social security is correlated (up to a certain point) with contributions into the system; welfare payments are not, they constitute a minimum pension which has not been sufficiently funded with the contributions of the beneficiary.

23. **A declining population in Ukraine has weakened the financial health of its social security system**. Population in Ukraine has actually declined in the last decade (from 51.6 million in 1993 to 44.6 million in 2015) at the same time as it has aged.[11] The combination of a shrinking labor force with a fast ageing population inevitably leads to a higher tax burden and a higher

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[10] This measure would have benefited about 140,000 taxpayers, with a cost to the budget close to UAH 51 billion. The number of taxpayers earning more than 17 MW is 76,570 (2014).

[11] The cohort aged 65+ represents today 15 percent of total population, larger then each the cohorts between 0 - 14 and 15-24 years of age. Source: UN World Development Prospects. Ukraine ranked 226 among 237 countries according to the proportion that 0-14 years of age represented in total population. *CIA World Factbook*, 2005.

incentive not to work or to do so in the informal sector. Thus, Ukraine faces the challenge of a dwindling payroll tax base already subject to a very high tax rate, generating an incentive for a growing informal sector that deprives the social security system from further funds. Inevitably, social security benefits must be financed increasingly from the general budget.

24. **Active coverage, defined as participation of workers in mandated pension schemes, is also reduced with growing informality**. Traditional social security systems rely on formal employment to fund and deliver benefits, that is, on employers to withhold payroll taxes and on employees' payroll contribution to select beneficiaries and determine the amount of pension benefits. The growth of informality necessarily leads to a larger number of persons dropping out of the system, with no safety net in old age. When governments respond to this problem by implementing non-contributory benefits and special regimes for the self-employed, the social security system adds a welfare component financed from general funds.[12] This is potentially a vicious circle rendering informality a more attractive option for employment and a strong disruptor of the traditional social security system.[13]

25. **The question arises why a separate social security system for employees in the formal sector should be kept at all**. Benefits could be entirely financed from the budget, finding possibly a more efficient instrument to obtain revenues to do it, eliminating the payroll tax. In a way, keeping separate general government accounting to fund social security benefits is a financial fiction in that whichever reserves may be accumulated in the specific funds, usually, these are lent to the government to finance its current expenditure. The social security funds typically cannot invest their resources in any other vehicle than government treasury bills or their equivalent.

26. **The legal commitment however is very important.** A pay-as-you-go social security system is an intergenerational contract, a constitutional commitment, which the upcoming generation will contribute to finance the retirement of the current contributing cohort, in the same way as with the current generation of retired people. The fact that their contributions formally go into a committed social security fund fulfills that condition. So, regardless of how the revenues are collected, a separate accounting is needed so that social security entitlements are not negotiated and voted every year in the budget process.

27. **To the extent that a pension is provided through the social security system, the payroll will continue to be a relevant element of the system**. Since pensions are necessarily a percentage of the taxpayers' labor income, and benefits generally a function of contributions, regardless of how the revenue is obtained, the social security authority has to keep a record of

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[12] Low female participation rates is typically an additional problem, which added to informality, result in lack of coverage and low contribution densities. OECD/IDB/The World Bank (2014), *Pensions at a Glance: Latin America and the Caribbean*, OECD Publishing; http//dx.doi.org/10.1787/pension_glance-2014-en

[13] See for example S. Levy et al. *The End of Informality in Mexico?* IDB, Washington DC, 2012.

the (monthly) payroll of each taxpayer in order to determine their individual pension, and safeguard their entitlement, even if payroll is not the direct base of the tax. So, even if payroll taxes are substituted by other taxes in order to fund social security benefits, the payroll would continue to be an anchor of a pension system. Where social security only provides a uniform and universal stipend to all individuals above a certain age, the payroll becomes irrelevant and the system is simplified, but at the expense of delivering pensions as traditionally understood. Which model to follow, or which mix between both models to adopt, is a matter of social choice. As long as pensions are one of the main benefits of the social security system, there is a limit to how much taxation can be simplified in order to fund it.

Recommendation

- Consider fully funding pensions from the budget only when reviewing comprehensively the social security system and its pension benefits

E. The continuing allure of a flat PIT

28. **Ukraine introduced a flat tax in 2004, with single rate at 15 percent on income of all individuals**. This became a popular strategy in a number of Eastern European countries at the time. As recent as 2011 Ukraine introduced a second marginal rate of 17 percent for higher income individuals, but few actually paid this top rate (212,416 individuals – 1.3 percent of total PIT payers). So, for all practical purposes, the regime continued to be very close to a flat tax until the current year, when the top rate was increased to 20 percent. But there is a strong push to return to the flat tax, to replace the current PIT, the SSC and the Military Tax.

29. **The major appeal of the flat tax was its apparent simplicity and promised (up to a certain point) increase in supply of labor and thus tax revenues.** The simplicity of a flat tax system can easily be exaggerated, however. The increased difficulty of administering a tax system with three rates rather than one is practically immaterial. The real complexities in the tax system lie in how the base of the tax is determined: multiple options, exemptions, special regimes, ambiguous language, undefined concepts, inconsistent rules and many other intricacies are usually the culprit of a very complex tax system. The Ukraine is no exemption.

30. **Studies have shown that the expectation of higher revenues from introducing a flat tax is not strongly backed by empirical evidence**. Most countries that introduced the flat tax did not see a major employment surge and suffered a revenue loss. Where tax revenues increased, a wider package of measures had been introduced together with the flat tax, so that the revenue increase could not directly be imputed to the flat tax. As pointed out in M. Keen et. al. (2007), "Except in Russia, the second wave of low-rate flat tax reforms have been associated with a reduction in revenue from the PIT: behavioral responses may have mitigated the revenue loss, but in no case has there has appeared to have been a Laffer effect: these reforms have not set off effects strong enough for them to pay for themselves. And in Russia, there is little

evidence that the strong revenue performance after the reform was due to the flat tax itself: rather it appears to have reflected wider macroeconomic recovery."[14]

31. **Distributional aspects of a flat tax are also a concern**. The introduction of flat tax systems can have serious drawbacks on income distribution. The effect can be particularly severe for middle classes, while favoring the richest income brackets.[15] Thus, countries with a relatively equitable distribution of income, such as the Ukraine,[16] stand to suffer the most adverse distributional effects from introducing a flat tax.[17]

32. **Slovakia, one of the signature flat tax countries, re-introduced a progressive income tax system in 2013**. Although the flat tax was one of the measures which contributed to a strong economic performance after 2004 (although difficult to impute to the flat tax specifically), low levels of tax revenues and poor level of tax compliance, among other problems, led the government to discard the flat tax. It is particularly noteworthy how revenues declined as a percentage of GDP, from 39.6 percent in 1995 to 29.6 percent in 2013.[18]

33. **The introduction of the flat tax in Ukraine more than a decade ago served to signal a fundamental commitment to transition towards a market economy**. This was probably a very relevant message in 2004, but times have changed and public policy in Ukraine today needs to emphasize its commitment to prudent fiscal management and to a more efficient and fairer tax system. A flat tax does not clearly serve this purpose now; much less if it hopes to maintain tax revenues thanks to dynamic supply side effects. FAD's basic recommendation in its March 2015 report was to gradually reduce SSC only if a fully compensating strategy was adopted with a more progressive tax system. The mission finds no fundamental reason to believe that the flat tax option would be preferable.

Recommendation

- Do not overstate the simplification benefits of a flat tax system; keep a progressive structure for PIT.

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[14] M. Keen, Y. Kim, R. Varsano (2006), The Flat Tax(es): Principles and Experiences, *IMF Working Paper 06/218*.

[15] Low income individuals can be protected with a universal allowance or with an exempt (low) income bracket.

[16] The Gini coefficient in Ukraine in 2010 was: 24.8, comparable with those of countries showing the fairest income distribution, such as Denmark or Slovak Republic; World Bank, World Development Indicators.

[17] A. Paulus & A. Peichl (2009), "Effects of Flat Tax Reforms in Western Europe", *Journal of Policy Modeling*, Vol. 31 (5), Sept.-Oct.

[18] Remeta, J. et. al. (2015), "Moving Beyond the Flat Tax – Tax Policy Reform in The Slovak Republic", OECD Taxation Working Paper, No22, OECD: http://dx.doi.org/10.1787/5js4rtzr3ws2-en.

F. SSC rates and formal employment

Pros and cons of payroll taxes

34. **Payroll taxes often represent a high and un-graduated tax wedge for low income workers.** Contrary to typical PIT structures, payroll taxes, as the Ukrainian SSC, tax wages at the same rate starting form the first unit of earnings. PIT often exempts an initial low income bracket and graduates the tax burden as income increases. Thus, the PIT provides for a relatively smooth transition into tax-paying employment (aside from facilitating redistributive policies). SSC normally have the opposite pattern, imposing a proportionally high burden on lower income as the contribution is capped at some multiple of the minimum wage; the reason being that benefits are also capped and contributions are kept largely proportional to the benefits. It is generally accepted that such tax structure is a strong incentive to work in the informal sector, especially if social security benefits are not highly valued.

35. **The growth of the payroll may at times lag behind nominal GDP**. Real wages may grow slower during certain periods of the business cycle. For example, increasing unemployment and stagnating nominal wages led to payroll growth well below the inflation rate during the first half of 2015 (se Fig. 3).

36. **On the other hand, payroll taxes have a wide and more stable base**. SSC in Ukraine collect more than double the revenue of the PIT (11.8 percent of GDP versus 4.8 percent in 2014). This is because all wage-earners are subject to SCC, with no exemptions, loopholes, deductions or special regimes (there is no "social tax deduction" as in PIT). The payroll is also a more stable tax base than profits over the economic cycle, which is a desirable feature considering that SSC fund entitlements are thus protected from budgetary adjustments.

SSC rates and informality in OECD countries: empirical evidence

37. **The correlation between SSC rates and informality is not so straightforward**. Although an inverse relationship between SSC rates and formal employment stands as a general principle, empirically it is harder to verify. Fig. 4 shows little correlation between SSC rates and informality in OECD countries (correlation coefficient for sample = .25)[19].

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[19] O. Sanchez, "The Relevance of Credit Access to Informal Labor Dynamics", Inter-American Conference for Social Security Working Paper 0114, 2014. Same source for Fig. 5 and 6 below.

Figure 3. Ukraine: Average Wages and Inflation

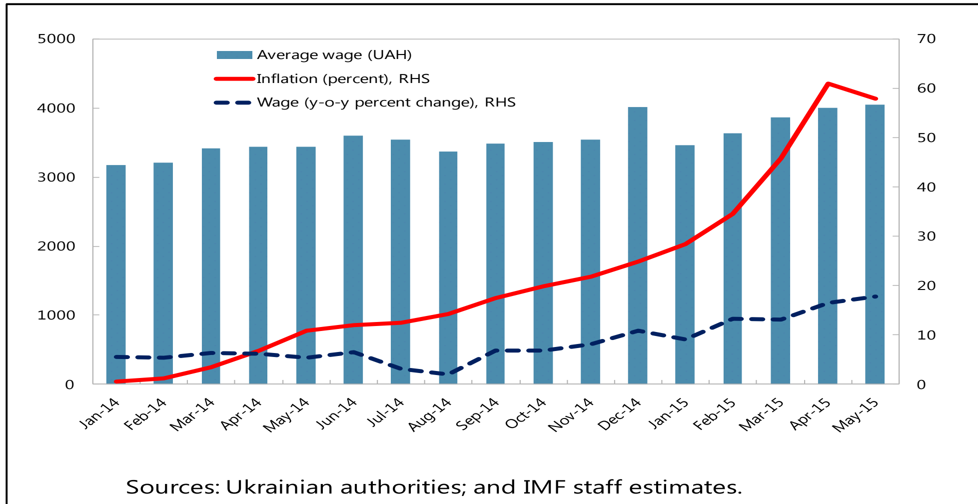
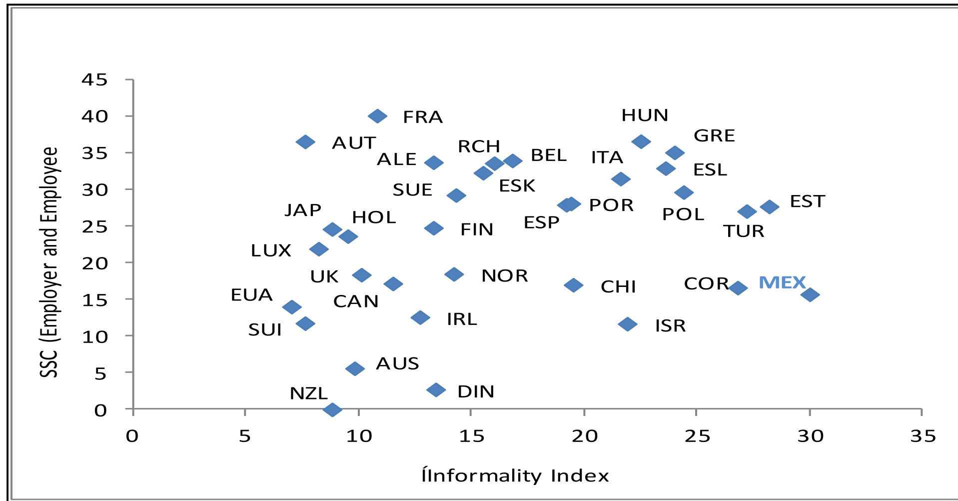


Figure 4. Social Security Contribution Rates and informality



38. **Cutting SSC rates is not strictly associated with declining informality**. About half of OECD countries between 2007 and 2012 reduced SSC rates, while the other half increase them, but—as shown in Fig. 5 and 6—both groups of countries experienced an almost equivalent reduction in informality.

Figure 5. Changes in SSC rates and informality

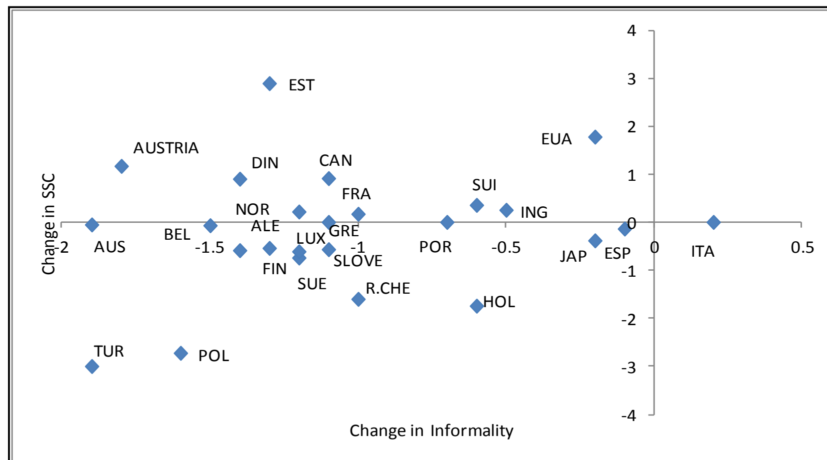
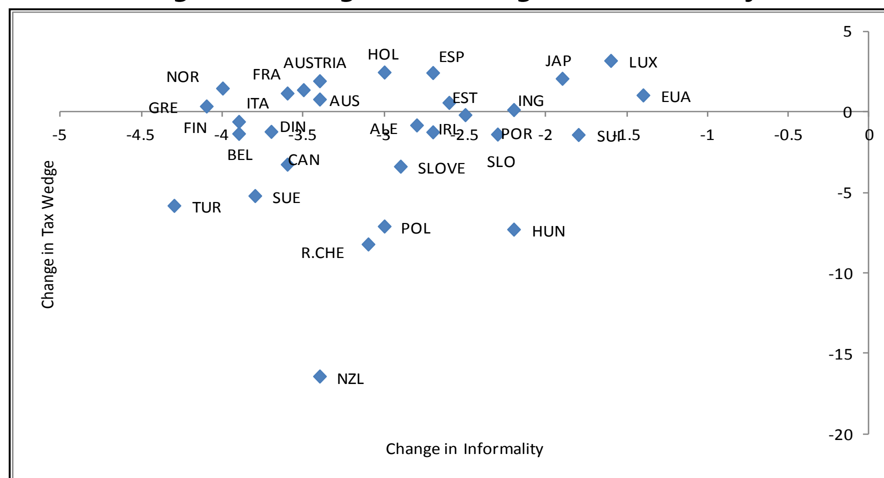


Figure 6. Change in tax wedge and informality



Labor regulations

39. **Other factors may have a stronger impact on informality.** The decision to employ formally or underground takes into account the full cost of a labor contracts, of which SSC are only a part. Inflexible labor regulations, high severance payments, collective bargaining, to cite a few examples, may be sufficiently costly to cancel the effect from a change in SSC rates.

40. **Informality is a multivariate problem and relying solely on reducing SSC rates to combat it risks having little effect**. [20] Ukraine may have to revise its labor regulations in order to make more decisive inroads in diminishing the underground economy. Although Ukraine follows fairly closely the pattern in the eastern European region, it is not competitive according

[20] F. Schneider, A. Buehn & C. Montenegro (2010) emphasize intensity of regulations, public sector services and earnings in the official economy, aside from SSC and taxes, as the main causes of the shadow economy.

to international standards. As shown in Table 3, rigidity in hours worked together with difficulty in redundancy are relatively high and may be an obstacle to reducing informality.

Table 3. Comparative Labor Regulations: Rigidity in Hours/Difficulty in Redundancy

	50-hour workweek allowed for 2 months a year in case of a seasonal increase in workload?	Maximum working days per week	Premium for night work (% of hourly pay)	Premium for work on weekly rest day (% of hourly pay)	Paid annual leave for a worker with 1 year of tenure (in working days)	Maximum length of probationary period (months)
Ukraine	No	5.5	20.0	100	18.0	1.0
Selected Eastern European Countries						
Belarus	Yes	6.0	20.0	100	18.0	3.0
Lithuania	No	5.5	50.0	100	20.0	3.0
Moldova	Yes	6.0	50.0	100	20.0	0.5
Poland	Yes	5.5	20.0	100	20.0	3.0
Romania	Yes	5.0	25.0	100	20.0	3.0
Russian Federation	Yes	6.0	20.0	100	22.0	3.0
				100		
Unweighted average (excluding Ukraine)	N/A	5.7	30.8	100	20.0	2.6
Rest of World (average)	N/A	5.9	14.0	0.5	17.2	4.0

Source: World Bank Doing Business: Labor Market Regulation
http://www.doingbusiness.org/data/exploretopics/labor-market-regulation

Minimum payroll tax base

41. **Low income earners are more prone to participate in the informal economy**. Some international evidence indicates that individuals that are most likely to participate in the underground economy are students (typically part-timers), welfare recipients and low income workers,[21] who transit more easily from the formal to the informal sector (and back). Imposing a relatively higher tax burden on them can make the informal sector more attractive. A higher burden can be imposed by introducing a minimum payroll base higher than actual earnings of low-income wage earners.

