INTERNATIONAL MONETARY FUND

IMF Country Report No. 20/302

UKRAINE

TECHNICAL ASSISTANCE REPORT—A FOLLOW-UP ON DISTRIBUTED PROFIT TAX, BEPS IMPLEMENTATION, VOLUNTARY DISCLOSURE PROGRAM, AND INDIRECT METHODS FOR DETERMINING TAXABLE INCOME

November 2020

This Technical Assistance Report 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 September 2020.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

F I S C A L   A F F A I R S   D E P A R T M E N T

Ukraine

A Follow-Up on Distributed Profit Tax, BEPS Implementation, Voluntary Disclosure Program, and Indirect Methods for Determining Taxable Income

Roberto Schatan, Martin Grote, Lee Burns and Oscar Molina

Technical Report

September 2020

CONTENTS

APPENDICES

ABBREVIATIONS AND ACRONYMS

AL	Arm's Length
ALP	Arm's Length Principle
AEOI	Automatic Exchange of Information
AML	Anti-Money Laundering
BEPS	Base Erosion and Profit Shifting Work Program Organized by the OECD
CbC	Country-by-Country
CFC	Controlled Foreign Corporation
CPT	Corporate Profit Tax or Corporate Income Tax
CUP	Comparable Uncontrolled Price
CUC	Controlled Ukraine Company
DPT	Distributed Profit Tax
EBITDA	Earnings before Interest, Tax, Depreciation and Amortization
ECT	Exit Capital Tax
FAD	Fiscal Affairs Department of the IMF
FATF	Financial Action Task Force
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
MNE	Multinational Enterprise
MOF	Ministry of Finance
NBU	National Bank of Ukraine
OECD	Organization for Economic Cooperation and Development
PE	Permanent Establishment
PEM	Place of Effective Management
PIT	Personal Income Tax
STS	State Tax Service
TP	Transfer Pricing
UAH	Ukrainian Hryvnia
UN	United Nations
UTC	Ukrainian Tax Code
VDP	Voluntary Disclosure Program

PREFACE

In response to a request from the Ministry of Finance, a technical assistance mission from the International Monetary Fund's (IMF) Fiscal Affairs Department (FAD) delivered a remote mission from Washington, DC, initially programmed for June 30 – July 13, and then extended to July 21, 2020, to review selected international tax issues and advise on a Voluntary Disclosure Program and the Exit Capital Tax. The mission comprised Messrs. Roberto Schatan (mission head), Martin Grote (both from FAD) and Mr. Lee Burns and Mr. Oscar Molina (external experts).

The mission presented the aide memoire and explained its recommendations to the Minister of Finance, Mr. Sergii Marchenko. During the mission the team had several rounds of productive (remote) discussions with technical staff of the MoF, headed by the Deputy Minister of Finance Ms. Svitlana Vorobey. The technical staff of the MoF included Messrs. Roman Goptsii and Yevhen Kozlov, Mr Kostiantyn Penskoy, senior tax managers in the Reform Support Team (MoF); Ms. Liudmyla Palamar, Head of the International Taxation Division; Victor Orcharenko, Deputy Head of the Tax Policy Department; Mr Andrii Khomutskii – Head of Personal Income Tax Unit; Ms Olena Markevich – Head of Corporate Income Tax Unit; from the STS: Igor Danylov –Tax Administration Department, Tetiana Radchenko, Tax Audit Division; Mr Viacheslav Krugliak – Deputy Head of Transfer Pricing Division. Also, Ms Olena Diachenko – Director of Directorate General on Economic Policy of the Presidential Office; and Mr Oleg Strynzha – Head of Finance Controlling Department of National Bank of Ukraine participated in the meetings.

The mission held video conferences with representatives from the private sector, including the European Business Association, the American Chamber of Commerce, KPMG, Deloitte, EY, PwC and Cargill.

The team acknowledges the support received from Mr. Ihor Shpak from the IMF Kiev office. Finally, the mission would like to express its appreciation to Ms. Iryna Krupska for her outstanding interpretation work.

EXECUTIVE SUMMARY

Tax policy in Ukraine is engaged in two fronts at once. On one front, very significant work has been done over the years on the gradual improvement and updating of the tax system; on the other, it questions essential tenets of the existing system, exploring fundamental changes to it. While serious efforts have been devoted, for example, to the modernization of the international aspects of the income tax, upgrading the regime to OECD standards, there is a strong push from some quarters of the policy debate to do away with the Corporate Profit Tax (CPT) altogether. The central idea is to replace it with a Distributed Profit Tax (DPT), generally referred to in Ukraine as the Exit Capital Tax (ECT). In essence, this system would not tax profits as they accrue to the corporation, deferring the tax to when the corporation distributes dividends to the shareholder.

Finding a middle ground does not seem to be a feasible option. In previous reports FAD has argued against the adoption of the ECT: it would lead to a significant loss of revenue, it is fundamentally regressive, it is complex to control, and there is no evidence that it may help growing investment. However, the push to adopt it has not died down, even if adopting it only partially as a compromise solution. Technically, however, this is hardly sustainable. Adopting it either for small taxpayers (defined by turnover) or in a few regions with a small tax base has several risks. It introduces the incentive for companies to split up to take advantage of the system, to shift profit through transfer pricing (with no legal restriction because there is no obligation to comply with the arm's length principle (ALP) for domestic transactions), and to divert investments rather than increasing them. Monitoring the effects on investment of a pilot ECT program could be highly misleading if the experience is extrapolated to the entire country. There is no assurance that a partial adoption of an ECT can be contained from eventually spreading much wider , an important reason why this mission does not recommend this approach. Accelerated depreciation of fixed investments, a more targeted tax incentive, has been recently adopted in Ukraine. This should be allowed to generate the expected results.

There is also in the tax policy pipeline a plan for a Voluntary Disclosure Program (VDP). The main purpose of the VDP is to allow taxpayers to come forth and regularize, for a fee, financial or physical assets which have evaded the income tax. This should allow to grow the tax base in the future since the income generated by those assets will become visible to the State Tax Service (STS). Supporters of the VDP argue that this is the right time to do it because of the entry into force of the Controlled Foreign Corporation (CFC) regime, which will effectively tax worldwide income of Ukrainian residents. It would be an opportunity for taxpayers to start complying with their tax obligations with a clean slate, after a long history of keeping assets abroad given foreign exchange and capital controls, and business uncertainty. However, the VDP would apply to domestic assets as well.

The proposals for the VDP have evolved over time. The mission reviewed a fourth version (VDP Policy Draft of 3 July 2020), which evidences considerable improvements. For example, it now states that market-related valuations of assets need to be undertaken by certified valuers in countries where assets are located; there is no longer a zero fee for converting repatriated foreign assets into Ukrainian government bonds; and, importantly, it strengthens guarantees that proceeds of crime and bribery cannot be concealed in a VDP application. In fact, fees paid for declared assets may be forfeited if the VDP supervisory authority subsequently establishes that the origin of those assets relates to crimes.

Despite the improvements, the VDP could be strengthened … Politically exposed persons (e.g. public office bearers, their family members, and close associates) should not qualify for the VDP; it should be clearer how financial institutions will comply in applying strictly anti-money laundering and counter-finance of terrorism controls on clients who repatriate assets; the novel 2.5 percent Fee on funds invested in Ukrainian government stock should be increased to at least 5 percent, a rate currently in the Tax Code.

… and some features ought to be eliminated. The latest VDP draft allows for UAH 400,000 in undeclared assets to remain untaxed and regularized without any questions asked, even if the person does not participate in the VDP (i.e., does not submit the one-time asset declaration). This is like a permanent amnesty, up to the said amount, applicable even if the person is audited after the period for participating in the VDP has expired. Worse still, the threshold is not always binding. Some assets in Ukraine can be regularized without a value cap, for example, apartments, houses (even under construction) under 120 sq. m, industrial buildings and land plots (below a certain surface area). Also, one vehicle can be regularized regardless of value.

The mission does not consider this 'permanent amnesty' being a good practice. Although the problem of unregistered property in Ukraine may be an important issue, a tax amnesty is not the appropriate instrument to resolve it, especially if the benefit extends to foreign held assets. Improvement of cadasters therefore deserve specific attention. Also, unregistered dwellings can be dealt more diligently under the indirect method for determining taxable income, rather than with a blanket tax amnesty.

The mission is supportive of adopting in Ukraine an indirect method for estimating taxable income. This should increase significantly the power of the STS to enforce the income tax. Crucially, the method shifts the burden of proof to the taxpayer. Discrepancies between the income reported in the tax return and evidence available to the STS of additional income, would have to be proven by the taxpayer, with documented evidence, that they correspond to non-taxable items. Failure to do so would allow the STS to assess a "deficiency of tax". This should heighten the perception of risk by the taxpayer and should encourage voluntary compliance. It would also increase the interest in participating in a VDP.

However, an indirect method regime works best when the tax authority has unrestricted access to third party information on taxpayers. An important challenge for Ukraine is that the access to taxpayers' financial information is protected by the financial secrecy law and the STS can obtain it only with the authorization of a judge on a case by case basis. This severely diminishes the effectiveness of the indirect method, which operates best when relying on large-scale data analysis. However, this auditing tool can still operate with limited information, but then it could be used more arbitrarily. Thus, the indirect method must be clearly defined in the law and regulations, including the parameters that may be used to determine presumptive income, as well as the documentation that will be considered valid to rebut the presumption of the tax authorities. Appendix 2 of this report provides Mexico's law on indirect method as an example.

A key message of this report is on sequencing indirect methods and the VDP. The indirect method should increase the perception of risk and this will encourage taxpayers to subscribe to a VDP. This means that the indirect method should have access to information independently of the VDP. Sequencing the instruments, the other way around would probably not work effectively. However, the indirect method could be legislated to enter into force deferred by one year, opening a window for the VDP to be in effect.

The mission also reviewed the technical development of the international taxation framework, which has been progressing very positively. Law 466 (May 2020) enacts provisions in the UTC implementing BEPS Actions 3, 4, 6, 7, 8-10, 13, and 14, which will protect Ukraine's tax base from international tax avoidance practices and align the UTC with international norms. Overall, the international tax reforms are well drafted and comprehensive in their coverage. Some recommendations are made in this Report to improve the technical detail of the rules on controlled foreign companies (CFCs), permanent establishments (PEs), indirect transfers of immovable property, and transfer pricing (TP).

A new test of Ukrainian residence of legal entities is included in the UTC based on the place of effective management (PEM) of the legal entity being in Ukraine. The test applies in addition to the existing residence test based on place of incorporation. A foreign-formed legal entity with its PEM in Ukraine can opt to be treated as a resident. The problem is, importantly, that a PEM resident is taxed only on Ukraine-source income. This has the (probably unintended) consequence of opening up opportunities for avoiding the CFC rules. Because of the serious risks to the tax base and the undermining of the CFC rules, it is recommended that the PEM residence test is repealed.

Newly enacted CFC rules, though comprehensive and generally well designed, have a few "weaknesses". Thus, the CFC legislation will require some amendments. For example, the "active" passive income exemption should be narrowed and the exceptions applicable to a settlor or founder of a foreign trust should be repealed. Further, the lower tax rate on CFC distributions made on a timely basis should be repealed as it creates an incentive for residents to invest outside Ukraine. As an incentive for Ukraine residents to wind-up existing CFCs prior to the commencement of the CFC rules, Law 466 provides that gains on the disposal of an interest in a foreign entity is exempt from tax. This incentive should be incorporated into the VDP so that the exemption applies only if the relevant VDP fee has been paid.

A taxing right over gains arising from indirect transfers of immovable property has been included in the UTC. This is an important amendment that closes a loophole whereby the tax on a gain on the disposal of Ukrainian immovable property by a non-resident can be avoided through the sale of the shares in the legal entity holding the property rather than that entity making a direct sale of the property. The amendment aligns the UTC with Ukraine's taxing rights under tax treaties. The tax is to be collected by the non-resident purchaser withholding tax from the proceeds of sale. It is doubtful, though, how effective this collection mechanism will be and the Report makes recommendations concerning other options for the collection of the tax.

Transfer pricing rules were improved considerably as well, although there is still some room for improvement. The report discusses four transfer pricing topics: commodity pricing, business restructuring, thin capitalization and, more importantly, the adoption of the business purpose test. Some of the issues identified here relate to some imprecise, or one-sided or incomplete definitions. Many would have been corrected with the version of Bill 2524 that was reviewed by this mission. However, it remains to be seen how much of the preliminary Bill remains in the final version approved by Rada.

The most salient issue here is the adoption of the business purpose test for all transactions with non-residents. According to the Law 466, transactions with non-residents that do not comply with the test are (for all practical purposes) non-deductible, including apparently the costs of sales when the transaction in question is a sale instead of a purchase. As defined by Law 466, a transaction would fail the business purpose test if it can be shown that the transaction was not profit motivated or its actual result did not translate in an economic gain. This is an overreach. Independent parties do not operate under perfect information or foresight, so they can engage in good or bad businesses. The STS should not be able to second guess them in this regard (unless fraud is involved). It is a different issue with controlled transactions, where parties do not have an independent will and may contract to shift profits, contrary to the arm's length principle (ALP).

Applying the business purpose test makes sense only in the context of controlled transactions that need to comply with the ALP. This would include transactions deemed to be controlled and only when they must comply with the ALP. The business purpose test is best understood as a tool in assisting the application of the ALP, especially when there are no independent comparables to be found in order to price the controlled transaction. The test then helps to determine whether the transaction should be disregarded (not deductible) or, when it is established that it has a legitimate business purpose, be priced at arm's length, with the most appropriate method given the circumstances and considering the realistically available business options to the taxpayer. Bill 2524 restored (for the most part) the right balance to the business purpose test, including delinking it from actual results. If the final Bill voted by Rada did not include this correction, it should be reconsidered.

Finally, instead of a broad application of the business purpose test, the Tax Code should reintroduce the business link requirement for deducting businesses expenses. Until 2014, like most corporate income regimes around the world, Ukraine required that deductible expenses had to be connected to the business of the taxpayer. This condition however should not question the purpose of the business, this would have to be taken for granted. This provision was eliminated because of the frequent conflicts it generated with taxpayers, mostly because of a biased reading of the provision by the STS, in that the expense had to generate actual profits, not just having to be necessary for the development of the business. The report recommends considering reintroducing this provision, with clear operations rules, and limit the business purpose test exclusively as a tool in the application of transfer pricing.

I. DISTRIBUTED PROFIT TAX

1. **The Ministry of Finance (MoF) requested to include in this report a critical review on new proposals for adopting the Distributed Dividend Profit (DPT).** This chapter addresses this request briefly, since it is a natural follow-up from previous mission reports. Herewith a summary of the discussions the mission had with the MoF and the Office of the Presidency on the DPT.

A. New Momentum for the Distributed Profit Tax

2. **The government of Ukraine is under renewed pressure to enact legislation substituting the Corporate Profit Tax (CPT) for a DPT**. This reform is seen as a political imperative, fulfilling presidential campaign promises. The National Reform Council, chaired by Mr. Saakashvili, is spearheading this latest effort which gained some further impetus by the recent proposal in Poland for adopting a similar scheme for small and medium sized taxpayers.[1] The proposed regime is labeled in Ukraine as the Exit Capital Tax (ECT). This is a long-standing tax policy discussion in Ukraine and the following analysis should be read together with previous ECT discussions by IMF missions (see the 2017 and 2019 TA Reports).

3. **There are various ECT initiatives already registered in the Rada;[2] all very similar to the proposal discussed in the FAD (2019) Report.** The negative assessment of the efficacy of the ECT in that Report would equally apply to these latest initiatives. As explained there in detail, the ECT:

- Significantly erodes tax revenue;
- Is regressive;
- Adds complexity to the system; and
- There is no evidence internationally that it would increase private investment.

However, the MoF, as well as Rada's Committee on Finance, Tax and Custom Policy have been exploring alternatives that may work as a compromise, safeguarding tax revenue.

[1] See KPMG, Tax Alert, Poland to implement 'Estonian solutions' in CIT collections (June 2020)). It should be noted that the proposal to introduce an ECT for small taxpayer in Poland is, as of now, only a proposal, not a policy. Also, Poland has been a relative economic success story among emerging market economies, having comparatively high income tax rates in the region.

[2] Bills 3665, 3665/1, 1185.

B. Compromise Proposals

4. **The main concern of the MoF is the negative revenue impact of the ECT on the budget.** It estimates that any of the three registered bills on ECT would cost around UAH50 billion, which cannot be afforded because the revenue loss is almost half of CPT revenue or close to 4 percent of all tax revenue projected for 2020. So, the Ministry would not support any of these tax reforms without compensating measures. Revenue substitutes have so far not been delineated.[3] The MoF compromise strategy is to adopt a limited ECT that would have a more limited revenue impact.

5. **Also, Rada's Finance Committee proposed a possible compromise.** The new proposal is to adopt the ECT for small taxpayers with sales up to UAH150 million. This would benefit 97 percent taxpayers (legal persons) and cost to the budget about UAH 8.5 billion.[4] This assumes a static behavioral response by taxpayers in that larger firms would not split into multiple units to take advantage of the tax benefit. The MoF estimated a revenue loss of about UAH13.5 billion per year in the event of companies indeed splitting up, as expected (the mission did not have the opportunity to discuss how this was calculated). This proposal has not been formally registered as an initiative in Rada, however a document was released for public comment.

6. **The MoF proposes an alternative compromise with the view to limiting expected revenue losses.** According to this proposal, ECT would be rolled out in only five regions, where there is little business activity and hence very small CPT collections. Evidently, the proposal's revenue loss is restricted to approximately UAH 1 billion, or 0.4 percent of total CPT revenue. In essence, this would be a pilot program, to explore whether the system is effective in increasing investment. If found that this indeed would be the case it could be expanded to other regions or the whole country.

7. **Other ECT options have been advanced by the private sector.** The information technology (IT) industry has lobbied for granting the ECT in special economic zones where IT companies could register and operate. The revenue cost of this plan amounts to UAH1.2 billion (MoF estimates). The industry claims that distributing dividends equivalent to just 10 percent of industry profits would compensate for the consequential CPT losses. However, the central point of this proposal is that taxpayers under this regime are discouraged to distribute dividends, so there cannot be much certainty on that percentage.

8. **According to some, there are other present-day compelling pressures to adopt the ECT**. These conditions did not exist when the FAD (2019) report was written. For example, the economic stress from COVID-19 requires government to be supportive of business and the ECT

---

[3] An asset tax was proposed as a compensating measure in the original ETC plan discussed in FAD (2019) Report. As pointed out there, this would have the opposite effect than the ECT, potentially nullifying it, since it inhibits business investment.

[4] MoF estimates.

would be an effective way to provide low-cost loan capital. Also, according to its proponents, it would help especially small businesses, not just with greater liquidity, but in simplifying their tax obligations and lowering their administrative costs. However, accounting regulations and deemed dividends calculations required under the ECT, as explained in the FAD (2019) report, make this regime intrinsically complicated. This is also the view of the MoF.

Discussion

9. **The reaction of the mission is informed by technical, not political considerations about the merits of the different ECT alternatives.** The position of FAD is that the ECT is a radical reform, which not only costs tax revenue, but changes the incidence and the administration of the corporate tax. It is regressive because, generally, the burden of the corporate profits tax (CPT) as it stands today in Ukraine, falls principally on shareholders. Instead, under the ECT, tax on profits would be deferred indefinitely for the most part, so that this tax would probably not be paid by shareholders. At the same time, the enforcement of the ECT is complicated; the State Tax Service (STS) would have considerable problems controlling that profits are not spent by companies on behalf, or for the benefit, of their shareholders without being taxed.

10. **The administrative argument is a strong motivation for those who support the ECT**. The reason why many representatives of civil society organizations with whom previous FAD missions met, who are dedicated proponents of the ECT, is that this tax would minimize the engagement between businesses and the STS and exposing them less to STS exercising its discretionary (they would say arbitrary) powers. Against this background, the mission's first reaction to this debate is that a partial and modest adoption of the ECT will not be, most probably, a stable solution. The ECT is a radical approach to remedy widespread administrative problems and to reduce the tax burden.

11. **There is uncertainty too regarding the estimation of revenue losses when adopting a partial ECT**. For example, when applying it only to small taxpayers, it creates the incentive for splitting companies to gain the tax benefit linked to a lower sales threshold, as recognized by the MoF. It is hard to estimate upfront the magnitude of this tax avoidance. In addition, there exists an even graver concern with the ECT: Ukraine has no transfer pricing regulations for domestic transactions. Local related companies (e.g., one company operating under the CPT and another operating under the ECT) could shift profits from one to the other with no obligation to comply with the arm's length principle.[5] This could translate into a significant revenue risk, as there is no limit to the number of paper companies with which CPT firms could do business in the ECT

[5] While companies under the ECT have to comply with their own type of transfer pricing rules when determining deemed dividends distributions, these rules only apply against profit shifting out of an ECT company, not for profit shifting from a CPT company into an ECT-related party.

sector, with the explicit objective to siphoning off profits. These TP risks do not dissipate under a partial ECT which clearly complicates the estimation of revenue losses.

12. While the Simplified Regime for small taxpayers in Ukraine may need revamping, the ECT is not the answer. The Simplified Regime has several shortcomings, which have been discussed in previous FAD mission reports.[6] One of them is that the regime is, in fact, quite complicated, offering several options and choices to taxpayers. The proposal of adopting the ECT for small taxpayers would not be in substitution of the Simplified Regime, but in addition to it, overlapping with it (with Group 3 that includes legal persons), creating yet another choice to arbitrage and minimize tax payments. Also, the tax regime for small taxpayers should be designed to encourage formalization. This is achieved not just with simplicity and a relative low tax burden, but by having the incentives for taxpayers to demand invoices. That incentive is reinforced to the extent that expenses in that regime are deductible, aside from complying with accounting and financial reporting rules. However, in the ECT invoices are not relevant in that respect, since only distributed dividends (formally or deemed) are taxed.

