

Comments on the Draft Tax Code of Ukraine

Kyiv, 5 November 2007

Introduction

Most of the remarks below indicate the necessity to restructure and reword the draft Tax Code. In general, the wording of the draft Tax Code could be improved as at times it is difficult to experts to understand, and therefore also to taxpayers. The Draft Tax Code is also changing on a daily basis; some minor changes were even submitted during the short period of this review. Despite the strategic goals issued by the Ukrainian government, the Parliament continues to be swayed by special interests when it comes to legal drafting.

The remarks made within this document cover the most important provisions of the draft Tax Code. Of note, the draft Tax Code contains numerous provisions which could have a severe negative impact on the business environment in Ukraine. A number of examples of these provisions are below, though there is insufficient space to elaborate fully here.

The Ukrainian Ministry of Finance has drafted the Tax Code to replace all tax legislation currently in force. In practice this means that all existing tax legislation will be combined into one document. However, there are significant problems with the current tax legislation. The government recognised some of these issues in a multiyear tax strategy it adopted at the beginning of 2007. The new Tax Code does not sufficiently address this strategy and some of the problems are not dealt with.

Compared to the existing tax laws some of the provisions of the draft Tax Code are long and detailed whereas it would be preferable for the draft to provide more conceptual definitions. In comparison with the current legislation, the length of the provisions has increased significantly, becoming more complicated and sometimes unclear. As such the draft Tax Code has not resulted in a simplification of the tax system in Ukraine.

The Need for Tax Reform

For many years, international organisations (International Monetary Fund, World Bank, Organisation for Economic Co-operation and Development, European Union) and the private sector have been calling for tax reforms in Ukraine. From the macro perspective of the international finance institutions, reforms are needed to improve the tenability and transparency of public finances, strengthen public investment, and encourage economic growth. The main problem areas identified in the past are the inadequate pension system, low public investment, high social expenditure, ineffective public (tax) administration, high tax burden and confusing tax legislation that encourages fraud and fuels the shadow economy. In response, the private sector has been demanding a reduction in the tax burden, greater transparency in the interpretation and implementation of the rules, adoption of international (EU) standards, and anti-corruption and anti-fraud measures.

In brief, the government is facing serious problems that have implications for the entire economy. The first step en route to the necessary reforms is to recognise the problems in the existing tax system. On paper, it looks as though this step was taken at the beginning of 2007, at least in part, with the government's adoption in February 2007 of a draft multiyear strategic document on tax reforms in the period to 2015. Its main goals are:

- gradual reduction of the overall tax burden;
- increase in the proportion of indirect taxes (such as VAT and duties) at the expense of direct taxes (such as payroll tax and corporation tax);
- simplification of tax legislation and harmonisation with EU standards;
- more effective use of the tax system as a tool to encourage investment, innovation, energy savings and other policy goals.

In addition to these general goals, more specific goals have also been set, such as the introduction of a property tax and reductions in both the corporate income tax (currently 25%) and VAT (currently 20%). Property tax has not yet been included in the draft Tax Code.

Some of the goals, such as reducing the tax burden, simplifying legislation and adopting EU standards and laws, are praiseworthy but others are debatable. Using the tax system more actively to achieve certain economic activities is not without controversy and Ukraine's experience with fiscal incentives in specific sectors of the economy is not very encouraging. Furthermore, according to the OECD and others, a rapidly developing economy is best served by a neutral fiscal policy with low tax rates and a broad tax base.

A troublesome development is the introduction of tax legislation which clearly results from the Ukrainian tax administration's lack of capacity to control compliance. In the design of tax legislation, the complexity of compliance should be considered and estimated prior to implementing a provision. In cases where compliance control of certain provisions in practice appears to be complicated, it appears that provisions are amended in such way that the provision becomes more burdensome for the taxpayer. Examples of such provisions are the current VAT provision that newly established companies can not apply for a VAT refund during the first 12 months of their operations and the application of VAT on the interest component of financial lease payments. It seems that such more burdensome legislation has been introduced purely because the tax authorities do not have the capacity to control the proper compliance of the tax.

Another change in the draft that does not correspond with the tax reform strategy is the decreasing of the VAT rate. Since the strategic goal is to increase the proportion of indirect taxes, decreasing VAT, the main indirect tax, would run counter to this goal. Firstly, it implies that duties would have to rise very sharply to compensate for the lost revenue from VAT. Experience in neighbouring countries shows that such an increase would simply lead to a boom in smuggling. Secondly, it is open to question whether VAT should be cut in a period of sharply rising consumption. A lower VAT rate would likely trigger a further increase in consumption rather than investment.

