Business
OMBUDSMAN
Council

SYSTEMIC REPORT

ADMINISTERING TAXES PAID BY BUSINESS

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TABLE OF CONTENTS

LIST OF ABBREVIATIONS

Abbreviations	Definition
ACC/SC	Administrative Cassation Court within the Supreme Court
ATO	Anti-terrorist operation
Central level commission	Commission within SFS/STS, which at different times was called: • Central level commission, which takes decisions on registration of TI/AC in the URTI or on registration refusal; • Central level commission on issues of suspension of TI/AC registration in the URTI
CMU	Cabinet of Ministers of Ukraine
Council	Business Ombudsman Council
CPT	Corporate profit tax
Draft Law No. 3475	Draft Law of Ukraine "On the Administrative Procedure" No. 3475 dated May 14, 2020
ECtHR	European Court of Human Rights
EU	European Union
Expert Council	Expert Council on preparation of generalized tax consultations of the Ministry of Finance of Ukraine
GAAP	Generally accepted accounting principles
GTC	Generalized tax consultations
IE	Individual entrepreneur
IFRS	International financial reporting standards
Instruction No.449	Instruction on the Procedure for Calculation and Payment of the USC, approved by the Order of the Ministry of Finance of Ukraine No.449 dated April 20, 2015
Interim Measures Law	Law of Ukraine "On Interim Measures for the Period of Anti-Terrorist operation" No.1669-VII dated September 2, 2014
ITC	Individual tax consultation
KPI	Key performance indicators

Abbreviations	Definition
Law No. 466-IX	Law of Ukraine "On Introducing Amendments to the Tax Code of Ukraine on Improvement of Tax Administration, Elimination of Technical and Logical Inconsistencies in Tax Legislation" No. 466-IX dated January 16, 2020, which became effective on May 23, 2020
Law No.592	Law of Ukraine "On Amendments to the Law of Ukraine "On Collection and Accounting a Single Contribution to the Compulsory State Social Insurance Fund" Regarding Elimination of Payers Discrimination" No.592-IX dated May 13, 2020
Law No.755	Law of Ukraine "On the State Registration of Legal Entities and Individual Entrepreneurs" No.755-IV dated May 15, 2003
Law No.1797-VIII	Law of Ukraine "On Introducing Amendments to the Tax Code of Ukraine Aimed at Improving Investment Climate in Ukraine" No. 1797-VIII dated December 21, 2016
Law No.2390	Law of Ukraine "On Introducing Amendments to the Law of Ukraine "On State Registration of Legal Entities and Individual Entrepreneurs" Aimed at Simplifying the Mechanism of State Registration of Termination of Businesses" No.2390-VI dated July 1, 2010
MD SFS	Main Department of State Fiscal Service of Ukraine in oblast
MD STS	Main Department of State Tax Service of Ukraine in oblast
MF	Military fee
MoF	Ministry of Finance of Ukraine
NBU	National Bank of Ukraine
OECD	Organization for Economic Co-operation and Development
OLT	Office of Large Taxpayers of STS/SFS
Order No.181	Order of the STS "On Data Sets Subject to Disclosure (update) in the Form of Open Data" No.181 dated November 25, 2019
PIR	Public Information Resource of the STS
PIT	Personal income tax
Previous report	Systemic Report of the Business Ombudsman Council "Problems with Administering Business Taxes in Ukraine" (October 2015)
Procedure for Forming a Plan-Schedule	Procedure for Forming a Schedule of Documentary Scheduled Audits of Taxpayers, approved by the Order of the Ministry of Finance No. 524 dated June 2, 2015

Abbreviations	Definition
Procedure No.117	Procedure for suspension of registration of TI/AC in the Unified Register of Tax Invoices and other procedures, approved by the Resolution of Cabinet of Ministers of Ukraine No. 117, which was effective from March 22, 2018 until February 1, 2020
Procedure No.422	Procedure for prompt accounting of taxes and duties, customs and other payments to the budget, a unified contribution for compulsory state social insurance by the SFS approved by the Order of the Ministry of Finance of Ukraine No.422 dated April 7, 2016
Procedure No.435	Procedure for Drawing Up and Submitting a Report on Unified Contribution Accrued Amounts for the Compulsory State Social Insurance Fund by Insurers, approved by the Order of the Ministry of Finance of Ukraine No.435 dated April 14, 2015
Procedure No.543	Recommended procedure for the interaction of SFS units in the complex testing of tax risks with VAT, approved by the Order of the SFS No. 543 dated July 28, 2015
Procedure No.569	Procedure for electronic administration of VAT, approved by the Resolution of Cabinet of Ministers of Ukraine No. 569 dated October 16, 2014
Procedure No.916	Procedure for formalization and submission of complaints by taxpayers and their consideration by supervisory authorities, approved by the Order of the Ministry of Finance of Ukraine No.916 dated October 21, 2015
Procedure No.1124	Procedure for considering complaints against payment notices on arrears under the USC for obligatory state social insurance by supervisory authorities, as well as the decisions on imposing fines, approved by the Order of the Ministry of Finance of Ukraine No.1124 dated December 9, 2015
Procedure No.1165	Procedure for suspension of registration of TI/AC in the Unified Register of Tax Invoices and other procedures, approved by the Resolution of Cabinet of Ministers of Ukraine No. 1165 dated December 11, 2019, which became effective on February 1, 2020
Procedure No.1246	Procedure for maintaining the Unified Register of Tax Invoices, approved by the Resolution of Cabinet of Ministers of Ukraine No.1246 dated December 29, 2010

Abbreviations	Definition
Regional level commission	Commissions within territorial authorities of STS/SFS, which at different times were called: • Regional level commissions, which take decisions on registration of TI/AC with the URTI or on registration refusal; • Regional level commissions on issues of suspension of TI/AC registration in the URTI
Resolution No.835	Resolution of the Cabinet of Ministers of Ukraine "On Approval of the Regulations on Data Sets Subject to Open Data" No.835 dated October 21, 2015
SCGS	State Classifier of Goods and Services
SEA (SEA VAT)	System of electronic administration of value added tax
SFS	State Fiscal Service of Ukraine
SIC	Standard Industrial Classification of Economic Activities
SMKOR	System of Monitoring Tax Invoices Compliance with Risk Criteria
STS	State Tax Service of Ukraine
Taxpayer's risk criteria	Taxpayer's risk criteria, which at different times were provided by the: • Letter of SFS No. 959/99-99-07-18 dated March 21, 2018 (approved by the letter of MoF No. 26010-06-10/7849 dated March 22, 2018); • Letter of SFS No. 4065/99-99-07-05-04-18 dated November 5, 2018 (approved by the letter of MoF No. 26010-06-05/28170 dated October 31, 2018); • Letter of SFS No. 1962/99-99-29-01-01 dated August 7, 2019 (approved by the letter of MoF No. 26010-06-5/20111 dated August 6, 2019); • Annex to the Procedure No.1165
TCU	Tax Code of Ukraine

Abbreviations	Definition
Temporary register	Temporary Register of Applications on VAT Amount Refund, lodged prior to February 1, 2016 in whose regard VAT is not refunded as at January 1, 2017
TI/AC	Tax invoice/adjustment calculation
TIC	Taxpayer's integrated card
TND	Tax notification-decision
UCGFEA	Ukrainian Classification of Goods for Foreign Economic Activity
UN	United Nations
URTI	Unified Register of Tax Invoices
USA	United States of America
USC	Unified social contribution
USC Law	Law of Ukraine "On Collection and Accounting a Single Contribution to the Compulsory State Social Insurance Fund" No.2464-VI dated July 8, 2010
USR	Unified State Register of Legal Entities and Individual Entrepreneurs
USRCD	Unified State Register of Court Decisions
USREOU	Unified State Register of Enterprises and Organizations of Ukraine
VAT	Value added tax
VAT Refund Register	Register of applications for refunds of VAT from budget

FOREWORD

This Systemic Report of the Business Ombudsman Council (**"Council"**) is devoted to administration of taxes paid by business in Ukraine (**"Report"**).

Approximately 5 years have passed since October 2015, when the Council's Systemic Report *"Problems with Administering Business Taxes in Ukraine"* (**"Previous Report"**) was published.

At the time of publication of the Previous Report, the Council was just launching its operations, having received **448** complaints from businesses, out of which **147 (32.8%)** were tax related.

We have come a long way since then. As at July 1, 2020, the number of complaints received by the Council reached **7,379** and the share of tax issues among them increased to **57.5%** (**4,241** complaints). These numbers eloquently testify the importance of tax issues for Ukrainian business, which is only increasing each year.

According to the Council's observations, the level of importance borne by tax issues for Ukrainian business almost does not depend upon the oblast. Complaints on tax issues predominantly came from Kyiv City (1632 complaints), Kyiv (379), Dnipropetrovsk (377) and Kharkiv (366) oblasts. The smallest number came from Chernivtsi oblast (13). However, if we look to percentage, the difference is insignificant (for example, tax-related issues were raised in 57.5% of all complaints lodged by businesses based in the capital of Ukraine and 41.9% of complaints lodged by Chernivtsi-based businesses).

It is thus not uncommon that the problems of tax administration and control in Ukraine are in the spotlight of many international organizations and research centers.

In the World Bank's Doing Business 2020 report[1], Ukraine was decently ranked 65th out of 190 countries by *"Paying taxes"* indicator. Meanwhile, the number of hours per year spent on tax administration procedures remains high enough (328). This figure is significantly higher than the average one for Europe and Central Asia (213.1). The lion's share of hours (199 out of 328), according to the study, is spent by businesses on value added tax (**"VAT"**) administration, another 92 hours — on unified social contribution (**"USC"**).

According to the Global Competitiveness Index[2] , in 2019, Ukraine was ranked 61st out of 141 countries by *"Burden of government regulation"* indicator[3], 104th by *"Distortive effect of taxes and subsidies on competition"* indicator[4]. Therefore, there is a reason to state that some problematic aspects of tax administration in Ukraine affect the country's global competitiveness.

According to the Tax Complexity Index measured within Global MNC Tax Complexity Project implemented by LMU Munich

[1] Source link: https://www.doingbusiness.org/content/dam/doingBusiness/country/u/ukraine/UKR.pdf

[2] Source link: http://www3.weforum.org/docs/WEF_TheGlobalCompetitivenessReport2019.pdf

[3] The indicator was measured based on companies' top managers replies to a survey question: *"In your country, how burdensome is it for companies to comply with public administration's requirements (e.g. permits, regulations, reporting)?"*.

[4] The indicator was measured based on companies' top managers replies to a survey question: *"In your country, to what extent do fiscal measures (subsidies, tax breaks, etc.) distort competition?"*.

University and Paderborn University[5], Ukraine was ranked 66th out of 100 countries surveyed by *"Overall tax complexity"* index, being 40th by *"Tax code complexity"* indicator and 83rd by *"Tax framework complexity"* indicator.

Imperfection of tax legislation of Ukraine and deficiencies in the practice of its implementation have been emphasized a number of times in documents of international organizations, such as the World Bank[6], International Monetary Fund[7,8], Organization for Economic Co-operation and Development (**"OECD"**)[9].

Therefore, in this Report, the Council set for itself a task to cover tax issues that are the most painful for business that the Council has encountered in its practice over these years.

In particular, the Council touched upon specific problems related to administration of the following four selected taxes paid by businesses in Ukraine: VAT, USC, single tax and corporate profit tax (**"CPT"**).

As far as **VAT** is concerned, the Council primarily attended to problems faced by business due to the manner in which innovative tools of its administration are functioning, namely — the Unified Register of Tax Invoices (**"URTI"**), the System of Electronic Administration (**"SEA"**) and the System of Monitoring Tax Invoices Compliance with Risk Criteria (**"SMKOR"**). Besides, the Council examined problems traditionally ascribed to this tax — i.e., review of accuracy of declaration and payment of VAT during tax audits and delays with its refund.

In response to URTI-related problems, the Council recommended developing a transparent and effective pre-trial mechanism for resolving issues related to dilatory registration of tax invoices/adjustment

5 Source link: https://www.taxcomplexity.org/

6 Thus, in Ukraine Public Finance Review published on June 27, 2017 (page 25), the World Bank noted: *"The tax system is complex, inequitable, and eroded by exemptions, and tax administration is large, inefficient, and widely perceived as corrupt. Although Ukraine already collects a high share of GDP as taxes, it can improve tax compliance and broaden the tax base"*.

Source link: http://documents1.worldbank.org/curated/en/476521500449393161/pdf/117583-WP-P155716-final-output-PUBLIC-2017-06-28-23-16.pdf

7 In the Technical Assistance Report *"Reducing social security contributions and improving the corporate and small business tax system"* (page 8) it is noted that: (*"Despite recent reforms the current general tax system is complex, but this arises mostly from the TC's intricate and sometimes vague language, leading to disparate and arbitrary interpretations of the law. This breeds a severely antagonistic relationship between taxpayers and the SFS, aggravated by the absence of effective dispute resolution mechanisms (either administrative or legal). Thus, proposals for simplifying the tax system often aim in fact at tying SFS's hands, or introduce schemes that permit taxpayers to side-step the tax authority. The mission agrees that the TC needs to be simplified by gaining clarity and improving technical legal drafting, but some important policy amendments are required"*.

Source link: https://www.imf.org/external/pubs/ft/scr/2016/cr1625.pdf

8 In the Technical Assistance Report *"Reforming the State Fiscal Service"* (page 5) it is noted that: *"Less progress is evident on issues that are important to the government, business and society at large—putting an end to corruption, delivering effective tax dispute arrangements, reducing the cost of tax administration and increasing compliance with the tax laws"*.

Source link: https://www.imf.org/external/pubs/ft/scr/2016/cr1648.pdf

9 In the OECD *"SME Policy Index: Eastern Partner Countries 2020: Assessing the Implementation of the Small Business Act for Europe"* (page 605) it is noted that: *"Tax administration [in Ukraine] remains overall quite complex"*.

Source link: https://read.oecd-ilibrary.org/development/2020_23da87c6-ru#page608

calculations (**"TIs/ACs"**) occurring due to hardware's technical failures or software bugs on the part of tax authorities. Among other recommendations of the Council on the URTI topic, it is worth mentioning the idea to cease the practice of imposing fines for dilatory registration of "reducing" ACs, unless legal grounds for their imposition are provided by law.

The Council also elaborated quite comprehensive set of recommendations regarding operation of the SMKOR. In particular, we recommended (i) developing certain legislative amendments aimed at ensuring more straightforward legal definition of taxpayers' risk criteria; as well as (ii) improving selected practices employed by tax authorities (including enforcement of court decisions ordering registration of VAT invoices to be conducted within a reasonable period of time).

Other recommendations of the Council related to VAT administration include, *inter alia*: (i) eliminating common causes of unreasonable reduction (or reset) of registration limit in the SEA VAT, particularly in case of corporate reorganization, as well as in case of annulment and subsequent renewal of registration of VAT payer; (ii) ensuring practical implementation of the principle of "indisputability" of VAT tax credit, if the provision of law, which currently enshrines this principle, is not amended; (iii) solving the long-standing problem of VAT refund for "old" periods; (iv) ensuring an immediate refund of agreed amounts of VAT for "new" periods in the event of an ongoing dispute being considered by the court of cassation.

While analyzing complaints related to **the USC**, the Council started with the issue (which emerged in 2017) of its accrual to dormant (inactive) individual entrepreneurs. Thereafter the Council highlighted several selected issues connected with practical implementation of USC reliefs. In particular, the Report highlights the problem of impossibility to withdraw erroneously filed reports even by those entrepreneurs for whom payment of the USC is not mandatory at all (retired or disabled persons). Recommendations are given to overcome a rather chaotic situation that has emerged due to practical implementation of USC reliefs for businesses registered in the ATO territory. At the end of the chapter, the problems related to system of recording USC debt were analyzed.

Among key recommendations of the Council — (i) to change the legal status of the claim for repayment of debt (arrears) under the USC by turning it from a "reminder letter" into a full-fledged administrative act (an analogue of tax notification-decision (**"TND"**)); and (ii) to introduce the practice of adding a detailed calculation of a debt (arrears) thereto. The Council recommends to align the procedure of challenging such claims with a procedure currently used for challenging TNDs.

Turning to the study of a simplified taxation system (**single tax**) — which plays an extremely important role in the life of small business in Ukraine — the Council begins with the problematic aspect of determining and applying rates of this local tax (they may vary to some extent depending on the discretion of municipal authorities). Thereafter, the Council raises a set of issues stemming from the fact that minor procedural violations on the part of businesses can often result in a loss of their right to remain on the simplified taxation system and, in addition, give rise to an extremely strict liability.

In the chapter devoted to **the CPT**, it was decided to selectively touch upon several problematic aspects that businesses frequently report to the Council: (i) the practice of non-recognition of deductibility of expenses having "no business purpose" by tax authorities; (ii) controversial issues related to calculation of advance payments of the CPT; and (iii) disputes arising from accounting certain common types of financial transactions carried out within groups of companies (such as accounting exchange differences on loans in foreign currency received from the parent company, or debt-to-equity swap).

Summarizing the content of this chapter, the Council issues a set of recommendations proposing respective authorities to give a series of clarifications on disputable issues (e.g. to present detailed criteria used to identify transactions having no business purpose).

The Report then proceeds to consideration of selected procedural aspects of conducting **tax audits** (particularly, formation and periodic adjustment of schedules of tax audits, appointment of unscheduled tax audits, performing such procedural actions during tax audits as requesting documents, physical stock-taking of tangible assets, etc.). Attention is also paid to the importance of setting correct key performance indicators (**"KPIs"**) for control and audit activities.

Among recommendations provided by the Council — to remove legislative loophole effectively enabling tax authorities to adjust schedules of tax audits due to alleged "technical errors". The Council also recommended the State Tax Service of Ukraine (**"STS"**) to ensure that tax authorities take into account the judicial practice, according to which the current legislation does not empower tax authorities to require participation of their representatives in physical stock-taking of taxpayers' tangible assets.

In the chapter dedicated to **appealing** decisions of tax authorities the Council dwelled both on (i) the procedure for considering objections to tax audits reports; and (ii) the procedure of administrative (internal) appeal of tax authorities' decisions to the STS.

The Council provided a set of recommendations aimed at improving the foregoing procedures by complementing and specifying (taking into account peculiarities of the tax sphere) recommendations set forth in the Systemic report *"Administrative Appeal: Current State and Recommendations"* (July 2019).

A broader implementation of practice of consideration of appeals in the regime of tele- or video conference, as well as publication of decisions taken within the appeal procedure, are only some of the steps suggested by the Council.

The remaining chapters of the systemic report deal with **generalized tax consultations ("GTC")**, disclosure of **public information** by tax authorities and maintenance of taxpayers' integrated cards (**"TIC"**).

To intensify the activity of the Expert Council on issuance of GTCs set up under auspices of the Ministry of Finance of Ukraine (**"MoF"**); to publish better statistics on outcomes of consideration of tax disputes in courts as well as more information on functioning of the SMKOR; to improve the mechanism for making corrections to TICs — this is only a selected recommendations provided by the Council in the remaining chapters.

* * *

Given a significant number of taxes, fees and other levies existing in Ukraine, the Council was unable to dwell on each of them in detail in this Report. Thus, the Report does not cover the problems that may arise due to fiscal nature and peculiarities of administration of personal income tax (**"PIT"**), military fee (**"MF"**), excise tax, environmental tax, rent payment and property tax. Yet, general issues of tax administration, which are relevant to these taxes as to any other, are considered in the respective chapters.

In this Report, the Council did not attend to issues related to formation of the state tax policy. In particular, the Council has not assessed feasibility of cancellation of certain taxes or their substitution by other ones (e.g. a possible replacement of a CPT by an exit capital tax, or replacing VAT with a gross receipt or sales tax). The Report did not cover the issue of fairness of existing tax rates, bases, reliefs and discounts, a total tax burden being sufficient or excessive for certain categories of taxpayers, etc.

The Council has not analyzed herein the issue of tax authorities' institutional reform, particularly the Council did not engage into discussions related to the future of the STS, feasibility of its reorganization, merger with other agencies or division into several agencies, etc.

Issues related to fight of law enforcement agencies against criminal offenses in the taxation sphere are also out of scope of this Report. This topic was discussed in the Systemic Report *"Abuse of Powers by the Law Enforcement Authorities in Their Relations with Business"* (January 2016).

Issues associated with administrative appeal against decisions, actions or inaction of tax authorities were considered by the Council in this Report only to extent required by peculiarities of tax sphere. Meanwhile, the Council's basic recommendations on improving mechanism of administrative (internal) appeal — set forth in the Systemic Report *"Administrative Appeal: Current State and Recommendations"* (July 2019) — remain fully relevant.

This report has been prepared by:
Deputy Business Ombudsman
Iaroslav GREGIRCHAK

Council's investigators:
Volodymyr ZABUDSKYI
Volodymyr KUTSENKO
Yuliia MYKHAILIUK
Yuliana REVYUK
Oleh DYKYI

Council's translator:
Rodion RIABCHUK

Under the supervision of
Business Ombudsman
Marcin ŚWIĘCICKI

During preparation of the Report, the Council received a valuable professional input in the form of comments from the State Tax Service of Ukraine.

2 ADMINISTRATION OF VAT

This section covers the most widespread subject of complaints received by the Council since it launched its operations back in May 2015.

As at July 1, 2020, the Council received a total of 7379 complaints, 2204 of them (29.87%)[10] dealt with issues relating specifically to VAT. Another 1048 complaints (14.2%) related to tax audits, many of which also featured VAT issues[11]. Also, VAT was the main underlying theme of the complaints (whose merits are no longer relevant) challenging termination of agreements on recognition of electronic documents and assignment of the so-called "status 9" (183 complaints, 2.48%). Hence, it appears that virtually every third complaint ever received by the Council related specifically to VAT.

This chapter will begin with the overview of VAT administration's evolution in Ukraine. The emphasis will be placed on VAT fraud and on measures the State undertook to combat it. After all, "side effects" of such measures create certain challenges and inconveniences for the business.

A historical insight, set forth in Section 2.1, is required to demonstrate the origins of problems that are still relevant today. It will also help explaining why VAT administration in Ukraine has taken such unprecedentedly complex form as it bears now. Among other things, the genesis of such tools as the URTI, SEA VAT and SMKOR will be explained.

Thereafter, Sections 2.2-2.6 will cover practical issues in the field of VAT administration that businesses are currently facing, and provide recommendations on how to address them.

2.1 History and overview of the current state of VAT administration

VAT has existed in Ukraine since 1992.

This tax is widely used worldwide. As at 2018, 166 of 193 United Nations (**"UN"**) member states applied VAT, including all OECD countries (except for the United States of America (**"USA"**))[12] and the European Union (**"EU"**)[13]. The primary VAT rate in Ukraine is 20%. This rate is mainly in line with rates employed in developed countries[14].

[10] This figure covers complaints related to the following instances of business malpractice: suspension of VAT invoices; inclusion to lists of high-risks taxpayers; failure to enforce court decision obliging to register VAT invoices; VAT electronic administration; VAT refund; annulment of registration of VAT payers.

[11] In June 2020, as part of the work on this System Report, the Council staff analyzed in detail the topics of 838 complaints received by the Council related to tax audits, and found that 710 of the analyzed complaints (85%) affected, inter alia, VAT issues.

[12] Source: OECD Consumption Tax Trends 2018 Report (link: https://www.oecd-ilibrary.org/taxation/consumption-tax-trends-2018_ctt-2018-en).

[13] The Directive No.2006/112/EC, dated November 28, 2006 on the common system of VAT is currently in force in the EU (link: Council Directive 2006/112/EC dated November 28, 2006 on the common system of value added tax); gradual approximation of the Ukrainian legislation with the Directive No.2006/112/EC is foreseen in Annex XXVIII to the Chapter 4, "Taxation", of the Association Agreement between Ukraine, as the one part, and the European Union, the European Atomic Energy Community and their Member States, as the other part (link to the agreement: https: //zakon.rada.gov.ua/laws/show/984_011; link to Annex XXVIII: https://eu-ua.org/tekst-uhody-pro-asotsiatsiiu/dodatky-rozdil-v/opodatkuvannia).

[14] For example, the EU member states apply the following rates (in the ascending order): Luxembourg — **17%**, Malta — **18%**, Germany, Romania, Cyprus — **19%**, the United Kingdom, France, Slovakia, Bulgaria, Estonia — **20%**, the Netherlands, Belgium, Spain, the Czech Republic, Lithuania, Latvia — **21%**, Italy, Slovenia — **22%**, Portugal, Poland, Ireland — **23%**, Finland, Greece — **24%**, Sweden, Denmark, Croatia — **25%**, Hungary — **27%** (source: https://en.wikipedia.org/wiki/Value-added_tax#cite_note-OECD_2018_VAT_trends-1).

VAT is one of Ukraine's state budget key revenues sources. In particular, in 2019 the budget received (with VAT refund deducted) UAH 88.929 bn of VAT from domestic goods (**8.91%** of total revenues) and UAH 289.760 bn. VAT from imported goods (**29.03%** of total revenues)[15].

2.1.1 How VAT works

The final (real) VAT payer is the end consumer. This is a person buying and consuming a product or a service, whose price includes VAT.

However, in terms of administration, VAT is paid to the budget by businesses — manufacturers, importers, wholesalers and retail sellers of goods and services on the domestic market.

Each VAT payer calculates the amount of this tax (to be paid to the budget) on a monthly basis, based on two key components, the first of which increases this amount and the second one decreases it, namely:

1) a tax liability (the amount of VAT included in the value of goods and services sold, the so-called **"outgoing"** VAT);
2) a tax credit (the amount of VAT included in the value of goods and services purchased, the so-called **"incoming"** VAT).

The difference between the "outgoing" and "incoming" VAT should be paid by the VAT payer to the state budget. If such difference is negative — VAT payer acquires a right to claim refund of VAT from the state budget (this usually happens in case of export of domestic goods/services, because Ukrainian VAT applies to export transactions at 0% rate).

It is worth noting that the amount of "incoming VAT" in Ukraine must always be confirmed by a special document — a tax invoice ("TI"). The TI is issued by a supplier of a product or a service, whose purchase price includes VAT. Without such a document, the buyer is not entitled to benefit from VAT tax credit. That is why TIs and adjustment calculations ("ACs") — special documents introducing adjustments to TIs — bear crucial importance for businesses in Ukraine.

2.1.2 How schemes of VAT fraud work

Due to its nature, VAT is quite vulnerable to fraudulent schemes. Therefore, all states where this tax is applied, have to take significant steps to counteract fraud.

For example, the so-called "*carousel VAT fraud*" is relatively common even in the EU[16]. In particular, according to the report prepared at the request of the European Parliament in October 2018[17], this type of fraud costs the EU member states between 40 to 60 billion euro annually.

VAT fraud is very common in Ukraine as well. Typically, it is linked with CPT evasion and the so-called "cash conversion". These schemes are usually orchestrated by organized crime groups specializing in this kind of fraud (the so-called "conversion (conversion and transit) centers"). Such organized groups may

[15] Source: https://index.minfin.com.ua/en/finance/budget/gov/income/2019/

[16] Source: https://en.wikipedia.org/wiki/Missing_trader_fraud.

[17] The report is available at the link: https://www.europarl.europa.eu/cmsdata/156408/VAT%20Fraud%20Study%20publication.pdf.

sometimes act in concert with or under the "cover" of former and/or existing tax and/or law enforcement officials[18].

The state is constantly trying to counteract VAT fraud. In response to the actions undertaken by the State, fraudulent schemes are evolving and continue to exist. This, in turn, requires new approaches to combatting them.

In Ukraine, combating VAT fraud was developing gradually and undergone several reform stages, namely:

- 2011 — introduction of the URTI;
- 2015 — creation of SEA VAT based on "VAT deposition" principle;
- 2017 — launch of SMKOR.

Although each of these mechanisms equipped the State with the new instruments to administer VAT, — it also created new challenges for businesses. Some of the most common issues faced by business that stem from URTI's, SEA's and SMKOR's functioning are discussed in more detail in the Sections 2.2, 2.3 and 2.4 of this Systemic Report respectively.

Despite all modern innovations, traditional tools the State has long been using to counteract a "sham" VAT turnover — such as tax audits and refusals (delays) with VAT refund — remain relevant to some extent. Hence, in the Sections 2.5 and 2.6 of this Systemic Report we focus on the respective issues currently faced by businesses.

2.2 The Unified Register of Tax Invoices (URTI)

Since URTI's inception back in 2011, the list of TIs/ACs subject to registration with the URTI has been gradually expanding until this register became truly comprehensive.

The following figures demonstrate the huge size of the URTI's operation: within 3 months only (a period from July 1, 2017 to September 30, 2017), nearly 63 mn TIs/ACs were submitted for registration[19] — i.e., about 21 million TIs/ACs per month. Based on 20 operation days per month and 12 operating hours in one operation day, the average URTI load over this period should have been: over 1.05 mn TIs/ACs per day, 87.5k per hour, 1.46k per minute, about 24 invoices every second.

Existence of the URTI enabled tax authorities (even without conducting documentary audits) to analyze all VAT-taxable transactions occurring in Ukraine and to detect the movement of suspicious ("sham") VAT. The data, thus generated, was utilized as follows:

- Firstly, it was used during tax audits of taxpayers. In the framework of such audits, tax officials recorded the fact of obtaining VAT tax credit under sham (fictitious) transactions; reduced such VAT credit as groundlessly obtained by a taxpayer; accrued additional VAT sums; and applied fines for its understatement[20];

[18] For more information on their activities, *see* Annex 1 to this Systemic Report.

[19] Source: https://news.dtkt.ua/taxation/pdv/45655

[20] Some of the major business issues related to tax audits (including VAT matters) were analyzed in the Section 5 of the Previous Report.

(link: https://boi.org.ua/media/uploads/q3report/sysrep_tax_eng_pdf.pdf).

Important issue of verifying the legality of formation of VAT tax credit in course of tax audits is discussed in the Section 2.5 hereof.

- Secondly, it was scrutinized by the Tax Police under the framework of criminal investigations, including those launched against organizers of "conversion centers"[21].

Subsequently, the URTI became the basis for introducing next steps in the VAT administration's development — creation of SEA and launch of SMKOR.

In lieu of the crucial place occupied by the URTI in the VAT administration system, the State is interested in encouraging all taxpayers to timely register every TI/AC in this register.

The most effective incentive mechanism here is the "ironclad rule" stipulated by the Tax Code of Ukraine (**"TCU"**), according to which, if a supplier did not register the TI/AC with the URTI, a buyer is not entitled to claim VAT tax credit[22].

Therefore, due to the effect of this rule, in the overwhelming majority of cases, tax authorities actually do not need to specifically motivate taxpayers to timely register TIs/ACs — they are motivated to do so by their own buyers.

It is worth noting, though, that the legislator not only (i) set TI/AC registration deadline (by the end of the month — for those ones issued in the first half of the month; by the 15th day of the following month — for those ones issued in the second half); but also (ii) introduced penalties for failure to register or late registration of the TI/AC[23].

The existence of these penalties and practice of applying them has given rise to a whole range of problems in relations between business and tax authorities, which the Council has frequently faced in its practice in the past and at present. The most relevant of them, according to the Council's observations, are discussed below.

2.2.1 TIs/ACs registration delay due to technical problems on the side of tax authority

Article 120-1 of the TCU provides for penalties for failure to register TIs/ACs with the URTI or missing registration deadline thereof. The amount of penalties varies depending on the delay period and is calculated as % of the amount of VAT specified in such TIs/ACs. It starts with 10% in case of a slight delay and can reach 50%, and in certain circumstances 100%.

In the language of Article 120-1 of the TCU, a taxpayer is fully responsible for timely registration of TIs/ACs. Meanwhile, it does not take into account that taxpayer can only submit the TIs/ACs for registration; while the actual registration of TIs/ACs is within the scope of the tax authority's competence.

Due to such wording, the perception even spread in the professional environment that penalties provided thereunder should even not be applicable to taxpayers. In the end, it is the tax authority rather than the taxpayer who conducts actual registration of TIs/ACs.

Such radical approach is not currently supported and is unlikely to find support in the judicial practice. Nonetheless, advocates of this approach are raising an important issue that Article 120-1 of the TCU effectively

[21] Some of business-related issues related to such pre-trial investigations were discussed in the Systemic Report "Abuse of Powers by the Law Enforcement Authorities in Their Relations with Business" (January 2016) (*see* at: https://boi.org.ua/media/uploads/sysrep_criminal_ukr_final.pdf).

[22] Paragraph 201.10 of article 201 of the TCU envisages, inter alia, that absence of registration by a seller of VAT invoice with the URTI triggers lack of right of a buyer to include respective VAT amount to its VAT credit.

[23] These matters are governed by articles 201 and 120-1 of the TCU respectively.

ignores the fact that delays or non-registration of TIs/ACs with the URTI might not always be resulting from the taxpayer's fault (moreover, they might sometimes result from the fault at the part of the tax authorities).

Although in its practice the Council has, on the numerous occasions, encountered several variations of this situation, — credit is nonetheless worth being given here to the central level tax authority (SFS/STS) — as such situations were infrequently resolved successfully for business as early as at the administrative appeal stage.

Case No. 1. Untimely registration of a number of TIs due to unlawful termination of the agreement on recognition of electronic documents by the tax authority

At the end of 2015, a Kyiv-based enterprise working in the sphere of maintenance and service of air and space vessels (their elements) (the **"Complainant"**) faced unexpected problems.

The company learned that the tax authority had terminated agreement on recognition of its electronic documents. Without such an agreement, the company was denied the opportunity to submit any electronic reports as well as to register TIs/ACs related to certain commercial transactions with the URTI.

The company had to seek protection of its rights in court, which in the summer of 2016 upheld its claim. The tax authority's actions to terminate the agreement were declared illegal. Moreover, the court explicitly obliged the tax authority to deem TIs/ACs the taxpayer sought to register with the URTI in the absence of a valid agreement as registered on the submission date.

However, a year later, in December 2017, the Complainant still received penalties from the MD SFS in Kyiv totally amounting to over UAH124k for allegedly untimely registration of these TIs/ACs. The tax authority's position was simple: if there was a fact of the TI/AC late registration, there should be a penalty then.

The story had a happy end. A higher-level tax authority (the SFS) concurred with both the Complainant's and the Council's arguments. In particular, by the decision of the State Fiscal Service of Ukraine, dated February 12, 2018, the disputed TND was canceled under the framework of administrative appeal procedure. The decision recognized absence of any unlawful actions at the part of the Complainant.

Nevertheless, the practice of tax authorities in situations when taxpayers refer to their failure to ensure timely registration of TIs/ACs with the URTI due to technical reasons (including SFS/STS server's crashes and overloads) is somewhat less favorable for businesses.

From the non-biased standpoint, it should be admitted that such situations could be quite diverse. The truth is that taxpayers are not always right. The Council has encountered a number of cases where the most likely cause of the TI/AC's late registration was technical problems on the taxpayer's side (e-mail provider's failures or software bugs; disruption of access to the Internet, etc.).

Hence, similarly to courts, the Council generally accepts the approach of the tax authorities, which in such controversial situations require taxpayers to provide strong evidences that the TI/AC was delivered to the tax authority's server in the timely manner. Without such evidences, — taxpayer should not be exempt from liability for late registration of TI/AC.

It is worth admitting, though, that the Council recorded several cases where taxpayers actually provided serious evidence of a causal link between problems of the server and late registration of TIs, which, however, were not taken into account by tax authorities.

Case No. 2. Delay with registration of the TI most likely caused by the SFS's server overload on January 15, 2019

Protoriya LLC, a Kyiv-based company specializing in retail trade by hardware and software ("Complainant") approached the Council.

On January 14, 2019 — a day prior to expiration of the deadline prescribed by law — the Complainant submitted its TI for registration.

Pursuant to the explicit rule (*see* paragraph 13 of Clause 201.10 of Article 201 of the TCU) unless during the operational day a receipt on acceptance or rejection or suspension of the TI/AC registration is issued, — the TI submitted for registration is deemed to be registered with the URTI.

However, only on January 16, 2019, the taxpayer received a receipt evidencing rejection of the TI due to the alleged shortage of registration limit with the SEA VAT.

Meanwhile, the Complainant argued (by referring to the information from its electronic cabinet) that its registration limit in the SEA VAT was more than enough at the time when TI was lodged for registration (i.e., January 14, 2019). However, for unknown reasons, breach of the order of processing TIs lodged for registration has occurred at the server of the SFS (those ones submitted later were processed earlier). Consequently, on January 16, 2019, — at the moment when it was finally the turn for the disputable TI to be processed — the balance of registration limit was already insufficient to register it.

The Complainant quite naturally linked the delay with processing its TI (as well as breach of the order of processing) to the fact that on January 15, 2019 overload occurred at the SFS's server, which was subsequently publicly acknowledged on the authority's official website.

On January 17, 2019, the Complainant submitted the disputed TI for registration again, and that time it was successfully registered. But in November 2019, the penalty worth UAH 78 k for two day of delay of TI registration was imposed on the Complainant.

During the administrative appeal procedure, the Complainant referred to the explicit rule set forth in paragraph 13 of Clause 201.10 of Article 201 of the TCU, effectively pointing out that the TI in question should be deemed registered with the URTI on the day when it was lodged for registration — i.e., January 14, 2019. As a proof, a printout of an electronic receipt sent from the SFS's server was provided, confirming that the TI had indeed been delivered to the server on January 14, 2019 and processed only on January 16, 2019.

The Council asked the STS to satisfy the appeal, — unless the tax authority could prove that the Complainant's electronic printout of the e-receipt was actually forged.

However, the STS, — apparently without assessing key evidence and commenting on the reasons for not applying the paragraph 13 of Clause 201.10 of Article 201 of the TCU, — by its decision issued on January 23, 2020 dismissed the appeal.

This case is quite a vivid example of a general state of affairs with application of paragraph 13 of Clause 201.10 of Article 201 of the TCU. Although this rather liberal provision of tax law is widely employed in the judicial practice[24], — in the practice of tax authorities this rule is perceived as a declarative one and thus lacks proper practical application in view of the absence of an adequate mechanism of its enforcement. Indeed, currently there is no clear procedure of entering with the URTI of a correct data about registration of those TIs/ACs that had not been processed in the timely manner (such TIs/ACs should be deemed registered on the date when they were lodged for registration).

Hence, in the Council's view, it would be appropriate to introduce the procedure enabling any VAT payer to approach the tax authority with the statement that its particular TI/AC had not been processed in a timely manner, to be supported by the relevant

[24] In particular, in the Resolution issued on July 12, 2019 in the case No. 0940/1600/18, while adjudicating the dispute regarding application of the fine for violation of the registration deadline of the TI submitted for registration on April 15, 2018 and actually registered on April 16, 2018, the Administrative Cassation Court within the Supreme Court ("ACC/SC") concluded that: "[...] the VAT payer liability established by the norms of Clause 120-1.1 of Article 120-1 of the TCU for missing the deadline provided for in Article 201 of the Code for registration of the tax invoice and/adjustment calculation to such VAT invoice with the URTI, may, in the form of a fine, be applied if the taxpayer failed to provide (send) a tax invoice (adjustment calculation) to the STS within the period prescribed by this article" (link: http://reyestr.court.gov.ua/Review/82996815).

ACC/SC arrived to substantially identical conclusions in its Resolution issued on April 17, 2018 in the case No. 820/6330/16 (dispute regarding application of a fine for violation of the registration deadline of the TI submitted for registration on January 1, 2016 and actually registered on January 2, 2016) (link: http://reyestr.court.gov.ua/Review/73596516); as well as Resolution issued on May 10, 2018 in case No. 819/869/17 (dispute regarding application of a fine for violation of the period of registration of the TI submitted for registration on August 24, 2016 and actually registered on August 25, 2016) (link: http://reyestr.court.gov.ua/Review/73901937).

evidence. Based on the outcomes of such statement's consideration, the tax authority could issue a conclusion, which would constitute the basis for making corrections with the URTI (so that the date when TI was lodged for registration would be specified as the date of its actual registration).

In conclusion it is worth mentioning here the Law of Ukraine "On Introducing Amendments to the Tax Code of Ukraine on Improvement of Tax Administration, Elimination of Technical and Logical Inconsistencies in Tax Legislation" No. 466-IX, dated January 16, 2020, which became effective on May 23, 2020 (**"Law No. 466-IX"**).

The Council observes that the Law No. No. 466-IX introduced certain amendments that can make it even more difficult to resolve such disputable issues in a favor of business. In particular, it is now explicitly stated that the liability, envisaged in Article 120-1 of the TCU, occurs regardless of the taxpayer's guilt.

Meanwhile, new ground for exempting taxpayer from liability, introduced by the Law No. 466-IX (subparagraph 42-1.10 and sub-paragraph 129.5.1 of the TCU) covers only instances of technical failures of the taxpayer's electronic cabinet (which, however, is just a taxpayer's electronic interface, through which it can lodge TIs/ACs for registration). The matter of technical failures of the software and hardware on the part of tax authorities was omitted.

Such legal framework narrows down even more the possibility for resolving such cases on the ad hoc basis (i.e., by cancelling or upholding certain TNDs depending upon existence and degree of guilt of a particular taxpayer in a particular case).

Therefore, the need to have a systemic mechanism governing practical application of the rules set forth in paragraph 13 of Clause 201.10 of Article 201 of the TCU became even more urgent.

COUNCIL'S RECOMMENDATIONS:

To strengthen protection of legitimate interests of taxpayers who lodged their TIs/ACs for registration in time but such TIs/ACs failed to be registered in a timely manner due to the guilt of the tax authorities, — the Council recommends as follows:

1. **The Ministry of Finance of Ukraine and the State Tax Service of Ukraine** — to develop and submit for approval, while the **Cabinet of Ministers of Ukraine** — to approve (i) draft amendments to the Procedure for Maintaining the Unified Register of Tax Invoices, approved by the Cabinet of Ministers of Ukraine Resolution, dated December 29, 2010 No. 1246; or (ii) a separate legislative act governing practical implementation of the rule set forth in paragraph 13 of Clause 201.10 of Article 201 of the TCU. Such amendments should introduce procedure enabling taxpayers to approach tax authority with the statement/application that TI/AC lodged for registration was not processed in the due time and enclose relevant evidence thereto. Having reviewed such statement/application, tax authority should, within reasonable time, issue a conclusion, constituting ground for making corrections with the URTI (so that the date when TI was proved to have been lodged for registration would be specified as the date of its actual registration).

2.2.2 Delay of registration of TIs/ACs not provided to recipients

The real surge of disputes between taxpayers and tax authorities (with the Council ending up just in the middle of it) was caused by controversy around interpretation of the new wording of Article 120-1 of the TCU, which entered into force on January 1, 2017[25].

The wording of the provision triggered dispute among experts whether it envisages existence of two separate grounds for exemption from a penalty foreseen in this Article (TI is not subject to be provided to the recipient; TI is issued for a transaction exempted from VAT or subject to VAT at zero rate) or only one ground, which implies simultaneous presence of both of these criteria.

Why was this issue so important for Ukrainian business?

