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## Corporate income tax: evolution, problems and possible solutions

**Abstract.** Corporate income tax is one of the most important taxes in acquiring government revenue and fiscal regulation of economic activity. Corporate income tax in Ukraine has low fiscal and regulatory efficiency. The methods of corporate taxation used in Ukraine are constantly changing. Many of those changes have not had a positive influence on taxation and economic growth because the equilibrium between interests of the government and taxpayers is not maintained. The aim of this paper is to identify existing problems and propose ways for improving the taxation of corporate income in the context of balancing the interests of taxpayers and the government. Historical and trend analyses were used as methods in this paper.

The process of evolution of corporate income taxation in Ukraine can be divided into several stages, each of them having an influence on income taxation.

At the first stage, the object of income taxation changed several times during the year in order to increase the fiscal efficiency of the corporate income tax. It caused a negative reaction from businesses, and as a result many businesses moved into the shadow economy of Ukraine.

At the second stage, a large number of tax exemptions and exceptions were applied. Most of the exemptions and exceptions were given for special interests without proper controls, and were not meant to stimulate investment. These benefits were granted for an unjustifiably long period, and the excess profits derived from this preferential taxation were not directed at reinvestment in industries, but were distributed among the new owners. As a result, outdated technological structures were not improved. This is one of the reasons why they are not competitive today, both internationally and in the domestic market.

At the third stage, various types of tax incentives were regularly introduced. Their introduction was for a period of short duration. In particular, preferential mechanisms of income taxation for special economic zones, priority development areas, and technoparks were designed. On the whole, the idea of preferential taxation of these entities was aimed at stimulating economic development in depressed regions and boosting economic innovation. Despite the fact that this idea had had success in many developed countries, it did not work in Ukraine, mainly due to the fact that those who had income tax exemptions used them for the construction of tax evasion schemes.

Between 2010 and 2014, the tax base moved closer to being calculated on financial results according to accounting data, and revenues and expenses began to be recognised on the accrual principle. Despite significant progress in changing the object of income taxation, the system of income taxation which was in force at that time retained significant differences relevant to the taxation of income from securities transactions, taxation of banking institutions, insurance companies and collective investment institutions. At the beginning of 2015, the mechanism of accrual and payment of income tax changed radically again. Today, taxes are determined according to data of financial accounting in accordance with the National Provisions (Standards) of Accounting (P(S)A) or International Financial Reporting Standards (IFRS). However, a number of differences were identified between the two methods of accounting to which the object of income taxation has to be adjusted (tax adjustments that may increase or decrease the object of corporate income taxation).

The changes in corporate income taxation did not take into account the necessity of a balance of interests between the government and taxpayers. In general, those changes were made to increase fiscal efficiency. It is necessary to improve the mechanism of corporate income taxation to find the equilibrium between the interests of the government and taxpayers. It could be possible if the government develop a long term economic strategy based on the welfare economic theory.

**Keywords:** Income; Corporate Income Tax; Tax Base; Tax Rate

**JEL Classification:** H20; H21; H25

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**Податок на прибуток підприємств: еволюція, проблеми, можливі шляхи вирішення**

### Анотація

Стаття присвячена проблемам розвитку податку на прибуток в Україні. У статті викладено основні етапи еволюції податку на прибуток в Україні та окреслено основні проблеми кожного етапу еволюції. Визначено те, як проблеми розвитку податку на прибуток на кожному етапі вплинули на сучасний стан функціонування податку на прибуток. Виявлено причини низької фіскальної та регуляторної ефективності податку на прибуток, їх вплив на динаміку збитковості українських підприємств. Обґрунтовано можливі напрями вирішення проблем у сфері справляння податку на прибуток підприємств.

**Ключові слова:** прибуток; податок на прибуток; податкова база; податкова ставка.

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**Налог на прибыль предприятий: эволюция, проблемы, возможные пути решения**

**Аннотация.** Статья посвящена проблемам развития налога на прибыль в Украине. В статье представлены основные этапы эволюции налога на прибыль в Украине и очерчены основные проблемы на каждом этапе эволюции. Определено то, как проблемы развития налога на прибыль на каждом этапе повлияли на современное состояние налога на прибыль. Выявлены причины низкой фискальной и регуляторной эффективности налога на прибыль, их влияние на динамику убыточности украинских предприятий. Обоснованы возможные пути решения проблем в сфере взимания налога на прибыль.

