

New tax law puts squeeze on optimization schemes

Feb 17, 2011 Oksana Faryna – Kyiv Post

Business are confused how to interpret and apply the new tax code.

Uncertainty and ambiguity are rife among businesses in Ukraine after the new tax code was adopted at the end of last year. Lawyers, accountants, auditors and tax consultants are overloaded with clients' requests how to understand and apply certain provisions of the new legislation.

One of the main provisions raising questions is relations between businesses and private entrepreneurs who provide services to them and pay taxes under the simplified system of taxation.

It's a scheme that allows companies to avoid declaring de facto staff as employees, in turn freeing them of the obligation to pay hefty payroll taxes which often exceed 30 percent of salaries paid to staff.

Long used as a tax optimization scheme by employers, registering de facto employees as private entrepreneurs has deeply hurt revenues going to the pension fund.

With the new tax code, authorities have tried to eliminate it. But from a legal standpoint, it remains unclear whether the scheme can still be used.

But this is by far not the only problem area businesses are facing in connection with the new tax code. "All the disadvantages that the tax code contains are becoming visible now and are driving accountants and specialists who deal with taxes mad," said Oleksandr Minin, senior partner at law firm KM Partners.

"At the same time, the state tax administration is taking a very tough position that is very unfavorable for taxpayers."

Most chapters of the recently adopted tax code came into force at the beginning of 2011. Some other rules envisioned in the new tax law will take effect several months later this year.

The first two months of 2011 showed that businesses still have many questions that have no clear solutions – neither by lawyers nor by tax authorities.

Among them are procedures related to the refunding of value-added tax, payment of dividends and royalties and calculation of profit tax, the rate of which will be gradually reduced from the current 25 percent to 23 percent in 2011 and 16 percent in 2014.

"We have a lot of work at hand," said Hennadiy Voytsitskyi, partner and head of the tax practice at the Ukrainian office of Baker & McKenzie, an international law firm.

Voytsitskyi said that since the beginning of the financial crisis in 2008 a large part of their work was devoted to their clients' court disputes with tax authorities. Now, however, clients are more busy seeking consultations regarding the new tax code and how it will affect them.

Back in the shadows

Use of the private entrepreneur scheme, which has for many years allowed de facto full-

time employees at companies to pay a “simplified” tax of Hr 200 per month, is one of the biggest headaches.

“Many sectors of our economy have been very dependent upon such schemes,” said Voytsitskyi. “This is one of the factors why a significant part of the Ukrainian economy remains beyond official statistics – in the shadows.”

Estimates published in Ukrainian media suggest that about three million employees across the country abused the system. Firms could deduct the costs of goods and services purchased from these private entrepreneurs from their tax bills.

But from April 1 this year, they won’t be able to do so anymore, making it less favorable to work with many small traders who have no other way to earn income. Voytsitskyi from Backer & McKenzie offers four solutions in this situation.

In the short term, companies – especially unprofitable ones – could continue working with private entrepreneurs, not declaring their losses. In the long term, this solution is not suitable as every company is interested in being profitable sooner or later.

A second scenario proposed by the lawyer is to work with private entrepreneurs who pay not Hr 200 under the privileged tax option, but the usual 15-17 percent individual profit tax. In this case the employee may agree partially or completely to cover additional tax expenses of the individuals.

However, this will only happen with qualified professionals who are in demand on the market. More often the tax burden will be carried by the individuals.

The third possibility is for individuals to open a private service company, which according to the new tax code will receive a five-year tax holiday.

The fourth solution for the company is to hire those private entrepreneurs as full-time employees and to pay the hefty payroll taxes.

“Regarding tax planning, the best option is the simplest one,” Voytsitskyi said, referring to the fourth option. “The simplest solution is to switch to labor relations where everything is regulated. But it is a big is whether this advice corresponds with business models and business opportunities of the clients.”

The answer, says Olexander Minin from KM Partners, is that many businesses are not prepared to shoulder the burden of heavy payroll taxes and prefer to operate in the shadows.

“In most cases companies are not ready to register these people as staff employees and pay all social taxes,” he said. “As often happens, individuals will be left to survive on their own. Shadow payments and salaries in envelopes will increase at that point. Others will lose their jobs.”