13. Similarly, experimenting with the ECT in a few regions appears to be a risky approach. First, the results could be a 'false positive' in the sense that increased capital flows into those regions could be simply a shift of investment away from other regions under the standard CPT, amounting almost entirely to a zero-sum game. For the same reason, the results of a pilot program in a few regions may not replicate well to the entire country, when all (or nearly all) regions have the same tax system. The pilot program would be, however, a live experiment, with real effects while being operated. This means, on the one hand, that it will be hard to eliminate as vested interests have been established. Second, the competitive advantage that it creates vis-a-vis other regions will probably entice businesses located in these regions to demand for the same tax privilege. This will increase the probability that the regime will expand across Ukraine instead of remaining restricted to some localities and that even if it fails in promoting significant new investment. It is a very slippery slope indeed. On the other hand, to the extent that some investment is shifted regionally, the country will have to live with this inefficient' allocation of capital.[7]

14. Benefiting specific sectors with ECT amounts to selective industrial policy. The selection per se is hard to justify, but this would be more complicated with an industry like IT. It is a growing and relatively prosperous industry in Ukraine, as indicated by the MoF. It is an industry that is hard to define and can deploy very flexibly, registering in one place and

---

[6] See R. Schatan et al, (2015), *Reducing Social security Contributions and Improving the Corporate and Small Business Tax System*. IMF, Fiscal Affairs Dept. and R. Schatan et al (2017),

[7] The international experience with special economic zones in countries with unequal regional development, where tax benefits have been used to promote investment in disadvantaged locations, show mixed results. A common argument when the incentives do not work in those cases is that the regions lack business potential, not that the incentive is ineffective. So, the logical conclusion is that the incentive should be used in an appropriate location, where investment prospects are better (and where investment would probably happen anyway). This is one expansionary driver of regional tax incentives.

operating in another. It is not clear why this industry should benefit with an ECT. Instead, Ukraine introduced accelerated depreciation in May 2020 (Law 466). This is a more robust and targeted tax incentive for increasing investment across all sectors of the economy. It would be prudent to wait and see how successful this instrument is in attracting additional investments.

15. Finally, adopting the ECT is not the right solution to short-term liquidity needs in the private sector. While the priority at this point is to put in place a set of measures to alleviate liquidity problems, eventually, fiscal consolidation will be required. Instead, the ECT is a structural change with long term (negative) impact on the budget, thus not an appropriate response to a temporary shock. Instead, the CPT offers its own automatic stabilizer: no tax is due when businesses have no profits, while losses can be carried forward for several years; revenues will be collected when fortunes are reversed.

II. VOLUNTARY DISCLOSURE PROGRAM

A. Previous Advice on Draft VDP Legislation

16. The 2019 TA Mission[8] analyzed the key Voluntary Disclosure Program policy proposals that were circulated by the National Bank of Ukraine in the first half of 2019. The mission reflected on key aspects of the proposed VDP such as (1) to promote transparent ownership of foreign and domestic assets regardless of the period they were owned; (2) that in order to encourage Ukrainian residents to voluntarily declare their foreign assets (mostly accumulated in violation of foreign exchange rules) the State Tax Service (STS) would waive all outstanding taxes, penalties and interest; (3) that as a *quid pro quo* for this tax amnesty an attractive VDP fee system would be instituted to part-compensate for the avoided or evaded taxes; (4) that this approach attempts to introduce some horizontal fairness with the view to maintaining tax morale of hitherto compliant taxpayers; (5) the VDP further aims to prospectively grow Ukraine's future tax base; and (6) that it is a precursor for the implementation of the "indirect control method" of assessing personal income by establishing a more credible deterrent against non-compliance.[9] The findings of the July 2020 tax policy mission on the still evolving VDP proposals need to be read together with the analysis and recommendation of the 2019 TA mission. That mission's key policy advice and concurrence with some of the 2019 VDP proposals include the following:

- The 2019 VDP proposals provided that during and until the end of the VD period, natural persons may not be audited for periods before 1 January 2019. Previous FAD advised against this provision and suggested rather that the legislation should stipulate that

[8] Schatan, R., M. Grote, and L. Burns, 2019. *Ukraine—Distributed Profit Tax; Voluntary Disclosure of Assets, and BEPS Implementation,* IMF, Fiscal Affairs Department (Washington, DC), the *2019 TA Mission* hereafter.

[9] The National Bank of Ukraine's discussion document on the VDP stated that one of objectives of the VDP is to prepare for the future implementation of the indirect (tax) control method over personal income.

individuals who are already under investigation by the STS cannot apply for the VD. This recommendation has not yet been accepted by the authorities and taxpayers are therefore entitled to apply for the VD within a specified period, irrespective of ongoing audits by the STS.

- The mission concurred with the proposed 9 percent VDP Fee for disclosing foreign-held assets kept offshore and thereby grow the personal income tax base through taxing on a worldwide basis (at the existing rate) income from overseas assets owned by Ukrainian residents. This policy element seeks to internalize the horizontal equity principle that whereas domestic income from capital (interest, rental income, capital gains, royalties, etc.) attracts income tax, dividend withholding tax and capital gains tax, income from foreign *and hitherto non-disclosed* assets only attracted tax by the foreign source jurisdiction.[10] Non-disclosure of foreign assets therefore translated into a tax benefit vis-à-vis a Ukrainian resident earning domestic capital income.

- Similarly, the mission concurred with the proposed incentive to disclose foreign liquid assets ("currency values") but pay a lower VDP fee of 5 percent if such disclosed assets are subsequently repatriated and deposited in Ukrainian bank accounts, as currently stipulated in the tax Code. Such fee rate differential is a common feature of many international VDPs and this fee rate differential has also been maintained in all subsequent VDP drafts in Ukraine.[11]

- The mission advised against a zero percent Fee for repatriated assets that are reinvested in government securities; subsequent draft laws increased this fee to 2.5 percent.

- The full alignment of the VDP and asset repatriation program with anti-money laundering legislation and practices (AML) and Counter-Terrorist Financing (CTF) preventative measures remains an agreed minimum condition between the Fund and the Ukrainian authorities.

- Informed by sobering global lessons about the efficacy of tax amnesties, the credible and proven enhancement of a tax administration's collection and enforcement capacity needs to be displayed prior to introduction of an amnesty in order to make *ex ante* sure that there is no need for a follow-up VDP, tax amnesty and asset repatriation program. Global lessons

[10] Resident individuals are taxed on their worldwide income. Non-residents are taxed on their Ukrainian-source income only. Dividends received from resident companies are taxed by a final withholding tax at the rate of 5%, while dividends received from nonresident companies, mutual investment funds and entities which do not pay corporate income tax are taxed at the rate of 9% (article 167.5 of the UTC). The tax is levied on the gross amount; no deductions or allowances are granted from dividend income. Stock dividends are exempt, provided that the shareholding remains unchanged and the company's charter capital is increased by the amount of the dividend distribution. Interest is taxed by a final withholding on the gross amount at the rate of 18% (article 167.5 of the UTC). Royalties are subject to a final withholding on their gross amount at the rate of 18% (article 167.5 of the UTC). Rental income from immovable property is taxable at the rate of 18%. Also, a 'military tax' at the rate of 1.5% is levied on the same taxable base as the personal income tax.

[11] Draft Law 1232 by Mr. D. O. Hetmantsev, People's Deputy of Ukraine, 2019 and an English Draft of a further amended Draft Law 1232, on which FAD TP commented on 25 May 2020.

indeed suggest that repeated amnesties have a deleterious effect on long-term tax compliance behavior.

- Previous advice that tax avoidance and evasion facilitators (in the guise of legal persons) should be covered under the contemplated VDP so that tax avoidance structures and mechanisms can be revealed has been assumed into the revised 2020 VDP draft legislation.
- As to a competent and unbiased amnesty or VDP administration, previous advice on establishing a special central amnesty administrative unit comprised of STS and NBU staff who jointly adjudicate applications has not yet gained traction.
- It is advisable to extend the amnesty period to 10 or 12 months as due diligence and verification of asset registers is time consuming, especially since it involves data sharing and coordination with competent authorities in other tax jurisdictions.
- The proposed amnesty unit should with inception of the VDP prepare monthly statistical reports to the Minister of Finance on the uptake of the VDP program with associated amnesty and asset repatriation to reveal to the taxpaying public that the process is active, that applicants are treated fairly, and that they can regularize with certainty at a significantly reduced cost their foreign asset ownership.

B. Policy Attraction of VDPs and General Amnesties

17. The current mission wishes to reiterate that tax evasion is a pervasive problem to which policymakers generally respond with enhanced auditing and legal sanctions against tax evaders. Another response to reverse entrenched tax non-compliance is to offer some kind of tax amnesty, following a substantial shift in the administration of the tax system and in the perception by taxpayers of the probability of being inspected. This can take many different forms, but the essence is to give taxpayers a chance to come clean in respect of past offenses and to escape or reduce taxation and/or penalties or interest for late payments. In the short term, governments retrieve part of tax revenues previously evaded; in the longer run, they hope to bring back a number of tax evaders into the tax net, effectively expanding the tax base. Amnesties have also been used to reverse capital flight, i.e., the Voluntary Disclosure Programs.

The Risks of General Tax Amnesties

18. As highlighted by the 2019 TA report,[12] tax amnesties, especially frequent ones, are to be avoided since they trigger long-term declines in revenue collections due to an erosion of tax morale of compliant taxpayers. If tax amnesties are repeated with regularity taxpayers reasonably conclude that it pays to transgress tax laws as revenue authorities show

[12] Schatan, R., M. Grote, and L. Burns, 2019. *Ukraine—Distributed Profit Tax; Voluntary Disclosure of Assets, and BEPS Implementation,* IMF, Fiscal Affairs Department (Washington, DC).

leniency to lull back tax evaders who openly flout the law by forgiving penalties and interest. In contrast, tax amnesties combined with asset repatriation programs are more successful when they happen in the new governance framework of bilateral tax treaties with automatic exchange of information among tax authorities (AEOI Standard) and anti-money laundering (AML) cooperation with jurisdictions where undeclared assets are located. In tax amnesties, taxpayers are obligated to pay outstanding taxes with relief for penalties and interest due to late payments. In VDPs, penalties and interest are often waived, or immunity from imprisonment is granted, and confidentiality to taxpayers is granted only for those assets voluntarily declared and adjudicated by the authorities. This protects them against repeated audits and follow-up investigations by other law enforcement and anti-corruption administrations.

19. A recent OECD survey of 2015[13] established that 13 out of 47 countries which implemented tax amnesties, introduced special disclosure programs for foreign-held assets. Some of these VDPs introduced incentives for asset repatriation to the taxpayers' home countries. Out of the 47 countries, five required or offered asset repatriation. More recently, emerging market economies such as Brazil, Indonesia, Mexico, Argentina, Chile, Kenya and Turkey introduced VDPs that specifically pursued asset repatriation.

VDPs for Foreign-Held Assets

20. VDPs are a recent and new tax compliance trend that has been introduced by several countries. The use of relatively narrow-window VDPs as an integral part of tax agencies compliance strategies is a development that will likely grow in use. Their success in encouraging targeted taxpayers to voluntarily disclose their hitherto untaxed assets depends on an increased detection capability by the authorities (central bank, financial intelligence authority, exchange of information and revenue administration) and a firm commitment to take follow-on action against taxpayers who continue to hide their assets. This requires ramping up the risk of increased penalties, reputational risks, and potential prosecution. Unlike many tax amnesties, VDPs are not focused on short-term capital repatriation of assets—rather the long-term benefit from a broadening tax base (i.e., foreign assets) which can be taxed prospectively. Rather VDPs aim to increase voluntary compliance by targeting a high-risk area of non-compliance.

21. While VDPs apply only for several months, the over-arching compliance strategy with tougher audits and enforcement steps for non-disclosed assets (supported by AEOI standards) should become a permanent feature—and this is a goal the STS should aspire to. This more nuanced approach distinguishes VDPs from many amnesties that seek to broaden the tax base in advance of promised reforms by ensuring that the promised changes become reality. Importantly, successful VDPs tightly manage the benefits offered to disclosing taxpayers to ensure that these taxpayers pay a price for their non-compliance (so-called fees on gross assets) and to maintain and ideally increase the tax morale of complying taxpayers.

---

[13] OECD. 2015. Update on Voluntary Disclosure Programmes: A pathway to tax compliance https://www.oecd.org/ctp/exchange-of-tax-information/Voluntary-Disclosure-Programmes-2015.pdf

Key Elements of Tax Amnesties

22. Countries typically introduce tax amnesty programs mainly for the purpose for raising revenues quickly, and/or encouraging the repatriation of illegally held foreign assets. General tax amnesties not explicitly linked to a VDP, vary in terms of duration, qualifying taxes, and types of absolved penalties and interest. Irrespective of the controversial nature of amnesties, they remain popular. Evidence is mounting that tax amnesties (without a VDP) generate much less incremental revenue than expected and there are high opportunity costs associated with tax amnesties for the simple reason that tax administrators are diverted from normal collection procedures of taxes, and without additional resources, enforcement and collection backlogs may develop elsewhere in the system. In any case, amnesty programs should be one-time events to clean the slate concurrent with the introduction of a new tax instrument or a new efficiency-enhancing organizational model for the revenue administration.

23. Typically, VDPs are for a limited period in connection with a specific opportunity, such as increased cooperation with other tax administrations through AEOI provisions (OECD, 2010). These programs allow for voluntary taxpayer disclosure and regularization of taxes on non-disclosed foreign assets. They are often associated with the option of tax relief to repatriate these within the set timeframe of the VDP. Obligatory repatriation is less frequent but usually the program regulates how repatriated assets can be invested domestically. Fixed assets like real estate have limited applicability with repatriation programs but their asset disclosure for income tax purposes (rental and capital gain income) is very important.

Best Practice in Implementing Tax Amnesties and VDPs[14]

24. Global experience with amnesties and VDPs has established several key principles and preconditions for the efficacious management of tax amnesties. Unambiguous legislation and the ability to speedily draft secondary legislation/regulations to find solutions for unforeseen problems will ensure objective and competent administration of the amnesty program. Enabling legislation should grant an agency or revenue administration the authority to administer the VDP and should specify non-discretionary program parameters, such as duration, general timing, penalties and interest waivers, applicable fees, payment provisions, and qualifying taxpayers. Such solid legal framework should build taxpayers' confidence in the objectives of the VDP, entice them to declare their undisclosed assets, and guarantee protection against penalization and intrusive tax investigations.[15]

---

[14] Martin, L. and A. Camarda, 2017. "Best Practices in Tax Amnesty and Asset Repatriation Programmes", *Transparency International* and Civil Forum for Asset Recovery, European Commission.

[15] KPMG. 2015. Tax Amnesty - A viable Option for Boosting Revenue https://assets.kpmg.com/content/dam/kpmg/ng/pdf/tax/tax-amnesty-a-viable-option-for-boosting-revenue.pdf

Ukraine's Ongoing Revisions of the VDP and One-Time Asset Declaration

25. So far, the TA mission has reviewed four (4) different versions of the VDP with asset repatriation, that were released since 2019—defining the most appropriate asset disclosure program for the Ukraine is therefore an ongoing process. It creates a risk that proponents of a certain idea seek approval of the idea from the IMF, which however, could quickly change in subsequent drafts. The mission will therefore specify which elements of a proposal are acceptable without providing an omnibus approval for a new revised draft law.

C. Further Advice on the Draft VDP for Foreign-Held Assets

26. On July 3, the mission received from the Ministry of Finance a fourth draft VDP proposal for the one-time declaration of assets held by Ukrainian residents and on which taxes have not been paid. The VDP covers both offshore and domestic assets. The current draft contains a discussion of broad principles of the VDP without detailed legal provisions on the reporting, valuation, maintaining confidentiality in respect of the application documentation, identity of applicants, or aspects of administration of the VDP program; as pointed out by the MoF this is a work in progress document. This contrasts with the detailed Draft Law No. 1232 on which the Tax Policy Division and Legal Department of the IMF commented, and it is important that earlier IMF's concerns will be addressed in future drafts.[16]

27. Hence, this report cannot be construed to support the July 3 Draft VDP—it merely comments on the feasibility or acceptability of its new or revised key provisions. It is important to note that the acceptability of the final VDP depends on a review of the full draft with all its required safeguards on anti-money laundering and counter-terrorist financing regulations. The revised draft VDP provides for the legalization of assets held as on December 31, 2021, by an adult natural person of Ukraine. This voluntary one-time declaration shall list all hitherto undisclosed assets on which taxes and fees were not paid in accordance with the provisions of the Ukrainian Tax Code (UTC); other tax legislation; or currency regulation. The voluntary declaration can be submitted in the period from April 1 till end of December 2021. The STS is the nominated administrator of the VDP and will waive applicants from all outstanding taxes, penalties and interest liabilities for the non-disclosed assets. The applicant however must pay a flat fee on the nominal value of the undisclosed assets as compensatory measure in order to regularize the asset ownership going forward. The 2019 TA Report discussed in detail the pros and cons of such amnesty or VDPs and these considerations will not be repeated.

Qualifying Persons and Eligible Assets

28. Any Ukrainian natural person who owns (co-owns) and is a beneficiary or beneficial owner (controller) of assets eligible for the VDP can participate in the program. Eligible

---

[16] Draft proposal by Mr. D. O. Hetmantsev, People's Deputy of Ukraine, Draft Law, No. 1232 on which FAD TP commented on 25 May 2020.

assets are financial instruments such as foreign currencies, bank metals, fixed and movable property, unfinished constructions, and other assets acquired as of December 31, 2021.[17] It includes rights or beneficial ownership of securities, intangible assets, rights to shares in property of legal persons or rights to funds, including a controlling interest in controlled foreign companies (CFCs)—and on which hitherto no taxes and fees were paid in accordance with the UTC.

29. Public office bearers are permitted to apply for the VDP but may need to meet additional requirements. From an anti-money laundering and combatting the financing of terrorism (AML/CFT) perspective, all "politically exposed persons", i.e. individuals who are, or have been, entrusted with prominent public functions and their family members and close associates, such as elected officials, senior bureaucrats, executives at a state-owned enterprise, and officers in the armed forces (including when they are the beneficial owners of the assets or accounts) should be prohibited from availing or participating in the VDP. According to the Fund's Legal Department, enough sanctions against these persons should likewise be put in place to effectively dissuade them from taking advantage of the program.

Aligning the VDP with Anti-Money Laundering Provisions

30. The current draft One-Time Declaration does not specifically state that its adjudication procedures will be fully compliant with Financial Action Task Force (FATF) principles. It is expected that the final draft will explicitly abide with Ukraine's commitments or obligations under AML/CFT rules (such as customer due diligence, recordkeeping, and suspicious transaction reporting requirements). The 2019 TA Mission understood from discussions with the NBU that the Ukrainian VDP will follow the FATF principles that among others disallow full or partial exemption from AML requirements.[18] The FATF principles include elements such as: (1) repatriated assets are deposited with a financial institution that is subject to AML/ CFT measures; (2) assets coming from countries that do not adequately apply the FATF recommendations are given particular attention; (3) the authorities raise awareness among financial institutions on the potential for abuse and the money laundering risks in the asset repatriation program; and (4) that any documents or statements issued regarding the assets repatriated are not official endorsements that the assets involved are of legitimate origin (FATF, 2012). Thus, financial institutions should be obliged to apply AML/CFT controls for clients who repatriate assets

[17] The latest VDP draft envisages that the one-time declaration can be submitted in the period from April 1 to December 31, 2021 to the State Tax Service of Ukraine in electronic or paper form. These VDP dates need to be confirmed by the legislator's final approval of VDP legislation.

[18] Not all tax amnesties are fully aligned with the FATF's Principles for Voluntary Tax Compliance Programs. See Said, E.W., 2017. "Tax Policy in Action: 2016 Tax Amnesty Experience of the Republic of Indonesia", MDPI Laws, School of Law, Politics and Sociology, University of Sussex, Brighton. The IMF mission received assurances from the NBU that if funds are repatriated to Ukraine, they would be transferred from foreign bank accounts. When no income/assets are repatriated into Ukraine (disclosure of assets not held in bank accounts) separate AML and CFT procedures appear irrelevant.

(including identifying the beneficial owner of the account into which the assets are repatriated, taking reasonable measures to establish the origin of the asset, and reporting any suspicious transactions to the financial intelligence unit).

31. The mission believes that the AML-CFT controls will support a successful rolling out of the VDP for foreign-held assets and would suggest its prioritization. Proponents of general amnesties argue that an amnesty should be offered to taxpayers in transitional periods from inadequate administration to enhanced enforcement. The same argument holds for VDPs of foreign-held assets as new currency laws with stricter financial intelligence legislation force holders of foreign assets to come forward, disclose their existence with the view to accessing these funds in future. Still, the fact remains that amnesties are discriminatory as compliant taxpayers absorb the full statutory tax burden for no reward whilst non-compliant taxpayers enjoy discounted tax burdens (waiver of interest, penalties, and tax). International experience suggest that long-run revenue effects of amnesties are discouraging; frequent amnesties have a deleterious effect on long-term revenue collections (see Box 2 in the 2019 TA Report). However, prioritizing the foreign asset VDP would immediately expand the personal income tax base and it would be equity-enhancing, since high-net worth Ukrainian residents have not yet complied with the worldwide income tax provisions.

Impersonal Application through a Notary

32. The July 2020 draft adds a new feature, that an applicant can protect his/her identity by authorizing a notary to apply on his/her behalf. The purpose of filing an impersonal one-time declaration, is to protect the applicant against identity theft by criminal elements as well as to protect the confidentiality of provided information which is a key concern in amnesties. The mission was assured that the provisions of the draft law stipulate that proceeds from crime and bribes cannot be regularized. Even if the identity is protected through agency filing by the notary, the concealed applicant cannot receive state guarantees for an amnesty nor confidentiality as to his/her identity against other law enforcement agencies. To dispel any suspicion of collusion between a notary filing a one-time declaration on behalf of an applicant that seeks to launder proceeds from non-tax crimes, consideration should be given to increase considerably the costs for a notary who may attempt to misuse the well-intended VDP. This can be achieved by providing in the VDP legislation that a notary and applicant are jointly and severally exposed to criminal prosecution with steep penalties—possibly even the loss of the professional license—if they attempt to launder proceeds from organized crime and bribery.