Although questions can be asked about some of the goals, the government has at least put forward ideas about the economic function of the tax system and how it should evolve in the medium term. Its vision should therefore form the substantive framework for the new Tax Code. Closer study of the draft Tax Code, however, shows that this is not always the case.

Draft Tax Code – General Comments

A project that has been on the agenda for many years and has already seen several failed attempts was taken to hand in recent months: the combination of all existing tax legislation in one Tax Code. This time, the chance of success is higher because all the main political camps have said they recognise the importance of new tax legislation.

The main benefit of the draft Tax Code is that it is a single document. At the moment, the tax system's legal framework is made up of hundreds of separate laws and regulations. The individual laws are often inconsistent with each other and amendments are made without considering the implications for the tax system as a whole. In practice, this makes the current system illogical for the taxpayer and puts the tax department in a very strong position. Integrating all the tax laws into a single document will make the system more transparent. Furthermore, if policy is changed, only one document will need to be amended and its consistency will not be jeopardised.

The Ukrainian private sector has indicated that the biggest problem which they meet in the Ukrainian tax system is its unpredictability: in 2005, 78% of surveyed businesses in Ukraine

stated that frequent changes in legislation are a severe problem. Anecdotal evidence suggests that the situation has deteriorated further since the survey. In addition, approved legislative documents very often contain conflicting provisions. Corrections of such conflicting provisions sometimes take place without cancelling the old provisions (1) resulting in a situation where different provisions are still governing the same subject. Tax legislation is so confusing that the Customs and Tax Administration agencies interpret legislation incorrectly more often than any other state agency. Furthermore the changing legislation is a severe administrative burden for the private sector and can give rise to abuse of power by the tax authorities.

Possibly a step forward in relation to the predictability of the Tax Code is the fact that according to Section XVIII Article 4 amendments to the Code can not take place (with the exception of minor issues) during a period of five years after the Tax Code becomes effective. On the other hand it will also be impossible to amend the Tax Code for the better.

The new Code is a summary of all existing laws with no substantive changes in line with the government's strategic goals for tax reform. Furthermore, the document, like the existing legislation, is far too detailed and complex. The Code is therefore very difficult to interpret and even confusing and inconsistent. This is in direct opposition to the goals set in the strategic document. Modernisation, the move towards EU standards, and simplification are hardly considered. The new tax regulations do focus on innovation and investment, but they should be drafted in such way that more is expected from them.

Another complaint heard chiefly from the private sector is that the new Tax Code creates even more tension between the state and the taxpayer. Instead of liberalising the relationship, one of the Ministry of Finance's official goals, the Code gives the tax department more power and imposes stricter rules and a heavier administrative burden on the taxpayer.

Reading the Tax Code is a challenge in itself. The language used in the tax code is poor and sometimes it is simply not clear what the provisions are stating. Therefore the draft Tax Code creates uncertainty with respect to its interpretation. A good tax system – one that facilitates and encourages compliance – needs to be understandable to those who are expected to pay the tax and by those who administer the tax. The current wording of the Tax Code puts pressure on the taxpayer as well as the tax administration as both cannot understand the tax system. Consequences of the poor wording of the Tax Code include: unintentional misstatements of tax liability, which create inefficiencies and impair the government's ability to administer the tax system; plus increases in costs for the government to control compliance. The poor wording of the Draft Tax Code is of such serious nature that it should be considered whether approving it in its current condition should be recommended.

The Yanukovich government has put the domestic economy at the top of the agenda. Introducing a multiyear tax strategy is undeniably a good sign. It illustrates the government's ability to take strategic decisions for the medium term. Issuing a document, of course, is just the first step. However, the draft Tax Code does not sufficiently address the problems identified previously. Furthermore, the multiyear strategy might disappear from view since it has no formal status and the new government may not feel obliged to implement the reforms. Yet the current draft Tax Code will probably remain on the agenda because all the main political parties have said they want to introduce a new Code quickly.

The new parliament and government will hopefully make up for a number of missed opportunities in the draft Tax Code, ideally on the basis of a multiyear vision of the tax system. Even if the draft Tax Code is adopted in its current form, it will still have the

¹ According to Tax Administration of Ukraine, the tax system comprises more than 1,900 legal acts and regulations, in which the provisions are often found to conflict one another.

significant advantage of being just one document. This will make it possible to make clear and consistent amendments at a later date as greater insight is obtained.