**Ключевые слова:** прибыль; налог на прибыль; налоговая база; налоговая ставка.

**1. Introduction**

Corporate income tax is naturally a key tax in the formation of tax systems in most countries. It is an indicator of profitability and economic activity of the corporate sector of an economy and reflects the state of a country's economy as a whole. In recent years, Ukraine has faced a noticeable drop in the share of corporate income tax in total tax revenues due to objective reasons, such as economic and political crises, military operations in the east, and the annexation of the Crimean peninsula, and subjective reasons, such as imperfect tax legislation and tax accrual mechanisms, a tendency of the corporate sector to engage in tax evasion, and attempts to reduce the tax base both by legal and illegal means. Given the significant role of income tax in the formation of revenues and the need to improve the fiscal and regulatory efficiency of the tax, the analysis of problems related to taxation in Ukraine and the search for ways to increase its efficiency has become an extremely important field of research.

The methods of taxing corporate income in Ukraine are constantly changing. The changes are aimed at improving and simplifying calculation methods, procedures of reporting, and payment of taxes, as well as at reducing the workload on accountants. However, these changes have adversely affected the quality of the calculations of tax liabilities, and have led to mistakes in its calculation because tax legislation is open to ambiguous interpretations, which have increased the number of lawsuits brought by taxpayers against tax authorities based on the results of tax audits, illegal additional tax accrual by the tax authorities, leading to a negative attitude of taxpayers to the regulator. In addition, this instability in income taxation to some extent suppresses business activity in Ukraine (both domestic and foreign), thereby preventing effective planning of financial flows, profitability, return on investment projects and business decision-making. Finally, constant changes in methods of income taxation negatively affect income tax revenue, and the presence of unequal conditions of taxation creates conditions for an increase in tax evasion. In this context, it is important to study foreign experience related to income taxation and to assess the capability of its implementation in Ukraine.

**2. Brief Literature Review**

Various aspects of income taxation are reflected in researches conducted by domestic and foreign economists. Features of the formation and development of income tax in Ukraine are represented in the work by A. Sokolovska (2004) [1]. Effects of income tax on the decisions of investors and entrepreneurs are reflected in the works by A. Sokolovska and I. Maiburov (2011) [2], and A. Krysovatyi (2005) [3]. Effects of income tax on macroeconomic indicators are examined in the works of R. Dennis (2004) [4], J. Diamond and A. Viard (2008) [5], C. Favero and F. Giavazzi (2009) [6], J. Gravelle (2014) [7], Ch. Huang and N. Frenzt (2014) [8], and A. Laffer (2004) [9]. The need of corporate tax reforms was justified in articles written by M. Sullivan (2011) [10], W. Davis (2014) [11], and D. Shaviro (2014) [12]. Possible ways to improve tools of corporate taxation were represented by Jane G. Gravelle (2011 and 2012) [13; 14], Mertens, K. and M. O. Ravn (2013) [15].

Most studies have a unilateral nature. They reflect the impact of income tax on both the payer and the macroeconomic situation. In modern conditions, there is a need for a thorough study of how to optimise the impact of income tax on revenues considering the behavior of taxpayers.

**3. The purpose** of this paper is to identify existing problems and propose ways to improve the taxation on corporate income in the context of balancing the interests of taxpayers and the government.

**4. Results**

Choosing the best mechanism relevant to the taxation on corporate income can be seen as a process of balancing the interests of the taxpayer and the state. States, behaving like rational economic agents, try to maximise income in the form of income tax. Taxpayers, wishing to maximise their income, will seek to reduce costs, including tax cuts. Hence, the basic interests of the taxpayer and the state are diametrically opposed, and in order to balance them it is necessary to find a compromise. When defining an income taxation mechanism, the state should take into account that such a mechanism should be acceptable to the taxpayers in terms of the possibility and feasibility of further development of their businesses. Business development is beneficial for the state because in the long run it will mean an increase in tax revenues by expanding the tax base. For taxpayers, income taxes should not be burdensome. An income tax is not onerous if the taxpayer does not consider it to be a threat to his livelihood. This can be achieved both by moderate taxation of income and by the compensatory mechanisms of the state. The taxpayer must be sure that the state uses funds paid through taxes in order to increase the social welfare of all citizens, not just the wellbeing of government employees. This aspect is essential for Ukraine in searching for directions to improve income taxation mechanisms. Given the peculiarities of Ukrainian development, sometimes even the implementation of reforms using the best of international experience may not work if the recipient's macroeconomic environment differs significantly from the donor's macro environment.