Improved Deterrents against Attempts of Laundering Crime Proceeds

33. The revised draft law stipulates that, in case questions arise concerning the source of proceeds that led to the acquisition of foreign (and domestic) assets as reflected in the one-time declaration, the STS may request the notary for additional information. This should enable an investigation by the notary that proceeds from crime cannot be concealed in the application—the notary must provide information about the declarant supported by documents confirming the origin of such assets. There is no prescribed limit for keeping such submitted one-time declarations or records in the hands of the STS, which will enable it in the future to refer to this provided information for further investigating the sources of income of individuals. As to the modalities of investigating applications for the possible risks of money laundering, the authorities informed the Mission that the STS has already full investigative powers to verify the origin of assets. If, however the STS could under these circumstances rely on a close interagency coordination arrangement with other Ukrainian law enforcement agencies needs to be further assessed as the mission is at this stage not in the position to make an authoritative assessment. The suggested enhanced investigative STS powers contrast with some of the older foreign asset disclosure programs (see Box 1 for procedures adopted by the South African VDP prior to new AML and CTF rules).

Forfeiting Lodged Fees for Attempts of Concealing Crime Proceeds

34. In a preventative way, a VDP can be designed to increase the risk for applicants who may attempt to launder their crime proceeds. Requiring the payment of the applicable VDP fee (fee differentiation discussed below) at the time of filing the VDP application and a threat by the VDP agency that paid fees may be forfeited if no satisfactory answers or information is provided for the source of the foreign assets, increases materially the risk for an applicant that intends to launder proceeds from criminal activities (see also the country experience in the second bullet in Box 1). The mission was informed that the 4th draft VDP will require full payment of the fee at the time of the application or even the depositing of the fee at a recognized financial institution before the application is being lodged.

35. The draft law provides that proceeds from crime and bribes cannot be regularized. In the event such crime proceeds are identified, state guarantees provided by the VDP are null and void—differently put, filing a one-time declaration and payment of the respective fees cannot legalize proceeds or assets acquired by criminal means. If it is shown that the applicant's declared income or assets are directly linked to criminal activities, any provided amnesty immunity is waived, and the declarant is not released from criminal liability for committed crimes. A full investigation by other law enforcement agencies can be unleashed on the applicant and the draft law does also not provide for the reimbursement of the paid fees.

Box 1. Lessons from the South African Exchange Control Amnesty with Supporting Tax Measures[1]

Investigative Powers of the Amnesty Unit

- *At the outset one should mention that the Amnesty Unit's approach was a simplified one.* It is probably true that international financial disclosure requirements have increased considerably since 2002, when the legislation pertaining to the South African Amnesty Unit was promulgated.
- *The Amnesty Unit had no investigative powers.* Even if suspicions as to the source of funds (say proceeds of organized crime) arose, the Unit could not investigate or make requests for further investigations. The Unit could merely ask applicants for more information to satisfy reasonably all concerns. In addition, as stipulated by law, the Unit could not make any information available to the SA Police Service or any other investigative body. However, the Unit created through a letter a material risk for the applicant if there was a suspicion that proceeds from criminal activities might be whitewashed. The letter explained to the applicant that lodged amnesty fees could be forfeited if satisfactory explanations were not forthcoming and that indeed the whole amnesty could be withdrawn.
- *Information (including applications) could only be shared with the SA Revenue Service (SARS) and the SA Reserve Bank (SARB, exchange control).* But in turn, these two institutions could not subsequently use information disclosed in amnesty applications as a basis for any investigation against amnesty applicants for amnesty-declared and regularized assets.
- *Moreover, the Unit did not have the power to request any details on the source of the funds held abroad:* Requesting such details could have implicated other parties and were therefore excluded from the powers of the Unit.
- *In practice, therefore, the Unit had to rely on the declaration made by amnesty applicants in their applications, stating that the source of the funds disclosed were not the proceeds of crime, corruption, etc.* In addition, the two amnesty letters (as explained below) stated that the amnesty was granted based on the declaration and could be withdrawn if the source of funds was ever found to be (not by the Unit but subsequently by another government structure) the source of crime, corruption, etc.
- *This preceding legal stipulation of an attestation by letter made the Unit's work much easier.* Going beyond this and trying to prove one way or another the source of funds would have extended the Unit's work for many years: Afterall, the Unit had to work through 43,000 applications in a reasonable period. In the end, the time taken by the Unit to consider all applications was considered unreasonable by some of the authorities.
- *Money laundering risks by accepting any cash balances in declarations and any fee payments in cash were not accepted.* The whole design and operation of the amnesty through the Amnesty Unit relied solely on banks' electronic reporting and payment systems because in South Africa handling of large amounts of cash posed very high security risks.

[1] The 2020 IMF TA mission discussed the operational functions and level of investigative powers with the Unit's former Chief Operating Officer under the stewardship of Advocate M. R. Madlanga, DC, who chaired the Amnesty Unit in a part-time capacity, July 11, 2020.

Fee Rate Differentiation

36. The VD program requires the payment of a one-time declaration fee at differentiated rates for assets declared by the resident natural person. By voluntarily disclosing the locality and existence of foreign assets, and by paying the Fee in lieu of all standard taxes, legal certainty and immunity is bought against further investigations and prosecution for prior related tax misdemeanors.[19] The following rates are proposed: 9 percent on financial instruments in foreign bank accounts and property registered abroad; 5 percent on financial instruments held in Ukrainian bank accounts with balances kept until the end of the VDP, as well as on property and other assets located in Ukraine, including real estate and similar objects; the full PIT rate of 18 percent on cash in order to discourage cash holdings; and 2.5 percent of the nominal value of government bonds of Ukraine with a maturity of 12 months without the right of early redemption, and purchased before the submission of the one-time declaration. The mission considers the 2.5 percent levy on government bonds as a too generous tax expenditure that cannot be justified as it rewards handsomely all previous exchange control and accompanying tax violations. Indeed, it compromises the horizontal equity principles. Also, this low rate is not applied on any other tax base of the present personal income tax system.

No Need for a *De Minimis* Tax-Free Threshold

37. The TA mission is not convinced that the VDP for assets needs a further generous incentive to entice non-compliant taxpayers and exchange control violators to voluntary disclose their illegal offshore assets. The new Draft Bill confirms a *de minimis* amount for foreign and domestic assets, capped for financial instruments at UAH 400,000. The 2019 VDP draft provided for a higher *de minimis* threshold of UAH 1 million.[20] Draft Law 1232 caps the *de minimis* threshold at UAH 30,000. The justification for the VDP threshold is that in case the declarant does not submit the one-time asset declaration the following assets are considered regularized without any further questions. The minimum amount of assets that are deemed to have been acquired without having violated the tax code and thus are automatically legalized/regularized, are:[21]

- Cash, securities, financial instruments, jewelry, precious (bank) metals, antiques and art objects, the total value of which is equal to 400,000 hryvnias;
- Immovable property located in the territory of Ukraine, which as of March 31, 2021 belongs to a natural person: including:

[19] Para 41 of the FAD 2019 Report explicitly makes reference to the underlying intention that "*The VD shields natural persons from criminal prosecution for crimes set forth in the 2019 draft law (i.e., sham business activity, negligence, document forgery, tax default and penalties for tax transgressions with respect to the disclosed assets and sources of their acquisition). In assessing the tax penalty, chargeable income shall be decreased by the disclosed VD base.*" Subsequent 2020 draft refinements to the VDP do not deviate from this underlying idea—immunity is however only granted for tax and foreign exchange control violations. Proceeds from organized crime and bribery can still not be regularized or laundered.

[20] If the amount of funds or other assets acquired out of income reported in the databases of tax authorities or covered by all duly paid taxes is less than UAH 1 million, guarantees of voluntary disclosure apply to the amount not exceeding UAH 1 million.

[21] Note that there is no minimum of amnestied amount for income stemming from committed crimes and bribes.

(a) an apartment or flat in an apartment building of unfinished construction, the total area of each of which does not exceed 120 m.[2]

(b) a dwelling house or a dwelling house of unfinished construction and / or an industrial building used for its intended purpose in the declarant's economic activity and not leased by the owner, leasing, loan or building of an unfinished construction industry with a total area not exceeding 500 m^2 (this apparently will now be lowered to 300 m^2).

(c) a land plot that does not exceed the norm of gratuitous property transfers during the privatization period (art 121 of the Land Code of Ukraine);[22]

- Movable property the ownership of which was registered in accordance with the legislation of Ukraine (at this stage only one motor vehicle is intended).

- Corporate rights, the issuer of which are business entities that are subject to entry in the Unified State Register of Legal Entities, Individual Entrepreneurs.

38. This mission, in line with the Fund's May 2020 comments of Draft Law 1232, is not convinced that for purposes of foreign assets such a tax-free threshold is warranted. It creates another generous exemption or an "amnesty within an amnesty". This light-touch tax enforcement can have an adverse impact on hitherto compliant taxpayers. In fact, the idea of the VDP is to follow it up with a much stricter compliance culture. The VDP waives tax, interest, and penalties for non-disclosed assets that violated exchange control legislation and benefitted from years of tax deferral. Thus, all foreign assets should be disclosed and the *ad valorem* VDP fee should be paid on the total value of undisclosed assets. Indeed, the advocated *de minimis* threshold signals potential weakness in the tax administration capacity to verify domestic asset registers on immovable property and motor vehicles.

39. The question arises why taxpayers would comply if they realize that the STS cannot access up-to-date Ukrainian cadasters. What are the chances then that the STS could conduct a lifestyle audit and apply the indirect method of assessment? Differently put, the *de minimis*

---

[22] According to Article 121 of the Land Code citizens of Ukraine have the right to free transfer of land plots from state or communal lands in the following amounts: (a) If there are several agricultural enterprises in the territory of a village, settlement, or city council, the size of the land share is determined as the average for these enterprises. In the absence of agricultural enterprises in the territory of the relevant council, the size of the land share is determined as the average for the district; (b) for personal farming - not more than 2.0 hectares; (c) for horticulture - not more than 0.12 hectares; (d) for the construction and maintenance of a residential building, outbuildings and structures (homestead plot) in villages - not more than 0.25 hectares, in settlements - not more than 0.15 hectares, in cities - not more than 0.10 hectares; (e) for individual country house construction - not more than 0.10 hectares; (e) for the construction of individual garages - not more than 0.01 hectares.
Thus, referring to Article 121 of the Land Code for the purposes of the VDP provide the exemption for the unnecessary declaring of the land plots, that were provided to the declarant in a legal way and duly registered.

deemed asset regularization simply confirms that the STS cannot turn a new leaf and enforce tax compliance due to its inability to access third party data and to cross-check filed tax returns.

40. To conclude, in the case of the VDP for foreign assets, today's banking system together with its financial intelligence and AEOI protocols should pick up repatriations of income or change in deposits of even relatively small amounts. It should enable the STS, if it could get access to banking information (see the discussion on the indirect method), to enforce fully foreign asset disclosures, trace foreign financial transactions, and enforce compliance with worldwide taxation provisions after the VDP has run its course.

VDP Administration Challenges

41. All four draft laws have disclosed little information how potentially large numbers of VDP applications will be managed across the STS regional offices or whether a more coordinated and centralized administration is contemplated. Amnesty and VDP administrations are challenging especially if staff resources are withdrawn from normal taxpayer registration, collection and enforcement functions. If not managed proactively, overall tax revenues may decline. The 2019 TA report discussed in some detail amnesty administration and challenges with asset valuations, fee collection, and delays in repatriation of funds, and reporting obligations (see paragraphs 55-60). It seems that the STS will adopt its normal business model without perhaps having had the benefit of real practical experiences with an amnesty (Ukraine has not utilized amnesties), indicating that it could resist so far introducing these risky programs. Box 2 shares some important practical administrative lessons from the South African VDP.

Box 2. Aspects of the South African Amnesty Legislation that were Difficult to Implement

Some of the aspects that were found to be impractical and impeded the effective functioning of the Amnesty Unit:

- The initial time frame for submission of applications were too tight, as many applicants had to obtain the required documents. This was subsequently extended, which was beneficial in as much as:
    - Some approvals of amnesty were granted, and applicants received amnesty as promised without any negative consequences for applicants. Word of this spread, enticing more people to apply. So, if applications remain open once initial approvals are granted, it helps to get more amnesty applications. News that the administration of the amnesty is reasonable, assisted in spreading the word that the process is fair; prospective applicants developed the necessary trust in the system.
    - More than 50 percent of all the 43,000 applications were received in the last week of the amnesty period, including the final day (Sunday) until 23:59 midnight.
- Thus, it is important to allow the assigned Amnesty Administration through its actions to earn the confidence of the public.

Box 2. Aspects of the South African Amnesty Legislation that were Difficult to Implement (concluded)

- The legislation as promulgated made no provision for individual staff members of the Unit to consider applications. Initially, each application therefore had to be considered in a full Unit meeting with all Unit members attending. This was untenable and made for a very slow decision-making process. This matter was subsequently amended, with each application thereafter considered by a two-person team, comprising a representative of the SA Reserve Bank and the SA Revenue Service.
- The stipulated payment period of 3 to 6 months was problematic. Three months were simply too short and even 6 months became challenging. A period should be provided in legislation, but the Unit should have the discretionary power to extend this, if informed by objective criteria or facts. For example, it was shown that banks make serious mistakes, to the detriment of the amnesty applications. According to legislation it could have meant that the applicants can lose their amnesty owing to non-payment or because of incorrect payment by banks. (In this regard, it is important to note that all applications must be processed within the time set aside for the VD. Indeed, the FAD 2019 mission Report recommended an extended VDP period of 10 to 12 months as due diligence and verification of asset registers is time consuming, especially since it involves data sharing and coordination with competent authorities in other tax jurisdictions.
- Refund provisions for paid fees and applications were problematic. Initially nobody expected refund requests, but these related to observed errors by financial intermediaries (e.g., banks).
- Refund requests by applicants caused suspicion amongst the Amnesty Unit members, as a refund from the SA Reserve Bank is really the best way to launder money. However, applications could show, for instance, that banks paid the same amount twice to the Unit. Experience indicated that refund requests were never for big amounts; they merely pointed to clerical errors by the banks.
- In the South African case, levies amounting to some R3 billion (2003: approximately USD 387.5 million in current value) were collected, so one should expect errors.
- Initially, only individuals could apply for amnesty, not companies, or trusts. This was too limiting, especially were personal affairs of applications were intertwined with private companies or trusts. Planning for a more general amnesty would have taken longer but would have worked better.
- It was necessary to issue provisional and final letters to applicants, with provisional letters stating the amnesty is to be finalized once the levy payment was received. These letters stated that amnesty was granted only based on the disclosure made by applicants in respect of the original sources of funds that led to the creation of foreign assets. However, this resulted in large number of complex administrative requirements.
- In 2003, digital capacity was underdeveloped and at the time, amnesty applications were paper based. In practice, 43,000 applications had to be filed and locked away. Any future amnesty should be electronic, rather than paper based, with a system that generates electronic response letters, etc.
- It is important to note that people already under investigation by the exchange control department of the SARB could not qualify for amnesty. This turned into an administrative nightmare, as exchange control records were poor or inadequate with missing names of listed investigation targets when reported to the Unit. A further complication was that the SARB exchange control department could continue issuing letters of investigation without verifying that investigation targets may already have filed an amnesty application. So, it happened, that some people submitted amnesty applications and then received letters of investigation, unrelated to their applications, which led to some suspicion and threatening the uptake ratio of the amnesty. With hindsight the administrators felt that the amnesty should therefore cover people under investigation or potentially under investigation.
- Owing to the volume of applications, the Unit existed much longer than initially envisaged—and hence, the advice to extend the duration of the amnesty period to up a full year.

Recommendations

42. The Mission wishes to make the following proposals (the findings and recommendations of the 2019 TA Mission and May 2020 comments on the Draft Law 1232 remain relevant but will not be repeated in this TA Report):

- All politically exposed persons, their family members, and close associates should be prohibited from participating in the proposed VDP.
- Financial institutions should be obliged to apply fully AML/CFT controls for clients who repatriate assets, taking reasonable measures to establish the origin of the asset(s), and reporting any suspicious transactions to the financial intelligence unit.
- Since these AML/CFT controls support a successful VDP implementation for foreign assets, even overcoming some capacity deficits in the STS, which suggests its prioritization over rolling out the indirect method, taxing for the first-time overseas wealth held by affluent Ukrainians will improve distributional fairness.
- In order to ramp up the deterrent against attempts to launder proceeds from crime, require payment of applicable VDP fees before or at the time of lodging the one-time asset declaration without reimbursing it if subsequent investigations reveal incidence of crime.
- Increase the 2.5 percent VDP fee on government bonds to at least 5 percent on par with the fee withheld on repatriated balances held in domestic banks.
- Do not grant a blind and permanent amnesty to assets under the threshold of UAH400,000. Resolve the problem of unregistered properties with a specific program to regularize these. Also, consider the corresponding flexibility under the indirect method, not in the VDP.

D. Draft One-Time Asset Declaration for the "Indirect Method"

43. The new proposals of a *de minimis* deemed asset declaration threshold has been discussed in par 22 above. This section seeks to point to asset registration alternatives that could be used in preparation of the indirect method and which would not diffuse the strategic objectives of a VDP for foreign assets.

Voluntary Asset Declaration Substituting for Incomplete Cadasters

44. The key motivation for a VDP is to encourage stricter compliance by coming voluntarily forward and declaring one's foreign-held and domestic assets, in the absence of the authorities having developed credible and comprehensive legal cadasters and vehicle registration data. The envisaged special asset declaration rule which is not subject to documentary verification seems to reflect weakness in administration and verification processes as apparently there seems to be doubt that the STS can cross-check taxpayers' assets in property title registries or motor vehicle registrations of the interior ministry.

45. If the Ukraine experiences challenges with incomplete and contested overlapping property titles for immovable property, spending resources on building and maintaining credible and effective central registries for ownership titles should be a high priority. The voluntary disclosure of real estate by their owners would probably not solve the problem—especially if there is a disincentive for them to do so honestly and comprehensively in the event they wish to secure the steady flow of state subsidies that are granted on the basis of a means test. Instead, Government should aim to update and maintain a comprehensive legal cadaster (centrally maintained) and decentralized fiscal cadasters by utilizing modern technology of satellite imagery and on the ground follow-up, with the view to tracing and registering the rightful owners of recorded real estate parcels (see Box 3 for a discussion of measures to maintain accurate ownership titles in a country, supported by enforcement through the property tax system). Utilizing electricity connections of the power utility company could assist with owner-tracing—*Appendix 1* discusses ways towards a comprehensive registration of immovable property in a central cadaster with reference to some international practices.

Box 3. Updating Ownership Registers of Immovable Property in lieu of a VDP Process

Property tax reforms could present the catalyst for merging and amalgamating fragmented institutional approaches in property registration, property valuations and tax administration. This entails, inter alia, the recording of ownership titles, describing the location of property in form of a cadaster, assessing market values, cooperating in establishing data banks, and upgrading the legal and geodetic registers.

Moreover, global experience with non-registration of change in ownership of immovable property suggests the introduction of the following anti-avoidance legislation which could address this kind of tax transgression: (1) attempts to avoid the registration of change of ownership through an entry in the central property title registry could be a punishable offence; and (2) any litigation related to enforcing the terms of a sales contract between the seller or purchaser of immovable property should only be allowed to serve in a court if the parties can prove that change of ownership has occurred. The transfer of ownership is evidenced by a change to the title deed which however should only occur after full payment of all relevant transfer or stamp duties and all outstanding property taxes. Differently put, basic anti-avoidance legislation should provide that the transfer of property cannot be registered before the property tax is paid. Immovable property should therefore not be included in the amnestied threshold. Besides, its taxes should be paid as these are important revenue sources for subnational level of government.

46. These investments in establishing and maintaining accurate and up-to-date cadasters are needed for multiple purposes: (1) creating certainty for owners of property rights that is essential for investments into the real estate market; (2) accessing finance with immovable property providing essential collateral; (3) maintaining a buoyant property market where property ownership transfers are managed seamlessly; and (4) establishing a productive property tax system (preferably value-based) as an important local government own source revenue. Thus, there are multiple compelling reasons for building and maintaining credible cadasters. It should not be left to a self-declaration system by "owners' and central government should prioritize putting own resources into this effort. For this reason, the mission recommends a rethink of the *de minimis rule* in the one-time declaration by rather initiating a separate cadastral study and registration process for the whole country. The same argument holds for registries for vehicles. Given the porous state of asset ownership registries in the Ukraine which may take years to correct, prioritization of the VDP for foreign assets may be compelling. To conclude, these measures would all need to be addressed before an efficacious operation of the indirect method can be established.

Recommendations

- Submit any property declaration under a voluntary one-time asset disclosure to official verification, especially if there are overlapping property titles.

- Elevate the cadastral registration as a high-priority central government initiative that will require adequate resourcing and be prepared to manage this for a couple of years to advance the centrality of this key data bank.

III. INDIRECT METHODS TO ESTIMATE TAXABLE INCOME

A. Indirect Methods and the Perception of Risk

47. Enforcing the income tax in Ukraine is particularly challenging. Historically, according to the MoF, a large portion of the assets of the rich have been held abroad and out of reach to the STS. Moreover, when the STS can attest that the taxpayer leads a lifestyle many times more expensive than what the income declared in his/her annual tax filing could support, the tax authority has few instruments to address what might be flagrant tax avoidance or evasion. The biggest weakness in the STS available enforcement measures is that the burden of proof is on the tax authority to show that the taxpayer has omitted to report earned income. The STS has little recourse to dispute the taxpayer's expected argument that the omitted income was earned or received in a fiscal year beyond STS' reach, which can be either attributed to the statute of limitations of 3 years, or relate to the period when in Ukraine records were scarce anyway.

48. Countries often have means to tax estimated income; Ukraine does not. Presumptive taxation is an indirect method to determine taxpayers' income when direct records are unavailable. [23] One form of presumptive income taxation[24] is to estimate income indirectly which is then used to determine an omission in the amount of income declared in the tax filing. Based on the assumption that funds received are either saved or spent, a way to determine omitted income is by documenting the difference between consumption spending or deposits in banks accounts (including cash holdings) and the income filed in the tax return. Under a presumptive income taxation regime, or indirect method, it is the duty of the tax authority to estimate that difference, but the taxpayer has the burden of proof in showing that such difference is not a taxable income.

49. An effective indirect method is, in itself, a valuable enforcement tool, but it also creates an incentive for voluntary compliance. Tax evasion can be intertwined with other, sometimes more complicated issues. Funds may have shifted abroad simply to profit from lower taxation (e.g., Cyprus) or could have been left outside Ukraine due to past foreign exchange regulations or capital controls. Economic and political uncertainty could also be a reason to keep wealth out of the authorities' radar. More worrying, hidden wealth can be related to illegal transactions.[25] However, common to all these cases is that funds remain untaxed by Ukraine because of the taxpayers' low perception of risk of having to pay the tax and the corresponding penalties.