In reality significant part of TIs issued by VAT payers are not subject to be provided to recipients at all — so that no one forms a VAT tax credit against these TIs. Such scenario primarily comprises situations (though not only them) related to supply of goods to the end consumers, who are, in fact, ultimate VAT payers[26].

In order to simplify this task, the legislator enabled the suppliers in such cases to issue and register a consolidated TI with the URTI once per month for the entire volume of similar transactions with non-payers of VAT[27].

As already mentioned, in transactions between VAT payers it is the buyer who motivates the supplier to timely issue and register the VAT invoice with the URTI, as this makes the former eligible to seek VAT credit. At the same time, there is no such motivating factor in transactions between payers and non-payers of VAT.

The Council observes many business believing that issuance of VAT invoices which are not subject to be provided to recipients is an unnecessary bureaucratic formality; and untimely issuance of such VAT invoices does not harm anyone. Because of this belief (and also because drafting monthly consolidated VAT invoices by large retail networks objectively require a large amount of information to be processed) — registration of such TIs with the URTI is usually being postponed until the last moment. Besides, in lieu of the wording of Article 120-1 of the TCU — which allegedly promised business an exemption from penalties for late registration of such type of TIs — registration was often delayed.

Some entrepreneurs discovered that registering such TIs after the statutory deadline may even bring some benefit. After all, at the moment of registration of the "outgoing" TI in the URTI, the supplier's registration limit in the SEA (which every

[25] The rule was set forth in the new wording by the Law of Ukraine "On Introducing Amendments to the Tax Code of Ukraine Regarding Improvement of the Investment Climate in Ukraine" No. 1797-VIII, dated December 21, 2016.

[26] For example, when consumers buy goods in supermarkets, each of these micro-transactions is subject to VAT. Consumers are usually not too interested in the fact VAT is included in the price of goods they purchase. But the supermarket is obliged to declare VAT tax liabilities and pay VAT to the budget, and in addition — issue a TI (which in this case is unnecessary for and not issued to the buyer.

[27] According to Clause 201.4 of Article 201 of the TCU taxpayers supplying goods/services within the period for which such tax invoice is drawn up (whose supply is continuous or regular):

To buyers-taxpayers — shall draw up not later than the last day of the month in which such deliveries are made, consolidated VAT invoices for each taxpayer with whom supplies are of such nature during the period for which such VAT invoice is drawn up taking into account the total volume of supply of goods/services to the respective payer during such month;

To buyers-non-registered taxpayers — shall draw up not later than the last day of the month in which such deliveries are made, a consolidated invoice, taking into account the total volume of supplies of goods/services to such purchasers with whom such deliveries are made during such month.

enterprise seeks to keep at the highest level possible) is reduced by the respective amount of VAT. Therefore, if a taxpayer does not care about observing such TI's registration deadline (end of the month or the 15th day of the following month, depending on the TI's issue date) — the registration limit will decrease respectively (by applying a special ΣExceed component) only after submission of the VAT return, in which the VAT tax liability arising from respective transactions will be reflected. The deadline for submitting tax return, on its turn, is the 20th day of the following month.

However, the ecosystem, which has gradually shaped up in this niche, was destroyed when tax authorities took the position that the new version of Article 120-1 of the TCU actually provides only for one ground for exempting from penalties instead of two separate grounds. Therefore, even if a particular TI is not due to be provided to the recipient, but includes the amount of VAT above zero (i.e., implies a 20% or 7% rate), — penalties, in the opinion of tax authorities, should nevertheless be imposed.

In many disputes that arose on this matter, the Council generally supported the business. Narrow interpretation of the exemption provided for in Article 120-1 of the TCU, in the Council's view, was illogical, since such interpretation effectively meant that only TIs/ACs not having any VAT at all were subject to exemption (i.e. when the transaction is subject to 0% VAT or is fully exempted from VAT). However, it is the VAT amount that constitutes the basis for calculating penalty. So, what for did the legislator specifically describe in the TCU a case of exemption from a penalty in which a penalty cannot in fact be imposed anyway?

However, unexpectedly for the Council, the judicial practice in such disputes took undesirable turn for taxpayers. There were numerous precedents when the Supreme Court settled such disputes in favor of tax authorities[28].

This state of affairs forced the Council, — consistently advocating the need for tax authorities to follow the Supreme Court's practice[29] — concur with lawfulness of the tax authorities' actions imposing such penalties.

[28] The said practice of the Supreme Court includes, inter alia, decisions of the ACC/SC Panels of Judges dated September 04, 2018 in case No. 816/1488/17, December 11, 2018 in case No. 807/68/18, February 7, 2019 in case No. 808/3250/17, August 13.2019 in Case No. 2040/7988/18 etc.

[29] It's worth taking into account Part 5 of Article 13 of the Law of Ukraine "On the Judiciary and the Status of Judges", dated June 02, 2016 No. 1402-VIII: "Conclusions regarding application of the norms of law set forth in resolutions of the Supreme Court shall be mandatory for all government entities that use a legal act containing the respective legal provision in their activity."

Case No. 3. Significant penalty for failure to register consolidated TIs not subject to be provided to the recipient

The complainant is a company, which sells cosmetic products via the Internet (**"Complainant"**).

In August 2019, the Complainant was penalized by UAH 46 mn for failure to register with the URTI monthly consolidated TIs for supply of goods to non-VAT payers.

While appealing the penalty the Complainant's main argument was that in such cases Article 120-1 does not foresee imposition of such penalties. Nonetheless, the Council was unable to support the Complainant's main argument as by that time the Supreme Court's practice, not supporting a taxpayer-friendly interpretation of this provision, had already been shaped.

Hence, by its decision dated October 21, 2019 the STS upheld the penalty.

In such cases, the Council could not employ any grounds to recommend the SFS/STS canceling such penalties. Yet, the Council pointed out that amounts of penalties do not meet the principle of proportionality — i.e., keeping the justified balance between adverse consequences for the rights, freedoms and interests of individuals and goals the decision (action) pursued by public authorities.

Within the framework of administrative appeal procedure, the tax authorities were not vested with the discretion to reduce the amount of contested penalty expressly stipulated by the respective article of the TCU (i.e. if the amount of penalty is fixed by mandatory rules set forth in the TCU — then TND imposing a penalty cannot be partially canceled within the administrative appeal procedure solely because the penalty is disproportionate). Therefore, the problem could only be solved by amending legislation.

In view of the foregoing facts, the Council supported the initiative (which was supported by a number of business associations and partially implemented in the Law No. 466-IX) aimed at reducing in such cases the amount of penalties provided for in Article 120-1 of the TCU. From the Council's perspective it was also a good idea to extend a statutory period for registration of consolidated VAT invoices by additional 5 calendar days, as provided by the Law No. 466-IX. The Council also welcomes the initiative to expand reduction of liability to cases which already exist — approach adhering to the spirit of Article 58 of the Constitution of Ukraine[30].

The only "fly in the ointment" was that during the long time while the Law No. 466-IX (in the status of the Draft Law No. 1210) awaited for a signature of the President of Ukraine, the provision, which used to guarantee retrospective effect of reducing liability

[30] The one should be mindful that retrospective effect of norms, which reduce liability of a person, does not apply to legal entities automatically by virtue of Article 58 of the Constitution of Ukraine and requires a special direct provision in the respective law. It follows, in particular, from paragraph 3-4 para of clause 3 of the judicial disposition of the Decision of the Constitutional Court of Ukraine in case of the constitutional appeal of the National Bank of Ukraine (**"NBU"**) regarding official interpretation of the provisions of Part 1 of Article 58 of the Constitution of Ukraine (the case on retroactive effect of laws and other legal acts), dated February 9, 1999 No. 1-рп/1999.

partially lost its relevance. In particular, to the extent the provision covers penalties imposed prior to December 31, 2019, — while it remains being quite relevant taking into account the date of adoption of the law by the Verkhovna Rada of Ukraine (January 14, 2020); it is, however, no longer relevant considering the date of its entry into force (May 23, 2020). During 2020, the Council has already faced with several practical cases when such penalties were imposed. The fact that complainants in these cases will not benefit from reduction of liability (unlike those to whom similar penalties were imposed in 2017-2019) from the Council's point of view is unfair.

While signing the Law No. 466-IX, the President of Ukraine proposed further improving some of its provisions[31]. In view of the Council, in course of this work, which may take several months, it is advisable to address the issue mentioned above — i.e., to extend the retroactive effect of the reduction of liability under Article 120-1 TCU to all penalties imposed until May 23, 2020 inclusively.

COUNCIL'S RECOMMENDATIONS:

In order to ensure extension of the reduction of excessively strict liability prescribed by old wording of the Article 120-1 of the TCU (with regard to certain types of TIs/ACs) equally to all taxpayers to whom such penalties were imposed prior to the date when the Law No. 466-IX entered into force, the Council recommends as follows:

2. **The Ministry of Finance of Ukraine and the State Tax Service of Ukraine** — if necessary, to develop and submit to the Cabinet of Ministers of Ukraine, and the **Cabinet of Ministers of Ukraine** — to submit to the Verkhovna Rada of Ukraine the Draft law of Ukraine introducing amendments to paragraph 73 of subsection 2 of section XX "Transitional Provisions" of the TCU, by replacing in the first paragraph and in the second paragraph words and figures "prior to December 31, 2019" with words "prior to entry into force of the Law of Ukraine" On Introducing Amendments to the Tax Code Ukraine Aimed at Improving Tax Administration and Elimination of Technical and Logical Inconsistencies in Tax Legislation".

[31] The source: https://www.president.gov.ua/news/podatkova-reforma-prezident-zvernuvsya-do-uryadu-z-nizkoyu-p-61277.

2.2.3 Penalties for late registration of "reducing" ACs

As was mentioned above, the AC is a special document designed to adjust the TI's quantitative or monetary indicators.

Typical instances requiring issuance of the AC comprise change of prices after delivery of goods; full or partial return of delivered goods by the buyer; or return of a previously received prepayment to the supplier; as well as the need to cancel (annul) TI issued by error.

It is quite natural that the AC can be either "increasing" (increasing the amount of VAT in the TI, which was previously issued) and "reducing" (reducing it), as well as "zero" one (not affecting the price and VAT amount, only correcting the nomenclature and the quantity of products/services or other details).

According to the Council's observations, "reducing" ACs are the most common in practice. Issuing and registering the "decreasing" ACs with the URTI results in the decrease of VAT tax credit that could be claimed by the buyer in the amount corresponding to VAT amount reduced in previously drawn up TI.

If such AC (like TI itself) were to be issued and registered by the supplier, many controversial situations could occur in the triangle "supplier-buyer-state" in lieu of the buyer's obligation to refrain from claiming such "extra" VAT credit.

To prevent such situations, the legislator provided a kind of "safety net" in Article 192 of the TCU — it introduced a rule according to which it is the buyer that must register the "reducing" AC issued by the supplier with the URTI. While doing so, the buyer actually recognizes the need to reduce its VAT tax credit and reduces its registration limit with the SEA VAT (*see* also discussion below in Section 2.3).

So, what is the problem with registering "reducing" ACs?

The point is that penalties foreseen in Article 120-1 of the TCU for delay of their registration or non-registration should, in theory, not be imposed. After all, the base for calculating these penalties is the amount of VAT in a particular TI/AC. If the amount of VAT is negative, then the amount of penalty is negative as well (and therefore, it cannot be imposed).

Such a conclusion follows solely from a literal reading of the rule set forth in Article 120-1 of the TCU. Having analyzed the objective of this rule, the one has to admit that untimely registration of a "reducing" AC is no more or less publicly harmful act than a late registration of a "increasing" AC or the TI itself. After all, all these documents affect both taxpayers' VAT tax liabilities and VAT tax credit, as well as their registration limits in the SEA VAT.

Meanwhile, in the Council's view, the principle of legal certainty, and especially a special principle of interpreting ambiguous provisions of tax legislation in taxpayer's favor (clause 4.1.4 of the TCU), does not give sufficient grounds for imposing penalties provided for by the current wording of Article 120-1 of the TCU in case of late registration of the "reducing" AC.

Tax authorities (supported by the MoF in this case) choose the route of giving preference to the purpose of the norm over its literal content, and indicated in their explanations that the basis for application of fines is the absolute amount (module) of the VAT in the TI/AC. That means that a sign of a number (plus or minus) is not taken into account.

Case No. 4. Penalty imposed for late registration of «reducing» ACs

In the summer of 2019, the Office of Large Taxpayers of SFS (**"OLT"**) inspected a large retail chain specializing in the sale of construction materials (**"Complainant"**), and fined it for breach of deadline for registration of a number of TIs and ACs (including "reducing" ones).

Penalties related to "reducing" ACs were a bit controversial, as the amount of VAT in these ACs was negative.

This argument of the Complainant was supported by the Council.

But in November 2019, the STS upheld all fines by its decision on the results of consideration of the appeal.

While making such a decision, the STS was guided by the approach to the interpretation of Clause 120-1.1 of Article 120-1 of the TCU enshrined in the FAQ in category 101.27 in the Public Information Resource of the STS of Ukraine (**"PIR"**). According to this approach, the basis for the penalty (financial sanction) is the module (absolute value) of the amount of VAT in the TI/AC.

The interpretation of provisions of tax law by a tax authority, which changes (supplements) their literal content is considered to be an undesirable practice and a rather dangerous precedent that the Council cannot approve.

Therefore, the Council advocates more explicit regulation of the liability for delay of registration of "reducing" ACs. Until then — such liability should not be applied, since, in the Council's opinion, there are no legal grounds for that.

COUNCIL'S RECOMMENDATIONS:

In order to avoid bringing taxpayers to groundless liability for breach of registration deadline or for failure to register with the Unified Register of Tax Invoices of adjustment calculations containing a negative VAT amount, the Council recommends as follows:

3. **The Ministry of Finance of Ukraine** or **the State Tax Service of Ukraine** — to issue a new official explanation to withdraw the previous ones and advise taxpayers and tax authorities that the current wording of Article 120-1 of the TCU does not allow imposing penalties for breach of registration deadline or failure to register ACs containing negative VAT amount with the URTI since the basis for the penalty is a negative amount.
4. **The Ministry of Finance of Ukraine and/or the State Tax Service of Ukraine** — if necessary, to develop and submit to the Cabinet of Ministers of Ukraine, and **the Cabinet of Ministers of Ukraine** — to submit to the Verkhovna Rada of Ukraine the Draft law of Ukraine introducing amendments to Article 120-1 of the TCU providing that, while determining basis for imposing the fine, an absolute value (module) of the amount of VAT in the TI/AC shall be employed.

2.2.4 No registration of TIs/ACs, which were never issued

A noteworthy phenomenon is the imposition of penalties foreseen in Clause 120-1.2 of the TCU due to the taxpayer's failure to issue a TI/AC for a particular transaction at all (although, in the tax authority's view, it should have issued).

The peculiarity of this situation is that such taxpayer's inaction is often combined with understatement (failure to declare) of VAT liabilities for the same transaction. Noteworthy, Article 123 of the TCU envisages separate sanction for this violation in the amount ranging from 25% to 50% of VAT liabilities determined by the tax authority.

Case No. 5. Double liability of a taxpayer who failed to issue the TI for a "deemed supply"

In early 2020, the OLT conducted tax audit of a large manufacturing enterprise with foreign investments, which specializes in producing food products (**"Complainant"**).

In the result, the tax authority concluded that marketing services purchased by the Complainant (that were services for placing goods under its trademarks to be sold to end customers at points of sale) has no connection with the Complainant's business. In this regard, the company, in view of tax inspectors, had to accrue itself a "compensatory" VAT liabilities in the amount equal to VAT credit formed due to the purchase of the foregoing services (to made a so-called "deemed supply").

Tax officials accrued the Complainant about UAH 3 mn of additional VAT liabilities by reducing its VAT refund accordingly and imposed penalty in the amount exceeding UAH 760 k (25% of the amount of accrued VAT liabilities) for their [VAT liabilities'] overstatement. However, it did not end up at that — the Complainant received a separate penalty worth over UAH 1.5 mn. (50% of the amount of VAT) for failure to register the TI for "deemed supply" of service.

In April 2020, the STS left the decision unchanged, and the Complainant's appeal — without satisfaction.

Generally, in such situations courts do not observe any violation of the constitutional principle of inadmissibility of a double punishment for the same violation (Article 61 of the Constitution of Ukraine). After all, the TCU formally provides for two separate offenses (Articles 120-1 and 123), each of which is present in such situations. However, it is worth admitting that, in most cases, the said two types of offense are almost inseparably linked with each other and have a common subjective side.

A business that was unlucky to find itself in such a situation carries a heavy burden of paying two penalties at once from the same base (the VAT amount on a certain business transaction): 50% for the absence of registration of the TI/AC (paragraph 1 of clause 120-1.2 of the TCU) and another 25% or 50% for understatement of tax liabilities (clause 123.1, or 123.2 of the TCU)[32].

By the way, if the taxpayer does not register the TIs/ACs after these penalties have been imposed, it ends up on the verge of receiving a third penalty amounting to another 50% of the same base (paragraph 2 of clause 120-1.2 of the TCU).

Noteworthy (as illustrated by the foregoing case) it is a business acting in good faith (even if erroneously) that often gets caught in such a situation. For example, such implication will be suffered by a taxpayer who wrongly applied provision of tax legislation to a particular transaction and thus incorrectly concluded that it was not obliged to issue a TI for a "deemed supply" (with which the tax authority disagreed in the course of the subsequent tax audit).

For comparison, a taxpayer acting with an expressly fraudulent intent (forming a VAT tax credit based on sham business transactions,

[32] The last fine is imposed if tax liability's understatement led to understatement of VAT amount due to be paid to the budget or overstatement of VAT amount claimed for refund.

converting cashless funds into cash) will be subjected to less stringent sanction — it will face only one penalty under Article 123 of the TCU amounting to 25% or 50% of the amount of such "fictitious" VAT tax credit.

Hence, the Council is hopeful that the concept of guilt and varying degree of liability depending upon its presence and form (intent or negligence) introduced by the Law No. 466-IX will help balancing liability for different types of tax offenses. Yet, as was mentioned above, the liability provided for in Article 120-1 of the TCU is incurred regardless of a taxpayer's guilt.

COUNCIL'S RECOMMENDATIONS:

In order to prevent bringing to double liability for the same action those VAT payers who neither issued VAT invoice nor declared VAT tax liabilities arising from the business transaction due to which this VAT invoice must have been issued, the Council recommends as follows:

5. **The Ministry of Finance of Ukraine and the State Tax Service of Ukraine** — to develop and submit for the approval of the Cabinet of Ministers of Ukraine, while the **Cabinet of Ministers of Ukraine** — to submit to the Verkhovna Rada of Ukraine the Draft law of Ukraine introducing amendments to Article 120-1 of the TCU. Such amendments should provide that if taxpayer is subjected to penalty (financial sanction) foreseen by Article 123 of the TCU due to accrual by tax authority of VAT liabilities or reduction of the amount of VAT refund due under particular transaction related to supply of goods/services — penalties provided for in paragraph two of this paragraph and clause 120-1.1 of this Article shall not apply to such a taxpayer. Alternatively, amendments may be introduced to clause 201.10 of Article 201 of the TCU, where a special period for registration of TI / AC in case of accrual of VAT liability by tax authority could be specified, starting from the date when the respective VAT obligation acquires "agreed" status.

2.3 System of Electronic Administration (SEA) of VAT

In 2015, Ukrainian tax legislation was amended to introduce an innovative tool of VAT administration and combating VAT fraud — SEA VAT. It was based on VAT deposition principle.

The nature of this principle is that VAT payer (supplier of goods or services) technically cannot issue and register with the URTI any TI/AC for the amount of VAT exceeding its "incoming" VAT unless it deposits a respective amount of funds onto its e-account with SEA VAT, thereby increasing its registration limit.

This innovation was not welcomed by the business given a number of inconveniences caused by it (further complication of VAT administration process and loss of a portion of enterprises' working capital due to the need to deposit VAT)[33].

In view of the burden for business, in October 2015, the Council recommended abandoning VAT deposition principle[34]. However, the State decided not do this. Over time, VAT deposition principle got entrenched in the Ukrainian legislation and the Council had to recognize its former recommendation as being no longer relevant.

The business gradually got adapted to the controversial innovation. Implementation of some of the Council's recommendations set forth in the Previous Report contributed to this adaptation effect.

Nonetheless, SEA VAT remains to be an extremely complex system, whose internal mechanics remain largely unclear to many VAT payers and even tax experts. Its practical application is still associated with serious difficulties.

Since becoming operational back in May 2015, as at July 1, 2020, the Council received 270 complaints related to VAT electronic administration.

As at July 24, 2020, among 216 investigations ultimately completed by the Council, 142 cases (65.74%) were closed with successful outcome for complainants thanks to the Council's facilitation; 15 cases (6.94%) — with a successful result irrespective of the Council's intervention; in 42 cases (19.44%) investigations were discontinued without a successful outcome; and in 10 cases (4.62%) the Council recognized complaints unsubstantiated or materially unsubstantiated and dismissed them.

As at the same date, investigation of 63 cases in this category was completed with the issuance of the Business Ombudsman's recommendations subject to further monitoring. Implementation of 9 of these recommendations is still being monitored. Out of 54 recommendations, monitoring of whose implementation is completed, 38 (70.37%) are successfully implemented, while monitoring of 16 recommendations (29.62%) was ceased without their implementation.

The dynamics of this category of complaints is more or less stable.

[33] Some of the most widespread issues faced by business in connection with functioning of SEA VAT are covered in more detail in Section 2.3 of this Systemic Report.

[34] For more details *see* Section 2 of the Previous Report (*link:* https://boi.org.ua/media/uploads/q3report/sysrep_tax_eng_pdf.pdf).

Number of complaints regarding sea VAT

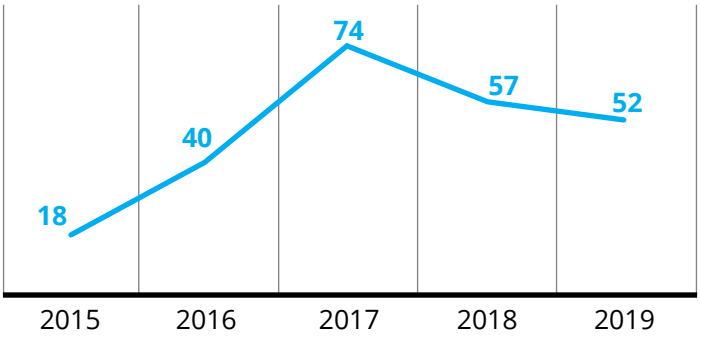

Fig. 1.
Number of complaints related to VAT electronic administration received by the Council

Having analyzed these complaints, the Council identified several systemic issues.

2.3.1 Calculating registration limit in the SEA VAT

Since introduction of SEA, the registration limit (also called «registration sum» or «∑Inv» indicator) took an important place in the activity of each and every VAT payer[35].

The unified formula for calculating the registration limit enshrined in law is perceived by business as somewhat positive phenomenon minimizing the possibilities of manual tampering with the SEA and discrimination of VAT payers.

However, practice has shown that existence of formula "rigidly" fixed in the legislation has deprived SEA of even the smallest flexibility necessary to respond to certain non-standard situations and to restore a normal state of affairs in the event of certain failures.

Let's consider several examples illustrating imperfect functioning of the SEA.

It turned out that the law does not directly regulate situations when the registration of VAT payer is annulled and renewed afterwards based on a court decision. Only during 2016-2018, according to the official information of the SFS[36], annulled registration of at least 191 VAT payers was subsequently renewed by courts. All these VAT payers faced the fact that their registration limit with the SEA has automatically been reset at the time of annulment of their registration and, afterwards, was not automatically renewed.

[35] For more information on the registration limit and how it is calculated, *see* Annex 2 to this Systemic Report.

[36] This information is taken from the letter received by the Council from the STS Ref. No. 11313/6/99-99-15-03-01-15 dated March 11, 2019.

Case No. 6. Reset of registration limit in case of annulment and subsequent renewal of registration of VAT payer

In October 2018 and in May 2019, the Council received two similar complaints from two legal entities, not connected with each other — cleaning company Chistaya Planeta TM LLC and fuel trader (**"Complainants"**).

Tax authorities annulled their registration as VAT payers. Thereafter courts decided that it has to be renewed. However, their registration limits with SEA (which in one case amounted to UAH 236k, in another one — over UAH 3.1 mn) were reset. Therefore, in order to issue and register any TI/AC for the sale of goods/services — which were purchased by the Complainants (and the corresponding "incoming" VAT was received) prior to annulment of their registration — the Complainants needed to transfer additional funds to their e-accounts with SEA.

Despite numerous requests and Council's recommendations issued during 2018-2020, tax authorities failed to re-establish disappeared registration limit, referring to the lack of appropriate legislation and technical capabilities.

The situation became more complicated due to the fact that courts, while resolving the dispute regarding allegedly unlawful annulment of VAT payer's registration, did not explicitly oblige tax authorities to restore the registration limit in the SEA along with the annulled registration. Therefore, tax authorities had an excuse to tell taxpayers about their right to go to the court with new lawsuits, so that courts could separately decide whether to restore the registration limit or not.

At the time of publication of this Systemic Report, the Council's reccomendations remained not implemented and the registration limit in the SEA of Complainants had not been restored. Prospects for resolving this issue without lodging new lawsuits by the Complainants remain quite illusory.

The positive outcome of these cases was that, as a result of the Council's numerous proposals, the norm, intended to resolve this issue at least for the future, was included in the Law No. 466-IX. It was directly established that, when renewing the VAT payer's annulled registration, its registration limit in the SEA should be also automatically restored[37]. However, the Council's proposal to resolve the issue retrospectively was not supported.

[37] Clause 115 of the Law No. 466-IX added the respective paragraphs 27 and 28 to the Clause 200-1.3 of the TCU.

A similar problem arose with the “transfer” of the registration limit from a legal entity to its legal successor(-s) in the event of corporate reorganization (acquisition, merging, division, separation, etc.).

Despite the fact that this problem is specifically regulated by respective provisions of the TCU, — the technical functionality of the SEA appeared insufficient to implement the process of “transfer” of the registration limit.

For example, in April-May 2019, the Council received several complaints from businesses challenging inaction of tax authorities comprising failure to ensure proper "transfer" of the registration limit in SEA within the process of corporate reorganization. Amounts of registration limit thus “lost” by various complainants ranged from UAH 140 k to almost UAH 40 mn. As at July 24, 2020, the Council’s recommendations provided to the SFS/STS under the framework of investigation of these individual cases to increase the complainants’ registration limit was not implemented. The Council continues to monitor implementation of recommendations issued under 2 (two) cases; ceased monitoring of other 2 (two) cases as complainants sought judicial protection of its rights.

By the way, a common feature of the foregoing types of situations is that both cases (annulment and subsequent renewal of registration of VAT payer or its corporate reorganization) entail change of the taxpayer’s e-account in the SEA. According to the Council's observations, the closure of the "old" and the opening of the "new" e-account in the SEA is perceived by tax authorities as "the beginning of a new life from the scratch". In other words, indicators of SEA that were "linked" to the "old" e-account are not "pulled up" to the "new" e-account. Moreover, occurrence of certain events associated with the "old" e-account (for example, registration of VAT invoice, which was issued and sent for registration by the supplier when the buyer’s "old" e-account existed, but was registered with a delay due to suspension of VAT invoice, etc.) — has no impact on indicators of the "new" e-account.

Meanwhile, when closing the "old" and opening a "new" e-account in the SEA VAT, the VAT payer remains to be the same person (the same legal entity having the same individual tax number). Moreover, pursuant to the TCU and the Procedure for electronic administration of VAT, approved by the Resolution of Cabinet of Ministers of Ukraine dated October 16, 2014 No. 569 (“Procedure No. 569”), indicators in the SEA should have been an integral attribute of a particular person (taxpayer) rather than of a person’s specific e-account with the SEA.

Having analyzed the practice of tax authorities on this matter, the Council ascertained occurrence of a systemic misconception, namely — the opening of a new e-account in the SEA VAT is actually perceived as the emergence of a new VAT payer, although it is not true according to the law. The logic hidden behind this approach, in view of the Council, is quite simple — tax authorities want to reserve the right to ultimately deprive "unreliable" VAT payers of the "doubtful" registration limit in the SEA by annulling their registration.

In view of the Council, such an approach theoretically could exist, but there is one hitch. Ultimate deprivation of the registration limit in the SEA VAT in its essence is a sanction, which entails significant material implications for VAT payer. By its nature, such sanction is similar to confiscation, if we treat registration limit as a property. Such a sanction may be

imposed if it is provided by the law. However, the current legislation of Ukraine does not stipulate such a sanction. Not to mention that the proportionality between the severity of the sanction and the gravity of the violation is not observed in this case (registration of VAT payer can be annulled, for example, due to the failure to submit certain reports or absence of an office at the legal address; while the actual consequence of such annulment is a loss of registration limit which may exceed hundreds of thousands or even millions of UAH). Therefore, the Council supports refraining from such highly controversial approach as "new e-account in the SEA VAT = reset of all indicators", unless this approach is clearly enshrined in law.

In the foregoing cases the complainants, with the Council's assistance, sought restoration of the proper status of their registration limit in the SEA without going to courts. However, according to the Council's observations, even going to court and receiving a successful outcome of a judicial process does not guarantee the business a prompt resolution of SEA-related issues.

In particular, as at July 24, 2020, the Council is monitoring implementation of a number of recommendations issued to the SFS/STS seeking increase of the registration limit as a matter of implementation of court decisions. The registration limit amounts in some cases exceeds UAH 40 mn.

According to the Council's observations, court decisions contemplating adjustments in the SEA are the most problematic ones in terms of their implementation by tax authorities. Indeed, pursuant to the law, the registration limit is calculated automatically according to the fixed formula and always represents the sum of certain summands. The logic of the law is that the sum cannot be changed without changing any of the summands. The indicator "Σ Court ", for example, — whose existence might have allowed adjusting registration limit for such amounts as stated in court decisions, — is not provided by law. As a result, the Council observes numerous cases where implementation of court decisions in this category of cases is delayed for an indefinite period of time.

The Council is aware that the SFS and its successor — the STS — have developed a number of internal documents and procedures related to implementation of court decisions in this category of cases.

For example, there is the Order of the STS dated October 24, 2019 No. 137 "On Approval of the Working Procedure and the Working Group to Address Issues Arising During Implementation of Court Decisions Related to Operation of the SEA VAT and the SEA of Fuel and Ethyl Sales".

The Council welcomes tax authorities' efforts aimed at finding a way to ensure enforcement of court decisions — even where it is technically and legally difficult.

It should be noted that there have been many cases in the Council's practice where court decisions were eventually implemented and the registration limit was adjusted in the SEA in accordance with such court decisions.

However, it should also be pointed out that efforts of tax authorities in a number of cases do not lead to the implementation of court decisions over a long period of time. Sometimes — as can be seen from an impartial person's standpoint — these efforts are focused on the process rather than on the result.

Sometimes the Council observes numerous requests of tax authorities lodged with courts (in which, in the Council's view, there is no real need) asking to clarify the content of court decisions or establish a manner of their enforcement. However, court rulings issued upon consideration of such requests are often further challenged with courts of higher instances.

Sometimes there are numerous meetings of working groups, where the only issue stated is the apparent impossibility to enforce a court decision. Sometimes there is endless official correspondence between tax authorities of different levels, which mainly indicates only an existence of the problem.

In the Council's view, situations where court decisions remain unenforced for years, are inacceptable. They adversely affect the image of Ukraine as a democratic state declaring its commitment to the rule of law[38].

In the Council's view, the mechanism for implementation of court decisions ordering adjustments in the SEA should be more effective.

In particular, such a mechanism should include both the normative part (internal documents of the STS governing the manner of implementation of court decisions of the respective type) and the technical part (proper technical capabilities to adjust indicators in the SEA).

At present, the STS already has a procedure in place, which starts as soon as the tax authority becomes aware of a court decision on the adjustment of taxpayer's registration limit in the SEA. This procedure usually results in the issuance of an internal document (a conclusion of the working group) recognizing the need to make adjustments to the SEA and thus ensure enforcement of a court decision. However, this is not enough. Apart from it, a technical ability to make proper adjustments in the SEA must be ensured.

It is also worth noting that, for the purpose of enforcement of court decision it does not matter, whether the defendant in the court case and the recipient of the court decision was the STS, or its predecessor — the SFS, or the regional division of any of the indicated agencies (especially, given the contemplated transition to the concept of a "single legal entity").

Taxpayers have the right to rely on the existence of an effective workflow within the SFS/ STS, allowing any court decision to reach the authority (division) competent to enforce it.

Taxpayers are also entitled to expect that any tax authority will not evade from taking actions reasonably required to be taken in order to implement the court decision on the sole ground that this specific authority was not the defendant in the specific court case.

[38] It is appropriate mentioning here numerous judgments of the European Court of Human Rights (**"ECtHR"**) which in similar cases established a violation of Article 6 of the Convention for the Protection of Human Rights and Fundamental Freedoms; in particular, in cases of *"Yuriy Ivanov v. Ukraine" and" "Burmych and others v. Ukraine"*.

COUNCIL'S RECOMMENDATIONS:

In order to resolve problems affecting proper calculation and adjustment of the registration limit in the SEA, the Council recommends as follows:

6. The Ministry of Finance of Ukraine and the State Tax Service of Ukraine:

6.1. to undertake all required measures (including organizational and technical), which will ensure:

6.1.1. Restoring SEA VAT indicators of those VAT payers whose registration had been annulled and subsequently renewed, without the need for the taxpayers to go to courts requesting restoration of such indicators.

6.1.2. Transferring SEA VAT indicators from one VAT payer to another in case of corporate reorganization, without the need for taxpayers to go to courts requesting transfer of such indicators.

6.1.3. Saving SEA VAT indicators in case of closure and opening new e-account in the SEA VAT (except for certain cases when such indicators should not be saved, if such cases are clearly stipulated by the law).

6.1.4. Implementing court decisions obliging STS/SFS (their regional bodies) to adjust the registration limit and/or other indicators of VAT payers in the SEA. The STS should be able to promptly correct indicators in the SEA manually, based on an internal document (order, the working group conclusion, etc.) issued by respective officials. The implementation of court decisions should be ensured within a reasonable time-limit upon their entry into force (within the period not exceeding 1 month), provided that the court decision was sent by the court to the STS/SFS (its regional authority) or handed over to their representative.

6.2. if it is necessary to implement foregoing recommendations — to develop and submit to the Cabinet of Ministers of Ukraine, while the **Cabinet of Ministers of Ukraine** — to approve draft amendments to the Procedure No.569 and/or other delegated legislative acts.

2.3.2 Registration limit's seizure (arrest) and release

While describing problems related to the SEA functioning currently faced by business, the one cannot ignore the problem of the registration limit's seizure (arrest) and its subsequent release.

There is no consensus among the Ukrainian judiciary whether the registration limit in the SEA is a "property" in the full sense of this word and whether the use of such mean of securing criminal proceeding as its seizure is actually legitimate[39].

Rulings of investigating judges on the seizure or refusal to impose it are not subject to cassation, so the Criminal Cassation Court within the Supreme Court or the Grand Chamber of the Supreme Court has not yet expressed any position on this matter, which would be binding vis-à-vis lower-level courts and public authorities.

In any case, a number of such seizures imposed by investigating judges (mostly based on requests of investigators of tax police lodged within pre-trial investigations of criminal proceedings alleging tax evasion and related criminal offenses) is quite significant.

Contrary to many other categories of court decisions — whose ways of enforcing have been unsuccessfully sought by tax authorities for years — this type of quite controversial court rulings, according to the Council's observations, is implemented easily and strictly. This observation is quite notable in lieu of the fact that relevant legislation (in particular, the Procedure No. 569) neither mentions the possibility to seize registration limit nor does it regulate this matter in any way either. Hence, although serious difficulties with implementation of such rulings might have been expected, — nonetheless they are actually not observed in practice.

Until recently, the exceptional coordination of actions and efficiency with enforcement of these rulings was facilitated by the fact that tax officials and tax police officers worked "under one roof" — in the SFS. But even after "separation" of the law enforcement and tax administration functions between two different state agencies (the SFS and the STS respectively), according to the Council's observations, such court rulings are still being enforced promptly and easily.

Unfortunately, based on the Council's experience, situation with enforcement of rulings obliging to lift previously imposed seizures instead appears to be somewhat worse.

[39] Examples of appellate court decisions alleging impossibility to seize registration limit in the SEA are: the Ruling of Kyiv City Court of Appeal in case No. 752/16869/18, dated November 15, 2018; the Ruling of Kyiv City Court of Appeal in case No. 757/34890/2018, dated August 20,2018; the Ruling of Kyiv City Court of Appeal in case No. 11-cc/824/435/2018, dated October 11, 2018; the Ruling of Kyiv City Court of Appeal in case No. 760/27048/18, dated November 22, 2018; the Ruling of Kyiv City Court of Appeal in case No. 11-ss/824/1325/2018, dated October 11, 2018.

Case No. 7. Lengthy enforcement of the court ruling ordering to lift seizure of the taxpayer's registration limit in the SEA

The Council was approached by a small enterprise Volis LTD LLC from Zaporizhia City, which trades household goods (**"Complainant"**).

On September 26, 2018 the court of appeals by its ruling cancelled seizure of the Complainant's registration limit in SEA worth UAH 1,810,954 imposed by the earlier ruling of the investigatory judge, dated June 27, 2018.

However, as at May 24, 2019, when the Complainant approached the Council, the registration limit was still blocked.

In its letters of response to the Complainant and the Council sent during May-July 2019, the SFS referred to various reasons causing delayed release of the registration limit. Initially, it informed on *"undertaking ongoing measures to enforce the court ruling"*; then it informed that it would not enforce the ruling until it is properly recorded with the Unified State Register of Court Decisions (**"USRCD"**), as there were frequent cases of receipt of forged court decisions; then advised that it was decided to send a request to the court of appeal asking to explain why the ruling is absent in the USRCD.

However, within the framework of the investigation, the Council was able to conclusively establish that, in fact, a copy of the ruling certified by the court was actually received by the SFS by a registered mail back in April 19, 2019, and there was no reason to doubt its authenticity.

Only on September 10, 2019, the Complainant's representative informed the Council that the ruling had finally been enforced.

The Council is aware that the SFS/STS has certain internal documents and procedures related to enforcement of court decisions in this category of cases. For example, the Order of the STS, dated June 06, 2018, No. 357 approved the Procedure determining the mechanism for resolving issues related to enforcement of court decisions regarding seizures/releases of e-accounts in the SEA.

The foregoing internal document stipulated that release of the SEA e-accounts was carried out based solely on the decision of the working group comprising representatives of various structural divisions of the SFS.

Meanwhile, the said document did not regulate the timeframe for actual enforcement of court decisions. In the end, this document became irrelevant due to the establishment of the STS and leaving law enforcement function with the SFS.

It is worth noting that this question is attempted to be addressed in "FAQ" Section of the PIR. But the answer is unclear. It is noted that, while enforcing court decisions, there are no general rules for recovery of indicators in the SEA. So taxpayers are advised to seek individual tax consultation (**"ITC"**) in accordance with Article 52 of the TCU[40].

The Council stands for introduction of transparent and effective mechanism that would ensure strict enforcement of court decisions ordering release of registration limits in SEA within a reasonable time period once the SFS/STS becomes aware of such court decision's entering into force.

COUNCIL'S RECOMMENDATIONS:

In order to resolve problems impairing due release of registration limits and funds on e-accounts of VAT payers in the SEA after cancellation of their seizure, the Council recommends as follows:

7. **The Ministry of Finance of Ukraine** and **the State Tax Service of Ukraine** and/or **the State Fiscal Service of Ukraine**:

   7.1. to undertake all required measures (including organizational and technical), which will ensure implementation of court decisions obliging to release VAT payers' registration limits or funds on e-accounts in the SEA. Such court decisions should be implemented within a reasonable period of time upon their entry into force (not exceeding 10 calendar days), provided the court decision was sent to the STS/SFS (its regional authority) or handed over to its representative.

   7.2. if it is necessary to implement foregoing recommendations — to develop and submit to the Cabinet of Ministers of Ukraine, while the **Cabinet of Ministers of Ukraine** — to approve draft amendments to the Procedure No.569 and/or other delegated legislative acts.

[40] *See* Q&A "What is the procedure for registering VAT invoice/adjustment calculation to VAT invoice with the URTI, if the court decides to cancel seizure of registration limit amount in the SEA VAT?" in category 101.17 in ZIR (http://zir.sfs.gov.ua/main/bz/view/?src=ques).

2.4 The System of Automated Monitoring of Tax Invoices' Compliance with Risk Criteria ("SMKOR")

2.4.1 Overview of SMKOR-related issues

A widespread use of VAT fraudulent schemes[41] forced the State to devote a great deal of attention and considerable resources to controlling and supervisory activities focused on VAT. Conducting tax audits in case of receiving applications from businesses for VAT refund was one of the forms of such reaction. Tax authorities were quite suspicious about any VAT tax credit, through which businesses reduced their amount of VAT payable to the state budget or formed amounts subsequently declared for refund.

Meticulous attention of tax authorities to these matters has caused considerable irritation among many business (especially large and medium-sized businesses, including exporters). Indeed, dissatisfaction of business was largely caused by the fact that tax authorities challenged VAT tax credit — generated under the framework of real transactions for purchase of goods or services, — solely because their suppliers (mainly small businesses), might have used illegal "schemes" in their business activity.

While investigating complaints challenging outcomes of tax audits[42] the Council observed that in situations where SME suppliers are too small and inconvenient in terms of tax control (sometimes it is difficult to physically find them and collect underpaid taxes due to lack of property and funds) — tax officials might have erroneously (and sometimes deliberately) qualified such small suppliers as sham business ("transitors" operating within the framework of "conversion and transit center"), when, in fact, they likely were "beneficiaries" in the scheme. Larger enterprises, to which small suppliers actually supplied goods or services were, in such cases, qualified by tax authorities as "beneficiaries" of the scheme, although they did not actually participate in the scheme at all (*see* practical cases in the Section 2.5).

In such a situation, a new innovative approach has emerged. The idea was to create an automated system that would evaluate all TIs for compliance with certain prescribed risk criteria and instantly block potentially "sham" VAT already at the stage of issuance of the TI by the supplier. If the TI underwent such an automated monitoring (or has been manually unblocked as a result of additional review according to the established procedure), the buyer can be almost completely sure that it can form/claim the VAT tax credit based on this TI.

This would, on the one hand, shift focus of the VAT control from responding to tax fraud consequences (tax audits) to preventing it (VAT invoice suspension).

On the other hand, it should be acknowledged that this step has transferred the main burden of VAT control from buyers (who nowadays have a lesser need to protect their "incoming" VAT during tax audits) to suppliers (which now often have to prove the reality of their "outgoing" VAT at the stage of issuance of VAT invoices), which are mostly small and sometimes medium-sized businesses.

The foregoing considerations explain the rationale for creating the SMKOR — a mechanism, whose essence and mechanics is quite difficult to understand for both Ukrainian taxpayers and foreign investors. After all, this mechanism is a kind of Ukrainian know-how.