42. **In Ukraine the SSC burden on part-timers was increased.** In the March 2015 reform a minimum SSC base for part-timers was adopted equaling to one monthly minimum wage. The initiative hopes to clamp down on full-time employees who declare earnings for less than 40 hours of work per month. This may actually drive them further into the shadow economy, with an undetermined net effect on revenues.[22] On the other hand, the reform does not affect

[21] See for example T. Lemieux, B. Fortin & P. Frechette, "The Effect of Taxes on Labor Supply in the Underground Economy", *The American Economic Review*, Vol. 84, No.1, March 1994.

[22]It should be noted however that there is no data on how many individuals who register less than 40 hours of work per week are legitimate part-timers and how many earn unregistered income (or how much). Other systems

unregistered payments ("brown envelopes") of higher income individuals. Expected revenue gains from this minimum wage base on part-timers could be illusory.

Other determinants of informality

Access to financial services

43. **It has been pointed out in the literature that a large and persistent informal sector is closely related to low levels of income**. Often very low income individuals or businesses are formally classified in a category that has no tax obligations—although they are not illegal but rather "outsiders".[23] For example, in some countries businesses with up to five employees may have no obligation of enrolling their employees in the social security system. Any specific variable that hampers the growth of these businesses would enhance informality, while SSC rates would in fact be irrelevant. Access to financial services, for example, has a stronger empirical correlation with informality than SSC rates have, as shown in Fig. 7.

44. **Tangible benefits obtained from social security are a strong incentive in favor of formal employment.** Although pensions may often be the more costly benefit, health services for the contributing population may have a greater appeal, as individuals (especially young people) may place a heavy discount on pension benefits. For example, a recent study in Uruguay showed that extending health benefits to dependent children of private sector salaried workers had a significant effect on informality rates.[24]

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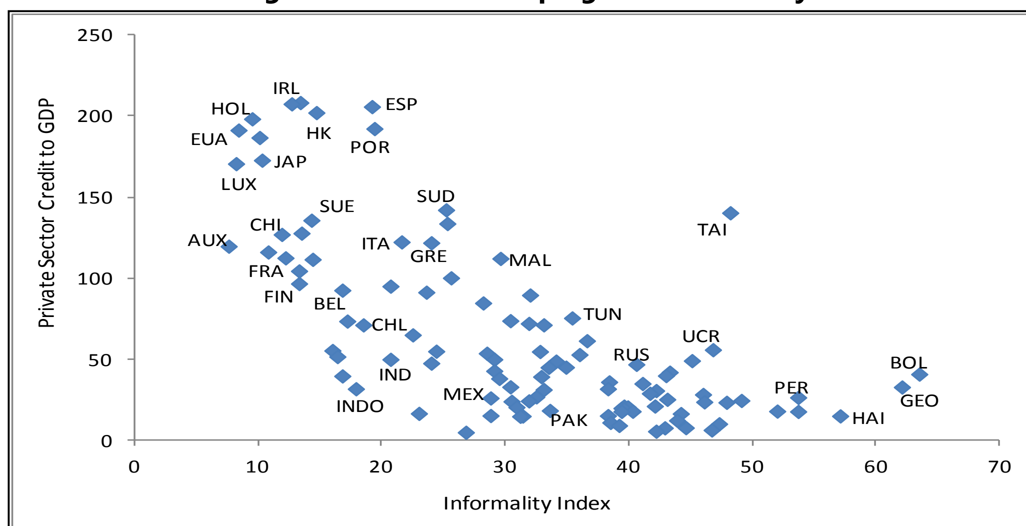
that impose a minimum social security base, such as that in Bulgaria, dos not apply to part-time employees. See K. Pashev, "Presumptive taxation and gray economy: Lessons from Bulgaria", *Center for the Study of Democracy Working Paper 0512/1*, December 2005.

[23] Ravi Kanbur, *Informality: causes, consequences and policy responses*, Working Paper 2014-18, August 2014, Charles H. Dyson School of Applied Economics and Management, Cornell University.

[24] M. Bergolo & G. Cruces, *Labor informality and the incentive effects of social security: Evidence from health reform in Uruguay*, CEDLAS, March 2001. http://www.iadb.org/wmsfiles/products/publications/documents/35968282.pdf

Figure 7. Financial Deeping and Informality



Some administration issues

45. **Complex administrative procedures can go a long way in explaining informality.** The challenges with SSC are quite unique in that they involve more than one authority. In Ukraine the SFS is responsible for collecting SSC, but not for enforcing all other rules concerning compliance with social security regulations. This requires non-trivial inter-institutional coordination and well-defined division of responsibilities.

46. **There are limitations to enforcement.** Employers have the obligation to register their employees and a registration card needs to be issued to the employee (procedure now temporarily suspended), registration records must be kept at a central office which may be a different place than that where workers perform their job. Thus, an onsite inspection may find that no worker has a registration card, no records held either, but this in itself would not constitute a violation of any labor regulation. In fact, it is only since January 2015 that registration of employees is required before they start work.

47. **The cash problem.** Unreported wages cannot be deducted for CIT purposes, so avoiding SSC poses a problem for employers who do not have large earnings in cash which they can keep unregistered. Thus, employers need to present false invoices to make up for the wage bill paid in cash. The most likely supplier of such invoices (at a price) is a business that is rich in cash from non-legal origins and that needs to launder its earnings. However, the SFS has limited powers to investigate the financial transactions of this type of companies because of very strict bank secrecy laws. The SFS can obtain bank statements only with a court order and the information so obtained is restricted generally to general account balances. A decisive push against an expanding informal sector would require softening bank secrecy laws, for example, requiring only the intermediation of the central bank to obtain the information. To the extent that Ukraine signs on to ongoing international efforts to expand bilateral and multilateral exchange of information for tax purposes, it will also have to ensure that it has access to such

information—including bank account information—for the purpose of sharing it with partner countries.

Recommendations

- Keep SSC as a separate payroll tax.
- Develop a comprehensive, inter-institutional strategy to combat informality.
- Do not increase presumptive taxation on low income earners
- Relax bank secrecy regulations for tax purposes
- Continue to seek technical assistance on tax administration related to SSC

G. The social security regime for the self-employed

48. **The social security regime for the self-employed represents a serious flaw in the system.** Informality is not the only way employers can avoid SSC payments. Hiring workers as if they were self-employed is another way, with the advantage of legal coverage. The key problem lies with individuals who have their own business (sole proprietors) who are excluded from PIT under the Single Tax (ST) regime, which provides for a minimal SSC. Table 4 below shows the SSC rates for different types of business establishments.

49. **The general principle is that for sole proprietors profits are the SSC base.** There are two types of self-employed individuals who are employed under civil law contracts: service providers and individual entrepreneurs or sole proprietors. Service providers are treated for tax purposes as employees; those who contract them withhold under general PIT and SSC rules and rates.[25] SSC is due on their profits, subject to a minimum. Sole proprietors are treated differently, and the specific rules depend on whether they are registered for ST for tax purposes. If they pay PIT under the general regime, the only condition is that the payments must not be less than one minimum wage per quarter, even when they show losses (if they have no income then there is no SSC obligation). Whether the correct amount was paid is left to SFS audit and enforcement.

50. **Sole proprietors who register under the simplified (ST) regime enjoy a privileged regime**. Specifically, they contribute at the rate of 34.7 percent of one MW, regardless of the income earned. A higher payment would be entirely voluntary and presumably motivated by greater social security benefits. The generalized perception is that hardly anybody does so. The minimum quota applies even if no income is earned. This regime is cheaper for anyone earning

[25] For statistical purposes these are classified as employees by the SFS under code 102.

more than a minimum wage. Evidently, the incentive is to hire workers as sole proprietors under the ST regime. Private sector representatives admit that this is a common practice.

Table 4. Ukraine: Social Security Contribution Rates

Type of contribution	Employer's Contribution	Employee's Contribution
Enterprises and Permanent Establishments (PEs) using a hired labor force	36.76-49.7%*	3.6%
Employers paying remuneration under civil law contracts	34.7%	2.6%
PEs registered as taxpayers under the simplified tax system	34.7% (of one MSW)	
Individuals engaged in independent professional activities	34.7% (of one MSW)	

*Depending on the class of professional hazard

If monthly income is less than one minimum wage the base of SSC is one MW.

51. **Sole proprietors may be salaried employees for all practical purposes, except for their formal contract with their employers**. However, the Labor Code does not have a sufficiently clear definition of what constitutes an employee, so that workers can be classified as sole proprietors even if they work under similar conditions and circumstances as regular employees.[26] Nor is it clear that the inspectors of the Ministry of Social Policy have the authority to re-characterize contracts into labor contracts to trigger a collection procedure for SSC past due.

52. **The current preferential SSC rate for sole proprietors results in unequal treatment of similar labor services and results in revenue loss for the budget**. The revenue loss of reduced SSC payments by sole proprietors may be as high as UAH 3.85 billion (0.25 percent of GDP) in 2014. This revenue estimate is based on Group 2 and 3 sole proprietors who are under the ST regime. There are 905,195 sole proprietors in these two groups accounting for 80 percent of the population of individuals in the ST regime. Requiring them to pay SSC similar to other labor providers would enable equal treatment of similar service and improve the revenues of the social security system. It is unknown how many of these sole proprietors are legitimate entrepreneurs who under the general system would still have the opportunity to pay based on

[26] A simple way to clarify the distinction would be, for instance, to introduce a rule into the Labor Code according to which a person is classified as an employee if they meet a minimum number (say 4) criteria out of a list of criteria, such as whether (i) the person is free to choose their workplace and work schedule, (ii) the person is free to perform the activity for several clients, (iii) the risks of the activity are attributed to the person, (iv) the activity is carried out using the person's assets, (v) the activity is performed by the person using their intellectual capacity and/or physical skills, (vi) the person is member of a professional body with supervisory and/or regulatory powers, and (vii) the person is free to carry out the activity with their employees or other third parties. Similar rules were recently introduced in Romania (Law No 187/2015).

one MSW per month. We assume conservatively one half of the taxpayers in this group would continue to pay on the basis on one MSW. The ST regime—including its revenue implications—are discussed in detail in Chapter III below.

Recommendations

- Eliminate preferential SSC treatment for sole proprietors under the ST regime.
- Legally define the concept of employee to include those formally under contract as sole proprietors but de facto working under the same conditions as employees and make these liable to general SSC rates.

H. Revenue effects of proposed SSC reforms

Revenue effects of reducing the SSC contribution rate

53. **This section provides estimates of the amendments to the SSC and some alternative scenarios**. Table 5 shows the current distribution of wages and salaries of the employed population and their incomes and SSC payments for 2014. The current average SSC rate is 41 percent and contributions are capped at 17 MSW. Out of 13.87 million taxpayers 87 percent earn less than UAH 5,000 per month. Those earning less than UAH 5,000 pay 61 percent of the SSC.

Table 5. Ukraine: Distribution of Income and SSC Payments, 2014

	No. of Employees			Income (in UAH billions)			Average monthly income per person		Average monthly SSC per person		Annual SSC - total (in UAH billions)		
Income Class (UAH)	Private sector	Budgetary sector	Total	Private sector	Budgetary sector	Total	Private sector	Budgetary sector	Private sector	Budgetary sector	Private sector	Budgetary sector	Total
0 - 500	634,717	497,046	1,131,763	1.18	0.84	2.03	13	141	64	58	0.49	0.35	0.83
500 - 1,000	990,938	350,961	1,341,899	5.86	2.76	8.63	493	656	202	269	2.40	1.13	3.54
1,000 - 5,000	6,399,186	3,220,615	9,619,801	159.69	94.11	253.80	2,080	2,435	853	998	65.47	38.59	104.06
5,000 - 10,000	1,077,361	354,050	1,431,411	82.73	24.47	107.20	6,399	5,760	2,624	2,362	33.92	10.03	43.95
10,000 - 20,000	224,371	41,126	265,497	33.98	5.70	39.68	12,620	11,546	5,174	4,734	13.93	2.34	16.27
20,000 - 50,000	61,990	6,203	68,193	20.37	1.50	21.88	27,389	20,188	8,434	8,001	6.27	0.60	6.87
50,000 - 100,000	9,775	170	9,945	7.41	0.08	7.50	63,207	41,006	8,489	8,489	1.00	0.02	1.01
100,000 - 200,000	2,847	23	2,870	4.29	0.02	4.31	125,513	84,370	8,489	8,489	0.29	0.00	0.29
200,000 - 500,000	1,107	4	1,111	3.61	0.00	3.62	272,121	57,261	8,489	8,489	0.11	0.00	0.11
500,000 - 1,000,000	216	-	216	1.65	-	1.65	638,232	-	8,489	-	0.02	-	0.02
1,000,000 - 5,000,000	112	-	112	2.22	-	2.22	1,650,807	-	8,489	-	0.01	-	0.01
5,000,000 - 10,000,000	2	-	2	0.07	-	0.07	2,899,644	-	8,489	-	0.00	-	0.00
10,000,000 +	2	-	2	0.21	-	0.21	8,875,410	-	8,489	-	0.00	-	0.00
Total	9,402,625	4,470,197	13,872,822	323.29	129.50	452.79	-	-	-	-	123.92	53.05	176.97

Source: State Fiscal Services of Ukraine IMF FAD staff calculations.

54. **SSC rates were reduced by 60 percent in 2015, subject to conditions, and will be reduced unconditionally to 40 percent of the old rate in 2016.** Although the MoF has some partial data on taxpayers applying the beneficial SSC rate for the first half of 2105, it is not possible to establish employers' actual response in formalizing their payroll. It is therefore difficult to estimate the net aggregate revenue effect of the reduction in SSC for the whole year. The consequences of SSC reform in 2016 is easy to estimate, as there is no conditionality on

reducing rates: next year losses in SSC revenues (using 2014 figures) would be UAH 70.8 billion (4.5 percent of GDP), as shown in Table 6.[27]

55. **Reducing SSC lowers deductible labor cost for employers.** This in turn would increase taxable profits and thus mitigate to some extent the fall in payroll taxes. If this effect was entirely translated in higher CPT, the negative impact of SSC cuts for 2016 could be reduced to 3.9 percent of GDP, still a very significant impact to public finances. However, this offsets is unlikely to materialize fully because of large Advance Corporate Tax refund arrears and corporate loss-carry forwards.

56. **The need for compensating tax revenues could be reduced with alternative rate reduction scenarios.** Table 6 indicates revenue losses and fiscal compensation required at more moderate levels of SSC rate cuts (to 30 or 28 percent) and raising the cap to 25 MSW. Financing requirement in these cases would respectively be 2.9 percent and 3.5 percent of GDP.[28] Introducing a second SSC rate at 5 percent on individuals earning over UAH 30,000 per month generates an additional but small amount of additional SSC revenue.

Table 6. Ukraine: Revenue Impact of Changes to the SSC Rates, 2014

	Revenue Change	
	(1)	(2)
Changes to the SSC rates and cap	(in UAH billion)	(as % of GDP)
a. Reduce the SSC rate by 40%		
SSC Revenues (capped at 17 MSW)	-70.8	-4.5%
b. Reduce the SSC rate by 60%		
SSC Revenues (capped at 17 MSW)	-106.2	-6.8%
c. SSC rate at 30% and increase cap to 25 MSW	-46.0	-2.9%
d. SSC rate at 28% and increase cap to 25 MSW	-54.3	-3.5%
e. Additional rate of 5% on incomes over 30,000 UAH/month	1.4	0.1%

Revenue effects of merging the SSC and PIT system into a flat PIT

57. **A proposal combining the SSC with the PIT is under consideration at the Task Force for Tax Reform**. The key features of the proposal are: (1) replacement of the SSC, Military Tax and the PIT by a flat 29 percent PIT rate; (2) gross up of the wage bill by the amount of SSC and the Military Tax. The re-arrangement of the tax basis with the new rate would cost initially

[27] This estimate assumes an unchanged 17 MSW cap.

[28] When offsetting CPT revenues are taken into account, the financing requirements would be 2.6 percent and 3.0 percent of GDP respectively.

UAH 75.2 billion in tax revenues[29] (see Table 7). Supporters of this plan propose mitigating this initial impact by substantially increasing the tax burden on taxpayers that benefit today from the ST regime for small taxpayers, decreasing net wages of public employees and with an estimated increase in revenues from formalizing the underground economy.

58. **The proposal would also tax at a much higher rate the income of persons benefiting from the ST.** The plan would impose a 20 percent rate on gross income across the board to taxpayers in Groups 2 and 3, both to legal persons and individuals. According to MoF calculations (and roughly confirmed by the mission with SFS data) this would generate close to UAH 22 billion, reducing the short-fall from UAH75.2 to UAH53.1 billion (3.4 percent of GDP) (see Table 7).

59. **As proposed, taxation of small taxpayers would still be a distinct regime.** It would be a different regime than the CPT and the PIT, since individuals earning a salary would not have the benefit of the 'social tax deduction' or the lower 15 percent marginal PIT rate, and sole entrepreneurs and legal persons would not be allowed to deduct expenses. Under these assumptions the initial effect of combining the three taxes into a single flat 29 percent tax would be mitigated to a net UAH 53.1 billion revenue loss (Table 7).

Table 7.Ukraine: Revenue Effect of Merging the SSC and the PIT Systems with a Single PIT

		(in UAH billion)
1	**Revenue Change from Merging SSC with PIT**	
	Total PIT at 29%	167.3
	Current PIT Revenue forgone	-60.5
	Military tax forgone	-5
	SSC forgone	-177
	Net revenue change	**-75.2**
2	**Estimate of Revenue from Third Group of Single Taxpayers (Individuals)**	
	Total income	73
	Tax at 20%	14.6
	Forgone ST revenue	3.4
	Net revenue change	**11.2**
3	**Estimate of Revenue from Third Group of Single Taxpayers (Corporate)**	
	Total income	64.5
	Tax at 20%	12.9
	Forgone ST revenue	2
	Net revenue change	**10.9**
	Total Net Revenue Effect	**-53.1**

60. **Increased revenues from taxing ST taxpayers may be overestimated, however**. A 20 percent tax rate on turnover compares unfavorably to CPT (18 percent on net income), so it could be expected that these taxpayers would switch over. Legitimate individual sole proprietors

[29] All estimations are done as if applied in 2014.

could also deduct their expenses in the regular PIT regime and pay a lower rate too if their income is under than 10 MW, which is the case with over 60 percent of the individual taxpayers in Groups 2 and 3of the ST regime. Also, the increase in the tax burden on this group of individuals may lead many into the informal sector, eroding even further the gain in tax base assumed in the proposal.