Structure of the Draft Tax Code

Section I	General Provisions
Section II	General Administrative Provisions
Section III	Corporate Income Tax (CIT)
Section IV	Personal Income Tax (PIT)
Section V	Value Added Tax (VAT)
Section VI	Excise Tax
Section VII	Vehicle Tax
Section VIII	Environmental Tax
Section IX	Stamp Duty
Section X	Universal Duty Charged at Customs Checkpoints on the Borrower of Ukraine.
Section XI	Court Fees
Section XII	Land Fees
Section XIII	Rental Fees for the Transportation of Oil and Oil Products with Main Pipelines and Oil Product Pipelines, the Distribution of Natural Gas and Ammonia via Pipelines across the Territory of Ukraine
Section XIV.	Subsurface Resource Use Fees
Section XV.	Other Taxes and Duties
Section XVI.	Local Taxes and Duties
Section XVII.	Special Tax Schemes
Section XVIII.	Final and Transitional Provisions

General Administrative Provisions – Section II

Appeals process

Articles 17 and 18 of Section II are stated too generally. Particularly with tax legislation, it is of crucial importance that the provisions with respect to what services are offered to taxpayers are clearly stated.

Penalties

Article 96.3 does not recognize different degrees of underreporting. Fifty percent, of the current underreported amount, is too high. It is recommended to include a graduated scale of penalties.

Tax Inspections

The current system of government regulation and control over the activity of enterprises impedes sustainable economic development and erodes Ukraine's competitiveness. For the number of inspections per business, Ukraine occupies one of the top places in the CIS. During the past few years, the State Tax Administration has been instituting a series of structural changes and improvements to the system of tax inspections. Nevertheless, the percentage of enterprises inspected by tax authorities each year has remained high: 54% of Ukrainian enterprises passed through the tax inspections in the first seven months of 2006². The tax authorities not only inspect a huge number of enterprises each year, but also they inspect these enterprises several times a year (average number of tax inspections per year 2.2).

This illustrates that the approach to inspections is not based on an assessment of risk. Obviously, it may be prudent to inspect businesses that present some risk to public revenues more than once a year, but multiple inspections should not be necessary for low-risk businesses. Not only tax authorities inspected enterprises in Ukraine but the tax police (a special branch of the State Tax Administration created to fight tax crime) also perform inspections, and the frequency of inspections by the tax police is approximately the same as the tax administration's inspections. In 2006, the tax police inspected 12% of enterprises, which were also inspected by the tax authorities.

From a cost-benefit perspective, the existing system of tax inspections is far from effective. Maintaining such rigorous control over business activity requires substantial government resources. Ukraine's tax revenue index is quite similar to some European countries: the Netherlands 0.94, France 0.88, and Ukraine 1.0³. However, the number of tax inspections conducted annually in Ukraine is a dozens times higher than it is in European countries, and the government pressure on the enterprises in Ukraine is much higher.

In April 2007, the President of Ukraine signed the Law "On the Basics of State's Supervision (Control) of Business" (Law on Inspections)⁴, which stipulates a system of provisions for optimal state regulation of businesses in a market economy. The draft Tax Code does not

² Ibid, p.55.

³ The index was estimated as a GDP per capita-weighted tax revenue per tax administration employee.

⁴ The Law was adopted by Ukrainian Parliament and signed by the President on the 5th of April 2007 but has not enforced yet.

match the Law on Inspections and creates a lot of obstacles and a level of instability for business development. Specifically:

1. The Law on Inspections stipulated (i) requirements to establish criteria for including a business in a certain risk category, and (ii) a provision according to which the frequency of conducting inspections should be different for different group risks. The draft Tax Code does not contain corresponding provisions.
2. In the Law on Inspections, an irregular inspection looks strictly into matters that necessitated such an inspection; however in the draft Tax Code, during an irregular on-site documentation inspection, the inspector can check compliance with other legislation which is within the scope of tax authorities⁵;
3. In the Law on Inspections, the frequency of regular inspections is determined by the category of risk under which a business is placed, but the draft Tax Code has a contrary approach: in general, the overall frequency must not exceed once per calendar year, but, for example, in the case of inspections of enterprises which manufacture goods that are subject to excise duty, or any enterprise that performs registration transactions, payments in cash and/or uses cash registers, the frequency will not exceed once per month⁶.
4. Compared to the Law on Inspections, the draft Tax Code provides an increased number of reasons for ad hoc tax inspections of taxpayers which creates an additional uncertainty, and an increased administrative burden for taxpayers.
5. The draft Tax Code stipulates many more rights (powers) for tax inspectors (at least 23 items) than in the Law on Inspections, introducing yet more uncertainty⁷.
6. The draft Tax Code gives more possibilities for tax inspectors to extend the duration of regular and non-regular tax inspections compared to the Law on Inspections, which prohibits such extensions⁸.
7. According to the draft Tax Code tax inspections can be put on hold and resumed later, while the Law on Inspections does not provide for such a possibility⁹.