[41] For more details on the mechanism of such "schemes", including explanations of key terms such as "tax pit", "transitor", " beneficiary", "two-way transit" etc., *see* Annex 1 to this Systemic Report.

[42] Since launching its operations in May 2015 as at July 1, 2020, the Council received **1048 complaints** related to tax audits (mainly challenging outcomes thereof).

FOR REFERENCE

Are there SMKOR analogues in international practice?

In most countries, where VAT is introduced, VAT invoices are being used[43]. Many of these countries have standards requiring VAT invoices to be issued and stored in electronic form and their electronic registers to be maintained, which are directly administered by tax authorities or to which the latter have free access[44,45]. Tax authorities of many countries use the data of such electronic registers for tax analysis and identification of possible tax fraud[46].

At the same time, SMKOR is an innovation that was first introduced in Ukraine and, as far as the Council is aware, has no exact foreign analogues.

Introduction of such a system in Ukraine was caused by the crucial need to combat VAT fraud, the urgent demand to simplify and speed up the process of VAT refund as well as to reduce the excessive scrutiny of tax authorities to legality of VAT tax credit during tax audits of businesses.

In the Council's view, the absence of foreign analogues is not a self-sufficient argument to support allegation that SMKOR is an unreliable or ineffective tool for combatting VAT fraud. The lack of international experience in the use of such instruments is only a pretext for a more detailed and in-depth analysis of the results of the use of this instrument in Ukraine and making sound conclusions as to whether the advantages provided by this tool outweigh its disadvantages.

[43] For example, in the EU, the uniform requirements for issuance of invoices are set forth in Articles 217-240 of Directive 2006/112/EC dated November 28, 2006 on a common system of VAT (link: Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax).

[44] According to EY Worldwide Electronic Invoicing Survey (2018) (https://www.ey.com/Publication/vwLUAssets/ey-Worldwide-electronic-invoicing-survey-2018/$File/ey-Worldwide-electronic-invoicing-survey-2018.pdf), among 82 countries surveyed, in 57 countries there are provisions enabling issuance of VAT invoices in electronic form, and there are no such provisions only in 25 countries. Issuance of VAT invoices exclusively in electronic form is mandatory for B2B operations in 10 countries (including Ukraine), prohibited in 5 countries, in the rest of the countries it is up to taxpayers, or is not regulated by law.

[45] For example, an electronic register very similar in nature to the Ukrainian Unified Register of Tax Invoices (URTI), is maintained in Chile, an OECD country (source: Summary Report of the OECD Forum on Tax Administration, Twelfth Plenary Meeting 26-28 March, 2019, Santiago, Chile (link: https://www.oecd.org/tax/forum-on-tax-administration/publications-and-products/forum-on-tax-administration-2019-summary-report.pdf).

[46] The respective OECD specialized report cites the experience of a number of countries (Argentina, Mexico, Singapore, Slovakia, Italy, Greece, the PRC, etc.) effectively using electronic VAT invoices and similar electronic automation systems as a tool to tackle tax evasion and tax fraud. Source: OECD Report Technology Tools to Tackle Tax Evasion and Tax Fraud (2017). Annex B. Catalog of country solutions for electronic invoicing. Pages 47-53 (link: https://www.oecd.org/tax/crime/technology-tools-to-tackle-tax-evasion-and-tax-fraud.pdf).

After SMKOR system was working in the test mode for a while, on **July 1, 2017, the first phase** of its full-scope operation started, which lasted until **January 1, 2018** inclusively.

At this stage, SMKOR operation was based on the principle of complete (practically complete) automation and minimization of any manual interference with processes related to monitoring and suspension of registration of VAT invoices[47]. The human factor was "activated" only at the stage of their unblocking — i.e., while considering explanations and sets of documents that taxpayers provided to prove the reality of business transactions related to suspended TIs/ACs.

The first version of risk criteria, on which the operation of SMKOR was based, were the most objective ones (criteria referred to specific parameters of business transactions, in particular, comparison of the nomenclature and the volume of purchased and sold goods) and were applied equally to almost all taxpayers.

However, application of the first version of SMKOR caused serious trouble as the number of taxpayers and TIs/ACs affected by it was quite significant[48].

In particular, due to an insufficient selectivity of criteria, a large number of TIs/ACs issued in lieu of real transactions were suspended just because, for objective reasons, they went beyond the quantitative, cost and qualitative parameters embedded in SMKOR.

Among other things, it turned out that while in most cases SMKOR "understands" trading activities, there were problems with correct "understanding" of the manufacturing activity (in which volumes and nomenclature of "incoming" and "outgoing" goods and services were significantly different, and it was extremely difficult to correctly compare them to distinguish an artificial "product substitution" from the actual manufacturing process). The so-called "taxpayer's data tables" were aimed at resolving this problem, but the mechanism of their application was insufficiently "polished" at that time.

Massive TIs/ACs suspension gave rise to a great wave of public outcry, that finally resulted in suspension of SMKOR's operation by the special law starting from January 1, 2018 until it is improved.

The second phase (following SMKOR's improvement) commenced on **March 22, 2018** and is ongoing.

At this stage, SMKOR's work is based on the new risk criteria[49]. Some criteria are based on assessment of objective quantitative and qualitative characteristics of business transactions and their participant's (business transactions' risk criteria and some taxpayers' risk criteria). A part of criteria, however, was formulated in a rather subjective manner (especially the last of the taxpayers' risk criteria sounding like *"availability of tax information that proves carrying out risky transactions [...]"*). Such criteria enabled special commissions of regional tax authorities to

[47] Several criminal investigations — based on allegations of unauthorized (unlawful) manual tampering with the operation of SMKOR — were given publicity. To the Council's best knowledge, for the time being, none of these investigations have been completed, so it is impossible to judge whether they are grounded and to what extent.

[48] According to the letter of the STS, dated October 09, 2017 No. 13296/D/99-99-07-05-02-14 during period from July 1, 2017 to September 30, 2017 (as at October 3, 2017), 372 674 out of 62 866 581 TIs/ACs (**0.59% of invoices**) submitted for registration, were suspended for the amount of UAH 7 606 464,7 out of UAH 354 159 871,2 k (**2.15% in monetary terms**). Suspension concerned 14710 out of 185035 taxpayers who submitted TIs/ACs for registration (**7.94% of taxpayers**). Source: https://news.dtkt.ua/taxation/pdv/45655

[49] Their first version was launched in March 2018; the second one — in November 2018; the third one — in August 2019; and the last one — in February 2020.

form the so-called "lists of risky taxpayers", the inclusion to which means further suspension of all or almost all TIs/ACs issued by such a taxpayer. In practice, the lists of risky taxpayers bear key importance in SMKOR's operation[50].

The mechanism of SMKOR's operation is described in more detail in Annex 3 to this Systemic Report.

Despite fears of many business that increased influence of subjective factors would worsen the situation, the second phase of SMKOR's operation (since March 22, 2018) was, on the contrary, more successful than the first one. According to the STS, the share of suspended TIs has dropped significantly and continues to decrease[51,52].

Dissatisfaction of business has significantly gone down as well, as illustrated by the dynamics of complaints received by the Council on this topic.

Number of complaints regarding SMKOR

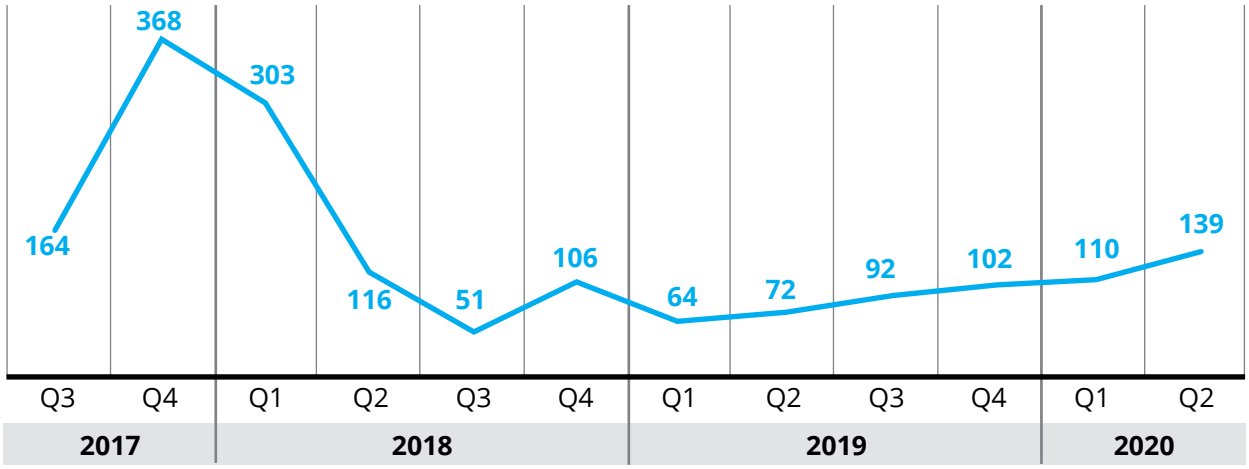

Fig. 2.
Number of complaints related to operation of SMKOR received by the Council, including complaints about suspension of registration of TIs/ACs, regarding inclusion into the lists of risky taxpayers and regarding failure of tax authorities to enforce court decisions obliging to register suspended TIs/ACs.

[50] In particular, according to the MD STS in Kyiv, out of **5.4 k**. VAT invoices suspended in January 2020, **5 k** (or 93.2% of the total number of suspensions) were issued by risky taxpayers (source: http://vobu.ua/eng/analytics/news/item/analityka-za-napriamkom-roboty-smkor). The information related to Kyiv City is indicative, since almost half of risky taxpayers were registered with MD STS in Kyiv (according to the Annex to the Letter of the STS, dated February 26, 2020 No. 269/ZPI/99-00-06-05-03-0), namely: whereas total number of risky taxpayers in Ukraine — **24 767**; **12 220** from them (i.e. **49.3%**) are registered in Kyiv City.

[51] According to the STS, in November 2019, the number of taxpayers, who faced suspension of registration of VAT invoices was **1.75%** of the total number of VAT payers whose TIs/ACs were registered with the URTI. For comparison, in November 2018 this number was **2.71%**. The ratio of suspended TIs/ACs to the registered ones in November 2019 was **0.11%**, in November 2018 — **0.17%**. The ratio of amount of VAT in suspended TIs/ACs to the registered in November 2019 was **0.57%**, in November 2018 — **0.78%**. Source: https://www.tax.gov.ua/media-tsentr/novini/403797.html

[52] According to the MD STS in Kyiv, 3.9 million of VAT invoices were submitted for registration by taxpayers from Kyiv City in January 2020, for the total amount of VAT UAH 28.4 bn. Registration of 5.4 k was suspended (this is **0.1%** of all VAT invoices submitted for registration) with the total amount of VAT being equal to UAH 198.6 mn (or **0.7%** of the total amount of VAT in registered VAT invoices). Source: http://vobu.ua/eng/analytics/news/item/analityka-za-private-roboty-smork

This trend becomes even more noticeable when we consider only "classical" complaints regarding TI/AC suspension.

Number of complaints regarding suspension of VAT invoices

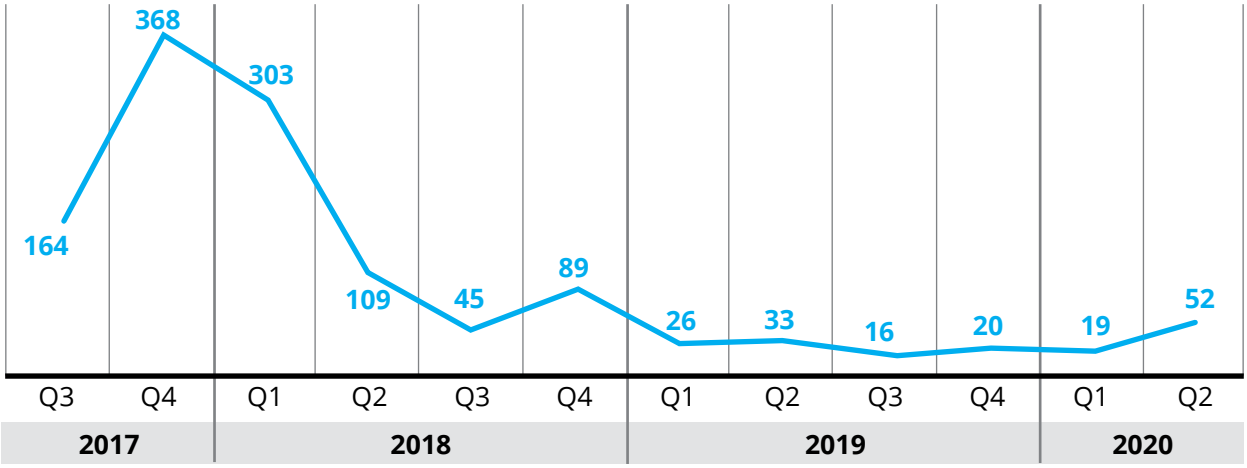

Fig. 3.
Number of complaints received by the Council to challenge failure to enforce court decisions obliging tax authorities to register suspended TIs/ACs

At the same time, the STS continued reporting that SMKOR successfully suspends the "sham" VAT[53].

Meanwhile, despite these positive developments, which are indeed occurring, according to the Council's observations, at least two new issues have become topical.

The first problem is connected with the fact that the manner in which "subjective" criteria of taxpayers' risk is used in not sufficiently "targeted"; and that lists of risky taxpayers are not always generated transparently and used for due purposes. It is illustrated by both the significant number of complaints received by the Council on these issues and the gradual increase of their share.

[53] According to the official announcement by the press service of the STS on its website dated January 3, 2020 (source: https://tax.gov.ua/media-tsentr/novini/403232.html) it is difficult to overestimate SMKOR effectiveness: for the period from March 23, 2018 to December 31, 2019, the number of TIs/AC, whose registration was suspended as a result of automated monitoring and for which taxpayers have not provided explanations and copies of documents, is **354 065** TIs/ACs; thus enabling tax authorities to prevent registration of groundless VAT tax credit worth **UAH 8.4 bn**. According to the STS, all these taxpayers did not even want to confirm the reality of business transactions (without having primary documents at all or knowing that commissions of the tax authority will give a proper legal assessment of the documents submitted). According to the STS, it is these companies being the most interested in disrupting the work of this effective mechanism of combating VAT fraud.

Number of complaints regarding lists of risky taxpayers

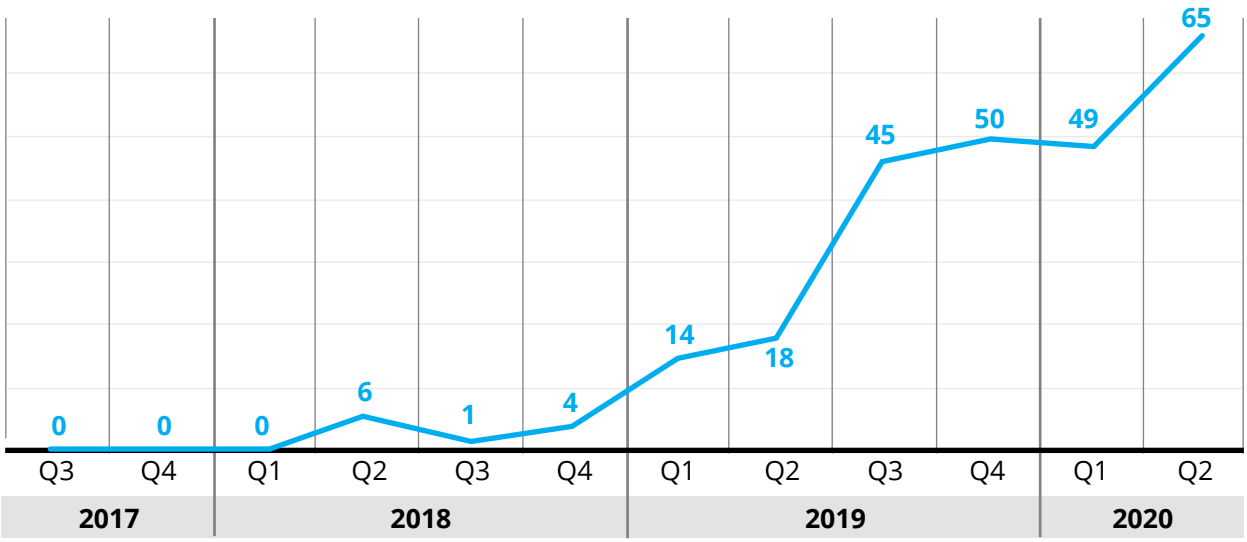

Fig. 4.
Number of complaints received by the Council challenging inclusion to lists of risky taxpayers

The second problem is that courts very often oblige tax authorities to register suspended TIs/ACs with the URTI. Tax authorities, in turn, are reluctant to enforce such court decisions.

The urgency of this issue is also clearly visible in the dynamics of the respective category of complaints.

Number of complaints regarding court decisions on registration of TIs/ACs

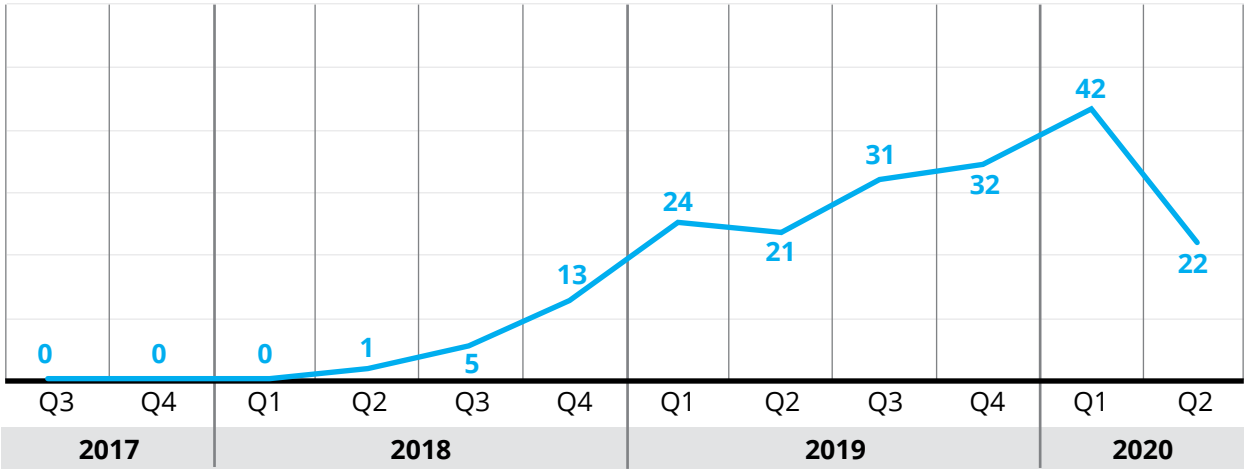

Fig. 5.
Number of complaints lodged with the Council to challenge failure to enforce court decisions obliging tax authorities to register suspended TIs/ACs.

2.4.2 Lists of “risky” taxpayers

Here we should begin with the fact that tax audits — as the “traditional" tool of tax control — has for some time already failed to prove its efficiency to counteract VAT fraud in Ukraine. While employing control measures only, the State was always one step behind tax fraudsters, and only fought against consequences of their actions, rather than prevented fraudulent schemes. However, in addition to conducting tax audits, tax authorities also aspire to promptly “neutralize” sham businesses generating the “sham” VAT.

For this purpose, different tools at different times were used, including:

1) assigning the so-called “status 9” to VAT payer and subsequent annulment of such VAT payer’s registration (this tool allows to “neutralize” the company generating the “sham" VAT making it unable to issue and register TIs/ AC since the date of annulment of its registration);

2) termination or suspension or refusal to conclude an agreement on electronic reporting with the VAT payer (this tool also allows placing the taxpayer “out of the game” since currently it is possible to submit VAT reporting and issue VAT invoices only in the electronic form, without the hard copy alternative), etc.

It is worth noting, though, that these (and other similar) tools were not always used by tax authorities as intended. In addition, their use was often so incorrect from a legal perspective that it bordered on a legal nihilism. Therefore, their use has always caused a great deal of controversy. This conclusion can be drawn from both the Council’s experience (since it has started investigating complaints of business in May 2015)[54] and previous experience of its professional staff.

In view of the foregoing circumstances, the Council laid certain hopes on the launch of SMKOR as a step allowing to establish a more transparent and legally correct way of responding to VAT fraud.

Ideally, SMKOR had to block certain TIs/ACs only if there were objective signs of some suspicious business transactions, without taking into account the “personal identity" of participants of such transactions at all.

However, the reality has shown that this idea was utopian. In practice, it turned out to be impossible to completely deny broad discretion of the tax authorities to identify and “neutralize” VAT payers who, according to tax officials’ estimates, pose a significant risk.

That was exactly the reason why the new taxpayer’s risk criteria (effective since March 22, 2018) actually allowed regional tax authorities (the respective commissions established in their structure) to assign such a characteristic as *“meets the taxpayer’s risk criteria”* actually to any VAT payer within their territorial jurisdiction.

[54] Since launch of operations the Council has received **183 complaints** on termination or suspension or refusal to conclude an agreement on recognition of electronic reporting with the VAT payer (the peak number of this category of complaints was recorded in 2016-2017, and also 9 complaints regarding the “Status 9”. The Council received **30 complaints** regarding cancellation of VAT payer’s registration for respective period.

In particular, the problem of “state 9” was described in detail in the Section 4 of the Previous Report. (link: https://boi.org.ua/media/uploads/q3report/sysrep_tax_eng_pdf.pdf).

FOR REFERENCE

The scope of "risky" taxpayers' lists problem

Given SMKOR's designated purpose (termination of the "sham" VAT circulation; for more information — *see* Annex 1), only sham businesses existing exclusively to facilitate VAT fraudulent schemes or a real business substantially involved in such fraudulent activities (for example, a business that is a supplier in the scheme of "two-way transit") (*see* Annex 1 for more details) should have been included to such lists.

As at July 2020, according to the Head of STS Lyubchenko Oleksii Mykolayovych, approximately 30 000 VAT payers were included to lists of risky taxpayers in Ukraine[55]. It is unclear precisely what part of them are sham businesses existing solely for VAT fraudulent schemes; what is real businesses significantly involved in VAT fraudulent schemes; and what are law-abiding businesses not involved at all, or insignificantly involved in such schemes.

Based on its own observations backed up by a large amounts of data, the Council generally agrees with tax authorities that the vast majority of taxpayers included to such lists are indeed likely to be sham businesses or real businesses significantly involved in VAT fraudulent schemes.

However, it does not in any way relieve the State of the obligation to respect rights of such entities, in particular as regards the transparency of administrative procedure and due substantiation of decisions of public authorities. Moreover, failure to comply with these principles subsequently results in the adoption of court decisions against the State in court disputes. That is what we currently observe in the judicial practice.

In addition, there are reasons to believe that a significant number of taxpayers included to such lists (hundreds of businesses and entrepreneurs across Ukraine) are real businesses not involved, or only insignificantly involved in VAT fraudulent schemes and have been erroneously or unsubstantially included to lists.

In particular, as at July 1, 2020, the Council received 252 complaints challenging inclusion to the lists of risky taxpayers. 159 cases were closed, 92 of them — with a positive result for the complainants (in 76 cases such result was connected due to the Council's facilitation) — i.e. complainants were excluded from lists of risky taxpayers.

[55] *See* link: https://ua-news.liga.net/economics/articles/intervyu-zelenskiy-pogodivsya-scho-reforma-podatkovoi---ne-panatseya-glava-dps-lyubchenko

Having completed a large number of investigations of such cases, the Council had in some cases found that real business regarding which there was no strong evidence that it was involved in VAT fraud was nonetheless included in “risky” lists.

Case No. 8. Groundless inclusion of an agricultural trader from Kropyvnytskyi into the “risky” list

In August 2019, the Council received complaint from a small enterprise based in Kropyvnytskyi city specialized in agricultural products procurement and its further sale for export (**“Complainant”**).

The Complainant obviously looked as a law-abiding business.

It is worth noting only the fact that the average salary of the enterprise’s employees exceeded UAH 10 k (far above the average for the oblast, which clearly shows it was officially paid).

There were no signs the company was involved into turnover of “sham” VAT. Moreover, the company regularly passed tax audits to confirm legality of VAT amounts declared for a refund.

The Complainant learned about having been included in the “risky” list from his e-cabinet. The reasons why this happened were unknown.

On September 17, 2019, a joint working meeting at the MD STS in Kirovograd oblast with the participation of the Council’s representative was held. At the meeting, as well as in an official letter sent to the tax authority, the Council drew special attention to the fact that the Complainant should either be excluded from the “risky” taxpayers’ list, or a clear justification of the reasons why it is still there should be provided.

On September 25, 2019, the Complainant's representative informed the Council by e-mail of the Complainant’s exclusion from the “risky” list.

The reasons why it had been put on this list have never become clear.

Sometimes the purpose of qualifying business as "risky” was to discipline the business or punish for certain actions not related to VAT (underpayment of other taxes and fees; not allowing tax officials to conduct tax audits; failure to respond to their requests, etc.) — i.e. seemingly improper use of “risky” lists was in occurring.

Case No. 9. Inclusion of Kharkiv-based enterprise into the "risky" list to induce it to allow tax inspectors to perform an unscheduled documentary audit

In July 2019, the Council was approached by a private scientific and technical center from the Kharkiv City, which carries out research and experimental development in the field of biotechnology (**"Complainant"**).

The company complained about being on the "risky" list and having no idea why it was there.

On September 4, 2019, the Council's representative participated in the working meeting at the STS in Kharkiv oblast, where the Complainant's issue was discussed. In the course of the discussion, it was discovered that the tax authority had difficulties finding the company at its legal address and performing its unscheduled audit.

At the meeting, in the presence of the Council's investigator, the "gentlemen's agreement" was reached that if the Complainant were to cooperate with tax authorities to allow it to perform a tax audit, it would be removed from the "risky" list, regardless of the audit's findings and their possible appeal in the future.

It is necessary to point out that the agreement was respected — on September 11, 2019 the audit was performed and already on September 12, 2019, the Complainant was excluded from the "risky" list.

However, on September 16, 2019, the Complainant appeared on the "risky" list again. The Complainant's immediate re-inclusion to the list, from the tax authority standpoint, obviously, did not contradict the reached agreement.

Moreover, on September 25, 2019, following the audit, tax audit report accusing the taxpayer in a number of violations of tax laws was issued.

It is worth noting that this complaint was one of numerous episodes of a difficult history of relations between the Council and the SFS/STS in Kharkiv oblast. For example, during July-December 2019, the Council corresponded with this authority regarding a large number of complainants, and each of at least 10 letters of response referred to the fact that information about the reasons for complainants' inclusion in the "risky" list was "restricted". Two further iterations requiring involvement of the STS Ukraine were needed to establish appearance of at least slightly better cooperation.

In other cases, the Council, for its part, saw strong evidence that a particular enterprise classified as "risky" was indeed involved in VAT fraud, or, perhaps, was even sham. However, tax authority sometimes could not or did not wish to show this evidence and justify why it had classified the enterprise as a "risky" one.

With such opacity, the tax authority actually "gave the weapon" in the hands of the allegedly dishonest business, and allowed them to reasonably state (including — in courts) that the business had been included to the list unreasonably because it was not clearly and formally explained why it had been included there.

Case No. 10. The importer possibly involved in VAT fraud

In January 2020 a company from Dnipropetrovsk oblast, which positioned itself as an importer and wholesale trader of wide range of goods (**"Complainant"**) approached the Council in an attempt to challenge allegedly groundless inclusion to the "risky taxpayer's" list.

In observance of impartiality principle, the Council had to admit that from the viewpoint of an independent observer many aspects of the enterprise's activity raised suspicions of it falling within the category of "two-way transit" supplier (importing goods, selling them on the "black market" for cash, and selling accumulated VAT tax credit together with cash to the "conversion center").

Meanwhile, SMKOR was precisely designed to counteract such "schemes".

The problem was that the foregoing considerations were not mentioned at all in the relevant commission's decisions on the Complainant's compliance with the taxpayer's risk criteria. One of such decisions just quoted provisions of the *Procedure for suspension of registration of TI/AC in the Unified Register of Tax Invoices and other procedure, approved by the Resolution of Cabinet of Ministers of Ukraine No. 1165 dated 11.12.2019* (**"Procedure No. 1165"**), while the other contained only words "two-way transit" in the field when the respective reasoning should be present.

The Council's investigator had to perform his own analytical research and several rounds of communication with the tax authority before he managed to gather sufficient information to allow the Council on April 2, 2020 to reasonably dismiss the complaint as largely unsubstantiated by explaining to the Complainant that its' inclusion to the list does not appears to be groundless.

Nonetheless, according to the Council's observations, a number of decent companies and entrepreneurs, who obviously should not be in the "risky" taxpayers' lists, are occasionally included therein. And even those companies whose appearance in the lists does not appear to be occasional, — usually do not receive well-grounded explanations.

Therefore, in the Council's view, there is an urgent need to minimize such instances and create conditions for their prompt correction by excluding law-abiding businesses from being groundlessly included to the "risky" lists and by providing all other taxpayers with clear and comprehensive explanations of the grounds employed for their inclusion therein.

In particular, the Council observes that the complexity of the problem is caused by the following factors:

1) there are no clear criteria for establishing who is considered "risky";
2) tax authorities often do not substantiate in sufficient details (though they have to, especially under the new regulation effective since February 1, 2020) why they believe someone to be "risky";
3) there is no effective pre-trial appeal mechanism (to a higher-level tax authority) to challenge decisions classifying taxpayers as "risky".

Therefore, according to the Council's observations, "risky" taxpayers lists — despite real necessity to maintain them — are not transparent enough and are not always used for their intended purpose either.

This state of affairs contributes to primarily negative attitude towards this instrument not only on the part of representatives and lobbyists of the "grey economy" sector (for whom SMKOR is an annoying obstacle in conducting VAT fraud) but also from many law-abiding businesses.

An important step towards overcoming this problem was the adoption of the Procedure No. 1165. Despite the fact that most of the Council's proposals to its draft were rejected[56], some progress has been achieved on at least several issues.

Firstly, the right of taxpayers to initiate their exclusion from the "risky" list was clearly stipulated; as well as clear procedure and terms of consideration of relevant matters by respective commissions of regional tax authorities were established (i.e. the mechanism aimed at protecting taxpayers' rights was introduced).

Secondly, a form of decision on compliance/non-compliance with risk criteria (Annex No. 4 to Procedure No. 1165) now has a special field *"Tax information"* in which it has to be explicitly stated what tax information supports the conclusion that the taxpayer performs risky transactions (i.e., decision's substantiation requirements were introduced).

The Council noted some improvement of the situation after the Procedure No. 1165 entered into force.

However, in the Council's view, progressive innovations of the Procedure No.1165 are in practice often used improperly. Hence, they haven't solved problems they were focused on yet.

In particular, starting from February 1, 2020, the Council came across dozens of decisions issued by commissions of regional tax authorities on compliance with taxpayers' risk criteria. Copies of such decisions were provided to the Council by various complainants from different oblasts of Ukraine. And it was identified that, unfortunately, only some tax authorities (such as the MD STS in Kyiv City) practice more or less clear reasoning of their decisions. A lot of decisions were either insufficiently substantiated, or unsubstantiated at all (in the appropriate field, where the reasoning should be, there are often dashes, quotes from legislation or meaningless information instead).

With regard to the appeal mechanism, the reference to which is present in the new forms of decisions, the lack of a properly regulated appeal procedure became an insurmountable obstacle to its implementation. And, indeed, despite general provision of Article 56 of the TCU, which guarantees the right to appeal any tax authorities' decision within the administrative appeal procedure, in reality such appeals are not properly considered by

[56] The letter of response of the STS Ref. No. 11727/6/99-0006-05-01-15, dated December 3, 2019 to the Council's proposal set forth in its letter No. 22192, dated November 29, 2019.

the STS. Instead, appeals are forwarded to regional tax authorities or being addressed by formal answers containing quotes from the Procedure No.1165.

At the end of 2019, the Council proposed[57] the STS to introduce a clear mechanism specifically designed to challenge "risky" decisions and similar decisions on rejection of taxpayers' tables with the central level commissions. However, the STS rejected[58] such Council's proposal arguing that its implementation would require amendments to the TCU (obviously, clauses 56.23 of Article 56 of the TCU were meant).

COUNCIL'S RECOMMENDATIONS:

To protect law-abiding businesses from being included to the "risky" taxpayers list and prevent other violations of their legitimate interests caused by selected problematic aspects of SMKOR's functioning, the Council recommends as follows:

8. **The State Tax Service of Ukraine** and **the Ministry of Finance of Ukraine** — to issue a letter of explanation binding for all regional tax authorities (or other similar document, such as methodological guidelines, internal procedure of the STS, etc.), and/or, if necessary, to develop and submit for approval to the Cabinet of Ministers of Ukraine (while the **Cabinet of Ministers of Ukraine** — to approve) a package of amendments to the Procedure No. 1165 to:

8.1.1. Refine and specify list of instances, when taxpayers should be qualified as those which match clause 8 of taxpayers' risk criteria set forth in Annex 1 to the Procedure No.1165 (in particular, it should be specified that this clause can be used only in case of signs of sham business transactions in regard of which a taxpayer issued TIs/ACs to buyers — VAT payers, thus enabling the latter to form a VAT tax credit at the expense of probably "sham" VAT or transfer an allegedly "sham" VAT to third parties);

8.1.2. Establish minimal standards of substantiation (justification) of decisions evidencing adherence of a taxpayer to risk criteria. It should be clearly stated that such decisions must include at least the following information:

— exact sources of tax information used;

— what business transactions are risky, with indication of names of counterparties and their Tax IDs; types of business transactions; codes of types of goods or services;

— reference to specific signs evidencing risky nature of such business transactions.

8.1.3. Determine that decisions of regional level commissions on adherence to risk criteria and on rejection of taxpayers' data tables can be appealed by taxpayers with the STS in accordance with Article 56 of the TCU, and such appeals should be considered under the Procedure No.916, unless a special procedure of their consideration is established by law.

[57] The Council's letter Ref. No. 22192 dated November 29, 2019.

[58] The letter of the STS Ref. No. 11727/6/99-0006-05-01-15 dated December 3, 2019.

COUNCIL'S RECOMMENDATIONS:

9. **The State Tax Service of Ukraine** and **the Ministry of Finance of Ukraine** — to develop and submit to the Cabinet of Ministers of Ukraine, while the **Cabinet of Ministers of Ukraine** — to submit to the Verkhovna Rada of Ukraine the Draft Law of Ukraine introducing amendments to Clause 56.23 of Article 56 of the TCU to directly foresee the possibility of appeal of decisions on adherence with risk criteria and on rejection of taxpayers' data tables in accordance with the procedure set forth in that Clause. After introduction of such amendments to the TCU, — the Procedure No. 1165 should be amended accordingly.

2.4.3 Enforcement of court decisions ordering registration of suspended TIs/ACs

It is worth noting that lawfulness of activities of tax authorities related to SMKOR's functioning were mostly negatively assessed in the judicial practice[59].

Although the Council does not have aggregated statistics on this matter, according to subjective observations of our experts, the vast majority of court cases related to challenging decisions of regional tax authorities' commissions on refusal to register suspended TIs/AC are adjudicated in taxpayer's favor.

[59] In the Ruling of the Panel of Judges of the ACC/SC, dated April 02, 2019 in case No. 822/1878/18 (link: http://www.reyestr.court.gov.ua/Review/80894116) the court concluded that any decisions on registration refusal of TIs/ACs drawn up on based on the Procedure No. 117 were illegal.

However, this conclusion is not final and has not been applied by the Supreme Court in some of its other decisions, in particular, in the Ruling of the Panel of Judges of the ACC/SC, dated June 18, 2019 in case No. 560/3562/18 (link: http://www.reyestr.court.gov.ua/Review/8244718).

Even more noticeable was the decision rendered on June 5, 2019 by the District Administrative Court of Kyiv in case No. 826/12108/18 (link: http://www.reyestr.court.gov.ua/Review/82538197) — left unchanged by the Resolution of the Sixth Administrative Court of Appeal, dated December 10, 2019 in case No. 826/12108/18 (link: http://www.reyestr.court.gov.ua/Review/86273752) and the Decision of the Panel of Judges of ACC/SC, dated March 3, 2020 (link: http://www.reyestr.court.gov.ua/Review/88124778) — which declared invalid the provisions of the legal act specified in Clauses. 10. 20, 21 of the Procedure No. 117, as those that did not adhere with the legal act bearing higher legal force.

FOR REFERENCE

Court practice in cases related to suspension of registration of TIs/ACs

Until January 1, 2019, this category of disputes was not singled out in the USCRD, which hampered collection of statistical information on it.

Starting from January 1, 2019, though, the corresponding "tax invoices registration suspension" category appeared in the USRCD.

As at July 24, 2020, this category of cases with the USRCD comprised some 3711 decisions of administrative courts of first instance; 1669 decisions of administrative courts of appeal instance; and 81 decisions of courts of cassation.

The Council selectively checked the outcome of the first (most recent) 10 court decisions out of 3711 administrative courts decisions of courts of first instance identified based on a respective search query. It turned out that all 10 reviewed court decisions were in favor of taxpayers (claims were fully or largely satisfied).

The Council observes the following key reasons of systemic tax authorities' defeat in their attempts to defend their decisions in courts:

1) the lack of sufficient transparency and justification while determining whether taxpayer (and its TIs/ACs) adhere to taxpayers' risk criteria as well as business transactions' risk criteria; and while making decisions on refusal to register specific TIs /ACs;

2) selected deficiencies in legal framework (some of which, however, have been eliminated with the adoption of the Procedure No. 1165), which allow taxpayers to successfully employ in courts the argument that suspension of TIs'/ACs' registration is, as such, illegal.

Anyway, nowadays, almost every working day courts issue a significant number of decisions obliging the STS to register previously suspended TIs/ACs with the URTI.

According to information from open sources (such as letters issued by the STS[60]) — the number of TIs/ACs registered in accordance with court decisions (including the amount of VAT in such TIs/ACS) are as follows:

1) **In 2018 — 1.4 k TIs/ACs amounting to UAH 110.4 mn of VAT;**

2) **In 2019 — 8.8 k TIs/ACs amounting to UAH 817.6 mn of VAT;**

3) **In the first quarter of 2020 — 4.9k TIs/ACs amounting to UAH 436.1 mn of VAT.**

Overall, according to this statistics, at the end of Q1 2020, 15.1 k of TIs/ACs amounting to over UAH 1.36 bn were registered in accordance with court decisions. At the same time, these statistics include only those court decisions which are already enforced by the

[60] *See* Letter of the STS (outgoing No. 587/ZPI/99-00-08-04-03-10), dated April 10, 2020 and Letter of the STS (outgoing No. 372/ZPI/ 99-00-08-04-01-10), dated March 6, 2020 published by "Yedyna sluzhba pravovoyi dopomohy" (Unified Legal Aid Service) news agency available at: https://3222.ua/newsview/vidnovlennya-reestratsiji-podatkovikh-nakladnikh-za-rishennyam-sudu.html.

SFS/STS. However, according to the Council's observations, enforcement of such court decisions is another problem.

Since mid-2018, the Council has begun receiving significant number of complaints challenging the STS's long-lasting inaction comprising failure to enforce court decisions obliging this authority to register TIs/ACs with the URTI.

Plaintiffs in these cases have formal ground to argue about violation of their rights (also when turning to the Council) almost since the next business day after court decision's entry into force. Indeed, the legislation contains strict (and even to some extent unrealistic) provisions setting forth deadlines for enforcement of such court decisions by tax authorities[61]. Moreover, it would be fair to say that the foregoing legislative provisions have never worked in practice.

Meanwhile, the SFS/STS has developed internal procedures that regulated this issue in more realistic manner[62] (which is generally incorrect, though, as internal documents cannot override legislative acts). Having examined their provisions, the Council ascertained that the realistic time within which the STS's structural divisions can complete all internal procedures aimed at enforcing court decision obliging to register TI/AC is 15-20 working days upon such court decision's receipt by a tax authority.

However, even this quite realistic term is far from being always observed in reality.

Case No. 11. Long-lasting failure to enforce court decision ordering registration of suspended TI with the URTI

In early March 2020, the Council received another typical complaint from attorney-at-law representing the company from Kyiv City working in the sphere of architecture (**"Complainant"**).

A lawyer informed that the STS was reluctant to register a VAT invoice with the URTI, although it had been obliged to do so according to court decision that had entered into force.

Among many similar complaints, this one was taken as an example because of the fact that the court decision entered into force in January 2019.

The entity has not been active for some time on this matter hoping in vain the STS would enforce the court decision voluntarily.

This is a good example illustrating that the mere fact of a court decision's entry into force and the receipt of its copy by the STS does not lead to its enforcement and the TI/AC registration with the URTI— neither immediately nor in a month nor a year later.

[61] In particular, pursuant to Clause 28 of the Procedure No. 117 (was effective until February 1, 2020), the TIs/ACs whose registration is suspended are registered on the same day when court decision ordering registration of TI/AC entered into force. According to paragraph 2 of Clause 19 of the Procedure No. 1246 (still in force), TI and/or AC whose registration is suspended, shall be registered on the same day when court decision ordering registration of TI and/or AC entered into force (in case of the SFS's receipt of the respective decision).

[62] The first wording of the Procedure setting for mechanism of enforcement of court decisions rendered in matters pertaining to registration or cancellation of registration of TIs and/or ACs with the URTI was approved by the *Procedure of the STS, dated June 6, 2018 No. 357*; the second one — by the *Order of the STS No. 65, dated September 6, 2019*.

Only the Complainant's and the Council's and/or state enforcer's proactive approach finally triggered beginning of the process of its enforcement (which, in turn, may also take some time). Thus, on March 25, 2020, the STS replied to the Council's first request dated March 6, 2020, in which it informed that measures aimed at enforcement of the court decision were being taken.

On April 9, 2020, a similar reply of the STS to the Council's second request, dated March 25, 2019, was received.

The Council had to send a third request on 9 April 2020, to which a third similar reply was received on April 27, 2020.

Only in June 2020, the Council successfully completed the investigation of this complaint in view of enforcement of the court decision by the STS.

It is worth acknowledging, though, that most of the court decisions were eventually enforced. In particular, out of 159 such cases closed by the Council at July 24, 2020, some 155 were closed with the successful outcome for the complainant (146 cases — due to the Council's involvement).

At the same time, in the Council's view, the situation — when such court decisions are currently enforced only under permanent pressure and with considerable delays — is unacceptable.

Possible ways of solving this systemic problem can be found in both administrative (improvement of the administrative practice of the STS) and legislative perspective.