61. **The proposal changes the distribution of the current combined tax burden of SSC and PIT.** Taxing a gross-up wage at 29 percent flat tax would have a progressive effect on the present system, which relies on high SSC rates on low income individuals. The new rate, as proposed, would increase the tax burden of high-income individuals who would no longer be protected by the cap on SSC. The opposite would occur with the lower income individuals, as they would be relieved of the full weight of SSC. As shown in Table 8, the breakpoint is UAH 50,000 per month. Individuals earning above this income level would stay in the old system. This alone represents an under-estimation of the proposal's effect on the public deficit of about UAH 0.5 billion. The progressivity of the proposal is also lost so long the new system is optional.

Table 8. Ukraine: Distributional Impact of a flat 29 percent PIT Rate, 2014

INCOME CATEGORY		Total number of taxpayers	Change in PIT	Additional PIT Revenue from	Change in Total PIT after Gross up with SSC	Military Tax	SSC	Net Change in Taxes	Change in Taxes as Share of Average
					(in UAH billion)				
0 -	500	1,131,763	0.59	0.16	0.75	0.02	0.83	(0.10)	(5.2)
501 -	1000	1,341,899	2.44	0.68	3.13	0.10	3.54	(0.50)	(5.8)
1001 -	5000	9,619,801	41.84	20.14	61.98	2.80	104.06	(44.88)	(17.7)
5001 -	10000	1,431,411	15.68	8.51	24.19	1.18	43.95	(20.95)	(19.5)
10001 -	20000	265,497	5.64	3.15	8.79	0.44	16.27	(7.91)	(19.9)
20001 -	50000	68,193	2.63	1.74	4.37	0.24	6.87	(2.74)	(12.5)
50001 -	100000	9,945	0.80	0.59	1.40	0.08	1.01	0.30	4.0
100001 -	200000	2,870	0.44	0.34	0.78	0.05	0.29	0.44	10.3
200001 -	500000	1,111	0.36	0.29	0.65	0.04	0.11	0.49	13.6
500001 -	1000000	216	0.16	0.13	0.29	0.02	0.02	0.25	15.3
1000001 -	5000000	112	0.22	0.18	0.39	0.02	0.01	0.36	16.1
5000001 -	10000000	2	0.01	0.01	0.01	0.00	0.00	0.01	16.3
10000001 -	+	2	0.02	0.02	0.04	0.00	0.00	0.04	16.5
Total		13,872,822	70.83	35.93	106.76	5.00	176.97	(75.21)	(16.6)

Source: IMF FAD staff calculations.

62. **The revenue shortfall would be remedied by government payroll savings and attracting people to the formal sector**. A key feature of the proposal is that it envisages very significant savings in net government expenditure. Savings would come from a drastic reduction in the net payment to all public employees because government employees would not get their wages grossed up with the elimination of SSC, but they would still have to pay a 29 percent PIT rate. For them the PIT tax burden almost doubles, with no increase in wages. The rest of the change in tax bases is a wash for the government. Of course, the new system would have to be compulsory for them in order to obtain such savings. The mission cannot estimate how much tax revenues could increase from a shift of informal activities into a legal sector with a lesser tax burden. It was argued above that empirical evidence in this regard is mixed and results quite uncertain.

I. Other tax measures to compensate SSC reform

63. **Reductions of the SSC rate within the existing tax structure could be explored.** Previous FAD tax policy reports have suggested that a gradual reduction in SSC rate can be a way forward if reliable revenue sources can be found to compensate for it. The tax system would be less stressed if compensation would be limited, at least initially, to a reduction of SSC rates to 30 or 28 percent while increasing the cap significantly, for example to 25 MSW. Combining a SSC rate cut to 28 percent with such a cap would result in a revenue shortage of 3.5 percent of GDP, assuming no CPT offset due to lower SSC deduction by employers.

64. **There could be sufficient fiscal space in indirect taxation and other components of the income tax to allow for a reduction in SSC rates.** However, reforming the ST regime in particular has to be an integral part of this change in order to stop the erosion of the system though the self-employed. This is discussed in detail in Chapter III. Below we discuss different scenarios that may be considered to produce a revenue neutral tax package including a reduction in SSC rates.

VAT measures

65. **The first choice for financing the revenue shortfall in SSC rate reduction by indirect taxation.** These are the least distorting and more growth friendly taxes.[30] Increasing the general VAT rate by one percentage point, for example, would generate about UAH 7 billion (0.4 percent of GDP). Increasing the preferential rate applied to pharmaceuticals (currently 7 percent) to the new general rate of 21 percent (comparable to neighboring countries) would increase revenues by about UAH 20.1 billion (1.3 percent of GDP).[31] Additionally, if the government succeeds in eliminating the special VAT regime for the agriculture industry, a conservative estimate is that an additional 0.3 percent of GDP can be collected.[32] Thus, VAT alone could provide a fiscal space of close to 2 percent of GDP.

Excise tax rate increases

66. **Other than the excise on petroleum products, excise rates are relatively low.** Detailed recommendations on increasing the excise revenues are described in Chapter IV. Therefore, these measures are not discussed here. Based on the recommendations in Chapter IV it is possible to increase tax revenues by 0.6 percent of GDP in 2016 (see Table 22 in Chapter IV).

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[30] See IMF, *Fiscal Policy and Long-Term Growth*, June 2015.

[31] Estimate is for 2014.

[32] Government of Ukraine, “Memorandum of Economic and Financial Policies, July 2015.

Income taxes

Introduce a new PIT rate and bracket structure

67. **There is less room to increase revenues from income taxes.** Introducing a third bracket and a new marginal rate would improve the progressivity of the PIT system and raise some additional revenue. For example, a 25 percent rate applied to an income bracket above UAH 15,000, estimating only on the basis of wage income, would generate tax revenues around UAH 3.5 billion, or 0.2 percent of GDP (Table 9). However, the estimate is based on wage income only, which is more concentrated in the lower income brackets.[33]

68. **Additional revenues can be expected from including the de facto employees into the PIT who are now in the ST regime as sole proprietors**. It is difficult to estimate this effect because it is not known how many individuals in this group are in fact employees. In the extreme, where all individuals under this regime are considered employees, the 2014 income that would be shifted into PIT would amount to UAH 225.5 billion. At the average effective PIT rate of 13.4 percent this would yield an increase of UAH 32.6 billion in revenues. A more prudent estimate would assume no more than one half of that amount. This is a potential buffer to a SSC tax reform, but is intentionally not included in the set of possible compensating measures listed in Table 10.

Table 9. Ukraine: Revenue Impact of a Change in PIT Structure, 2014

INCOME CATEGORY		Total number of taxpayers	Change in Total Tax: Total Taxpayers (in UAH billion)	Share of Change in Tax Liability (%)	% Change in Tax Liability	Change in Average Tax Rate	Average Effective Tax Rate - Current Law	Average Effective Tax Rate - Proposal
0 -	500	1,131,763	-	-	-	-	-	-
501 -	1000	1,341,899	-	-	-	-	0.67	0.67
1001 -	5000	9,619,801	-	-	-	-	12.52	12.52
5001 -	10000	1,431,411	0.89	25.4	5.75	0.83	14.37	15.20
10001 -	20000	265,497	1.00	28.5	16.98	2.51	14.78	17.28
20001 -	50000	68,193	0.73	21.0	19.74	3.35	16.97	20.32
50001 -	100000	9,945	0.31	9.0	22.92	4.20	18.31	22.50
100001 -	200000	2,870	0.19	5.6	23.99	4.51	18.79	23.30
200001 -	500000	1,111	0.17	4.8	24.54	4.68	19.06	23.73
500001 -	1000000	216	0.08	2.3	24.81	4.76	19.18	23.94
1000001 -	5000000	112	0.11	3.0	24.92	4.80	19.24	24.04
5000001 -	10000000	2	0.00	0.1	24.96	4.81	19.26	24.07
10000001 -	+	2	0.01	0.3	24.99	4.82	19.27	24.09
	Total	13,872,822	3.49				13.36	14.13

Source: SFS of Ukraine data IMF FAD staff estimations.

CPT measures

69. **Revenue yield of CPT in Ukraine has been declining.** This is discussed in Chapter V, which recommends a number of measures to tighten up the base of the tax. If these measures accompany an increase in the tax rate from 18 percent to 20 percent, revenues could be

[33] Using 2014 taxpayer data. Disaggregated non-wage data was not provided to mission by income brackets

increased by around 0.3 percent of GDP. Moreover, to the extent that there are companies with no tax arrears or losses to carry forward, as explained before, SSC reduction will increase CPT revenues. However, this effect is not estimated.

Property taxes

70. The March 2015 FAD tax policy report demonstrated that there is scope to increase property taxation.[34] This includes reducing exemptions in residential properties and motor vehicles. A circulation tax on luxury cars was introduced in 2014 at a rate UAH 25,000 per year, but it is applied to a small promotion of luxury cars. This can expand in line to what was recommended in that report.

Summary of measures

71. **A summary tax revenue enhancing measures are provided in Table 10.** The estimates are intended to provide possible revenue options in indirect taxes and profits taxation in order to compensate for the revenue losses from reducing the SSC. These estimates do not include revenues from rolling back the informal economy, from decreasing the net wages of the public sector or from incorporating individuals and legal persons from the ST regime to income tax regime. This shows that there is room for lowering SSC without taking unnecessary risks for the budget. The preferred menu of measures would emphasize indirect and property taxation.

Table 10. Ukraine: Summary Revenue Effects of Tax Measures

	Revenue impact	
	w/o CPT offset	as % of GDP
SSC rate 28 percent and cap is 25 MSW	-54.3	-3.5
Compensatory measures		
PIT 3 rates	3.5	0.2
VAT rate increase on medicine	13.2	0.8
Excises	9.9	0.6
STS reform		
PIT	12.0 - 17.0	0.8 - 1.1
SSC	18.7 - 26.3	1.2 - 1.7
CPT rate from 18% to 20%	4.4	0.3
VAT rate increase form 20% to 21%	7.0	0.4
Eliminate special VAT regime for agriculture	4.7	0.3
Total Compensatory measures	73.4 - 81.0	4.7 - 5.2
Net Revenue Effect	19.1- 26.7	1.2 - 1.7

Source: IMF FAD staff calculations.

Recommendations

- Do not reduce SSC rate below 28 percent and increase the cap to 25 MSW.

[34] Schatan, R., Grote, M., and Caner, S., (2015), "Restoring a Strategic Approach to Tax Reform," IMF.

- Compensate reduction in SSC with a combination of the following measures:
    - Increase the VAT rate from 20 percent to 21 percent.
    - Eliminate the preferential VAT rate on pharmaceuticals.
    - Eliminate special regime for agriculture.
    - Increase excise tax rates as recommended in Chapter IV.
    - Increase the CPT rate from 18 percent to 20 percent.
    - Introduce a third PIT rate of 25 percent on incomes over UAH 15,000.
    - Eliminate concessional features of the ST regime as described in Chapter III.

III. SIMPLIFIED TAXATION REGIMES FOR SMALL TAXPAYERS

General design objectives of a simplified tax system

72. **Most countries have special income tax and VAT schemes for small taxpayers.** These schemes have two main—but related—objectives: (i) to reduce the cost of compliance for small taxpayers,[35] and (ii) to allow tax authorities to concentrate on monitoring large and medium size enterprises. Small businesses are very heterogeneous across countries, so it is impossible to identify a single best practice model regime for all cases. Heterogeneity also exists within the same country, ranging from the subsistence economy, artisans and vendors, to small companies. Defining the ceiling below which entities are deemed 'small' for the purpose of these schemes varies, but generally it is a modest amount of turnover—which is generally considered to be the easiest proxy for size and/or capacity to comply with the tax system.

73. **The objective of a simplified tax system is simplification, not to reduce the tax burden of small taxpayers.[36]** If taxpayers in the simplified tax system enjoy a substantially lower tax burden than those in the general tax regime, small taxpayers are not encouraged to transit to

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[35] When measured against sales or assets, compliance costs for small VAT taxpayers are significantly higher than for large and medium size businesses; see, for instance: OECD, *Survey on the taxation of small and medium-sized enterprises – Draft report on responses to the questionnaire* (2007); available online here: www.oecd.org/tax/tax-policy/39597756.pdf.

[36] *Taxation of small and medium enterprises* (2007), Background paper prepared by IMF staff for International Tax Dialogue (ITD) Conference in Buenos Aires (October 2007), available online here: http://www.itdweb.org/SME_Argentina_Oct_2007.zip; see also, ITD, *A decade of sharing experiences and knowledge – Key issues and debates in VAT, SME taxation and the tax treatment of the financial sector* (2012), available online here: www.oecd.org/tax/tax.../ITD-publication-decade-sharing-experiences.pdf.

the general system. A lower tax burden also confers a competitive advantage compared to those businesses operating above the threshold. This can have very distortive effects, as taxpayers will have an incentive to manipulate their affairs to qualify for the lower tax burden, including by splitting up into several businesses that are ultimately controlled by the same person. Furthermore, the transition to the general system should be as smooth as possible so as not to involve steep increases in the total tax burden. Finally, a simplified tax system also facilitates voluntary compliance and could therefore help to reduce informality, but it is not the only tool to do so.

74. **Simplified systems should only apply to genuinely small taxpayers**. The aim of these systems is to facilitate compliance of small businesses that lack the capacity to comply with all administrative and bookkeeping requirements that are mandatory for larger taxpayers. For this reason, most countries exclude from the simplified system legal entities, companies with more than a certain limited number—say five—employees, and entities engaged in certain activities such as financial intermediation, international trade (exporters and/or importers), or the production or provision of excisable goods or services. It may reasonably be presumed that such businesses are capable of keeping proper tax records and apply the general tax system.

75. **A key consideration when designing a simplified system is to set a reasonable threshold.** Three effects should be considered when setting the VAT registration threshold:[37] increasing the VAT threshold (i) reduces administrative and compliance costs (effect 1), (ii) reduces tax collection (effect 2), and (iii) may affect efficiency to the extent that those outside the VAT net are conferred a tax benefit (effect 3). Thus, while a relatively high VAT threshold that leaves too many taxpayers outside the VAT system may facilitate control, it may come at a high cost in revenue and efficiency. On the other hand, a very low threshold might be efficient but will be very difficult to control in practice and impose an undue burden on the smallest businesses. The considerations for setting an appropriate ceiling for a simplified tax system are similar in these respects to those for setting the VAT threshold. Therefore—and also because this further simplifies the tax system as a whole—there are good arguments for setting the upper ceiling for the application of the simplified tax system at the same turnover level as the VAT threshold.

Current situation

76. **Ukraine has effectively four different simplified tax regimes.** Collectively these regimes are referred to as the Single Tax ("ST").[38] This terminology is somewhat misleading because between, and sometimes within, each of these regimes or "Groups" the applicable tax

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[37] M. Keen and J. Mintz, "The optimal threshold for a value-added tax", *Journal of Public Economics* 88 (2004), pp. 550 – 576.

[38] Chapter 1 of Part XIV of the Tax Code of Ukraine, Articles 291 et seq. All references hereafter are to the Tax Code of Ukraine, unless indicated otherwise.

rates and bases vary, depending on the circumstances specific to the regime in question. The remainder of this section focuses on Groups 1 through 3. Group 4 consists of the farmers qualifying for a flat rate of tax based on land area—the former Fixed Agricultural Tax (FAT), which was discussed in detail in a previous FAD report.[39]

77. **About 1.3 million taxpayers are currently registered for ST of which 1.14 million are individuals.** The distribution of ST taxpayers and their tax liabilities are shown in Table 11. With more than 631,000 individuals Group 2 is by far the largest, followed by Group 3 (more than 274,000 individuals and almost 161,800 legal entities) and Group 1 (more than 234,200 individuals).

Table 11. Ukraine: The ST Regime Taxpayers' Income and Taxes, 2014

		Number of taxpayers	Total turnover / income (000)	Taxes paid on turnover / income (000)	VAT paid	Effective tax rate (%)
PIT (Personal Income Tax)		13,872,822	452,791,130,302	60,478,344,258		13.36
Single tax		1,301,155	437,599,795	6,904,371		
Individuals		1,139,399	234,515,768	4,968,875		2.12
	Group 1	234,204	9,052,517	260,018	-	2.87
	Group 2	631,046	152,026,724	1,529,937	-	1.01
	Group 3	274,149	-	3,178,920	245,543	4.38
Corporates		161,756	42,004,786	1,935,497	825,902	4.61

Source: STS of Ukraine and IMF FAD calculations.

Features of ST system common to all groups

78. **The ST regime has a range of common features common to all (or most) groups.** These include that ST taxpayers:

- May *choose* either for the normal (PIT, CPT, and in some cases VAT) tax regime or for the ST regime, and within the ST regime if they meet the criteria for more than one group they may choose for which Group to register (Article 291.3 TC);

- Are *excluded from engaging in specified activities*, including gambling and lotteries; foreign exchange; manufacture and dealing in excisable goods; manufacture and dealing in precious metals and stones (except jewelry and household items); activities in the area of mineral resources; financial intermediation (except insurance agency) and other financial and insurance services; company management services; technical testing,

[39] IMF, *Restoring a Strategic Approach to Tax Reform*, March 2105.

analysis and auditing services; leasing of real estate (land, accommodation and non-residential property) (Article 295.1 TC);

- May keep the following *simplified books and accounts*:
  - Sales registers for taxpayers of Groups 1 and 2, and individuals who are not VAT taxpayers of Group 3;
  - Income and expense statements for individual taxpayers of Group 3 who are VAT taxpayers; and
  - Simplified double-entry accounts for all legal persons of Group 3 (Articles 44.2 and 296.1 TC);
- Generally have *longer reporting* (yearly reporting for Groups 1, 2 and 4 and quarterly for Group 3) *and payment cycles* (monthly for Groups 1 and 2 and quarterly for Groups 3 and 4) than taxpayers under the normal tax regime (Articles 294 and 295 TC);
- Only pay 34.7% SSC *on the MSW* except for legal entities of Group 3;[40] and
- Are *exempt* from CPT, PIT, VAT (except for Group 3 taxpayers who choose to pay the lower 2% ST rate; see below), property tax and rental fee for water usage (Group 4 taxpayers) (Article 297.1 TC).

Group 1 (more than 234,200 individuals)

79. **Group 1 is for individual entrepreneurs with turnover of not more than UAH 300,000.** Entrepreneurs in this Group are not allowed to hire employees and must be engaged exclusively in retail trade, i.e. selling goods on market places or providing consumer services (Article 291.4, item (1) TC; A *non-exhaustive* list of consumer services is in Article 291.7). They are subject to a fixed rate of tax of up to 10% of the MSW for the income year (Article 293.2, item (1)).[41]

Group 2 (more than 631,000 individuals)

80. **Group 2 is for individual entrepreneurs with turnover of not more than UAH 1,500,000 and not more than 10 employees.** Entrepreneurs in this Group may provide consumer services as well as services to other ST taxpayers, be engaged in the production and/or

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[40] Article 7(1)(3) of Law of Ukraine "On the Collection and Accounting of the Unified Contribution to Universal Compulsory State Social Insurance" (No. 2755-VI, dated December 2, 2010).