⁵ See draft Tax Code, Section II, Article 47.1., sub-Article Articletwo.

⁶ See draft Tax Code, Section II, Article 46.3., 48.

⁷ See draft Tax Code, Section II, Article 49.

⁸ See draft Tax Code, Section II, Article 50.5.

⁹ See draft Tax Code, Section II, Article 50.6.

Corporate Income Tax – Section III

(Hereinafter referred to as CIT Law)

The draft Tax Code includes a new method to calculate corporate tax and draws heavily on international accounting standards. According to the private sector, the result is an increase in the administrative burden without any benefit for tax revenue. The Ministry of Finance, however, hopes this measure will encourage more companies to adopt international accounting standards. To reduce the tax burden and encourage investment, the corporate tax rate will be cut from 25% to 20% for profits that are invested in the same period in which they are recognised. A tax credit will also be introduced for innovation and investment, however, that it is not certain who will benefit or when. This is at the expense of transparency and opens the door to arbitrary taxation (to say nothing of favouritism). Finally, benefits are introduced for technology parks and energy savings. The wording of the provisions which regulate this benefit should be changed in that it becomes clearer to whom or what the benefit will apply and under which conditions. The general rate of 25% will remain unchanged for the time being.

Tax Rates

Article 4.1 provides for a newly reduced tax rate of 20% in cases where the taxpayer has invested in certain 'new' fixed assets. The Article is unclear for example in whether the reduced rate will apply in situations where, for example, new fixed assets will be obtained in financial leasing. Moreover, the Ukrainian government should be reluctant to create tax incentives by offering a *reduced rate* in relation to new investments. In principle, internationally experience has shown that in some cases the costs (including distortions in economic choices) of tax incentives are larger than the benefits and moreover, incentives are likely to generate abuse. Moreover, it should be considered whether there are sufficient resources within the Ukrainian tax administration to control proper use of the underlying tax incentive and whether the use of such resources would be efficient from a financial perspective.

Revenues (Taxable Income)

Article 14.1.23 of section 1 "General Provisions", provides for a definition of "usual price", which is used as a transfer pricing guideline in order to ensure that prices charged between associated enterprises for the transfer of goods and services accord with the arm's length principle for the purpose of calculating taxable profit under the Corporate Income Tax Section III of the Draft Tax Code. The definition, which provides for a more detailed description compared to the definition in the current Corporate Income Tax, contains rules which reflect the OECD Transfer Pricing Guidelines (e.g. "comparable non-controlled price method", in OECD Guidelines referred to as "comparable uncontrolled transaction method"). In applying the different methods by the Ukrainian tax authorities, it is important to note that the Article provides that the methods "shall be used in the specified sequence in accordance with provisions of this sub-item". This is an important step forward for the Ukrainian taxpayer in understanding which method will be applied by the tax authorities. Furthermore, in determining the "usual price", it is a positive development that the Article refers to "time of sale" of goods which should avoid discussion in case such goods increased in price in the period between concluding the contract and their actual delivery.

In general it can be concluded that many of the provisions in the definition of what is taxable income are incomprehensible or at the least very difficult to understand. In other cases it is questionable why certain provisions are included in the definition of taxable profit (example Article 6.3).

Article 6.23.2 contains a provision which states that “VAT amounts received (accrued) by the VAT payer accrued on the value of the sale of goods (performed work, provided services), except for cases when the seller enterprise is not a VAT payer”. It is unclear what this provision seeks to regulate. It needs to be reworded as it gives the impression that VAT is subject to Corporate Income Tax.

Expenses

Article 7, which provides for deductible expenses, is extremely lengthy. It is questionable whether the Article needs to go into such detail that it has to describe, for example, that expenses made for repairing containers is a deductible expense. It is recommended that the Ukrainian government consider coming to a more conceptual definition of deductible expenses. Furthermore, the legislator should consider leaving the amount of the expense to the discretion of the taxpayer. In this case, the tax authorities should only determine whether or not the expense was a business expense.