The legislative dimension of the problem may include:

1) firstly, the establishment of a reasonable (but not excessive) period for registration of suspended TI/AC based on court decisions in the Procedure No. 1165 and/or Procedure No. 1246;

2) secondly, the introduction into the TCU of a rule entitling the taxpayer (who has been deprived of the right to form VAT tax credit or reduce its VAT tax liabilities and to have its registration limit in the SEA VAT[63] increased during all the time during which the relevant TI/AC was not registered with the URTI), compensation in the form of interests, in the similar way how this issue is currently settled in case of delay in VAT refund[64]. The threat of additional losses of the State Budget, caused by illicit refusal to register suspended TI/AC, should be a significant additional incentive for tax authorities to avoid adoption of such illicit decisions, and, in case of their cancellation by courts — to implement court decisions immediately.

Meanwhile, in the Council's view, the appearance/perception of courts often obliging the STS to register TIs/ACs on sham transactions within which "sham" VAT is transferred, should not justify failure to enforce court decisions.

[63] Matters related to the registration limit in the SEA VAT are described in more detail in the Chapter 2.3 of this Systemic Report and in Annex 2 thereto.

[64] According to paragraph 200.23 of Article 200 TCU, the amount of tax not refunded to taxpayers within the period specified in this article, are considered as a debt of the budget. Interests are accrued on the amount of such debt at the rate equal to 120% of the discount rate of the NBU, established at the time of accrual of interests, during the period of existence of such debt, including the date of its repayment.

Instead, this trend has to prompt the STS to take certain actions. The objective of such actions is to ensure that arguments of tax authorities regarding fictitiousness of business transactions in whose regard TIs/ACs have been issued are duly set forth in the respective decisions, presented and heard by courts in the future.

First of all, from the Council's point of view, detailed court statistics and analytics on outcomes of consideration of such cases should be collected and made public. Not only tax authorities, but also independent experts and civil society are entitled to receive objective information about outcomes of consideration of such cases by courts (because this is the only way to get a full picture of SMKOR's functioning). This matter is addressed in more details in the Chapter 9 of this Systemic Report.

In the Council's view, in order to properly identify origins of judicial practice, the representatives of the STS and regional tax authorities, should deeply investigate the court practice, and, if needed — to conduct inter-agency communication with the ACC/SC.

The STS should prepare a summary of court practice on this category of cases, which would clarify the legal and factual reasons explaining why regional level commissions' decisions on refusal to register suspended TIs/ACs are most often recognized by courts as unlawful and canceled.

Having identified origins of current court practice, the STS would be able to take steps to eliminate common reasons why courts take negative decisions in most cases.

In the Council's view, such efforts should be primarily focused on improving the regional and central level commissions effectiveness (more substantive reasoning of decisions, etc.), as well as on improving the quality of representation of tax authorities in courts in such cases.

COUNCIL'S RECOMMENDATIONS:

To respond to a significant number of disputes lost by tax authorities in cases where regional commissions' decisions on refusal to register suspended TIs/ACs are contested, as well as the widespread phenomenon of failure to timely enforce court decisions in such cases, the Council recommends as follows:

10. **The State Tax Service of Ukraine** and **the Ministry of Finance of Ukraine** — to develop and submit for approval to the Cabinet of Ministers of Ukraine, while **the Cabinet of Ministers of Ukraine** — to approve draft amendments to the Procedure No. 1165 and/or Procedure No. 1246, which would introduce a deadline within which suspended TI/AC must be registered with the URTI in accordance with the court decision. Such a term should be reasonable (to allow the STS to ensure its strict following) and should not exceed 15 calendar days from the date when the court decision enters into force. After such amendments entered into force, all episodes of missing the specified deadline shall be the basis for carrying out official internal investigations by the STS and bringing guilty persons to liability.

11. **The State Tax Service of Ukraine** and **the Ministry of Finance of Ukraine** — to develop and submit to the Cabinet of Ministers of Ukraine, while **the Cabinet of Ministers of Ukraine** — to submit to the Verkhovna Rada of Ukraine the Draft Law of Ukraine introducing amendments to the TCU, which will vest the taxpayer with the right to receive from the State Budget of Ukraine interests at a rate equal to 120% of the discount rate of the NBU, established at the time of accrual of interests, for the entire period during which such a taxpayer was unlawfully deprived of a right to form VAT tax credit or reduce its VAT tax liabilities, and to have the amount of its registration limit in the SEA VAT increased accordingly, due to illicit refusal to register suspended TI/AC with the URTI. Interests should be accrued from the date of entry into force of the decision of the relevant Commission on refusal in registration of TI/AC till the day when TI/AC is actually registered with the URTI on the basis of a court decision.

12. **The State Tax Service of Ukraine** — to prepare a summary of court practice of the ACC/SC in this category of cases, which would describe legal and factual reasons why regional level commissions' decisions on refusal to register suspended TIs/ACs are usually recognized by courts as unlawful and cancelled.

13. **The State Tax Service of Ukraine** — to develop and publish the Action Plan to address widespread (systemic) grounds for which numerous illegal decisions are made by regional level commissions subsequently cancelled by courts. Such action plan may include:

    13.1. measures aimed at improving regional and central level commissions effectiveness (more substantiated reasoning of decisions, etc.);

    13.2. measures aimed at improving the quality of representation of tax authorities in courts in such cases;

    13.3. initiating amendments to legislative provisions, which are vague, inconsistent, or ambiguous.

2.5 VAT-related tax audits

VAT has always attracted a lion's share of attention in the course of tax control.

In June 2020, as part of the work on this System Report, the Council's staff analyzed in detail the topics of 838 complaints received by the Council related to tax audits, and found that 710 of the analyzed complaints (85%) affected, *inter alia*, VAT issues.

Like any tax audit, VAT-related audits generally have the same common problems and disputed issues. They will be covered in details in Chapters 6-7.

This chapter, though, will address the problem now frequently raised by Ukrainian businesses — why "traditional" VAT tax audits not disappeared at all, or not became extremely rare after the introduction of the SMKOR?

Businesses did not forget that while introducing SMKOR, the legislator also introduced the principle of "indisputability" of the VAT tax credit confirmed by registered TIs/ACs[65].

For the proper understanding of the meaning and purpose of this provision it is important to recall that it was introduced on January 1, 2017 by the *Law of Ukraine "On Introducing Amendments to the Tax Code of Ukraine Aimed at Improving Investment Climate in Ukraine", dated December 21, 2016, No. 1797-VIII* (**"Law No. 1797-VIII"**) — thus laying down the legislative framework for SMKOR's creation.

In the past tax legislation had already defined existence of TI registered with the URTI by a supplier as a prerequisite for forming VAT tax credit (although did not guarantee it). Hence, it is logical that the inclusion of additional provision in the legislation that defined TI as a sufficient ground for forming VAT tax credit was perceived by business in such a way that (simultaneously with launching SMKOR) it effectively introduced the principle of "indisputability" of VAT tax credit confirmed by registered TIs/ACs.

Even in the Explanatory Note to the Draft Law No. 5368, dated November 7, 2016 *(which subsequently became the Law No. 1797-VIII) it was stated on: "impossibility of canceling VAT tax credit confirmed by a tax invoice/adjustment calculation, issued and registered with the Unified Register of Tax Invoices after July 1, 2017"* [66].

If, even despite this argument, someone continued having doubts as to the meaning of this provision, such doubts should have disappeared when the *Law of Ukraine "On Introducing Amendments to the Tax Code of Ukraine and Laws of Ukraine Aimed at Ensuring the Balance of Budget Revenues in 2018", dated December 7, 2017 No. 2245-VIII* suspended it simultaneously with the temporary suspension of SMKOR's functioning for the period of its improvement from January 1 to March 22, 2018 (i.e. *"no SMKOR — no indisputable VAT tax credit"* principle was effectively applied).

Yet, from the outset for many experienced Ukrainian tax law practitioners it was hard to believe that with the start of the era of SMKOR tax authorities would completely abandon such an inherent instrument as tax audits to scrutinize the legitimacy of VAT tax credit's formation.

This premonition proved to be right this time as well.

Already in November-December 2017[67] official explanations appeared in open sources, from which it followed that, in the opinion of tax authorities, "indisputability" of VAT tax credit confirmed by registered TIs/ACs does not exist.

The Committee on Tax and Customs Policy of the VRU of previous convocation acknowledged in its letter[68] that in its practice the SFS alters the essence of this TCU provision resulting in violation by tax authorities of taxpayers' legal rights to form VAT tax credit. But even position of key parliamentary committee did not change the practice.

The Council also observed that the principle of "indisputability" of the VAT tax credit does not really work in practice shortly after SMKOR was launched. This conclusion can be illustrated by many cases.

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[65] We refer to the provisions of paragraphs 2 and 3 of Clause 201.10. of Article 201 of the Tax Code: "The tax invoice issued and registered with the Unified Register of Tax Invoices by the taxpayer performing transactions on supply of goods/services shall be the ground for the buyer of such goods/services to claim tax amounts related to tax credit.

The tax invoice and/or the adjustment calculation thereto, issued and registered after July 1, 2017 with the Unified Register of Tax Invoices by a taxpayer performing transactions on the supply of goods/services, shall be sufficient for the buyer of such goods/services to include respective amounts of VAT to the VAT tax credit and shall not require any other additional proof.".

[66] Explanatory Note is available on the Verkhovna Rada of Ukraine website at: http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=60443

[67] In particular, we refer to the letter of the STS, dated November 29, 2017 No. 35/99-99-11-04-04-18 and the letter of the MoF, dated November 8, 2017 No. 11310-09-10/30469.

[68] Letter of the VRU Committee, dated October 4, 2018, No. 04-27/10-614.

Case No. 12. Large grain trader and its relentless saga with confirmation of VAT tax credit received from allegedly "dubious" counterparties

In early April 2019, a large exporter of agricultural products — belonging to the worldwide known group of companies (**"Complainant"**) — approached the Council seeking help.

The complaint related to TNDs for the amount exceeding UAH 3.5 mn issued by the OLT, by which the exporter was denied VAT refund due to non-recognition of the VAT tax credit received from three "dubious" suppliers. At the same time, the tax authority did not state the Complainant's suppliers were sham businesses. Fiscal authority's representatives also had no doubts in reality of transactions of purchase of agricultural products (which were later exported). Nonetheless, tax authority's officials stated that agricultural products had an "unknown origin" (i.e., having analyzed the entire supply chain tax authorities could not identify the manufacturer of agricultural products). It looked quite obvious that some of traders-intermediaries in the chain of supply purchased products on the "black market" and converted the funds received from customers into cash. However, there was no evidence that the exporter (i.e., the Complainant) could be directly involved.

The situation was bitterly "flavored" by the fact that all TIs/ACs issued by the Complainant's suppliers passed SMKOR's automatic monitoring and were registered with the URTI. The tax officials, however, ignored the Complainant's remarks that in such circumstances its VAT tax credit should be considered "indisputable".

It is not the first time the Complainant approached the Council with a similar complaint. This complaint was the eighth one, to be exact (and, as it turned out, not the last one). The previous seven complaints on a similar topic were lodged with the Council in 2016-2018.

The USRCD was abundant with information on numerous disputes between the Complainant and the OLT on such issues. Out of 13 such cases that the Council identified, only 2 were resolved by courts in favor of the tax authority (and even that decisions were still challenged in courts of higher instance).

On April 26, 2019, after considering the Council's proposals, the STS canceled disputable TNDs. It is worth noting that the reason for their cancellation was not the "indisputability" of the VAT tax credit — apparently it was "incomplete investigation of relevant circumstances in course of tax audit".

That Complainant's victory proved to be Pyrrhic. After all, the SFS conducted new tax audit on the same issue, and on September 30, 2019, new TNDs worth over UAH 2.7 mn appeared as a follow-up (additional accruals were made based on relations with 2 out of 3 "doubtful" suppliers).

Only after the Council's second involvement, on December 6, 2019, these new TNDs were completely canceled by the STS.

Meanwhile, on December 9, 2019, a new complaint on a similar subject were received by the Council (and another one — on March 2, 2020).

The foregoing case is vivid, but not unique example of the Council's practice proving that any "indisputability" of VAT tax credit in reality does not exist.

Moreover, we have to reject the assumption that cases observed by the Council are rare. Indeed, if it were to be true, the situation would not cause much concern in business environment. However, such concern exists and are quite grave[69].

In the Council's view, no matter how badly some tax officials want to simultaneously use all available methods and tools for combating illegal VAT "schemes", their attempt to "sit on all chairs" trigger increased distrust of business in the State and predictability of its tax policy as well as worsened investment climate.

Thus, if a key emphasis in the area of control over VAT taxation was decided to be placed on SMKOR's functioning, the State has to practically (not just declaratively) ensure compliance with the principle of "indisputability" of VAT tax credit at least for those TIs/ACs that successfully passed SMKOR automated monitoring, or that have been registered with the URTI based on decisions of the corresponding commissions under tax authorities or rendered by courts.

If business community weren't feel any advantages of modern methods of tax administration (such as reduced burden of tax audits and simplified process of VAT refund), — it is unlikely that it will agree with assurances of representatives of the respective state institutions that these alleged advantages outweigh obvious inconveniences (the latter are discussed in detail in Sections 2.2-2.4).

A growing firm resistance to the very idea of existence of such tools as the URTI, SEA and SMKOR may sooner or later result in a full or partial waiver of these mechanisms against the backdrop of populist processes in the state tax policy which arise occasionally in any country.

Hence, the Council encourages the State to change its approach to the concept of VAT tax credit's "indisputability" (paragraphs 2 and 3 of Clause 201.10 of Article 201 of the TCU) towards the one being more loyal to taxpayers (which, in the Council's view, was laid down in this norm from the outset).

Impossibility to reduce VAT tax credit as a result of tax audits should be clearly regulated in the internal documents of the STS (such as, in particular, *Recommended procedure for the interaction of SFS units in the complex testing of tax risks with VAT, approved by the order of the SFS dated July 28, 2015 No. 543* (**"Procedure No. 543"**) or its equivalent).

In addition, to eliminate any doubt about application of this norm, in the Council's opinion, the TCU can be supplied with the provision like: *"The VAT tax credit confirmed by the TI/AC, registered with the URTI during the period of application of Clause 201.16 of this Code, may not be reduced by a tax authority based on tax audit findings"*.

During the preparation of this Systemic Report, representatives of the STS provided comments, based on which such a limitation (in the form of applying the principle of indisputability of the VAT tax credit formed on the basis of TI/ACs registered with the URTI) will unjustifiably reduce possibilities to effectively respond to VAT fraud by means of tax control and criminal prosecution. Representatives of the STS also noted that decisions of tax authorities on accrual of VAT tax liabilities or decrease of the negative value of VAT are subject to judicial review, and therefore — current legislation provides a sufficient level of protection of rights of the taxpayer.

The Council understands the position of the STS, as it is aware that practical implementation of the principle of indisputability of the VAT tax credit confirmed by registered TI/ACs would simplify life not only for real business. A side effect of such an approach would be granting fraudsters

[69] For example, on April 16, 2020, the American Chamber of Commerce's in Ukraine Tax Committee drafted a position paper addressing this issue.

who managed to register TI/ACs issued within sham business transactions with the URTI, using certain loopholes and shortcomings in the work of SMKOR, with full indulgence and immunity from liability.

The Council also understands that a situation in which SMKOR-related instruments will remain the only available to tax authorities to respond to possible VAT abuses, may sometimes create more inconveniences for businesses than benefits. For example, inability to go through a tax audit and selectively challenge a "doubtful" VAT tax credit or accrue additional VAT liabilities to a particular taxpayer may prompt the tax authority to include that taxpayer in the list of risky taxpayers. Such step, in turn, will lead to suspension of registration of almost all TI/ACs issued by such a taxpayer by the SMKOR. Such a scenario is much more stressful for the business than a regular tax dispute based on the results of a tax audit.

Meanwhile, in the opinion of the Council, the difficult dilemma behind the principle of indisputability of the VAT tax credit should be a concern of the legislator, and deserved to be the subject of thorough analysis before the relevant rule was included in the TCU. But since this norm is already in the law, the Council cannot support the idea of ignoring it or interpreting it clearly contrary to its essence and purpose, even for reasons of protection of public and state interests.

If the experience accumulated during last years shows that the concept of indisputability of the VAT tax credit proved to be unviable, because it was based on unjustified overestimation of the filtering ability of the SMKOR (which in practice is not able to stop 100% of "sham" VAT and objectively requires “a second line of defense” in the form of post-SMKOR-control) — it is the legislator who must recognize this reality and address it by making appropriate amendments to the TCU. For example, it can be clarified that the VAT tax credit, even confirmed by the TI/AC registered with the URTI, can still be challenged if the criminal offence discovered committed by persons involved in the preparation, registration or receipt of such TI/AC, as well as in preparation of primary documents on business transaction to which this TI/AC relates.

However, such a step can be reasonably perceived by the business community as a kind of "unfair game" on the part of the state: while in 2017 the state introduced SMKOR "in one box" with an indisputable VAT tax credit, let’s imagine that in 2021 it officially cancels indisputability (which in practice did not work anyway), while leaving the SMKOR in place. To reduce such a negative perception, in view of the Council, legislative amendments that adjust the principle of indisputability of the VAT tax credit (if such are planned) should be balanced by certain amendments that are clearly favorable for business (many suggestions for such amendments, by the way, can be found throughout this System Report).

As long as the current version of paragraph 201.10 of Article 201 of the TCU will remain in force, the Council sees no other option but to continue to insist on its compliance not only during judicial review of tax disputes, but also in the administrative practice of tax authorities (in particular, in the framework of tax audits).

COUNCIL'S RECOMMENDATIONS:

To practically implement the principle of "indisputability" of VAT credit confirmed by TIs/ACs registered with the URTI during the period of SMKOR's functioning (paragraphs 2 and 3 of clause 201.10 of Article 201 of the TCU), the Council recommends as follows:

14. The State Tax Service of Ukraine and Ministry of Finance of Ukraine:

14.1. Revoke the SFS's letter dated November 29, 2019, No. 35/99-99-11-04-04-18, the letter of the Ministry of Finance dated November 8, 2017, No.11310-09-10/30469 and other similar explanatory and informational documents denying principle of "indisputability" of the VAT tax credit confirmed by TIs/ACs registered with the URTI during the period of SMKOR's functioning.

14.2. Issue a new explanatory letter — and introduce amendments to respective sources of secondary legislation and internal rules and regulations of the STS (including the Procedure No. 543 or a more recent equivalent) — to expressly acknowledge that the taxpayer's VAT tax credit confirmed by the TI/AC registered with the URTI during the period of the SMKOR's functioning cannot be reduced based on tax audit's findings.

15. The State Tax Service of Ukraine and the Ministry of Finance of Ukraine — to develop and submit to the Cabinet of Ministers of Ukraine, while the Cabinet of Ministers of Ukraine — to submit to the Verkhovna Rada of Ukraine the Draft Law of Ukraine on introducing amendments to the TCU, which would establish that the amount of VAT tax credit confirmed by TIs/ACs registered with the URTI during the period of validity of para 201.16 of the TCU — cannot be reduced by tax authority based on tax audit findings, with exceptions directly stipulated by the TCU (which, if stipulated, may include the case of discovering a criminal offence committed by persons involved in the preparation, registration or receipt of such TI/ACs, as well as the preparation of primary documents confirming business transactions to which such TI/ACs relate).

2.6 VAT refund

VAT refund have traditionally been the most problematic aspect of administering this tax in Ukraine.

Since launch of operations and as at 01.07.2020, the Council received a total of 215 complaints on VAT refund related issues.

As at July 24, 2020, out of 187 complaints accepted into the Council's consideration, 152 cases (81.28 %) were closed with successful outcome for the complainants due to the Council's involvement; in 3 cases (1.6%) success was achieved irrespective of the Council's intervention; in 29 cases (15.5%) the investigation was discontinued without successful outcome; and in 3 cases (1.6%) the Council found complaints unsubstantiated or materially unsubstantiated and dismissed them.

As at the same date, investigation of 64 complaints of this category was completed with the issuance of the Business Ombudsman's recommendations subject to further monitoring. In 6 cases implementation of recommendation is still being monitored.

Amongst those 58 recommendations, whose monitoring have been completed, some 45 (77.59%) were implemented, while monitoring of 13 recommendations (22.41%) was ceased without implementation.

The dynamics of complaints received in this category quite accurately illustrates the level of "painfulness" of this issue for Ukrainian business.

Number of complaints regarding VAT refund

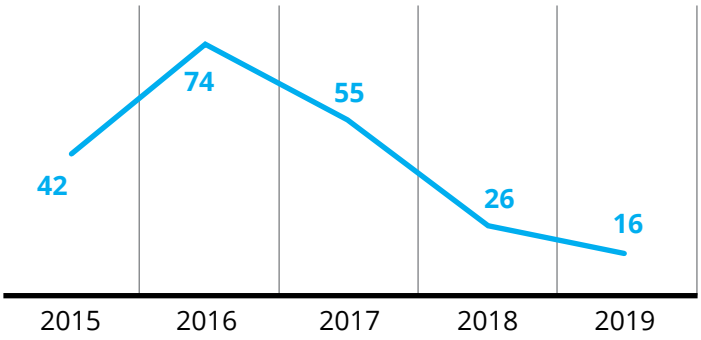

Fig. 6.
Number of complaints related to delay of VAT refund received by the Council (ongoing disputes challenging denial of VAT refund based on findings of tax audits are not included in this category).

Given the increasing relevance of issues related to VAT refund between 2015 and 2016, it is not surprising that a substantial part of the Council's recommendations set forth in the Previous Report dealt with the VAT refund.

Meanwhile, since the time of publication of the foregoing systemic report, Ukraine has made a big step forward in the field of VAT refund.

To make the statistical picture full, it is worth noting that some of issues related to VAT refund faced by the Council, are "hidden" in another category of complaints — complaints related to tax audits (the number of complaints the Council receives in this category is stable). In particular, taxpayers often get unjustified refusals in VAT refund as a result of tax audits. This issue has already been covered in more detail in Section 2.5.

But even in view of this aspect, it is impossible to deny that the relevance of the VAT refund issue for Ukrainian business has indeed decreased.

And indeed, statistics, — which is regularly published by the STS and regional tax

authorities[70] to illustrate significant improvement of the situation with VAT refund in recent years, — looks quite impressive and valid.

It is encouraging that the recommendation set forth in the Previous Report which provided that Ukraine's state budget should reflect the net VAT (i.e. the difference between revenues from VAT and the cost of VAT refund) is being continuously implemented. In particular, starting from 2016, the planned VAT revenues from goods (works, services) produced in Ukraine are shown in the state budget as a net balance between tax collection and its refund. Similarly, the STS mainly uses net VAT in its official analytics and statistics.

Despite all these positive changes, certain issues which cause problems for business connected with VAT refund still exist and are worth mentioning below in this section.

2.6.1 Temporary Register

The Council cannot ignore the “ghost of the past” preventing Ukraine from finally turning over the previous page of VAT refund history — the issue of a "frozen" VAT refund for the past periods, which representatives of the State promise for a long time, but still do not dare to settle.

Much has been said and written, including by the Council’s experts[71], about the infamous Temporary Register of Applications on VAT Amount Refund, lodged prior to February 1, 2016 in whose regard VAT is not refunded as at January 1, 2017 (**“Temporary Register”**). According to the law, the Temporary Register had to be created back on January 1, 2017. But it has never been completely filled and still does not work[72].

The European Business Association, one of the founding associations of the Council, is constantly reminding publicly[73] about this old problem faced in reality for many businesses. The Council is fully like-minded on this matter.

Complaints on this subject were, perhaps, the most “hopeless” of all the Council had ever considered.

In respect of many of these complaints the Council had to discontinue investigations without a positive outcome for complainants (on various grounds, including due to the lawsuits filed by complainants, sometimes — in the second or third time); while investigation of many complaints resulted in the issuance of the Council’s individual recommendations, whose implementation is still being monitored.

[70] Links to examples of such materials:

Article “New STS Fighting with VAT Minimization Schemes in Figures”, published on November 15, 2019 in the “Bulletin of the State Tax Service of Ukraine”: http://www.visnuk.com.ua/uk/news/100015254-borotba-novoyi-dps-iz-minimizatsiynimi-skhemami-v-sferi-pdv-u-tsifrakh;

Article “UAH 33.6 bn of VAT Refunded to Big Business in 2019”, published on April 5, 2019 in “Bulletin of the STS”: http://www.visnuk.com.ua/en/news/100011845-33-6 -mlrd-grn-vidshkodovano-pdv-in-2019-rotsi-big-business

[71] Link to Andrii’s Bodnarchuk (one of the Council’s investigators) publication: https://nv.ua/eng/biz/experts/chi-zapracyuye-timchasoviy-reyestr-vidshkoduvannya-pdv-2471845.html

[72] Links to the Temporary Register in its current form: https://cabinet.tax.gov.ua/registers/vat-refund https://mof.gov.ua/uk/vat-refund/results?page=2020

[73] Links to publications describing EBA’s efforts in this area: https://eba.com.ua/vidsutnist-opublikovanogo-tymchasovogo-reyestru-ye-porushennyam-zakonodavstva/, https://interbuh.com.ua/ua/documents/onenews/128571

Case No. 13. The company has not yet received UAH 5 mn of VAT refund due for February 2015

Investment company from the Kyiv City (**"Complainant"**) approached the Council.

In May 2015, based on tax audit findings, the Complainant's right to receive VAT refund due for February 2015 exceeding UAH 5 mn was confirmed. The tax authority sent a so-called "conclusion" required to proceed with the refund to the oblast Division of the State Treasury Service of Ukraine. But this conclusion was returned due to the reported lack of aggregated information on sums of VAT refund throughout Ukraine.

By June 2017, when the Complainant turned to the Council, the refund was still not paid. In October 2017, the Council recommended the SFS to take actions to solve the problem. As at the end of July 2020, the recommendation is still pending.

The issue is discussed from time to time at the meetings of the joint expert group comprising representatives of both the Council's and the STS/SFS. However, there is no visible progress.

In an effort to break the deadlock, the Council in its Previous Report has made quite a radical step and recommended to treat non-refunded VAT amounts as domestic state debt and start negotiations on its restructuring with taxpayers. This systemic recommendation of the Council was not implemented and the Council eventually had to a look for other ways of solving the problem.

Over the past years, state authorities periodically referred the Council to "life-saving" draft laws and other initiatives aimed at resolving issue of the "old" VAT refund. None of the initiatives, however, were completed.

Many taxpayers have succeeded in finding the way to get "long-awaited" VAT refund by going to courts (usually they had to do it more than once). A legal conclusion issued on February 12, 2019 by the Grand Chamber of the Supreme Court in its Decision in the case No. 826/7380/15 only contributed to this solution[74].

In particular, the Grand Chamber of the Supreme Court concluded that such remedies as the tax authority's obligation to issue a conclusion confirming VAT refund amount the taxpayer had claimed; or to enter a company's application in the Temporary Register are not effective when it comes to proper restoration of the taxpayer's right. In view of this, the Grand Chamber of the Supreme Court concluded that the effective remedy, which would ensure the restoration of the infringed claimant's right, was to collect both the debt (VAT refund) as well as the fine accrued on the amount of such debt, from the State budget in favor of the company.

[74] Link: http://reyestr.court.gov.ua/Review/80427413

This new (and certainly progressive, in the Council's opinion) court practice is currently followed by courts of lower instance when considering new claims[75], as well as by the ACC/SC while reviewing existing decisions within the cassation procedure[76].

Although the Council encourages complainants to be proactive and use this new opportunity, we have to admit that going to court (especially in a second or third time with the same issue) is a taxpayer's right, but not a prerequisite for the receipt of VAT refund which such taxpayer is anyway entitled to receive in accordance with the law.

The Council cannot acknowledge as correct one decision to permanently leave "in limbo" many of those VAT payers that have not yet received actual refund despite securing interim court decisions in their favor (i.e., obliging tax authority to issue a conclusion confirming refund of specific VAT amount claimed by the taxpayer; or to enter a taxpayer's application with the Temporary Register).

Therefore, the Council has to raise this issue again and recommend the respective state bodies to resolve it.

2.6.2 VAT Refund Register

Even though business recognizes significant improvement in the situation with VAT refund in 2017-2020 — when the new Register of applications for refunds of VAT from budget (**"VAT Refund Register"**) started to work — some aspects do not allow to call this matter completely resolved.

The tax authorities still have the right to conduct tax audits to check the legality of formation of VAT amounts claimed for refund. They actively use this right (slightly more details in this regard — in the Section 2.5 above). As a result of such audits, tax disputes arise sometimes, which have to be resolved by courts. This phenomenon appears to be inevitable, and should be perceived by business as one of the risks inherent for economic activity.

Meanwhile, it is very important to ensure that VAT refund is paid promptly following court's resolution of the matter in taxpayer's favor.

After all, such a rule is provided for by the TCU. In case of entry into force of a court decision canceling the TND on the reduction of amount of VAT refund, such an amount is considered agreed and is due to be paid.

Unfortunately, based on the example of several cases from its practice, the Council found that not infrequently tax authorities "do not know how to lose". Even after a decision has been rendered in taxpayer's favor by the court of appeals, tax authorities tend to submit cassations. Lodging cassations is their right, which cannot be limited. Besides, they cannot be limited in asking the court of cassation to suspend the execution or effect of the contested court decisions. However, it is impossible to accept the fact that tax authorities treat an ongoing cassation process as an unconditional ground for not refunding VAT (even if the court of cassation has not suspended enforcement or effect of the impugned court decisions).

[75] Example: http://www.reyestr.court.gov.ua/Review/88645701

[76] Examples: http://www.reyestr.court.gov.ua/Review/88627805, http://www.reyestr.court.gov.ua/Review/88575450

Case No. 14. The company's VAT refund is delayed due to the ongoing cassation process

In March 2018, small agricultural firm from Lviv oblast (**"Complainant"**) approached the Council to challenge its failure to receive VAT refund due for January 2017 in the amount being equal to UAH 816,000. Meanwhile, the court decision cancelling the TND — which was made based on the outcomes of the tax audit and confirming that VAT amount claimed for refund has been legitimately formed — came into force in October 2017. The tax authority filed a cassation against this decision. However, the court of cassation refused to satisfy the tax authority's motion to suspend the effect of the contested court decision.

Based on the answers received from the tax authorities of both levels (MD SFS in Lviv oblast and SFS) it turned out that the latter do not see the possibility of paying VAT refund until the end of the cassation process.

Moreover, it turned out that — in case of existence of data on ongoing cassation proceeding in the relevant court case — technical settings of the ITS "Tax Block" actually block the possibility of entering information with the VAT Refund Register specifying agreed amount of VAT refund.

At the end of 2018, the Council had to stop monitoring the implementation of its recommendation in this case due to discovering that the Complainant, getting tired of meaningless dialogue with the tax authority, went to court again. This time, the company asked the court to oblige the tax authority to enter the relevant data with the VAT Refund Register.

In February 2019, a court decision came into force in this second court case, also in favor of the taxpayer. The attempt of the tax authority to challenge it in the court of cassation was unsuccessful.

According to the VAT Refund Register, the long-suffered amount of VAT was finally refunded to the Complainant only in July 2019, and even then not completely.

The Council was concerned by the discovery that the algorithms of computer programs that ensure operation of the new VAT Refund Register are based on a legally incorrect approach, according to which an ongoing cassation process is an obstacle for the payment of VAT refund.

Whereas this approach has nothing in common with current Ukrainian legislation, the Council insists that the relevant algorithms should be adjusted accordingly.

COUNCIL'S RECOMMENDATIONS:

In order to resolve issues with VAT refund currently faced by businesses, the Council recommends as follows:

16. The Ministry of Finance of Ukraine and the State Tax Service of Ukraine:

16.1. to complete filling the Temporary Register of Applications for VAT Amounts Refund submitted prior to February 1, 2016 in whose regard as at 1 January 2017 the VAT has not been refunded;

16.2. to ensure including expenditures necessary to refund foregoing amounts of VAT to the draft State Budget of Ukraine for 2021 (and, if necessary — in the subsequent years) to be submitted to the Cabinet of Ministers of Ukraine (while **the Cabinet of Ministers of Ukraine** — to ensure preservation of such expenditures in the version of the draft State Budget of Ukraine submitted to the Verkhovna Rada of Ukraine).

17. **The Ministry of Finance of Ukraine** and **the State Tax Service of Ukraine** — to ensure adjustment of technical settings of ITS "Tax Block" (and other automated systems) to ensure that information on amounts of VAT refund agreed by results of adjudication is entered into with the VAT Refund Register immediately after entry into force of the relevant court decision, regardless of the cassation process (except cases where the court of cassation by its ruling suspended the effect or enforcement of the court decision).

3 UNIFIED SOCIAL CONTRIBUTION

The Unified Social Contribution (**"USC"**) is indeed a unique category in Ukraine's tax legislation. In particular, debt accrued under the USC is almost never subject to write-off[77]; limitation period is not applicable to calculation, use and enforcement against arrears amounts, fines and penalties under the USC[78]; whereas notice to pay a debt (arrears) under the USC bears the status of an enforcement document[79]. As a result, the obligation to redeem arrears under the USC and pay respective fines may, sometimes, arrive quite unexpectedly and "rise up from the ashes". The main reason for such a phenomenon is selected deficiencies of the legal framework and/or practice of its application. The following explains this in more detail.

The above statement is backed up by the fact that for over five years of operations, out of 7379 complaints received by the Council as of July 1, 2020, the issue of USC administration was investigated in 162 complaints (3.8% of the total number of tax related complaints). Most of them are complaints lodged by IEs, for whom arrears amounts received are extremely considerable.

At the same time, it should be noted that the first half of 2020 was marked by a great progress aimed at solving some of problems business faces in respect of USC administration. Particularly, the issues of the USC "double" payment, exemption of the general taxation system entrepreneurs from the obligation to pay the minimum USC in case of non-receipt of income, bringing administrative appeal deadlines in this area in line with the TCU, etc. are now being settled.

Therefore, the Council will further focus on the description of those USC problems of administration, which, in its view, are faced by domestic business from year to year and solution of which is practically impossible at the law enforcement level. Thus, the Council will first describe the issue of USC accrual to entities, who were once registered as entrepreneurs, but did not re-register in the Unified State Register of Legal Entities and Individual Entrepreneurs (**"USR"**) back in the days and, therefore, believed that their entrepreneurial status was automatically lost, however, they were still registered with the tax authorities for all that time (Section 3.1). This will be followed by an analysis of situations related to the USC benefits, namely: when an entity erroneously defines his/her obligation to a unified contribution and, having the benefit, is deprived of any opportunity to correct the submitted reports (Section 3.2), as well as when it comes to exemption from USC payment on the territory of the anti-terrorist operation (Section 3.3). The Council will then look into analysis of the set of issues on the procedure for determining, agreeing and adjusting USC arrears amounts (Section 3.4). Finally, at the end of the chapter the Council will provide recommendations, which, in its view, will contribute to resolving the issues covered.

[77] Except for cases concerning full liquidation of a legal entity or death of an individual entrepreneur, declaring him/her disappeared, incapacitated, deceased or absence of a person, who bears obligation to pay USC under this Law (*see* Part 7 of Article 25 of the USC Law).

[78] *See* Part 16 of Article 25 of the USC Law.

[79] *See* paragraph 5 of Part 4 of Article 25 of the USC Law.

3.1 Charging persons about whom data is absent in the USR with the USC

The USC has become actively discussed in the public domain relatively recently — i.e., since January 1, 2017, when obligation to charge and pay the USC by IEs ceased to be dependent upon the fact of receipt of any income or profit from carrying out entrepreneurial activity[80]. Since then, the minimum monthly amount of USC payable by entrepreneurs was introduced as follows:

in 2017 — UAH 704/per month;

in 2018 — UAH 819,06/per month;

in 2019 — UAH 918,06/per month; and

in 2020 — UAH 1039,06/per month.

Since then persons, who might have not been carrying out entrepreneurial activity for more than 12 years but failed to properly document closure of their business (whether due to their own fault or negligence on the part of state registrars) started receiving the so-called "chain letters" with the payment notices on debt (arrears) under the USC along with the decisions to impose fines and penalties.

In order to ascertain why this happened, it is necessary to take into account that the state policy in the sphere of state registration was not always consistent. To summarize, the legal framework evolution in this sphere was made up of the following 5 consecutive stages:

1) **Post-Soviet Stage** — captures legal framework that existed prior to the *Law of Ukraine "On the State Registration of Legal Entities and Individual Entrepreneurs" No.755-IV dated May 15, 2003* (**"Law No.755"**). At that time, state registration of entrepreneurial activity was conducted with the executive committees of district and city councils[81]. Centralized recording of businesses was facilitated by creation of the State Register of Reporting (Statistical) Units of Ukraine[82], later succeeded by the Unified State Register of Enterprises and Organizations of Ukraine (**"USREOU"**)[83,84].

2) **Centralization Stage** — is caused by the Law No.755 entry into force on July 1, 2004, and creation of the Unified State Register of Legal Entities and Individual Entrepreneurs

[80] *See* paragraph 2 of clause 2, clause 3 of Part 1 of Article 7 of the USC Law (in the wording that existed prior to June 3, 2020).

[81] *See* Part 1 of Article 8 of the *Law of the Ukrainian Soviet Socialist Republic (afterwards — the Law of Ukraine) "On Entrepreneurship" No.698-XII dated February 7, 1991*.

[82] *See Regulation "On the State Register of Reporting (Statistical) Units of Ukraine", approved by the Resolution of the CMU No.538 dated July 14, 1993.*

[83] *See Regulation "On the Unified State Register of Enterprises and Organizations of Ukraine", approved by the Resolution of the CMU No.118 dated January 22, 1996.*

[84] These registers were primarily formed to facilitate classification of business entities required for conducting statistical examination of structural changes in economy, occurring in course of their creation, reorganization and liquidation. The focus of the USREOU on collection of statistical information is also confirmed by the current mechanism of state registration of business entities at that moment, which provided for the obligation of the registering authority to submit information on economic entity's registration to the state statistics authority within ten days. (Article 8 of the *Law of Ukraine "On Entrepreneurship" as amended on December 22, 1995*) (*follow the link:* https://minjust.gov.ua/m/str_9998).

("**USR**"). Pursuant to the new legal framework, state registration of legal entities and IEs was treated **as entering respective entries into the USR**[85]. That is why in course of 2004-2005, upon receipt of registration cards lodged by legal entities and IEs, state registrars were obliged to replace previously issued registration certificates with the new ones following a unified template[86].

3) **Final Stage** — establishes clear deadlines for completing final update of the USR's data and specifying legal status of outdated registration documents.

   In particular, the *Law of Ukraine "On Introducing Amendments to the Law of Ukraine "On State Registration of Legal Entities and Individual Enterpreneurs" Aimed at Simplifying the Mechanism of State Registration of Termination of Businesses" No.2390-VI dated July 1, 2010* (the **"Law No.2390"**) envisaged that the process of recording data with the USR on legal entities and individual entrepreneurs, registered prior to July 1, 2004, **must be completed by them a year after this Law entering into force — by March 3, 2012**[87]. After this date registration certificates of these persons issued with the use of old forms and prior to July 1, 2004, **are deemed invalid**; whereas obligation to take inventory of entities data about whom was still not included in the USR, remains to be vested with bodies of executive power and municipalities, responsible for preparation of analytical information for temporary inter-governmental special commissions[88].

   Hence, after March 3, 2012, the State asserted the obligation to enter data into the USR about legal entities and IEs registered before July 1, 2004, whose registration was not properly terminated[89].

4) **Reverse Stage** had to be launched as practical implementation of the previous stage, i.e., provisions of the Law No.2390 restrictive in time, turned out to be partially impossible[90]. Hence, it was decided to abandon the idea of March 3, 2012, being the deadline for entrepreneurs to ensure that data about them is being duly entered into the USR; whereas activities aimed at filling the USR with the data about such businesses were extended for an indefinite period of time.

   Hence, the new *Law of Ukraine "On Introducing Amendments to Certain Laws of Ukraine to Ensure Entering Data About Existing Legal Entities and Individual Entrepreneurs with the Unified State Register" No.1155-VII dated March 25, 2014*, obliged all existing legal entities and IEs, created and registered prior to July 1, 2004, to lodge a registration card with a state registrar to

[85] As such, the Law No.755 introduced the mechanism of unity of information about legal entities and IEs in the existing state registries. In particular, with the Resolution of the CMU dated June 22, 2005, No.499 the Regulation on the USREOU was set out in a new wording, paragraph 12 of which provides that entering or deleting data on entities in the USREOU, as well as amendments to USREOU shall be made upon the receipt of information by the state statistics authority from the state registrar on registration actions performance as provided by Law No.755 (*follow the link*: https://minjust.gov.ua/m/str_9998).

[86] *See* clause 2 of Chapter VIII of the Law No.755 (in the wording that existed prior to June 19, 2011).

[87] *See* clause 2 of Chapter II of the Law No.2390 (in the wording that existed prior to April 25, 2014).

[88] *See Regulation on Temporary Intergovernmental Special Commissions on Issues Pertaining to Taking Inventory of Legal Entities and Individual Entrepreneurs, approved by the Order of the Ministry of Justice of Ukraine No.575/5 dated April 12, 2012* (repealed pursuant to the *Order of the Ministry of Justice of Ukraine No.935/5 dated June 16, 2014).*

[89] The former State Registration Service of Ukraine reported that as a result of work carried out by the temporary intergovernmental special commissions in 2012 state registrars entered data into the USR with respect to 28 089 legal entities and 50 637 individual entrepreneurs (*follow the link:* http://ddr.minjust.gov.ua/uk/a51d5c697993cc957b7cce8a89479028/pidsumky_diyalnosti_derzhavnoyi_reestraciynoyi_sluzhby_ukrayiny_za_2012_rik/).

[90] *See* Explanatory Note to the *Draft Law of Ukraine "On Introducing Amendments to Certain Laws of Ukraine Regarding Entering Data About Existing Legal Entities and Individual Entrepreneurs with the Unified State Registry" No.2484 dated March 7, 2013 (follow the link:* http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=46000).

enter the respective data into the USR. **It is noteworthy, no deadline was set for carrying out such actions.**

5) **Current Stage** is characterized by setting out the Law No.755 in the new wording, which became effective at the beginning of 2016, where provisions governing state registration of entering data into the USR about legal entities and IEs registered prior to July 1, 2004, were transferred to the main text of the Law[91]. The current wording of the Law No.755 neither specifies deadlines for re-registering data about such businesses with the USR, nor envisages liability for failure to do so. Moreover, extracts from the USR now state that as the USR is undergoing transformation, the information about legal entities and IEs registered prior to July 1, 2004, and not included in the USR, shall be retrieved in the executive body, which carried out original state registration.

Hence, legal entities registered prior to July 1, 2004, data about whom was not re-registered with the USR or whose registration was terminated by making certain mistakes in the past, might have not been de-listed from tax records. As a consequence, from the tax authorities' standpoint, starting from January 1, 2017, such persons continued to bear status of entrepreneurs and, at least formally, satisfied all criteria of the USC payer. As a result, calculation and collection of arrears, fines, and penalties amounts from USC vis-à-vis such persons continued in an ordinary manner and without any privileges thereto.