[41] The rate is set by the municipality.

sale of goods, and provide restaurant services (Article 291.4, item (2) TC). They are subject to a fixed rate of tax of up to 20% of the MSW for the income year (Article 293.2, item (2) TC).[42]

Group 3 (more than 435,800 of which more than 274,000 individuals)

81. **Group 3 is for individual entrepreneurs or legal entities with turnover of not more than UAH 20 million.** There is no limit to the number of employees that entrepreneurs or entities in this Group may hire, nor to the type of activities that they may carry out (other than the activities generally excluded from the ST regime; see above) (Article 291.4, item (3) TC). Taxpayers in Group 3 pay a proportionate tax rate of either 2% or 4% on their turnover, depending on whether or not they are registered for and pay VAT (Article 293.3 TC).

Analysis

The current regime remains overly complex and excessively concessional

82. **While the December 2014 tax reform reduced the number of ST groups from six to four, this reform amounted to simplification in name only.** First, rate and base variations remain between and within groups of ST taxpayers. Secondly, the aggregate number of ST taxpayers has remained constant,[43] albeit that they are now classified into four instead of six groups—with former Groups 3, 4, 5 and 6 taxpayers now classified in the new Group 3, broadened to include both individuals and legal entities. Thirdly, the criteria for a taxpayer to qualify for a ST regime continue to be—depending on the circumstances—a combination of the taxpayer's legal status, turnover, number of employees, and type of activities. Finally, the same taxpayer may meet the criteria for more than one ST regime, allowing it to opt for the most favorable regime on the basis of its particular circumstances.

83. **In addition to remaining overly complex, the ST regime is excessively concessional.** Group 1 and 2 taxpayers—whose income or turnover may be as high as UAH 1.5 million—only pay a minimal flat rate of tax and SSC unrelated to their turnover or income. Group 3 taxpayers—whose income or turnover may be as high as UAH 20 million—also pay low—albeit proportionate—rates of tax, and individuals in that Group enjoy a flat rate of SSC. Consequently, as shown in Table 11, effective ST tax rates for both individuals and legal entities are extremely low. For instance, based on 2014 figures, individual taxpayers of Group 2 enjoy an effective tax rate that is thirteen times lower than the average PIT rate.

84. **The ST regime offers ample opportunities for tax planning and arbitrage.** Not only is the ST in and of itself an overly generous tax regime, in particular at the higher end of the income/turnover bands, the regime also offers ample opportunities for taxpayers to abuse the

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[42] The rate is set by the municipality.

[43] In fact, the total number of ST payers has *increased* because the payers of the Fixed Agricultural Tax (FAT)—which used to be regulated by Chapter 2 of Part XIV of the Tax Code—now make up Group 4 of the ST.

system even further. While taxpayers undoubtedly use many other mechanisms and schemes to exploit the ST, the most obvious ones include:

- *Business splitting*. While this is a common problem for all turnover-based tax concessions—including for the VAT threshold—the incentives for business splitting to enjoy ST tax concessions are particularly important. This is because ST replaces, in most cases, both CPT/PIT (depending on legal status of the person) and VAT, and allows entrepreneurs to pay a nominal amount of SSC. The SFS currently has no specific powers under the Tax Code to combat this type of avoidance which, at least from anecdotal evidence, is pervasive. The only existing limit is on direct ownership of ST payers by legal entities which are not themselves ST payers,[44] but there is no such limit on ownership by individuals nor are there any rules on aggregating activities of closely related individuals (spouses, family members). The main purpose of business splitting is to avoid exceeding the income or turnover limits of a particular ST group. It can also be used to subdivide activities within one business in order to maximize the tax advantage. For instance, it is not uncommon for restaurants—which, depending on turnover, qualify for Group 2 to pay a flat rate of tax—to split off the business of selling alcoholic beverages, an activity that is excluded from the ST and for which standard PIT (or, in the case of a Group 3 legal entity, CPT) rates apply. Restaurant clients are then given two receipts, one for their meal and one for the alcoholic drinks, formally issued by two different but obviously related entities.

- *Profit shifting between related parties*. Ukraine's newly adopted transfer pricing rules do not apply to transactions between resident entities or persons.[45] In combination with the business splitting opportunities described above this situation creates opportunities for related parties—one subject to the general tax system and the other to the ST—to engage in transactions designed to shift income from the latter to the former. In the absence of specific or general anti-avoidance rules in the Tax Code these practices are difficult if not impossible to combat effectively.

- *Reclassifying as entrepreneurs.* Given the important difference between effective SSC rates for employees (or persons providing services under civil law contracts) versus individuals performing services as entrepreneur under a ST regime—for whom the SSC is calculated on the MSW opposed to actual wages—there is an important incentive for employees to organize themselves as ST entrepreneurs of Group 2 or 3 (depending on

[44] Article 291.5.5. This restriction does not prevent tax planning schemes, for instance, where a legal entity that is not a ST payer fully controls one or more subsidiaries indirectly through a wholly owned intermediate entity that qualifies for ST.

[45] Article 39 of the Tax Code, as introduced by of Law of Ukraine "On Amendments to the Tax Code of Ukraine to Improve Tax Control of Transfer Pricing" (No 72-VIII, dated 28 December 2014).

income/turnover and the legal status of their 'employer'/client). Anecdotal evidence suggests that this is a pervasive practice especially in high-paying service sectors. In the IT sector, for instance, approximately 75,000 engineers are now working as independent contractors—representing salaries of UAH 150 million per month or UAH 1.8 billion per year—according to sector representatives.

- *Circumventing other classification provisions.* As mentioned above, the Tax Code provisions that define the criteria to qualify for—or be excluded from—the ST regime are often complex and imprecise, resulting in opportunities for arbitrage. Just one example out of many: leasing of real property is an excluded activity, but only if the activity is carried out by individuals. Hence, it is sufficient for a taxpayer to incorporate to enjoy a 2 or 4 percent tax on up to UAH 20 million of leasing income, instead of paying standard CPT/PIT rates.

Design considerations for reforming the STS

85. **ST reform should be informed by the objectives of a properly designed small business tax regime.** To avoid many of the problems that the tax system is facing today with taxpayers rearranging their affairs to take advantage of the overly generous ST system, the focus should be on simplification rather than on tax incentives. As explained above, the case for simplification—and perhaps some tax concessions—is greatest for the smallest taxpayers ("micro businesses"). Beyond this group there may still be a case for simplification but—importantly—not for significant tax benefits. Furthermore, the simplified tax system for this second group should be as closely aligned as possible with the normal tax regime so as to ensure a smooth transition to the normal regime.

86. **Partitioning taxpayers into different regimes is best done on the basis of turnover or gross income alone.** While not without its shortcomings,[46] on balance, turnover or gross profit is the easiest and most straightforward basis for vertically classifying taxpayers into different regimes. It also allows to align the small business regime with the VAT regime. On the other hand, number of employees as a criterion should be avoided, as this may create adverse incentives towards informality or to reclassify employees as independent entrepreneurs.[47]

[46] At least conceptually, turnover or gross income are not necessarily close proxies for taxpayer size and/or capacity to pay. On the other hand, total value of assets, for instance—a criterion that some countries use, sometimes in combination with other criteria, to define small business—is also not without its shortcomings, as such values vary widely between business sectors and professions and are not easily verified for taxpayers who hold only very simple business records such as sales and purchase records.

[47] It may be appropriate to continue to prohibit the smallest taxpayers from hiring employees—see hereafter.

87. **VAT taxpayers should no longer qualify for the reformed simplified regime.** The main argument for this is that VAT taxpayers—because of their bookkeeping and filing requirements for VAT—can be presumed to have sufficient capacity to deal with the normal tax system.[48] Of course, this presupposes that the VAT threshold is set at an appropriate level. The existing VAT threshold of UAH 1 million (approximately USD 47,500)—raised from UAH 300,000 (approximately USD 14,200) in January 2015—is broadly in line with that of many countries, slightly below the average for selected developed countries but higher than the average for selected emerging economies (see Table 12). In addition to adjusting it for inflation, and considering the tax increases stemming from the proposed imposition of normal PIT and SSC rates on entrepreneurs above the threshold for the smallest taxpayers, consideration could be given to raising the VAT threshold somewhat further, say to UAH 2 million.[49] This would allow the vast majority of current Group 2 and 3 ST taxpayers—more than 99% of Group 2 and more than 95% of Group 3 taxpayers—to remain outside the VAT system[50] (see Table 14).

Table 12. VAT registration thresholds (selected countries)

	Threshold			
Country	Local Currency 2014	US$ 2015	US$ 2014	Observations
Ukraine	300,000	46,186	25,019	1,000,000 in 2015
Developed Countries				
Denmark	50,000	7,580	8,896	
France	82,200	93,054	109,255	
Germany	50,000	56,602	66,457	
United Kingdom	80,000	123,211	131,783	
Ireland	41,000	46,414	54,495	
Israel	79,482	21,337	22,215	
New Zealand	60,000	46,359	49,855	
Sweden	30,000	3,608	4,377	
Simple average		49,771	55,917	
Emerging Economies				
Argentina - Services	50,000	5,592	6,154	
Argentina - Goods	75,000	8,387	9,231	
Belarus				No registration threshold
Czech Rep	1,000,000	40,919	48,204	
Georgia	100,000	44,865	56,655	
Hungary	5,000,000	18,833	21,496	
Latvia	35,000	39,622	46,520	
Mexico	160,000	10,905	12,037	
Moldova	600,000	31,074	42,748	
Poland	150,000	41,176	47,542	
Romania	35,000	9,399	10,453	
Slovak Rep	49,790	56,365	66,178	
Simple average		27,922	33,383	

Source: Prepared by staff with data from WEO and IBFD.

[48] See *Taxation of small and medium enterprises* (2007), p. 25.

[49] VAT paid in 2014 by the taxpayers in Group 3 in the income bracket between UAH 1 and 3 million amounted to UAH 110.4 million, less than 0.1 percent of total VAT revenue.

[50] Of course, taxpayers would continue to be entitled to voluntarily register for VAT under the normal rules (Article 181 of the Tax Code) in the same way as Group 3 taxpayers can currently do, but doing so would henceforth disqualify them from the small business regime. Raising VAT threshold should be conditional to STS reform. The assumption is that not many VAT tax payers below UAH 2 million do not belong to Group 3 and would not voluntarily register for VAT if they came to be under the proposed threshold.

88. **Similarly, legal entities should be excluded from the reformed simplified regime.** The most common practice is for countries not to extend their simplified tax regime to legal entities.[51] The rationale for relieving taxpayers from disproportionate compliance burdens—particularly bookkeeping requirements—usually does not apply to legal entities which are typically required to keep double-entry accounts under general company and accounting law, as is the case in Ukraine. Finally, excluding legal entities streamlines the simplified regime as no special rules are needed to deal with specific issues for legal entities (e.g. with respect to mergers, acquisitions and dividend distributions).

89. **Except for the smallest taxpayers normal SSC rates should apply to entrepreneurs and their employees.** A major incentive of the current ST regime is to avoid proportional SSC rates by reclassifying as individual entrepreneur. To eliminate this incentive individual entrepreneurs qualifying for the reformed simplified regime should be subject to normal proportional SSC on their business income, and should be required to withhold SSC and PIT at the normal rates on wages paid to their employees. Micro businesses (current Group 1) could continue to be subject to nominal SSC in lieu of the proportionate rate, in which case it would be advisable to continue to prohibit them from hiring employees.

90. **But for a narrow list of excluded activities, taxpayers in the reformed simplified regime should be allowed to engage in any economic activity.** In a simplified regime redesigned along the lines described here there is no reason to define the economic activities qualifying taxpayers are allowed to engage in too narrowly. In particular, taxpayers in the reformed simplified regime should be allowed to deal with all customers irrespective of their legal and tax status. While it might make sense to continue to exclude certain activities from the reformed simplified regimes, these exclusions should be limited, well-defined and only apply to activities which are already subject to special (tax or non-tax) rules such as financial intermediation, lottery and gambling, mineral resource extraction and manufacturing of excisable goods.[52] Reducing such limitations and restrictions would simplify the regime and reduce opportunities for arbitrage and potential disputes between taxpayers and the tax service. For micro businesses (current Group 1) the existing limitations should be maintained given the concessional nature of their tax and SSC treatment.

91. **Imposing PIT on entrepreneurs of Groups 2 and 3 on a cash flow basis is superior to a flat tax on turnover.** The advantage of taxing on a cash flow basis is that businesses can immediately deduct capital expenses. Pure investments—both income and expenses—would not be taken into account. This means that, as is the case under the current ST regime, interest and

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[51] See *Taxation of small and medium enterprises* (2007), p. 25 – 29.

[52] However, the current exclusions for certain technical, professional and management services, leasing of real property and retail sales of excisable goods (but not as manufacturer or wholesaler who is liable for excise tax) could be eliminated.

dividend income would be subject to normal withholding tax, while financial expenses such as interest would not be deductible. Similarly, it would be advisable to exclude deductions for real property to further simplify the system and prevent abuse—see Table 13. Another advantage of taxing entrepreneurs at regular PIT rates on a cash basis is that it more closely approximates their tax burden under the regular system. It thus allows for a smoother transition to the normal regime and reduces the tax (and SSC) incentive for taxpayers to 'hide' in the simplified regime. Finally, it requires only moderate sophistication in record keeping—sales and purchase records should suffice—which would not be a disproportionate burden for current Group 2 and 3 taxpayers.

Table 13. Comparison between normal GAAP and proposed cash flow taxation

	GAAP	Cash flow
Type of transaction or event	Accruals basis: profit is based on sales made and expenses incurred, not on "cash in and cash out"	Cash basis: income and expenses recognized on "cash in cash out" basis; capital items (except real property) immediately expensed
Income	Sales, whether or not money is received	Sales for which money is received
Work in progress	Relevant amount included in sales	Ignored
Expenses	Expenses incurred deducted from income, whether or not paid	Deducted from income only when paid
Accruals	Expenses related to accounting period included, even where invoices not yet received	Ignored
Prepayments	Only proportion relating to accounting period deducted	Deducted from income when paid
Stock	Deducted from income when sold or used, even if not yet paid	Deducted from income when paid
Capital expenditure (e.g. office furniture)	Deprecation allowance deductible	Fully deducted when paid; asset sale taxed on receipt of payment
Entertainment expenses	Not deductible	Not deductible
Mixed use assets	Only costs relating to business use are deductible	Only costs relating to business use are deductible
Business loan repayments	Interest element is allowable expense, capital repayment is not	No deductions

Source: Adapted from UK Office of Tax Simplification, 2012.

Revenue implications

92. **Reforming the ST system along these lines could raise significant additional income tax revenue**. In addition, it would establish horizontal equity between employees and entrepreneurs in terms of their tax burdens. Imposing general PIT rates on individual taxpayers of Groups 2 and 3 has a revenue potential of UAH 32.6 billion (2.3 percent of GDP – see Table 14).[53] Given that under the proposed regime entrepreneurs will be allowed to deduct their business

[53] The revenue gain estimates shown in Table 14 use data on turnover and taxes paid by individual ST taxpayers in 2014.

expenses on a cash flow basis, the revenue gain will be less than this amount.[54] Assuming that half of the affected taxpayer population (Groups 2 and 3) is or could convert into a legitimate independent entrepreneur and could obtain a 50 percent profit margin[55], the expected revenue gain would be UAH 24.3 billion (1.6 percent of GDP). However, critically, those affected with a higher tax burden (Groups 2 and 3) could move into the informal economy. If they behave just as the average does, anywhere between 30 and 50 percent of income would be informal and remain untaxed. Potential revenues, more realistically viewed, could range therefore more likely between UAH12 and 17 billion. It is assumed, conservatively, that legal persons moved into the general regime would not pay more taxes as they do now.

Table 14. Ukraine: Revenue Estimates of Moving Individuals from Single Tax Regime to PIT, 2014

INCOME CATEGORY (000)		Number of taxpayers	Total turnover / income	Single tax paid, UAH	PIT Tax Liability	Change in Tax Liability
Group 2						
				(in UAH billions)		
0 -	150	361,385	69.04	0.69	10.67	9.98
150 -	1000	268,325	78.56	0.79	13.19	12.39
1000 -	3000	1,298	4.13	0.04	0.79	0.75
3,000 -	5000	38	0.29	0.00	0.06	0.05
5000 -	20000	-	-	-	-	-
	Total	631,046	152.03	1.53	24.70	23.17
Group 3						
INCOME CATEGORY (000)		Number of taxpayers	Total turnover / income	Single tax paid, UAH	PIT Tax Liability	Change in Tax Liability
				(in UAH billions)		
0 -	150	171,973	11.44	0.48	1.61	1.13
150 -	1000	88,678	36.62	1.55	6.23	4.68
1000 -	3000	12,790	23.48	0.99	4.32	3.32
3000 -	5000	261	0.97	0.04	0.18	0.14
5000 -	20000	93	0.92	0.04	0.17	0.13
	Total	273,795	73.44	3.11	12.51	9.40
Total (Group 2 and 3)		904,841	225.46	4.64	37.21	32.57

Source: SFS data and IMF FAD staff estimations.

[54] The estimates are for Group 2 and 3 taxpayers who are not incorporated. Many taxpayers in Groups 2 and 3 would be service providers (in particular employees who reclassified as entrepreneurs) whose turnover is mostly income. Others would have more business related expenses.

[55] Percentage is introduced for illustrative purposes, since the mission did not have a good estimate for this profit margin; in the U.S. profit margins of small business owners range from 2 percent to nearly 30 percent, depending on the industry sector, all in the formal economy. Source: Scott Shane, *How much money do small business owners make?* http://smallbiztrends.com/2010/11/how-much-money-do-small-business-owners-make,htlm. Presumably businesses in the informal sector in Ukraine face much higher risks and may have higher expected returns.

93. **In addition to paying general PIT rates Group 2 and 3 entrepreneurs would also pay regular SSC.** Currently these taxpayers pay a flat SSC of UAH 422.6 per month. Under the proposed regime in Chapter II of this Report their aggregate SSC payments would increase from UAH 5 billion to UAH 55 billion—an increase representing 3.2 percent of GDP. As shown in Table 15, most of the additional SSC revenue would be generated from taxpayers with an annual turnover or gross income under UAH 1 million. However, this is not a realistic expectation: not all individuals in these groups are employees and many will move fully or partially into the informal economy, or may seek to reclassify under Group 1, as there is a considerable overlap in income levels between groups.[56] Applying the same assumptions used in the estimation of PIT revenue gains of ST taxpayers, i.e., one half remain as entrepreneurs with a 50 percent profitability rate, the potential SSC that could be raised from individuals currently under Groups 2 and 3 of the Single Tax regime, would be between UAH 18.7 and 26.3 billion (1.2 to 1.7percent of GDP). And these amounts may prove difficult to collect due to administrative difficulties in taxing this segment of the population.