Article 7.5.1, “ the last day of the reporting tax period of the deadline for the payment of the tax liability under the tax or duty (another statutory payment) shall be deemed to be the date of the expenses accrued by the taxable person in the form of amounts of taxes, duties (other statutory fees)”. Although the Article is hard to understand, it is unclear why it is required to include tax amounts which are deductible under this provision in the reporting period following the period in which the expenses were incurred.

Article 7.9 determines the allowable deduction with respect to production costs of sold goods. Most of the Article is a copy from the text of the National Accountancy Standards (NAS) Nr. 16 (expenses). It could be considered to make a reference to the NAS rather than repeating the text.

Article 8 Depreciation:

The first observation is that the Article needs to be restructured. For example, it is remarkable that in the first sub-Article the provision provides details on the depreciation of perennial plantings as opposed to working from a general to a more detailed perspective. It is a positive development that the declining balance method in the current CIT will be replaced in the draft Tax Code by a straight line method and in certain cases a double declining balance method. An improvement of the depreciation Article compared to the current CIT law is that the depreciation can commence the month after the asset was taken in operation as opposed to the current CIT, where the depreciation can only start in the reporting period (quarter) following the date the asset was received.

In Article 8.5.2, it is unclear why this provision suspends depreciation accrual during periods of modernization and improvement of a fixed asset. Perhaps it is assumed that such fixed assets are not in use. However, in practice such assets are often still used.

Article 8.5.5 provides a favourable depreciation scheme of certain assets to space activities and technology parks. In this context it should be considered to grant such favourable depreciation scheme with respect to those assets which are uniquely used by such technology parks and enterprises active in space activities.

Taxation of Real Estate Transactions by Non-Residents

Article 13.1 provides that the revenue received by non-residents on the sale of real estate in Ukraine is taxable by 15%. The taxable base is the sales value of the real estate. The underlying provision seems extremely unreasonable and burdensome. Moreover, this provision is discriminatory as the non-resident is subjected to taxation which is more

burdensome than the taxation to which Ukrainian residents are subjected under the same circumstances. Therefore it is recommended to redraft the provision and to include that the taxable base will be the sales price of the real estate minus purchase price or any other type of calculation which would reflect a taxation of a gain as opposed to the whole sales price. Moreover, in case the provision is redrafted it should not provide for a more burdensome taxation for non-residents.

Personal Income Tax – Section IV

(Hereinafter referred to as PIT Law)

Ukraine's flat-rate personal income tax will remain unchanged at 15%. The draft Code, however, broadens the tax base by extending the tax to, for example, commercial assets (such as shares) and interest income. The dividend tax rate will be reduced from 15% to 5%.

Personal Income Tax (PIT) on Interests

The draft Tax Code maintains the rate of 15 percent on taxable income and introduces a 5 percent tax rate for interest income on bank deposits, saving accounts, etc. On the other hand the dividend tax rate will be reduced from 15% to 5%. The introduction of the 5% tax on interest generated from bank deposits is disputable particularly in the context of promoting long term savings and reducing the tax burden on direct taxes, both necessary in Ukraine. Therefore it is strongly recommended to reconsider the introduction of this provision.

Taxation of Real Estate Transactions:

Article 12 PIT provides that residential real estate will be taxable at a rate of 5% if the sale of real estate takes place within a period of three years after the date the real estate was purchased. The sale of real estate owned for a period longer than three year will therefore be not subject to this tax. The taxable base is the calculated as follows:

- $(\text{Sales price} - \text{purchase price}) \times (1 - 0.075 \times (\text{number of years the real estate was owned by the seller} - 1))$

While it is understandable that the sale of real estate is taxed in case an individual pursues this as an economic activity, it should be considered whether such sale should be taxed in case of a sale by a regular individual. Even in case the Ukrainian government would pursue with the introduction of this provision, it seems reasonable that a negative result of a real estate transaction should become a deductible cost. In most countries it is not common to tax the sale of real estate by regular individuals. It should also be considered that the draft Tax Code provides already for a stamp duty (1% on total sales price) for such transactions¹⁰. As an alternative, the government could consider levying tax on real estate transactions only for real estate which is not owner-occupied.