Case No. 15. USC accrual to an IE in the absence of information about him in the USR

Assuming that an individual has an entrepreneurial status, in November 2018 the MD SFS in Lviv oblast issued a notice ordering to pay debt (arrear) under the USC in the amount of UAH 15,819.5. Having received such a decision, this "entrepreneur" (**"Complainant"**) appealed against it to both the SFS and the Council.

The Complainant advised the Council that, upon receipt of the payment notice he had immediately approached the Chervonohrad USTI of the MD SFS in Lviv oblast seeking comprehensive explanations of the exact grounds employed to issue such a notice. The tax authority explained that it had been issued due to the fact that, despite being registered as the IE for the last two years the Complainant reportedly failed to pay the USC, which resulted in accumulation of certain indebtedness. The Complainant reassured in response that his "entrepreneur" status was terminated back in 2004; however, as the time passed by the respective papers were lost, thus making it impossible for him to present the document confirming termination of entrepreneurial activity. Therefore, the only "asset" at the Complainant's disposal was absence of any data about him in the USR as the IE.

Considering that the MD SFS in Lviv oblast erroneously treated the Complainant as the IE, the Council supported his position by providing its own arguments within the framework of the respective administrative appeal procedure.

[91] *See* Part 3 of Article 17 and Part 2 of Article 18 of the Law No.755 (in the wording dated January 1, 2016).

In March 2019, the SFS informed the Council that the Complainant's appeal was satisfied and the payment notice on the debt (arrear) under the USC was cancelled. Meanwhile, to finally resolve the entrepreneurial activity termination issue, the Complainant was recommended to approach a state registrar in accordance with the procedure, set forth in the Law No.755.

However, having failed to properly finish the administrative appeal procedure, in February 2019 the MD SFS in Lviv oblast put forward a new decision in respect of the Complainant. This time the amount of debt was increased by the minimum quarter payment amount and constituted UAH 18,276.72. As a result, the Complainant had to launch a new administrative appeal procedure having gained the Council's support for the second time.

Due to the decision issued by the SFS on the identical merits, the Council strongly disagreed with the approach employed by the tax authority and asked it to promptly undertake measures aimed at restoring the Complainant's legitimate rights.

Fortunately, the SFS was consistent and cancelled the payment notice on the debt (arrear) for the second time, thus satisfying the Complainant's request. Therefore, the case was closed due to success.

For over three years' existence of the problem described herein, the practice of consideration by lower courts of administrative cases on the legality of USC accrual to persons about whom (as entrepreneurs) information is missing in the USR, has remained inconsistent[92]. It was only in July 2020 that the Grand Chamber of the Supreme Court ruled[93] in favor of the USC payers in this category of cases. The conclusion of the Supreme Court is that the lack of official confirmation of the entrepreneurial status in the manner prescribed by the Law No.755, excludes the possibility of lawful business activities and income, which, in the absence of evidence to the contrary, excludes the possibility of formal and factual participation in the compulsory state social insurance system under the relevant status.

The recent position of tax authorities on this matter is[94] that they are ready to make changes to the records on businesses subject to their receipt of the following:

[92] *See*, for instance, the following decisions issued by appellate courts in favor of individual entrepreneurs: rulings of the Eighth Appellate Administrative Court dated March 11, 2020, in the case No.500/2595/18; dated March 3, 2020, in the case No.1.380.2019.004272; dated February 19, 2020, in the case No.857/13143/19; dated February 13, 2020, in the case No.857/11913/19. Meanwhile, in the supervisory authorities' favor the following decisions have been adopted: ruling of the Sixth Appellate Administrative Court dated April 6, 2020, in the case No.320/5369/19; ruling of the Seventh Appellate Administrative Court dated March 20, 2020, in the case No.120/2687/19-a.

[93] *See* the ruling of the Grand Chamber of the Supreme Court dated July 1, 2020, in the case No. 260/81/19. While rendering this decision, the Supreme Court concluded that the IE status is a form of exercising the constitutional right to entrepreneurial activity; the absence of confirmed entrepreneurial status in the state-defined form, as required by the new legal regulation effective since 2004, excludes the possibility of automatic transfer of entrepreneurial features acquired before July 1, 2004, as far as a person cannot be forced to exercise his/her right in these conditions, and uses it at his/her own discretion. At the same time, the changes in the procedure of administration of the state registration system in respect of individual entrepreneurs, introduced by the Law No. 2390 and Law No. 1155, only determine the powers of authorized bodies in relation to natural persons who intend to continue business activities started by July 1, 2004, which is confirmed by their fulfillment of the obligation to submit a registration card, or a statement of a person's refusal to acquire the IE status by failing to submit such a registration card (which should have resulted in the refusal to replace the state registration certificate with a new one and recognition of their outdated state registration certificates, issued before July 1, 2004, as invalid).

[94] *Follow the link:* http://cv.sfs.gov.ua/media-ark/news-ark/386547.html.

- an extract from the USR evidencing state registration of data with the USR including subsequent termination of registration;
- a document evidencing state registration of termination of entrepreneurial activity by business until July 1, 2004, issued by the executive body, which conducted original state registration;
- written acknowledgement of Pension Fund authorities that the USC payer has been removed from the records by October 1, 2013.

Therefore, willing to finally resolve this situation, in pursuance of tax authorities' recommendations, individuals often appealed to state registrars to include information about themselves in the USR alongside business activities cessation.

A certain consensus for the general settlement of this situation was reached only in mid-2020 by adopting the *Law of Ukraine "On Amendments to the Law of Ukraine "On Collection and Accounting a Single Contribution to the Compulsory State Social Insurance Fund" Regarding Elimination of Payers Discrimination" No.592-IX dated May 13, 2020* (**"Law No.592"**).

Thus, the legislator decided that in case of non-receipt of income (profit), the amount of arrears from the USC accrued to IEs (except for those, who have chosen the simplified taxation system) and persons engaged in independent professional activities for the period from January 1, 2017, prior to the date of Law No.592 entry into force as well as fines and penalties accrued on these arrears amounts, are subject to write-off.

To do this, an individual who once had the status of an entrepreneur (but has not been engaged in business activities for a long time and information about him/her is still missing in the USR) must meet a number of conditions, namely, within 90 calendar days from the Law No.592 entry into force:

1) submit an application[95] for state registration of entrepreneurial activity termination to the state registrar, and the USC returns for the period from January 1, 2017, to the date of enactment of the Law No.592 to the tax authority (in case of failure to submit it);

2) submit an application for writing off the USC arrears amount, accrued fines and penalties to the supervisory authority;

3) obtain a positive outcome of the tax desk audit or a reasoned decision to refuse to write off arrears, penalties and fines[96].

Therefore, persons who have rather recently learned that they are being accounted as USC payers, and after receiving a payment notice on the debt (arrears) from the USC were slow on repaying it, were able to put an end to this issue using the mechanism proposed by the Law No.592[97].

At the same time, provisions of the Law No.592 do not give answers to questions of what will happen to persons who, prior to this Law enactment date, have somehow "co-operated" with tax authorities and performed state registration of entering information in the USR simultaneously with the IE business activity termination. It is clear that if such persons managed to voluntarily or forcibly repay their USC arrears during 2017-2020, it

[95] *See the Order of the Ministry of Justice of Ukraine dated May 19, 2020, No.1716/5 "On Updating Application Forms for Legal Entities, Individual Entrepreneurs and Public Associations in the Field of State Registration".*

[96] The tax authority may decide not to write off the amount of arrears, penalties, and fines provided that the audit revealed that: (i) the taxpayer received income (profit) during the period from January 1, 2017, to the date of the Law No.592 entry into force and/or (ii) arrears amounts under the USC, as well as fines and penalties accrued on arrears amounts were independently paid by the taxpayer in full, or collected in the manner prescribed by the USC Law (*see* para. 6 and para. 7 of the paragraph 9-15 of Section VIII "Final and Transitional Provisions" of the USC Law".

[97] As of the date of publication of this Systemic Report, the Council is not aware of any systemic problems faced by businesses in exercising their right provided for by the Law No.592 in early summer of 2020. At the same time, there is information in public sources that the debt write-off will be reflected in the USC payer's integrated card only after the relevant amendments to the STS software are implemented.

would be impossible for them to recover these funds now[98]; however, if registration data is updated and the USC arrears amount is not agreed, — the question is left open.

In the Council's view, amendments made by the Law No.592 to Section VIII "Final and Transitional Provisions" of the *Law of Ukraine "On Collection and Accounting a Single Contribution to the Compulsory State Social Insurance Fund" No.2464-VI dated July 8, 2010* (**"USC Law"**[99]), in fact, are aimed at canceling individual entrepreneurs' obligation, who are nominally on the general taxation system[100], to pay a minimum USC in case of non-receipt of any income (profit) from their activities as established since January 1, 2017.

In the Council's view, to ensure actual elimination of discrimination and proper implementation of the provisions of Law No.592, **it is necessary to foresee an algorithm for USC payers who, as at the date when the Law No. 592 entered into force, already included information about themselves with the USR with subsequent termination of registration as entrepreneurs.**

Also, in the case of going through the procedure provided by the Law No. 592 in the summer of 2020, the question remains as to the legality of accounting for arrears accrued after the date of entry into force of this law and before the date of registration of business termination in the USR. Thus, on the one hand, the Law No. 592 does not directly provide for the write-off of the USC amounts accrued in June-August 2020; on the other hand, their accrual would contradict the purpose of the new legal regulation, as well as the recent findings of the Supreme Court[101].

3.2 USC privileges: reporting correction issues

Until recently, the only privilege related to payment of the USC, determined by the USC Law and currently enforced "on a permanent basis", applies to individual entrepreneurs (including those who opted for simplified taxation system) and members of farmers' enterprises, if they receive old-age pension, suffer from disability or reached retirement age and receive a pension or a social welfare under the law[102]. Since January 1, 2021, this privilege will apply also to persons engaged in independent professional activities[103]. The privilege means the relief from obligation to pay the USC for oneself and, therefore, such persons may not submit a USC reporting.

These privileged persons, however, can pay USC voluntarily, — they can participate in the compulsory state social insurance

98 *See* para. 11 of paragraph 9-15 of Section VIII "Final and Transitional Provisions" of the USC Law.

99 Hereinafter, unless specified otherwise, the reference to the USC Law means the wording of this Law dated July 1, 2020.

100 As far as the Council is aware, the situation with availability of information in the Register of Insurers of Individual Entrepreneurs information about whom is not entered in the USR, does not apply to entities of the simplified taxation system.

101 *See* the ruling of the Grand Chamber of the Supreme Court dated July 1, 2020, in the case No. 260/81/19.

102 *See* Part 4 of Article 4 of the USC Law.

103 *See* para. 1 of the Law No.592.

system if they want to[104]. This, at first glance, inconspicuous norm, in practice sometimes leads to the emergence of significant USC arrears amounts, penalties and fines, which are almost impossible to get away from.

All that is because at the by-law level the issue of exercising the right to voluntary participation in the compulsory state social insurance system is somewhat differently regulated for those having privileges for paying USC for themselves. In particular, it is envisaged that in the case of self-determining the USC accrual base, privileged persons form and submit a USC reporting once a year[105]. In fact, it means that in order to participate in the compulsory state social insurance system, beneficiaries may only need to submit a USC reporting. Hence, like other payers, they will be responsible for correctness and accuracy of the submitted report, whereas the corresponding USC amounts will be subject to unconditional payment in a defined amount.

At the same time, USC voluntary payment issues are regulated by Article 10 of the USC Law. Conceptually, voluntary participation in the compulsory state pension insurance system is an opportunity to guarantee a pension insurance record and create conditions for increasing a future pension amount. That is, if a person did not pay insurance contributions in certain periods, the only way to include these periods in the insurance record period is to voluntarily pay such contributions. Voluntary participation of a person who wishes to be a USC payer primarily involves conclusion of an agreement on voluntary participation in the compulsory state social insurance system.

Therefore, the problem described in this section is that from the moment when a privileged person submitted a report on the USC and determined a certain income amount herein, as well as liabilities amount under the USC, he/she, according to tax officials, ceased to be privileged and lost the right not to pay the USC in the respective reporting period.

However, the Council considers that the described approach of fiscal officials does not correspond to the requirements of the USC Law as the mere submission of a USC reporting by a person cannot indicate voluntary and, most importantly, conscious participation of such a person in the compulsory state social insurance system. The same opinion is upheld by administrative courts nowadays.

Case No. 16. USC arrears based on erroneously submitted report

In November 2019 the Council was approached by an individual entrepreneur, who has been an old age pensioner since January 2017 (**"Complainant"**). Some time ago the Complainant notified the supervisory authority about his retirement and desire to take advantage of the privilege under the USC. Therefore, the Complainant did not enter into the agreement on voluntary participation in the compulsory state social insurance system.

[104] *See* Part 4 of Article 4 of the USC Law.

[105] *See* paragraph 3 of clause 3 of Section III of the *Procedure for Drawing Up and Submitting a Report on Unified Contribution Accrued Amounts for the Compulsory State Social Insurance Fund by Insurers, approved by the Order of the MoF No.435 dated April 14, 2015* (**"Procedure No.435"**).

Nonetheless, in January 2019, the Complainant lodged the Report on Sums of Accrued Profit of Insured Persons and Amount of Calculated Contribution by mistake, where he specified UAH 9,828.72 as the monetary obligation amount under the USC due to be paid for Y2018.

The following day the Complainant approached the Taxpayer's Servicing Centre of Prymorsk STI of the Southern Department of Odesa city of the MD SFS in Odesa oblast with the request not to accept his report and rescind USC charged pursuant to the report, which had been lodged erroneously.

Afterwards the Complainant several times sent similar letters to the controlling authorities (the MD SFS in Odesa oblast and the STS), however all of them were rejected. The main reason was the existence of the lodged USC report and, consequently, — independent calculation of the USC, which is due to be paid on general grounds.

Having received the Complainant's complaint, the Council approached the MD STS in Odesa oblast with the request to re-consider its position and consider the possibility to disregard the Complainant's Y2018 report. While substantiating its position, the Council argued that the approach employed by the supervisory authority does not comply with the current case-law[106], including legal position of the Supreme Court on application of legal provisions, which are to be enforced by public authorities[107].

Nonetheless, the Council's arguments did not convince tax authorities and their fiscal-motivated position remained intact. Therefore, having exhausted all means of pre-trial resolution of this matter, it was decided that seeking judicial protection is the only remaining recourse available for further protection of the Complainant's infringed rights and interests.

Hence, in January 2020 the Council discontinued consideration of this complaint without achieving a successful outcome for the Complainant.

[106] In particular, Grand Chamber of the Supreme Court in its ruling issued on April 10, 2019, in the case No.814/779/17 (the case about exempting from paying USC of individual entrepreneurs, who are entitled to old-age pension but subsequently opted for pension granted due to death of breadwinner) noted, inter alia, that: "[...] *Part 4 of Article 4 of the Law No.2464-VI envisages payment of the USC by a person, who receives payments from the compulsory state social insurance system after reaching age level, specified in Article 26 of the Law No.1058-IV, — exclusively on the voluntary basis*".

This matter also drew attention of the Collegium of Judges at the ACC/SC. In particular, its ruling issued on March 20, 2018, in the case No.805/2195/17-a left intact a court decision issued by the appellate court, obliging tax authority to return to the plaintiff (who is pensioner by age) the USC in the amount of UAH 18,330.58 paid by mistake for the period from April 24, 2014, until January 2017, even though the USC had been erroneously calculated and paid by the plaintiff.

Legal positions issued by the Supreme Court have been further developed in the practice of administrative courts, which, in accordance with the Council's observation, is mainly shaping up in the taxpayers' favor (*see*, in particular, ruling of the Eighth Appellate Administrative Court dated September 18, 2019, in the case No.857/7544/19; ruling of the Sixth Appellate Administrative Court dated September 26, 2019, in case No.320/5761/18; ruling of the Sixth Appellate Administrative Court dated October 1, 2019, in case No.320/5530/18; ruling of the Eighth Appellate Administrative Court dated October 7, 2019 in case No.857/7542/19; ruling of the Eighth Appellate Administrative Court dated November 14, 2019, in case No.857/9983/19. Court decisions, bearing position to the contrary, are quite seldom (*see*, for instance; ruling of the Seventh Appellate Administrative Court dated September 17, 2019, in the case No.240/4809/19).

[107] *See* Part 5 of Article 13 of the Law of Ukraine *"On the Judicial System and Status of Judges"* dated June 2, 2016, No. 1402-VIII.

The Council observes existence of the substantial number of disputes stemming from the fact that IEs (who are vested with privileges when it comes to paying USC and who could pay USC only on the voluntary basis) often lodge USC reports by mistake only to learn afterwards that there is no procedure to withdraw or correct them and that supervisory authorities commenced enforcement procedure seeking collection of the USC debt (arrears) accumulated amounts.

This situation is particularly worrying as such persons (aged and disabled people) are highly likely to make mistakes, not only by submitting a report on the USC, as such, but determining certain amounts thereunder due to be paid. It is noteworthy, in accordance with the position of tax authorities, any amount declared shall be deemed as "finally approved" and, thus, subject to forced collection[108].

Meanwhile, the USC Law contemplates that the only way to abandon privilege related to payment of the USC is by entering into agreement on voluntary participation in compulsory state social insurance system. Yet, the practice of erroneous submission of USC reports by persons who might want to use their privilege, is quite common. **That is why, in the Council's view, it would be appropriate to vest categories of people with privileges with the right to correct or withdraw report(-s) they have submitted within a certain period of time.**

Moreover, the Procedure No.435 provides that as long as deadline for submission of the USC report has not expired, the taxpayer is entitled to correct mistakes by forming and lodging such a report for the second time. The last report lodged by an insured person in electronic or paper form prior to the expiration of the terms for submission of reporting determined by the Procedure No.435 (and which has been vetted through all control stages while being uploaded to the Register of Insurers or the Register of Insured Persons) shall be deemed valid[109].

However, once the deadline for submitting a USC report has expired, current legislation **no longer provides for the possibility to independently correct mistakes relating to monetary parameters** (arithmetical mistakes, incorrectly calculated amounts of profit/USC, etc.). And this is despite the fact that pursuant to the USC Law[110] and *Instruction on the Procedure for Calculation and Payment of the USC, approved by the Order of the MoF No.449, dated April 20, 2015* (the **"Instruction No.449"**), upon identification of the USC which was not calculated and/or paid in a timely manner, USC payers are obliged to calculate the correct amount of these sums, reflect them in the reporting documentation and pay them accordingly; moreover, penalties are applied to such payers[111].

Therefore, since obligations under the USC may be changed (increased or decreased) by the supervisory authority based on the tax audit results[112], and payers in this case are obliged to form and submit an updated report to supervisory authorities[113], tax authorities suggest[114] correcting mistakes by applying for an audit and specifying the respective reason.

However, as is well known, documentary and desk audits on the completeness and timeliness of accrual and payment of USC are carried out in accordance with the procedure

[108] Pursuant to paragraph 3 of clause 5 of Chapter VI of the Instruction No.449, a notice seeking payment of debt (arrear) cannot be challenged in the administrative appeal procedure to the extent it relates to the amounts of debt (arrears) originating from the substance of the lodged reports related to calculated USC amounts.

[109] *See* clause 1 of Chapter V of the Procedure No.435.

[110] *See* Part 2 of Article 25 of the USC Law.

[111] *See* paragraph 1 of clause 2 of Chapter VI of the Instruction No.449.

[112] *See* Part 3 of Article 9, clause 2 of Part 1 of Article 13 of the USC Law.

[113] *See* paragraph 14 of Chapter VI of the Instruction No.449.

[114] *See* consultation in the PIR (category 201.06.02).

established by the TCU[115]. In case of receipt of the taxpayer's application for an audit, the head of the tax authority may decide on auditing such a taxpayer. However, the TCU does not contain a norm on the mandatory inspection by the supervisory body at the request of the taxpayer and deadlines for making a decision on ordering such an audit. This fact, in the Council's opinion, is a significant obstacle to implementation of the current way of correcting errors in the USC reports by conducting an unscheduled tax audit at the request of the taxpayer.

Thus, the Council sees the need to develop an effective mechanism to correct independently detected errors on monetary indicators values in the USC reports and giving privileged persons the opportunity to withdraw an erroneously submitted USC report.

3.3 USC privileges: relief from payment on the ATO territory

Introduction of additional privileges in calculating and paying the USC is already commonplace for Ukraine in the period of crisis. For example, in the context of measures to prevent outbreak and spread of coronavirus disease (COVID-19)[116], as well as for the period of anti-terrorist operation (**"ATO"**)[117].

As Ukraine has encountered quarantine measures relatively recently and the relevant USC problem has not captured the Council's focus yet, below we will briefly cover the analysis of the situation in 2014-2020 around USC taxpayers registered with tax authorities located on the ATO territory.

On October 15, 2014, the *Law of Ukraine "On Interim Measures for the Period of Anti-Terrorist operation" dated September 2, 2014, No.1669-VII* (**"Interim Measures Law"**) entered into force. In this respect Section VIII "Final and Transitional Provisions" of the USC Law was amended. Particularly, it was supplemented by the paragraph 9-3 , which[118] provided for:

1) relieve of the USC payers registered with tax authorities located in the territory of ATO, from the obligation to timely accrue, calculate and pay the USC in full for the period from April 14, 2014, until the end ATO, or martial law, or state of emergency. The ground for such relief is the USC payer's application, submitted to the supervisory authority within 30 calendar days following the day of ATO termination;
2) non-application of liability, penalties and financial sanctions provided by the USC Law for failure to perform their obligations within the specified period;
3) write-off of arrears incurred by such USC payers as uncollectable.

[115] *See* Part 2 of part of Article 13 of the USC Law.

[116] *See* clause 2 of Section I of the *Law of Ukraine "On Amendments to the Tax Code of Ukraine and Other Laws of Ukraine on Support of Taxpayers for the Period of Measures to Prevent the Outbreak and Spread of Coronavirus Disease (COVID-19)" dated March 17, 2020, No.533-IX*.

[117] *See* paragraph 9-4 of Section VIII of the USC Law (in the wording that existed prior to February 13, 2020).

[118] According to the *Law of Ukraine "On Amendments to Section VIII "Final and Transitional Provisions of the "Law of Ukraine "On Collection and Accounting a Single Contribution to the Compulsory State Social Insurance Fund" regarding Reducing the Burden on the Wage Fund" dated March 2, 2015, No.219-VIII,* it was decided to recognize the paragraph 9-3 of Section VIII "Final and Transitional Provisions" of the USC Law in the wording of the Interim Measures Law as the paragraph 9-4.

Further change in the macroeconomic situation in the country resulted in the adoption of the *Law of Ukraine "On Amendments to Certain Legislative Acts of Ukraine" dated December 24, 2015, No.911-VIII,* which entered into force on January 1, 2016. This law, inter alia, excluded from the Interim Measures Law the legal norm, which originally introduced additional privileges for USC payers. As a result, some lawyers (including tax authorities' representatives) thought that since January 1, 2016, paragraph 9-3 (which later became paragraph 9-4) of Section VIII "Final and Transitional Provisions" of the USC Law has also expired, and thus there is no ground for USC privilege application either.

However, this opinion was not confirmed by the case-law[119] and legislative practice, which shows that **the respective paragraph of Section VIII of the USC Law remained in force after January 1, 2016**. In addition, this norm was deliberately excluded from the USC Law only at the beginning of 2020[120].

Meanwhile, after January 1, 2017, as is known, the obligation to pay the USC by all payers in the amount not less than the minimum insurance contribution regardless of the fact of receiving any income or profit was introduced[121]. In addition, after January 1, 2017, the USC Law still contained the paragraph 9-4 of Section VIII, which continued relieving from the obligation to accrue, calculate and pay the USC for the period from April 14, 2014, until the end of the ATO, or martial law, or state of emergency. Such a relief, as already mentioned, concerned USC payers registered with tax authorities located on the territory of municipalities where the ATO was carried out.

On April 30, 2018, the *Decree of the President of Ukraine dated April 30, 2018, No.116/2018 "On the Decision of the National Security and Defense Council of Ukraine dated April 30, 2018 "On a Large-Scale Anti-Terrorist Operation in Donetsk and Luhansk oblasts"* was published on the official website of the President of Ukraine which put the specified decision into effect (for internal use). There is an opinion that the issuance of the said Decree of the President of Ukraine was an announcement of the end of the ATO. This opinion is supported, in particular, by the fact that a number of amendments were subsequently made to laws and regulations, in which the "anti-terrorist operation" term was replaced or supplemented through the conjunction "and/or" by the term "measures to ensure national security and defense, repulse and deterrence of the armed aggression of the Russian Federation in Donetsk and Luhansk oblasts carried out through the Joint Forces operation (JFO)".

However, the opinion that the ATO was completed on April 30, 2018, is not currently confirmed by the case-law, from which it

[119] The conclusion that this legal provision remained in force after January 1, 2016, was made, in particular, in the ruling of the ACC/SC dated March 30, 2018, upheld by the Grand Chamber of the Supreme Court on November 6, 2018, in the exemplary case No. 812/292/18; the rulings of the ACC/SC dated November 13, 2018, in case No.805/775/16-a; dated August 21, 2018, in case No.805/826/16-a; dated January 30, 2018, in case No.812/505/17; dated August 21, 2019, in case No.360/137/19.

[120] *See* sub-paragraph "y" of paragraph 83 of Part 3 of Section II "Final and Transitional Provisions" of the *Law of Ukraine "On Amendments to the Customs Code of Ukraine and Some Other Legislative Acts of Ukraine" Due to the Administrative Reform Implementation" dated January 14, 2020, No.440-IX,* which entered into force on February 13, 2020.

[121] *See* paragraphs 2, 3 of Part 1 of Article 7 of the USC Law (in the wording after January 1, 2017).

follows that the ATO period (particularly for the purposes of applying the Interim Measures Law) is considered to be still ongoing[122]. Thus, **even after April 30, 2018, the "beneficial" paragraph 9-4 of Section VIII of the USC Law remained in force** officially being repealed only on February 13, 2020.

At the same time, the Council is aware of cases of arrears under the USC, penalties and fines to entities registered in the territories where, according to the CMU's directives, the ATO was carried out (which, according to the case-law, is now transformed into Joint Forces operation). Arrears charge often dates back to 2017, since the minimum USC amount is subject to payment regardless of any income receipt.

Thus, validity of paragraph 9-4 of Section VIII of the USC Law is confirmed by the Supreme Court practice (mandatory to be taken into account by public authorities[123]). However, information on taxpayers who in 2014-2020 were registered with tax authorities located on the ATO territory does not correlate with this preferential norm. Therefore, the Council finds it necessary to **bring such TIC information in line**. It will reduce the burden on the judiciary system and put an end to determining arrears amounts emerged during this time and having no limitation period.

3.4 Determining, agreeing and adjusting arrears amounts

The USC Law defines arrears as the USC amount not calculated and/or paid in a timely manner, which is calculated by the tax authority in cases provided by this Law[124].

The USC payer is obliged within 10 calendar days from the date of receipt of the payment notice on arrears to pay its amount as well as fines together with the accrued penalty. In case of disagreement with arrears amount calculation, a USC payer may agree it with the tax authority by lodging the relevant claim whether in administrative or judicial procedure[125].

It is noteworthy that the USC amounts, which were independently determined by payers in the respective reports, but not paid in a timely manner, are not subject to adjustment[126] and further administrative appeal[127], i.e. are considered indisputable. Therefore, only those decisions formed by the controlling authority as a result of audits or based on the relevant data records may be appealed administratively.

At the same time, it should be pointed out that the approved debt (arrears) payment notice form **does not provide for specifying**

[122] Thus, the conclusion that paragraph 9-4 of Section VIII of the USC Law remained in force after October 30, 2018, follows, in particular, from the decision of the ACC/SC dated August 21, 2019, in case No.360/137/19.

[123] Pursuant to Part 5 of Article 13 of the *Law of Ukraine "On the Judiciary and the Status of Judges"* conclusions on application of rules of law set forth in the Supreme Court rulings, are binding on all public authorities using a legal act containing the relevant rule of law in their activities.

[124] *See* paragraph 6 of Part 1 of Article 1 of the USC Law, clause 3 of Chapter VI of the Instruction No.449.

[125] *See* paragraphs 6, 7 of Part 4 of Article 25 of the USC Law.

[126] *See* the Section 3.2 *"USC privileges: reporting correction issues"* of this Report for more details.

[127] *See* paragraph 3 of clause 5 of Chapter VI of the Instruction No.449.

a detailed calculation of such debt with indication of periods when arrears emerged[128]. This fact complicates its appeal in practice, because both the higher-level supervisory authority and the payer need to take additional actions to find out the origin of arrears amount.

The experience gained by the Council also shows that the administration of USC by issuing payment notices on debt (arrears) is characterized by certain issues pertaining to USC. Let's consider them in more detail.

3.4.1 The legal nature of the payment notice on USC debt (arrears)

As is known, supervisory authorities determine monetary obligations for payment of taxes, fees and other payments specified by the TCU through issuing TNDs. Such obligations cease to exist in case of cancellation (withdrawal) of the respective TND. However, the situation with the USC, from the Council's standpoint, is not clearly regulated by the USC Law either.

Particularly, in case of violations related to the USC accrual and payment, the debt (arrears) amount arises based on the tax audit reports, USC reports or data records from the tax authority's information system[129]. That is, the tax authority does not make any decision similar to the TND in its form and substance. **The payment notice on debt (arrears) under the USC, in turn, is not actually the ground causing such arrears (debt), but rather its consequence and serves a kind of reminder to repay it**[130].

Therefore, after a successful appeal of a specific decision on payment of debt (arrears) under the USC in court or administratively, it will be withdrawn. However, this will not automatically adjust information in the TIC[131]. In practice, it means that after some time the USC payer may receive a new notice for payment of debt (arrears) under the USC, although it will refer to the same circumstances that could have been previously analyzed by the STS or the court and resolved in favor of the payer.

Therefore, the currently guaranteed opportunity to challenge only USC arrears amount calculation, in the Council's view, **cannot be considered an effective remedy for the violation**. After all, recognizing the payment notice as illegal and its cancellation does not lead to correction of conclusions contained in documentary tax audit reports or data records of the payer. As a result, the tax authority has a reason for forming a new payment notice on the debt (arrears) under the USC guided by the same tax audit report or information in databases.

Therefore, a logical question arises: is it possible in case of cancellation (withdrawal) of the decision on paying the debt (arrears) to oblige the tax authority to properly correct the USC payer's card for information about the existence of debt to be removed? Theoretically yes, but without making certain

[128] Annex 6, 7 to the Instruction No.449.

[129] *See* paragraph 1 of clause 3 of Chapter VI of the Instruction No.449.

[130] This statement is confirmed by the fact that in accordance with the provisions of paragraph 7 of Part 4 of Article 25 of the USC Law, a USC payer shall have the right to initiate an administrative or judicial appeal procedure against payment of debt (arrears) under the USC only in case of disagreement, i.e. having remarks on the amount and not the essence of additional payments.

[131] *See* the Section 10 *"Taxpayers' Integrated Cards"* of this Report for mode details.

amendments to the USC Law, the appropriate corrections must be made manually, and each time — based on a separate decision of the head of the tax authority or his/her deputy[132]. Moreover, the difficulty of fixing incorrect data in the TIC at the taxpayer's initiative is recognized by the Council as a separate systemic problem, which is described below in Section 10 *"Taxpayers' Integrated Cards"* of this Report.

At the same time, the trouble in implementing any decisions on the correction of data in the USC payer's TICs is that such a correction will actually lead to the write-off of arrears amount. And the USC Law strictly prohibits such a write-off, except for cases involving complete liquidation of a legal entity or death of an individual entrepreneur, declaring him/her disappeared, incapacitated, deceased or absence of a person, who bears obligation to pay USC under this Law[133].

Thus, the USC Law lacks norms that would provide an opportunity to appeal not only of the payment notice on the USC debt (arrears) calculation, but also such the debt itself. Then cancellation (withdrawal) of such a decision will mean the write-off of the amount accrued by the controlling authority, which would allow avoiding formation of a new notice on the same grounds in the next period of the debt accounting.

3.4.2 Determining arrears amount based on tax audits findings

USC arrears are often based on the supervisory authority's conclusions that certain amounts were not included in the entity's income, and, therefore, were not subject to PIT. That is, as a result of the PIT-related conclusions of the tax authority, the base for USC accrual also increases. As a result, apart from respective TNDs, the payer also receives a notice for paying the debt (arrears) under the USC and a decision on application of penalties.

In this context, it is important to pay attention to the fact that for a long time the deadlines for reviewing complaints against supervisory authorities' decisions, stipulated by the TCU and the USC Law, significantly differed — up to 60 days for TNDs[134] and up to 30 days — for payment notices on USC arrears[135].

Yet, despite the fact that the grounds for accrual of tax liabilities from PIT and USC were often the same circumstances set forth in a uniform tax audit report, the supervisory authority had to first decide on the USC, and then on the TND itself by which PIT had been additionally accrued. However, due to tighter deadlines, USC complaints were usually not given due consideration, but remained in force "by default", because the corresponding audit

[132] Such a mechanism, in the Council's view, is provided for in the clause 5 of Chapter I of the *Procedure for Prompt Accounting of Taxes and Fees, Customs and Other Payments to Budgets, a Unified Contribution for Compulsory State Social Insurance Fund by the State Fiscal Service of Ukraine authorities, approved by the Order of the MoF dated April 7, 2016, No.422* (**"Procedure No.422"**).

[133] *See* Part 7 of Article 25 of the USC Law.

[134] *See* paragraph 56.9 of Article 56 of the TCU.

[135] *See* paragraph 7 of Part 4 of Article 25 of the USC Law (in the wording that existed prior to February 27, 2020).

report conclusions related to PIT remained relevant at the time of the decision on the USC. At the same time, another department dealing with complaints against PIT-related TNDs could have cancelled it though finding audit report conclusions to increase PIT liabilities unfounded, however this no longer affected debt (arrears) claims under the USC left in force by the supervisory authority only a few weeks ago.

Case No. 17. Contradictory consequences of the administrative review on PIT and USC

Based on the tax audit findings, in October 2018 the MD SFS in Kyiv oblast concluded on an IE's overstating his expenses for purchasing freight forwarding services (**"Complainant"**). This, in turn, resulted in an understatement of his obligations to pay both PIT and the USC and, therefore, the Complainant soon received a TND (for PIT), a payment notice on the debt (arrears) under the USC as well as a decision on application of penalties.

The Complainant challenged all these decisions in administrative procedure. However, since the terms of consideration of appeals against TNDs and USC payment notices at the time of administrative proceedings were different, the STS:

1) in February 2019 left in force the payment notice on the debt (arrears) from the USC in the amount of UAH 43,381.88 and a decision to impose penalties amounting to UAH 9,183.39, thus rejecting the Complainant's appeal in this part;

2) in March 2019 withdrew the TND on PIT by satisfying the complaint in this part and declaring conclusions of the MD SFS in Kyiv oblast on overstatement by the Complainant of expenses for the purchasing freight forwarding services and a corresponding increase in the payer's taxable income for such expenses amount unfounded.

In the autumn of 2019, having discovered a USC debt record in the amount of UAH 53,247.98 in his e-office, the Complainant asked for the Council's assistance.

Having accepted the complaint, the Council asked the controlling authorities to check correctness of the information displayed in the Complainant's e-office and, if necessary, to correct his TIC. Soon the MD STS in Kyiv oblast explained: arrears are accounted due to non-payment of USC automatically accrued in February 2018 for 2017 amounting to UAH 8,448.00, as well as based on decisions taken following the Complainant's tax audit conducted in October 2018. In addition, it was noted that after the STS refused to satisfy the complaint in February 2019, the Complainant did not go to the administrative court to protect his rights.

At the same time, considering that the Complainant's appeal consideration outcome regarding the PIT directly affects his USC accrual base[136], in February 2020, the Council recommended that the STS and the MD STS in Kyiv oblast delete the record on existence of arrears emerged based on a tax audit report drawn up in October 2018[137].

[136] Since, in accordance with paragraph 2 of Part 1 of Article 7 of the USC Law, the USC and PIT accrual bases coincide for general taxation system individual entrepreneurs.

[137] The Council reasoned the possibility of making such a correction by referring to the paragraph 5 of clause 5 of Section I of the Procedure No.422.

Upon receiving this recommendation, supervisory authorities firstly refused to make any corrections to the Complainant's integrated card. This response was reasoned by the fact that decisions of the STS, adopted in February 2019 to uphold the payment notice on the USC debt (arrears) as well as the decision to apply penalties, are final, and the Complainant still has the right to appeal them in court.

Also, in March 2020, the Complainant received a new notice for payment of debt (arrears) under the USC formed based on data records from the tax authority's information system.

The administrative appeal outcomes against the new payment notice on the debt (arrears) under the USC were successful: this decision was cancelled by the STS and the MD STS in Kyiv oblast deleted accrued amounts from the Complainant's TIC. Having received a confirmation of the absence of USC pending arrears in May 2020, proceedings on the complaint were closed.

The Council hopes that the situation described in this chapter will be resolved through "up-to-date" amendments to the legislation, which have already been called the beginning of tax reform. Thus, since in most cases the USC accrual base coincides with the PIT one, starting from January 1, 2021, a single unified document will be introduced by combining separate tax reporting forms currently submitted by business entities at different times (USC report is submitted on monthly basis, while 1ДФ form — on quarterly basis)[138].

Moreover, USC payers' appeals consideration deadlines have also been recently aligned with timeframes for reviewing the appeals on TNDs and are now 60 days long[139].

The concern, however, lies in the fact that the *Procedure for considering complaints against payment notices on arrears under the USC for obligatory state social insurance by supervisory authorities, as well as the decisions on imposing fines, approved by the Order of MoF dated December 9, 2015, No.1124* (**"Procedure No.1124"**), which now establishes the relevant procedure, according to the Council, is not perfect. A much better example is the *Procedure for formalization and submission of complaints by taxpayers and their consideration by supervisory authorities, approved by the Order of the MoF dated October 21, 2015, No.916* (**"Procedure No.916"**).

The Procedure No.916, in particular, clearly and in detail regulates the issue of open hearing of complaint materials or their closed consideration in the presence of a taxpayer, while the Procedure No.1124 contains only a declarative provision on the right of the complainant's representative to be present during complaint consideration. The Procedure No.916 also provides for the involvement of the Council and the obligation to respond to its proposals, while the Procedure No.1124 does not provide for such a rule.

That is, in the Council's view, the Procedure No.916 establishes **a sounder and more thorough (with quasi-judicial elements) procedure for reviewing taxpayers' appeals**, while the Procedure No.1124 establishes a more simplified procedure for the USC payers.

[138] *Follow the link:* https://mof.gov.ua/uk/news/verkhovna_rada_zaprovadila_z_1_sichnia_2021_roku_iedinu_zvitnist_z_iesv_ta_pdfo-1810.

[139] *See* paragraph 9 of Part 4 of Article 25 of the USC Law (as amended after February 27, 2020), which entered into force on July 1, 2020.

At the same time, the Council considers that the idea of introducing a unified reporting on USC and PIT and unifying the deadlines for reviewing appeals related to these obligations should be inextricably linked to ensuring that the procedure for reviewing complaints regarding USC and PIT should be common. Thus, it is not deemed expedient to further apply the Procedure No.1124 to review appeals against payment notices on debt (arrears) under the USC.

3.4.3 Determination of arrears based on data records

Pursuant to the Instruction No.449, payment notices on debt (arrears) under the USC drawn up based on USC payers data records shall be sent (furnished) to legal entities within 10, and individuals — within 15 working days following a calendar month in which arrears amount originated, increased or partially decreased[140].

At the same time, frequent are the cases when tax authorities issue notices for payment of arrears under the USC to the so-called "dormant" individual entrepreneurs (i.e. those who do not carry out active economic activity, but whose registration in the USR is maintained) after a year and a half since the occurrence of the "first-time" arrears. That is, despite the fact that the arrears under the USC for such entities appeared for the first time in February 2018 (if they used the general taxation system) and then amounted to UAH 8,448.00[141], subsequently having increased quarterly by UAH 2,457.18 during 2018, they could learn about the existence of their debt only in 2019 when the next USC payment obligations date was due and the debt was close to, or even exceeded UAH 20 k.

The reason why it happened is because a 10- and 15-day period established by the Instruction No. 449 for issuing a notice for payment of a debt (arrears) under the USC is in fact "tied" to the next date when the payment in favor of the social insurance fund is due. It does not matter whether this is the first payment missed by the USC payer or not. It also does not matter whether the USC payer has previously been informed that he/she has any pending debt.

Such unlimited powers of the supervisory body, in the Council's view, **give it the practical opportunity of issuing payment notices on debt (arrears) under the USC not when the debt is still relatively small, but when it becomes a five digit amount one**. And it is despite the fact that the limitation period does not apply to USC (and, therefore, the debt amount has to be paid), while each overdue payment is also accompanied by a fine for late payment[142] and a penalty of 0.1% for each day of delay[143].

The Council's position on this issue is that it is important to provide for the legal consequences of delay in issuing notices for payment of debt (arrears) by supervisory authorities, as well as decisions on penalties and fines for non-payment (non-transfer)

[140] *See* clause 3 of Chapter VI of the Instruction No.449.

[141] Starting from January 1, 2017, general taxation system IEs, who did not receive income (profit) in the reporting year or a separate month of the year, are obliged to pay USC for themselves not less than the minimum insurance contribution per month: in 2017— not less than UAH 704 per month, in 2018 — not less than UAH 819.06 per month. The deadline for USC payment for 2017 is February 9, 2018, and starting from this year the USC is paid on quarterly basis by April 19, 2018, July 19, 2018, October 19, 2018, January 19, 2019, and according to the submitted report for Y2018 (by February 9, 2019) — on such report submission day (*follow the link:* http://ck.sfs.gov.ua/media-ark/news-ark/351983.html).

[142] *See* Part 11 of Article 25 of the USC Law.

[143] *See* Part 10 of Article 25 of the USC Law.

or late payment (late transfer) of a unified contribution in the USC Law. In particular, it is necessary to set a certain deadline for issuing a notice for payment of debt (arrears) under the USC with missing of which the decision must be considered illegal and subject to cancellation in whole or in part. For example, it would be appropriate **to limit the maximum arrears amount** that the tax authority intends to collect if the respective notice is made for the first time after expiration of more than a certain number of calendar months within which arrears are consistently recorded as pending for a taxpayer.

THE COUNCIL'S RECOMMENDATIONS:

18. The State Tax Service of Ukraine jointly with the Ministry of Finance of Ukraine to develop amendments to the USC Law (as well as Instruction No.449 and Procedure No. 435 in the respective part), aimed at:

18.1. Ensuring practical possibility of writing off arrears amount under the unified social contribution, as well as penalties and fines accrued on it, to individual entrepreneurs who, as at the date of the Law No.592 entry into force included information about themselves in the USR and made an entry on activity termination (i.e. took separate actions established by paragraph 9-15 of Section VIII "Final and Transitional Provisions" of the USC Law, but as of the date of Law No.592 entry into force have pending arrears under the USC emerged in the period from January 1, 2017, to the date of registration of their activity termination);

18.2. Abolition of legal grounds for accrual by the tax authority of the single contribution for June-August 2020 to persons who used the mechanism established by the paragraph 9-15 of Section VIII "Final and Transitional Provisions" of the USC Law, and received a positive decision on full or partial write-off regarding the USC arrears, accrued since January 1, 2017, as well as the relevant fines and penalties;

18.3. Establishing legal consequences of delaying by the supervisory authority the time for issuing notices for payment of debt (arrears) as well as decisions on penalties and accrual of fines for non-payment (non-transfer) or late payment (late transfer) of a unified social contribution.