Table 15. Estimated Social Security Contributions of Single Tax Groups 2 and 3 Taxpayers, 2014

Annual Income	Number of Taxpayers		Income	Estimated SSC Revenues under new Regime				Current SSC Revenues			Change in
(000)	Group 2	Group 3	Group 2	Group 3	Group 2	Group 3	Total	Group 2	Group 3	Total	SSC
						(in billions of UAH)					
0 to 150	361,385	171,973	69.0	11.4	19.3	3.2	22.5	2.0	0.9	2.9	19.6
150 to 300	92,772	39,137	12.1	9.1	3.4	2.3	5.6	0.2	0.1	0.3	5.3
300 to 1,000	175,553	49,541	78.6	36.6	18.6	6.8	25.4	1.2	0.4	1.6	23.8
1,000 to 3,000	1,298	12,790	4.1	23.5	0.1	1.3	1.4	0.0	0.1	0.1	1.4
3,000 to 5,000	38	261	0.3	1.0	-	-	-	-	-	-	-
5,000 to 20,000	-	93	-	0.9	-	-	-	-	-	-	-
Total	631,046	273,795	152.0	73.4	41.5	13.6	55.1	3.4	1.5	4.9	50.1

Source: SFS data and IMF FAD staff estimations.

94. **Incorporated business currently in Group 3 would be excluded from the simplified system and pay normal CPT.** The revenue effect of this change would be negligible. Because under the ST regime their effective tax rate is higher than the effective tax rate of taxpayers paying under the CPT system.

Revenue administration considerations

95. **The design and management of a simplified tax system should not be directed exclusively by current deficiencies in tax administration**. There is general consensus that both the current design of the ST and the lack of administrative control[57] over its application have

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[56] Taxpayers earning less than UAH 300,000 per year (2014) represent of 63 percent persons in Group 2 and 71 percent for Group 3. These taxpayers earn only 23 percent of the total income taxed under Groups 2 and 3.

[57] A moratorium on SFS tax audits of ST taxpayers is in place for 2015 and 2016, albeit it qualified for certain circumstances (e.g., subject to court order or for criminal investigations) and phased out for certain categories of

been largely driven by mutual distrust between taxpayers and the SFS. Concerns of taxpayer harassment and corruption are widely reported and acknowledged by all stakeholders. It is imperative that this vicious cycle between poor design and poor administration is broken, as the current situation—characterized by huge horizontal inequities, distortions and perverse tax incentives—is unsustainable. Hence, without wanting to downplay the tax administration challenges, any sustainable reform of the ST and SSC—and indeed the tax system more generally—must be premised on the expectation that, at least gradually, the quality of tax administration will improve and mutual trust between taxpayers and tax authorities is restored to a level that is required for a normal tax system to operate. Concretely, this means that moratoria on audits must be phased out and should not be reintroduced.

Recommendations

- Keep the ST regime for individual entrepreneurs of Group 1 unchanged, and replace the ST regime for individual entrepreneurs of Groups 2 and 3 by a simplified tax system imposing normal PIT rates based on cash flow.
- Allow entrepreneurs in the reformed simplified tax system for Groups 2 and 3 to engage in any type of economic activity (except for a narrowly defined list of excluded activities) and to employ an unlimited number of employees.
- Impose proportionate SSC at normal rates on all entrepreneurs in the simplified tax system, including on their employees.
- Exclude all VAT taxpayers—including those who are voluntarily registered for VAT—from the simplified regime.
- Exclude all legal entities from the simplified regime.
- Consider raising the VAT registration threshold to up to UAH 2 million.
- Remove—or at least do not extend or reintroduce—moratoria on tax audits, including of taxpayers under a simplified regime

IV. EXCISE TAXATION

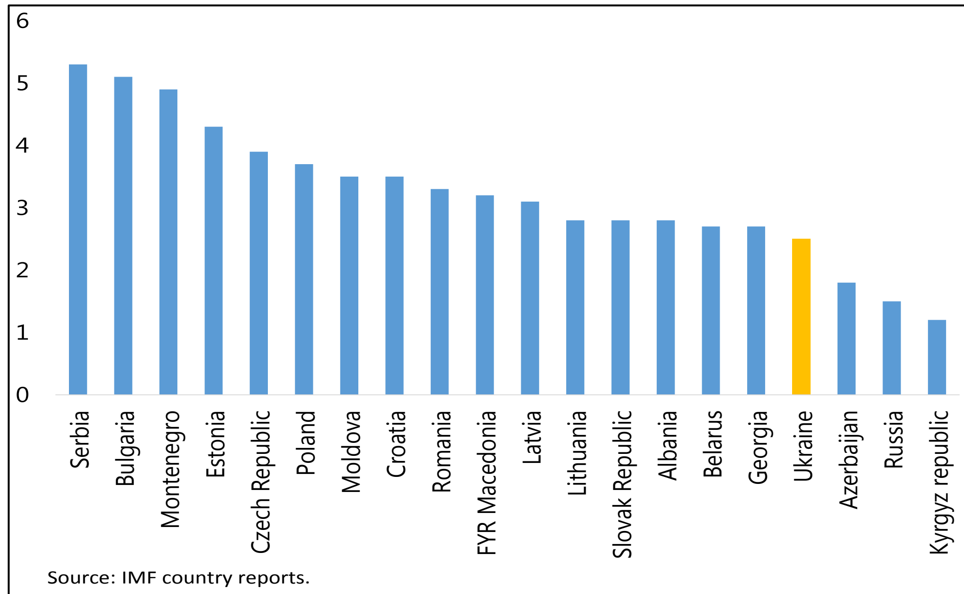
A. Room for increasing rates

96. **Excise taxes have become an important source of budgetary revenue over the last few years but remain low by international standards.** Revenue from excise taxes accounted for almost 3 percent of GDP in 2014 or 8 percent of total tax revenue (Table 16). This revenue has

individual entrepreneurs; *See* Item 3 of the Concluding Provisions of the Law of Ukraine «On Amending the Tax Code of Ukraine and Certain Laws of Ukraine re Tax Reform» of December 28, 2004 No.71-VIII.

about doubled in real terms from 2008. While before 2014 the share of domestic excise taxes accounted for about ¾ of the total excise tax revenue, in 2014 it dropped to about 60 percent. This was largely due to exchange rate deprecation, which inflated the customs value of imported goods. Despite its increase in recent years, the revenue from excise taxes is one of the lowest in the region (Figure 8).

Figure 8. Excise Tax Revenue in Central and Eastern Europe and CIS (in percent of GDP)



Source: IMF country reports.

97. **Domestic tobacco accounts for the lion's share of excise tax revenue**. Excise taxes are levied on tobacco, alcohol beverages, petroleum products, motor vehicles and electricity.[58] All rates are specific with the exception of tobacco and electricity. Tobacco has a specific and an ad valorem component while excise on electricity is ad valorem. Except for petroleum products and motor vehicles, all excise tax rates are set in hryvnia. Domestically produced tobacco contributes almost 40 percent of the total excise tax revenue. It is followed by gasoline and other oil products, both accounting for about another one third of the total excise tax revenue.

[58] Electricity became an excisable good as the earmarked surcharge to the existing tariff on electricity was eliminated with the tax reform in December 2014.

Table 16. General Government Revenue from Excise Taxes, 2008-2015

	2008	2009	2010	2011	2012	2013	2014	2015*
				in UAH millions				
Excise	**12,783**	**21,624**	**28,316**	**33,919**	**38,429**	**36,668**	**45,100**	**64,943**
Domestic excise	10,230	17,934	23,715	26,097	28,661	27,721	28,244	42,277
Import excise	2,553	3,690	4,601	7,822	9,768	8,947	16,855	22,667
				in percent of GDP				
Excise	**1.3**	**2.3**	**2.6**	**2.6**	**2.7**	**2.5**	**2.9**	**3.3**
Domestic excise	1.0	1.9	2.2	2.0	2.0	1.9	1.8	2.1
Import excise	0.3	0.4	0.4	0.6	0.7	0.6	1.1	1.1
Memo item:								
Tax revenue (in percent of GDP)	36.1	35.6	37.6	38.4	39.0	37.6	35.8	35.1
GDP (in UAH billions)	991	947	1,079	1,300	1,405	1,465	1,567	1981

* Estimate.
Source: Ukrainian authorities; and IMF staff estimates.

98. **There are also excises on motor vehicles which vary by size of engine and age.** Ukraine appropriately taxes more heavily older and bigger motor vehicles. Considering the number of taxes on vehicles and the recommendation made in the March 2105 FAD report on circulation taxes for luxury cars, this report does not discuss excises on motor vehicles and endorses the relevant recommendations of the previous report.

99. **In response to budgetary pressures, the government introduced a number of changes in excise taxation during the last 18 months**. In March 2014 specific excise tax rates were raised on tobacco by 33 percent, on beer by 40 percent and on ethyl spirits by 25 percent. In addition, the government unified excise rates on diesel fuel and increased the maximum rate by more than 30 percent. Additionally, the December 2014 tax reform: (i) increased proportionally the taxation of petroleum products substituting for an environmental tax; (ii) introduced electricity as an excisable commodity following the elimination of the earmarked surcharge to the existing tariff; (iii) unified excise tax rates on filtered and unfiltered cigarettes at a higher rate; and (iv) introduced a new excise tax on retail sales of alcohol and tobacco at 5 percent of the sales value, which aims to strengthen the revenue base of subnational governments.

100. **Following the large exchange rate depreciation and inflation most of the excise rates are lower than in the neighboring countries**. The hryvnia depreciated by 100 percent since the March 2014 tax code amendments that increased excise tax rates. Year-on-year inflation is currently running at 60 percent, making most excise duties a smaller share of retail prices. As a result, excise tax rates on tobacco and alcohol are among the lowest compared to most other countries in the region, particularly EU members (Table 19). The specific excise tax rate on cigarettes is $1/9^{th}$ of the average in the EU, almost $1/ 2.5^{th}$ of the rate in Russia, and half the average in Belarus. Similarly, excises on beer are only a small fraction of those in neighboring countries: 15 percent of the rate in Russia, 22 percent of that in Belarus, 30 percent of that in Georgia, and 50 percent of that in Moldova. The excise rate on ethyl spirits is also one of the

lowest. However, the rates on petroleum products, while significantly lower than those in the EU, are higher than in CIS peers.

Table 17. Comparison of Excise Tax Rates in Ukraine and Neighboring Countries

	Unit	Ukraine	EU Average	EU Maximum	Poland	Romania	Bulgaria	Russia	Belarus	Moldova	Georgia
Tobacco products	1000 pieces	8.7	77.5	255.7	49.5	64.2	51.6	20.3	8.8 16.4 19.8	9.7	4.1
Alcoholic beverage											
Beer (5% alcohol)	1 liter	0.05	0.47	1.60	0.23	0.11	0.10	0.32	0.21	0.10	0.16
Wine products (still)	1 liter	0.00	0.77	4.25	0.38	0.00	0.00	0.15	0.39	0.00	0.00
Ethyl alcohol	1 liter	2.71	17.81	56.24	13.64	10.75	5.62	8.12	2.52	3.79	1.06
Oil											
Motor gasoline	1 tonn	202.00	591.26	853.12	399.24	527.80	424.38	122.32	124.4 214.2	180.99	101.97
Diesel fuel	1 tonn	132.00	428.60	674.15	348.93	430.25	329.79	67.41	68.1 92.1	75.24	61.18

Sources: Ukraine - http://zakon4.rada.gov.ua/laws/show/2755-17; EU - http://ec.europa.eu/taxation_customs/taxation/excise_duties; Russia - http://base.garant.ru/10900200/34/#block_20022#ixzz3gG772TcD; Belarus - http://etalonline.by/?type=text®num=Hk0900071 Moldova - http://base.spinform.ru/show_doc.fwx?rgn=3834; Georgia - https://matsne.gov.ge/ka/document/view/1043717.

Notes:
Specific rates only. Does not include ad valorem rates. Adjustments were made to make the rates comparable.
Tobacco rates are for filtered cigarettes, wine is for standard natural wines.
For EU, excise rates on tobacco include only specific rates. According to the EU directive 2011/64 overall excise duty on cigarettes shall represent at least 60 % of the weighted average retail selling price of cigarettes released for consumption.
Exchange rates used in calculations are from the rates around mid-July. For Ukraine, projected average exchange rate for 2016 is used.
EU average rate is calculated as a simple average. Russia excise rates are those that will become effective from January 1, 2016.
For excise taxation filtered cigarettes in Belarus are divided into three categories.

101. **There is significant scope for increasing excises on selected commodities in Ukraine.** Because of depreciation of the hryvnia and inflation, excise rates on most products are now at a relatively low level, which is likely creating a positive demand effect. Therefore, there is significant room to increase rates and maintain the real value of the excises. Ukraine could target bringing its excises more on par with other countries in the region, considering that they are levied on goods that have low elasticity of demand and result in less excess burden than taxing other products. Also, excises are easy to administer as they are levied at the point of production or importation. Nonetheless, rates should be increased cautiously, taking into account the implications for cross-border transactions, legal or otherwise. Raising excise tax rates would also help internalize negative externalities that tobacco, alcohol and petroleum consumption impose on society. It may also encourage gradual decline in consumption to less harmful levels.

102. **Many excisable products have low tax burdens even when combined with the effect of VAT.** Table 20 shows the burden of excises and VAT on selected products. Given the current level of tax burden especially the excises, it is possible to continue with the rate increases of these products. One can easily observe that wine, motor vehicles and beer currently have very low tax burden levels.

Table 18. Ukraine: Tax Burden of Selected Products

	Tobacco			Beer			Wine			Spirits			Motor Vehicles		
Alcoholic Beverages	Rates/ Specific Amount	Equivalent rate on retail price	Price of Popular Brand (UAH)	Rates/ Specific Amount	Equivalent rate on retail price	Representative Price (UAH)	Rates/ Specific Amount	Equivalent rate on retail price	Representative Price (UAH)	Rates/ Specific Amount	Equivalent rate on retail price	Representative Price (UAH)	Rates/ Specific Amount	Equivalent rate on retail price	Representative Price (UAH)
Retail Price Including All taxes (P)			22			15			150			250			380,600
Taxes															
Specific Tax t_s	4.55		4.55	1.24		1.24	0.01		0.01	70.53		70.53	11,784		11,784
Ad valorem t_a*P	12%	8.50%	1.87	0%	0.00%	-	0%	0.00%	-	0%	0.00%	-	0%	0.00%	-
VAT (t_{vat})	20%	16.67%	3.67	20%	16.67%	2.50	20%	16.67%	25.00	20%	16.67%	41.67	20%	16.67%	63,433
Total Tax $\{t_s+[t_a+(1+t_a)*t_{vat}]*P\}$			10.08			3.74			25.01			112.20			75,217
Retail Price ex-taxes P_0			11.92			11.26			124.99			137.80			305,383
Total Tax Burden			66.50%			33.20%			16.68%			73.09%			22.86%
Share of Excise Tax			29.16%			8.27%			0.007%			28.21%			3.10%

Source: IMF FAD staff calculations.

103. **Ukraine could potentially raise additional revenue of 0.4–0.9 percent of GDP from excises in 2016, as shown in Table 21.[59]** Three rate increase scenarios are shown in this Table, each calibrated to bring rates closer to those in neighboring countries. However, in all cases, excise tax rates remain well below the average rates in the EU. The largest room for increasing rates is for beer, followed by ethyl spirits, tobacco and motor vehicles. Excises on motor fuels are higher in Ukraine than its CIS peers, therefore, the proposed rate hikes are more modest. Estimates are based on the conservative assumption that consumption of excisable goods will remain unchanged from the estimated levels in 2015 (current projections of GDP and import growth are 2 and 7 percent, respectively). The estimates ignore possible increase in illegal production and smuggling.

104. **Considering the recent increases in excise taxes, selected rate increases could target additional revenues of up to 0.6 percent of GDP.** The selected excise rate increases and their revenue impacts are shown in Table 22. The table includes rate increases over the next two years. The excise rates for beer are still modest compared to other countries, only slightly more than the rates in Romania and Bulgaria. Excise on natural wine is currently UAH 0.01/liter, which is very low—although this is common policy in wine producing countries to subsidize the industry. However, an increase to UAH 0.05/liter would not be perceived as a change in this policy. Even though excises on spirits were increased earlier this year, they are still much lower than the rates in other countries in the region. A more aggressive increase in excise is justified for these products, as explained below.

[59] Last row of the table.

Table 19. Excise Tax Revenue under Different Scenarios

	Current	Rate after increase by			Rate after increase by		
Cigarettes							
Excise tax rates	rate	20%	30%	40%	20%	30%	40%
Hryvnia per 1000 pieces	227.3	272.8	295.5	318.3	272.8	295.5	318.3
		Total revenue			Change in revenue		
Revenue (UAH billion)	20.5	24.6	26.6	28.7	4.1	6.1	8.2
Revenue (percent of GDP)	0.9	1.1	1.2	1.3	0.2	0.3	0.4
Beer	Current	Rate after increase by			Rate after increase by		
Excise tax rates	rate	50%	100%	150%	50%	100%	150%
Hryvnia per liter	1.24	1.86	2.48	3.10	1.86	2.48	3.10
		Total revenue			Change in revenue		
Revenue (UAH billion)	2.3	3.4	4.5	5.7	1.1	2.3	3.4
Revenue (percent of GDP)	0.1	0.2	0.2	0.3	0.1	0.1	0.2
Ethyl spirits	Current	Rate after increase by			Rate after increase by		
Excise tax rates	rate	50%	63%	75%	50%	63%	75%
Hryvnia per liter	70.53	105.80	114.96	123.43	105.80	114.96	123.43
		Total revenue			Change in revenue		
Revenue (UAH billion)	6.7	10.1	10.9	11.7	3.4	4.2	5.0
Revenue (percent of GDP)	0.3	0.4	0.5	0.5	0.1	0.2	0.2
Gasoline	Current	Rate after increase by			Rate after increase by		
Excise tax rates	rate	0%	5%	10%	0%	5%	10%
Hryvnia per liter	202	202	212	222	202	212	222
		Total revenue			Change in revenue		
Revenue (UAH billion)	9.7	9.7	10.1	10.6	0.0	0.5	1.0
Revenue (percent of GDP)	0.4	0.4	0.4	0.5	0.0	0.0	0.0
Diesel	Current	Rate after increase by			Rate after increase by		
Excise tax rates	rate	0%	5%	10%	0%	5%	10%
Hryvnia per liter	132	132	139	145	132	139	145
		Total revenue			Change in revenue		
Revenue (UAH billion)	19.9	19.9	20.9	21.9	0.0	1.0	2.0
Revenue (percent of GDP)	0.9	0.9	0.9	1.0	0.0	0.0	0.1
Total							
Revenue (UAH billion)	59.1	67.6	73.2	78.7	8.6	14.1	19.6
Revenue (percent of GDP)	2.6	3.0	3.2	3.5	0.4	0.6	0.9

Sources: Ukrainian authorities; and IMF staff calculations.