The process of the evolution of income taxation in Ukraine can be divided into the following stages.

The period of 1992-1994. It was a period of chaos. Income taxation changed several times within one year: gross revenue in the first quarter, then profit, and then the gross revenue again. Those changes were conditioned by the need to fill the budget at any cost. Hyperinflation, barter, and breaks in the economic ties between former Soviet republics virtually destroyed the Ukrainian industrial sector at that time, whereas the small business sector had not been formed yet. At the time when enterprises tried to survive in those difficult conditions and did not have much profit, the government decided to tax their income. This is a typical example of irrational behavior by the state when the need to maximise income does not take into account long term consequences. The result was the growth of the shadow economy. It should be noted that the shadow economy was not a new phenomenon brought about by the capitalist readjustment at that time. The shadow economy existed in the Soviet era, but in slightly different forms [16]. After the collapse of the Soviet Union, only this sector of economy started to grow, but the unofficial (shadow) sector increased faster than the official one. This was due not only to poor quality of controls instituted by the state, but also by the inability of small businesses to pay the amount of tax based on profit, which had been established by the state, as tax rules for small businesses were identical to those of major taxpayers with greater access to capital. In fact, it was the state itself in the period of 1992-1994 that set the preconditions for the growth of the shadow economy.

The next stage of transformation of income tax was in the years 1994-1998. During that period, a large number of tax exemptions and exceptions were applied. It should be noted that most of the exemptions and exceptions were misused, and they were not meant to stimulate investment. There was a widespread practice of granting privileges to certain industries or even individual taxpayers. Such measures from the government were aimed at saving individual companies or industries (mainly the mining, metallurgical and machine building industries). Of course, this decision was not purely economic; it had a political character. Groups of deputies in Parliament, supported by owners of businesses, were recipients of the benefits of their legislative actions. Overall, some specific privileges should not be characterised as solely negative. If these benefits are short-term, they may be an alternative to direct budget subsidies. However, as practice showed, these benefits were granted for an unjustifiably long term, and the excess profits derived from this preferential taxation were not directed at upgrading industries, but were distributed among the new owners. As a result, there was a preservation of outdated technological structures in these areas. That is why in modern conditions they are not competitive both internationally and in the domestic market. High energy needs in production make their products uncompetitive.

The next stage of income taxation development took place between 1998 and 2010. During that period, there was a radical change in the methodology of income taxation. The tax base was calculated as a difference between gross revenue and gross expense. Gross expenses were restricted. They were redefined each year. The size of income before taxes done for tax accounting was never equal to the true value of the financial results. In fact, taxpayers conducted two types of accounting: financial accounting and tax accounting. The difference between the two forms was so great that accounting lost meaning in determining the real income. Moreover, legislation at that time required proper accounting, but did not define the mechanism of applying penalties when accounting was improper. During that period, various types of short-term tax incentives were regularly introduced. In particular, preferential mechanisms of income taxation for special economic zones and priority development areas and technoparks were designed. On the whole, the idea of preferential taxation of these entities was aimed at stimulating economic development in depressed regions and boosting technological innovation. Despite the fact that this idea had had success in many developed countries, it did not work in Ukraine, mainly due to the fact that it was used for the construction of tax evasion schemes.

