German Advisory Group

Institute for Economic Research and Policy Consulting

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Comments on Depreciation Methods foreseen for Profit Taxation in the Draft Tax Code

(Draft Tax Code version as published on August 3, 2010)

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About the German Advisory Group

The German Advisory Group on Economic Reforms, which is active in Ukraine since 1994, advises the Ukrainian Government and other state authorities such as the National Bank of Ukraine on a wide range of economic policy issues and on financial sector development. Our analytical work is presented and discussed during regular meetings with high-level decision makers. The group is financed by the German Federal Ministry of Economics and Technology under the TRANSFORM programme and its successor.

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This policy briefing provides a comparison of depreciation methods applied in current Ukrainian tax legislation, as foreseen in the draft Tax Code and as regulated by German tax legislation. It has been prepared upon request from Deputy Finance-Minister Efimenko.

1. Introduction

This policy briefing discusses different depreciation methods for profit taxation. It first describes the tax depreciation method currently applied in Ukraine (chapter 2). In chapter 3, the depreciation method foreseen in the 2nd draft of the Ukrainian Tax Code (dated August, 3) is discussed. In the 4th chapter, we describe the tax depreciation method applied in Germany. Finally, in the 5th chapter we provide recommendations regarding the draft Tax Code, taking into account German legislation.

2. Current Ukrainian Tax Depreciation (4 Groups)

Current Ukrainian tax depreciation is applied for fixed assets (FA) and non-material assets (NMA), which are in use for commercial activities.

Fixed assets are divided into 4 groups:

1) Real Estate and land constructions:

- Depreciation 2% per quarter

2) Equipment, means of transport, office furniture, office equipment:

- 10% per quarter

3) Other fixed assets (if not group 1 or 2):

- 6% per quarter

4) Computer and other IT:

- 15% per quarter

For all groups, the residual value of the previous quarter is the base of depreciation.

Group 1 is accounted and depreciated per item. For group 2-4, the total value of the group is the base of depreciation. Following this, the purchase of a new item for group 2-4 enlarges the total value of the group. Costs of transport, insurance and other expenses connected to the purchase are to be included into the purchase price. The enlargement of the group value can be accounted only in the subsequent quarter after the item has been purchased; meaning a purchase e.g. on April 1 enlarges the group value only for July 1 of the same year.

In case of sale of fixed assets out of group 2-4, the sales price reduces the value of the group. In case the sales price is higher than the total group value, the group value will be

zero and the difference of the group value to the sales price is to be accounted as income for profit taxation.

Expenses on maintenance or modernisation of fixed assets are for taxation purposes to be accounted as current expenses as long as the cost for repair do not surpass the limit of 10% of the total residual value of the FA (all groups) at the beginning of the year.

Non-material assets have to be amortised linearly, whereas the term of depreciation is defined by the profit tax payer himself. However, the term cannot exceed 10 years.

3. Depreciation Methods foreseen in the Ukrainian Draft Tax Code

The draft Tax Code correlates much more to the Ukrainian Accounting Standards (UAS) than the current tax legislation and this correlation can also be noticed concerning amortisation.

Non-current assets of minor value are -as in the current regulation- defined with purchase price below UAH 1000 and term of use less than 1 year. As in the current legislation the purchase price of those assets can be directly accounted as current expenses of the tax period. The new draft foresees in addition the alternative of 50% of depreciation in the first month of their usage and 50% in the last month of their usage.

In part 3 (profit taxation) of the draft Tax Code, Article 13-17 regulates the depreciation of fixed assets and non material assets.

Similar to the UAS there are the following terms defined:

- The initial value of fixed and non material assets is the base of amortisation
- Revaluation of fixed assets influences the depreciation of fixed assets (which is in the current legislation not the case).
- Accounting of fixed assets per item and then combined to 16 groups for FA and 6 groups for non-material assets
- Useful economic life is not defined in the draft Tax Code, the period is defined by the tax payer himself (as in UAS), but in the draft Tax Code are foreseen minimum terms (e.g. min. 2 years for electronic devices and other office equipment, min. 20 years for buildings and land constructions)
- In case the useful economic life changes due to lower/higher exploitation of the respective asset, amortisation changes accordingly
- 5 different depreciation methods can be applied

The following points foreseen in the draft Tax Code are explicitly different to the Ukrainian Accounting Standards:

- No amortisation of goodwill and non-commercial assets
- Minimum terms of useful life (e.g. min. 2 years for electronic devices and other office equipment, min. 20 years for buildings and land constructions)
- The method of depreciation can be changed monthly (UAS only yearly via changing internal accounting principles)
- Expenses on modernisation of rented FA have to be accounted and depreciated as separate FA (as in the current tax regulation)
- No amortisation of FA/NMA received free of charge
- Initial value of FA brought in as contribution in kind cannot be valued higher than market (fair) value (different to current regulation)
- Expenses on maintenance of FA can be written off directly to expenses as long as expenses do not surpass 10% of residual value of respective FA at the beginning of the year

4. Depreciation in German Tax Legislation

Regarding commercial accounting, companies in Germany can choose between different accounting standards, e.g.: German GAAP (HGB), IFRS, US-GAAP. However, no matter which method of amortisation is applied, for taxation purposes the accounting needs to be adjusted to German tax legislation.

For defining general useful economic life terms for taxation, the German Ministry of Finance published a table (Afa-Tabelle) in which more than 500 groups of fixed assets are outlined. For each group, a fixed period of depreciation between 3 and 33 years is set.

The periods have been set on the base of the average useful life terms collected and obtained during official tax compliance checks, whereas business associations have been consulted prior to publishing the table.

The fixed useful economic life term can be changed by application of the tax payer but only if reasonable proved and accepted by the tax authority.

For about 250 industrial sectors, separate tables with useful economic life terms have been published. In case a FA is listed in the table of its industrial sector, the respective term has to be applied, but not all FA-groups are listed in the tables of the industrial sectors.

The depreciation methods applied in German tax legislation are linear and declining.

5. Conclusion

Since the draft of the Tax Code correlates much more to the Ukrainian Accounting Standards (UAS), which are originally based on IFRS, the regulations concerning amortisation provide the tax payer with much flexibility regarding the choice of a depreciation method which complies to the real exploitation of the respective FA.

Generally, the most important parameter on amortisation is the useful economic life period of the respective FA. Following this, moving from the current system (fixed depreciation rates mostly not corresponding to useful economic life, no accounting of FA per item in group 2-4) to an accounting per item and useful economic life terms is a good move.

Moreover, if fair values for the FA will be applied by the tax payer, depreciation terms should - in comparison with the current depreciation rates- generally enlarge, which should result in higher bases for taxation with respect to amortisation.

However, it should be taken into consideration that neither Ukrainian tax payers nor tax authorities are used to apply fair value principles for defining useful economic life terms of FA, which might lead to abuse from the side of the tax payers and will very likely create many disputes with the tax authorities.

Leaving the definition to the tax payer is of course generally welcome, because the tax payer himself knows better about level of exploitation of respective FA, but due to missing experience it might be reasonable postponing this to the time when tax payers and tax authorities have obtained more experience with applying IFRS and fair value principles. Meanwhile, a solution could be strict amortisation tables as for example applied in German tax legislation.

Following this, we would recommend not leaving the decision of defining depreciation terms to the tax payer himself, but to include into the new tax code fixed depreciation terms based on international practice. The German tax legislation offers concrete examples for this.

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