Table 20. Ukraine: Excise Tax Rate Changes and Revenues

		Current Rates	Year 1 (UAH) 1/	Year 1 % GDP	Year 2 (UAH)	Year 2 % GDP
Beer	Rate (UAH)	1.24/lt	2.48/lt		3.10/lt	
	Change in Revenue		2.3	0.1	3.4	0.2
Wine	Rate (UAH)	0.1/lt	0.05/lt		0.1	
	Change in Revenue		0.13	0.001	0.26	0.002
Spirits	Rate (UAH)	70.53/lt	105/lt		123/lt	
	Change in Revenue		3.4	0.2	5	0.2
Cigarettes	Rate (UAH)	227.3/ per thou.	273/ per thou.		295.5/ per thou.	
	Change in Revenue		4.1	0.3	6.1	0.3
Total Change in Revenues			9.9	0.6	14.8	0.7

1/ All revenues are in billions of UAH.
Source: Ministry of Finance and IMF FAD staff calculations.

105. **There is potential to generate additional revenue from fuel excises without increasing the rates but by strengthening administration**. According to the estimates from the fuel industry, about 20 percent of the fuel market evades paying taxes. There are multiple tax evasion schemes, which include smuggling, production of counterfeit fuels, re-labeling into different fuel types to which lower excise rates apply. Draft tax code amendments submitted to parliament in July 2015 propose to introduce electronic administration of the excise taxation on fuel products similar to VAT electronic administration, which could help to curb tax evasion.

B. The special case of alcoholic beverages

High negative externalities in Ukraine

106. **Ukraine has a very high per capita consumption of alcohol**. In 2010, male consumption was 22 liters per year of pure alcohol equivalent (population 15+ years of age). This is considerably higher than in most counties in the world. For example, in North America (Canada, U.S. and Mexico) consumption ratios are 12-15 liters per year. Only Ukraine's neighboring countries have similar consumption rates.[60] Also, according to the World Health Organization (WHO), the most risky patterns of alcohol consumption (binge drinking) are observed in Ukraine (alongside Russia).[61]

107. **High consumption of alcohol comes with high costs in public health**. In Ukraine the fraction of all deaths (both sexes) attributable to alcohol consumption is 34.4 percent, while for

[60] WHO, Global Status Report on Alcohol and Health, 2014.
http://www.who.int/substance_abuse/publications/global_alcohol_report/msb_gsr_2014_3.pdf?ua=1

[61] Ukraine is also one of the largest consumers of tobacco in the world ranking 18th out of 182 countries assessed by the TobaccoAtlas.

most other countries this number is somewhere in the range of 3 to 6 percent.[62] This explains to an important extent why Ukraine presents a rare case of declining life expectancy and a high mortality rate, leading to a sustained population decline in the last 15 years.[63] There is also a strong link between alcohol use and suicide rates.[64] Ukraine has one of the highest suicide rates in the world, ranking 16 among 170 countries according to WHO data.

108. **Strong negative externalities from alcohol consumption in Ukraine justify a more aggressive approach to raising excise rates on alcoholic beverages.** There is a well-established (negative) relationship between taxation and excessive drinking. The literature assessing the effectiveness of alcohol tax policy finds strong empirical evidence that increasing the price of alcohol reduces excessive alcohol consumption and related harms.[65] Raising excise taxes on alcohol has proven to be an effective strategy for protecting public health, and it would be entirely appropriate in Ukraine to have higher rates where about the worst indices of alcohol consumption and related harms coexist with about the lowest excise rates in the world.

The timing of the excise tax

109. **A key feature of excise tax design is the time of payment.** Typically excises are levied at the point of production when the excisable good is first sold. This has important advantages: it is fundamentally easier to control and there is no need for a crediting system (as in VAT). When the tax is levied at a later point of sale down the supply chain the payment of the excise is deferred, providing a financial benefit for taxpayers up in the supply chain, but increasing significantly the administrative burden on the system as a whole and, with it, its vulnerability to illicit trade in excisable goods. The timing issue is particularly relevant for producers of alcoholic beverages (PAB) because they may purchase pure alcohol from a distiller in order to produce their spirits and in this case the option is to tax the sale of pure alcohol and generate a credit on the sale of alcoholic beverages to distributors.

110. **The system in Ukraine combines both options.** The excise is paid when PAB sell the good to their customers (distributors), but they have to guarantee the payment when they purchase pure alcohol from distillers. PAB have to sign a promissory note in favor of the SFS for the amount of excises that will eventually arise from the use of the pure alcohol acquired. The

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[62] WHO, op cit. The incidence of alcohol related deaths for males in Ukraine was 40 percent.

[63] N. Levchuk (2009), "Alcohol and Mortality in Ukraine", Max Planck Institute for Demographic research, WP 2009-017. http://www.demogr.mpg.de/papers/working/wp-2009-017.pdf

[64] M. Pompili, International Journal of Environmental Research on Public Health, 2010 7(4)

[65] R.W. Elder, et al, (2010), "The effectiveness of tax policy interventions for reducing excessive alcohol consumption and related harms", *American Journal of Preventive Medicine*, 38 (2). The authors examine seventy-two papers technical reports evaluating outcomes relevant to public health (e.g., binge drinking, alcohol-related crash fatalities).

note is cancelled when the excise is paid by PAB, as if it were a virtual reverse credit system. If it cannot be documented and certified that the ethyl alcohol has been used for the production and sale of alcoholic beverages, or its end-use cannot otherwise be demonstrated, the SFS redeems the guarantee.

111. **The system requires intricate and labor-intensive controls by SFS throughout the production and distribution chain with high costs of compliance for taxpayers**. The supply chain is closely monitored as the SFS controls the different points of delivery and reception of pure alcohol and alcoholic beverages, checking physically the documentation and goods at each step, certifying that products have not been diverted into the black market without paying the tax. Documentation must match sales of alcoholic beverages (and corresponding excises) with purchases of pure alcohol in order to extinguish the guarantee (the promissory notes). This system does not compare well with the option of simply charging the excise when pure alcohol is sold, especially considering that in Ukraine ethyl alcohol is produced and sold by a single enterprise, a state monopoly, UkrSpirt. A credit system for PAB must apply in that case, quite like in the VAT system, where monitoring is focused on refunds and exemptions.

Exemptions

112. **Ethyl alcohol has other uses than the production of alcoholic beverages and these should not be taxed with excises.** This applies with any model of excise tax and presents a risk for pure alcohol to be diverted to illicit production of beverages. Currently in Ukraine pure alcohol used for medicinal purposes or by the chemical industry is zero rated, but these end-users can buy ethyl alcohol only under a specified quota authorized by the Cabinet of Ministers. Also, the same administrative system applies: authorized purchasers must sign a promissory note when they buy the ethyl alcohol and have to demonstrate eventually that the quota has been fully used as input for producing authorized products. Failure to do so triggers collecting on their note by the SFS. Under the alternative system a refund mechanism would have to operate for these users of pure alcohol. Taxpayers have not had a good experience with refunds from the SFS, so they will resist this system, but it is the more efficient way to levy the tax, as it narrows the areas of high risk. Technical assistance in revenue administration may be useful so that the SFS may adapt to refunds as a normal feature of its excise operation.

113. **The exemption should apply to all end-users of ethyl alcohol which are not PAB.** Currently this is not the case, as the exemption is limited to the quotas issued by the Cabinet of Ministers to a restricted number of activities. UkrSpirt itself is one of the companies most affected by this limitation, since this stops it from integrating vertically into the production goods that are not in the exempted list. Instead of taxing all products derived from ethyl alcohol (aside from those already zero rated) as if they were alcoholic beverages, monitoring should focus on UkrSpirt operations to prevent it from diverting pure alcohol into illicit uses. Significant production opportunities may be lost here, especially in the area of biofuels, which can be imported under the correct classification and thus free of excises.

114. **Ukraine has the highest unrecorded consumption of alcohol in the world**. The consumption of home brews or illegally produced alcohol beverages represents more than half of total consumption, which is an extraordinary percentage by international standards. The ratio in Belarus, one of the few countries with drinking patterns similar to Ukraine, is 22 percent; the same ratio in the U.S. is 6 percent. This has the double (negative) consequence of increasing the risks of alcohol consumption and escaping taxation. This alone strongly indicates that the current system does not work.

Recommendations

- Increase excises on beer to UAH2.48/lt and 3.10/lt in the next two years.
- Increase excise rate on wine from UAH 0.01/lt to UAH 0.05/lt and UAH 0.1/lt in the next two years.
- Increase excise rate on spirits from UAH 70.53/lt to UAH 105/lt and UAH 123/lt in the next two years.
- Increase excise rate on cigarettes from UAH 227.3/thou. sticks to UAH 273/per thou. sticks and UAH 295.5/thou. sticks in the next two years.
- Tax the sale of ethyl alcohol and allow credits against the tax on the sale of alcoholic beverages and eliminate the system of guarantees.
- Zero rate all products derived from ethyl alcohol which are not for human consumption and allow refunds.
- Prioritize monitoring operations of UkrSpirt and those which claim refunds so that ethyl alcohol is not diverted to illicit uses.
- Request technical assistance to set up this monitoring program and the refund process.

V. CORPORATE PROFIT TAX CORPORATE PROFITS TAX

A. Revenue performance

115. **CPT revenue has declined to its lowest level since 2006 and is now well below the regional average.** CPT revenue declined from about 4 percent of GDP in 2011 to 2.6 percent (UAH 40.2 billion) in 2014. This is its lowest level since 2006, and is now well below regional

average (see Table 23).[66] However, actual CPT revenue is even lower when outstanding Advance Corporate Tax (ACT) credits are taken into account.[67]

Table 21. Corporate Income Tax Revenues

	Corporate Profits Tax
Ukraine	2.6
Armenia	3.1
Georgia	3.4
Kazakhstan	9.1
Kyrgyz Republic	1.4
Moldova	0.7
Russian Federation	4.1
Average (excluding Ukraine)	3.6
Source: GFS Statistics IMF.	

116. **A case can be made to raise the CPT rate to 20 percent.** This could increase CPT revenues by UAH 4.4 billion (0.3 percent of GDP) and bring its revenue yield closer to the regional average. It would also reduce the incorporation bias arising from the difference between the 18% CPT rate and the 20% top marginal PIT rate.

117. **The Corporate Profit Tax in Section III of the Tax Code was substantially rewritten at the end of 2014.** The new rules closely approximate financial and tax accounting for the purpose of the CPT. While the reform promised simplification, it has also introduced some problems that pose a threat for tax revenue. The drafting of the new provisions also leaves substantial room for improvement. It is also noteworthy that there is no penalty for incorrect filing of a corporate tax return for 2015.[68]

118. **The remainder of this Chapter discusses:** (A) a current proposal to replace the CPT by a tax on distributed profits, (B) adjusting the operation of the CPT for inflation, (C) other CPT design issues that should be addressed as a matter of priority, and (D) concludes with observations on the (re)drafting of the Tax Code.

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[66] Moldova raises even less corporate tax revenue, but also has a much lower corporate tax rate of currently 10 percent (up from zero in 2012 and 2013).

[67] Actual CPT payments in 2014 amounted to UAH 36.5 billion. This indicates that the difference (UAH 3.7 billion) between gross CPT collections and actual CPT payments is attributable to outstanding ACT credits for 2014. The mission understands that the total stock of outstanding ACT credits reaches UAH 25 billion but was not able to verify this amount.

[68] See point 31 of the Law of Ukraine «On Amending the Tax Code of Ukraine and Certain Laws of Ukraine re Tax Reform» of December 28, 2014, No.71-VIII.

B. Replacing the CPT by a tax on distributed profits

119. **It has been proposed to further simplify the CPT by replacing it with a tax on distributed profits, but this would not in fact be a simplification**. The proposal, based on the Estonian system, would impose corporate tax only when profits are distributed. While at first glance this seems simple, in fact taxing distributed profits requires the same recordkeeping and auditing as corporate taxation in Ukraine today. Since only profit distributions are taxable, taxpayers must still keep the same accounting books as today to determine whether a distribution is subject to tax. Non-deductible expenses should also be subject to tax, as in Estonia. This includes transfer pricing adjustments as well as interest expenses that are nondeductible under thin capitalization rules.

120. **A distributed-profit tax would also pose a substantial revenue risk.** If taxpayers respond by failing to distribute dividends, corporate tax revenue would decline substantially. While in theory a distributed profits tax is neutral in terms of the incentive to distribute, taxpayers short of cash may respond by retaining earnings. They may also speculate that future tax policy changes will reduce the tax burden on accumulated dividends. This may happen, for example, when Parliament decides to lower the tax burden on accumulated dividends, partly to raise revenue and partly to remove a perceived tax barrier to profit distribution. Accordingly, it would be risky to assume that corporate tax revenues would continue coming in at the same rate as today.

121. **Replacing the CPT by a distributed profit tax would represent needless change.** Taxpayers have only recently faced an overhaul of the CPT that came into effect in 2015. Unless there is a substantial reason to do so, it would be irresponsible to change again to a totally new system so soon. The preferred approach should thus be to focus on making specific changes to improve the current system. Fundamental change should only be contemplated after several years' experience with the current system, and even then should only be considered if the current system is not working.

Recommendation

- Do not replace the CPT by a distributed-profit tax but instead improve the current system.

C. Inflation adjustment

122. **Ukraine is currently experiencing a significant rate of inflation, which is expected to continue**. It is well known that such levels of inflation substantially distort the tax system. The corrective measures are likewise well known. This section describes the standard inflation corrections that other countries have adopted in similar circumstances.

123. **There are two broad options for dealing with significant inflation in the tax system.** These are to either provide for comprehensive inflation adjustments to the tax system as a whole,

or to provide ad-hoc adjustments to specific items relevant for determining taxpayers' liabilities. Both options are discussed in detail in Appendix A to this aide-mémoire, which also includes sample provisions for inflation adjustments to the CPT.

Recommendations

- Include a mechanism in the TC to adjust for inflation all amounts expressed in hryvnias in the Code.
- Harmonize any differences in payment deadlines between taxpayers for various taxes.
- Adopt comprehensive inflation adjustment rules for the CPT to come into effect for 2016 depending on the inflation rate in 2016.
- If comprehensive inflation adjustment is not adopted, consider ad-hoc adjustment for at least the most important items of the corporate tax base.
- If corporate interest expense is adjusted for inflation, reduce the rate of withholding tax on interest paid to resident individuals with respect to hryvnia-denominated debt.
- If inflation exceeds a specified level, index monthly incomes and advance payments of tax for individuals required to file returns.

D. Other design issues with the Corporate Profits Tax

124. **Despite—and in some cases as a result of—the 2014 CPT reform further design issues need to be addressed in the CPT.** These are explained in detail in Appendix B to this aide-mémoire.

Recommendations

- Only allow a deduction for expenses connected with the generation of taxable income, and exclude deduction for specified expenses (expenses of a personal nature, meals and entertainment; passenger vehicles and associated costs; fines and penalties; bribes and other illegal payments).
- Correct the thin capitalization rule (use monthly amounts of debt outstanding; assimilate foreign-currency gains and losses to interest income and expense) and consider reducing the debt-equity ratio from 3.5.
- Clarify whether tax depreciation is based on revalued amounts and allow greater flexibility in accepting accounting policy on small-value assets.
- Provide for tax adjustments in the case of a change in method of accounting.

- Clarify that taxpayers covered by consolidated financial accounts must continue to file and account separately for CPT purposes.
- Clarify the rules defining a finance lease.
- Provide for an adjustment for tax purposes where income is deferred under accounting standards on the basis that there is an associated future liability.
- Allow ACT to be credited against provisional payments made during the year, and reduce provisional payments where the current year's sales have declined relative to the previous year.
- Limit special treatment of investment funds to regulated entities and provide for a withholding tax on annual income allocable to investors, with inflation adjustment.
- Eliminate the special regime for companies with turnover of less than 20 million hryvnias, and repeal 2016 audit moratorium for these companies.
- Tax nonprofit organizations on business operations that are not related to their exempt purpose, with the exceptions of operations that are very small.

E. Drafting issues

125. **Appendix C offers some observations and recommendations on the (re)drafting of the current Tax Code.** The appendix highlights the main issues with the current drafting of the Tax Code, discusses how it can be redrafted, and concludes with specific recommendations.

Appendix A. Inflation adjustments

This Appendix discusses (A) options for inflation adjustments, and (B) provides illustrative inflation adjustment rules for the Corporate Profits tax.

A. Options for inflation adjustments for tax purposes

Comprehensive inflation adjustments

1. **The values in real terms of amounts in hryvnia in the Tax Code deteriorate by the rate of inflation**. The remedy is simple: periodically adjust all hryvnia amounts in the TC for inflation. Typically, this is done through a parliamentary delegation to the executive to restate these amounts. Given current inflation levels a quarterly or annual adjustment might be appropriate, depending on the item in question. For example, on a quarterly basis, the MOF could publish the threshold for required VAT registration, together with any other amounts to be adjusted on a quarterly basis. And annually, the MOF would publish those hryvnia amounts which require annual adjustment only.[69]

2. **Inflation also makes it important to pay attention to payment deadlines**. Particularly distortive are rules that allow different groups of taxpayers to pay tax at different times. The TC should be reviewed to minimize such distortions, and to assure that the time lag between when a tax liability is incurred and the tax must be paid is not too long. For example, under the Single Tax, some taxpayers use a calendar quarter as the reporting period while others use the calendar year; some pay tax every month, and others every quarter.[70]

3. **The most complicated issues arise for the determination of the tax base**. This is relevant mostly for taxes that are computed on an annual basis, since the tax base for such taxes involves adding and subtracting amounts relating to different months and thus involving different values of national currency.

4. **International and national accounting standards prescribe inflation indexing rules that are relevant for determining profits**. While IAS 29 (Financial Reporting in Hyperinflationary Economies) does not identify a specific annual inflation rate at which it must be applied, Ukraine's inflation rate appears to be near the scope of application of that standard. The standard requires that amounts expressed in national currency must be valued at the balance sheet date. Ukrainian GAAP standard No 22 takes a similar approach, and requires—as the

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[69] For the convenience of taxpayers the actual adjusted amounts—as opposed to an adjustment factor—should be published. This is also because the actual amounts to be used usually involve some rounding.

[70] Another example is that property tax is paid at substantially different times by legal and physical persons; see Article 266.1 of the Tax Code.

mission understands—that inflation adjustment must be made if cumulative 3-year inflation exceeds 90 percent. It is possible that this level will be reached by the end of 2015.

