

April 20, 2015

MEMORANDUM FOR

Ms. Olena Makeieva and  
Members of Informal Working Group

From: Bob Conrad

Subject: Withholding on Payments for Certain Services

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I was asked to further describe my idea for reverse withholding, a method that might be useful in Ukraine given the particular circumstances regarding labor taxation.

I. Context

There is currently a tax on entrepreneurs as part of the small business tax system. It is claimed that this system is subject to abuse for several reasons, but primarily because the rate charged entrepreneurs is lower than the combined rate of personal income tax and social taxes in the normal regime. Thus, there is a strong incentive for individuals and firms to arbitrage the taxes by defining individuals as entrepreneurs as opposed to employees. Both social taxes and personal income taxes are lower as a result. In addition, there could be regressive consequences for the tax system because people who are entrepreneurs (consultants) are generally people who would otherwise be highly-compensated employees.

One possible solution to this problem is to have a clear definition of “employee” in the tax law and to have that definition be uniformly applied. Such definitions are difficult to enforce in the best of situations and it might not be possible to administer any reasonable definition of employee for some time in Ukraine.

A second option is to modify the tax on entrepreneurs and the small business tax. I have proposed such an option in another memorandum. Such modifications cannot address the problem completely, however. Legitimate entrepreneurs sell to the general public (e.g., our example of a flower shop last Sunday) and so the small business tax must cover a broader range of activities than supplies of labor services to business.

II. Withholding

One potential practical solution to this problem would be to require withholding by purchasers of such services. In general, the proposal could contain the following elements.

a. Withholding Tax Imposed

A withholding tax of X% is imposed on any payment, paid or accrued, for services supplied by the following persons:

- i. Suppliers of services subject to Value Added Tax for which a VAT invoice is not supplied, and

- ii. Any other service, including labor services, supplied by a physical person who is not an employee of the payer.

b. Credit Allowed

- i. The purchaser of such services, hereafter defined as the withholding agent, shall supply an invoice to the supplier containing the amount of tax withholding, and
- ii. The supplier may use such amounts as credits against their personal income tax, patent, or small business tax liability, as the case may be.

c. Enforcement

Purchases of services subject to withholding will be disallowed as deductions from profits tax, small business tax, or other income-related charges to the extent that withholding records are not maintained.

III. Example

Suppose physical person A supplies consulting services to legal entity B. Person A charges entity B 100 for such services. These services are either not subject to VAT or are labor services. Suppose further that the withholding tax rate is 15%. Entity B will pay Person A 85, withhold 15 from the payment, and remit the withheld amount (15) to the Government.

If person A is a small business taxpayer who pays tax on a cash flow basis, total income at the end of the year would be 100 (from this particular contract) and the tax would be 15. Person A will be allowed to take a credit for the 15 leaving 85 in net income, the correct answer as a matter of policy and practice.

IV. Discussion

1. Labor services might have to be defined and I believe the definition should be general in the sense that any consulting service (including most professional services such as legal, accounting, architectural, medical, engineering, economic, software development, and similar services) should be included to the extent that such services are not subject to VAT. Larger professional organizations will not be subject to withholding because they are either VAT taxpayers or operate as some type of legal entity.
2. There is no presumption here that suppliers subject to withholding are operating in an illegal fashion. Recipients of such services simply withhold.
3. As a practical matter, withholding will be performed by Government and legal entities subject to the profits tax. There may be occasion for those subject to the small business tax to withhold, but most revenue will accrue from larger enterprises.
4. Ideally, the rate should be set so that a supplier is indifferent between being an independent supplier of labor services and being an employee. The extent to which this

objective can be achieved will depend on a final determination of the combined personal income tax and social tax.

5. If the tax rate on legal entities and the personal income tax rate are the same, then the disallowance of the deduction will have the same effect on tax revenue as the collection of withholding, to the extent that profits tax would otherwise be positive. Thus, the Government will be indifferent, other things equal, between receiving the withholding tax and disallowing the deduction without withholding. Of course, there might be concerns about compliance by Government, the not-for-profit sector, and taxpayers with negative profits. In effect, this is a type of “no fault” system under which interest and penalties are not charged for lack of compliance with the withholding regime. This might be reasonable, at least initially, in order to encourage compliance.

The system is not perfect but it might be a reasonable option in situations where labor services, particularly higher-skilled labor services, escape the generally applicable tax.

I will be happy to further expand the concept and supply additional information should you desire.

I hope this is helpful.

Thank you.