Despite the desire to create the illusion of support for business development by reducing the tax burden, the state resorted to outright fiscal measures that were not conducive to such development (in particular, the mechanism of depreciation). It should be noted that in the mid 1990's the depreciation of fixed assets in the Ukrainian industrial sector reached 50%, and it was 68% at the end of 2013, and even 80% in some other sectors of the economy [17]. In such a situation, the mechanism of depreciation accrual was aimed at a renewal of fixed assets. However, the mechanism of depreciation which was in force at that time did not contribute to it. In particular, P(S)A No. 7 «Fixed Assets» envisaged the possibility of using five methods of depreciation, the practice of which allowed the determination of the true cost of production. However, in practice most taxpayers calculated depreciation by the tax method, which only made it possible to legally reduce the value of taxable income and did not ensure the proper use of depreciation. Although theoretically the possibility of using accelerated depreciation was provided, financial resources from its use were directed primarily to working capital replenishment. Furthermore, although the law prohibited the government from seizing depreciation charges of companies, in 1999 in Ukraine the so-called depreciation tax was used, by which 10% of depreciation charges of enterprises had to be transferred to the government. This measure did not stimulate improvement in fixed assets, since it was necessary to transfer the depreciation tax to the state. Later the depreciation tax rate was lowered to 6%. Finally, the tax was abolished, but the negative impact it had implemented was complete. There

was a decrease in the residual value of fixed assets and the rate of depreciation became critical.

During the same period, there was a catastrophic growth of losses among domestic enterprises. In 1995, 20% of Ukrainian enterprises were unprofitable, then 33% in 1996, 50% in 1997, and more than 50% in 1998; the administration of income tax could not claim a high fiscal efficiency. In practice illegal methods of dealing with the unprofitability of enterprises were used. For example, tax officers simply did not accept timely declarations in which losses were declared. Acceptance of declarations was carried out after the balance sheet date with the tacit consent of the taxpayer. As a result, taxpayers declared losses (but hypothetically late) and the Tax Administration reported the reduction of unprofitability (because the report did not reveal declarations accepted after the reporting date) and reported fines (since a late filing led to payment of a fine). However, such measures could not serve as a basis for solving the problem; therefore in 1999 a Presidential Decree introduced a simplified system of taxation, accounting, and reporting. Such a measure provided two positive effects. Firstly, conditions for self-employment were created, since the simplified tax system was indeed simplified for individual entrepreneurs. Entrepreneurs were to pay a single fixed tax and maintain a minimal form of accounting that was possible without a professional accountant. That helped to reduce unemployment and had a positive impact on the main macroeconomic indicators in terms of employment and the development of small enterprises. The second positive result was a reduction in the number of unprofitable enterprises. During the introduction of this simplified tax system, tax officers strongly recommended unprofitable enterprises that fell under the criteria of a small business to go from the general to the simplified taxation system. A single tax for legal entities that were on the simplified system of taxation represented a version of the turnover tax, for it was set as a percentage of revenue. During the years 1999-2011 there were small changes in the mechanism of levying the single tax; they mainly concerned groups and rates for legal entities, and also features of payment of fees for compulsory pension and social insurance (later, the unified social tax).

In general, the implementation of the simplified system of taxation, accounting and reporting cannot be considered to be solely negative. It had its positive effects. However, the long-term existence of this alternative tax regime made it not only a tool to minimise income tax but also had a positive impact on other taxes. This reduction in fiscal tax efficiency and its low regulatory effects caused further stages of reform in income taxation.

In the years 2010-2015, taxation reached its financial result according to the accounting data, revenues and expenses began to be recognised on the accrual principle. After 2011, a new tax code was implemented in Ukraine which defined new approaches to corporate income tax from gross revenue and gross expenses that were formed on the basis of the first events, eliminating the need for a business to report pre-paid revenue as income. It should be noted that such changes of the methods did not substantially influence the amount of tax revenue, which at that period of time fell constantly due to the deepening economic crisis and corruption processes taking place within the country.

The list of dual-use costs (which were included in the object of taxation under certain conditions) was revised. For example, voluntary contributions to insurance (including private pension provision) of employees could not exceed 25% of the wage fund; warranty costs, clothing and footwear, insurance and so on were taxed in a limited way. Restrictions on different types of costs significantly increased the fiscal effectiveness of income tax, but limited the implementation of its regulatory capacity.