Article 12.7 provides for a more burdensome taxation of the sale of real-estate by non-residents as compared to residents. As such the provision is discriminatory and should be redrafted in that both residents and non-residents are taxed equally.

Movable Property Sales

Article 13 of the draft Tax Code establishes that the income arising from the sale of non-real estate property would also be considered taxable income. The compliance control on this provision is likely not feasible. It is preferable to tax the sale of moveable property only when an individual pursues such activity as an economic (entrepreneurial) activity. Income received from the sale of moveable property is not taxed in most countries.

Social Tax Breaks

Article 9 provides a lengthy list of social tax breaks, which, considering the existence of a flat PIT rate, should protect low income taxpayers. The current structure however, due to its

¹⁰ See draft Tax Code, Section IX, Article 4.3.

complexity, will increase compliance costs. Perhaps a more simple method, like a fixed proportion of the income, can be considered.

Value Added Tax - Section V

(Hereinafter referred to as VAT Law)

General remarks

For many years, the collection (administration) and repayment (or non-repayment) of VAT has been one of the most serious problems in the Ukrainian tax system. This has a highly adverse impact on the business and investment climate. The Ukrainian tax authorities have received technical assistance and advice from many sources on how to solve this problem. But the legislation itself is only a small part of the problem: the problem lies chiefly in the implementation and enforcement of the law. Nevertheless, clear, understandable modern legislation would help create the conditions necessary to resolve the problem. The draft Tax Code does not do this. The section on VAT is very detailed and complex and differs little from the current legislation in this area. This means, amongst other things, that the VAT legislation does not meet EU standards and contains unnecessarily complex exemption regulations (e.g. for agriculture). One advantage of the new legislation that is welcomed by the private sector is that mergers and acquisitions will no longer be taxed. In addition, the draft Tax Code provides a new lower VAT rate of 17% (now 20%).

VAT Credit and Refund Procedures

The VAT refund system appears to be the largest tax problem in Ukraine. A VAT Law with a refund system which is not functioning makes VAT a cost for enterprises, which is against the nature of VAT as it should be neutral to businesses. Unfortunately the provision in which the VAT refund procedure (Article 22 VAT Law) is regulated is hardly readable and comprehensible for the average taxpayer. Article 22.4a explains that in case of a limited number of transactions (including export transactions) a tax credit will be refunded to the taxpayer without being obliged to offset against output VAT in future tax periods. Subsequently, Article 22.4b confuses by providing that if any negative balance remains after the budget refund, this should be included into deductible amounts of the next tax period. This provision is contradictory as on one hand Article 22 states that a negative VAT balance will be refunded and on the other hand Article 22 states that after VAT is refunded, the remaining negative VAT balance will be included into deductible amounts of the next period. It seems that the amount of VAT refund is completely up to the discretion of the tax administration.

In all other cases, Article 22.5 provides that the any negative VAT amount should first be offset by output VAT which arises in subsequent 12 months. This actually means that a taxpayer should first see whether he can offset his negative VAT amount against any output VAT that arises in the coming twelve months. Subsequently the provision states that if the negative amount has not been offset against VAT liabilities in these twelve months, the amount shall be refunded by the State Budget. It is not clear from the law whether it provides that for each reporting period a negative balance should be carried forward to offset against output VAT, and therefore each tax period has a maximum period of twelve months to be offset or that from the first moment a VAT credit appears, a taxpayer should seek to offset the negative balance of VAT during a period of twelve months, and in case this balance can not be offset in these twelve months the refund will take place (which will then also include VAT credits of later tax periods following the first tax period in which a negative balance arose).

Furthermore, the provision states that the amount to be refunded shall be the amount of the VAT paid in prior tax periods to the suppliers of such goods or services or the VAT amount paid to the budget by the recipient of the goods or services in prior tax periods, which most likely refers to VAT paid on import transactions. Likewise, in Article 22.4 it is not clear if the

(whole) negative balance of input VAT will be refunded because Article 22.5 also ends with the phrase that any negative balance after the budget refund shall be included into deductible amounts of the next tax period. If the interpretation of this Article is correct, it seems that the VAT Law reserves the right not to refund the whole VAT credit but to allow the taxpayer to carry the VAT credit forward to following tax periods. Considering the VAT arrears that exist in Ukraine, *these arrears should become interest bearing*, particularly now that it appears to be up to the discretion of the tax authorities to determine the amount of the VAT refund.