19. The Ministry of Finance of Ukraine:

19.1. To amend the Procedure No.435 with respect to:

19.1.1. introduction of a mechanism for self-correction of errors by the USC payers regarding monetary indicators values declared in the report on the amounts of accrued income of insured persons and the amount of accrued unified social contribution;

19.1.2. provision for the possibility and establishment of the procedure for withdrawal of the USC report submitted by the privileged person;

19.2. To amend the Instruction No.449 regarding:

19.2.1. establishing the obligation to add a detailed calculation of arrears amount under the unified social contribution to the notice issued by the tax authority, which is sent (furnished) to legal entities and individuals;

19.3. To bring the procedure for consideration by the supervisory authorities of appeals against payment notices on arrears under the unified social contribution for the obligatory state social insurance fund and on decisions on accrual of fines and imposition of penalties in line with the USC Law and harmonize it with the Procedure No.916;

20. The State Tax Service of Ukraine:

20.1. To conduct a comprehensive awareness campaign about provisions of the Law No.592 for business entities that were established and registered before July 1, 2004, but information about which was not included in the USR;

20.2. To adjust USC arrears amounts accrued from April 14, 2014, to February 13, 2020, to taxpayers registered with tax authorities located in the territory of the ATO/JFO;

20.3. To ensure consistence of the procedure for reviewing appeals of business entities against TNDs on PIT and related notices for payment of debt (arrears) under the USC through simultaneous review of such appeals materials and sound administrative appeal outcomes in this part.

4 SIMPLIFIED TAXATION SYSTEM

In Ukraine there is a special mechanism for collecting taxes and fees aimed at replacing a number of separate independent taxes and fees with the single (unified) tax and simultaneous accounting and reporting simplifications. This mechanism is called a "simplified taxation system". Hence, single tax payers are currently exempt (with certain restrictions)[144] from the obligation to accrue, pay and report on the following taxes and fees: CPT, PIT, VAT[145], land tax and rent for special use of water, as well as a MF[146].

A legal entity or an individual entrepreneur may independently choose a simplified taxation system and be registered as a single tax payer, if such a person meets the requirements established by the TCU.

The main requirements for the simplified taxation system are the **type of activity, the annual revenue amount and the allowed number of employees**. According to these criteria, all single tax payers fall into four groups[147]. Failure to meet some of the criteria is the ground for the single tax payer to switch to a general taxation system and pay all taxes and charges imposed by the TCU without any preferences. Failure to comply with this obligation will constitute the ground for the controlling authority to independently invalidate the respective single tax payer's registration from the date when the latter ceased to meet the established requirements.

That is why tax authorities have tools allowing them to remotely and constantly monitor compliance with criteria by "simplified" taxpayers, in particular: for activities — the USR and the Register of Single Tax Payers; for the number of employees — notice of hiring and reporting on a single social contribution; for the level of income — cash registers[148].

Meanwhile, over the years, the Council has frequently dealt with the peculiarities of simplified taxation system's application. As for the Council's statistics, out of 7379 complaints received by the Council as at July 1, 2020, the issues pertaining to simplified taxation system

144 *See* paragraph 297.1 of Article 297 of the TCU.

145 With the exception of single tax payers of the third group paying a single tax at the rate of 3%.

146 *See* clause 1.7 of paragraph 161 of sub-section 10 of Section XX, sub-paragraph 165.1.36 of paragraph 165.1 of Article 165 of the TCU.

147 **First group** — individual entrepreneurs who do not have employees and carry out exclusively retail sale of goods from outlets in the markets and/or provide personal service activities, and whose income during the year does not exceed UAH 1 mn. They pay a fixed monthly single tax at the rate of up to 10% of the minimum subsistence level for able-bodied persons, which in 2020 equals to UAH 210.20 per month;

Second group — individual entrepreneurs who have no more than 10 employees at a time, carry out economic activities for the provision of services, including personal, to other single tax payers and/or the population, production and/or sale of goods, perform activities in the restaurant industry, and whose income does not exceed UAH 5 mn. These payers have to pay a fixed monthly single tax at the rate of up to 20% of the minimum wage every month, which in 2020 equals to UAH 944.60 per month;

Third group — individual entrepreneurs and legal entities whose income does not exceed UAH 7 mn, and for whom no special restrictions have been set on the number of employees or types of activities. The obligation to pay a single tax for these persons is set as a percentage of income: 3% if the individual is also a VAT taxpayer, and 5% if VAT is not applicable;

Fourth group — agricultural producers: legal entities where the share of agricultural production is equal to or exceeds 75%, as well as individual entrepreneurs who operate exclusively within the farm and meet the requirements set forth in clause "b" of sub-paragraph 4 of paragraph 291.4 of Article 291 of the TCU. For them, the amount of tax rates per hectare of agricultural land and/or water fund lands depends on the category (type) of land and their location.

148 Currently, the use of cash registers is voluntary in most cases, but from January 1, 2021, it will become mandatory for all taxpayers of the second-fourth groups.

were raised in 69 complaints (1.6% of total tax related complaints). According to the Council's observations such complaints were largely related to individual entrepreneurs belonging to the first, second and third single tax groups.

Therefore, below the Council will focus on selected issues related to single tax administration which bear systemic nature and whose resolution is impossible without certain legislative changes.

This chapter will begin with the critical analysis of the practice of applying top (maximum) single tax rate for taxpayers of the first and second groups when their business activity's location and tax address do not match (Section 4.1). Next, we will analyze the problem of practical application of the rule envisaging that transition to a single tax scheme can be made only once per calendar year (Section 4.2). Further, we will consider issues of legal consequences that may occur in case of failure to specify current Standard Industrial Classification of Economic Activities (**"SIC"**) codes in the Register of Single Tax Payers (Section 4.3). Finally, we will focus on cases when single tax payers violate simplified taxation system rules, and then do not independently switch to a general taxation system, as required (Section 4.4).

The chapter ends with a set of recommendations aimed at solving some of the problems described herein.

4.1 Top single tax rate application

Although single tax fixed rates for the first and second groups of taxpayers are established by the local self-governments[149], — maximum allowed rates (10% of the minimum subsistence level or 20% of the minimum wage respectively) may, nonetheless, be applied to them by a tax authority in case of:

i. performing several types of economic activities[150];

ii. performing economic activities in the territories of more than one village, settlement, city or a united territorial community's council[151].

The TCU[152] stipulates that economic activity is the **one connected with the production (manufacturing) and/or sale of goods, performance of works, delivery of services** aimed at obtaining income and carried out by an entity independently and/or through its separate divisions, as well as through any other entity acting in favor of the first entity, in particular under commission agreements, a power of attorney and agency agreements.

According to tax authorities, if the single tax payers' business activity location and their tax address (which is usually the residence address) do not match, — the top single tax rate should be applied vis-à-vis business activities performed in more than one administrative and territorial unit.

To substantiate their position, tax authorities typically argue that as an IE submits applications, reporting, receives certificates, pays taxes to the tax authority at his/her tax address, — the tax address is, therefore, directly linked to entrepreneur's activities.

149 *See* paragraph 293.2 of Article 293 of the TCU.

150 *See* paragraph 293.6 of Article 293 of the TCU.

151 *See* paragraph 293.7 of Article 293 of the TCU.

152 *See* sub-paragraph 14.1.36 of paragraph 14.1 of Article 14 of the TCU.

Case No. 18. Application of the top single tax rate by default

In December 2018, the Council received a complaint from IEs having status of the second group single tax payers (the **"Complainants"**) challenging allegedly illegal application of top single tax rate by Novoukraiinskyi Department of the MD SFS in Kirovohrad oblast.

Particularly, the Complainants carry out their economic activities in the city of Novomyrhorod, Kirovohrad oblast — i.e. on the territory of Novomyrhorod City Council of Kirovohrad oblast.

Meanwhile, the Complainants' tax address is administratively located on the territory of Kapitanivka Village Council of Novomyrhorod District of Kirovohrad oblast.

The same rates for single taxpayers of the second group — 10% of minimum wages per month — had been set by decisions of both Novomyrhorod City Council of Kirovohrad oblast and Kapitanivka Village Council of Novomyrhorod District of Kirovohrad oblast, as published on the official website of the MD SFS in Kirovohrad oblast.

On February 19, 2019, the Complainants approached Novoukraiinskyi Department of the MD SFS in Kirovohrad oblast with a request to apply to them a single tax rate of 10%, as in fact Complainants have a sole business activity location (Novomyrhorod city); whereas under their tax address (the village of Pryshchepivka reporting to Kapitanivka Village Council) they are just registered and actually reside.

In March 2019, the Complainants received a reply from Novoukraiinskyi Department of the MD SFS in Kirovohrad oblast regarding consideration of their applications on the simplified taxation system. According to conclusions set forth in the foregoing decision, since the Complainants' business activity location and their tax address do not match, therefore, in the supervisory authority's view, the Complainants carry out business activities in more than one administrative and territorial unit. Therefore, a top single tax rate application is justified and is not subject to revision.

Given that the court proceedings was the only way to protect their rights and Complainants did not manage to lodge the respective lawsuit, they had to continue paying top single tax rate.

It is worth mentioning here that during numerous discussions between the Council and the STS, the latter reported on abuses at the part of dishonest single tax payers who, living in an area with lower single tax rates, carry out actual economic activities within administrative and territorial units with higher single tax rates.

Although the Council is sympathetic to this approach, it is worth noting that interpretation of the TCU provisions proposed by tax authorities is not confirmed by the actual case-law[153].

Therefore, in the Council's view, it is necessary to either adhere to the customary case-law or to introduce amendments to the relevant TCU provisions governing application of the top single tax rate.

4.2 "Once a calendar year" rule

Since the simplified taxation system can truly be considered as a certain privilege available to entrepreneurs subject to satisfying a number of conditions, — the current legislation does not allow to non-systematically switch back and forth from the general to simplified system — i.e., transition to a single tax scheme can be made only once within a calendar year[154].

In particular, a business entity submits an application to the tax authority to choose (or switch to) a simplified taxation system. Hence, entrepreneurs who are payers of other taxes and fees, submit such an application no later than 15 calendar days before the beginning of the next calendar quarter[155]. Business entities that have just performed state registration may apply for a simplified taxation system by lodging a relevant annex to application for state registration, or by submitting it to the controlling authority before the end of the month when the state registration took place (for the first and the second groups of single tax payers),[156] or within 10 days from the state registration's date (for the third group taxpayers)[157].

However, current tax legislation does not provide a clear answer to the question whether the "once a calendar year" rule is applied to cases where during one calendar year an IE decides to cease operations, and after a while re-registers as the individual entrepreneur in the USR. After all, the law does not set limits of how many times an entrepreneur may cancel his/her state registration and then re-register — i.e., no imperative time periods to be met by an entity between such registration actions are set.

It is worth noting that while this issue is not new, it became especially relevant due to introduction of quarantine restrictions on the territory of Ukraine in March 2020. In

[153] For example, decisions of courts of the first and appellate instances in case No.2040/6602/18 were in favor of the taxpayer, while the Supreme Court denied the tax authority in opening the cassation proceedings.

[154] *See* paragraph 1 of sub-paragraph 298.1.4 of paragraph 298.1 of Article 298 of the TCU.

[155] *See* paragraph 1 of sub-paragraph 298.1.4 of paragraph 298.1 of Article 298 of the TCU.

[156] In this case, business entities would be considered single tax payers from the first day of the month following the month in which state registration took place (*see* paragraph 1 of sub-paragraph 298.1.2 of paragraph 298.1 of Article 298 of the TCU).

[157] In this case, business entities would be considered single tax payers from the date of their state registration (*see* paragraph 1 of sub-paragraph 298.1.2 of paragraph 298.1 of Article 298 of the TCU).

practice, quarantine measures have largely led to the unwanted temporary suspension of the possibility to perform a large number of personal service activities[158] by individual entrepreneurs of the first and second groups. Meanwhile, their obligation to pay a single tax in the fixed amount for all months of shutdown, as well as USC remained the same regardless of the fact of getting any income (profit).

Therefore, it is not uncommon that entrepreneurs who could not carry out business activities during the quarantine period due to the objective reasons, — having realized the need to make some decisions "here and now" rather than waiting for the next package of amendments from the legislator, — decided to suspend their activity. This can, of course, be called an extremely radical measure, however it is hard to consider other options available in the legislation as more practical. For example, changing the single tax group to the third one in order to calculate the tax based on income earned can only be done no later than 15 days before the next quarter[159] (i.e. it must have been done before March 16, 2020; while next time this option became available only in three months — starting from July 2020); and application of the right to exemption from payment of the single tax within one calendar month during the annual vacation[160] does not solve the issue when the activity has to be suspended for a longer period.

In an attempt to elaborate a certain balanced decision to resolve this situation, amendments to the tax legislation were made in April 2020, thus giving local self-government authorities the right to reduce single tax rates for taxpayers of the first and second groups in 2020 under the simplified procedure[161]. Tax authorities also explained[162], that in case single tax fixed rate changes based on the decision of village, settlement or city council, — entrepreneurs do not have to submit any additional applications in order to apply them.

The foregoing, however, does not address the issue of what to do about a simplified taxation system after a repeated state registration by an IE during the calendar year. For instance, it does not explain whether this scheme is available to a taxpayer, if a lockdown caused termination of his/her business activity, let's say, in April 2020, and then he/she decided to re-register, for example, in August 2020.

From the STS's perspective[163], non-compliance with the requirements of sub-paragraph 298.1.4 of paragraph 298.1 of Article 298 of the TCU — (according to which transition to a simplified taxation system can be made only once per calendar year) — is the ground for the supervisory authority to refuse to register an entity as a single tax payer. That is, if an IE, — who at the beginning of the current year enjoyed the simplified taxation system and in whose regard the state registrar decided on business activity's termination, — renewed registration during the current year, he/she is considered a payer of other taxes and fees. Meanwhile, it will be possible for him/her to switch to the simplified taxation system only starting from January 1 next year, provided compliance with the requirements set forth in Article 291 of the TCU[164].

158 *See* paragraph 291.7 of Article 291 of the TCU.

159 *See* sub-paragraph 298.1.5 of paragraph 298.1 of Article 298 of the TCU.

160 *See* paragraph 295.5 of Article 295 of the TCU.

161 *See* paragraphs 52-6 and 52-7 of sub-section 10 of Section XX of the TCU.

162 *See* the respective explanation in the PIR (category 107.01.04).

163 *See* the respective explanation in the PIR (category 107.05), as well as the relevant publication in the "Visnyk. Officially about Taxes", an official resource of the STS (*follow the link:* http://www.visnuk.com.ua/ua/pubs/id/7482).

164 Reference to the procedure established in the paragraph 4 of sub-paragraph 298.1.4 of paragraph 298.1 of Article 298 of the TCU is meant.

The foregoing position, however, in the Council's view, cannot be fully applied to situations with individual entrepreneur's state re-registration during the year, as it regulates the procedure for **transition** to a simplified taxation system rather than its **selection**. Moreover, since a single tax payer's registration is perpetual, taxpayers do not need to submit any additional applications to have a continuous registration as at the beginning of the calendar year. Therefore, submission of a relevant application by an IE after re-registration can be formally considered a transition to a simplified system that took place exactly once a calendar year.

As of August 1, 2020, the Supreme Court has not given its own assessment of the situation. Meanwhile, recent lower administrative courts decisions speak for single tax payers[165].

In particular, the courts pointed out there were no reservations in the current legal framework making it impossible to apply a simplified taxation system by a newly created business entity (including individual entrepreneurs) in case if he/she decided on his/her own to terminate the activity. Having analyzed the respective TCU provisions, courts concluded that conditions for transition to a simplified taxation scheme set out in sub-paragraph 298.1.4 of paragraph 298.1 of Article 298 of the TCU apply to those entities already being payers of other taxes and fees. Meanwhile, provisions of sub-paragraph 298.1.2 of paragraph 298.1 of Article 298 of the TCU regulating acquisition of a single tax payer's status by entities whose state registration has recently taken place, do not contain any restrictions vis-à-vis individual entrepreneurs that have been re-registered during the current year.

In the Council's view, the foregoing demonstrates **vague and contradictory nature of the respective legal framework** that violates legal certainty principle and triggers application of the principle of the most favorable interpretation of tax legislation in favor of taxpayers.

In view of the foregoing, the TCU provisions shall be specified to establish the procedure for the selection of the simplified taxation system by IEs after their state re-registration within a calendar year. It would also be appropriate to clarify whether the fact of an ongoing registration as a single tax payer at the beginning of the year — when a business entity voluntarily switched to a general system, and after a while decided to once again become a single tax payer — would be considered as reiterative transition to the simplified taxation system[166].

[165] In particular, it concerns the decision of the Eighth Administrative Court of Appeals dated February 6, 2020, in case No.1.380.2019.004792 and the decision of Kyiv District Administrative Court dated December 23, 2019, in case No.320/2713/19, both of which entered into legal force.

[166] According to the tax authorities' position, an individual, who at the beginning of the year was a single tax payer and switched to other taxes and fees (general taxation scheme), cannot return to the simplified taxation system this year, as such a person has already exercised his/her right on application of the simplified taxation scheme in the current year: (*follow the link:* http://www.visnuk.com.ua/uk/news/100006436-skilki-raziv-protyagom-kalendarnogo-roku-mozhna-zminiti-sistemu-opodatkuvannya).

4.3 Single tax and SIC codes

It is known that freedom of entrepreneurial activity is one of the main principles of civil law[167] and belongs to the core principles of economic management[168]. It means, inter alia, that entrepreneurs are entitled to perform any business activities independently without any restrictions, unless it is prohibited by law[169]. Such principles, respectively, include free choice of business activities, independent formation of the entrepreneur's activities plan and independent foreign economic activity, etc.[170]. From the point of view of choosing the tax system, provided that all the established requirements are met, these principles are implemented, in particular, by the independent choice of an entrepreneur of the most suitable single tax group. Meanwhile, the tax authority is not endowed with the competence to change the group chosen by the taxpayer at its own discretion. The only power that the controlling authority has is to establish the fact of violation and transfer the taxpayer to the general system of taxation, thus effectively cancelling previously submitted application for the application of the simplified tax system.

For the purposes of statistical recordation of enterprises and organizations by type of economic activity, conducting state statistical observations of economic activities and analysis of statistical information at the macro level in Ukraine, the so-called SIC have been introduced. Hence, SIC is primarily a statistical tool for arranging economic information. Although SIC's "common language" mechanism is used in many other areas (including tax), it is, however, not always fully adapted to the respective tasks. That is why the SIC was introduced with the idea not to trigger any legal consequences[171].

Meanwhile, ignoring the SIC codes in some instances can lead to adverse legal consequences, including those in the context of "safe" staying on the simplified taxation system. And, indeed, since single tax payers are subject to a number of restrictions on activities they can carry out while enjoying the simplified taxation system, — failure to comply with them may be the ground for applying an increased single tax rate and even taxation system's change.

Tax officials dwell on[172] existence of two different types of tax (financial) liability in the event when an IE receives income from activities not belonging to the SIC codes as determined by the latter (him/her).

1) If no changes have been entered with the USR

If the entrepreneur received income from activities not specified as entrepreneurial activity in the USR, — then such income is considered to be received not by an entrepreneur, but by an individual.

[167] *See* paragraph 4 of Part 1 of Article 3 of the *Civil Code of Ukraine*.

[168] *See* paragraph 3 of Part 1 of Article 6 of the *Commercial Code of Ukraine*.

[169] *See* Part 1 of Article 43 of the *Commercial Code of Ukraine*.

[170] *See* Article 44 of the *Commercial Code of Ukraine*.

[171] *See* para. 8 of para. 1 of the *National Standard Industrial Classification of Economic Activities (SIC) DK 009:2010, adopted by the Order of the State Committee of Ukraine for Technical Regulation and Consumer Policy No.457 dated October 11, 2010*.

[172] *Follow the link:* http://www.visnuk.com.ua/uk/publication/100004792-pidpriyemnitska-diyalnist-6.

In this case, the taxpayer is obliged to include such income amount in the total annual taxable income and file a tax return for the reporting tax year, as well as to pay tax on such income[173] (i.e. a PIT at the rate of 18% and a MF of 1.5%).

2) If no changes have been entered with the Register of Single Tax Payers

If an IE received income from business activities specified in the USR but, at the same time, not displayed in the Register of Single Tax Payers due to absence of an application for making changes to the Register[174], — then in this case the single tax payer is obliged to switch to payment of other taxes and fees specified by the TCU to be done starting from the first day of the month following the tax (reporting) period in which such activities were carried out[175].

If the taxpayer did not switch to the general taxation system under these circumstances, — then his/her single tax payer registration may be canceled through removal from the Register of Single Tax Payers by decision of a controlling authority[176]. Annulment of registration of the single tax payer of the first, second and third groups is documented by the decision of the tax authority adopted based on the audit report from the first day of the month following the quarter in which violation was committed. In this case, the entity will be able to return to the simplified taxation system only after four consecutive quarters from the date of the supervisory authority's decision on registration's annulment[177].

In addition, the single tax rate is set at 15% for the income received from activities not listed in the Register of Single Tax Payers for taxpayers of the first or second groups[178].

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From the Council's point of view, the appropriateness of applying such severe liability measures in case of receiving income from activities reflected in the USR, but not listed in the Register of Single Tax Payers, should be re-considered. First of all, this is due to the fact that individual entrepreneurs, who often do not outsource consultants in the framework of current economic activities, may commit genuine mistake while ascertaining correlation between activity type and the SIC code and, therefore, simply be unaware of doing something wrong.

Of course, ignorance of the law is no excuse. However, it is also necessary to point out that information entered with the USR has the official status[179]. In practice, a single tax payer will not necessarily carry out all the activities declared by him/her in the USR. Moreover, some activities contained in the USR may not be compatible with the simplified taxation scheme. However, it still remains unclear what is the idea behind deprivation of the right to enjoy the simplified taxation system in the case of a carrying out an activity, which is fully consistent with the taxpayer's chosen single

[173] *See* sub-paragraph 168.2.1 of paragraph 168.2 of Article 168 of the TCU.

[174] *See* sub-paragraphs 298.5 and 298.6 of Article 298 of the TCU.

[175] *See* clause 7 of sub-paragraph 298.2.3 of paragraph 298.2 of Article 298 of the TCU.

[176] *See* clause 3 of paragraph 299.10 of Article 299 of the TCU.

[177] *See* para. 1 of paragraph 299.11 of Article 299 of the TCU.

[178] *See* clause 2 of paragraph 293.4 of Article 293 of the TCU.

[179] Pursuant to Article 10 of the Law No.755 in case documents and information subject to be entered into the USR have been entered herein, such documents and information are considered reliable and can be used in a dispute with a third party.

tax group, but corresponds to another SIC code, which is still specified in the USR, but not reflected in the Register of Single Tax Payers.

On the one hand, types of activities that can be performed by *single tax payers of the first and second groups* are clearly defined and directly affecting the single tax rate to be applied to a single tax payer. Therefore, single tax payers of the first and second groups must submit a new simplified taxation system application in case of changing economic activities[180]. In this case, such entities must anyway pay an additional tax at a rate of 15% from the income received from activities not specified in the Register of Single Tax Payers[181].

On the other hand, for *single tax payers of the third group*, who can use all the SIC codes (except for the ones incompatible with the simplified taxation system[182]), the obligation to notify of changes in activities is not directly provided. It is due to the fact that such taxpayers pay a single tax regardless of the activity type they perform — the main point is that it is allowed. Therefore, if a single tax payer of the third group receives income from an activity not specified in the Register of Single Tax Payers, he/she still pays the single tax rate set for him/her — 3% or 5%.

However, according to the TCU, it can last this way only until the end of the reporting period. In the future, a single tax payer, who received income under SIC codes not reflected in the Register of Single Tax Payers must switch to a general taxation system[183]. If one fails to do it — after the tax audit, the tax authority itself annuls the single tax payer registration retroactively together with the accrual of fines and penalties for late payment of all other taxes. In connection therewith, single tax payers of the third group (similarly with the first and second groups taxpayers) are strongly recommended, in case of changing economic activity, to submit to the supervisory authority a new simplified taxation system application alongside tax return for the relevant tax (reporting) period[184].

Therefore, the establishment by a supervisory authority of the fact of receiving income from activities not reflected in the Register of Single Tax Payers is the ground for the taxpayer's forced switch to the general taxation system.

[180] Such an application shall be submitted no later than the 20th day of the month following the month in which such changes took place (*see* paragraph 298.5 of Article 298 of the TCU).

[181] *See* clause 2 of paragraph 293.4 of Article 293 of the TCU.

[182] *See* paragraph 291.5 of Article 291 of the TCU.

[183] *See* clause 7 of sub-paragraph 298.2.3 of paragraph 298.2 of Article 298 of the TCU.

[184] *See* paragraph 298.6 of Article 298 of the TCU.

Case No. 19. Loss of the single tax payer status due to receipt of income from activities not specified in the Register of Single Tax Payers

In March 2020, the Council received a complaint lodged by an IE, who had the status of a third group single tax payer (**"Complainant"**), to challenge a number of TNDs, other decisions and claims adopted by the MD STS in Donetsk oblast.

Particularly, at the end of December 2019, an unscheduled documentary desk audit of the Complainant was carried out. It was conducted in the absence of the Complainant or her representatives and without reliance on any explanations taken into account provided by her as well as primary and other documents, ledger of income, etc. The supervisory authority took certain measures to notify the Complainant of the tax audit, however (according to the Complainant, due to improper work of the postal operator), she was never informed thereof. Thus, during the inspection, only tax information available to the controlling authority was used, particularly the one received from the Prosecutor's Office in Donetsk oblast.

Among other things, based on bank statements sent to the tax authority by the Prosecutor's Office in Donetsk oblast, it was established during the audit that the Complainant received monetary funds amounting to UAH 48 k on her account in December 2016 with the payment purpose of *"purchasing wheel disks for vehicles"*. As a result, the tax authority concluded that the Complainant had received income from a transaction corresponding in its nature to trading in parts and accessories for motor vehicles (SIC code 45.3), which, however, was absent in her entry with the Register of Single Tax Payers.

Thus, despite the fact that such transactions are generally not prohibited for single tax payers of the third group, the Complainant's violation was a mere fact the corresponding activity have not been declared in the Register of Single Tax Payers.

Based on this fact, guided by the clause 7 of sub-paragraph 298.2.3 of paragraph 298.2 of Article 298 of the TCU, the supervisory authority concluded that from January 1, 2017, the Complainant was obliged to switch from simplified to the general taxation system. Therefore, in the context of the remaining part of the period audited (from January 1, 2017, to business activities termination date) the controlling authority already treated the Complainant as an individual entrepreneur using the general taxation system with respective tax implications relating to PIT, MF, VAT and USC, as well as application of the requirements for using cash registers.

While formulating its legal position on this case, the Council pointed out that the mere receipt of funds from third parties to a bank account does not necessarily indicate that the account holder had received income related to commercial activity. For example, banking documents do not exclude erroneous (incorrect) purpose of payment's indication by the taxpayer, which does not correspond to the real nature of the business transaction to which the payment is assigned. Moreover, it has not been investigated or established which disks for vehicles were sold by the Complainant (those purchased by her as goods for resale, or those previously used by her on her own (leased) vehicle for business or private purposes). That is, there are signs that decisions made by the MD STS in Donetsk oblast based on the results of the Complainant's tax audit are premature.

However, in May 2020, the STS rejected the Complainant's complaint and left the disputed decisions unchanged. Therefore, the Complaint's consideration was terminated without a positive outcome and its subject matter was transferred by the Complainant to the administrative court.

In the Council's view, stripping businesses of the right to use simplified taxation system in case they receive income from activities not listed in the Register of Single Tax Payers, **cannot be recognized as a fair and proportionate punishment**. In particular, for single tax payers of the first and second groups there is a separate liability for failure to comply with the requirement to update information in this register in the form of additional taxation of such income at a separate rate of 15%. And single tax payers of the third group work based on "the more income, the more taxes" principle. Besides, it does not in any way deny the need to switch to the general taxation system in case if taxpayers of the first-third groups carry out activities not compatible with the simplified tax system[185].

4.4 Liability for breaching requirements of simplified taxation system

It happens that those payers of single tax who violate the rules of simplified taxation system, do not switch to the general one as required by law. However, when the tax authority detects such violations, it is highly likely to annul such single tax payer's registration retroactively and calculate tax liabilities' understatement amount from the other taxes and fees, apply penalties and fines for the entire period of such understatement.

It is important to note here that tax legislation empowers the controlling authorities to annul registration of single tax payers of the first, second or third groups by a decision made based on the audit report[186]. This legal norm has been interpreted by the Supreme Court in such a way that the decision to annul registration of a single taxpayer by excluding him/her from the Register of Single Tax Payers is possible only based on a documentary audit of the taxpayer and subject to existence of the established violations of the latter, according to which the taxpayer cannot use the simplified taxation system[187]. Meanwhile, as far as the Council is aware, there are cases when supervisory authorities decide to cancel a single tax payer's registration not within the tax audit, but based on taxpayers' integrated cards (TIC) analysis. Tax authorities justify this approach by the fact that Article 75 of the TCU, which defines types of inspections, does not provide for such a subject of inspection as compliance with the simplified taxation system requirements.

[185] *See* clause 5 of sub-paragraph 298.2.3 of paragraph 298.2 of Article 298 of the TCU.

[186] *See* paragraph 299.11 of Article 299 of the TCU.

[187] The respective legal opinions are contained in the decisions of the SC/ACC dated May 14, 2019, in case No.813/1373/16; dated November 12, 2019, in case No.820/274/17; dated November 19, 2019, in case No. 200/5738/19-a; dated February 26, 2019, in case No.805/1396/17-a; dated February 5, 2019, in case No.805/206/17-a; dated January 24, 2019, in case No.813/1346/18; and dated June 5, 2018, in case No.813/4266/17.

Case No. 20. Annulment of the single tax payer's registration without an audit

The Council received a complaint lodged by an IE (who had been a second group single tax payer since January 2012) (**"Complainant"**) to challenge her exclusion from the Register of Single Tax Payers. In particular, the Complainant reported that in February 2020, when attempting to submit annual reporting through the taxpayer's e-office, she noticed existence of overpayment in the corresponding single tax field. Further on, having checked the information in the Register of Single Tax Payers, the Complainant discovered the fact of her being excluded from the Register over six months ago — at the end of June 2019.

Within the framework of complaint investigation, the Council managed to ascertain the existence of discrepancies in the single tax liability amount for certain months of 2017, as accounted by the Complainant and the supervisory authority — the MD STS in Dnipropetrovsk oblast. Back in the day, existence of the relevant debt was recorded by the tax authority in the tax desk audit report, which later became the basis for the adoption of TND on the Complainant totally amounting to almost UAH 4 k.

However, according to the Complainant, due to the flaws of the postal operator's work, neither the tax audit report nor the corresponding TND were received by her. According to the information of the supervisory authority, the latter received notices on failure to deliver the specified postal items. Thus, the TND sent to the Complainant in November 2018 automatically acquired the "agreed" status and soon turned into a tax debt. Therefore, all new Complainant's payments were applied to repay the tax debt and not to cover the next single tax payments.

Thus, a situation emerged when the Complainant had her tax debt accounted for two consecutive quarters, hence resulting in MD STS in Dnipropetrovsk oblast decision to cancel the Complainant's registration as a single tax payer. The ground for this decision was solely the information from her TIC. By the way, the decision on single tax registration's annulment was also not delivered to the Complainant and after a while it was returned to the controlling authority with a corresponding notice on delivery failure.

Meanwhile, the administrative appeal attempt, made by the Complainant with the Council's facilitation in the spring of 2020 failed — the STS refused to consider the complaint on the merits due to expiration of the administrative complaint submission term.

Thus, the Complainant decided to challenge the decision on her registration's annulment as a single tax payer in court, and the supervisory authority's violation of the procedure for making such a decision is currently her major argument.

A single tax payer's registration annulment means that as at a certain date, a business is required to pay other taxes and fees. In particular, it is about the need to calculate and pay PIT, MF, as well as VAT in the manner prescribed by the TCU, use cash registers and otherwise determine the basis for the USC accrual. If a taxpayer has not changed the tax system on his/her own, it will be done by the tax authority by **retroactively calculating all tax liabilities for each tax from which the single tax payer wrongfully considered himself exempt, as well as penalties**[188] **and fines**. Let's look into this issue in more detail.

1) PIT and MF

Income of IEs received during calendar year from economic activity is subject to PIT at the rate of 18% and MF at the rate of 1.5%.

The object of taxation is the net taxable income — i.e. the difference between the total taxable income (yield in a monetary or non-monetary form) and documented expenses related to economic activity of such an IE.

Accordingly, IEs on the general taxation system maintain a Ledger of Income and Expenses, while entrepreneurs-single tax payers (except for those of the third group who are also VAT payers) — only the Ledger of Income by daily reflecting their income at the end of the working day. This is due to the fact that amount of expenses incurred by the single tax payer in no way affects his/her tax liability amount.

Therefore, the lack of accounting and documentary evidence of the expenses incurred by the single tax payer means his/her net taxable income amount will actually be equated to proceeds (yields).

2) USC

A USC accrual base for businesses on the simplified and general taxation systems is also different. Thus, the basis for accrual of a USC for single tax payers is determined by them on their own, while it is equal to PIT accrual basis for taxpayers on the general taxation system.

So, if a single tax payer used to pay a USC at a minimum level, a single tax payer registration cancellation will also result in a unified contribution's liability re-calculation, since the accrual base (net profit, which in the absence of expenses accounting will be equated to proceeds) is likely to result in the top USC accrual base application[189].

3) VAT

If the total amount from supply of goods/services subject to taxation in accordance with the TCU accrued (paid) to IE during the last 12 calendar months cumulatively exceeds UAH 1 mn (excluding VAT), such a person is obliged to be registered with the controlling authority as a VAT taxpayer.

Therefore, if it turns out that the annual income of the single tax payer after annulment of his/her registration exceeded the aforementioned amount, one has to additionally pay 20% of VAT. Meanwhile, the business is not entitled to accrue a tax credit and receive a refund for periods when he/she did not have a due VAT payer registration.

[188] Penalties will be calculated not only in view of the ex-single tax payer's understatement of tax liabilities from these taxes and fees, but also by establishing facts of other violations (for example, failure to submit declarations of property and income, VAT tax returns, improper maintenance of the Ledger of income and expenses, etc.).

[189] The top USC accrual base in 2020 is UAH 70,845.00 per month.

In lieu of the foregoing, retroactive annulment of registration of business as a single tax payer can easily trigger an individual entrepreneur's obligation to pay over 50% of proceeds received from the date of such cancellation to the budget.

The situation is complicated by the fact that an IE secures all his/her obligations (including tax ones) by his/her property, regardless whether it is used in economic activities or intended to meet an individual's personal and household needs[190].

In its practice, the Council has frequently observed that the potential risk of receiving multi-million fines in the event of non-compliance with conditions of staying on the simplified taxation system by many single tax payers was not even theoretically considered. It may indicate a **lack of IEs' awareness of the liability** looming over them in such cases.

Moreover, from the Council's point of view, fines in the event of retroactive cancellation of an entrepreneur's registration as a single tax payer **are among the most severe** in the national law. And the situation with them is primarily complicated by a special subject — an IE, whose liability is not limited (in comparison to most legal entities).

Therefore, the Council considers it appropriate to initiate revision of liability measures currently enforced in case when tax authority detects failures to comply with requirements of simplified taxation system (for example, to provide for a reduced time limits for re-calculation of other taxes and fees, whose tax liability to pay had been understated; or to establish a universal financial liability for breach of conditions of staying on the simplified taxation system).

[190] *See* Article 52 of the *Civil Code of Ukraine*, Part 2 of Article 128 of the *Commercial Code of Ukraine*, as well as the List of property that cannot be enforced on collateral contained in *Annex to the Law of Ukraine "On Enforcement Proceedings" dated June 2, 2016 No. 1404-VIII*.

COUNCIL'S RECOMMENDATIONS:

21. **The State Tax Service of Ukraine jointly** with the **Ministry of Finance of Ukraine** — to develop draft amendments to the TCU aimed at:

21.1. Clarifying rules governing application of top (maximum) single tax rate *(paragraph 293.7 of Article 293 of the TCU)*;

21.2. Clarifying rules governing single tax payer's re-registration during the calendar year by an individual entrepreneur, who, as at the beginning of the calendar year, had an ongoing registration (i.e. did not submit a separate application for transition to a simplified taxation scheme) and during this year:

21.2.1. voluntarily switched to payment of other taxes and fees, but attempts to return to a simplified taxation system;

21.2.2. registered termination of business activity, after which re-registered as an entrepreneur and attempts to qualify for the simplified taxation system;

21.3. Cancelling liability in the form of loss of the right to enjoy the simplified taxation system in case of receiving income corresponding to the SIC codes contained in the USR, but not reflected in the Register of Single Tax Payers *(clause 7 of sub-paragraph 298.2.3 of paragraph 298.2 of Article 298 of the TCU)*;

22. **The Ministry of Finance of Ukraine** — to create a working group to re-consider current approach to the level of liability established in the TCU for taxpayer's illegal staying on the simplified taxation system;

23. **The State Tax Service of Ukraine** — to conduct awareness (information) campaign among single tax payers to advise them on the substance of legislative provisions governing scope of their liability for breaching the rules of staying on the simplified taxation system.

5 CORPORATE PROFIT TAX

CPT is a national tax, where the object of taxation is a profit — defined based on accounting data — and adjusted by the margin, stipulated by the TCU[191].

CPT's effective administration bears significant importance for generating planned budget revenues as this tax is traditionally ranked third (after VAT and PIT) in terms of planned tax revenues, both in 2019 and in the current year[192].

As far as statistics are concerned, out of 4244 complaints received by the Council as at July 1, 2020, issues related to CPT's administration made up 401 complaints (9.45% of the total number of complaints on tax issues). Most of these complaints related to outcomes of the respective tax audits (336 complaints or 32% of the total number of complaints on tax audits).

As analysis of tax audit's procedural aspects and administrative appeal of their outcomes is set forth below in Sections 6 and 7 hereof, this section will be focused on selected problems with CPT's administration the Council faced in its practice.

We are going to start with the problem of companies' expenses "not related to economic activity"/"having no business purpose", whereby in course of tax audits authorities continue alleging absence of grounds for accounting expenses for the purchase of some types of services (Section 5.1).

Then we will critically review mechanism of CPT's mandatory advance payments when paying dividends for the period for which the tax has already been fully paid (Section 5.2).

Thereafter we will attend to the issue of proper accounting of exchange rate differences on currency liabilities. In particular, we will focus on the practice of issuing TNDs reducing negative value of CPT's tax object and imposing additional tax obligations due to taxpayers' alleged failure to repay principal and interest under the loan granted by a non-resident lender (Section 5.3).

Finally, we will focus on insufficient and ambiguous legislative treatment of debt-to-equity swap (Section 5.4).

Eventually this Section will end with the set of comprehensive recommendations addressing all issues described herein.

[191] Sub-clause 134.1.1 of clause 134.1 of Article 134 of the TCU.

[192] According to the Law of Ukraine "On the State Budget of Ukraine for 2019" No. 2629-VIII dated November 23, 2018 in Ukraine CPT revenues in 2019 were planned in the amount of UAH 95.52 bn. making up 11.36% of the planned tax revenues of Ukraine and 9.48% of the total revenues of the State Budget of Ukraine

In general, the CPT's share in the world is quite big in the structure of tax revenues of developing countries. For example, in Africa and Latin America, the corresponding share exceeds 15%. In OECD member countries, on the other hand, the corresponding figure averages 9%. For more information, *see*: http://www.oecd.org/tax/corporate-tax-remains-a-key-revenue-source-despite-falling-rates-worldwide.htm

5.1 Companies' expenses "not related to economic activity"/"having no business purpose"

Rules governing calculation of expenses while ascertaining tax base (the so called "business purpose" rules) exist in one form or another in many developed jurisdictions. Until January 1, 2015, the TCU also contained a direct norm prohibiting inclusion of non-production expenses (costs not related to profit or income) in the entity's tax accounting expenses.

Since January 1, 2015, because of the tax reform, the situation has changed dramatically. Firstly, almost all specific provisions governing tax accounting of non-production expenses disappeared from the TCU (with a few exceptions). Secondly, the accounting itself became the basis for tax accounting of enterprises.

The foregoing changes were aimed at bringing positive changes for law-abiding taxpayers. Nonetheless, while conducting tax audits regional divisions of the STS continued alleging absence of grounds for accounting expenditures for acquisition of certain types of services.

Case No. 21. The company successfully challenged tax authority's additional tax charges

A LLC, providing services comprising promotion of various goods in retail networks (**"Complainant"**) turned to the Council challenging imposition of additional obligation to pay CPT.

In particular, on February 13, 2019, the MD SFS in Kyiv issued the TND imposing obligation vis-à-vis the Complainant to pay CPT in the principal amount of UAH 2,411,414 and UAH 1,205,707 of penalties (financial sanction). The basis for issuing the TND was the Audit Report, which alleged: (i) the Complainant's overstatement of expenses in the amount of UAH 13,270,667 due to inclusion to the costs incurred in 2016-2018 certain services purchased from several IEs, which are not related to the Complainant's business activity; (ii) the understatement of the Complainant's income for 2017 in the amount of UAH 126,078.

On February 27, 2019, having disagreed with the TND, the Complainant lodged a complaint with the SFS, and on March 3, 2019, he approached the Council.

On March 28, 2019, the Council's representative participated in the complaint's materials consideration at the SFS and on April 23, 2019, the Council provided the SFS with its position on the complaint's merits. In the Council's view, the conclusion on costs overstatement in the amount of UAH 13,270,667 set forth in the Audit Report on the relationship with the individual entrepreneur (and the TND in the part based on this conclusion) does not meet the requirements of GAAP 16 "Expenses", recognizing expenses in case of a decrease in assets or an increase in liabilities (which leads to a decrease in the company's equity) provided that these expenses can be reliably

evaluated (regardless of substantiation of these expenses connection with economic activity). As the Complainant provided neither dismissing arguments nor any documents proving that recordation of additional income for 2017 in the amount of UAH 126,078 was not groundless, — the Council refrained from commenting in this regard.

On April 25, 2019, the SFS ruled to partially rescind the TND and thus satisfy the Complaint to the extent it challenged tax treatment of transactions with certain IEs (in whose respect the expenses were reduced by UAH 13,270,667 by the Audit Report — so that the original TND ordered additional CPT obligation in the principal amount of UAH 2,388,720 and penalties in the amount of UAH 1,194,360.)

