



German Advisory Group

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Otten Consulting

Technical Note [TN/03/2016]

Tax Code Optimization

- Main findings -

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About the German Advisory Group

The German Advisory Group on Economic Reforms, which has been 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 for Economic Affairs and Energy.

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Tax Code Optimization

Executive Summary

The Tax Reform-2016, which came into force at the beginning of this year, did not solve all the questionable issues in the Tax Code of Ukraine ("TCU"). Practical experience shows that the current edition of the TCU still contains a number of shortcomings. Also, some old shortcomings have not been considered within the tax reform as well.

This Technical Note presents our suggestions and comments on the provisions of the Tax Code, which need to be further improved, such as:

- ✓ restoring tax expenses on writing off bad debts – to allow including to tax expenses the amount of written off debts which correspond to the requirements of art.14.1.11 of TCU within the amount of reserve for doubtful debts;
- ✓ cancelling CPT advance payments when paying dividends by agricultural companies - if they are exempted from CPT in principle, they should be exempted from CPT advance payments for paying dividends as well;
- ✓ increase the limit of taxpayer's annual income for tax differences obligatory calculation – the limit shall be increased from UAH 20 m to EUR 2 m in order to release microbusiness from tax differences calculation;
- ✓ cancelling 20% tax on value of advertising services ordered abroad – this is a very old regulation, which hinders advertising abroad;
- ✓ keeping the right for VAT credit on VAT paid at customs from customs value of free of charge imported goods - if such goods are aimed to be further used in business activity and in VAT-taxable operations;
- ✓ introducing mechanisms of combating fake entrepreneurship - based on German experience;
- ✓ elimination of the simplified taxation system for agricultural producers - to keep it temporary only for really "small" agri-producers, and its further total elimination starting from 2018;
- ✓ enlarging terms for taking legal actions against decisions/acts of tax authorities - the current terms of 5/10 days are much too short for taxpayers and shall be enlarged to 15/30 day;
- ✓ setting up a strict deadline of 60 calendar days for the tax audit to be hold in case of liquidation of a taxpayer- in case the tax audit wasn't held within the specified period, that means tax authorities confirm the liquidation of the taxpayer is possible without such audit.

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1 Introduction

After the Tax Reform-2016 came into force at the beginning of this year, practical experience has shown that the Tax Code of Ukraine still contains some shortcomings and some old shortcomings have not been considered within the Tax reform as well.

Given Technical Note discloses main suggestions and comments to the current edition of the Tax Code of Ukraine, which are aimed to improve provisions on:

- Corporate Profit Tax (restoring tax expenses on writing off bad debts, cancelling advance payments when paying dividends by agricultural companies and 20% tax on value of advertising services ordered abroad);
- VAT (to clarify the right for VAT credit on VAT paid at Customs from customs value of free of charge imported goods);
- Administration of Taxes and Duties (enlarging terms for taking legal actions against decisions/acts of tax authorities)

In addition, the Technical Note contains as well some recommendations, which previously were included into the Technical Notes TN/03/2015 and TN/05/2015, but unfortunately were not considered during the Tax Reform-2016:

- *introducing mechanisms of combating fake entrepreneurship;*
- *elimination of the simplified taxation system for agricultural producers;*
- *increase the limit of taxpayer's annual income for tax differences obligatory calculation;*
- *setting up a strict deadline for the tax audit to be hold in case of liquidation of a taxpayer.*

Therefore we would suggest addressing all mentioned above proposals to the Ministry of Finance and the Head of the Tax Committee of the Parliament for further discussion in order to amend and optimize the Tax Code application.

2 Corporate profit tax (CPT)

2.1 Writing off bad debts

There is a mistake in provisions of art. 139.2 of the current edition of the Tax code of Ukraine (hereinafter TCU), which formally deprive taxpayers (that apply tax corrections) to reduce their taxable result on writing off doubtful debts amounts, within the accrued reserves for doubtful debts, even if such debts which have been written off correspond to the requirements of art.14.1.11 of the Tax Code. Several letters of State Fiscal service (hereinafter SFS) have been recently issued that confirm such understanding of art.139.2 provisions as well.

Currently there is the only possibility to reduce taxable result – it's when the amount of written off doubtful debts that correspond to the requirements of art.14.1.11 TCU exceeds the amount of reserve for doubtful debts – then the amount of exceeding goes directly to expenses and is included to the taxable result.