Crackdown planned

Why did protests by smaller businesses erupt last year? The new taxation legislation essentially decreases the burden on big businesses, cutting profit taxes, for example. It increases the burden on small- and medium-sized businesses.

There are signs that government is preparing to crackdown on tax optimization schemes used by small and medium-sized businesses.

But no specific action is seen by government to also target big companies that have long funneled much of their profits into offshore tax havens, such as those owned by the nation's all-powerful oligarchs.

According to Iryna Akimova, deputy head of presidential administration, the government has been preparing a draft law on a simplified system of taxation that may limit application of a single tax.

Besides this, the new tax code already contains a rule that if relations between an employer and an individual are recognized as a full-time job, they will have to pay full payroll taxes.

"The rule is not clear but it gives room for tax officials to abuse their powers," said Ivan Yurchenko, senior attorney at Vasil Kasil & Partners. Amendments to the civil code adopted recently contain a definition of reasonable business object.

It says that if the transaction, or in this case an agreement between company and individual, does not have a reasonable business object but is aimed at minimizing taxes, then it will be recognized invalid with all legal consequences.

"New rules and amendments are not clear enough but give a sign that the tax authorities will operate more actively regarding tax optimization schemes using this new arsenal of tools," Yurchenko said.

Source: *Kyiv Post* staff writer *Oksana Faryna*

Business Sense: New tax code opens dangerous doors; fines could be very high

Feb 25, 2011 Yuri Delikatny at *Kyiv Post*

Certain provisions of the new tax code have come under assault from business circles in Ukraine and abroad.

Some of the causes for complaint include vague laws and a somewhat aggressive attitude toward those businesses that are willing to open their books to the tax authorities.

In addition, the severe penalties set out in the new tax code for non-compliance scare away those businesses that are willing to come out of the shadows and conduct business in a more transparent fashion.

While the tax code does provide for a grace period through June 30, 2011, during which the penalty for noncompliance will be only Hr 1, this grace period will soon be over.

Once this period is over, Ukrainian businesses will have to work under the threat of severe penalties, which appear to have increased under the tax code compared with those which applied under the older tax laws.

Under the previous tax law, penalties could be imposed on businesses which underpaid taxes due. With some exceptions, most such penalties varied from 10 percent to 50 percent – the older the overdue tax, the higher the penalties.

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The new penalties apply regardless of how long a given tax is overdue, and under the tax code penalties range from 25 percent to a whopping 75 percent.

If the tax authorities identify a tax underpayment for the first time, in addition to the tax they will charge a penalty of 25 percent. If the tax authorities identify a similar tax issue two or more times within the next three years, they may apply penalties of 50 percent and then 75 percent, respectively.

Businesses will also be hit with another nasty surprise, as the tax authorities will be authorized to impose penalties on businesses even if no tax underpayments had been detected.

For example, the same 25 percent to 75 percent penalties can be imposed on the basis of incorrectly computed losses or value-added tax refunds, even if such incorrect calculations do not result in a loss of money to the Ukrainian state.

In response to such criticism, the government asserts that the new tax code has reduced the tax burden on businesses.

However, all of these rather punitive measures, combined with vague laws and possibly inconsistent application, will not result in a reduced overall tax burden and are not likely to increase the transparency of Ukrainian business practice.

Potentially, taxpayers can protect themselves from the imposition of a penalty if they apply for and obtain a ruling on a relevant tax issue from the tax authorities.

Under Ukrainian law, a taxpayer cannot be penalized if he strictly follows a position set out by the tax authorities in a ruling addressed directly to that taxpayer.

However, unlike under prior law, a taxpayer cannot conclusively rely upon general opinions expressed by the tax authorities, nor can the taxpayer rely upon tax rulings addressed to other parties.

To take advantage of any "safe harbor," a tax ruling must be addressed to the specific taxpayer who relies upon that ruling. Although past experience shows that individual letters issued by the tax authorities to specific taxpayers at times were not very helpful and also led to further uncertainties, the tax code provides that a taxpayer, if he disagrees with a tax ruling, can now challenge it in court.

Although it remains to be seen how these new procedures will be applied in practice, it is definitely worth taking the time now to minimize risks that may arise.

Source: Yuri Delikatny is head of tax at the Kyiv office of Noerr, a German law firm.