5. **Countries that have experienced high inflation have applied the principles behind IAS 29 for tax purposes.** This was the case in Chile, Argentina, Brazil, Israel, and Mexico. While some of these countries have subsequently stopped adjusting for inflation as rates have decreased, such adjustments could continue to be applied even at very moderate inflation rates as this would result in a more accurate measurement of corporate profits.

6. **Inflation adjustment involves valuing each element of the calculation of taxable profit at price levels prevailing at the time of the closing balance.** The basic rules follow from the expression of corporate profit as the difference between the net equity in the closing balance sheet and the opening balance sheet, plus the amount of dividends and other distributions to owners during the tax period, minus any contributions to capital. If each of these amounts is valued in national currency as of the end of the tax period, then profit has been adjusted for inflation. For example, assets included in the closing balance sheet could be valued at historical acquisition costs, adjusted for inflation occurring between the month of acquisition and the balance sheet date. As for the value of equity in the opening balance sheet, this must be adjusted for inflation between the beginning and end of the year. As for dividends and other distributions, as well as contributions to capital, taking place during the course of the tax year, these should be adjusted for the change in the price level between the month in which the transaction takes place and the close of the year.

7. **The Tax Code should be amended to specify that comprehensive inflation adjustment will come into full effect in 2016 only if the annual inflation rate for 2016 exceeds a specified level.** Inflation adjustment rules should first specify a comprehensive revaluation of assets for the opening balance sheet for 2016. This will assure that such calculations as depreciation for 2016 are based on current end-2015 values. Likewise, gains or losses on asset dispositions will be based on end-2015 adjusted values. However, the law should specify that comprehensive inflation adjustment for inflation occurring during 2016 should apply only if the inflation rate for 2016 exceeds a specified rate.

8. **The situation for individuals is more complex**. Because individuals typically do not keep double entry books, they do not have a balance sheet with opening and closing values. Therefore inflation adjustment for individuals must take the approach of adjusting specific transactions. For example, if an individual receives wages during the course of the year, it is not appropriate to simply add these amounts together to obtain an annual total. Rather, each monthly amount of wages should be indexed according to the price level of that month, and the resulting monthly amounts added together. Correspondingly, amounts of tax withheld in any given month should be indexed for purposes of adding up amounts withheld in computing the credit for tax withheld. In relation to wages, this exercise is not needed if the amount of withholding is accurate. Thus, if the correct amount of tax is withheld from wages each month, it is not necessary to come up with an annual total. For items such as interest income, conceptually

it would be necessary to determine how much the value of the loan principal has eroded due to inflation, and to subtract that from interest received (which, if accrued on a monthly basis, would also have to be adjusted to year-end price levels). The same applies for debts for which an interest deduction is allowed.

9. **To simplify resulting calculations for individuals tax systems often adopt ad-hoc solutions.** For example interest income might be subject to a low flat-rate final withholding tax. In practice, capital gains of individuals represent the most complex problem, because it is necessary not only to adjust the acquisition price of assets disposed of, but also to adjust any corresponding interest expense. It is also necessary in respect of individual capital gains to determine how to handle inflation that occurred before indexing rules came into effect.

10. **Countries experiencing substantial inflation have typically adopted a combination of approaches.** These might involve comprehensive inflation adjustment of corporate accounts along the lines of IAS 29, while adopting more specific and practical solutions to deal with the effects of inflation on the taxable income of individuals. Section B of this Appendix contains an example of comprehensive inflation adjustment rules.

Ad-hoc adjustments for CPT

11. **An alternative approach to comprehensive inflation adjustment is to only adjust specific elements of corporate accounts for inflation.** Under current law, the effects of inflation on the CPT base differ substantially for different items:

- *Depreciation*. Ukraine used to provide for some inflation adjustment, and the tax balance sheet value for depreciable assets reflects inflation adjustments to December 1, 2014. It appears that further inflation adjustment of depreciation was stopped as of January 1, 2015. However, given that the Tax Code does not clearly specify the value of fixed assets for depreciation purposes, it is possible that taxpayers would continue to use an inflation-adjusted base. This could happen if, for accounting purposes, the taxpayer voluntarily revaluated fixed depreciable assets. Such a revaluation would show up on the capital account rather than the current profit and loss account, and would therefore not lead to taxable profit. The taxpayer would argue that it is entitled to use this value for tax purposes, given that the Tax Code is silent or unclear on this point. Thus, while post-2014 inflation is no longer taken into account for purposes of depreciation, there is some lack of clarity on this under current tax law.

- *Foreign currency exchange*. Gains and losses are taken into account in the closing balance sheet. This means that inflationary gains—strictly speaking, currency appreciation gains—will be taxed, and a corresponding deduction will be allowed for accrued foreign exchange losses, even if there is no realization event.

- *Inventory*. Because the LIFO method is not allowed for inventories, an inflationary gain is taken into account when inventory is sold. As a result, the corporate tax base is increased by inflationary gains on inventory holdings.

- *Securities, investment real estate, and biological assets.* Since these are required to be valued at fair value under national GAAP and IFRS, this will result in an inclusion in income for both accounting and tax purposes, since no adjustment with respect to these items is specified in the Tax Code. As with foreign currency gains and losses, the result is that inflationary gains are taxed even if there is no realization event. On the other hand, financial instruments to be held to maturity are not revalued at fair value (this might include most derivatives). This means there will be no adjustment, but the inflationary gain is taxed at the time of realization.

- *Interest.* To the extent that interest expense is deductible, the taxpayer benefits from a lack of inflation adjustment (as with exchange gains and losses on foreign currency obligations). However, some interest is capitalized (when for accounting purposes it is linked to capital assets), while some interest is nondeductible because of the thin capitalization rule.[71]

- *Withholding tax.* When interest is paid by corporations, withholding tax must be paid on the nominal amount of interest without adjustment. The most disadvantageous situation seems to be for local currency borrowing from residents, since a 15% withholding tax must be paid on interest due to investors. This might occur directly if a corporation borrows from an individual or indirectly if a corporation borrows from a bank which in turn pays withholding tax on the interest accrued on a deposit in local currency.

12. **Ad-hoc adjustments would involve establishing specific inflation adjustment rules for the above-discussed items.** In the case of depreciable assets, one approach would be to accept for tax purposes the revaluation that is done for accounting purposes. Alternatively, the Tax Code could specify an inflation adjustment mechanism for depreciable assets. For foreign currency, one approach would be to assimilate foreign currency gains and losses to interest income and expense, and to adjust the net amount for inflation. For inventory, allowing the use of LIFO would result in the deferral of inflationary gains. For securities and other assets valued at fair value, the resulting gain could be offset by an inflation adjustment.

[71] However, as noted under D. below, the application of the thin capitalization rule as currently drafted can easily be avoided by taxpayers.

B. **Illustrative inflation adjustment rules for corporate profit tax**[72]

The inflation adjustment rules apply to enterprises preparing financial statements and are based on the value of assets and liabilities included in the balance sheet of the enterprise. The values of items included in the closing balance sheet are adjusted for inflation taking place during the year. The total amount of these inflation adjustments is added to taxable income.

The amount of net worth (assets minus debts) in the opening balance sheet is adjusted for inflation, and this adjustment is subtracted from taxable income. The adjustment is corrected for certain transactions resulting in a change in net worth that take place during the course of the year. The inflation adjustment to transactions resulting in an increase in net worth is subtracted from taxable income. The inflation adjustment to transactions resulting in a decrease in net worth is added to taxable income.

The net effect of inflation adjustment on taxable income is the algebraic sum of these adjustments, which are described below.

Art. 1—Adjustment of Opening Net Worth

(1) The amount of opening net worth is adjusted for inflation for the taxable year. The amount of this adjustment is subtracted from taxable income.

(2) In the event that the opening net worth is negative, the above operation results in an increase in taxable income because a negative number is being subtracted.

(3) Net worth is the difference between –

(a) the total assets in the tax balance sheet, and

(b) the sum of the debts of the taxpayer and reserves taken into account under the provisions of this Code.

(4) The inflation-adjusted value of opening net worth is the value of net worth in the opening tax balance sheet, adjusted according to the percentage change in the consumer price index for the taxable year. The opening tax balance sheet is the same as the closing tax balance sheet for the preceding taxable period.

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[72] The provisions below are adapted from the Appendix to Chapter 13 of *Tax Law Design and Drafting* by Victor Thuronyi (ed), available online here: http://www.imf.org/external/pubs/nft/1998/tlaw/eng/. Please see that publication for further details and commentary on the draft language below.

Art. 2—Adjustment of Increases in Net Worth

(1) Contributions to capital and nontaxable income are adjusted for inflation occurring between the month in which the transaction takes place and the close of the taxable period. The total amount of these adjustments is subtracted from taxable income.

(2) Inflation-adjusted contributions to capital are contributions to capital made during the taxable period, adjusted according to the percentage change in the consumer price index between the month in which the contribution is made and the end of the taxable period.

(3) Inflation-adjusted incomes that are not taxable are incomes that are not taxable under the provisions of this Part, adjusted according to the percentage change in the consumer price index between the month in which the income is received and the end of the taxable year.

Art. 3—Adjustment of Decreases in Net Worth

(1) Distributions to owners and nondeductible expenses are adjusted for inflation occurring between the month in which the transaction takes place and the close of the taxable period. The total amount of these adjustments is added to taxable income.

(2) Inflation-adjusted withdrawals made in favor of the owners are distributions or other transfers of property in favor of the owners made during the taxable period, adjusted according to the percentage change in the consumer price index between the month in which the distribution or transfer is made and the end of the taxable period.

(3) Inflation-adjusted expenses that are not deductible are expenses paid during the taxable period, other than capital expenditures, that are not allowed as deductions under this Part, adjusted according to the percentage change in the consumer price index between the month in which the expense is paid and the end of the taxable period.

Art. 4—Adjustment of Items in Closing Balance

The value of items in the closing balance is adjusted as described in Articles 5 and 6, depending on the type of asset or debt. The amount of the adjustment, that is, the difference between –

(a) the adjusted value of the asset or debt; and
(b) its historical cost, if acquired during the year, or its value on the previous balance sheet,

is added to taxable income (subtracted in case of adjustment of a debt).

Art. 5—Valuation of assets and debts in closing balance

(1) In applying Article 4, assets (other than inventory) and debts included in the closing tax balance sheet are valued as prescribed in this Article.

(2) The values of assets (other than assets described in paragraphs 3–8) are adjusted according to the percentage change in the consumer price index. The value of an asset on hand at the beginning of the year is adjusted according to the percentage change in the consumer price index for the taxable year. The value of an asset acquired during the taxable year is adjusted according to the percentage change in the consumer price index between the month in which it was acquired and the end of the taxable year.

(3) Assets for which depreciation is allowed under Article [ ] (relating to depreciation deduction) are valued according to the historic acquisition cost, adjusted for inflation, and reduced by cumulative depreciation.

(4) Debt claims and debts (other than those described in paragraph 6) are valued by including accrued interest (including original issue discount or market discount) and accrued adjustments to principal (including adjustments under an adjustment clause).

(5) (a) Foreign currency; and

(b) debt claims, other assets, or debts denominated in foreign currency are valued at the prevailing foreign exchange rate at the end of the taxable year.

(6) Publicly traded securities are valued at their market quotation as of the end of the taxable year.

(7) Gold or silver bullion or coins are valued according to the market price as of the end of the taxable year.

(8) Cash and assets denominated in national currency are valued at their nominal value.

Art. 6—Valuation of inventories and unfinished products

(1) In applying Article 4, assets and unfinished products included in the closing inventory are valued as provided in this Article.

(2) Goods of a particular type are valued at the cost of the last-acquired item of that type, adjusted according to the percentage change in the consumer price index between the month in which the item was acquired and the end of the taxable year. The preceding sentence applies only if the last-acquired item was acquired during the taxable year.

(3) If no item of such type has been acquired in the taxable year, the goods are valued at the value in the opening balance, adjusted according to the percentage change in the CPI for the taxable year.

(4) Goods included in closing inventory that are produced, rather than purchased, including unfinished products, are valued according to the same principles, in relation to the costs incurred in their production.

(5) For purposes of this Article, an acquisition at an artificial price will be ignored.

Appendix B: Other design issues with the CPT

Nondeductible expenses

1. **The absence of rules on nondeductible expenses in the TC is problematic.** Allowing a deduction for any item that is recorded in the accounting books is prone to abuse and poses a substantial risk to the corporate tax base. Standard practice is to include a rule in the Tax Code that only expenses related to the business are deductible. Such a rule should be drafted in a way that is clear and does not allow discretion for auditors to challenge deductions on an arbitrary basis. Personal expenditures, or those incurred in favor of shareholders, directors, or employees, should be specifically mentioned as nondeductible.[73]

2. **The Tax Code should specify that certain categories of expenses are not deductible for tax purposes.** These include:

- *Entertainment expenses.* These provide a private consumption benefit to individuals and should not be deductible for CPT purposes. A typical definition of entertainment expenses includes expenditures for meals. While exceptions to this rule are sometimes made for situations like travel expenses or canteens for workers in remote sites, a simpler approach would be to deny a deduction for meals in all cases. Entertainment expenses should be defined as including expenses for organizing parties, sporting and cultural events and other live entertainment, memberships or rights to visit saunas, sport or fitness clubs, and any similar items.

- *Cars and associated expenses.* Expenses for company cars, including associated costs such as fuel cost, are often specified as nondeductible, particularly if they are not otherwise taxed as fringe benefits to employees. The definitional issue here involves the use of company vehicles for deliveries and industrial uses. Part of the answer is to exclude from the deduction only passenger vehicles. Vehicles that are used exclusively for deliveries and are not available for private use of employees—which should be defined as including transportation to or from home—can also be excluded.

- *Fines and penalties.* These are typically specified as being nondeductible. Usually, these are amounts payable to the government for violations of various kinds, including but not limited to tax law violations.

- *Bribes.* All OECD countries now deny a tax deduction for bribes. It would be unusual for Ukraine to do otherwise. The definition should be broad, including bribes, kickbacks, and other illegal payments.

[73] Unless to the extent such expenses are considered employee benefits and taxed as wages.

Thin capitalization

3. **The current thin capitalization rule based on the average loan value as of the beginning and end of the year is easily avoided.** Taxpayers can manipulate the rule by arranging borrowing during the course of the year and repaying it before the end of the year. This way, substantial interest expense can still be incurred but the thin capitalization rule does not apply. One way to deal with this problem is to specify that the amount of debt is computed as the average for each calendar month of the tax year. The applicable amount for each calendar month is the greatest amount of debt outstanding to related parties at any time during the month.

4. **Foreign exchange gains and losses should be assimilated to interest income and expense for purposes of the thin capitalization rule.** In an inflationary environment, most of the cost of borrowing in foreign currency will take the form of a foreign exchange loss rather than interest per se. In order for the thin capitalization rule to work properly, and treat borrowing in foreign currency and local currency on an even-handed basis, foreign currency losses on liabilities should be treated as interest expense and foreign currency gains on foreign currency deposits, other loans, or currency holdings should be treated as interest income. If inflation adjustment rules are adopted, these will also need to be coordinated with the thin capitalization rule, so that there is no double denial of a deduction.

5. **There are many options for formulating a thin capitalization rule.**[74] The general approach taken in the Tax Code falls within the range of reasonable approaches. The 3.5 debt/equity ratio is on the high side, and consideration could be given to lowering this. On the other hand, the importance of a strict thin capitalization rule is closely related to what is done on inflation adjustment. If a comprehensive adjustment for CPT is adopted, then most of the benefit from deducting interest expense will be eliminated and there will be less pressure on the thin capitalization rule.

Depreciation

6. **There are many reasonable options for designing depreciation systems.** In the absence of a compelling reason for change, it may be best to leave the existing system as it is for the time. Technical corrections should, however, be made. First, it should be clarified whether tax depreciation is based on historical cost or can take into account revaluations of assets that are made for financial accounting purposes. Second, the tax law could refrain from making an adjustment to accounting policy on the issue of which small-value assets are treated as depreciable property, perhaps with a value limitation.

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[74] See IMF, *Ukraine, Restoring a Strategic Approach to Tax Reform*, March 2015.

Change in method of accounting

7. **The Tax Code currently does not include in income amounts resulting from a change in method of accounting.** A change in method of accounting can occur if a taxpayer changes from using national GAAP to IFRS.[75] It can also happen, however, from a change in accounting policy within the framework of either national GAAP or IFRS. For example, if the taxpayer switches from a method of accounting involving the valuation of an asset on the closing balance at 100 to a new method where the balance value is 150, in the absence of an adjustment the new balance sheet value of 150 will result in exclusion of 50 from income. The problem arises because the Tax Code specifies no adjustment for a change in method of accounting. There are various options for how to include the adjustment in taxable profit. Some countries do so right away and others do so over a specified period of years.

8. **The Tax Code should provide that adjustments must be included in taxable profit (or deducted as a loss) in case of a change in method of accounting**. Otherwise income may be taxed twice or not included at all as a result of the change. In general terms, this would mean that where a change in accounting policy increases the value of the opening balance as compared with the closing balance of the preceding year, the difference should be included in income for the current year. By contrast, if the opening balance is lower than last year's closing balance because of the change in policy, then a deduction should be allowed for the difference.

Consolidation

9. **Consolidated accounting is allowed under IFRS and national GAAP but there is no provision in the Tax Code explicitly requiring separate accounting.** However, there was no conscious policy decision to depart from entity-by-entity reporting for tax purposes. The Tax Code should therefore include a provision requiring taxpayers who prepare consolidated financial accounts to continue to prepare and submit separate accounts for tax purposes.

Long-term contracts

10. **Both national GAAP and IFRS provided for percentage-of-completion accounting for long-term contracts.** There is some flexibility in terms of national GAAP as to how to determine the percentage of completion, but as long as the broad principle is there it should be acceptable for tax purposes.

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[75] This might not be possible under current legislation but could become possible in the future if greater use of IFRS is made.

Leasing

11. **While the Tax Code contains a detailed definition of finance lease it is not clear what role this definition plays.**[76] Normally, where a tax law contains such a definition, it also includes a provision that specifies that for corporate profit tax purposes, the lessee of assets under a finance lease is treated as the owner of those assets. The same result seems to apply under current law, but it is reached through the interaction with the national GAAP or IFRS treatment of finance leasing. There is scope for confusion, though, because the definition of finance lease under accounting standards will differ somewhat from the Tax Code definition. Generally the taxpayer has greater flexibility for classifying a lease under financial accounting. This should be an acceptable tax result, as long as it is clear that the lessor and lessee may not take inconsistent classification positions. The situation should be clarified if necessary. The definition of finance lease should be deleted from the Tax Code if the term is no longer used in the Code.

Recognition of income where liability to provide future service

12. **Accounting standards allow the deferral of income where there is a liability to provide a future service.** For tax purposes, such rules are generally disfavored, since they allow the taxpayer to postpone paying tax into the future. Such timing issues are particularly important under inflationary conditions, since inflation accentuates the time value of money. Rules should be formulated providing for an adjustment for tax purposes where income is deferred under accounting standards on the basis that there is an associated future liability.