To our opinion it obviously would be logical that all the amount of written off debts which correspond to requirements of art.14.1.11 of TCU (within the reserve and exceeding the reserve) should change the taxable result.

Thus we would suggest further improvements of the Tax Code provisions, namely to supplement the art.139.2.2 with the paragraph two, that *allows including to tax expenses the amount of written off debts, which correspond to requirements of art.14.1.11 of TCU, within the reserve for doubtful debts.*

Our proposals how the wording of TCU might be changed are presented only in the Russian version of this Technical Note.

2.2 Corporate profit tax advance payments by agricultural companies

Tax code provisions foresee that *Corporate profit tax (hereinafter CPT) advances shall be paid while paying dividends regardless to the CPT-payer status of the entity which pays dividends.* That means agricultural companies paying fixed agricultural tax, which substitute CPT (simplified taxation system of Group 4), at the same time are obliged to pay CPT advance payments when paying dividends to their shareholders-legal entities. Moreover, such CPT advance payments done when paying dividends can be offset only against declared CPT obligations, but cannot be returned to the entity or offset as payment of obligations on other taxes and duties (e.g. fixed agricultural tax).

In the long run, such existing CPT exemption as fixed agricultural tax for agricultural companies should be cancelled (please see par. 4.2 of the given document), but as long as CPT exemption exists, obligatory advance payments of CPT is inconsistent and should be deleted.

Thus we would recommend cancelling CPT advance payments for agricultural companies (simplified taxation system of Group 4 replacing CPT) in case they pay dividends to legal entities: If they are exempted from CPT in principle – they should be exempted from CPT advance payments for paying dividends as well.

The provisions of art.57.1¹ of the TCU shall be amended accordingly. Our proposals how the wording of the TCU might be changed are presented only in the Russian version of this Technical Note.

2.3 Tax differences

With the Technical Note #TN/03/2015 we recommended following changes to the Tax Code of Ukraine regarding Corporate Profit Tax:

- To increase the limit of taxpayer's annual income for tax differences obligatory calculation **from UAH 20 m to EUR 2 m**, in order to release Microbusiness from tax differences calculation when defining taxable profit.

Unfortunately, our proposal was not considered within the Tax Reform-2016, but we still think it's being of high importance as it may help to reduce the time required for CPT accounting and reporting by Microbusiness.

Thus, the provisions of art.134.1 of the TCU shall be amended accordingly. Our proposals how the wording of the TCU might be changed are presented only in the Russian version of this Technical Note.

2.4 Taxation of advertising services ordered abroad

We recommend canceling 20% Tax on value of advertising services ordered from non-residents: this is a very old regulation, which hinders advertising abroad.

At the same time, the given regulation being in force:

- ✓ *is discriminatory with regard to the residents that order advertising services from providers non-residents, since such residents have to pay (on their own cost) tax on income paid to non-residents;*
- ✓ *is contrary to the art. 141.4.1.i) of the Tax Code, which states that non-residents' income in the form of revenue from services provided to a resident by a non-resident, is not a subject for taxation on the territory of Ukraine;*
- ✓ *does not foresee application of the provisions of Double taxation agreements between Ukraine and the countries of residence of advertising services providers, when paying this tax.*

The provisions of art.141.4. of the TCU shall be amended accordingly. Our proposals how the wording of TCU might be changed are presented only in the Russian version of this Technical Note.

3 Value Added Tax (VAT)

3.1 VAT paid for customs clearance of received free of charge goods

Currently VAT paid for customs clearance of received free of charge goods (e.g. spare parts received by importer from non-resident producer within warranty period) may be not accepted as VAT credit due to formal reasons.

Within the last few years, tax authorities had been changing their opinion on given VAT credit issue several times. In some consultancies and letters, they said VAT credit was allowed if free of charge imported goods are aimed to be further used in business activity and VAT-taxable operations, but in some other consultancies and letters, tax authorities changed their opinion to the opposite – no VAT credit since there is no fact of purchase.

The amount of VAT on imported free of charge goods is calculated basing on their customs value. Art. 190.1 of the Tax Code determines that the VAT base for goods imported into the customs territory of Ukraine is their contract price, but not lower than their customs value determined in accordance with the Customs Code of Ukraine, including customs duties and excise tax payable.

Customs value is defined according to the provisions of the Customs Code (art.57-64). The main method of customs value definition is based on the contract price of imported goods, but there are also other methods available (contract price of identical goods, contract price of similar goods etc.). Defining customs value of imported free of charge goods is a specific task of customs brokers. But from our practice we know that the customs value of imported free of charge goods/materials is never zero (prices of identical/similar goods are used to define the customs value), and VAT as well as customs duties are normally paid at customs basing on the customs value.