50. Realistically, it is not possible for any tax authority to audit a large percentage of the taxpayer population, but the low perception of risk goes beyond this fact. The low perception of risk of being audited by the STS may be explained by additional factors. It could be due to structural deficiencies such as shortages in trained personnel, resources, technical limitations or lack of data and information about taxpayers' dealings, especially about cash transactions. Indirect methods are an appropriate instrument to address some of these limitations, leading to an increased perception of risk by the taxpayer, and this could be its most important consequence.

51. The possibility of applying an indirect method encourages voluntary compliance. Compliant taxpayers have a sense of a greater fairness in the system because the tax agency has an efficient audit tool and the perception of risk by delinquent taxpayers is increased. Currently, Ukraine uses only direct methods to review tax compliance. It relies especially on the analysis of returns, business records and account books.

---

[23] Vito Tanzi and Milka Casanegra (1987). Presumptive Income Taxation: Administrative, Efficiency, and Equity Aspects. International Monetary Fund. FAD Working Paper; Victor Thuronyi, Presumptive Taxation, Tax Law Design and Drafting, volume 1; International Monetary Fund, 1996. Chapter 12.

[24] Presumptive taxation includes the use of a proxy measure for taxable income. For example, some taxpayers, for reasons of simplicity, are taxed on their gross income, like the Simplified Regime for small taxpayers in Ukraine.

[25] Centre for Applied Research, (2015), *Global Financial Integrity, Financial Flows and Tax Havens. Combining to Limit the Lives of Billions of People*. Norwegian School of Economics. Available at: http://creativecommons.org.

52. Ukraine has a large informal sector and a considerable number of high net worth individuals that presumably do not report much of their income. An indirect method can be an important supporting instrument for an enforcement strategy, to increase the perception of risk of having unreported income identified and having to respond to a legal notice of deficiency based on discrepancies between the income declared and documental evidence of consumption or financial transactions. This will be reinforced with greater international cooperation to exchange information between competent authorities. Ukraine is not part of the OECD´s international network of countries automatically exchanging financial information, but it is in the final stages of the process of joining such program, which will become eventually an important source of information for applying the indirect method.

B. Implementing the Indirect Methods

53. Implementing an indirect method in Ukraine will encounter serious limitations. A major obstacle is the intermediated access to taxpayers' financial information. Auditing with the indirect method relies on the information provided by third parties. Typically, the information that best reflects the spending habits of individuals is the information recorded by financial institutions. Banks register the value of transactions, the parties to the transaction with respective dates, which combined allow to build a picture about the nature and the timing of the presumptive income. Currently, banking secrecy laws in Ukraine constrain the ability of the STS to obtain such information directly from the financial sector. It is obtained only with the authorization of a judge and on a case by case basis. This severely diminishes the effectiveness of the indirect method, which operates best when relying on large-scale data analysis. However, the method can operate as well with limited information, for example, by reviewing data from other government agencies[26] and public notaries.

54. The argument not to share information with the tax authority is generally based on the fear that it will be misused. The first condition to remedy this issue is to have clear provisions in the law protecting the confidentiality of this information, including severe penalties for breaching this trust. Secondly, there should be a clear set of rules on how the indirect method can be applied. Despite the strong resistance to abandon strict bank secrecy rules, countries have moved in that direction, and Ukraine will have to consider following the same path. One important step in that direction would be to have the financial sector regulator be the intermediary to baking information requested by the STS (rather than the courts). Access to this information would allow the STS to develop a better risk profile of taxpayers and thus a more

[26] Obtaining information from other government agencies is also subject to limitations, for they require a collaboration agreement with the agency in question. STS does not have an automatic access to it.

effective targeting of audits. This would tend to spare compliant taxpayers from more intense scrutiny. [27]

55. Taxpayers' rights under the indirect method should also be protected. The tax agency should share with the inspected taxpayer all the contemporaneous information and calculations leading to the assessment of an omitted income. Without it, the taxpayer would not have a fair chance to challenge the STS presumptions. Also, the taxpayer should have enough time to search and obtain the documentation necessary to make his case. Importantly, the STS should exhaust the means available to it in determining the inconsistencies identified indirectly are indeed omitted taxable income.[28] The indirect method should not become the first and final stop in STS' inspection work.

C. Elements of an Indirect Method

56. The core of an indirect method is assessing income of the taxpayer based on indicators different than reported records and this way being able to determine tax liabilities more accurately. The essence of the method is detecting potential unreported income based on objective indicators, which is a legally valid method to determine a tax omission. Indicators that may support such scrutiny are, for example, increases in assets, purchases, business or personal expenses, and reductions in liabilities. The onus is then on the taxpayer to challenge the presumption that such income is taxable. It is important to note that the powers to estimate taxable income indirectly must be established in law. The legislation may provide ample discretion to the tax authority to decide which indirect method to use or it may limit that power to a specific list of indicators[29]. Also, the authority's application of an indirect method can be graduated. For instance, greater authority can be granted when faced with uncooperative taxpayers, or when taxpayers' business books and records are not available. With cooperative taxpayers the indirect method could be used more restrictively, based only on discrepancies found on information obtained from certain third parties.

57. A key aspect of the process is the taxpayer's challenge of the presumptive income determined by the tax authority. Not all differences or discrepancies from receipts or expenses with reported income in the tax filing represent necessarily omitted taxable income. Expenses, for example, may be financed from savings, sale of assets, loans, all of which may originate from funds that have been already taxed or are non-taxable. So, the taxpayer must have the opportunity to demonstrate that differences between income reported and presumptive income

---

[27] Another way in which the tax authority may access taxpayers' financial information is by establishing that bank statements are invoices for tax purposes, i.e. serving as legal proof of interest (or other type of financial) income. This is the case, for example, in Mexico.

[28] For example, it should not be acceptable that all deposits into a taxpayer's bank account be characterized as taxable income without first eliminating transfers form other own accounts, to mention only one such exemption.

[29] Edmund Biber. Technical Notes and Manuals. Revenue Administration: Taxpayer Audit-Use of Indirect Methods. Fiscal Affairs Department. International Monetary Fund. April 2010.

correspond either to income previously taxed or to funds that are not taxable (loans or inheritances), or to income beyond the reach of taxation because of the statute of limitations. The manner in which the taxpayer can document his/her case should also be clearly regulated since relying just on his/her word constitutes insufficient evidence.

In Sum, the Indirect Method should have the Following Key Features:

58. ***Legal framework.*** The legislation must state that unreported income may be identified according to an objective indicator and when inconsistent with reported income, the tax authority can recalculate taxpayer's income, who can therefore be subject to a new tax assessment. This presumptive income should be legally defined as taxable income unless and up to the amount the taxpayer cannot refute with valid documentation.[30]

Box 4. Legislation on Indirect Methods – the Case of Mexico

The Mexican Tax Code (art 55) defines which tax bases the tax authority may determine presumptively and in which circumstances it may do so. Specifically, the tax authorities may presumptively determine taxpayers':

- taxable profits
- deemed taxable distributions by non-profit organizations
- gross income
- the value of the transactions (for VAT purposes) or
- the value of assets (for asset tax purposes)

When:

I. Taxpayers resist or hamper the tax authorities audit; or when they fail to file the tax return (filing after the taxpayer has been notified that an audit will begin would not stop the authority from applying the indirect method).

II. They fail to submit the accounting books and records and the supporting documentation (mainly invoices) of more than 3 percent of any of the items reported in the tax return.

III. Any of the following irregularities occur:

  a) Failure to record transactions, earnings, purchases, or cost of sales, above 3 percent from the amounts reported for the fiscal year.

  b) Recording purchases or expenses that did not take place.

  c) Omission or alteration of existing quantity or value of inventories, provided that the amount be in excess of 3 percent of the cost of the inventory.

IV. Officially approved cash registers are not used or are altered or destroyed

V. Any other irregularities in the accounting records that prevent the tax authorities from understanding the taxpayers´ transactions.

These provisions are not applicable to social security contributions.

[30] The rules should allow also for the taxpayer to demonstrate that calculating his/her income under the normal tax accounting rules is less than the indirect method estimation.

59. ***Rebuttable presumption.*** This relates to who bears the burden of proof in a tax audit. Typically, the burden of proof is on the tax authority in demonstrating discrepancies between the tax return and other records reflecting unreported income. Thereafter, the burden of proof shifts to the taxpayer to challenge the presumption of omitted income made by the tax authority.

60. ***Balancing rules vs discretion.*** The by law authorized/sanctioned use of the indirect method should increase taxpayers' perception of risks and change their behavior accordingly, but it must not be used arbitrarily by tax inspectors. Objective criteria and rules should be established on selecting taxpayers under this method and which indicators are acceptable for presuming taxable income (see Box 4 for Mexico's example)

D. General Operational Aspects of the Indirect Method

61. **The general procedure for applying the presumptive tax is quite simple.** To the extent that all expenses made by the taxpayer are equal or below the sum of his/her filed income in the return and his/her non-taxable income, no additional tax is due. However, where expenses exceed reported income, and the taxpayer cannot prove the excess was financed from non-taxable sources, the tax authority will notify the taxpayer that a tax deficiency has been found (Box 5). Then a presumption can be made about expenses or taxpayer's funds available in financial institutions or in cash or in valuable goods (e.g. gold). Income reported in the taxpayer return should be subtracted from the funds available after this adjustment and the excess should then be presumed to be non-reported income. Operationally, the STS must be able to verify the amount of funds saved by taxpayers, so it needs to access data on bank deposits, including business and personal accounts, and loan accounts. Hence, the STS would need to access this financial data from all financial institutions, including credit unions and investment trusts.

Box 5. A Basic Formula for an Indirect Method including Cash

- From third party sources, determine taxpayer's total cash expenditure during fiscal year;
- Add known increase in cash on hand at the end of the period;
- Less nontaxable receipts (e.g., transfers between own accounts, loans)
- Equals corrected gross receipts
- Less gross receipts as per declaration
- Equals understated income

62. **The STS has very limited access to third party information.**[31] This evidently limits the application of the indirect method to tax unreported income. Although bank secrecy will have to

[31] The STS obtains data on wages paid from employers, and generally on income paid by domestic sources, from other government agencies with which it has an agreement for such collaboration. The STS can also access

(continued)

be relaxed for the indirect method to work to its full extent, having the method in the law will help Ukraine in those individual audits where the STS manages to obtain information about excess consumption, like the purchase of a large real estate property.

E. Administrative Issues

63. One approach is a rather mechanical application of the indirect method. Ideally, a software would search in a large database for mismatches between tax returns and third-party information on individual taxpayers (financial institutions, car agencies, notaries, property registries), according to pre-established parameters. This routine 'machine' checking approach reduces discretionary criteria by tax officials in selecting taxpayers for review. The STS could first send a letter to taxpayers (automatically sent) inviting them to explain the discrepancy or to self-correct their tax return, paying the omitted tax. If the taxpayer does not come forward, the tax authority can begin an audit. Its starting point would be the estimated income discrepancy, that would be the bases for determining the underreported income and the tax deficiency

64. The risk with indirect methods is that they may be used arbitrarily. To minimize this problem, regulations should be clear about when and how the method should be used (see Appendix 2), the parameters that may be used to determine presumptive income, as well as the documentation that taxpayers need in order to prove that the differences are not taxable. In other words, regulations need to be drafted stipulating what documentation will be considered valid to rebut the presumption of tax authorities. In the case of inheritances, for example, records need to demonstrate that the goods, funds or assets were in the possession of the deceased person. Also, for tax purposes, a loan should be documented with bank transfer records, not just a contract, or a signed "I owe you" (IOU) among individuals. If this is all a taxpayer can show to justify the receipt of funds as a loan from another person, the rule should stipulate that this will be considered as a taxable presumptive income.

F. The Voluntary Disclosure Program and the Indirect Method

65. It has been argued by the MoF that the voluntary disclosure program (VDP) is an important component of the package aiming at instituting the CFC regime. This is in turn would allow making worldwide income taxation a reality in Ukraine, capturing the considerable wealth that Ukrainians are believed to hold abroad. Once assets have been declared, arguably, they will broaden the tax base and thus increase tax revenues. This was discussed at some length

---

information from notary publics on purchases of real estate (and other notarized transactions), all of which may be useful in individual audits.

in FAD (2019) tax policy report.[32] The VDP would be open to all assets, including those at home, under important restrictions explained in Chapter II of this report.

66. There are a couple of key connections between presumptive taxation and the VDP. On one hand, the assets declared under the VDP which have paid the corresponding fee under the program, should be considered as non-taxable income under the indirect method. In other words, consumption paid for from funds so disclosed should be treated as if withdrawn from legitimate savings. However, the income generated by disclosed assets should henceforth be considered taxable income as any other. The VDP is in a way an opportunity for taxpayers to establish a sanctioned income buffer for the presumptive tax regime. The disclosure might also facilitate the job of tax auditors because the VDP would trace and document disclosed assets.

67. While the VDP eases the entry into force of the indirect method, a credible indirect method is essential for the VDP to work. They reinforce each other, but – importantly, income taxation via an indirect method should be an option to the tax authority regardless of a VDP. The corner stone of an indirect method is the access to reliable, high quality information about taxpayer's wealth and expenses, that can be assembled especially from third parties (e.g., financial institutions, vendors, or public notaries). The VDP may provide an additional source of information but it is not the main resource, nor does it substitute those other sources that should be regularly available to the STS in order to implement a successful program of income tax audits. The VDP is a goodwill offer to taxpayers to regularize their asset ownership titles prior to a qualitatively higher level of tax enforcement. However, the indirect method is in principle independent of a VDP. Without other sources of information, presumptive income taxation will be very weak, and will reduce the incentive to participate in a VDP. Ideally, therefore, prior to a VDP being launched, there should be good registries of real estate and movable property, easier access to financial information for the STS, strong confidentiality guardrails for taxpayers information at the STS, ongoing exchange of information with foreign competent authorities, and an indirect method in place in the law.

Recommendations

- Adopt a presumptive income taxation regime in the law.
- Include in the legislation the general rule on how to construct indirectly taxpayers' income, including the sources of funds that would not be taxable under this regime.
- Defer to regulations the specific operation of the indirect method, describing the type of documentation that will acceptable to rebut the presumptive determination by the STS.

[32] Roberto Schatan, Martin Grote and Lee Burns (2019), Ukraine. *Distributed profit tax; voluntary disclosure of assets; and BEPS implementation*. IMF, Fiscal Affairs Dept.

- Consider removing the banking secrecy for the STS, or at least replace the courts by the financial sector regulator as intermediation body for the STS to obtain taxpayers' information from the banking system.

IV. INTERNATIONAL TAX MEASURES

A. Introduction

68. Ukraine is a member of the BEPS Inclusive Framework. As a member of the BEPS Inclusive Framework, Ukraine is obliged to implement the four BEPS minimum standards, namely BEPS Action 5 (harmful tax competition), Action 6 (abuse of treaty), Action 13 (Country-by-Country (CbC) reporting), and Action 14 (mutual agreement procedure). Law 466 (May 22, 2020) enacts provisions implementing the BEPS Actions 6, 13, and 14 minimum standards. Ukraine will be subject to a peer review of tax concessions to determine whether there are any breaches of BEPS Action 5. Bill 2524 proposes some amendments to the international tax reforms enacted by Law 466. Some relate to the starting date of several of the reforms.[33]

69. In addition to the minimum standards, Law 466 enacts provisions implementing BEPS Action 3 (CFCs), Action 4 (limitation on the deductibility of interest), Action 7 (permanent establishment (PE) definition), and Actions 8-10 (transfer pricing). Law 466 also introduces a new residence test for legal entities based on the place of effective management (PEM). A legal entity that is incorporated or formed outside Ukraine is a resident taxpayer if the entity's PEM is located in Ukraine. While Ukraine residents are normally liable for tax on worldwide income, a PEM resident taxpayer is liable for tax only a territorial basis (i.e. Ukraine-source income). As discussed below, this creates tax planning opportunities, particularly in relation to the CFC rules.

70. This section of the Report should be read in conjunction with two earlier FAD Reports that dealt with BEPS implementation.[34] The discussion below focuses mainly on new issues, particularly the PEM residence test, application of CFCs to resident individuals, and some technical issues. However, some previous recommendations that were not included in Law 466 are reiterated in this Report.

B. Place of Effective Management

71. Law 466 introduces place of effective management (PEM) as an alternative test of Ukraine residence for a legal entity. PEM residence is not a BEPS measure. The proposal to

[33] Bill 2524 was voted by Rada on July 14, 2020, when the mission was preparing its preliminary report. Some provisions related to BEPS and TP issues were excluded but will be resubmitted to Parliament in a separate bill.

[34] R. Schatan, et al, *Rethinking dividend distribution tax, rationalizing simplified taxes, and adopting BEPS measures*, FAD/IMF, May 2017, and R. Schatan, et al, *Distributed profits tax, voluntary disclosure of assets, and BEPS implementation*, FAD/IMF, July 2019 (referred to as the "2019 Mission Report").

include the PEM residence test originated in Tax Committee of the Verkhovna Rada and not in the Ministry. The test is not well integrated into the Ukraine Tax Code (UTC). In particular, PEM is not included in the general definition of "resident" in Article 14.1.213 of the UTC, but rather is included in the list of resident taxpayers for the purposes of the CPT in Article 133.1. New Article 133.1.5 of the UTC provides that a foreign-formed legal entity is a resident taxpayer under the CPT if its PEM is located in Ukraine. However, this applies only for the purposes of the CPT. Consequently, a foreign-formed legal entity with its PEM in Ukraine may be a resident taxpayer for the purposes of the CPT but a non-resident for other purposes of the UTC, so CFC rules do not apply to it.

Meaning of Place of Effective Management

72. PEM is commonly used by countries as a test of corporate residence. Many countries use both place of incorporation and PEM as alternative tests of corporate residence, while some countries use one or other as the sole test of corporate residence. Where the tests are alternatives, a legal entity is a resident if it is incorporated or formed in the jurisdiction. Even if the legal entity is incorporated or formed outside the jurisdiction, it is a resident if it has its PEM in the jurisdiction. Prior to the 2017 amendments to the OECD Model Tax Treaty[35] and UN Model Tax Treaty,[36] PEM was the tiebreaker test under the Article 4 of the Model Treaties (Residence) where a legal entity was resident of both Contracting States under each State's domestic law.

73. Given its wide use (including under tax treaties), the PEM concept is well understood. It is a reference to the place where high-level management, commercial, and financial decisions are made that are necessary for the conduct of an entity's business as a whole. It is distinguished from the place where day-to-day management decisions are taken. In broad terms, PEM is a reference to the location of the superior directing authority of a legal entity. Ordinarily, this is the executive body of the entity, such as the board of directors of a company and, therefore, the PEM is where the executive body of an entity meets to make high-level decisions concerning the entity's operations. The PEM of a legal entity is determined by taking into account of all relevant facts and circumstances relating to the management of the entity.

74. The ordinary meaning of PEM is reflected in paragraph (a) of Article 133.1.5 of the UTC, which refers to the holding of meetings of the executive body of a legal entity in Ukraine. If such meetings are held in different countries, then the place of effective management is in Ukraine if such meetings are more regularly held in Ukraine. Paragraphs (b) and (c) of Article 133.1.5 of the UTC appear to refer to a broader notion of management (which could include management of day-to-day operations) but does refer to the relevant management being carried out primarily in Ukraine.

[35] OECD, *Model Tax Convention on Income and Capital* (2017) (OECD Model).

[36] United Nations, *Model Double Taxation Convention Between Developed and Developing Countries* (2017) (UN Model).

75. While a legal entity may have multiple places of management (particularly of day-to-day operations), it is generally understood that an entity has only one place of effective management. The concept of place of effective management was developed at a time when the members of the executive body of a legal entity met together in the same place. However, the notion of a single place of effective management is under challenge today given that the meetings of the executive body of a legal entity may be held electronically with members of the body located in different places. This is recognized in Art. 133.1.5 of the UTC, which provides that the PEM of a legal entity may be divided between different locations. Article 133.1.5 of the UTC includes rules allocating the place of effective management to Ukraine in the case of divided PEM.

76. Applying PEM residence on an opt-in basis increases the possibility of abuse as Ukraine residents controlling foreign-formed legal entity can, in effect, elect for the entity's residency status based on what gives the best tax outcome. In discussions with the private sector, there was uncertainty as to whether the PEM residence test is self-executing or applies only on an opt-in basis by a foreign-formed legal entity. Article 133.1.5 of the UTC appears to be framed as self-executing in the sense that, if a foreign-formed legal entity satisfies the specified criteria for having its PEM in Ukraine, then it is a resident taxpayer. However, at the end of Article 133.1.5 of the UTC it is provided that a foreign-formed legal entity can elect to be a resident taxpayer under the CPT and can also renounce its status as a resident taxpayer. The opt-in and opt-out provisions in Article 133.1.5 of the UTC do not expressly cross-refer to PEM, but they are in the provision setting out the PEM residence test. The Ministry confirmed that (from a literal reading of the law) the PEM residence test applies only on an opt-in basis. On this basis, a foreign-formed legal entity with its place of effective management in Ukraine is a resident taxpayer only if the entity elects to be treated as a resident.

Scope of Taxation

77. A PEM resident taxpayer is subject to tax under the CPT on a territorial basis only (Article 134.1.1 of the UTC). This means that a PEM resident is taxed only on Ukraine source income. This creates the unusual situation under which the scope of taxation of a resident legal entity depends on the entity's basis for being a resident. A legal entity incorporated or formed in Ukraine is subject to tax on worldwide income, whereas a legal entity incorporated or formed outside Ukraine but with its PEM in Ukraine and that elects to be a resident taxpayer is subject to tax only on Ukraine source income.

78. The PEM test operates only one way, i.e. to determine whether a legal entity is a resident of Ukraine. It does not apply, for example, to determine whether a legal entity is a resident of another country for the purposes of the CFC rules. Under the CFC rules, a legal entity is a foreign legal entity if it is incorporated or formed outside Ukraine. Consequently, there is a potential mismatch as a legal entity incorporated or formed outside Ukraine but with its PEM in Ukraine can be both a resident of Ukraine (election under the PEM test) and a foreign legal entity under CFC rules (place of incorporation or formation test). Technically, such a legal person is both a resident and a CFC. This conflict is resolved under Article 133.1.5 of the UTC, which provides that a foreign legal entity that is a PEM resident is not a CFC. As the company is a PEM resident, it is subject to tax only on Ukraine source income. While not expressly stated, it is assumed that the territorial taxation of a PEM resident means that the CFC rules do not apply in relation to any foreign-incorporated companies that it controls.