Noteworthy, from the Supreme Court's standpoint, the tax authority is entitled to assess neither appropriateness of expenses nor certain services ordered by the taxpayer. This position, in particular, is set forth in the Ruling, dated May 21, 2019, in the case No.826/11026/15, namely:

*"The court acknowledges that economic competence is exercised by the plaintiff as a business entity at its own risk, which means its responsibility for effectiveness and appropriateness of decisions; [hence, the latter] **decides on its own what costs it needs to incur to support its activities and may independently choose service providers.** Exercising economic competence is beyond the tax authority's control."*

Interestingly, according to the Council's observations, not only courts but also the SFS (at its administrative appeal practice level) were sometimes capable of arriving to quite progressive conclusions.

In particular, in the Decision, issued by the SFS upon consideration of the complaint, dated July 20, 2017 (also involving Council), it was stated that even if it was established that a taxpayer transferred funds under fictitious transaction for supply of goods (services), — such payment should be qualified not as payment for goods (works, services) but, rather, as non-refundable financial aid provided to another taxpayer.

At the same time, the tax authority noted that non-refundable financial aid transaction falls under the category of "expenses", as it results in a decrease in economic benefits due to retirement of assets in the form of cash. Therefore, such a transaction should be recorded by a taxpayer as expenses of the current period and taken into account accordingly while calculating the pre-tax financial result.

Hence, the tax authority concluded that:

*"[...] The **findings set forth in the Audit Report** alleging increase of the pre-tax financial result due to reduction of costs audited for the period [...] in the relationship with [...] a**re groundless, as made without examining the actual essence, content and payments.**"*

Unfortunately, though, the foregoing practice at the part of the tax authorities is not sufficiently widespread. Meanwhile, the Law No. 466-IX provides for certain changes in this area. In particular, for tax purposes, the transaction will be considered as having no sound economic reason (business purpose) provided that:

- the main objective or one of transaction's main objectives and/or its result is non-payment (incomplete payment) of taxes and/or reduction of a taxpayer's taxable income;
- in the comparable conditions an entity would not be willing to buy (sell) from unrelated entities such works (services), intangible assets or other commercial objects.

Here the Council draws attention to the potential risk of simplified interpretation of the foregoing provisions by tax authorities. Among other things, it can lead to adverse consequences for business, comprising refusal to treat a number of services as tax expenses. Therefore, to minimize such risks, it would be appropriate for the MoF/STS to provide detailed explanations in this regard.

5.2 CPT advances while paying dividends

In 2015, under the framework of tax reform, current mechanism of advance payments while paying dividends was originally introduced. It contemplates that during or prior to paying dividends, a Ukrainian company is actually obliged to pay CPT in advance. However, this advance payment cannot be credited to payment of other taxes and fees[193].

The TCU contains a number of simple rules governing such advances' calculation and payment. In particular, the advance amount is not paid in lieu of the dividend's entire amount, but rather is based on the sum representing extent to which dividends (due to be paid) exceed value of the object of taxation for the respective tax (reporting) year, based on whose results dividends are paid[194].

If, however, dividends are paid not for the entire calendar year — to calculate the specified excessive amount, the taxation object's value is **calculated proportionately to the number of months for which the dividends are paid**[195].

Therefore, if there were no problems in practice, the SFS's position expressed, in particular, in letters No.21414/6/99-99-15-02-02-15, dated October 3, 2016, No.14030/6/99-99-15-02-02-15, dated June 24, 2016 and No.36336/6/99-99-15-02-02-15, dated May 24, 2017 could be quite logical.

In the foregoing letters (using Q4 as the example) proportionality of the number of months, dividends are due to be paid for, was interpreted literally as division of CPT's object for such a year by 12 and multiplication by 3. However, in its practice the Council faced the problem when, upon such interpretation of the TCU, the tax authority's letters effectively resulted in creation of a new illogical legislative provision.

In particular, while investigating one complaint, the Council examined position of the STS, according to which, in spite of paying the entire amount of CPT for the whole year, — the tax authority actually demanded paying an advance payment for Q4 in the amount, which, eventually, would have resulted in CPT's overpayment. The tax authority substantiated its position by referring to the foregoing letters of the SFS.

[193] Para 7 of sub-clause 57.1-1.2 of clause 57.1-1 of Article 57 of the TCU.

[194] Para 2 of sub-clause 57.1-1.2 of clause 57.1-1 of Article 57 of the TCU.

[195] Para 3 of sub-clause 57.1-1.2 of clause 57.1-1 of Article 57 of the TCU.

Case No. 22. The company failed to convince the STS about illegality of the additional accrual of advance payment

In November 2019, the Council was approached by one of the largest bottom ash and metallurgical slag sale companies (**"Complainant"**) for which the MD STS in Kyiv determined a CPT monetary liability (an advance payment of such tax) in the amount of UAH 1,134,248.93, including UAH 907,399.14 of the principal obligation and UAH 226,849.79 of penalties (financial sanctions).

During audit it was ascertained that the Complainant filed CPT returns for 2018, which defined the object of taxation (profit) amounting to UAH 13,264,487.

In the previous tax return for three quarters of 2018 the object of taxation was UAH 3,072.745. Therefore, by employing principle of calculating tax liability on accrual basis, for Q4/2018 (October-December 2018) the object of taxation amounted to UAH 10,191,742.

On March 5, 2019, the Complainant paid CPT (for the Q4/2018 the amount was UAH 10,191,742*18% = UAH 1,834,513.56).

On March 13, 2019, the net profit for Q4/2018 (October-December 2018) amounting to UAH 8,357,228 08 was paid by the Complainant as dividends.

Given that dividends amount (UAH 8,357,228.08) exceeded neither the tax object amount for 2018 (UAH 13,264,487) nor the tax object amount for Q4 2018 (UAH 10,191,742), — the Complainant did not make the advance payment.

In its turn, the tax authority concluded that — although the Complainant has fully paid its CPT monetary liabilities for 2018 by the time when dividends payment was made for Q4 (October-December) of the current year — the Complainant was not relieved of the obligation to calculate the CPT advance payment upon making payment, as foreseen in sub-clause 57.1-1.2 of clause 57.1-1 of Article 57 of the TCU.

Hence, in the tax authority's view, the Complainant was obliged to use not the actual taxable income for Q4 2018 (UAH 10,191,742) but the anticipated object of taxation to be obtained by dividing the object of taxation for the whole 2018 by 12 and multiplying by 3 (i.e., UAH 13,264,487/12*3 = UAH 3,316,122).

In turn, as amount of paid dividends (UAH 8,357,228.08.) actually exceeded such anticipated amount (UAH 3,316,122) by UAH 5,041,106.33, — according to the tax authority the Complainant was obliged to make an advance payment when paying dividends in the amount of UAH 907,399.14.

Moreover, the tax authority disregarded the fact that the CPT for 2018 has already been paid in full by the Complainant and, therefore, the advance payment of CPT for this year would (if made) result in overpayment (overpaid tax obligation).

Since the STS's decision adopted upon consideration of the taxpayer's complaint was final and was not subject to further administrative appeal, the Complainant appealed to the court and the Council discontinued investigation of the complaint.

The Council considers such interpretation of paragraph 3 of sub-clause 57.1-1.2 of clause 57.1-1 of Article 57 of the TCU by the tax authority as not correct. In particular, it results in an illogical conclusion that the taxpayer must pay CPT advance for the period for which the income tax has already been paid in full; despite the fact that such advance payment immediately gets an "overpayment" status once paid. Apparently, courts also disagree with the interpretation of sub-clause 57.1-1.2 of clause 57.1-1 of Article 57 of the TCU applied by the SFS/STS[196].

The Council is carefully monitoring outcomes of taxpayers' complaint consideration, where the Council's legal position was not taken into account by the STS Ukraine. As for the case No. 22 mentioned above, — it is currently under consideration of the court of first instance.

In that regard the Council has high hopes for restoration of GTC mechanism discussed in the Section 8 hereof.

5.3 Accounting currency exchange differences under currency obligations

The Council observes that in 2018-2019 it has become quite a common practice to adopt TNDs decreasing CPT tax object's negative value and accrued tax liabilities of this tax due to the taxpayers' apparent failure to repay the loan and interests to their non-resident creditors. Failure to repay such debt used to exist due to prohibition to prepay loans in foreign currency set by the NBU.

Under these circumstances, as at reporting dates, taxpayers, generally transferred UAH equivalent debt on the loan at then current exchange rate, and attributed UAH equivalent debt increase amount triggered by currency fluctuations to expenses on account 945 "Losses from operational exchange rate difference"; while the reduction amount — to income on account 714 "Income from operating exchange difference".

In their actions taxpayers applied paragraphs 4, 7, 8 of GAAP 21 "The Effects of Changes in Foreign Exchange Rates" and the letter of the MoF, dated March 24, 2004 No.31-04200-20-25/4757 interpreting GAAP 21 "The Effects of Changes in Foreign Exchange Rates" provisions.

Meanwhile, according to tax authorities, taxpayers should have reflected the said exchange rate differences not as operating expenses and income, but as part of other additional equity.

[196] As evidenced by the Decision of Dnipropetrovsk Administrative Court of Appeal, dated December 21, 2017 in the case No.804/337/17 vis-a-vis the claim lodged by SE "Eastern Mining and Processing Plant"; the Decision of the Fifth Administrative Court of Appeal, dated July 15, 2019 in case No.420/801/19 vis-à-vis the claim lodged by SE "Izmail Sea Commercial Port".

Case No. 23. Illegal CPT object's negative value reduction

In June 2018, the Council received complaint lodged by LRP Ukraine LLC (**"Complainant"**) to challenge TNDs issued by the MD SFS in Kyiv.

The said TNDs reduced negative value of the Complainant's taxation object for 2017 by UAH 5,005,219; accrued CPT obligations in the amount of UAH 214,492; and imposed fines amounting to UAH 53,623.

On June 2, 2008, the Complainant entered into a loan agreement with a non-resident lender, London & Regional Group Finance Ltd.; the loan was due to repay on June 30, 2018. During 2015-2017, the Complainant did not repay the loan or paid interests due to prohibitions on prepayment of loans in foreign currency set by the NBU.

According to the MD SFS in Kyiv, the Complainant should have reflected the exchange rate differences under the loan agreement not as operating expenses and income, but as part of other additional equity, by employing paragraph 9 of GAAP "The Effects of Changes in Foreign Exchange Rates": *"**Exchange rate differences arising on** receivables or liabilities for settlements **outside Ukraine, which are not planned or improbable in the near future**, are reflected as part of other additional equity and reflected in other aggregated income."*

However, during the audit it was **not investigated whether London & Regional Group Finance Ltd. is a business entity outside Ukraine vis-à-vis the Complainant**".

And, indeed, according to the Complainant, the foreign company **is neither its subsidiary, associate, joint venture, nor a branch, representative office or other division**. It should be noted that the sole founder of the Complainant, according to the USR, is another foreign company. Meanwhile, if the lender does not fall under the definition of "business entity outside Ukraine", there is no reason to apply paragraph 9 of GAAP 21, and there is no ground for challenging the Complainant's right to incur costs as exchange rate differences as at balance sheet dates.

And, most importantly, the MD SFS in Kyiv **did not prove the Complainant's obligation under the loan agreement (the period under review) was not planned and improbable to be fulfilled in the near future**.

In addition, the Complainant's sensible arguments concerning the fact he **always planned repaying the loan under the loan agreement in the near future, and could not repay it in full due to prohibitions in force set by the NBU** were in no way refuted. It should be noted that while each of the bans was temporary, — the NBU extended its validity each time. Taxpayers could not have known in advance that prohibitions' continuous period would, in total, exceed four years (from February 6, 2014 to March 3, 2018), and could have reasonable hoped that the ban would be lifted and could have planned repayment of the loan in the near future.

At the same time, the Complainant's **intention to repay the loan was also supported by his further actions**. In particular, since March 3, 2018, according to the NBU Resolution No. 19 dated March 1, 2018, repayment by resident-borrower of loans/loans in favor of non-residents was

allowed, provided that the total amount of such prepayment under credit/loan agreements did not exceed USD 2,000,000 within a calendar month. **Shortly after the NBU's ban lifting, the Complainant repaid the loan and interests in full ahead of schedule** (evidence thereof was provided by the Complainant during submission of objections to the Audit Report).

Unfortunately, the STS dismissed the complaint and the Complainant had to go to court.

On July 1, 2019, the Administrative District Court of Kyiv ruled[197] in case No.826/17777/18, by which it cancelled the foregoing TNDs. On November 26, 2019, the Sixth Administrative Court of Appeal issued the Ruling[198] dismissing the complaint of the MD STS in Kyiv. The decision came into force, and on February 7, 2020 the cassation appeal of the STS in Kyiv was left without consideration due to non-payment of court fees[199].

The decision came into force, but on June 1, 2020, cassation proceedings were opened on the complaint of the State Tax Service in Kyiv.

The Council has to state that during audits, as a rule, it is **incompletely investigated whether non-resident lenders of Ukrainian taxpayers (borrowers) falls under the category of "business entity outside Ukraine"**[200].

In particular, it often turned out that non-resident companies **are neither a subsidiary, associate, joint venture nor are they a branch, representative office or other division of** companies-borrowers.

In addition, according to the Council's observations, tax officials sometimes **face difficulties in proving that obligation owed to non-residents under loan agreements was such that its repayment was not planned and improbable in the near future**.

Thus, taxpayers' arguments that they **constantly planned to repay such loans in the near future, and could not repay them solely due to the prohibitions set by the NBU** are usually not properly dismissed.

It should also be noted that **intentions of taxpayers to repay the loan were often supported by their further actions**. In particular, as soon as repayment of loans in favor of non-residents by a resident borrower was partially allowed, **taxpayers repaid such debts and provided respective confirmations to tax officials**.

It is why the Council observes that in such instances tax authorities **often do not fulfill the obligation imposed on them by the TCU to prove legality of issued TNDs**.

197 http://reyestr.court.gov.ua/Review/84617169

198 http://reyestr.court.gov.ua/Review/86102263

199 http://reyestr.court.gov.ua/Review/89578830

200 According to para 4 of GAAP 21, "a business entity outside Ukraine is a subsidiary, associate, joint venture, branch, representative office or other division of an entity that is or doing business outside Ukraine".

5.4 Debt-to-equity swap

Despite a number of recent steps aimed at reforming corporate legislation, several old problems are still awaiting their ultimate resolution. One of these is exercise of debt-to-equity conversion (debt-to-equity swap) mechanism. While this mechanism has been successfully used in many countries for a long time — its application in Ukraine remains problematic due to insufficient and ambiguous legal framework.

The importance of debt-to-equity swaps has surfaced in 2014, when Ukrainian companies began considering options for offsetting shareholder's monetary claims owed by a debtor's entity against corporate rights in the latter's capital. This mechanism was intended to free the debtor from the corresponding debt obligation owed to the creditor and provide him (the debtor) with additional opportunities to improve its financial and economic state.

However, implementation of this mechanism often resulted in companies-debtors receiving additional accruals from tax officials, who treated such a swap as debt forgiveness and, accordingly, a company's taxable revenue.

Meanwhile, International Financial Reporting Standards (**"IFRS"**) stipulate that redemption of an existing liability usually means that one business entity gives away resources that may be used to obtain certain economic benefits in the future to have its debt repaid to the other party. Besides, debt redemption can be made in different ways, for example, by [...] conversion of the given obligation into one's own equity[201].

Case No. 24. Reduction of CPT's tax object negative value by significant amount dropped by the STS

In July 2019, the Council received a complaint lodged by manufacturer of sanitary products, belonging to the worldwide known group of companies **("Complainant")** to challenge several TNDs, by one of which the MD SFS in Khmelnytskyi oblast, reduced negative value of the CPT's tax object by significant amount.

The tax authority alleged that the Complainant was obliged to attribute the particular amount to other operating income, which had been forgiven by the Complainant's shareholder (a foreign investor) and converted into the Complainant's "other invested capital".

Accordingly, since forgiveness of debt and interest under the loan along with crediting the forgiveness amount to increase additional equity — didn't not increase the Complainant's shareholder's corporate rights in the form of shares and dividends, according to tax officials, such a transaction cannot be considered a participant's contribution to the Complainant's equity because:

i. The Complainant did not increase the authorized capital, i.e. crediting of forgiven financial assets to the additional equity did not increase its authorized capital;

[201] *See* para 4.17 of the Conceptual Framework for Financial Reporting — a document that is not a standard, but plays a significant role in the development of international standards and harmonization of approaches to financial statement formation (https://zakon.rada.gov.ua/laws/show/929_009).

ii. Forgiveness of financial assets gives an unconditional right to refuse to buyback participants' shares;

iii. The Complainant's shareholder forgiveness of loan and interests is, therefore, the Complainant's income in accordance with the provisions of IFRS 18 "Income", as it led to a decrease in financial liabilities on the loan and interest in that amount.

In the course of complaint investigation, the Council argued as follows:

i. A corporate entity withdraws a financial liability (or a part of a financial liability) from its financial statement when and only when it is settled, — i.e., when the obligation under the contract is performed, cancelled, or is about to expire. The difference between the amount of financial liability's balance value (or portion thereof) settled or transferred to another party and compensation paid (including any non-monetary assets transferred and liabilities assumed) are recognized as profit or loss[202].

ii. Profit or loss is a total income with expenses deducted except for components of another aggregated income[203].

iii. Income is increase in economic benefits in course of the accounting period in the form of inflows or enhancements of assets or decreases of liabilities resulting in increase of equity, other than those relating to contributions from equity participants[204].

iv. Income is recognized in the income statement when an increase in future economic benefits related to a measurable increase in asset or a decrease of liability has arisen. This effectively means that recognition of income occurs simultaneously with recognition of increases in assets or decreases in liabilities (for example, net increase in assets arising upon disposition of goods or services or decrease in liabilities arising from waiver of a debt due to be paid)[205].

v. Revenue is the gross inflow of economic benefits that occurs during period arising in course of ordinary activity of an entity when equity increases as a result of such inflows rather than from contributions made by equity participants[206].

202 Paragraphs 3.3.1 and 3.3.3 of IAS 9 "Financial Instruments".

203 Para 7 of IFRS 1 "Submission of Financial Reporting".

204 Para 4.25 of the Conceptual Framework for Financial Reporting.

205 Para 4.27 of the Conceptual Framework for Financial Reporting.

206 Para 7 of IFRS "Income".

vi. Thus, according to IFRS, as a general rule, redemption of liability (including debt forgiveness) shall result in reduction of a taxpayer's liabilities, and, accordingly, increase of its own total taxable income. However, income would arise only where the increase in economic benefits is not related to contributions made by participants (shareholders).

The Council's position was taken into account by the STS through cancellation of the foregoing TND in full.

Generally, in the Council's view, in lieu of the foregoing, the following rules should be followed/the following conclusions should be made:

1) companies employing IFRS in their activities might recognize their obligations settled if the creditor forgives the existing debt;

2) the corresponding reduction of obligation would affect the company's income provided that a creditor is a third party rather than owner (participant, shareholder) in such obligation owed by the respective debtor;

3) meanwhile, the size of the owner's share, and the right of claim (to seek a refund, payment of dividends, etc.) does not matter.

COUNCIL'S RECOMMENDATIONS:

24. In order to address current problems with CPT's administration through unified application of the TCU provisions setting forth procedure for its calculation and payment:

24.1. The State Tax Service of Ukraine — to issue a letter of explanation on the following areas (issues):

a) Transactions having no reasonable economic reason (no business purpose):

i. provide detailed explanations about criteria employed for identifying transactions having no reasonable economic reason (business purpose);

ii. provide examples demonstrating tax authority's approach employed while proving the lack of a reasonable economic reason (business purpose) in certain commercial transactions;

b) CPT's advances while paying dividends:

i. Confirm correctness of employing CPT's real object of taxation for Q4 of the reporting year;

ii. Dismiss usage of "anticipated" object of taxation to be received by dividing the object of taxation for the whole year by 12 and multiplying by 3 (as provided for by existing letters of the SFS);

c) Recordation of exchange rate differences under liabilities expressed in foreign currencies:

i. set out clear criteria for determining whether non-resident companies are a subsidiary, associate, or a joint venture, a branch, a representative office or other division of companies — borrowers,

ii. provide a list of criteria (non-exhaustive) proving that the obligation owed to non-residents under loan agreements was such that repayment thereof was not planned and improbable in the near future;

d) Debt-to-equity swap and increase of a debtor entity's own capital at the expense of additional contributions:

i. confirm that entities applying IFRS in their activities may recognize their liabilities settled if the creditor has forgiven the existing debt;

ii. at the same time, however, make a reservation that:

a. corresponding obligation's reduction will affect the entity's income only if the creditor is a third party and not the owner (participant, shareholder) of the respective debtor in such obligation; and that

b. size of an owner's share, as well as claims received in exchange (to seek refund, payment of dividends, etc.) do not matter when applying this criterion.

24.2. The Ministry of Finance of Ukraine — issue a letter of explanation or a generalized tax consultation clarifying methodology of application of the TCU's provisions on the foregoing matters.

6 TAX AUDITS (SELECTED PROCEDURAL ASPECTS)

Tax audits should essentially be aimed at identifying real infringers of tax legislation and imposing reasonable additional tax charges, which could subsequently be converted into actual taxes paid. Yet, tax audits frequently trigger various disputes.

As at July 1, 2020, the Council received a total of 7,379 complaints, 1,048 of which (14,2%, or every 7th complaint lodged with the Council so far) concerned challenging tax audits findings by taxpayers[207]. These figures show that the tax audit issue is one of the most topical ones for business.

This chapter commences with the general overview of risk-oriented approach due to be employed by tax authorities while planning and carrying out audits/control and audit measures (Section 6.1). Then we will attend to such issues as appointing scheduled audits of taxpayers with the focus on adjusting the plan-schedule (Section 6.2) and interaction between taxpayers and tax authorities in the course of scheduling and conducting tax audits (Section 6.3). Thereafter we will embark upon analysis of interaction between taxpayers and tax officials during tax audit from the standpoint of document disclosure to auditors and exercise of such recourse measure as administrative arrest of property (Section 6.4). And, finally, we will focus on evaluating outcomes of control and audit activities (Section 6.5).

6.1 Risk-oriented approach: general overview

In 2016, the MoF (by adhering to the IMF's recommendations and in cooperation with the Council and major business associations) introduced a number of conceptual changes in control and audit activities at the part of tax authorities[208]. The purpose of these changes was to increase the effectiveness of their work during audits and reduce the pressure on law-abiding taxpayers.

One of the fundamental changes was the introduction of a risk evaluation system. This system is designed to effectively identify taxpayers and transactions that need to be scrutinized. Here, it was also pointed out to the need to ensure (1) the reasonableness of additional tax charges (so that they are not subsequently canceled in the appeal and judicial proceedings); (2) STS's officers high qualification (to ensure correct application of tax and other legislation); and (3) bringing to liability those tax officers who systematically impose unreasonable additional tax charges[209].

A risk-oriented approach is intended to identify risk criteria of non-compliance with tax legislation for each tax and to analyze

[207] Out of 886 complaints received by the Council, investigation was finalized in 308 cases (34.76 %) with a successful outcome for complainants due to the Council's involvement, in 6 cases (0.67%) the result was achieved without the Council's facilitation, in 511 cases (57.67%) the investigation was completed without a successful outcome, and in 31 cases (3.49%), the Council found the complaints unsubstantiated or largely unsubstantiated with further dismissal.

[208] Letter of the MoF dated September 27, 2016 No. 31-11000-07-10/27318; *Order of the SFS No. 880 dated October 20, 2016*.

[209] Letter of the MoF dated September 27, 2016 No. 31-11000-07-10/27318; *Order of the SFS No. 880 dated October 20, 2016*.

information available to tax authorities necessary to identify taxpayers acting in bad faith[210]. Actually, tax authorities monitor taxpayers' business transactions in the framework of tax risks comprehensive control on a daily basis. The consequences of such work (being inconspicuous at first glance) are, however, quite tangible for taxpayers. Thus, below we will be focusing on how the tax authority decides on appointing a scheduled, unscheduled or a factual tax audit while handling information based on the taxpayer's activities monitoring results.

In order to address tax risks and identify those involved in tax minimization schemes, STS authorities use a wide range of information and analytical resources. Among other things, this is the URTI; information from USR, customs declarations (EAIS); 1C "Tax Block" and 1C "Industry" data on the status of payments to the budget, etc. The STS is constantly working on expanding sources of information on possible violations. For example, in 2019, the tax authorities began using daily data on earnings through cash registers[211].

Based on this information, taxpayers are identified to be included in the schedule of documentary scheduled audits, as well as for which it is necessary to appoint an unscheduled or a factual audit[212]. Such information obtained as a result of monitoring should serve as a so-called "red flags" for tax authorities — i.e. risks markers that may indicate a violation of law. However, it is not a ground in itself for applying measures of recourse vis-à-vis taxpayers. *In essence* such information is not duly proven and, accordingly, cannot be considered reliable. The TCU establishes that such information is not considered sufficient to appoint a documentary unscheduled audit of the taxpayer. Therefore, prior to appointing audit, tax authority is obliged to contact the taxpayer seeking explanations and documents[213].

The problem is that in practice, the tax authority often refers to such information (particularly data retrieved from 1C "Tax Block") as allegedly reliable. As a result, decisions affecting rights and legitimate interests of taxpayers based on that information are made. At the same time, the latter are not even given the right to access such information and to participate in the decision-making process (including the opportunity to dismiss such information). The most common examples are decisions on a taxpayer's compliance with risk criteria or a taxpayer's tax invoice registration suspension[214]. However, the issue of decision-making based on the information of the 1C "Tax Block" is relevant for cases of appointing and conducting tax audits as well. In its practice, the Council encountered many cases where the tax authority's findings on audit results are based solely on information from 1C "Tax Block" and do not refer to any other information made available to the tax authority during tax audit.

In view of the significance *de facto* ascribed to such databases while carrying out tax supervision (control), quite often taxpayers try challenging tax officials' inclusion of certain information or opinions in these databases.

[210] Clause 2 of Section III of the Procedure for Forming a Schedule of Documentary Scheduled Audits of Taxpayers, approved by the Order of the MoF No. 524 dated June 2, 2015 (**"Procedure for Forming a Plan-Schedule"**).

[211] https://www.obozrevatel.com/ukr/economics/economy/pro-byudzhet-karantin-ta-vtratu-5-mlrd-na-pdv-intervyu-z-golovoyu-podatkovoi-verlanovim.htm

[212] Clause 3 of Section III of the Procedure for Forming a Plan-Schedule.

[213] Article 78.1.1 of the TCU.

[214] Discussed in detail in Section 2.4.2.

Meanwhile, the courts are reluctant to narrow tax authority's rights to carry out information and analytical support activities by employing various forms (including by entering certain data and tax authorities' views in the 1C "Tax Block" and processing such information). According to courts, information collected in accordance with the TCU norms can be stored and processed in tax authorities' information databases or directly by tax officials[215], which, as such, does not violate rights and legitimate interests of taxpayers. Tax information collected and results of its processing may be used both to fulfill functions and tasks assigned to tax authorities as well as by the MoF to develop and implement a unified state tax and customs policy[216]. Only if tax authority were to employ such information to render a certain decision affecting taxpayer's rights and legitimate interests, — the latter would become entitled to challenge it.

Customary court practice actually excludes the possibility of challenging tax officials' actions comprising entering and processing information in information databases. Yet, such actions might bear significant impact on the taxpayers' interests. Therefore, the Council finds it necessary to emphasize that information and analytical activities support, carried out by tax authorities, shall be based on good faith and reasonableness. Since courts generally perceive information in tax authorities' databases as such that does not affect the rights of taxpayers (i.e. essentially being technical, intermediate) — tax authorities should follow a similar pattern, without exaggerating such information's evidentiary weight, including during tax audits.

6.2 Scheduled audits: scheduling, forming and adjusting of plans-schedules

On December 22, 2017, the SFS first published plan-schedule of documentary tax audits for 2018 on its official website as required by Article 77.1 of the TCU. For the purposes of selecting legal entities to be included in the schedule, three risk degree criteria (high, medium and low) have been approved virtually covering entire range of taxpayers' economic activities[217]. In particular, there are 28 criteria by which a taxpayer-legal entity can be qualified as high-risk and, therefore, it is highly likely to be listed in the schedule. Among the most common criteria are transactions with "dubious" counterparties, certain anomalies in the dynamics of financial and tax reporting indicators of the taxpayer, open criminal proceedings based on allegations of tax evasion, etc.

Taxpayers had reasonable anticipations that thus published plan-schedule would remain unchanged throughout 2018. However, such expectations proved to be vain. In particular, starting from 2018, by employing provisions governing Procedure for Forming a Plan-Schedule, the tax authorities periodically made adjustments to plan-schedule by adding new taxpayers and changing audit dates. Such

[215] The Supreme Court Resolution dated November 20, 2019 in case No.480/4006/18, the Supreme Court Resolution dated April 25, 2018 in case No. 826/1902/15, the Supreme Court Resolution dated September 18, 2018 in case No.818/398/15, Resolution of the Supreme Court of Ukraine dated November 4, 2015 in case 21-1654a15.

[216] The Supreme Court Resolution dated March 2, 2018 in case No.820/2762/17.

[217] Clause 5 of Section III of the Procedure for Forming a Plan-Schedule.

adjustment of plan-schedule usually resulted in the growing number of audits.

Despite strong taxpayers' resistance, the STS is, for several years already, continuing the practice of introducing amendments to plan-schedule. The most recent adjustment was made in the end of June 2020[218].

Meanwhile, according to the STS, the TCU does not prohibit correcting (adjusting) the plan-schedule by adding new taxpayers. To justify their position tax authorities traditionally refer to sub-clause 1 and 3 of Section I and clause 4 of Section III of the Procedure for Forming a Plan-Schedule, vesting them with the right to make corrections to the schedule. The procedure was adopted according to Article 77.2 of the TCU, which provides that the plan-schedule formation and approval procedure, the list of risks and their degree classification shall be established by the MoF. These norms, in particular, stipulate that the annual plan-schedule shall be updated by way of its adjustment. The STS regional authorities are entitled to form draft adjustments of plans-schedules on a monthly basis in accordance with the form set forth in Annex 2 to the Procedure.

The position of the tax authorities was also supported by the MoF, which developed and approved the respective procedure. In particular, while investigating complaint lodged by entity included in the plan-schedule upon its adjustment in 2018, the Council approached the MoF. However, the latter actually upheld the STS's position by informing the Council that:

"Adjustments are required to promptly respond to cases where businesses that are highly likely to underpay or to conceal an object of taxation shall \ be covered by control and audit measures aimed at avoiding significant budget losses."

Tax authorities' confidence in their right to adjust the plan-schedule has been supported by a number of court decisions rendered in their favor[219]. Unfortunately, the judicial practice has not yet shown a unanimous approach, since in recent years court decisions have been taken in favor of both taxpayers and tax authorities. In a number of decisions, courts came to the conclusion that current Ukrainian legislation actually does not empower the tax authority to adjust the already formed and approved annual plan-schedule of tax audits by adding new taxpayers thereto[220]. Therefore, taxpayers were eagerly awaiting expressing by the Supreme Court of its legal position on adjusting the plan-schedule that would put an end to this confrontation.

However, this dispute was ultimately resolved by the legislator. In particular, on May 23, 2020, the Law No. 466-IX entered into force. The Law, in particular, amended Article 77.2 of the TCU stipulating that the plan-schedule may be adjusted, but not more than once in Q1 and once in Q2 — i.e. only twice a year. At the same time, the law provides for an exception in cases of a taxpayer's name change, provided that taxpayer had already been included in the plan-schedule and/or technical errors adjustment. In such cases, the plan-schedule can obviously be adjusted without any restrictions, if necessary.

For its part, the Council believes that the adjustments of the plan-schedule of tax audits by adding new taxpayers, which took place in 2018, 2019 and early 2020, is contrary to the law. In particular, according to the rule set forth in Para 2 of Article 19 of the Constitution of Ukraine, public authorities and bodies of local self-government and their officials shall be obliged to act only on the grounds, within the powers, and in the way determined by the

[218] https://www.tax.gov.ua/diyalnist-/plani-ta-zviti-roboti-/402509.html

[219] Decision of the Kharkiv Circuit Administrative Court dated February 26, 2019 in cases No. 520/10663/18; Ruling of the Eighth Administrative Court of Appeal dated April 17, 2019 in case No. 460/2672/18.

[220] Ruling of the Sixth Administrative Court of Appeal dated February 26, 2019 in case No. 810/2099/18; Decision of Donetsk Circuit Administrative Court dated October 4, 2018 in case No.0540/5690/18-a.

Constitution and the laws of Ukraine. Since neither the TCU nor the *Law of Ukraine "On Basic Principles of State Supervision (Control) in the Sphere of Economic Activity"*[221], nor any other law envisaged tax authority's right to adjust or update already published plan-schedule in 2018, 2019 and early 2020 , — the respective right cannot be established by the act of secondary legislation (i.e., adopted based on and in pursuance of the law), which is the Procedure for Forming a Plan-Schedule.

It is worth noting that provisions prescribing early publication of the plan-schedule were introduced in the TCU based on the Law No. 1797-VIII. The law was adopted to improve the investment climate in Ukraine by simplifying the tax system and tax administration, which, in turn, was designed to positively influence economic growth, encourage investment and create jobs[222]. Thus, when preparing the draft law, the legislator did not intend to grant additional or broader powers to tax authorities in terms of operational tax risks handling or responding to them. Thus, the Council believes that, prior to making respective amendments to the TCU in 2020, the tax authorities had no grounds to interpret and apply the norms of Article 77.1 of the TCU in a manner detrimental to taxpayers– i.e. by allowing to adjust tax audits plan-schedule.

The Council is convinced that tax authorities already have a wide range of powers available to promptly respond to taxpayers' alleged malpractices. In particular, in addition to scheduled audits, they are also entitled to conduct in-house, unscheduled and factual audits[223]. Hence, if tax authorities were to be allowed to use scheduled tax audits as a tool for prompt response to legislation violations, this would significantly expand their powers.

Recent amendments to Article 77.2 of the TCU — to the extent they introduce rules governing tax authority's right to adjust the plan-schedule — contemplate restoration of a certain balance between the rights of taxpayers and the tax authorities. However, such new rules yet have to be tested in practice, as it is still unclear how tax authorities are going to interpret the term "technical error" which provides them with grounds to adjust the plan-schedule almost every month. The plan-schedule published by the STS contains very limited information where a technical error could occur — in the name of the taxpayer, USREOU code, the month of the tax audit commencement, a note on the simultaneous auditing by other bodies. Therefore, there is high likelihood that tax authorities might interpret new TCU norms quite broadly and in a way that may burden taxpayers. For example, the tax authority might consider certain tax information regarding the taxpayer as a technical error, if corrected in course of economic activity's monitoring process due to receipt of new tax information.

Therefore, the Council considers it necessary to clearly establish the meaning of the "technical error" term in the context of application of Article 77.2 of the TCU. This term should be interpreted in a way that will neither burden taxpayers nor expand already broad powers of tax authorities.

[221] Part 1 of Article 5 of the *Law of Ukraine "On Basic Principles of State Supervision (Control) in the Sphere of Economic Activity"* states that 1. Amendments to the annual plans for state supervision (control) are not allowed, except for cases of changing the name of the business entity and correcting technical errors.

[222] Explanatory Note to the draft Law on Amendments to the Tax Code of Ukraine (to improve the investment climate in Ukraine) / https://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=60443

[223] Article 75.1 of the TCU.

6.3 Selected problems while appointing unscheduled and factual audits

As a result of tax control and monitoring measures local tax authorities can obtain tax information evidencing alleged violations. Such information, in turn, might constitute the ground for conducting an unscheduled tax audit. An exhaustive list of grounds for conducting an unscheduled documentary audit is set forth in the TCU[224].

In this case, the main object of criticism by taxpayers is primarily Article 78.1.1 and Article 78.1.4 of the TCU, where the wording of one of the grounds for appointing an unscheduled audit is set out so broadly that the tax authority almost always has the opportunity to appoint such an audit.

In particular, tax audit is mostly scheduled under this clause if the tax authority received tax information serving as evidence of violation of the law by the taxpayer (including information based on taxpayer's monitoring results). However, availability of such tax information cannot (in itself) be the ground for an unscheduled tax audit until the taxpayer is given the opportunity to provide explanations and documentary evidence dismissing tax authority's assumptions or speculations about occurrence of violations. Therefore, at this very stage, tax authorities send explanation and document inquiries to taxpayers under Article 78.1.1 of the TCU seeking documentary evidences proving possible violations of currency, tax and other legislation.

If such a request was drawn up in violation of prescribed requirements, the taxpayer is exempt from providing a response thereto[225]. Therefore, given the low level of confidence of taxpayers vis-à-vis tax authorities, this way of appointing tax audits is often contested in court, even if request's flaws are minor. Taxpayers also challenge in court appointment of tax audit if they are convinced that they had provided all the documents and necessary explanations at the tax authority's request and, therefore, there are no grounds for conducting documentary unscheduled tax audit.

The courts agree on the importance of respective functions of tax authorities and, therefore, emphasize on taxpayer's obligation to provide information at the former's reasonable and lawful request[226]. Therefore, taxpayers should be careful and cautious when refusing to provide documents at tax authorities' request, or when providing an incomplete package of documents. According to the Supreme Court's practice, explanations and documents provided must be comprehensive and tax authorities have the right to assess their content. If provided explanations and copies of documents failed to eliminate respective doubts, tax authorities have a reasonable right to carry out the audit[227]. At the same time, some deficiencies in the request for information and the order on appointing the tax audit do not matter. According to the customary court practice, the absence or incompleteness of references to specific TCU provisions should not be considered as grounds for declaring an order illegal, if the content of such order makes it possible to identify the statutory factual ground for conducting audit[228].

[224] Article 78 of the TCU.

[225] Article 78.1.1 of the TCU.

[226] The Supreme Court Resolution dated March 2, 2018 in case No. 820/2762/17.

[227] The Supreme Court Resolution dated June 20, 2018 in case No. 808/3151/16.

[228] The Supreme Court Resolution dated March 2, 2018 in case No. 820/2762/17.

6.4 Interaction between taxpayers and tax authorities' officials during tax audit

All issues pertaining to interaction between taxpayers and tax authorities' representatives during tax audits are regulated in detail by methodological recommendations[229]. Peculiarities of taxpayer's economic activity determines which taxes will be in the tax authority's focus and, accordingly, what documents will be required from the latter. Hence, in order to arrange effective communication and avoid misunderstandings between the taxpayer and the tax authority, it is important to properly record all auditors' and taxpayer's actions. However, misunderstandings are often unavoidable.

The following comprises more detailed analysis of main aspects of problem of interaction between taxpayers and tax authorities during tax audits both at the stage of documents' disclosure to auditors (Section 6.4.1) and taking inventory (Section 6.4.2).

6.4.1 Document disclosure

During the audit, the tax authority first of all requests supporting and consolidated accounting documents, as well as cash and settlement documents. If certain episodes of economic activity give rise to doubts, tax authorities may also request additional documentation and explanations. However, the requested documents should relate to the subject matter of audit[230].

The tax audit is carried out based on originals or duly certified copies of supporting documents[231]. For large taxpayers, there is a special procedure for submitting documents in electronic form[232].

In order to arrange effective communication and avoid misunderstandings between the taxpayer and the tax authority, it is important to properly record the actions of auditors, the fact of documents transfer, as well as refusal to provide documents. Usually, the fact of transfer of documents is confirmed by the inventory register, or a transfer report to be signed by the tax authority representative. To prove proper disclosure of documents they

[229] Methodological Recommendations On the Procedure For Interaction Between State Fiscal Service Divisions During The Organization, Conducting And Implementation Of Taxpayers' Audit Materials, approved by the Order of the SFS No. 22, dated July 31, 2014.

[230] Article 85 of the TCU.

[231] Article 85 of the TCU.

[232] Article 85.2 of the TCU; *The Procedure for providing documents of a large taxpayer in electronic form during a documentary audit was approved by the Order of the MoF dated November 7, 2011 No. 1393*.

can also be submitted to auditors through the tax authority's administrative office, or via email. It is also necessary to make sure the tax authority duly documents specific actions descriptive of factual audit, such as sample purchase or timing[233].

Particular attention is worth being paid to the issue of requesting documents from taxpayers during **factual tax audits**, being a separate kind of audits. Factual tax audits are carried out at the place of the taxpayer activity, location of economic or other objects of ownership of such taxpayer and aim at verifying issues of regulation of cash circulation, the procedure for settlement transactions performed by taxpayers, cash transactions, licenses, certificates, including production and circulation of excisable goods. During factual tax audits, it is necessary to pay attention to content of statements and documents that auditors are entitled to request.

For example, over the last few years quite a common ground for appointing an audit was to obtain information about the so-called "deemed employment" — i.e. use of hired workforce without proper labor relations registration and paying wages by employers without paying taxes to the budget[234]. In such cases, the tax authority verifies proper labor relations registration, issues of keeping records of work by an employee, accounting for labor costs, as well as information on the employee's remuneration. To clarify the fact of proper labor relations registration with the employee, documents or other papers allowing to verify his/her identity (a job description, driver's license, etc.) can be used[235].

According to the Council's observations, the situation is quite common in practice when tax authorities require information not directly related to the subject matter of the audit — and, therefore, the business entity is entitled to refuse providing such documents. For example, when conducting a factual tax audit of employees' employment, tax authorities do not have the right to check cash register documents or payroll documents. Similarly, while auditing cash settlements, demand to disclose documents related to employment of persons are to be met only to the extent of persons authorized to make settlements and their documenting.

6.4.2 Administrative arrest of property

Conflicts may arise at the beginning and during tax audits, when the taxpayer may disagree with the measures enforced by tax authority and, therefore, not allow to carry them out. In such situations, it is important to establish whether the tax authority has proper ground for taking measures and whether they are taken legally. On the other hand, it is also necessary to find out whether the taxpayer has legal grounds to disallow the actions of tax authority. Otherwise, the taxpayer will be exposed to the risk of administrative seizure of property. Typically, such situations arise from not allowing auditors to start the audit and refusing to take physical inventory under the supervision of auditors.

[233] Articles 20.1.11 and 80.8 of the TCU.

[234] Article 80.6 of the TCU.

[235] Article 81 of the TCU.

(a) Allowing tax audit to start

The TCU determines conditions and procedure for allowing auditors to conduct on-site documentary and factual tax audits[236]. The taxpayer is entitled to bar tax authority's officials from starting the audit on certain grounds. This right is mainly used by payers who consider the audit order illegal. Meanwhile, the TCU provides that grounds for not allowing auditors to start the audit are failure to provide or send the necessary documents (a copy of the audit order and identity cards of persons specified in the audit order) to a taxpayer, or presenting documents issued in violation of the requirements established by the TCU (the TCU establishes specific requirements for all these documents)[237].