Provisional and advance corporate tax payments

13. **There is currently a duplicative system of tax prepayment comprising both an Advance Corporate Tax (ACT) and provisional CPT payments based on last year's tax.** Both prepayments have different rationales. ACT can help assure that corporate tax is paid where there is a distribution to shareholders, even if at the end of the year there is no corporate profit because of evasion or some deficiency in corporate tax base measurement. Likewise, requiring preliminary monthly payments based on last year's tax makes sense in terms of assuring a stream of corporate tax revenue. The latter is particularly important in an inflationary environment, since if tax payment can be delayed to the end of the year, the taxpayer ends up reducing the effective tax burden.

14. **While both the ACT and provisional payment could be kept, it is important to make sure that they are not duplicative.** The taxpayer should be allowed to credit ACT against provisional payments made during the year. Only if the ACT liability exceeds preliminary

[76] Article 14.1.97 of the Tax Code.

payments made at the time the ACT liability arises should be taxpayer have to pay the net amount to the budget. Annex I provides examples of different scenarios.

15. **The liability for provisional payments could also be revised to align them to current year's sales.** A simple way to do this would be for taxpayers to compute a profit tax ratio for the previous year, i.e. profit tax as a percentage of total turnover as determined for profit tax purposes.[77] Taxpayers would then calculate the provisional payments due on the basis of their total turnover realized in the provisional payment period and multiply it by last year's profit tax ratio.

Investment funds

16. **The current tax treatment of investment funds is overly generous.** Amounts in a fund are free of tax until distributed to investors.[78] The rules to qualify for investment fund tax status also are too broad; countries usually restrict such special rules to regulated investment funds only.

17. **While investment fund tax regimes vary internationally, a general principle is that they should provide no more generous treatment than would be available if an individual made a direct investment in fund assets.[79]** A typical approach is to determine the fund's income at the end of the year and flow taxation through to the shareholders. For simplicity, and to assure that the tax is paid, shareholder taxable income should be subject to withholding tax. There are at least a couple of options for doing this. First, investment assets of the fund could be subject to mark-to-market treatment, with inflation adjustment. The fund would calculate a withholding tax as if the gain were distributable to individual shareholders. Under the second option, the fund would determine amounts of interest income, dividend income, and capital gain income, and these would then be subject to withholding taxes as if there were a distribution at the end of the year. Under both options undistributed amounts would be added to the shareholder's cost for purposes of calculating shareholder gain on sale of shares during the subsequent year. In the case of amounts allocable to a domestic legal person, a withholding tax at the general CPT rate could apply.

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[77] Alternatively, turnover for VAT purposes could be used, but this method would need to be adapted for financial institutions and other taxpayers with substantial VAT exempt sales, since for them VAT sales would not be a good proxy for total income.

[78] Article 141.6.1 of the Tax Code; investments funds are also exempted from making provisional; see Article 57.1 of the Tax Code.

[79] For an overview, see Eric Zolt, "Taxation of Investment Funds", in *Tax Law Design and Drafting* (Victor Thuronyi ed., 1998), available online here: http://www.imf.org/external/pubs/nft/1998/tlaw/eng/.

18. **The first option would mark all securities of an investment fund to market, while the second option would defer gains until they are realized by the fund.** In addition, the second option would calculate the withholding tax based on the character of the income, matching the withholding rate to that applicable under the individual income tax or under the international withholding rules in the case of foreign investors.

19. **Only regulated funds should be subject to the special tax rules for investment funds.** Investment funds are subject to special financial regulations. Only these funds tend to have many individual investors, which should receive special treatment. Other investment vehicles should be subject to the normal tax rules.

Simplified CPT regime for taxpayers with turnover less than 20m hryvnia

20. **The simplified CPT regime for taxpayers with less than 20m hryvnia turnover is open to abuse.** The special regime—buried in a sub-paragraph of the Tax Code[80]—consists of an exemption from tax adjustments to accounting profits. Despite the obscure drafting of this provision, it is of substantial importance to the vast majority of CPT taxpayers—according to one estimate about 95% of CPT payers apply this regime.[81] It allows taxpayers to account for tax on income determined under financial accounting, without any tax adjustments. Such taxpayers are also exempt from making provisional tax payments.[82] Finally, these taxpayers are also provisionally exempt from tax audits for 2015 and 2016.[83] However, even if they were audited after this moratorium expires—but before the period of limitations is reached—as noted below,[84] there would be no penalty for improper filing of their 2015 tax return.

21. **The absence of rules about aggregating corporations allows taxpayers to abuse this regime.** They can establish as many corporations as they find convenient and thereby take advantage of this rule for each of them. Corporate taxpayers can easily establish subsidiaries that qualify for this regime. They can then exploit inconsistencies between the tax and accounting rules. For example, they might use this kind of company to acquire fixed assets for which they can obtain accelerated depreciation, to the extent allowed by national GAAP.

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[80] Article 134.1.1. of the Tax Code.

[81] This simplified CPT regime does not apply to entities that opt for the ST regime in Group 3; see above.

[82] Article 57.1 of the Tax Code.

[83] See point 3 of the concluding provisions of the Law of Ukraine «On Amending the Tax Code of Ukraine and Certain Laws of Ukraine re Tax Reform» of December 28, 2014, No.71-VIII.

[84] See footnote 1.

22. **The case for a special CPT regime of this nature for taxpayers keeping books under accrual accounting under national GAAP is particularly weak.** The additional compliance burden involved in adjusting the accounting financial result according to the Tax Code is minimal. Accordingly, the best approach would be to abolish the CPT special regime and to have a single set of rules for all CPT taxpayers using accrual accounting under national GAAP.[85]

Other exempt enterprises

23. **Tax policymakers in Ukraine have done a good job in eliminating CPT exemptions with only few exempt enterprises remaining.** The mission has not had the opportunity to determine whether there is any abuse of the remaining exemptions. In the absence of evidence indicating otherwise, these remaining exemptions generally do not appear to pose a problem for the tax system.

24. **The exemption of religious or charitable organizations carrying out businesses unrelated to their non-profit purpose is, however, of concern.** The motivation to prevent audits of nonprofits with respect to inconsequential business operations is understandable in the current context. However, where business operations reach an important level, exempting them from taxation poses a risk of abuse. For example, it further facilitates the already pervasive practice of paying employees off the books, and also allows non-profits to serve as a source of invoices for the corporate sector seeking cash to employ people by paying them in envelopes. Accordingly, nonprofit organizations should be taxed on business operations that are not related to their exempt purpose, with the exception of operations that are very small.

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[85] Together with the ST reform proposed in Chapter III of this report consideration could be given to extending the cash-flow accounting method proposed there for small taxpayers to medium sized CPT taxpayers—a group that would then need to be further defined.

Appendix C: Drafting issues

Style and user friendliness

1. **A number of observers have remarked that the Tax Code is poorly drafted.** An important reason that the drafting is problematic is that the Tax Code lacks structure. There is a numbering system for articles that at first glance appears scientific, but the problem is that there are no stylistic rules for the structure of each article that are consistently followed.

2. **The lack of consistent stylistic rules makes for drafting that is poorly organized and difficult to follow.** This can be illustrated with an example. Article 133.2 (non-resident taxpayers) is a complete sentence. It takes the structure of a list. The introductory language of 133.2 says: "Taxpayers- non-residents are:", followed by two items: 133.2.1 (legal entities) and 133.2.2 (permanent establishments). Grammatically, from the introductory language to the end of 133.2.2, there is one complete sentence. On the other hand, Article 133.1, although it starts with similar introductory language ("Taxpayers-residents are:"), does not follow the same rules as 133.2. There is some similarity, in the sense that there would be a complete sentence if the second and third sentences of 133.1.1 were placed somewhere else. Even then, the inclusion in item (2) of 133.1.1 of rules about not distributing profits among founders, while it does not violate the sentence structure, makes the sentence rather complicated. Moving on to Article 134.1, there is again a list structure in the form of a complete sentence, but it is interrupted by a massive amount of material. If this material were moved so that only the first paragraph of 134.1.1 remained there, then there would be a list consisting of 134.1.1, 134.1.2, 134.1.3, and 134.1.4.

3. **One possible stylistic rule could be that, at the level of one decimal point, there should be one complete sentence and that the two-decimal level would be subdivisions of that sentence.** Article 138.3, however, shows a different structure. Here, the introductory words of 138.3 are a title. There follow three two-decimal subdivisions, each of which is at least one complete sentence on its own. Article 139 follows a similar structure. Here, there are three one-decimal divisions (139.1, 139.2 and 139.3). Each of these take the form of a title, and is followed by text at the two-decimal level.

4. **A second possible stylistic rule could be for each one-decimal level to consist of a title, followed by one or more sentences at the two-decimal level.** Either of these stylistic rules would be fine, but a decision should be made as to which approach to take. The second approach may make for a more user-friendly statute, because it is helpful to the reader to provide titles to each article and subdivision of an article—particularly where each article is long, as is the case in this Code. Under this second approach, for example, 133.1 would become a title (Taxpayers – residents), followed by a one-sentence 133.1.1 which would start "Taxpayers residents are…" and would be in a list form. Then there could be a 133.1.2, which could be a rule about nonprofits not distributing their profits to owners. The two independent sentences which

are currently floating at the end of 133.1.1 would become 133.1.3 and 133.1.4. Annex II shows how this could look.

5. **Basic stylistic rules for how the Tax Code should be written should be decided on and consistently followed.** This would require some reorganization and redrafting of the Code, but would not require a major rewrite. In a sense it would be editing the material that is there.

6. **Besides this stylistic problem, the Tax Code is plagued by language that is written in a repetitive manner.** For example, in 134.1.1 there is language about "adjustments to the financial result before taxation of all differences (except for the negative value of the object of taxation of previous tax reporting years." This language is repeated in the following paragraph. The repetition could be eliminated by a simple cross reference. There is also repetition of language about a taxpayer whose annual income (excluding indirect taxes) does not exceed twenty million hryvnias. Again, the repetition could be eliminated by a cross reference if the draft were appropriately structured. The result of eliminating duplicative language would be to make the rules easier to read and understand.

Poorly thought-out rules

7. **Another drafting problem of the Tax Code are rules that seem to have been drafted without taking full account of all considerations, including taxpayer response.** An example is the thin capitalization rule in Article 140.2. Under this rule, a limitation applies on deductible interest expense, in cases where the amount of debt with related persons exceeds 3.5 times the equity capital. For this purpose, the amount of debt is defined as the arithmetic mean of the values of debt and equity at the beginning and end of the fiscal period. Although this definition is clear, the way it is drafted leads to an obvious avoidance opportunity. As long as a loan agreement with a related party is contracted after the beginning of the year and the loan is repaid before the end of the year, the loan is not taken into account. This makes it easy in many situations for taxpayers to plan around application of the rule.

Ambiguous language

8. **In other cases, the problem with the drafting is ambiguous or imprecise language.** For example, item 11 of Section XX, subsection 4 of the Tax Code provides:

> 11. При розрахунку амортизації основних засобів та нематеріальних активів відповідно до пункту 138.3 статті 138 цього Кодексу балансова вартість основних засобів та нематеріальних активів станом на 1 січня 2015 року має дорівнювати балансовій вартості таких активів, що визначена станом на 31 грудня 2014 року відповідно до статей 144 - 146 та 148 розділу III цього Кодексу у редакції, що діяла до 1 січня 2015 року.

The difficulty is that the provision is limited to the calculation of amortization under Article 138.3. It is not clear from the provision how a gain on the disposition of an asset taking place after

January 1, 2015, should be calculated under Article 138.2. Should the historical cost, less accumulated depreciation, be used, or should the balance sheet value as of December 31, 2014, be used? The difficulty is that item 11 above refers to depreciation under Article 138.3, while the gain on the disposition of an asset is not a depreciation calculation, and is made under Article 138.2, not 138.3. In this case, the problem could have been fixed by a more precise reference to Article 138 of the Tax Code, instead of just to referring to depreciation under Article 138.3.

9. **Another example of ambiguity is the definition of foreign-source income.** For corporate income tax, one problem is that there are two definitions of foreign-source income. First, in the general definitions Article of the Tax Code (14.1.54) there is a list of items of foreign source income, and second there is a list in Article 141.4.1. The wording of these two lists differs. Moreover, the definitions are often vague. This makes it difficult for taxpayers to determine what precisely is subject to withholding.

10. **Imprecise cross-references or ambiguous language create situations where the taxpayer and the tax administration may take differing views, or where taxpayers are not sure what the correct rule is.** This of course makes tax compliance difficult. Because of the nature of language, ambiguity cannot be eliminated, but there is scope for substantial reduction of ambiguity in the Tax Code.

Excessive simplification

11. **In respect of the CPT, the 2014 reform eliminated a number of rules for the purpose of simplification, but this effort went too far.** A number of rules that are necessary to the proper functioning of the CPT have been eliminated, for example rules defining nondeductible expenses. The taxation of the nonprofit sector has been radically simplified. For example, nonprofits are no longer taxed on their unrelated business profits. The exercise to redraft Section III of the Tax Code therefore needs to include a review of the rules in the 2014 version of the Tax Code to see whether any provisions from prior law were eliminated with excessive haste. This does not mean that all the earlier rules need to be restored.

Redrafting process

12. **While the entire Tax Code could benefit from redrafting, a revision of the entire Code should be attempted only with sufficient time.** Typically, Parliament may be expected to need the better part of a year – at least – to adopt a completely new Tax Code. This suggests that if a draft new Tax Code is presented to Parliament early in 2016, for instance, that there should be a reasonable chance of its adoption by the end of 2016. On the other hand, the policy changes—discussed in the body of this report—that are desired to come into effect on January 1, 2016 would be best formulated as amendments to the existing Tax Code, and kept to the minimum needed to be enacted before end-2015. Of course, to some extent work can proceed on parallel tracks, but the priority in the immediate term should be on making the necessary amendments to the Tax Code to implement the desired policy changes for 2016.

13. **Good drafting requires setting up an institutional structure so that best drafting practices are followed in the future.** Experience in other countries shows that good tax legislative drafting can only be done if an office is set up with specialized personnel who have responsibility for all Tax Code amendments. It is not so important where this office is located—the SFS, MOF, or Verhovna Rada. The important point is to recruit and retain qualified personnel to do this task. Such an office might be quite small. The individuals involved should be lawyers with a specialization in taxation. It would be fine to find fairly young people for this job, who could deepen their experience over time, but it is important that they have the highest academic credentials and skills.

14. **Tax specialists in the government would continue to do the work of developing legislative proposals, but the specialist drafters would be the ones putting the proposals into legislative language.** The process of drafting involves an interaction between the drafting specialist and those with substantive specialization in the area of legislation in question. Thus, the drafting office would not be expected to come up with answers as to how legislation should be formulated, but rather would have the experience to be able to pose the right questions to the subject-matter specialists, so that together they could develop the draft language to be presented to Parliament.

Recommendations

- For the purpose of any future redrafting of tax laws: (i) decide on and consistently follow stylistic rules for the Tax Code, (ii) eliminate unnecessary language and ambiguities, and (iii) draft rules in anticipation of taxpayers' reactions.

- Adopt a reasonable timeframe for submitting a completely revised Tax Code to Parliament in view of its adoption by end-2016.

- Prioritize the drafting of amendments needed to implement the recommended CPT, ST and SSC changes by end-2015.

- Improve government capacity and management of the tax law drafting function, including through the recruitment and long-term employment of specialized tax lawyers.

Annex I: Illustration of proposed rules for Provisional Payments and ACT

The taxpayer is required to make monthly provisional payments of corporate tax at the time established for filing the VAT return for the preceding month, in the following amount:

A X B,

where

A is the total turnover for the preceding month, and
B is the ratio of the profit tax liability for the most recently filed tax return to the total turnover for the period corresponding to that return.

The taxpayer's obligation to make payments of Advance Corporate Tax ("ACT") with respect to dividend distributions is offset against provisional payments of corporate tax made for the current tax year prior to the date of the distribution. Any excess of ACT remaining after this offset is offset against subsequent obligations to make provisional payments of corporate tax, until this excess is exhausted.

Example

The corporate tax liability for 2014 and for 2015 is 10, and total turnover in each year is 100. Therefore, in 2016, the taxpayer uses a tax/turnover ratio of 10% in calculating provisional payments.
Suppose that in January through April 2016, turnover is 150 in each month. The taxpayer pays provisional CPT payments of 15 per month.

In May 2016 the taxpayer makes a dividend distribution, with respect to which the ACT is 90. In this case, provisional payments of 60 have been made for January through April, and the net payable by way of ACT is 30. For May and June, if sales continue at the same level, the taxpayer can credit the remaining ACT paid in May against the liability to make provisional payments.

(Note: under inflation adjustment, all the above payments would be adjusted for inflation.)

Annex II: Stylistic example

133.1. **Платники податку - резиденти**

133.1.1 Платниками податку - резидентами є:

1) суб'єкти господарювання - юридичні особи, які провадять господарську діяльність як на території України, так і за її межами, крім:

а) бюджетних установ;

б) громадських об'єднань, політичних партій, релігійних, благодійних організацій,

в) пенсійних фондів,

г) суб'єктів господарювання, які застосовують спрощену систему оподаткування, обліку та звітності, визначені главою 1 розділу XIV цього Кодексу.

2) Управитель фонду операцій з нерухомістю, який здійснює діяльність відповідно до Закону України "Про фінансово-кредитні механізми і управління майном при будівництві житла та операціях з нерухомістю" щодо операцій і результатів діяльності із довірчого управління, що здійснюється таким управителем через фонд.

133.1.2 Метою організацій, які зазначені у підпункті (б) підпункту (1) підпункту 133.1.1.пункту 133.1 статті 133 цього Кодексу, не може бути одержання і розподіл прибутку серед засновників, членів органів управління, інших пов'язаних з ними осіб, а також серед працівників таких організацій.

133.1.3 З метою оподаткування центральний орган виконавчої влади, що реалізує державну податкову політику, веде реєстр всіх установ та організацій, які зазначені у підпункті (б) підпункту (1) підпункту 133.1.1.пункту 133.1 статті 133 цього Кодексу.

133.1.4 Установи та організації, які зазначені у підпунктах 1(а), (б) або (в) підпункту (1) підпункту 133.1.1.пункту 133.1 статті 133 цього Кодексу,, не є платниками податку на прибуток лише після внесення таких установ та організацій до Реєстру неприбуткових організацій та установ контролюючими органами в порядку, встановленому центральним органом виконавчої влади, що забезпечує формування та реалізує державну податкову і митну політику.

133.1.5. Національний банк України здійснює розрахунки з Державним бюджетом України відповідно до Закону України "Про Національний банк України".