79. The reason for including the PEM residence test is unclear. One possible explanation advanced during the mission is that it is intended to overcome a recent Court decision involving a foreign-formed legal entity that had a person in Ukraine with a power of attorney over the entity's operations. It was argued that the person constituted a PE of the entity in Ukraine, but the Court held that there was no PE in Ukraine. On this explanation, the PEM residence test is intended to overcome a perceived weakness in the PE definition. This would explain the territorial basis of taxation as that is consistent with PE taxation. However, the PEM residence test has the (probably) unintended consequence of opening up opportunities for avoiding the CFC rules. PEM residence and PEs is discussed below (par 88-90).

80. Because of the risk that the PEM residence option poses to the successful implementation of the CFC rules (see paras. 120-122 below), PEM residence should be repealed. If the concern being addressed by the inclusion of the PEM residence option relates to the operation of the PE definition, then that concern should be directly addressed by amending the PE definition. If the PEM residence option is retained, then it should apply on a self-executing basis (and not on an opt-in basis) to provide some check against misuse of PEM residence.

PEM and BEPS Action 5

81. The PEM residence test may constitute a breach of BEPS Action 5. PEM residence applies to a foreign-formed legal entity that elects to be a resident based on having its PEM in Ukraine. A PEM resident is taxed on a territorial basis. The combination of electing for PEM residence plus territorial taxation creates the BEPS Action 5 risk. While a PEM resident may be directed and managed in Ukraine, it may not have a sufficient economic presence in Ukraine if its operations are offshore. In particular, its core income-generating activity may be outside Ukraine with limited physical presence in Ukraine. If the PEM residence test is retained, then it should be reviewed for possible breach of BEPS Action 5.

Recommendations

- Repeal the PEM residence option.
- If PEM residence is retained, then (i) apply PEM residence on self-executing basis and (ii) review PEM residence for possible breach of BEPS Action 5.

C. Permanent Establishment (PE)

82. Law 466 updates the PE definition in Article 14.1.193 of the UTC so that it better aligns with the definition in the OECD and UN Models, as amended based on the BEPS Action 7 recommendations. In particular, the amendments: (i) provide anti-fragmentation rules for the construction and services PE inclusions, and the preparatory and auxiliary activities exception; and (ii) revise the agency PE rule. The amendments to the PE definition in Bill 1210 were discussed in the 2019 Mission Report and some of the recommendations made in that Report have been captured in the enacted definition in Law 466.

Permanent Establishment and Jurisdiction to Tax

83. The international norm is that a country's jurisdiction to tax the business income of a non-resident is limited to such income that is attributable to a PE of the non-resident located in the country. There are two aspects to this taxing right. First, a non-resident must have a PE in the country. If there is no PE, then there is no taxing right over the business income of a non-resident.[37] Second, if the non-resident does have a PE, the country can tax only those profits attributable to the PE. The concept of PE is central to the taxation of business income of non-residents. The broader the definition of PE, the broader are the source taxing rights over business income derived by a non-resident.

84. Article 14.1.54 of the UTC provides that any income derived by a non-resident from a business activity in Ukraine is Ukraine-source income. The source rule in Article 14.1.54 is not expressly confined to income from business activities conducted through a PE in Ukraine. However, Article 133.2.2 of the UTC states that a non-resident with a PE in Ukraine deriving Ukraine-source income is a taxpayer for the purposes of the CPT and Article 141.4.7 of the UTC (as amended by Law 466) provides that the taxable profit of a PE is determined on the basis that the PE is a separate entity dealing wholly independently with the other parts of the non-resident entity. Based on Articles 133.2.2 and 141.4.7 of the UTC, a non-resident legal entity is liable for CPT on the profit attributed to the Ukraine PE of the non-resident. Consequently, the concept of PE as defined in Article 14.1.193 of the UTC is central to the taxation of the business income of non-residents under the CPT.

85. Given that Ukraine has over 70 tax treaties, the jurisdiction to tax the business income of non-residents will also be impacted by Ukraine's tax treaties. A tax treaty divides up the taxing rights between the two Contracting States in relation to income or gains derived from transactions between residents of the two States. In broad terms, a tax treaty prioritizes residence country taxation of such income or gains by limiting or excluding source country taxation. This may be done by limiting the rate of tax imposed by the source country that may be

[37] However, some countries tax on a withholding basis some items of business income, particularly technical fees and insurance premiums, derived by non-residents even if the income is not attributable to a PE in the country. In the case of technical fees, this taxing right is now included in Article 12A of the UN Model (2017).

imposed on particular classes of income, particularly, dividends, interest, royalties, and technical fees; or source country taxation may be excluded through a narrower definition of the taxation right under the treaty. In the context of business income, source country taxation is limited through the treaty specifying a narrower definition of PE than applies under domestic law.

86. Differences between tax treaties and the domestic tax law are usually resolved in favor of the treaty either under constitutional law or through legislative provision in the domestic tax law. In the case of Ukraine, Article 3.2 of the UTC provides that, in the case of conflict between the UTC and a tax treaty, the tax treaty prevails. For example, a lower withholding tax rate (10 percent) applies to royalties and the longer 18 month time limit applies for construction PEs under some of Ukraine's treaties. This is discussed further below in relation to the construction PE rule. While not common, it is possible that the opposite conflict can arise, namely the treaty source taxing rights may be broader than under the domestic law. For example, the domestic law may provide that the withholding tax rate on royalties is 10 percent, but a treaty may provide that the maximum rate for royalties paid by a resident of one Contracting State to a resident of the Other Contracting State is 15 percent. Again, the same can happen with the definition of PE. For example, the domestic law definition of PE may provide for a 12 month time limit under the construction PE rule, but a tax treaty may provide for a 6 month time limit.

87. The general position is that tax treaties are limiting only. Tax treaties do not impose tax, rather tax is imposed under domestic law. A treaty then applies to limit the scope for source taxation under domestic law of income or gains derived by a resident of the other Contracting State to the treaty. Importantly, a tax treaty cannot create a tax liability that does not arise under domestic law. In the royalty example above, the treaty does not impose a tax rate of 15 percent on royalties, rather the treaty provides that the tax rate imposed under domestic law cannot exceed 15 percent. If the tax rate under domestic law is lower than the treaty rate, then the lower domestic law rate applies. Similarly, a tax treaty cannot create a tax liability over business income that does not exist under the domestic tax law. In the example above, therefore, the longer time limit under domestic law applies. Again, this is discussed further below in relation to the construction PE rule.

Permanent Establishment and PEM

88. There is a relationship between PEM and the PE definition. Consistent with tax treaties, the PE definition in Article 14.1.193 of the UTC includes a place of management. Ordinarily, the place of management inclusion does not have a significant role to play as it would presuppose an office, which is a PE. However, a place of management is PE only if satisfies the general requirements for a PE, namely that the place of management is a fixed place of business and, therefore, the temporary performance of management functions in Ukraine would not constitute a PE.

89. For Ukraine, the primary importance of the PE concept is in its application to foreign investors establishing business operations in Ukraine (i.e., inbound investment). In this context, the PEM of a legal entity will be located outside Ukraine at the place where head office of the entity is located and, therefore, the reference to place of management will be to the day-to-day management of the Ukrainian operations of the entity and, as stated above, this will usually involve an office from which such management is conducted.

90. In the tax treaty context, it is understood that the reference to place of management is to all levels of management, including high-level management. However, if residence is based on PEM, then effective management will not be relevant for PE purposes. It will be relevant, though, where residence is based solely on place of incorporation or formation. This was the position in Ukraine prior to the enactment of Law 466. In this context, it is possible that the location of the PEM of a foreign-formed legal entity in Ukraine can give rise to a PE of the entity in Ukraine. This appears to be what was argued in the case referred to at para. 79 above. Even if this argument had been successful, if all the business operations of the legal entity are located outside Ukraine, it is difficult to see any significant profit being allocated to the Ukrainian PE. This highlights that the PEM concept is essentially a residence concept and also why it is curious that Ukraine has introduced PEM as a residence concept, but then taxes a PEM resident only on Ukraine-source income (i.e., as if it is a PE).

Construction PE

91. The scope of the construction PE rule in paragraph (a) of Article 14.1.193 of the UTC has been narrowed by extending the time limit from 183 days in Bill 1210 to 12 months in Law 466. The mission was advised that this change was made to align the UTC construction PE rule with that in many of Ukraine's tax treaties. It is right that the time limit under the construction PE rule in a majority of Ukraine's tax treaties is 12 months. However, there are over 20 treaties with a time limit of less than 12 months. In most cases, the time limit is 6 months, but there are several treaties with a 9 month time limit and one treaty with a 3 month time limit. It is also the case that there are a few treaties with a time limit of 18 or 24 months.

92. The relationship between the UTC and tax treaties is discussed above. As stated above, the general position is that tax treaties do not create a tax liability that does not arise under the UTC; rather, tax treaties operate to limit the source jurisdiction asserted under the UTC. Consequently, under those treaties with a time limit (such as 18 months) that is longer than 12 months, that longer time limit applies. This has the effect of narrowing the scope of source taxing rights over income derived from construction projects. For those treaties with a shorter time limit (such as 6 months) than under the UTC, the longer UTC time limit applies. This means that Ukraine loses the benefit of broader source taxing rights available under those treaties.

93. Where a treaty provides for a shorter period for the construction PE rule, the 12-month period in the UTC may result in mismatches in the taxing rights as between Ukraine and the other Contracting States. For example, if the construction PE rule in a tax treaty is 6 months and this is also the rule under the domestic law of the other Contracting State, then a Ukraine resident construction company will be subject to tax in the other Contracting State for any project that exceeds 6 months, whereas a construction company resident in the other Contracting State will be subject to tax in Ukraine only for projects that exceed 12 months.

94. As the purpose of tax treaties is to limit Ukraine's jurisdiction to tax as source country, the definition of PE in the UTC should be determined based on the best policy for Ukraine. Certainly, there is no obligation to align the UTC definition of PE with that applicable under the majority of Ukraine's tax treaties. In the case of the construction PE rule and given that Ukraine is a capital importing country, there is certainly a case for reverting to the 6 month time limit specified in Bill 1210. This also will give Ukraine some bargaining power in negotiating tax treaties as the definition of PE generally, and the time limit for construction PEs specifically, are key areas of treaty negotiation, particularly with OECD countries.

Services PE

95. The services PE inclusion seems to apply only where services are provided through employees. The provision of services personally by a non-resident individual on their own account appears to be excluded from paragraph (b) of the PE definition. Such an individual will have a PE only under the general requirement of having a fixed place of business in Ukraine. However, individuals providing services on their own account may stay at hotels and not have a fixed place of business. The purpose of the services PE rule is to base PE status not on having a fixed place of business but on the period of physical presence in the country. Paragraph (b) of the PE definition should be amended so that it applies also to non-resident individuals providing services on their own account. Further, the UN Model refers to services provided by employees or "other personnel" engaged by the service provider. Such other personnel include independent contractors. Paragraph (b) of the definition should also be amended so that applies to services provided by a non-resident through employees or other personnel to align with the UN Model.

Attribution of Profits to a Permanent Establishment

96. Article 141.4.7 of the UTC provides that the taxable profit of a non-resident conducting business in Ukraine through a PE is calculated according to the functionally separate entity approach. This is the authorized OECD approach that is now provided for under Article 7(2) of the OECD Model. Under the functionally separate entity approach, the profits of a Ukraine PE are calculated on the basis that the PE is a separate entity dealing wholly independently with the other parts of the entity. The arm's length principle applies to such dealings and the internal "price" charged can include a mark-up if supported by functions, assets, and risks.

97. The attribution of profits to the Ukraine PE of a non-resident is a source issue, i.e. how much of the non-resident's profits are sourced in Ukraine. The particular concern of the OECD in developing the functionally separate entity approach is to achieve consistency in the allocation of profit between PEs and other parts of the entity. The use of different methodologies (including formulary approaches) as between the PE and head office countries (or a PE of the non-resident in another country) can lead to double taxation or double non-taxation. The adoption of the functionally separate entity approach as the agreed OECD approach is intended to bring about uniformity in profit allocation.

98. In light of this, it is positive that Law 466 replaces the former formulary allocation approach with the functionally separate entity approach. However, as noted in the 2019 Mission Report not all countries (including OECD countries) use the functionally separate entity approach. It is again recommended that some flexibility should be retained in profit allocation where the other country does not use the functionally separate entity approach so as to limit double taxation and double non-taxation.

Registration of PEs

99. Law 466 provides for new Article 64.5, which provides for registration of non-residents: (i) carrying on business in Ukraine through a PE; (ii) that have an interest in Ukraine immovable property; or (iii) opens a Ukraine bank account. It is normal practice to register any non-resident deriving domestic source income that is not subject to final withholding at source. If a non-resident does not have any physical presence in the jurisdiction, then it is usual to require the non-resident to appoint a representative in the jurisdiction to meet the non-resident's tax obligations. The mechanics of registration of non-residents is largely a tax administration issue, so just a few general observations are made below on the issue.

100. As stated above, a non-resident carrying on business in Ukraine is required to register with the STS. The application must be lodged within 10 days of business registration. It is common practice now to provide a "one-stop shop" for business and tax registration. Under this approach, rather than having a separate tax registration process, the business registration authority is required to automatically notify the tax authority when any person (including a non-resident) has applied for business registration. This facilitates business and tax registration occurring at the same time and limits the possibility that a PE may operate in Ukraine without tax registration.

101. The PE registration process should apply to all PEs as defined in Article 14.1.193 of the UTC and not just those PEs that involve a fixed place of business in Ukraine. Registration should apply also for a PE that does not have any physical presence in Ukraine, such as an agency PE. In this case, the agent should be required to register in the name of the non-resident. Further, PE registration should apply even if the non-resident does not have a PE under any applicable tax treaty definition, particularly as the PE may be a withholding agent (such as an employer) or liable for VAT.

102. The registration of a non-resident operating in Ukraine through an unregistered PE is essentially a tax administration issue. It is usual practice for the tax law to specify an individual, or class of individuals, located in-country to act as the tax representative of the non-resident for all the purposes of the tax law, including registration, filing returns, and paying tax. For example, the UTC could provide that the local manager, or other local senior employee, of a non-resident is the tax representative of the non-resident. On this basis, the service of the notification of registration on the local manager or senior employee is treated as effecting registration of the Ukraine PE of the non-resident.

Recommendations

- If the PEM residence test is repealed, review the scope of the place of management inclusion in the PE definition.
- Revert to the 183-day time limit for the construction PE rule.
- Ensure that the services PE rule applies to an individual providing independent services. Also, consistent with the UN Model, ensure that the services PE rule applies when the services are provided by employees or contractors.
- Apply the functionally separate entity approach to allocating profits to PEs but retain flexibility to modify the outcome when the other country uses a different methodology of profit allocation so as to limit the possibility of double taxation or double non-taxation.

D. Controlled Foreign Company Rules

103. Law 466 includes new Article 39[2] into the Tax Code, which provides for controlled foreign companies (CFC) rules. The purpose of CFC rules is to counter the deferral of tax by resident taxpayers shifting passive income to foreign entities that they control. In the present context, deferral means the postponement of current taxation in Ukraine of foreign income that has economically accrued to a Ukraine resident taxpayer through their controlling interest in a foreign entity. In the absence of CFC rules, foreign income derived by a foreign entity is not subject to Ukraine tax until the foreign entity distributes the income as a dividend to the Ukraine resident controller of the entity or the controller sells their interest in the foreign entity. The longer the period of deferral, the greater the tax benefit. The benefit of deferral creates a bias in favor of Ukraine residents shifting passive investments to CFCs resident in low tax jurisdictions.

104. The CFC rules were intended to commence from January 1, 2021; however, Bill 2524 proposes that the first reporting year for the CFC rules is 2022. The CFC rules were considered controversial by the private sector and the start date is intended to allow more time for resident taxpayers with existing interests in CFCs time to prepare for the application of the rules, including taking advantage of the liquidation concession or VDP. For example, the delay in the passing of Law 466 meant that there may have been inadequate time for resident taxpayers to arrange for the liquidation of existing CFCs and repatriation of the profits of the liquidated legal entities to Ukraine.

105. The substantial shareholder threshold in Bill 1210 was 25 percent. This was reduced to 10 percent in Law 466 consistent with the recommendation in 2019 Mission Report. Bill 2524 proposes to amend Law 466 to provide for the phasing-in of the lower 10 percent threshold. The 25 percent threshold would apply for the 2022 and 2023 reporting years. The 10 percent threshold would apply for reporting reports after 2023.

Application of CFC Rules to Resident Individuals

106. Arguments have been made to the Ministry against applying the CFC rules to resident individuals. These arguments have focused on two things: (i) it is unfair to tax resident individuals on income that they have not received; and (ii) concerns about the potential disclosure of the offshore investments of individuals, particularly in CFCs.

Fairness Argument

107. It has been argued that it is unfair for a resident individual who is a controller of a CFC to be taxed on the CFC's income in advance of receiving a dividend from the CFC. In particular, comparison is made to an equivalent investment by a resident individual in a resident legal entity. In this case, the resident individual is not taxed on the resident legal entity's income until it is distributed to the resident individual. If the after-tax profits of resident legal entity are reinvested in the entity's operations, then there is no taxation of the resident individual on a current basis.

108. The fairness argument can be analyzed by considering the potential tax outcome for a resident individual who wishes to make passive investments. The resident individual may invest in passive investments directly or through a legal entity that they control, and they may invest in Ukraine passive investments or foreign passive investments. Four possible scenarios are analyzed: (i) a resident individual invests in Ukraine passive investments directly (i.e. the individual is the owner of the Ukraine investments); (ii) a resident individual invests in Ukraine passive investments indirectly by incorporating or forming a legal entity in Ukraine (controlled Ukraine company (CUC)) to hold the investments; (iii) a resident individual invests in foreign passive investments directly (i.e. the individual is the owner of the foreign investments); and (iv) a resident individual invests in foreign passive investments indirectly by incorporating or forming a CFC to hold the investments. In cases (ii) and (iv), the resident individual is the controller of the relevant legal entity.

109. If a resident individual invests directly in Ukraine or foreign passive investments, the individual is the owner of the investments and, therefore, is the taxpayer who derives the passive income. As the individual is a resident, the individual is taxed in Ukraine on a current basis in relation to domestic or foreign passive income derived. The effective tax rate on the passive income is 19.5 percent, comprising 18 percent PIT and 1.5 percent military tax. The resident individual may be subject to withholding tax in the source country of foreign passive income, but this may be creditable[38] against the Ukraine PIT payable on the foreign passive income, so may not be an additional tax burden on the income.

110. If a resident individual invests in Ukraine passive investments through a CUC, the CUC is the owner of the investments and, therefore, the taxpayer who derives the passive income. The resident individual does not derive any income until the CUC distributes the income to the individual. This may be done on a current basis or deferred until a later tax period. Importantly, a distribution is paid by a CUC out of its after-tax profits and, therefore, the CUC pays 18 percent CPT on the passive income on a current basis. If the CUC makes a distribution of the passive income to the resident individual controller of the CUC, there is an additional 6.5 percent tax paid on the passive income (after CPT), comprising 5 percent dividend tax and 1.5 percent military tax. This means that the effective rate of tax is 23.55 percent where the individual holds the investment through a CUC. Importantly, for the purposes of the fairness argument, even if the CUC reinvests the income rather than distributing it to the resident individual, the reinvestment is made after CPT, so a minimum of 18 percent CPT is paid in respect of the income on a current basis.

111. In the absence of CFC rules, if a resident individual makes foreign passive investments through a CFC, the Ukraine tax on the passive income is deferred until it is distributed to the resident individual. The longer the period of deferral, the greater the benefit to the resident individual because of the effect of time on the value of money. If the CFC is incorporated or formed in a tax haven, there will be little or no tax (Ukraine or foreign) until the income is distributed back to the resident individual.

112. The purpose of CFC rules is to remove the deferral benefit in making foreign passive investments through a CFC by taxing the resident individual controller of the CFC currently on the passive income of the CFC. The application of the CFC rules means that the tax outcome is largely the same regardless of whether a resident individual invests in Ukraine or foreign passive investments and invests directly in such investments or through a CUC or CFC. Consequently, the application of the CFC rules ensures fairness as between investors and efficiency as between investments. The norm is that CFC income is calculated on the assumption that the CFC is a resident of the country in which the controller is resident (in this case Ukraine). Consequently, the Ukraine tax rules applicable to resident companies apply in calculating CFC income and this is the case regardless of whether the controller is a resident individual or resident entity.

[38] While there is no unilateral relief from international double taxation under the UTC, foreign tax credit (FTC) relief is provided under Ukraine's tax treaties. Given that Ukraine has over 70 tax treaties, a FTC for foreign withholding tax will be available in many cases. Also, the investments may be made in tax havens or low tax countries that do not impose withholding tax.

Disclosure of Interests in CFCs

113. As discussed at paragraph 50 of the 2019 Mission Report, the planned introduction of CFC rules was an initial impetus for the VDP. An early aim of the VDP was to encourage Ukraine residents to disclose and regularize their investments in CFCs. In addition to any incentives available under the VDP, Law 466 includes a liquidation concession to encourage Ukrainian residents with interests in CFCs to liquidate the CFC prior to commencement of the CFC rules.[39] Article 170.13[1] of UTC provides that a liquidation distribution paid by a foreign legal entity or a foreign entity without legal status to a Ukraine resident is exempt income. In the absence of this concession, a liquidation distribution would be subject to Ukraine tax at the rate of 18 percent and, in the case of an individual, an additional 1.5 percent military tax.

114. There are two conditions that must be satisfied for the liquidation concession to apply:

(1) The foreign legal entity or a foreign entity without legal status must be formally liquidated or terminated in accordance with the foreign law under which it has been incorporated or formed.

(2) The resident taxpayer must apply for the exemption to apply. The application must be lodged with the taxpayer's tax return for the tax period in which the liquidation distribution is received and include: (i) information concerning the liquidated entity and the property comprising the liquidation distribution; and (ii) a copy of the liquidated entity's financial accounts prepared in accordance with IFRS as at the date of liquidation or termination of the entity.