Despite significant progress in changing the order of determining income taxation, the system of income taxation which was in force at that time retained significant differences in the taxation of income from securities transactions, taxation of banking institutions, insurance companies and mutual funds. The procedure of taxation of insurance companies provided that they did not pay tax on income, but they did pay tax revenue at the rate of 0% on transactions with long-term life insurance and at the rate of 3% at the implementation of other types of insurance. Thus, a difference between the taxation of insurance companies

and taxation of other taxpayers was formed, which led to the emergence of a large number of bogus insurance companies that were used in schemes of tax evasion. A similar situation exists in the development of joint investment institutions. Income accumulated in mutual funds was not taxed, and it was possible to withdraw the funds by paying dividends to individuals, which incurred a tax rate of only 5%, without paying advance contributions on income taxes. In fact, mutual funds were a type of tax haven in the country, which allowed the majority of construction companies and banks to legally declare losses for years prompting an increase in the number of mutual funds.

Starting on January 1<sup>st</sup>, 2015, the mechanism of accrual and payment of income tax changed radically again. The base of income tax is now determined according to data of financial accounting in accordance with the National Provisions (Standards) of Accounting (P(S)A) or International Financial Reporting Standards (IFRS). However, a number of tax differences have been identified, to which the object of income taxation has to be adjusted (tax adjustment that may increase or decrease the object of corporate income taxation). These tax differences are divided into 3 groups: differences arising from the depreciation of fixed assets, differences arising during the formation of reserves (provisions), differences arising from the implementation of financial transactions [18]. As in previous years, most of the differences are related to financial transactions.

The amount of time allowed for the reporting of income tax was increased, which is definitely a positive change. However, monthly payments of advance contributions are still required, and with the new rules, the presence of losses in one of the quarters does not exempt a business from the obligation to pay advanced contributions. This mechanism of income tax payment by advance contributions is very difficult for domestic enterprises. Therefore, enterprises with an annual income exceeding 20 million UAH (approximately 800,000 Euros), are required to pay a monthly tax by advance payments in the amount of 1/12 of the income tax paid in the previous year. If there is a decline in income, the tax overpayments are not returned to the business, but considered as taxes paid forward into the next. This mechanism of income tax payment leads to the drain of working capital within from Ukrainian enterprises and a deepening crisis of financing their activities. This problem was solved in 2016, but all the companies with an annual income exceeding 20 million UAH have to pay corporate income tax every quarter.

How the new system of income taxation in Ukraine will work and what risks may lower its fiscal efficiency can be predicted based on the systematisation of the main drawbacks and analysis of the causes of their emergence. In general, the practice of payment of income taxes by enterprises indicates the presence of the following major problems:

- there is a large share of unprofitable enterprises (including those with artificial losses);
- there exist unequal conditions of taxation for different tax payers, resulting in lower fiscal efficiency of income tax (Figure 1);
- there is a need to pay advance payments of income tax even if a certain entity has no income.

The share of unprofitable enterprises consistently is in the range of 40%. Such unprofitability is often artificial, since enterprises cannot work at a loss year after year without end. Artificial losses were made possible by the regulations between 1998 and 2010, when income and expenses included advances. Another reason is the parallel existence of the simplified system of taxation. Businesses actively use single taxpayers to minimize their own taxes. The third reason, as stated above, are other modes of income taxation for insurance companies and mutual funds. This allowed them to minimise their tax liability. After the reform of 2010 (the introduction of the Tax Code, which changed the approaches to income taxation by abolishing the methodology of «gross income – gross expenses» and the earlier regulations) the share of unprofitable enterprises began to decline. The situation worsened in 2014-2015, but that was not due to the technical features of calculation and payment of income tax, but due to the worsening of the economic and political situation in Ukraine.

As noted above, the parallel existence of the simplified and general tax systems and the presence of unequal conditions

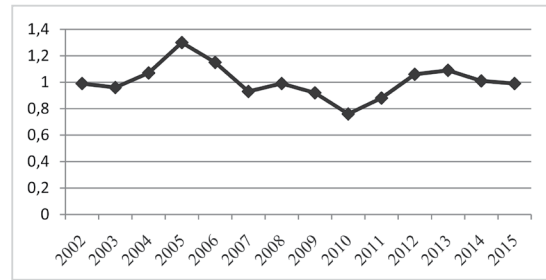


Fig. 1: Ratio of income tax productivity in Ukraine 2002-2015 (amounts of overpayments on income tax are not excluded)  
Source: Compiled by the authors according to data from the State Fiscal Service of Ukraine

for different payers of income tax negatively affect the fiscal efficiency and productivity of income tax (Figure 1).