It goes without saying that the unpaid refund claims hampers the business climate in Ukraine, and as such the economic development in Ukraine as investment decisions will take in consideration an additional cost of 20% where VAT refunds appear. Although it is clear that the tax code itself is just part of the VAT refund arrears, the draft Tax Code legitimates the Ukrainian tax authorities to have arrears of a substantial period (up to twelve months) and even after that it seems that the Ukrainian tax authorities can refer to Article 22.4b and 22.5 in justifying further delays.

Inspections for VAT refunds

It should be reconsidered whether Article 22 VAT Law, Section V, should contain detailed provisions on the inspection of VAT refunds. Tax inspections are regulated in Section II, General Administrative Provisions; following the structure of the draft Tax Code and for the purposes of clarity it should be considered to eliminate the provisions of the inspections in Section V and include those in Section II.

VAT Rates

Article 15 of the VAT Law provides for two tax rates a) 17% and b) 0%. The 17% rate will apply to the supply of goods and services, unless otherwise provided by Article 17 (zero rate), Article 18 (non-taxable transactions), or Article 19 (exemptions) of the VAT Law. From a business perspective a reduction of the VAT rate will be welcomed, particularly since the repayment (or non-repayment) of VAT has been one of the most serious problems in the Ukrainian tax system. However, the reduction goes contrary to the multiyear strategic document. In this document, the government declared its intention to increase the proportion of indirect taxes (such as VAT and duties) at the expense of direct taxes (such as payroll tax and corporation tax). As mentioned above, it is open to question whether VAT should be cut in a period of sharply rising consumption, since a lower VAT rate would likely trigger a further increase in consumption rather than investment.

Taxable Amount

Article 10 of the VAT Law provides that the taxable amount should be determined on the basis of the contractual value of goods and/or services and not be lower than the actual expenses of their production (acquisition) etc. Under the Sixth Directive¹¹ Article 11, the taxable amount is principally determined by everything which constitutes the consideration and which has been or is to be obtained by the supplier from the purchaser, the customer or a third party for such supplies, including subsidies directly linked to the price of such supplies

To determine the contractual value, the Ukrainian VAT Law is using either the production costs or acquisition costs as the basis for calculating the taxable amount while the EU Sixth Directive uses the consideration received by the supplier as the basis for calculating the taxable amount. The calculation of the taxable amount under Ukrainian law therefore differs

¹¹ Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes.

significantly from EU legislation as the Ukrainian VAT Law denies the economic reality that, under circumstances, goods can be supplied for less than their production or acquisition costs.

Another issue which has been raised by Ukrainian taxpayers is that the term “contractual value” seems to give rise to different interpretations by the Ukrainian tax authorities in that the term “contractual value”, sometimes is interpreted as meaning the same as “market value at the date of delivery of the goods” as opposed to the value agreed upon in the contract. In practice the value of goods at the time of signing the contract can differ significantly from the time the goods are actually delivered. Therefore, it should be clear to the taxpayer what is meant by “contractual value”. In case the Ukrainian tax authorities would interpret the taxable amount as the value of the goods when they are delivered, there could be a substantial difference between the consideration paid by the customer and the consideration received by the supplier. As a result the VAT could exceed the percentage of 17% of the actual consideration received by the supplier. As mentioned before, under the Sixth Directive¹² Article 11, the taxable amount is principally determined by everything which constitutes the consideration and which has been or is to be obtained by the supplier from the purchaser.

VAT Exemptions

Article 19 demonstrates the lack of a more conceptual description of VAT exemptions for certain supplies of goods and services. The list of VAT exemptions provided for seems to be endless and for many exemptions, (such as the exemptions granted to publishers, cosmetology assistance, and supply of baby food), one could question the economic advantage since it is questionable that a VAT exemption would really result in lower prices of such goods.

VAT for Agriculture Sector

In Ukraine, the agricultural sector has always had special status with respect to VAT. The draft Tax Code establishes a new scheme for the taxation of VAT in the sector which is a step in the right direction and moves the system closer to guidelines in the EU directive on VAT (6th Directive –Article 25) and WTO provisions on subsidies¹³. This implies the abolishment of zero rates and exemptions for agriculture sub-sectors such as meat and dairy, a reduced rate, and producers keeping the VAT receipts in their accounts (the latter as it is today). The rate established (11 percent) may be on the high side (producers keep VAT receipts in their accounts, the higher the rate the higher the subsidy).