115. The liquidation concession is a transitional measure applicable for the period prior to the commencement of the CFC rules. To qualify for the concession, the liquidation of the entity must commence on or after January 1, 2020 and be completed before December 31, 2020. Bill 2524 proposes an extension of the completion date of the liquidation to December 31, 2021, which coincides with the later start date for the CFC rules (January 1, 2022).

116. The liquidation concession is not explicitly linked with the VDP. The relationship between the two should be specified, particularly as the fee applicable to the disclosure of foreign assets depends on whether the assets continue to be held offshore or are repatriated to Ukraine with a lower fee applying to the latter. The liquidation concession effectively involves the repatriation of foreign assets to Ukraine and, therefore, the liquidation concession should apply only where the VDP fee has been paid in respect of the liquidated interest in a foreign entity.

117. The normal rules for the confidentiality of tax information held by STS should apply to information disclosed by taxpayers concerning CFCs. In particular, Article 17.1.9 of

---

[39] It is noted that the liquidation concession is not limited to CFCs and applies to interests in foreign entities generally.

the UTC provides for the confidentiality of tax information. Under Article 17.1.9, tax officials can disclose a taxpayer's tax information only with the approval of the taxpayer or in accordance with the Laws of Ukraine.

118. If it will better encourage voluntary disclosure of information by resident taxpayers of their interests in CFCs, the information could be subject to the same security requirements as apply to information received under Exchange of Information arrangements. Given that the STS may access some information concerning the interests of Ukraine residents in CFCs through information exchange, applying the same security requirements to voluntarily disclosed information means that all information acquired by STS concerning the CFCs controlled by resident taxpayers has the same level of security.

Recommendation

- Link the liquidation concession with the VDP so that concession applies only where the relevant VDP fee is paid.

Weaknesses in the CFC Rules

119. The introduction of the CFC rules has been the subject of criticism. However, given several weaknesses in the CFC and related legislation, concerns with the CFC rules may be more imagined than real. It is important that the CFC and related rules are amended to remove, or limit the effect of, these weaknesses.

PEM resident and CFC Rules

120. Prior to Law 466, place of incorporation or formation of a legal entity was the sole test of residence for legal entities under the UTC. Consequently, it is easy for a Ukraine resident to establish a legal entity as a non-resident of Ukraine by incorporating or forming the entity outside Ukraine, particularly in a low tax jurisdiction. As the legal entity is a non-resident, there is no current taxation of the foreign income of the legal entity. Ukraine tax is deferred until the foreign-formed legal entity pays a dividend to the Ukraine owner of the entity.

121. In theory, the PEM residence test may limit this form of tax planning where the foreign entity is effectively managed from Ukraine. However, a PEM resident is taxable only on a territorial basis rather than on worldwide income as applies to Ukraine incorporated legal entities. It is expressly provided in Article 133.1.5 of the UTC that a PEM resident is not a CFC despite the fact that it is a foreign-formed entity. As a PEM resident is taxed only on a territorial basis, the CFC rules do not apply to any CFCs of a PEM resident. Consequently, the CFC rules can be easily avoided by electing to treat a foreign-formed entity controlled by Ukrainian residents as a PEM resident. If the PEM resident has only foreign income, there is no current Ukrainian taxation of the PEM resident's income.

122. Further, dividends paid by a PEM resident are either exempt income if paid to a resident legal entity or subject to a 6.5 percent tax rate (dividend tax plus military tax) if paid to a resident individual. Consequently, foreign income derived by a PEM resident is lightly taxed compared to foreign income derived by a resident individual or a Ukraine incorporated or formed legal entity. The use of a PEM resident to hold foreign passive investments can reduce the effective tax rate from 19.5 percent to 6.5 percent. Whether this intended or not is unclear, but, as recommended above, the PEM residence rule should be repealed to prevent it being used to subvert the CFC rules.

Change in Residence

123. As PEM residence applies on an opt-in basis, residence change may be used to avoid Ukrainian CPT on the unattributed profits of a CFC (such as pre-CFC income or active income). If a CFC pays a dividend to the Ukrainian controllers of the CFC and the period of deferral is more than 2 years,[40] then the 18 percent rate applies (plus 1.5 percent military tax if the controller is a resident individual). However, if instead of paying a dividend, the residence of the CFC is changed by electing to treat the foreign entity as a PEM resident, the profits of the CFC are, in effect repatriated to Ukraine without being subject to CPT. The only Ukrainian tax is the 6.5 percent tax payable on a dividend subsequently paid by the PEM resident to a resident individual.

124. This form of planning under CFC rules can be countered. One way to do it is by establishing that the change in residence gives rise to a deemed dividend derived by the PEM resident that was formerly a CFC**.** The deemed dividend is a foreign dividend and, therefore, subject to tax at the 18 percent rate.[41] The profits of the PEM resident (former CFC) should be treated as a taxable dividend only to the extent that they represent untaxed profits derived while the legal entity was a CFC.

Active Passive Income

125. Law 466 includes an exception from CFC taxation for "active" passive income. The exception is provided for in Article 39^{2}.4.1 of the UTC and applies to passive income as defined in Article 14.1.268 of the UTC that satisfies two conditions:

(1) The CFC actually performs functions, bears risks, and uses assets in operations that result in the derivation of the passive income.

[40] If the period of deferral is less than 2 years, the dividend is taxed at the 9 percent rate under the distribution concession.

[41] The 9 percent rate will apply if the change in residence gives rise to a deemed dividend if the period of deferral is less than 2 years.

(2) The CFC has the necessary resources to perform these functions, manage these risks, and use these assets, particularly adequate personnel, and adequate equity and fixed assets.

126. The inclusion of an exemption for "active" passive income is good policy and consistent with the recommendation made in the 2019 Mission Report. However, using the functions, assets, and risks (FAR) transfer pricing methodology to determine whether passive income is "active" is not the right analysis. In broad terms, FAR is concerned with determining whether there is sufficient economic activity or presence for the purpose of allocating profits to an entity or a part of an entity (in the case of a PE). Those profits may be active or passive. In other words, FAR is not concerned with the classification of income as active or passive, but rather, it is concerned with where income is derived. FAR can apply to allocate active or passive income to a particular location.

127. It would be better policy to identify a limited number of specific cases where passive income may be classified as active in nature and, therefore, excluded from CFC taxation. The three standard cases of "active" passive income are:

(1) Interest derived by a CFC that is a bank or insurance company provided the CFC is registered as a bank or insurance company under the banking or insurance law of its country of incorporation. This exception should not apply to an in-house financier company or captive insurance company within a multinational enterprise (MNE). This would be an example of where the FAR analysis in Article 39^{2}.4.1 of the UTC may treat the income of an in-house financer or captive insurance company as active, but, for CFC purposes, the in-house income should still be treated as passive.

(2) Royalties derived by a CFC in respect of the licensing of industrial or intellectual property that has been actually developed by the CFC. This will not apply if the CFC is a "patent box" within a MNE, i.e. an entity established to hold and license out to related entities the industrial and intellectual property rights of the MNE.

(3) Rental income derived by a CFC from the lease of commercial premises (such as an office building or shopping mall) where the CFC provides substantial property management services to tenants.

Foreign Discretionary Trusts

128. The CFC rules apply to foreign arrangements without legal personality, such as discretionary trusts. For these foreign entities, the settlor or founder of the trust is treated as the controller of the trust. It was explained in paragraphs 86 - 87 of the 2019 Mission Report that the exceptions in Article 39^{2}.1.5.1 of the UTC are likely to result in some discretionary trusts, particularly "blind trusts", being excluded from the application of the CFC rules and, therefore, used as a deferral vehicle. As recommended in the 2019 Mission Report, it is best practice to treat the settlor or founder of the trust as the controller of the trust in all cases (i.e. no exceptions).

Distribution Concession

129. A concessionary tax rate of 9 percent applies to CFC income that is repatriated to a Ukraine bank account of the Ukraine controller either as an interim dividend or a dividend paid by the end of the calendar year following the end of the relevant reporting period in which the profits supporting the dividend were derived. In the latter case, the resident controller can file an adjusted return to give effect to the reduction in the tax rate from 18 percent to 9 percent. The Ministry advised during the 2019 Mission and again during this Mission that the purpose of the repatriation concession is to encourage the repatriation of CFC income.

130. It was pointed out in the 2019 Mission Report that the effect of the repatriation concession is that foreign income derived through a CFC is taxed at a lower rate than Ukraine-source income. This is likely to encourage Ukraine residents to invest offshore rather than in Ukraine. This is particularly the case given the limited investments available domestically and, therefore, Ukraine residents naturally invest offshore. However, giving priority to offshore investments through the repatriation concession is likely to run contrary to any industrial policy measures intended to encourage domestic investment. For this reason, it is again recommended that the repatriation concession is repealed, and thus taxed at the same rate as domestic income.

Technical Issues

131. Overall the CFC rules are well designed.[42] A number of technical amendments have been made in Law 466 to the earlier version of the CFC rules in Bill 1210. This includes amendments based on recommendations in the 2019 Mission Report. A few further technical issues are discussed below.

Control Rule

132. Article 39^{2}.1.2 of the UTC sets out the control rule. It provides for both legal control (based on legal interests in a foreign entity) and economic control. There are two alternative tests based on legal control:

(1) A single Ukraine resident holds an interest of more than 50 percent in the foreign entity. In this case, the Ukraine resident is the controller (paragraph (a)).

[42] Apart from technical issues raised in Part III(B) of the 2019 Mission Report and in this Part, the rules largely follow international norms in relation to the control and substantial shareholder rules, and in the calculation of CFC income, including the quarantining and carry forward of CFC losses on a "per CFC" basis.

(2) Ukraine residents collectively hold 50 percent or more of the interests in the foreign entity. In this case, any Ukraine resident that holds an interest of more than 10 percent in the foreign entity is treated as a controller (paragraph (b)).

133. It is noted that, under Bill 1210, both thresholds were aligned with 50 percent or more applying as the threshold in both cases. It is not clear why they have fallen out of alignment in Law 466. There would seem to be no reason why a different control threshold should apply under the two control rules. Internationally, both thresholds are used in CFC rules, although the "more than 50 percent" threshold is more common. However, the advantage of the "50 percent or more" threshold is that it prevents the use of a 50:50 joint venture entity to avoid the control rule. The fundamental point is that the same control threshold should apply under Article 39^2.1.2(a) and (b) of the UTC.

Substantial Shareholder

134. A substantial shareholder rule applies under the control rule in Article 39^2.1.2 of the UTC. The substantial shareholder rule limits the application of the CFC rules to those residents that are likely to have access to sufficient financial information concerning the CFC so as to be able to calculate the CFC taxable profit. The substantial shareholder threshold under Bill 1210 was 25 percent or more. This has been reduced to a "more than 10 percent" threshold under Law 466 consistent with the recommendation made in the 2019 Mission Report.[43] Yet, the "25 percent or more" threshold seems to still apply under Article 39^2.2.1 of the UTC. This should be clarified to ensure that the substantial shareholder threshold is consistently applied in the CFC rules.

Credit for CFC Tax

135. A controller of a CFC is entitled to a credit for foreign tax paid by the CFC on the profits of the CFC included in the taxable income of the controller. The amount of credit is limited to the Ukrainian tax payable by the controller on the CFC's taxable profits. It is correct policy to allow a controller a credit for the foreign tax paid by the CFC on the CFC's profits attributed to the controller. However, the credit is limited to foreign tax paid by the CFC. It is possible that a CFC may pay Ukrainian tax on its attributed income. While Ukraine-source income derived by a CFC through a PE in Ukraine and a dividend paid by a Ukraine resident company to the CFC are excluded from the CFC's taxable profits, other Ukraine source income (such as interest or royalties) are included as CFC income. This income will be subject to Ukraine withholding tax and it is usual policy under CFC rules to allow the controller a credit for Ukrainian tax paid by a CFC on any income of the CFC included in its taxable profit for CFC purposes.

[43] It is proposed in Bill 2524 that the 25 percent or more threshold would apply for the 2022 and 2023 reporting years.

Dividends Paid Between CFCs

136. The CFC rules can apply down an unlimited number of tiers of foreign entities provided the control rule is satisfied at each tier. The CFC rules apply directly to each foreign entity in the chain that is a CFC. This means that CFC-taxed profits of a lower tier CFC may be passed up a chain of CFCs as a dividend before being repatriated to the Ukraine controller of the CFC. The issue is the tax treatment of a dividend paid by a CFC to another CFC in a chain of CFCs with a common Ukraine controller.

137. A CFC will have two broad classes of profits: (i) CFC taxed profits (i.e. profits taxed to the resident controller of the CFC); and (ii) CFC exempt profits (i.e. profits that benefit from an exemption from CFC taxation). While there are several exemptions from CFC taxation, the main exemption is where the CFC passes the active income test under 39^2.4.1 of the UTC. In this case, the income of a CFC is primarily active income. The policy under CFC rules is that active income benefits from deferral, i.e. Ukrainian tax of the active income of a CFC is deferred until the income is distributed as a dividend to the resident controller of the CFC.

138. A dividend is "passive income" under the definition in Article 14.1.268 of the UTC. Consequently, in the absence of an exemption, a dividend paid by a CFC to another CFC in a chain of CFCs may be subject to CFC taxation in the hands of the receiving CFC. If the dividend is paid out of CFC-taxed profits, then taxing the dividend again as part of the CFC profits of the receiving CFC would amount to double taxation. In this case, double taxation is avoided by Article 39^2. 3.2.5 of the CFC, which provides that a dividend paid out of CFC-taxed profits is not included in the adjusted profit of the receiving CFC. It is noted that it is still treated as passive income and, as such, may be taken into account in determining whether the receiving CFC passes the active income test.

139. It appears that the exemption in Article 39^2. 3.2.5 of the UTC is limited to a dividend paid out of CFC-taxed profits. In the English translation of Law 466, the exemption applies to "accrued income", which is interpreted to mean CFC-taxed income. Consequently, a dividend paid by CFC out of exempt active income to another CFC may be subject to CFC taxation in relation to the receiving CFC. If this is right, then the payment of the dividend has the effect of converting exempt active income into taxable passive income because of the treatment of the dividend as passive income. The intention under CFC rules is that passive income is taxed on a current basis whereas taxation of active income is deferred until repatriated back to Ukraine. On this basis, Article 39^2. 3.2.5 of the UTC should apply to any dividend paid by a CFC to another CFC where the CFCs have a common Ukraine controller. This is particularly important as it is common to have a holding company as the first offshore entity that holds the shares or other interests in operating (i.e. active business) subsidiaries established in different countries. One reason for this structure is that it provides flexibility for the group to reinvest active business profits across the different operating subsidiaries. The CFC rules should not act as an impediment to this by, in effect, converting active income into passive income through the payment of a dividend. Consequently, the exemption in Article 39^{2}. 3.2.5 of the UTC should apply to all dividends paid between CFCs with a common Ukraine controller.

Dividend Ordering Rules

140. Because a CFC may have both taxed CFC profits and CFC-exempt profits, it is necessary to know which profits support the payment of a dividend as the tax treatment of the dividend will depend on the character of the profits supporting the dividend. This is relevant to both: (i) a dividend paid by a CFC to a resident controller;[44] and (ii) a dividend paid by a CFC to another CFC with the same resident controller. Even if all dividends paid between CFCs of the same controller are exempt from CFC taxation, it is still necessary to know the profits that have supported the payment of the dividend to know how it should be taxed when ultimately passed onto the Ukraine controller. It was advised during the 2019 mission and again this mission, that the ordering of profits for the purposes of paying a dividend is a matter for the company, i.e. the company can nominate the profits supporting a dividend. It was recommended in the 2019 Mission that explicit dividend ordering rules should be included to ensure effective tracking of profits, particularly through a chain of CFCs. That recommendation is made again in this Report.

Recommendations

- Apply CFC rules to resident individuals.
- If the PEM residence rule is retained in its present form, treat a change in residence from CFC to PEM resident as a deemed dividend to the extent that the legal entity has untaxed CFC profits.
- Limit the exemption for "active" passive income to a small number of specified classes of such income.
- Treat a settlor or founder of a foreign trust as the controller of the trust in all cases.
- Repeal the distribution concession.
- Align the control thresholds under Article 39^{2}.1.2(a) and (b) of the UTC. The "50 percent or more" threshold is preferred.

[44] The tax treatment of dividends paid by a CFC to a resident controller is discussed at paragraphs 100 – 101 of the 2019 Mission Report. The rules apply to ensure that there is no "double counting" of CFC profits, i.e. that attributed CFC profits are not taxed again on repatriation as a dividend. A similar double counting issue can arise where a resident controller disposes of their shares or other interest in a CFC that has undistributed taxed CFC profits. In this case, the amount of the gain should be adjusted to avoid the double taxation of the CFC profits. It is noted, though, that given the distribution concession discussed at paragraphs 129 – 130, it is likely that the profits of a CFC (taxed or untaxed) will be distributed to the resident controller prior to the sale of the shares or other interest in the CFC so that little or no gain arises on the disposal.

- Ensure that the 10 percent substantial shareholder rule is applied consistently in the CFC rules.
- Allow a FTC for any Ukraine tax paid on Ukraine source income included in the taxable profit of a CFC.
- All dividends paid between CFCs with a common controller should be exempt from CFC taxation.
- Include dividend ordering rules to apply where a CFC has both CFC-taxed income and CFC-exempt income.

E. Indirect Transfer of Immovable Property[45]

141. Law 466 provides for taxation of a gain derived by a non-resident arising on an indirect transfer of immovable property in Ukraine. New Article 14.1.54(i) provides a source rule for indirect transfers of immovable property and revised Article 141.4.1(e) provides for the taxing rule. For a transaction between two non-residents, revised Article 141.4.2 provides for a withholding rule under which the purchaser of the shares or other interest is required to withhold tax at the rate of 15 percent of the sale price.

142. The taxation of indirect transfers of immovable property are discussed at paragraphs 121 - 129 of the 2019 Mission Report. A number of recommendations were made concerning the design of the taxing rule for indirect transfers. In particular, it was recommended that the design of the taxing rule be more closely aligned with that applicable under Article 13(4) of the OECD and UN Models. The intention was to ensure that Ukraine can fully assert the taxing rights over indirect transfers of immovable property as permitted under Ukraine's tax treaties. The tax treaty alignment recommendation in the 2019 Mission Report would require three broad changes to Articles 14.1.54(i) and Article 141.4.1(e): (i) the inclusion of the 365 day test period; (ii) the elimination of the 50 percent or more ownership threshold; and (iii) the inclusion of the directly or indirectly rule in relation to immovable property as well as the ownership of shares or other interest. Of these, the only amendment made to the rules was the inclusion of the 365 day test period.

143. It was also recommended in the 2019 Mission Report that a definition of "immovable property" is inserted in the UTC that expressly includes mining and petroleum rights, including an interest in a production sharing contract. This was not adopted with Law 466 and the recommendation is made again in this Report.

---

[45] See generally "Taxation of Offshore Indirect Transfers – A Toolkit" (2017) by the Platform for Collaboration on Tax accessed at http://documents.worldbank.org/curated/en/322921531421551268/a-toolkit-draft-version-2; and Burns L, Le Leuch H, & Sunley E, "Taxing Gains on Transfers of Interest", in Daniel P, Keen, M, Swistak A, & Thuronyi V, *International Taxation and the Extractive Industries*, Routledge, 2016, pp 160-189.

144. In a meeting with private sector representatives, it was argued that there should be an exception to the indirect transfer rule where the transfer of shares is part of a reorganization within a corporate group. While a reorganization exception is not included in Article 13(4) of the OECD and UN Models, the Commentary to the OECD Model states that such an exception could apply.[46] The effect of the exception would be that no gain or loss is recognized to the seller on the indirect transfer and the purchaser of the shares or other interest is given a cost equal to the seller's cost at the time of the transfer. This has the effect of deferring recognition of the gain (or loss) on the transfer until the purchaser makes a subsequent disposal of the shares or other interest outside the corporate group.

145. Given that there is no general corporate reorganization rule under the TC, it is not recommended that a special rule apply in this case. Further, corporate reorganization rules are usually limited to transfers between resident companies so that they can be properly monitored and policed by the tax administration. In this case, the transfer is between two non-resident companies with no taxable presence in Ukraine and there is a high risk that a subsequent disposal of the shares or other interest is not reported. STS is also likely to face difficulties in substantiating that the two non-resident companies are members of a corporate group. Ultimately, a tax-free corporate reorganization rule for indirect transfers may create a loophole for the avoidance of tax.

146. The proposal to collect the tax by withholding is discussed at paras. 127–129 of the 2019 Mission Report. Two difficulties with this collection methodology were identified in that Report, namely: (i) the purchaser will not know the seller's cost to work out the gain; and (ii) as the transaction is between two non-residents with no physical presence in Ukraine, it is difficult to see how STS could enforce the withholding tax liability. Two collection options were discussed in that Report. The preferred approach is to require the entity that owns the Ukrainian immovable property to pay the tax as representative or agent of the non-resident seller. This is based on the reasonable assumption that the entity that owns the property can recover the tax under a shareholder agreement or a tax clause included in the sale of shares agreement. While it is accepted that this regime is not free of difficulties, it is considered a better enforcement option than the withholding tax rule.

Recommendations

- Include a definition of immovable property that covers mining and petroleum rights, including an interest in a production sharing contract, and mining and petroleum information.
- Collect the tax on an indirect transfer by requiring the owner of the Ukrainian real estate to pay the tax on behalf of the non-resident seller.

---

[46] Paragraph 28.7 of the Commentary to Article 13 of the OECD Model.

- Do not include a corporate reorganization exception.

V. CHANGES TO TRANSFER PRICING REGULATIONS

147. The BEPS package adopted with Law 466 (May 23, 2020) included important reforms to transfer pricing. Many reforms follow OECD guidelines closely and should not be controversial. The definition of related parties, for example, was modified, increasing the participation threshold from 20 to 25 percent. Joint ventures can also be related parties to companies in which one of the partners has a participation equal or above that threshold (L466, art 3. 17; UTC, art 14.1.159). Other changes were more complex, such as updating to Base Erosion and Profit Shifting (BEPS) standards the principles to allocate risk assumption in controlled transactions. Also, with Law 466 commodity pricing was basically aligned with BEPS Action 10, although it will represent an administrative challenge, as is often the case with transfer pricings provisions.