As seen from the graph, the coefficient of tax productivity has a mixed trend. The general trend also shows that tax changes in 2010 positively affected the fiscal effectiveness of income tax, which began to decline in 2014-2015 because of military operations in the east of the country. However, the schedule has other features, including a sharp increase in the coefficient of tax productivity of income tax in 2005-2006, and a trend according to which in the number of years the coefficient of tax productivity was greater than one, although with the presence of tax exemptions and exceptions it should always be less than one. This situation was caused by the practice of the advance payment of income tax. Such payments were required from companies for a long time informally (the law did not envisage the obligation to pay advance payments), but with the necessity to fulfill indicators of budget revenues, tax officers persistently asked taxpayers to pay income tax in advance. Since 2012, the practice of advance payments for income tax has been legalised, but its informal component continues to operate today, which leads to an increase in overpayments on income tax and distortion of the real indicators of budget performance. If to adjust revenues from income tax to the budget to the level of overpayments, the dynamic of the ratio of income tax productivity would look as follows (Figure 2).

As can be seen in the graph shown in Figure 2, the coefficient of tax productivity of income tax did not reach the value equal to 1 during any of the studied years. This means that the fiscal effectiveness of income tax was raised only by administrative methods without taking into account the interests of taxpayers. In fact, over the years the state actually stimulated taxpayers to evade income tax, forming a vicious circle: the state made taxpayers pay advance contributions, since it lacked regular revenues from income tax, whereas taxpayers had to pay income tax in advance in an amount which was determined by officers of fiscal services based on the performance of the enterprise, so taxpayers looked for ways to partially conceal their businesses, adding to the shadow economy. Generally, a hybrid phenomenon of shadow economy and gray economy has been formed in Ukraine: one and the same entity carries out one part of its activity officially, while the other part remains in the shadows [13]. Sometimes these two processes are so deeply entwined that it is almost impossible to separate them. Owing to this, rami-

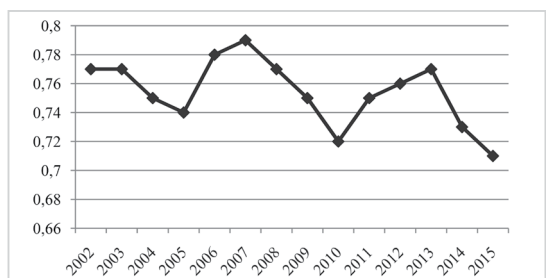


Fig. 2: Ratio of income tax productivity in Ukraine 2002-2015 (amounts of overpayments on income tax are excluded)  
Source: designed by authors according to the data from the State Fiscal Service of Ukraine

fied schemes of tax evasion, including income taxes, have been formed. The reason a large share of Ukrainian enterprises appear unprofitable is not so much a result of inefficient management, but the result of income tax evasion.

### 5. Conclusions

The results of this study reveal the key issues of corporate income taxation in Ukraine:

- the imperfection and ambiguity in tax legislation provisions, which leads to errors by accounting personnel in enterprises, tax authorities exceeding power during tax audits, improper calculation of monetary obligations and financial sanctions, the emergence of a significant number of lawsuits on taxation issues, general decline of trust regarding regulators;
- the mechanism of income tax payment by advance contributions, which leads to the drain of working capital in enterprises with a background of an overall shortage of available financial sources for Ukrainian enterprises;
- a system of tax benefits on income tax which is ineffective, causing a further shadowing, and illegal business lobbies from some areas among legislative bodies and resulting in a failure of the regulatory function of income tax in the implementation of state fiscal policies;
- a bad formulation of tax adjustments on income, the absence of transitional provisions for certain types of revenues or expenses; inefficient and overly complicated approaches to tax operations with non-current assets, securities, royalties, certain activities (insurance, investment, charity).

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