So we would recommend amending the provisions of the Tax Code in order to clarify the norms that provide the right for VAT credit on VAT paid at Customs from customs value of free of charge imported goods. That means no VAT obligations shall be further calculated on the customs value of free of charge imported goods if such goods are aimed to be further used in business activity and in VAT-taxable operations. To our mind, the offered below changes will help to stop manipulation of Tax authorities with the given topic by permanently shifting their approach to VAT credit on VAT paid at Customs on free of charge imported goods.

The provisions of art.198.1 and art.198.3 of the TCU shall be amended accordingly. Our proposals how the wording of TCU might be changed are presented only in the Russian version of this Technical Note.

4 Simplified taxation system

4.1 Combatting fake entrepreneurship

With the Technical Note #TN/05/2015 we recommended following changes to the Tax Code of Ukraine regarding combatting fake entrepreneurship:

- *To introduce the list of criteria to determine the fake entrepreneurship of natural persons (based on German experience).*

The Draft Tax Reform by Juzhanina as well contained certain provisions on fight against evasion of taxes and contributions on payroll (Personal Income Tax, Single Social Contribution) by registration of employees as private entrepreneurs on the simplified taxation system.

Unfortunately, neither our proposal nor proposal of Ms. Juzhanina were considered within the Tax Reform-2016, but we still consider this issue's being of high importance and needs implementation of respective amendmends to the TCU.

Thus we would like to suggest again improving of the TCU provisions by introducing the list of criteria to determine the fake entrepreneurship of natural persons, with under two or more of which the individual is deprived of the right to engage in entrepreneurship on Simplified system of taxation for the period provided by art.299.11 of the Tax Code. *Based on the German practice we provide a list of criteria that indicate evidences of the fake entrepreneurship of individuals.*

The provisions of art.291.5 and art. 299.10 of the TCU shall be amended accordingly. Our proposals how the wording of TCU might be changed are presented only in the Russian version of this Technical Note.

4.2 Simplified taxation of Agriproducers

With the Technical Note #TN/05/2015 we recommended following changes to the Tax Code of Ukraine regarding simplified taxation of agriroducers:

- *To keep the simplified taxation system only for really "small" agri-producers (< 200 ha, < UAH 5 m), provided for a simplified system of taxation, and only for 2 years (2016 and 2017);*
- *Since 2018 the simplified taxation system for agricultural producers should be eliminated completely.*

The Draft Tax Reform by Juzhanina foresees the elimination of the simplified taxation system for agricultural producers with an area of agricultural land > 3000 ha. or income > UAH 100 m.

Unfortunately, neither our proposal nor proposal of Ms. Juzhanina were considered within the Tax Reform-2016, but we still think this issue's being of high importance and needs implementation of respective amendmends to the TCU.

Thus, we would like to suggest it one more time that the provisions of art.291.4 of the TCU shall be amended, according to our recommendations mentioned above. Our proposals how the wording of TCU might be changed are presented only in the Russian version of this Technical Note.

5 Administration of taxes and duties

5.1 Terms for taking legal actions against decisions/acts of tax authorities

Currently a taxpayer can submit its objections against an Act of tax audit (in case of disagreement with the conclusions or facts and data stipulated in the act) to the tax authority where the tax payer is registered, within 5 working days following the day when the taxpayer received such act.

In addition, a taxpayer can submit its objections against a Tax notice-decision (in case of disagreement with the amount of tax obligations defined by tax authority) to the tax authority of higher level within 10 calendar days following the day when the taxpayer received such notice-decision.

In case the objection has been rejected, a taxpayer receives a Decision on full or partial rejection of taxpayer's complaints, and can submit the next objection to the tax authority of the following level within 10 calendar days following the day when a taxpayer received the Decision on rejection. The final step is to obtain a decision on SFS level, which means the end of administrative procedure and may be only objected in court.

The mentioned above terms for taking legal actions against decisions/acts of tax authorities are much too short.

Hereto we would suggest enlarging these terms as following:

15 working days – for submitting objections against an ***Act of tax audit***;

30 calendar days - for submitting objections against a ***Tax notice-decision*** (administrative procedure of 1st level);

30 calendar days - for submitting objections against a ***Decision on full or partial rejection of taxpayer complaints*** (administrative procedure of 2nd level).