148. Other measures will provide more information to the tax authority. Ukraine fully adopted country by country (CbC) reporting rules, including Master and Local files. Additionally, with Law 466 taxpayers will have to provide tax authorities a notification on participation in international group of companies ('Notice of participation'), aside from reporting yearly data on controlled transactions carried out with foreign residents (Ukrainian Tax Code, UTC, art 39.4.2). This will facilitate STS transfer pricing enforcement work.

149. However, there are some important transfer pricing issues that were not dealt with appropriately in Law 466. An initiative (Bill 2524) to reform the UTC again was already being discussed in Parliament while this mission was ongoing. The preliminary Bill, as presented to Rada's Finance Committee, would have addressed some important shortcomings in Law 466. However, the Bill was voted in the plenary session July 14, 2020, when this mission was finalizing its review. The mission did not have access to the final, approved version of the Bill, which is different form the preliminary Bill, according to the MoF. The recommendations of the mission are therefore based on the analysis of Law 466 and the preliminary version of the Bill 2524. Thus, the legislation on transfer pricing might have to be eventually reviewed again.

150. This chapter focuses on four issues: commodity pricing, business restructuring, thin capitalization ('thin cap') and, probably the most contentious, the business purpose test. The chapter ends with questions on uncommon exceptions made to the definition of related parties.

A. Special Rules for Transfer Pricing of Commodities

151. The UTC makes an exception regarding the choice of the method to price commodities. Taxpayers must preferably use the Comparable Uncontrolled Method (CUP)[47], a priority which is consistent with BEPS Action 10 and the new OECD TP Guidelines since 2017.[48] Importantly, the new law makes the regime for commodities more flexible as to which may be considered a comparable price under this method. The key addition is that the law now permits the use of "quoted prices" (Law 466, art 3. 8); UTC, art 14.1.94'), including those reported by recognized information agencies. It will be necessary that administrative regulations exemplify the types of agencies considered as adequate sources of information, which should include agencies such as Bloomberg, Thompson-Reuters, Platts, Argus Media, among others. The specific list should be drawn up by the MoF and the STS with the collaboration of industry specialists.

152. The definition of commodities subject to this special transfer pricing rule is general and imprecise.[49] However, it is deferred to administrative regulations by the Cabinet of Ministers to list which products will be considered commodities for transfer pricing purposes (UTC, art 39.3.3.4), which remedies the ambiguity in the law. It would be prudent that this list be short to begin with, including only commodities for which there is little doubt about the sources of market price data. The primary candidates to be included in this list are wheat, corn, soybean, and sunflower oil, given their significant share in Ukraine's commodity exports.[50]

153. Quoted prices can be adjusted under the CUP to solve for material differences compared to controlled transactions. This is standard transfer pricing methodology. However, as argued in the FAD (2019) Report,[51] given the homogeneity of commodities it is prudent to limit the types of adjustments that the taxpayer can perform. Freight, insurance, port costs[52] and quality differences should be admissible, but not other adjustments. Law 466 does not place any limits in this regard (UTC, art 39.3.3.4). It should be considered introducing them in the regulations.

---

[47] Law 466 states (as translated) that the use of the method is "mandatory" and an exception to the general rule of using the most appropriate method (UTC, art 39.3.2.1 & 39.3.3.4). This is not the most fortunate language; rather that an exception to that general rule, it could have been framed as CUP being the most appropriate method for pricing commodities.

[48] OECD (2017), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, Paris, OECD Publishing.

[49] In essence, the law defines commodities as those goods which are traded by independents in exchange markets but does not define what might be considered an exchange market.

[50] Transfer pricing for commodities was discussed at some length in previous missions.

[51] R. Schatan, M. Grote & L. Burns, 2019, Distributed profit tax; voluntary disclosure of assets; and BEPS implementation, IMF, Fiscal Affairs Dept, (July 2019); p. 63.

[52] Port costs could be deducted from quoted prices if paid by the buyer to an independent provider; otherwise it would have to show that those costs were paid at market prices.

154. The law states that commodity prices are defined as an average or as a range of prices. This needs to be further explained in administrative regulations. Possibly, the law meant to say that the daily price is quoted by the reporting agencies as a daily average or a daily range of prices (Law 466, art 13. 2, UTC, art 39.3.3.7). It should be clear, for example, whether the price average or range is the estimate of the daily price calculated by the reporting agency, rather than an average or range calculated by the taxpayer on the basis of reported data. The regulations should also explain what is meant by "range of ranges" and explain if a taxpayer can add different daily price ranges from different sources to construct a range wider than that reported by any individual source; if so, clarify consistency rules that should be followed.

Recommendations

- List in administrative regulation specialized agencies as sources of information for commodity price quotes, including Bloomberg, Reuters-Thomson, Platts, Argus Media, among others.
- Limit the list of commodities which will be subject to the mandatory CUP method to a few main Ukrainian exports, such as wheat, corn, soybean and sunflower oil.
- Limit the types of adjustments and discounts that taxpayers may apply to the application of the CUP method for commodities. At most, allow quality differences and freight, port and insurance costs paid by the customer; apply the arm's length principle (ALP) when customer is a related party of these service providers.
- Define in regulation "average" and "range of quotation prices". Explain whether they refer to daily prices. Define also the concept of "range of ranges".

B. Business Restructuring

155. Business restructurings are a difficult area in TP. When functions, assets and risks are reorganized within the MNE, the business of the MNE is effectively reshaped across-borders together with the profit profile of the different affiliates. As a result, tax bases are also redistributed, although no explicit controlled transaction has taken place. However, a similar shifting of business functions or opportunities among independent parties would not occur without appropriate compensation. What may appear as a strategic reorganization decision by the MNE's head office, among independents would amount to a market transaction valued according to the expected profitability that each party attaches to the transferred functions. The OECD TP Guidelines (2017) recognize that this situation needs to be valued at arm's length.[53]

156. Law 466 establishes that a business restructuring is one of the activities covered by transfer pricing. This is an appropriate expansion in the application of transfer pricing and the ALP. However, it qualifies the restructuring subject to TP obligations more than it should. The law

[53] This was adopted in the OECD TP Guidelines since 2010.

(L466, art 13; UTC art 39.2.1.4) limits the application of TP only to restructuring activities that reduce the financial result of the taxpayer.[54] This is biased, for the obligation to apply TP should be symmetrical to the outcome of the reorganization,[55] even if the MNE transfers activities or functions that are not yet yielding an income (e.g. an unexploited license).

Recommendation

- Eliminate reference to "negative impact to financial results" as a condition to subject a business restructuring to transfer pricing regulations.

C. Business Purpose Test

Definition

157. The general concept of "business purpose" existed in the UTC prior to Law 466. However, the definition was vague[56] and apparently served no purpose. The concept was not mentioned in any other section of the UTC except for the one where it was defined[57]. Law 466 (art 25, modifying UTC, art 14.1.231) added some meaning to it, indicating that "business purpose" is for economic gain or the preservation or increase in the value of the taxpayer's assets.[58] The concept is further defined by what it is not:

- Transactions with non-residents have no reasonable economic cause (business purpose) if the main purpose (or the outcome) of the transaction is a reduction of taxable income or the tax paid by the resident taxpayer.

- Also, there is no business purpose if under comparable conditions an independent person would not be willing to engage in the transaction. This does not apply when the controlled transaction involves the sale of goods.

158. There are several uncertainties about this definition. The wording of the first condition is imprecise; the taxpayer might have the intent of reducing taxable income even if

---

[54] "Art 39.2.1.4: Economic activity for the purposes of transfer pricing are … e) transactions in which the taxpayer's income and / or financial result is reduced as a result of …transfer of functions … tangible and / or intangible assets, benefits, risks and opportunities to another taxpayer in cases where in the relationship between unrelated persons such a transfer would not have taken place without compensation …".

[55] This is inconsistent with the adoption in Law 466 of the possibility of a correlative transfer pricing adjustment (L466, art 13. 4); UTC 39.5.5.2)

[56] Translated loosely as the intent of having an economic gain from a business activity (a profit motive); UTC (2019), art 14.1.231.

[57] The expressions in art 14.1.231 as shown in the English translation, economic reason or business purpose, do not appear again in a word search of the entire UTC.

[58] This business purpose test is different and should not be confused with the 'principal purpose test' applied to tax treaty beneficiaries, referred to in UTC art 103.3. The latter test is not discussed in this report.

results are positive or, vice versa, the result could be negative even if the objective of the transaction was economic gain. It is not clear whether these cases, to the letter of the law, could be dismissed as having no business purpose. As the name of the concept itself indicates, what should matter is the purpose of the transaction, irrespective of the actual result, which is always uncertain to begin with under ordinary business conditions. Linking business purpose with the actual results of the business is like claiming that companies operate under perfect foresight. However, it should not be minimized the practical difficulty of proving the intent of the transaction.

159. There is also a conceptual flaw. The second condition, as drafted, may exclude legitimate business situations, for MNEs may be willing and able to operate in ways that independents cannot. For example, where two independents have monopoly power over the other, uncertainty may hold them back from committing large investments (potential 'hold up' situations). This uncertainty dissipates among affiliates, allowing them to do business as if they were an integrated supply chain. So, the mere fact that independents would not enter into a similar transaction as MNEs do is not enough reason to proclaim lack of 'business purpose'. More qualifiers need to be considered, as discussed below.

Scope of Application of the Business Purpose Test

160. The concept in Law 466 applies generally to transactions with non-residents. This includes all independent parties abroad; the burden of proof is on the tax authority (except for transfer pricing cases, further discussed below). It is the mission's belief that there is no reason to potentially subject to verification all cross-border market (independent) operations whether they have a business purpose, even if they happen to be bad business. This is a misguided overreach of the tax authority. This overreach might be explained because Ukraine places no limit to accounting expenses that may be deducted for CPT purposes. But this is a separate problem which should not be conflated with a business purpose test (see Box 6).

161. The application of the business purpose test makes sense in the context of controlled transactions. These transactions should include those which are suspect of being controlled. The law already defines which are these transactions, like trading with low tax jurisdictions (LTJ).[59] The blanket application of the business purpose test to all transactions with non-residents is at the core of the problem with Law 466. Additionally, as the rule does not apply to transactions with residents, the proposal is in principle contrary to non-discrimination rules defined in art 24 of the OECD or UN Model Treaty Conventions. The problem is avoided if the rule applies only to (all) controlled transactions.

[59] LTJ and beneficial legal forms are already defined in the law. These are subjected to deduction limitations unless the taxpayer complies with the ALP, treating them as if they were controlled transactions; UTC arts 39.2.1.2, 140.5.4.

Box 6. Disallowing the Deduction of Non-Business Expenses

Until 2014 the Ukraine Tax Code (UTC) did not allow corporate taxpayers to deduct expenses which had no link with their business activity. This is commonly required in most countries. The tax reform of 2014 struck the rule down, so that any expense in the financial accounts became deductible, though it would be a taxable income for the person on the other side of the transaction. This system is very hard to control, and it is potentially a large tax loophole. The intention of this reform was to eliminate a source of continual disputes between taxpayers and the STS about which expenses were linked or not with the business activity.

Taxpayers pushed back against this perceived aggressive and arbitrary behavior by the STS. The agency would determine non-deductible, as recalled by taxpayers, expenses that were not connected with a profitable activity, stretching the concept that a deductible expense must be necessary for pursuing the business in question, regardless of the outcome. The reform's main objective was to withdraw from the STS an instrument that could be applied with too much discretion.

As explained by representatives of the private sector, Ukraine's Supreme Court (SC) ruled many times against STS when disallowing the deduction of expenses. However, there is no 'precedent law' in Ukraine, so each individual taxpayer needs to obtain the protection of the court, causing large litigation costs. The precedent is set in the sense that a previous ruling by the SC will determine the decision in the following trials but will not protect all taxpayers without a change in the law. So, the MoF opted for eliminating the deduction requirement from the UTC.

Administrative and procedural issues aside, the current requirements for deducting expenses do not protect the tax base, especially for expenses favoring non-residents. However, the problem is not corrected by introducing a business purpose test on transaction with non-residents. The issue here is simpler: all expenses need to be linked to the business activity of the taxpayer, regardless of the nature or purpose of the business. Ukraine should consider reinstating a well-designed deduction rule for expenses related to a business, explicitly saying that there need not be a direct link with profits.

Another area to explore is reexamining how jurisprudence is established. The idea is that a ruling of the SC may protect all taxpayers in the same situation, rather than having each taxpayer to relitigate the same issue to obtain the protection of the court. Also, it should be explored the possibility that the tax authority may act according to the ruling of the SC rather than following the letter of the law which has been struck down.

162. **A business purpose is specifically required for transfer pricing analysis, to avoid profit shifting by MNEs**. It is the taxpayer's duty to document and demonstrate that there is a business purpose for its intra-group transactions. The requirement is stated as part of the transfer pricing documentation process, now included in the UTC, art 39.4.6 (L466, art 13.3). This test differs from the general rule in that the burden of proof is on the taxpayer. Although transfer pricing is the right context for the business purpose test, Law 466 is not entirely consistent in how it introduces the concept in combination with the ALP (this is discussed in detail in Box 7).

163. **Controversially, Law 466 assumes that controlled transactions with goods always have a business purpose**. Thus, it exempts them from the test (UTC art 39.4.6). They would only be subject to readjustment in their value according to the ALP. However, the exemption opens a

potential loophole in the application of the ALP on related party transactions and should be eliminated.[60]

Business Purpose Test and Transfer Pricing

164. The business purpose test is particularly useful in applying the ALP when no comparable market transactions exist. The absence of independent comparables may occur because MNEs operate in ways that others cannot replicate either because i) MNEs have unique (and legitimate) business opportunities, or ii) because such transactions are modeled to lower the global tax burden of the enterprise and having thus no business purpose in the sense that independents could only engage in a similar scheme with a fraudulent intent.

165. The business purpose test allows the authority to decide how to proceed in these cases. Transactions with no parallels in the market, as appropriately delineated, could either be priced at arm's length (AL) with methods which do not rely on comparables or not recognized for having no business substance. The test is therefore an important instrument in the toolkit of transfer pricing practice, now available in Law 466. A key aspect of the business purpose test, in the absence of comparable transactions, is to ask whether an independent, profit motivated party would have entered into such transaction. A key element to answer this question is examining the realistically available option to them in case they operated as independent enterprises. For example, a centralized procurement arrangement with an affiliate would not be compliant with the business purpose test (and thus with the ALP) if the taxpayer could realistically purchase the supplies in question on better terms from another vendor.

166. The concept of realistically available options was not adopted with law 466. This is a weakness in the business purpose test in the context of transfer pricing methodology. This will create ongoing uncertainty and should be suitably corrected.

Box 7. Understanding the Business Purpose Test in Transfer Pricing

At the heart of transfer pricing methodology is the functional analysis required to find uncontrolled comparable transactions that may serve as a benchmark to value intra-group transactions. The functional analysis is about describing with precision (discovering) the nature of the controlled transaction in order to search for a comparable operation among independents whose price (profit margin) can be used to value the former and so comply with the ALP. In describing the transaction, attention must be placed in real transaction taking place among the related parties, not just what they might have registered in the contracts, since they do not represent opposing interests. In the language of the OECD (2017)

[60] For example, a taxpayer may claim that under an intra-group reorganization of functions, procurement of supplies for sale in local markets will be centralized globally in a (say) Swiss affiliate of the group. Under the reorganization all inventories of goods must be transferred (sold) to the Swiss affiliates so that the global stock is put immediately under its control. Under its new procurement functions, a few days later the Swiss affiliate sells the same goods back to the Ukrainian subsidiary at twice the price. The goods never move out of the Ukrainian warehouse. It can be argued that the transaction has no business purpose because no independent party would engage in such transaction. The realistically available option to the taxpayer is to keep the inventory and sell it directly to its clients; (this example is a simplified version of real case in another country).

Box 7. Understanding the Business Purpose Test in Transfer Pricing (concluded)

TP Guidelines, the starting point of transfer pricing analysis is the accurate delineation of the transaction in question. One key feature of this description is to understand the purpose of the business; an essential comparability factor in this pricing exercise.

If the accurate delineation of the transaction reveals a controlled business operation different than that described in the contracts, the tax authority should be able to recharacterize it accordingly in order to price it at AL. This is standard transfer pricing practice (though always controversial). The point is that the profit assigned to the affiliate should respond to the real business purpose of the transaction, not to what might have been alleged by the taxpayer. The difference must be adjusted so that the profit (price) is aligned with the reality of the transaction (UTC, arts 140.5.1 and 140.5.2). This is the essence of comparability analysis in transfer pricing and business purpose plays a key role in establishing the true nature of the transaction that must be valued.

The business purpose test may be usefully understood as a slightly different exercise than simply establishing the business purpose of a transaction in order to find a comparable. The test per se, it is suggested here, would apply when comparable market transactions are not found (for the accurately delineated transaction) and the question arises whether the controlled transaction is nonetheless a legitimate business operation which has to be priced at AL, or disregarded instead because it has no business purpose aside from (mainly) avoiding tax. In the latter case the deduction of expenses would be disallowed, applying UTC, art 140.5.15 (equivalent to appraising related transactions as having no value in the market).

To pass the business purpose test it must be shown that the transaction had a profit motive. This means that the transaction, as planned, should benefit the MNE for reasons different (for the most part) from a reduction of the global tax bill. In other words, the operation should benefit the MNE without making the affiliate party to the transaction worse off as compared to the realistically available business options it would have if it were an independent enterprise.

Consequences of Failing the Business Purpose Test

167. The expenses incurred in transactions with non-residents that lack business purpose are not deductible. This is the fundamental anti-abuse rule introduced in international taxation by the reform signed into law May 2020 (Law 466, art 3), adding to the UTC art. 140.5.15). It is an additional situation where the taxpayer must increase its financial result by the disallowed amount. This is straight forward when the transaction is a purchase: the deduction for the expense is then disallowed. When the transaction is a sale to a non-resident, it must be assumed that the costs of that sale are disallowed; however, nothing is said about the income from that sale, whether it is taxable all the same.[61]

168. Given that the provision is applicable to all non-residents, the rationale inevitably separates the ALP from the business purpose test. A genuine independent transaction may fail the business purpose test and this failure would be irrelevant to the ALP, because this principle does not apply to independent transactions. However, treating these concepts equally

[61] Law 466 introduced in the UTC art 140.5.5-1 to clarify the consequence of not applying the ALP to sales to residents in LTJ or in counties where they benefit from legal forms that allow not paying any CPT. The consequence is an increase in the results by 30 percent of the value of the sale. However, it is not clear that this would also apply when the transaction fails the business purpose test.

separate for controlled transactions leads to the incongruous possibility that a taxpayer may comply with the ALP but not with the business purpose test, or vice versa. Also, it may lead to situations where the taxpayer is exempt from complying with the ALP, because his turnover is below the threshold, but must comply with the business purpose test.

Self-Correction

169. Law 466 extends the possibility for taxpayers to self-adjust when they fail the business purpose test. This would allow taxpayers to correct in the same way deviations from the ALP as failing the business purpose test.[62] However, this possibility defies the logic of the test. Failing it means that independents would not engage in such trade, at no price whatsoever (except a price equal to zero)[63] By definition, a transaction that has no business purpose cannot have an AL price. That is why UTC art 140.5.15 mandates disallowing the expense rather than adjusting the price (or profit margin). Also, the UTC art 39.5.4.1 (as modified by Law 466) implies that a controlled transaction may have no business purpose but still comply with the ALP. Strictly speaking, if there is no business purpose, it cannot be AL. Thus, failing the business purpose test should not be subject to self-adjustment, but to non-recognition.

Amendments to Law 466

170. Soon after Law 466 was signed, Parliament drafted Bill 2524 which would amend several aspects of the business purpose test.[64] One of the changes considered in that Bill is that the law would no longer link business purpose to the actual results of the business transaction. The link would be strictly to the demonstrated objective of the operation (B2524, art 6, modifies UTC art 14.1.231, as in L466). This is a remedy to one of the important uncertainties about the definition of business purpose, particularly relevant at this time when economies are in recessions or downturns that affect taxpayer's financial results. Actual losses are insufficient grounds to determine whether a business is legitimate (although prolonged losses could be a risk indicator for selecting taxpayers for tax inspection).

171. The most important change Bill 2524 would introduce relating to business purpose is that it would have applied only to controlled transactions. The test would no longer be applicable to transactions with all non-residents. Its application would be limited to transfer

[62] Self-adjustment is permitted only if it will not decrease the tax liability. Law 466, art 4 (UTC 39.5.4.1).

[63] For example, a transaction would fail the business purpose test if it involved a service that had no value at all for the affiliate liable for the charge. The correction is the non-recognition of the transaction and disallowing the deduction for the expense. No solution could be found adjusting the price, unless a zero value was admitted as a market price.

[64] In the plenary session Rada voted Bill 2524 July 14, 2020 in the final days of the mission. The mission did not have access to the final version of the Bill as approved by parliament. The document mentioned here is a previous version that included numerous corrections to the Law 466 which apparently, according to the MoF, were not approved.

pricing.[65] This is the right approach. The more general problem with the Ukrainian corporate income tax (CIT) that deductible expenses need not relate to the business itself should be treated separately, because it represents a different problem. As explained in Box 1, this general anti-abuse rule does not question whether the business has a rightful profit motive. The business is taken for granted, and the condition is that the expense be connected to that business. The reintroduction of this general rule on deductions should be reassessed, as a complement to the business purpose test applied to controlled transactions.

172. The initiative also would correct the law in that it extends the application of the business purpose test to all controlled transactions, included those which involve the sale (purchase) of goods. Although it might be more difficult to structure a transaction with goods that has no business purpose, it is not impossible, as argued above, and exempting them from the business purpose test creates a potential loophole. Bill 2524 would close this loophole (B2524, art 6, modifies UTC art 14.1.231, as in L466). Indeed, the treatment should be uniform for all transactions that do not comply with the ALP. They should be adjusted to yield a market profit rate (or valued at a market price) and if this cannot be done because the transaction has no business purpose, then it should be disregarded (non-recognized).