Other Administration Issues

Article 5 provides regulations of the procedures for the administrative declaration and compliance with VAT. It is recommendable to include these issues into Section II of this draft Tax Code. These provisions may increase compliance costs. Sub-Article 5.19 makes a taxable person go through a new registration procedure when it changes location/residence to a district belonging to a different branch of STA. Since tax collection is centralized in Ukraine we would suggest the requirement of just a written notice from the taxpayer to the tax administration, not a full re-registration procedure.

¹² Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes.

¹³ See draft Tax Code, Section V, Article 31.

Excise Tax – Section VI

According to the Concept of Reforming the Tax System, the draft Tax Code must gradually harmonize excise collection mechanisms to EU & World Trade Organization (WTO) standards and create an effective system of excise taxation with the goal of an economically-reasonable level and structure of rates. The structure of the excises in Ukraine is moving closer to EU and WTO requirements with specific excises for alcohol and oil products and specific *plus ad valorem* rates on tobacco. The Draft Tax Code provides the following five groups of commodities which are excisable: (i) ethyl alcohol and alcoholic beverages, beer; (ii) tobaccos; (iii) oil products; (iv) passenger cars, their bodies, trailers and semi-trailers, motorcycles; (v) excisable raw materials¹⁴. Considering the increased reliance on indirect taxes and the reduction of the VAT rate it is likely that income from excise taxes has to be expanded in the future. In this perspective it should be considered that taxes on alcohol and tobacco are generally low in Ukraine.

¹⁴ See draft Tax Code, Section Vi, Article 5.1

Special Tax Schemes - Section XVII

Simplified Tax System (STS)

Ukraine has a very generous system (the Simplified Tax System) in which small and medium enterprises, including individual entrepreneurs, are exempt in full or in part from VAT, corporate tax and/or personal income tax. Contrary to its name, the system is anything but simple and the poor formulation of its rules encourages tax evasion. It is also an expensive system for both pension funds and other social funds (entrepreneurs can be exempt from personal income tax but they are still entitled to a state pension) on the one hand and the public purse (the system leads to an erosion of tax revenue) on the other. The draft Tax Code changes a number of parameters in the system but it is not expected to have any major consequences. In any event, it does not address the fundamental problems caused by the Simplified Tax System.

While reforms on this system are politically difficult, the government should take the opportunity to write a new Tax Code to address the problems the Simplified Tax System (STS) is causing to the tax system in general.

In order to qualify for the STS, Article 2 provides the following:

- the total income should not exceed 1.000.000 UAH if legal company has not more than 50 employees, or
- the total income should not exceed 500.000 UAH for physical persons with a maximum of 10 employees.
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It is not clear why Article 5.9 establishes a maximum of 300.000 UAH as opposed to the 500.000 UAH as above.

It is questionable whether the limit of 50 employees is an appropriate number to qualify for the STS in that such companies should be able to report under the normal tax system. Moreover, it is likely that larger companies (exceeding 50 employees) will break up their company into smaller units in order to qualify under the STS.

With respect to physical persons, the threshold of UAH 300.000 is rather high. It is likely that abuse of the system takes place on a large scale in that individuals who would normally be employed by a firm can work as an individual qualifying under the STS for the same firm. The result is a significant erosion of the base of Personal Income Tax and social insurance contributions. Furthermore, it should be considered whether the STS should apply to all types of professional activities.

Subsection 4 Free Economic Zones and Priority Development Areas

A number of special exemptions and privileges re-emerge in the draft Tax Code. In general an overall liberalization of the economy will have more added value than for example the privileged tax treatment a free trade zones or priority development area provides. International experience suggests that free trade zones have limited impact and in general show negative results. In general the tax treatment of companies in free economic zones is very generous. It is interesting that the draft Tax Code does not mention which and where these free economic zones would be established.

The draft Tax Code provides a system of Special Treatment for Taxation of Technological Parks under which companies and joint ventures can enjoy a large number of tax exemptions and privileges. Allowing companies to qualify for special tax treatment under this provision (likewise other provisions that provide a beneficial tax treatment) makes the Ukrainian tax

system particularly vulnerable for abuse and therefore result in significant losses for the budget. With respect to the Technology Parks it is to be expected that tax evasion with respect to import of capital goods will increase.

In general it can be concluded that the tax privileges provided in Section VIII, are generous and can have a significant distortional effect. As long as the compliance control mechanisms are not sufficiently developed in Ukraine the Ukrainian government should perhaps be more reticent as to granting such tax benefits. In particular when international experience proves that the impact of such benefits is limited or even shows a negative result.