The provisions of art.86 and art.56 of the TCU shall be amended accordingly. Our proposals how the wording of TCU might be changed are presented only in the Russian version of this Technical Note.

5.2 Deadline for tax audits in case of liquidation of a taxpayer

Currently we have a situation when tax authorities often violate requirements of the “Law on state registration” and provisions of the Order No. 1588 "On the Procedure of registration of taxpayers", Section XI, which specify the deadlines for the tax audit to be hold in case of termination of legal entities.

So tax authorities on practice do not perform checks within the set by law terms. As a result, the company may be waiting for the tax audit for years and cannot be liquidated in the terms provided by the legislation.

With the Technical Note TN/03/2015 we recommended following changes to the Tax Code of Ukraine regarding deadlines for tax audits:

- *To set up a strict deadline of 60 calendar days for the tax audit to be hold in case of liquidation of a taxpayer. In case there was no tax audit held within the specified period, that means tax authorities confirm that liquidation of the taxpayer is possible without such audit.*

Unfortunately, our proposal wasn't considered within the Tax Reform-2016, but we still think this issue's being of high importance and needs implementation of respective amendmends to the TCU

Therefore, we would like one more time to suggest setting up the deadline for tax audits, in case of liquidation, directly in the Tax Code. If the tax audit has not been conducted within the specified terms, there will be ground to cancel such tax audit. In other words, if a tax service doesn't come to such audit in time, it confirms that tax audit is not necessary for liquidation of the given company.

The provisions of the "Law on State Registration" and Order 1588 shall be amended accordingly.

The provisions of art.78.1 of the TCU shall be amended accordingly as well. Our proposals how the wording of TCU might be changed are presented only in the Russian version of this Technical Note.

List of recent Policy Studies

- Economic Reform Agenda for Ukraine, by Ricardo Giucci, Robert Kirchner, Georg Zachmann, Stephan von Cramon-Taubadel, Policy Study PS/01/2014

List of recent Policy Papers

- Improving SME Access to Finance in Ukraine, by Ivan Koriakin and Robert Kirchner, Policy Paper PP/02/2016
- Mopping up Ukraine's Banking Sector: Short-term Pain, Long-term Gain, by Philipp Engler, Robert Kirchner and Vitaliy Kravchuk, Policy Paper PP/01/2016
- Economic issues of internally displaced people in Ukraine, by Hanna Brenzel, Oleksandra Betliy and Robert Kirchner, Policy Paper PP/06/2015
- How to unbundle Naftogaz: Options and Policy Recommendations, by Georg Zachmann, Policy Paper PP/05/2015
- A cluster development programme for Ukraine: Design principles and key features, by Bjoern Vogler, David Saha and Olha Krasovska, Policy Paper PP/04/2015
- The industrial sector of Ukraine: trends, challenges and policy options, by David Saha Vitaliy Kravchuk, Policy Paper PP/03/2015
- Foreign Direct Investment in Ukraine: Past, Present, and Future, by Robert Kirchner, Vitaliy Kravchuk and Julian Ries, Policy Paper PP/02/2015

List of recent Policy Briefings

- Trade liberalisation with the EU and its impact on Ukrainian exports in 2015, Mykola Ryzhenkov, Veronika Movchan and Ricardo Giucci, Policy Briefing PB/10/2016
- Economic impact of the recent decrease in social security contributions. A model based analysis, by Philipp Engler, Simon Voigts, Robert Kirchner and Oleksandra Betliy, Policy Briefing PB/09/2016
- Außenwirtschaftsförderung in Deutschland: Die Rolle von AHK und GTAI, by Robert Kirchner and Inge Toshev, Policy Briefing PB/08/2016
- Außenwirtschaftsförderung in Deutschland: Die Rolle der Auslandsvertretungen, by Robert Kirchner and Inge Toshev, Policy Briefing PB/07/2016
- Überblick über die deutsche Außenwirtschaftsförderung, by Robert Kirchner and Inge Toshev, Policy Briefing PB/06/2016
- The impact of new trade restrictions on Ukraine's trade with Russia, by Mykola Ryzhenkov, Veronika Movchan and Ricardo Giucci, Policy Briefing PB/05/2016
- Ukraine's exports to Kazakhstan Impact of transit restrictions through Russia, by Mykola Ryzhenkov, David Saha, Veronika Movchan and Ricardo Giucci, Policy Briefing PB/04/2016

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