173. The universe of controlled transactions would include deemed controlled transactions that have to comply with the ALP to avoid a 'blind' increase in their taxable results. This is the case of transactions with LTJ or with foreign residents that benefit from legal forms[66] which allow them to pay no CIT (UTC arts 140.5.4 and 140.5.5-1) and the payment of royalties (UTC, art 140.5.6). While the intention of Bill 2524 is correct in paring the application of the business purpose test with the ALP, it introduces a mismatch, nonetheless. If the taxpayer chooses not to review whether the transaction complies with the ALP, its taxable income will be affected (deductions reduced by 30 percent in one case, income increased by 30 percent of sales in another, and lastly no deduction of royalties above 4 percent of sales). The problem is that if the same transactions do not comply with the business purpose test, they risk of being disallowed in their entirety, de facto, turning the test into a different and separate condition from the ALP. Instead, the test should be conceived as an integral part of complying with the ALP, meaning that failing one would mean failing the other, and both should lead to the same consequence for the taxpayer. This is issue is not entirely resolved by Bill 2524.

174. Bill 2524 proposed to introduce the concept of realistically available options to the taxpayer in order to strengthen the business purpose test. This is correct, as the concept allows to make the right call under the ALP as to the rationale of the controlled transaction in question. It is a necessary parameter for determining what independents would do in similar circumstances.

---

[65] B2524, art 69, 5, eliminating UTC art 140.5.15 and modifying 140.5.4

[66] These legal forms are identified in Ukraine cabinet of Ministers Decree # 480, July 4, 2017. The list includes over 100 legal forms in 26 countries.

Recommendations

- Redefine the concept of business purpose based on the intended rationale of the transaction and eliminate reference to its actual result.
- Do not apply business purpose test generally to transactions with non-residents.
- Limit the application of the test to controlled transactions or deemed controlled transactions which must comply with the ALP to avoid 'blind' penalties in their financial results.
- Apply the business purpose text to all controlled transactions, including trade in goods.
- Change the definition of business purpose test such that finding no independent comparable observations is not a sufficient condition to fail the test.
- Add the concept of "realistically available business options" to determine whether the absence of market comparables can be qualified as a failure of the business purpose test.
- Define the business purpose test as a condition to comply with the ALP, not as a separate test.
- Clarify that by failing the test the taxpayer also fails the ALP for the transaction in question.
- The exemption for complying with the ALP should equally apply to the business purpose test.
- Do not allow self-adjustment as a remedy for failing the business purpose test; the remedy is non-recognition.
- Consider the possibility of reintroducing a general requirement that expenses have to be connected with the business of the taxpayer (regardless of the purpose of the business) in order to be deductible.

D. Thin Cap

175. The thin cap rule with Law 466 is expanded to include debt with all non-residents. As explained in previous FAD reports, counties apply this anti-abuse measure in a variety of ways, but BEPS Action 4 summarized several best practices in this regard. Ukraine came closer to these BEPS standards with the recently enacted Law 466. Before, thin cap only applied to foreign related party debt, which weakened the rule. One reason is that back-to-back loans can be arranged with unrelated parties to channel funds from an affiliate. Law 466 was an important step in solving this problem by applying the limits to interest deduction with respect to debt with all foreign residents, related or not (L466, art 90. 2), 1st par, modifying UTC art. 140.2). Some analysts interpret Law 466 as covering all debt, including domestic lenders. The transitional provisions of the law (art 155) states that "The rules of interest accounting provided for in the first paragraph of para 140.2 of Article 140 of this Code shall apply … to all loans, borrowings and other debt obligations accounted for on the taxpayer's balance sheet as of January 1, 2021". This would be more in line with the non-discrimination clause (art. 24) in tax treaties, which does not allow restrictions on deductions to foreign residents of the treaty country that are not equally applicable to residents. A non-discriminatory approach was also endorsed by the FAD (2019) Report (p.44).[67]

176. Bill 2524 would reduce the scope of the thin cap rule adopted with Law 466. Specifically, it would exclude from the calculation debt with foreign banks (Bill 2524, initiative 104. 6), par before last, line c). While there could be an argument that bank lending, typically under strict financial regulations, should not be treated as intra-group operations, it is the experience of several countries that back-to-back loans do indeed occur through the banking system, especially when withholding taxes on interest payments are lower for banking loans than from other types of lenders, like a non-financial parent company[68]. Also, Bill 2524 changes law 466 in that thin cap is only applicable to debt with non-residents.

177. Interest payments are disallowed for tax purposes in Ukraine if they are above a double threshold. The thresholds apply sequentially; the interest payments that i) arise from debt in excess of 3.5 times of equity and subject to a deduction limit of ii) 30 percent of taxable profits. This second threshold was lowered from 50 percent of EBITDA with L466. This double test makes the thin cap rule weaker, especially because the first ratio in high. As pointed out in previous FAD mission reports, most countries that still have a debt to equity ratio in their thin cap rule have a lower ratio, often 2 or 1.5 to 1.

178. Prior to Law 466, the thin cap rule did not adequately interact with the ALP. Non-compliance with both limits would trigger separate adjustments, even if it pertained to the same interest payment. The Law now eliminates the (probably unintended) potential double adjustment increasing in taxable profits, once to comply with the ALP and a second to comply with the thin cap rule (L466, art 90. 2), 5th par, modifying UTC, art. 140.2).

179. The intent of the law, which would be clarified with Bill 2524, is that the ALP applies only when stricter than the thin cap rule. According to the MoF, no amount of interest would be deductible above the thin cap threshold, regardless of the ALP. However, the ALP would apply if the maximum deductible interest payment allowed under that principle is lower than the amount the thin cap rule would allow. This is how the relevant provision in Bill 2524 (initiative 104, 6); UTC, art 140.2) should be interpreted: "*The "adjustments" resulting from thin cap*

[67] To soften the impact of an "all-debt" thin cap rule, the European union, for example, has a *de minimis* rule whereby a specified, small amount of interest, regardless of origin of debt, is exempted from the thin cap rule. EU Council Directive July 12, 2016, art 4. The downside of this rule is that the relief is not proportional, but it benefits small taxpayers most.

[68] The UTC has a flat withholding rate (15 percent) on interest payments to non-residents. However, some treaties do provide for a special reduced rate when the interests are paid to financial institutions (e.g., Austria and Luxembourg).

will not apply when the amount of interest: a) is inconsistent with the arm's length principle …". From a legal, formal standpoint the ALP is applied first and then the thin cap rule, as a domestic anti-abuse measure, supersedes it when resulting in an interest deduction cap below the AL level.

Recommendations

- Lower the debt to equity ratio in the thin cap rule; consider a 2 to 1 ratio.
- Eventually consider keeping only one cap to interest deductions, a percentage of taxable profits.
- Clarify similarly if the intent of the law was for the thin cap rule to include all debt.
- Consider clarifying the interaction between the ALP and the thin cap rule, in the understanding that the ALP only limits interest payments below the thin cap level.

E. Special Rules Defining Related Parties and Thin Cap

180. There is an exception to the participation threshold determining if parties are related for TP purposes (UTC art 14.1.159)**.** Law 466 introduces a higher threshold for International financial organizations (which by treaty with Ukraine have privileges and immunities) allowing them a 75 percent participation in a Ukrainian business before they are considered related and having to comply with TP rules. It is not clear why such exception is granted, since the Ukrainian affiliate of such financial institution (which could be a commercial bank, for example) is probably subject to regular CIT and may have the same incentives to shift profits abroad, obtaining a competitive advantage in the domestic market. This exception does not appear justified. Also, the definition of related parties in terms of control through a ratio of debt to equity does not apply to these financial organizations. [69]

181. A similar exception is also made for thin cap in Bill 2524. The preliminary version of this Bill (art 104) would have exempted from the thin cap rule Ukrainian companies that are indebted to these International financial organizations. It should be underscored that the benefit is to the Ukrainian taxpayer which does business with the international organization, which is independent from the taxation (and immunity) of income of non-resident lenders.

Recommendation

- Eliminate the exception from complying with transfer pricing and thin cap rules for Ukrainian taxpayers that do business with *International financial organizations.*

---

[69] Two parties are related also when one is indebted to the other (directly or indirectly) by more than 3.5 times its equity (L466, art 3. 17); UTC art 14.1.159).

Appendix I. Approaches to Develop and Maintain Up-to-Date Property Cadasters

For purposes of creating a fiscal cadaster it is worth noting that the United Nations with the support of the Federation Internationale des Geometrics (FIG) developed the "Bogor Declaration on Cadastral Reform".[70] The Bogor Declaration proposed the development of "... *modern cadastral infrastructures that facilitate efficient land and property markets, protect the land rights of all, and support long term sustainable development and land management*". In this context land administration is considered to include land registration, cadastral surveying and mapping, fiscal, legal and multi-purpose cadasters and computerized parcel-based information supporting land use planning and valuation/land taxation systems. The question arises, how far has Ukraine advanced this process, and if so, what can the one-time asset declaration contribute usefully in this regard.

The Ukrainian government, if Bogor Declaration activities have not commenced or advanced enough, should develop as a priority a clearly defined national fiscal cadaster vision, strategy and national framework. Failing to do this could result in an un-coordinated and piecemeal approach to developing the fiscal cadaster. This would involve establishing the IT platform for the cadaster (which could be tapped by the proposed indirect method) which would reflect that most modern cadasters are based around GIS-centric spatial technology. It will follow that the strategy should meet the requirements of end users. Critically, the national framework should build upon the currently available data held by national and local government entities. In several Balkan jurisdictions, a national fiscal cadaster is developed as an integral component of the property tax reform. The experience also suggests that the creation and management of the fiscal cadaster is a Ministry of Finance function.

A key decision must be taken by the government in relation to ownership of the fiscal cadaster and where it shall be housed. Clearly, having a national cadaster is considerably preferable than having a multiplicity of separate cadasters at the local government level. Having centralized management will bring synergies that would not be possible if multiple local cadasters were to be developed. These would include efficiencies in the sharing of data with other entities and maintaining the integrity and quality of the data within the cadaster. The co-ordination for the initial development of the fiscal cadaster should ideally rest with the MoF.

A significant component of the fiscal cadaster is the data inventory. This represents detailed qualitative and quantitative information on each parcel and building across the Ukraine. The collection of this data is expensive and time consuming given the numbers involved. However, once the mass data collection has been completed only annual maintenance is required to deal

[70] Federation Internationale des Geometrics. UN-FIG. 1999. *United Nations-FIG Bathurst Declaration on Land Administration for Sustainable Development*. International Workshop on Cadastral Infrastructures for Sustainable Development, International Federation of Surveyors and the United Nations, Bathurst, New South Wales, Australia.

with any physical changes to existing buildings or the addition of new buildings. There may be a number of agencies in Ukraine that hold data on real property, from physical attribute data to addresses to ownership details (which the one-time asset declaration seeks to address). It will be important that the fiscal cadasters at subnational level have the capability to draw data from these various sources.

For example, in the case of Albania, the Albanian Power Distribution Operator (OSHEE) initiated a mass collection of property data. The mission provides this information to indicate that building an immovable property ownership register is a rather intricate process if accuracy is the objective. A Memorandum of Understanding (MoU) was signed between the Ministry of Finance and the OSHEE to conduct a nationwide collection of physical data on buildings. A pilot project was conducted by OSHEE in late 2016 to develop the IT infrastructure and to integrate the various databases that would be used to plan workflows for data collectors. Some 1,200 data collectors were employed including around 400 GIS and mapping experts. Data was collected on hand-held tablets, and GPS co-ordinates were taken to identify the precise location of the property. The data collection exercise has largely been completed (mid-2017) and currently quality control is systematically checking and verifying the data. At the same time the Ministry of Internal Affairs was planning to conduct a large-scale project to identify property owners and the address of each property. The project would use the National Address Registry as baseline data for in-the-field verification. It was decided to merge the projects of OSHEE and that of the Ministry of Interior given the similarity of the projects' field inspection methodologies. The total cost of the project was around 1 billion ALL (US$ 9million). This would translate to around a US$ 9 per property registration cost which is well within international standards for such a mass data collection exercise.

The OSHEE data collection project is limited to buildings and objects that have an electricity connection. Information on agriculture land is not part of the project. Nonetheless, an inventory of agricultural land should be undertaken for inclusion within the fiscal cadasters. Data on agricultural land is typically held by multiple organizations in a country and would require a different coordination.

As to registration of property titles, it will be essential that a common property identifier be established to ease the merger of data held by other government entities. This could represent a major problem if it is not agreed early in the establishment of the fiscal cadaster. A property or parcel identification number (PIN) should be created for every property/building and parcel. One organization should have clear responsibility for developing the standardized PIN methodology. This unique reference number would then be linked to all data associated with a parcel and/or building—including property taxation and the indirect method for income tax purposes.

Appendix II. Mexico's Legislation on Indirect Method

Tax Code arts 55 – 62 (except 58)
(Unofficial translation)

Article 55. -The tax authorities may presumptively determine taxpayers' taxable profits, or construct taxable distributions from non-profit organizations subject to Title III of the Income Tax Law, gross income and the value of the transactions, activities or assets on which they must pay contributions, when:

I. They resist or hamper the tax authorities in the exercise of their audit competence; or when they fail to submit the tax return for the fiscal year for any contribution up to the time in which they notice to the taxpayer the beginning of an audit, and provided more than one month has elapsed as of the day on which the term to submit the relevant return expired. The provisions of this section are not applicable to social security contributions.

II. They fail to submit the accounting books and records, the supporting documentation of more than 3% of any of the items set forth in the returns, or fail to furnish the reports demonstrating they have complied with the corresponding tax provisions.

III. Any of the following irregularities occurs:

a) Failure to record transactions, earnings or purchases, as well as alteration of the cost of sales, deviating more than 3% from the figures reported for the fiscal year.

b) The recording of purchases, expenses or services that did not take place or were not received.

c) Omission or alteration of existing stock that must be included in the inventory, or if such stock should be recorded at prices different from their cost, provided, in both cases, that the amount be in excess of 3% of the cost of the inventory.

IV. They did not comply with the obligations regarding the valuation of inventory or did not have in place a procedure to record inventory control as provided for in tax provisions.

V. That officially approved cash registers not be in operation or else that [taxpayers] destroy or alter the electronic equipment and systems authorized by tax authorities to record transactions for tax purposes or should [taxpayers] prevent that [such equipment and systems] be given the use for which they were installed.

VI. That other irregularities be found in the accounting records that prevent the tax authorities from understanding the taxpayers´ transactions.

The presumptive determination referred to in this article shall be applicable in addition to warranted sanctions.

Article 56.- For the purposes of the presumptive determination referenced in article 55, the tax authorities shall compute taxpayers' gross income, the value of transactions, activities or assets on which contributions must be paid, for the relevant fiscal year, indistinctly by any of the following procedures:

I. By using the data contained in the taxpayer's accounting records.

II. By taking as a basis the data contained in the returns for the fiscal year for any contribution, for the same fiscal year or any other, with the necessary adjustments that are, if it is the case, consequence of a tax audit.

III. [By using as a basis] the information provided by third parties upon request of the tax authorities, when they have business relations with the taxpayer.

IV. [By using] other information obtained by the tax authorities when exercising their audit authority.

V. By using economic or any other type of indirect research methods.

Article 57.- The tax authorities may presumptively determine the contributions that should have been withheld when omissions in withholdings but specifically in the payment of such withholdings are found that exceed 3% of the withholdings actually paid.

For the purposes of the presumptive determination to which reference is made in this article, the tax authorities may indistinctly use any of the procedures set forth in sections I through V of article 56 of this Code.

If the unpaid withholdings are related to the payment of wages and salaries and the withholder has more than twenty employees at his service, it shall be presumed that the contributions that must be paid are the following:

I. Those resulting from applying the relevant rate as if the employees were in the upper limit of the group in which each employee working for the withholder is classified for the purposes of the payment of social contributions … for the full period under review.

II. In the event the withholder has not paid the social contributions for his employees …, it shall be considered that the unpaid withholdings will be those resulting from applying the relevant rate on an amount equal to four times the general minimum wage of the economic zone where the withholder is located for the full period under review, for each employee working for him.

The provisions of this article shall also be applicable to presumptively determine the basis of other contributions, when consisting of the payments of wages and salaries of the Income Tax Law.

....

Article 59.- In verifying income or the value of the transactions, activities or assets on which contributions must be paid, as well as to establish if the standards are met as provided by law for application of the rates specified in tax provisions, the tax authorities shall presume, unless there is evidence to the contrary:

I. That the information contained in the accounting records, supporting documentation and correspondence in the taxpayer's possession relates to transactions undertaken by the taxpayer, even when [such transactions] are not recorded under the taxpayer's name or are recorded under the name of another person, provided it is possible to prove that at least one of the transactions or activities recorded in said items was undertaken by the taxpayer.

II. That the information contained in the accounting systems under the taxpayer's name that is in the possession of persons under the taxpayer's employ or of the stockholders or owners of the enterprise, relates to transactions undertaken by the taxpayer.

III. That deposits to the taxpayer's bank account that do not relate to entries in his accounting records which the taxpayer is obligated to record represent earnings and the value of goods or activities on which contributions must be paid.

For the purposes of this section, it shall be deemed that the taxpayer did not enter into his accounting records the deposits made to his banking account and to the extend is obligated to record such deposits, if the taxpayer fails to exhibit such records upon request in a tax audit.

It shall also be presumed that deposits made in the course of a fiscal year in an amount exceeding MXP$1'000,000.00, into banking accounts of a person not registered with the Federal Taxpayer's Registry or who is not under the obligation of keeping accounting records constitutes income and represents the value of goods or activities for which they must pay contributions.

The provision in the preceding paragraph shall not apply when before the authority initiates an audit the taxpayer regularizes this situation informing to the Tax Administration Service of such deposits, complying with all requirements establish on Temporary Tax Regulations.

IV. That the deposits made to the personal bank checking accounts of managers, administrators or third parties are earnings and the value of goods and activities of the enterprise on which contributions must be paid, when they pay the debts of the enterprise with checks drawn on said bank accounts or when they deposit in said accounts amounts that relate to the enterprise and the enterprise does not record them in its accounting records.

V. That the differences between the assets as recorded in the accounting records and the actual balance of such assets corresponds to earnings and the value of goods or activities of the last fiscal year under review on which contributions must be paid.

VI. That the checks drawn on the taxpayer's accounts issued to the taxpayers' suppliers or service providers that do not relate to transactions entered into his accounting records are payments for merchandise acquired or for services for which the taxpayer obtained earnings.

VIII. That inventories of raw materials, semi-finished and finished products, fixed assets, deferred expenses and charges which the taxpayer has or holds, as well as the land where the taxpayer's activities take place are owned by the taxpayer. The property to which reference is made in this paragraph shall be valued at its market value and in the absence of such market value at its appraisal value.

IX. That the goods the taxpayer declares as exported were sold in Mexico and were not actually exported, should the taxpayer fail to exhibit upon request from the tax authorities the supporting documents and information evidencing any of the following:

a) That the purchase of the goods involved actually took place or, such being the case, of actual existence of the raw materials and of the installed capacity to manufacture or process the goods the taxpayer declared as exported.

b) The means used by the taxpayer in storing the goods declared as exported or the reasons for which such storage was not required.

c) The means used by the taxpayer to transport the goods abroad. In the event taxpayer was not responsible for such carriage, taxpayer must provide evidence of the actual delivery of the goods and of the identity of the person that took delivery.

The presumption to which reference is made in this section shall operate even when the taxpayer has the export declaration documenting shipment of the goods.

Article 60.- When the taxpayer fails to record acquisitions in his accounting records and the tax authorities determine their existence, it shall be presumed that the property acquired and not recorded was sold and that the amount of the sale was that resulting from the following operations:

I. The amount as determined for the acquisition, including the price agreed upon and the contributions, ordinary or default interest, liquidated damages and any other item which was paid as a result of the acquisition is multiplied by the gross profit percentage with which the taxpayer operates.

II. The amount resulting shall be added to the amount as determined for the acquisition and the sum shall be transfer value.

The gross profit percentage shall be obtained from the data contained in the taxpayer's accounting records for the fiscal year involved and shall be determined by dividing said gross profit by the cost as determined by or determined for the taxpayer. For the purposes of that which is provided for in this section, cost shall be determined by following the generally accepted accounting principles. In the case it is not possible to determine the cost, it shall be assumed that gross profit is 50%.

The presumption that is established in this article shall not be applied when the taxpayer proves that the failure to record the acquisitions was due to acts of God or force majeure events.

The same procedure shall be followed to determine the transfer value of goods by which inventories fall short. In this case, should it not be possible to determine the amount of the acquisition, [the amount taken into consideration] shall be that of goods of the same kind acquired by the taxpayer in the fiscal year involved or else their market or appraisal value.

Article 61.- Should the taxpayer qualify for one of the causes for presumptive determination in article 55, and they are unable to prove their income or the value of the activities on which contributions must be paid for the period under review, it shall be presumed that these are equal to the result of one of the following operations:

I. If on the basis of the taxpayer's accounting records and documents or on third party information it is possible to reconstruct the relevant transactions for a period of at least thirty days as close to the end of the fiscal year as possible, the income or the value of the acts or activities shall be determined on the basis of the daily average of the reconstructed period, which shall be multiplied by the number of days corresponding to the period under review.

II. If the taxpayer's accounting records do not serve to reconstruct the transactions conducted for the thirty day period to which reference is made in the preceding section, the tax authorities shall use as a basis the total amount of the income or the total value of the acts or activities they observe for at least seven days including non- working days, and the resulting daily average shall be multiplied by the number of days covered by the period under review.

The relevant rate shall be applied to the income or value of the acts or activities as presumptively determined by one of the foregoing procedures. When involving the income tax, the taxable profit shall be determined first by applying to the estimated gross income the ratio established in the Income Tax Law to determine such profit.

Article 62.- In order to verify taxpayers' earnings as well as the value of their acts and activities the tax authorities shall presume, unless there is evidence to the contrary, that third party information and documents that relate to the taxpayer are transactions undertaken by the taxpayer when:

I. They refer to the taxpayer as identified by name, business or corporate name.

II. Any of the taxpayer's premises are identified [in such information or documents] as the place for the delivery or reception of goods or the supply of services relating to the taxpayers' activities, even when the name, business or corporate name of a real or fictitious third party is contained therein.

III. [Such information or documents] show the name or address of a real or fictitious third party, if it is proved that the taxpayer delivers or receives goods or services in that name or at that address.

IV. They refer to collections or payments made by the taxpayer or on the taxpayer's behalf, by means of an undisclosed agent or fictitious person.