However, taxpayers should be careful and cautious, because in case of their refusal to conduct a documentary or factual tax audit (provided there are legal grounds for the audit), or not allowing the tax authority's officials to start the audit, the latter has the right to resort to an administrative arrest — an exceptional way to secure performance of the taxpayer's duties.

Case No. 25. Well-grounded administrative seizure of taxpayer's property

In May 2019, an IE from Zaporizhia oblast (**"the Complainant"**) turned to the Council. He did not allow auditors from the STS in Zaporizhia oblast to perform the audit stating that he was not notified of a scheduled documentary on-site audit in a timely manner. In particular, the Complainant explained that he was not furnished a notice and an audit order copy at least 10 days prior to the start of the audit. He received the respective documents by post at the post office one day before the audit. As a result of the Complainant's refusal to allow start of the audit, the tax authority decided to impose administrative seizure of the Complainant's property.

During examination of the complaint's materials, the Council ascertained that the Complainant had actually been duly notified of the audit in accordance with the procedure established by the TCU. In particular, he was sent a registered letter (with delivery notice), a documentary scheduled audit order copy and a written notice specifying the date of commencement of such audit in compliance with the deadlines set by the TCU. The postal item was delivered to the addressee only one day before the audit, because the Complainant did not show up at the post office to receive it.

According to the paragraph 2 of clause 77.4 of Article 77 of the TCU: *"The right to conduct a documentary scheduled tax audit of the taxpayer shall be granted only if, not later than 10 calendar days prior to conducting such a tax audit, an order copy was delivered against receipt or sent by registered mail with return receipt and a written notice specifying the date of commencement of such an audit"*.

Therefore, as the TCU does not contain a precaution to make the taxpayer familiar with these documents exactly 10 days before the start of such an audit, provided that the taxpayer was sent the relevant documents, the Council acknowledged that the Complainant's malpractice allegation was not confirmed. In addition, validity of the arrest was confirmed by a competent court decision. Consequently, the Complainant suffered because of his own inattention and carelessness.

[236] Article 81 of the TCU.

[237] Para 5 of Article 81.1 of the TCU.

Administrative arrest may be applied to both the taxpayer's funds and property, except for property that cannot be seized in accordance with the law[238]. Even though the grounds for applying administrative arrest of tangible assets and freezing of funds on taxpayer's accounts are the same and determined by Clause 94.2 of Article 94 of the TCU, — they nonetheless vary depending upon the procedure of their enforcement[239].

Seizure of property other than funds is enforced based on the order of the head of the tax authority. However, if the court does not confirm the validity of the arrest within 96 hours, the administrative seizure of the taxpayer's property is terminated by virtue of law, regardless of reasons why the court's decision to confirm the validity of the administrative arrest was not made[240].

Meanwhile, seizure of funds on the taxpayer's account, although it is a part of the general taxpayer's property seizure, can be carried out solely based on a court decision resulting from tax authority's prior application to court[241].

An issue of interest is application of administrative arrest of property when there is a simultaneous dispute on the right between the taxpayer and the tax authority — i.e. when the taxpayer denies the legal grounds for the audit, does not allow auditors to start it and challenges the audit order in court[242]. After all, the fact of not allowing tax authority to carry out the audit may not only be illegal (as the tax authority considers when applying the administrative arrest), but legal as well. Therefore, if the court cancels tax audit order and, accordingly, confirms the lack of legal grounds for the audit, similarly there will be no grounds for imposing administrative arrest.

Hence, courts should give due consideration to such circumstances when considering the reasonableness of applying administrative seizure to tangible property or funds. In one such case, the Supreme Court concluded that there were no grounds to satisfy the tax authority's claim to impose arrest on taxpayer's funds, because, as a result of declaring the tax audit illegal and its cancellation, conditions for both performing the audit and allowing tax authority's officials to conduct it ceased to exist[243].

On a separate note, it should be mentioned that until recently, according to the legal position of the Supreme Court, allowing to start the audit by the taxpayer mitigated the legal consequences of procedural violations committed by tax authority while appointing tax audit. Therefore, it was considered that taxpayer could not challenge the legality of

238 Articles 94.4 and 94.6 of the TCU.

239 The Procedure for applying the administrative arrest is regulated by the *Procedure for Applying Administrative Arrest of Taxpayer's Property, approved by the MoF Order No. 632 dated July 14, 2017.*

240 Article 94.19.1 of the TCU.

241 Article 94.6.2 of the TCU.

242 The Supreme Court confirmed that taxpayer's appeal against tax authority's order on appointing the tax audit, decision to apply the administrative arrest of property — regardless of the chosen method of appeal: administrative or judicial — constitutes the dispute on the matter of law (the Supreme Court ruling dated November 30, 2018 in case No. 826/2195/16).

243 The Supreme Court Ruling dated February 28, 2019 in case No.813/483/17.

appointing tax audit if he allowed auditors to start it.

However, the Supreme Court reconsidered its legal position in the recent ruling and formulated the new one instead. From now on, regardless of the taxpayer's decision on allowing or disallowing tax officials to start tax audit, — taxpayer can further challenge the results of the tax audit (in the form of TNDs and other decisions) by referring to the legislation requirements violated by tax authority when carrying out such an audit, considering this results in such TNDs being illegal. In this case, such grounds for the claim, if any, should first of all be assessed by courts in legal terms. If they are not recognized by court as entailing illegality of decisions made as a result of tax audit, — then one should proceed to verifying the grounds of the claim for tax and/or other violation of legislation[244].

(b) Taking physical inventory during tax audit

The issue of administrative arrest may also arise when, during tax audit, the auditors demand to take a physical inventory of fixed assets, material assets, funds and left-over stock and cash[245].

To take a physical inventory at the company, an inventory commission is set up based on the executive order of the company's general manager. The commission should be made up of representatives of the management team of enterprise, accounting service and employees who are well aware with the object of inventory, pricing and primary accounting (engineers, technologists, mechanics, contractors, commodity experts, economists, accountants), members of the audit committee. The commission is chaired by the general manager (his or her deputy) or duly authorized head of the company's structural division[246].

It should be pointed out that tax authority is entitled to request taking an inventory, but it is not explicitly provided that the inventory should be under its supervision. It is only specified that tax authority's representatives "may be present during the inventory procedure"[247]. Therefore, based on a literal interpretation of this norm, the taxpayer is obliged to take a physical inventory at the request of the tax authority, grant auditors access to the descriptions of inventory of goods and fixed assets, but is actually not obliged to do so in the presence of tax officials.

The taxpayer's refusal to take inventory is the ground for applying the administrative arrest[248]. However, quite often in practice auditors require taking inventory in their presence, and treat the taxpayer's refusal to allow them to take the inventory as a rejection to do the inventory. If we interpret the norm not literally and assume that each right corresponds to a respective obligation, we can assume that auditors may be present during the inventory if they wish to (i.e. the auditors' right to be present during the inventory corresponds to the taxpayer's duty

[244] The Supreme Court ruling dated February 21, 2020 in case No.826/17123/18.

[245] Article 20.1.9 of the TCU.

[246] Clause 1 of Section II of *Regulation on inventory of assets and liabilities, approved by the Order of the MoF dated September 2, 2014 No.879*.

[247] Clause 1 of Section II of *Regulation on inventory of assets and liabilities, approved by the Order of the MoF dated September 2, 2014 No.879*.

[248] Article 94.2.8 of the TCU.

to allow their presence). Such interpretation helps to understand how to act in situations, for example, when taxpayer acting in bad faith continues to officially keep record of goods actually sold on the "black market" and which, thus, are effectively out of stock.

However, it should be noted that the Supreme Court upheld the taxpayers' position and pointed out that "presence of officials of the body that issued the request for an inventory is not mandatory." Thus, the Supreme Court concluded that if the taxpayer's inventory was carried out, but the taxpayer did not allow the tax authorities to be present, then there are no grounds for the administrative arrest under Article 94 of the TCU, since the tax authority's requirement to take such an inventory in the presence of the tax authority's officials is not envisaged by current legislation[249]. Meanwhile, the court emphasized that the ground for *"applying seizure of property in accordance with sub-clause 94.2.8 of clause 94.2 of Article 94 of the TCU is the taxpayer's refusal to take an inventory at all rather than the refusal to take it in the presence of tax authority's officials"*.

Therefore, in the Council's view, the STS needs to bring to the knowledge of the local tax authorities customary court practice, according to which the grounds for seizure of property in accordance with Article 94.2.8 of the TCU is the taxpayer's refusal to take an inventory at all, but not a refusal to take it in the presence of the tax authority's officials.

6.5 Evaluating outcomes of control and audit activities (measures): disclosing data and performance of respective KPIs

For many years in a row, the SFS (now — the STS) has been reporting on the results of its control and audit activities. Information on KPIs performance by the STS is published on its official website[250]. Such information is aimed at providing the public and all parties concerned with comprehensive data on the results and quality of such work.

However, the Council is concerned, that the way in which the STS discloses data on performance of KPIs related to control and audit measures does not allow to promptly obtain complete and accurate information about the results of tax authorities' work without special skills and knowledge. The data are published in separate tables (partly in Word format, partly in Excel) and contain information that one needs to process and compare on its own. For example, two separate tables contain data on the number of tax audits and additional tax charges amounts for such audits (in Word format), and a separate table contains information on the number of audits and additional tax charges amounts by oblasts (in Excel format).

[249] The Supreme Court Ruling, dated February 13, 2019 in case No. 820/817/17.

[250] https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/kontrolno-perevirochna-robota/

The Council is convinced that with the present-day development of big data processing and disclosing technologies, the STS has every opportunity to disclose data on the results of control and audit measures as comprehensively as possible and in a more user-friendly format. It is also important to ensure that the user can effectively work with the disclosed data, particularly perform a "smart" search, group the data and compare them. The Council believes that the openness and transparency by STS in disclosing data on the results of control and audit activities in a user-friendly manner will increase taxpayers' confidence level in the work of the STS. Therefore, the Council finds it appropriate for the STS to ensure disclosure of information on the results of control and audit measures in a unified format, as well as to facilitate the user's effective work with the disclosed data, particularly, by enabling a "smart" search, grouping data and comparing them.

Thus, in the context of issues addressed in this section, the Council considers it necessary to separately stress that while setting KPIs for the SFS in 2016, the MoF pointed out that it expected that, as a result of a risk-based approach implementation, a share of scheduled audits in 2017 would make up no less than 40% of the total number of audits[251]. However, the information on the performance of indicators published by the SFS did not confirm proper achievement of these goals. In particular, in 2017, some 7,985 unscheduled tax audits were conducted (whose results were reconciled), while in 2018 — already 13,841, and in 2019 — 10,230[252]. Meanwhile, in 2017, 4,085 scheduled tax audits were conducted (whose results were reconciled), in 2018 — 4,516, and in 2019 — 3,647. Thus, although in 2017 the corresponding indicator was actually achieved, in subsequent years the respective ratio indicators declined.

In the meantime, the Council draws attention to the fact that KPIs set for the SFS/STS for 2019 did not include such an indicator as the ratio of scheduled to unscheduled (as initiated by the tax authority) audits. There is no information on setting such an indicator for 2020. Thus, we can assume both the STS and the MoF do not currently consider such data important; and, therefore, it is highly unlikely that such data are tracked.

For its part, the Council is convinced that the MoF has to set a KPI for the STS to measure quality of the risk-oriented approach. Such a KPI should measure the ratio between the number of scheduled and unscheduled (initiated by the tax authority) audits of taxpayers in the reporting period and provide for a gradual increase in the number of scheduled audits and a decrease in unscheduled ones.

[251] Letter of the MoF dated September 27, 2016 No. 31-11000-07-10/27318.

[252] https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/kontrolno-perevirochna-robota/

COUNCIL'S RECOMMENDATIONS:

In order to ensure proper functioning of the risk-oriented approach and to protect taxpayers' rights while scheduling and carrying out tax audits, the Council recommends as follows:

25. **The Ministry of Finance of Ukraine** — to amend the Procedure for Forming Plan-Schedule of Scheduled Documentary Tax Audits of Taxpayers, approved by the Order of the Ministry of Finance of Ukraine No. 524, dated June 2, 2015, to align it with the norms of the Law of Ukraine No. 466-IX, dated January 16, 2020, which would contain an exhaustive list of cases falling under the notion of "technical error" as the reason for adjusting plan-schedule for the purposes of application of Article 77.2 of the TCU. In no case shall such a list broaden the tax authorities' powers.

26. **The State Tax Service of Ukraine** — to bring to the knowledge of the local tax authorities customary court practice, according to which the grounds for seizure of property, foreseen by Article 94.2.8 of the TCU, is the taxpayer's refusal to take an inventory at all rather than a refusal to take it in the presence of tax officials.

27. **The State Tax Service of Ukraine** — to ensure disclosure of information on the results of control and audit measures in a unified data format, as well as to enable the user to work effectively with the disclosed data, particularly, perform a "smart" search, group data and compare them.

28. **The Ministry of Finance of Ukraine** — to set an annual KPI for the State Tax Service of Ukraine to measure effectiveness of the risk-oriented approach. The KPI should measure the ratio of scheduled to unscheduled (i.e., initiated by the tax authority) audits of taxpayers in the reporting period, as well as should provide for a gradual increase in the number of scheduled audits and a decrease in unscheduled ones.

7 CHALLENGING RESULTS OF TAX AUDITS

In the Council's view, existence of an effective administrative (internal/institutional) appeal procedure to challenge decisions, actions and inactions of public authorities and local self-governments is one of the key pillars of proper protection of the rights of business. In particular, such a procedure enables out-of-court settlement of disputes between businesses and public authorities, thereby saving resources of both parties without diverting their time and money to resolve the matter in court.

It is for these reasons that the Council's Systemic Report *"Administrative Appeal: Current State and Recommendations"* (July 2019) was devoted to exactly this topic. The document contains a set of the Council's recommendations aimed at improving the administrative (institutional) appeal in Ukraine. Implementation of these systemic recommendations should have an impact on most areas of public administration and oversight, including tax administration.

In this Systemic Report, however, the topic of challenging tax audit's results is considered only to the extent the peculiarities of tax sphere might call for employing special approach. Hence, in this section, we are going to focus on the problems pertaining specifically to challenging tax audits results, as well as on those ones which, according to the Council's observations, are especially descriptive of this area. To address these issues, the Council elaborated set of respective recommendations. These recommendations are narrower and more targeted in their nature than those contained in its Systemic Report *"Administrative Appeal: Current State and Recommendations"*, which are inherently more general. The latter, meanwhile, remain fully relevant to the tax sphere.

In lieu of the prevalence of the essence over the form principle, the procedure for challenging tax audit's results in Ukraine can be viewed as comprising two stages, namely:

1) first, a taxpayer can resolve discrepancies with tax authority by submitting his or her objections to the conclusions set forth in the tax audit report;

2) if the tax audit's conclusions remain in force (fully or partially), and the tax authority issues a TND based thereon, the taxpayer may challenge the respective TNDs with the STS as a higher-level authority.

In the traditional meaning of the scope of this concept "administrative appeal" is only the second one of the foregoing procedures, since the subject matter of the appeal is, actually, a duly documented decision of the public authority. The first one is considered rather the final stage of the tax audit preceding the TND's issuance.

From the business perspective, however, these terminological nuances are somewhat insignificant, as both procedures are used by businesses for the same purpose — to re-consider unsubstantiated conclusions issued upon tax audits.

Thus, analysis of the mechanism employed for consideration of taxpayers' objections to tax audit results (Section 7.1) will be followed by comprehensive review of various problems affecting efficiency of administrative appeal specifically in tax sphere (Section 7.2). At the end of this chapter we elaborate set of recommendations aimed at resolving problems described therein.

7.1 Considering taxpayers' objections to tax audits reports

The discussion about deficiencies of procedures employed while reconciling tax audit's results and ways to eliminate them has been lasting for a number of years already.

However, in the Council's view, very little attention in this discussion has been paid to the first of the two existing procedures performed at the level of the tax authority conducting the tax audit. This is the procedure for considering the taxpayer's objections to the tax audit report.

Many taxpayers are familiar with situations when additional charges accrued by local tax authorities were completely dropped during the review at the STS. However, it is difficult to recall similar cases where additional charges were completely cancelled as a result of considering the taxpayer's objections by the local tax authority. This, along with many other factors, might point out to extremely low efficiency of this procedure. Indeed, taxpayers demonstrate low level of trust with the tax audit report's objections review procedure as a way to protect their rights, because they are skeptical about the prospects of reconsidering by the local tax authority of the conclusions made by its own officials. The Council, accordingly, receives complaints from taxpayers where it is argued that consideration of objections to the tax audit report is carried out by the tax authority as "window dressing", which is well illustrated by the following case.

Case No. 26. Controlling authority's ignorance to the Complainant's arguments

In April 2020, a large manufacturing enterprise from Khmelnytskyi oblast (**"Complainant"**) turned to the Council with a complaint challenging the TND. By the time of complaint's submission to the Council the Complainant tried to resolve the controversies with the tax authority locally as part of consideration of its objections to the tax audit report. As scheduled on-site documentary audit covered a large number of episodes of allegedly fictitious transactions with many counterparties for a long period of time (two years and a half) — objections to the report provided by the Complainant contained some 255 pages of text and objection's materials were voluminous and weighed about 10 kg.

As the Complainant found out later, on the same day when its objections were considered and when the Complainant addressed the tax authority with the request to carefully consider its objections, the company obtained a reply to the objection containing 23 pages. This gives good grounds to assume that tax authority was actually not intending to give due consideration to the Complainant's arguments and explanations and the response to objections had been prepared even before the Complainant's meeting with the tax authority. Therefore, the objections' review was purely formal.

As the practice shows, local tax authorities often do not even reconsider clearly unreasonable or improper conclusions of its auditors. As a result, the STS, a higher level tax authority in the hierarchy, bears the burden of consideration of too many administrative complaints. Therefore, the STS should be highly interested in improving the quality of consideration of objections by local tax authorities.

Hence, in the Council's view, at the first stage of reconciling the tax audits' results it is difficult to ensure effectiveness, because consideration of taxpayer's objections is carried out by the same body whose officials conducted the tax audit, so the process itself is not impartial[253]. Nonetheless, the Council is convinced this procedure can be significantly improved.

At present, the effectiveness of the procedure for reviewing objections of taxpayers is in no way monitored at the level of the STS and the MoF, at least the corresponding information is not disclosed. As described in more detail in Section 7.2.6 below tax authorities' statistics on the administrative appeal procedure covers only data related to TNDs already issued, but do not trace which portion of the auditors' findings were cancelled by the tax authority prior to the TND's issuance.

In view of this, the Council is convinced that proper quality control over the first stage of challenging the tax audits results should include:

1) collection of complete statistical data on the results of consideration of objections by the STS in terms of the maximum number of indicators (even names and surnames of auditors). Not all relevant data will be subject to disclosure, but collecting and processing such data by the STS will shed light on ensuring the quality of the relevant procedure in the regions and even track down those tax authorities' officials that are regularly making groundless decisions;
2) publication of such key statistics indicators on the STS's website;
3) setting KPI for the STS by the MoF related to arranging and conducting work at this stage of settlement of controversies of tax supervision, as well as reporting to be made by the STS on implementation of such KPIs.

In the Council's view, the STS should ensure collection and publication of at least the following statistics (in both absolute figures and as percentage ratios):

1) results of consideration of taxpayers' objections to tax audit reports by oblasts and additionally charged amounts;
2) administrative appeal results (by amounts of charges and number of TNDs) at the STS by oblasts in which the corresponding TNDs were issued;
3) judicial appeal results (by number of charges and number of TNDs) by oblasts in which the corresponding TNDs were issued.

It should be emphasized that some of the respective statistics are already published by the STS, but only in "positive" manner for the tax authorities — i.e. the only data published is the one on the number of audits, whose results have been reconciled, as well as additional charges due to be settled[254]. It goes without saying, it is necessary to ensure collection and publication of comprehensive statistics (including negative data as well) comprising results of objections consideration, as well as administrative and judicial appeal following which additional charges were canceled.

[253] In the Systemic Report *"Administrative Appeal: Current State and Recommendations"*, the Council highlighted the general peculiarities of appellate bodies' compliance with the impartiality principle if the administrative complaint is considered by the body that made the contested decision (*see* Section 3.2.1 "a") of the said Systemic Report).

[254] *See*, in particular, https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/kontrolno-perevirochna-robota/ (in Ukrainian).

7.2 Problems related to efficiency of administrative appeal procedure

The procedure of appealing the TND to a higher-level authority — the STS — is, actually, a classical administrative appeal procedure. According to best practices, during such a procedure principle of competition amongst parties should be adhered, whereas appeal authority should consider complaints impartially and thoroughly.

However, back to the time of preparing the Systemic Report on similar tax issues in 2015 (i.e. over five years ago), the Council noted that tax authorities usually employ a fiscal approach in the procedure of administrative appeal, whereby the administrative appeal system has not become an effective appeal tool for taxpayers. Therefore, to improve the administrative appeal procedure, on October 21, 2015, the MoF issued Procedure No. 916.

In particular, in accordance with the Procedure No. 916, closed session consideration of complaint's materials takes place with the participation of the Council's authorized representative. The Council also has the opportunity to file its own objections. The taxpayer may request an open review of the complaint's materials and make photo and video recording. In practice, most taxpayers extensively use such additional opportunities (options).

In general, we have observed certain improvement of quality in complaints material's consideration at the level of the STS both in terms of procedural and substantial matters. However, the actual implementation of the Council's recommendations is far from being complete due to a number of reasons, which, in the Council's view, primarily relate to how law is enforced in practice.

Thereunder we will examine the following aspects of administrative appeal which, in the Council's view, have room for further improvement, namely: i) engaging interested third parties in the review of complaints (Section 7.2.1); ii) using modern technologies (Section 7.2.2); iii) fulfilling by the tax authority of the obligation to prove the legality of its own contested decisions, and by the appellate body — of the obligation to substantiate its decisions on complaints' consideration results (Section 7.2.3); iv) taking case-law into account when considering complaints (Section 7.2.4); v) publicizing decisions made as a result of the appeal (Section 7.2.5); and vi) setting correct KPIs for the appeal procedure (Section 7.2.6).

7.2.1 Engaging third parties to administrative appeal procedure

The practical implementation of the principle of officiality (ex officio)[255] — one of the internationally recognized principles of administrative procedure — obliges the appellate body not to be limited to passive perception of evidence provided by the parties to the proceedings (by the complainant; the body, whose decision, action or inaction is challenged, etc.). This appellate body has the right on its own initiative to gather those evidence, which, in its opinion, are required for a comprehensive and objective consideration of a particular complaint.

A comprehensive review of complaint materials is possible subject to adherence to a number of conditions. These include, in particular, engagement of the tax authority's representatives, who conducted the tax audit, the MoF's representatives (especially in cases when methodological issues are considered) as well as ensuring presence of the STS's officials during complaint's consideration. However, the Council notes that in practice the requirement for high-quality and effective cooperation between public authorities (the so-called "sincere cooperation"[256]) is often not met.

Indeed, the Procedure No. 916 stipulates that the taxpayer has the right to request participation and providing explanations during complaint's materials review by officials, who conducted the audit, made decisions (acted) or participated in the adoption of the contested decision. Procedure No. 916, however, does not establish the obligation of the STS to ensure such presence. The STS likewise cannot procure the presence of the MoF's representatives during complaint's consideration, although this possibility is stipulated by the Procedure No. 916. In practical terms, implementation of such provisions may first of all be complicated by the workload of the respective authorities and their inability to be physically present during complaint consideration. However, such problems could be effectively and quickly resolved by connecting them online (for example, by teleconference).

Therefore, in the Council's view, the provisions of the Procedure No. 916 should be clarified in order to procure the possibility of engaging tax authorities locally and the MoF's representatives through online means of communication. This will help simplifying their involvement and ensure full realization by the taxpayers of their rights to involve respective representatives and to have comprehensive consideration of their complaints.

It should also be noted that the administrative appeal procedure in the tax sphere does not actually suggest participation of independent experts and other public authorities[257]. Meanwhile, such engagement would only contribute to a comprehensive and high-quality consideration. In addition, sometimes during complaint consideration by the tax authority, there is an objective need to clarify the other state body's position on the taxpayer's issue in question. Apart from the MoF, there's often a need to engage the NBU's representatives on currency regulation, the StateGeoCadastre — on determining the land tax base (rent) and so on.

The difficulty of engaging the representatives of the NBU or other authorities is that their participation is not explicitly stipulated by the Procedure No.916. Despite the fact that currency regulation issues are within the NBU

[255] Peculiarities of compliance with the officiality (ex-officio) principle (regardless of the tax sphere) in the administrative appeal procedure are highlighted by the Council in its Systemic Report *"Administrative Appeal: Current State and Recommendations"* (*see* Section 3.4 of the said Systemic Report).

[256] *See* Section 3.4.2 of the Systemic Report *"Administrative Appeal: Current Status and Recommendations"*.

[257] These issues were considered more broadly (regardless of the tax sphere) by the Council in Sections 3.3 *"Openness and Transparency"* and 3.4 *"Officiality"* of the Systemic Report *"Administrative Appeal: Current State and Recommendations"*.

competence — and, accordingly, the NBU's engagement can have a decisive impact on the taxpayer's issues resolution (for example, the issue of proper documenting of changes to the loan agreement with a non-resident) — participation of NBU representatives is possible only with their consent, and moreover — their good will. However, it is difficult to imagine that the NBU will show such good will when it is the STS who formally considers the taxpayer's complaint. In practice, taxpayers sometimes manage to get the NBU position in written form. However, from the point of view of ensuring the quality of appeal consideration and proper restoration of the taxpayer's rights, it is usually not enough.

In lieu of the foregoing it is appropriate to refer to the Council's Systemic Report *"Administrative Appeal: Current State and Recommendations"*, which has already emphasized the importance of establishing cooperation between the appellate body and other authorities in the administrative appeal procedure. In this case we refer to the STS's cooperation with the NBU, StateGeoCadastre, etc. Such cooperation can be established, for example, by signing memorandum on cooperation and exchange of information. Supplementing the Procedure No. 916 with norms (provisions) on the possibility of reviewing complaints using online means of communication (to be discussed in more detail below) will simplify engagement of other authorities' representatives and speed up the interaction process.

7.2.2 Effective use of modern technologies in administrative appeal

The Council has already touched upon the issue[258] of using modern technologies to ensure convenience and accessibility of the administrative appeal procedure — especially for oblast-based taxpayers. This issue is especially relevant for administrative appeals against decisions of tax authorities, given the large number of complaints regularly processed by the STS.

The importance of this issue has become particularly relevant due to introduction of quarantine in Ukraine. Starting from March 16, 2020, to prevent spread of COVID-19 disease[259] the STS temporarily suspended personal reception of citizens pursuant to the *Resolution of the CMU, dated March 11, 2020 No. 211 "On Prevention of COVID-19 Coronavirus Spread in the Territory of Ukraine"*. Thus, all taxpayers who filed complaints with the STS against TNDs with petitions seeking consideration of complaint's materials with their participation actually lost the opportunity to exercise their right to be heard.

At the Council's request, the STS arranged remote consideration (by teleconference) of complaints' materials processed by the Council. However, as far as the Council is aware, such possibility was not provided for all taxpayers on a general basis (at least no official information on this matter was made public).

Thus, introduction of mechanism enabling review of complaints in remote mode will come in handy given systemic changes that have already taken place in the organization of communication and meetings in the context of COVID-19 pandemic. In addition, as this

[258] The respective aspects are described in the Systemic Report *"Administrative Appeal: Current State and Recommendations"* (*see* Section 3.1.2 "b" of the said Systemic Report).

[259] https://www.tax.gov.ua/media-tsentr/novini/412046.html

approach is consistent with the new format of communication between businesses and citizens with state authorities envisaged by the *Draft Law of Ukraine "On the Administrative Procedure"*[260] , — it appears that such changes are inevitable in the future.

In the long run, the Council might even suggest considering the possibility of transforming administrative appeal solely into an electronic format based on electronic document flow. It is worth noting here that the STS already has successful experience working in this format when taxpayers challenge tax authorities' decisions on suspension of the registration of TIs/ACs.

7.2.3 Adherence to guarantees granted by the TCU

The Council observes that the STS often does not facilitate quality complaint's consideration in the administrative appeal procedure. In particular, it ensures neither strict adherence to the guarantees granted to the taxpayers by the TCU nor proper substantiation of its decisions[261].

Indeed, the TCU grants a number of guarantees to taxpayers aimed at ensuring proper consideration of their complaint, as well as protecting them as a "weak party" in the relationship with public authority, namely:

1) During administrative appeal procedure, the burden of proving that any charges imposed by the tax authority in cases specified by the TCU (or any other decision of the tax authority) is legitimate lies on the tax authority[262].

2) In the case where provision of the TCU (or other legal act issued based on the TCU) or where the provisions of different laws or regulations, or where the provisions of the same legal act contradict each other and allow ambiguous (multiple) interpretation of rights and obligations of taxpayers or tax authorities, — so that the decision can be made both in favor of the taxpayer and the tax authority, — the decision shall be made in favor of the taxpayer (the so-called "presumption of legality of taxpayer's decisions")[263].

In the Council's view, the practical implementation of these guarantees leaves much to be desired, and the measurement and assessment of the degree of their implementation are generally complicated by the lack of proper substantiation of tax authorities' decisions.

Thus, neither the TCU nor the Procedure No. 916 establish how the decision of the tax body should be substantiated. In the opinion of the Council, a reasoned decision should not only refer to the law, but also contain a proper evidence assessment presented by parties and reasoned conclusions drawn from examination of documents and complaint

[260] Part 4 of Article 51 of the *Draft Law of Ukraine "On the Administrative Procedure"*, No. 3475 dated May 14, 2020 (*see* the link: http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=68834).

[261] Peculiarities of implementation of the principle of substantiality, consistency and systemic nature within the administrative appeal procedure (regardless of the tax sphere) were studied by the Council in its Systemic Report *"Administrative Appeal: Current State and Recommendations"* (*see* Section 3.7 of the said Systemic Report).

[262] Article 56.4 of the TCU.

[263] Article 56.21 of the TCU.

materials, relevant and important arguments of parties. However, in the absence of systemic regulation of this issue[264], the tax authority actually independently sets the substantiation standard for its decisions.

7.2.4 Taking into account case-law and prospects of judicial consideration

Paying due regard to the case-law by tax authorities simplifies the decision-making process and makes the administrative appeal process more predictable. However, taking into account the case-law when making decisions both locally and at the STS remains a problematic issue. This problem has several dimensions.

The first dimension is paying due regard to the case-law of the Supreme Court[265]. The Council consistently encourages the STS to take into account the legal positions of the Supreme Court and the provisions of Part 5 of Article 13 of the *Law of Ukraine "On the Judiciary and Status of Judges" No. 1402-VIII, dated June 2, 2016: "Conclusions on the application of law set forth in the Supreme Court's rulings are binding vis-à-vis all public authorities applying the legal act containing the relevant rule of law in their activities".* During consideration of cases, the Council observes that the STS, as a rule, actually takes the established practice of the Supreme Court into account. Meanwhile, the Council does not have sufficient information on taking the Supreme Court's practice into account by local tax authorities.

The second dimension is taking into account the customary judicial practice in the absence of the Supreme Court's established legal position. Formation of the Supreme Court's legal positions is a long and selective process, while in today's ever-changing world the speed of business processes leads to constant emergence of new issues, the need to coordinate positions with the tax authority and the rapid development of appellate court practice. The Council's practice suggests that there are multiple cases when the case-law clearly argues in favor of the taxpayer, in particular, when the taxpayer's business model remains unchanged for many years in a row. Therefore, the tax authorities often raise the same issues during tax audits, although the results of such tax audits are subsequently canceled by the taxpayer in court. However, when conducting the next tax audit, the tax authority refuses to take the effective court decision into account arguing that the new charges relate to new circumstances. Unfortunately, at present, in such a situation nothing but common sense could make the tax authority align its conclusions with the conclusions of the court.

[264] In Section 3.7.1 of the Systemic Report *"Administrative Appeal: Current Status and Recommendations"*, the Council stated: *"[So that] the decision on the complaint met the principle of substantiality, the appellate body is obliged to check whether basic requirements of substantive and procedural law were met, namely: i) whether all relevant facts have been established; (ii) whether they are supported by appropriate evidence; and (iii) whether the law is properly applied. The appellate body leaves the disputed decision in force only when the public authority was "strong enough" in its conclusions, and, therefore, it is possible to speak with "due confidence" about the circumstances that formed the basis of its adoption."*

Hence, the second part of Article 81 of the *Draft Law of Ukraine "On the Administrative Procedure" No. 3475 dated May 14, 2020* provides that the subject of the complaint cancels in whole or in part an administrative act in case of violation of substantive law, significant violation of procedure (including competence) or incorrect or incomplete establishment of the circumstances of the case (*see* the link: http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=68834).

[265] The current situation, taking into account the findings of the Supreme Court by the appellate body (regardless of the tax sphere) is described in the Systemic Report *"Administrative Appeal: Current State and Recommendations"* (*see* Section 3.7.3 of the said Systemic Report).

The third dimension is to consider perspectives of further judicial consideration. Currently, the Council has no sufficient evidence proving that tax authorities make decisions in lieu of taxpayers' complaints by estimating perspectives of subsequent judicial consideration of their decisions. As noted above, the tax authority will weigh prospects of judicial consideration by taking into account legal positions of the Supreme Court, if any. However, it is very difficult to persuade the tax authority to estimate perspectives of judicial consideration by referring to the case-law produced by lower courts.

At the time of publication of the Previous Report in 2015, the SFS did not keep records of the results of taxpayers' cases consideration in courts, although this indicator directly shows the appeal mechanism effectiveness. The relevant KPI (the ratio of cases resolved in favor of the public authority, out of the total number of cases considered in courts after their consideration within the administrative appeal procedure) was introduced in the SFS in 2016, including with active participation of the Council. It is being monitored on a regular basis ever since. As described in Section 7.2.6 below, following 2019, the STS reported on the successful implementation of the respective KPI. However, the Council believes that the respective KPIs are objectively too low to properly assess effectiveness of the implemented tax control measures.

Currently the STS is working to generalize the case-law and bring it to the attention of local tax authorities. Such work is carried out by the Legal Department of the STS. For 2020, the STS also plans to arrange, on a monthly basis, work on the generalization of the case-law based on outcomes of dispute consideration with participation of tax authorities, as well as sending judgments to local tax authorities to organize their work. It also plans preparation and analysis of the reporting data on outcomes of consideration of taxpayers' complaints lodged to challenge decisions of regional authorities of the STS and overview letters preparation[266].

It is noteworthy that in 2020 a whole set of measures is planned to introduce a system for monitoring the effectiveness of consideration by courts of tax disputes that have gone through the administrative appeal procedure[267]. In the future, on the annual basis the results of work shall be made available to the public — i.e., to the extent they relate to ensuring taxpayers' right to have quality, comprehensive and objective consideration of complaints — particularly regarding the level of confirmation by courts of decisions taken by the tax authorities within the administrative appeal procedure.

It is also envisaged that monitoring and systematization of tax disputes outcomes in the administrative and judicial proceedings will be introduced, which will be further brought to the attention of other departments of the STS to unify approaches to the administration of taxes, duties and fees[268]. This work will include:

1) preparing and publishing report on outcomes of administrative and judicial tax disputes consideration containing overview of the most common disputes becoming the subject matter of the appeal and the appropriate way for resolving such issues (taking into account the Supreme Court's conclusions set forth in its rulings) to improve effectiveness of control and supervisory activities; as well as

[266] https://www.tax.gov.ua/data/files/249880.pdf

[267] Clause 10 of Section II of the *Action Plan for the implementation of conceptual directions of reforming the system of bodies implementing state tax policy, approved by the Resolution of the CMU dated July 5, 2019 No. 542-p.*

[268] Clause 11 of Section II of the *Action Plan for the implementation of conceptual directions of reforming the system of bodies implementing state tax policy, approved by the Resolution of the CMU dated July 5, 2019 No. 542-p.*

2) generalization of tax disputes consideration practice in administrative and judicial proceedings to be brought to the attention of the STS regional authorities.

However, in view of quarantine measures introduced in Ukraine in connection with COVID-19 pandemic, we expect this work to be postponed.

7.2.5 Publication of decisions issued by the STS

In the Council's view, another problem of administrative appeal procedure is the need to ensure consistency and systematization while adopting decisions by controlling authorities based on outcomes of consideration of taxpayers' complaints. The ability to get familiar with the practice of handling such complaints would allow taxpayers ascertaining their real chances of success in the administrative appeal procedure, as well as better prepare for reviewing complaint materials, especially for small taxpayers with limited capacity to engage professional consultants. It will also help the taxpayer and third parties ensuring that the controlling authority is not guided by double standards when making a decision, which would manifest in favor of tax authority's openness and transparency.

Hence, the Council considers it worth reiterating here its recommendation[269] originally issued in the context of procedure of administrative appeal of decisions issued by controlling authorities — this time with the emphasis on the need to publish the STS's decisions adopted following taxpayer complaint's consideration. In particular, we contend that it is appropriate to make such a publication in the form of a register taking into account requirements of confidentiality and data protection. It is necessary to enter information into the register about subsequent appeal of the corresponding decision in court (if any) and its outcomes. It would ensure consistency in approaches of tax authorities for taxpayers. From a technical point of view, it is important to provide a user-friendly interface to such registry of decisions so that users could perform a "smart" search by keywords, legislative provisions and other criteria.

[269] For more details, *see* Sections 3.3.2 "c" and 3.7.2 of the Systemic Report *"Administrative Appeal: Current State and Recommendations".*

7.2.6 Setting correct KPIs for administrative appeal procedure

In the Council's view, a more effective administrative appeal procedure can be ensured by setting correct KPIs, clearly measuring their implementation (execution) status and their correct reflection in public reporting[270]. Since 2016, KPIs have been established for the STS and the latter regularly reports on their implementation[271]. Four such KPIs — in one way or another — assess the quality of the administrative appeal procedure.

The effectiveness of administrative appeal procedure is evidenced, first of all, by the results of the judicial appeal against tax authority's decisions. If additional charges accrued by the tax authority are reasonable and lawful, the court is expected to confirm the tax authority's decision, adopted as a result of the administrative appeal procedure. Thus, it will also be confirmed that the state resources (particularly, funds for paying auditors, court fees, etc.) have been spent reasonably and in a resourceful manner. There is no doubt that respective KPIs are also strategically aimed at reducing the number of audits and additional charges groundlessly levied onto taxpayers.

Thus, the said KPIs actually evaluate two indicators: (1) disputes with taxpayers resolved in court in favor of the tax authority (in terms of number of disputes and their amounts); and (2) the ratio of reconciled tax liabilities additionally accrued (imposed) following tax audits.

According to data available for 2015, only 8% of additional charges accrued as a result of tax audits were ultimately paid to the budget (i.e. were reconciled in the administrative or judicial appeal procedure)[272]. Interestingly enough, according to KPI analysis published on the STS's website, this indicator has objectively improved, but it is not officially published[273]. During the discussion of KPIs for the SFS in 2016, it was assumed that the ratio of reconciled tax liabilities based on tax audit outcomes should be at least 75%[274]. However, the real statistics are far from reaching such a high level.

For example, according to the STS's information, from February 1, 2019 to January 1, 2020, the STS canceled only 6,403 out of a total of 32,634 TNDs within the administrative appeal procedure. Moreover, since statistics are not maintained with regard to TNDs appeal amounts (but only as regards the number of TNDs and complaints) — it is difficult to assess the real impact of such indicators on business[275].

For 2019, the KPI was set for the STS at 56.2% for the ratio of tax disputes resolved by courts of various instances in favor of tax authorities (i.e. tax authorities' decisions confirmation following the administrative appeal) in the total number of tax disputes resolved by courts of various instances (quantitative effectiveness of tax and customs disputes' judicial consideration). According to 2019 results, the STS performed at 42.8%. Meanwhile, when originally introducing this

[270] Peculiarities of compliance with the principle of effectiveness (regardless of the tax sphere) are described in detail in the Systemic Report *"Administrative Appeal: Current State and Recommendations"* (*see* Section 3.8 of the said Systemic Report).

[271] https://www.kmu.gov.ua/news/249360830; https://tax.gov.ua/diyalnist-/plani-ta-zviti-roboti-/398266.html

[272] Letter of the MoF dated September 27, 2016, No.31-11000-07-10/27318.

[273] https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/kontrolno-perevirochna-robota/

[274] https://www.slideshare.net/sadovnychyi/kpi-66595898

[275] https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/vregulyuvannya-podatkovih/apelyatsiyna-praktika/406575.html

KPI in the SFS in 2016, its strategic target was set at 85%.

Although based on 2019 results the STS reported about effective performance under one KPI and underperformance of the other one, — the respective indicators still remain objectively low and evidence that the STS's activities to impose well-substantiated additional charges (including performing control and supervisory activities, as well as appeal and judicial appeal) are largely ineffective[276].

As described in the Sections 6.5 and 7.2.6 above, the Council considers it necessary to improve the way in which the STS publishes information on KPI performance (including the administrative appeal). In particular, it is necessary to publish information in a unified format with a "smart search" option.

In addition, in the Council's view, the weak point of the currently set KPIs is also that they actually cumulatively evaluate performance of several departments within the STS. At least this approach is employed to the Audit and Appeal Department jointly. As a result, the information on the KPI published by the STS on its official website is not provided separately in terms of respective departments[277]. In fact, it does not allow to objectively assess each department performance individually to determine their respective share in the final KPI, and, therefore, properly encourage or punish those persons responsible for failure to achieve the KPI.

Undoubtedly, the STS reports on the audit department performance results on control and supervisory activities indicators. However, as far as audits of legal entities are concerned — for the time being only information on the number of audits with reconciled tax charges and the amount of additional charges due to be settled is disclosed[278]. Meanwhile, information on the number of audits, whose results had been canceled within the administrative and the judicial appeal, and, accordingly, the amount of non-reconciled additional charges, is not disclosed. Theoretically, such information can be obtained by comparing all published information of the STS and, if necessary, by obtaining additional information through public information access request. However, the Council is convinced that the STS is obliged to take exhaustive measures to ensure that such comprehensive information is available in a user-friendly form on the STS's website.

The Council believes that a comprehensive and objective assessment of the STS authorities activities in terms of the administrative appeal is possible only by taking statistics on these indicators into account.

[276] The necessity to establish a mandatory KPI — the level of confirmation by courts of decisions made in the administrative appeal procedure (or *"the ratio of cases resolved in favor of the public authority, out of the total number of cases considered in courts after their consideration within the administrative appeal procedure"*) and a step-by-step method of its calculation has already been discussed in the Council's Systemic Report *"Administrative Appeal: Current State and Recommendations"*. For the purposes of implementing this and other KPIs, the Council recommended the Cabinet of Ministers of Ukraine to approve the corresponding legal act (regulations, procedures, methods, etc.) to determine the regional divisions, officials) whose functions include consideration of complaints filed within the administrative appeal.

[277] https://www.tax.gov.ua/diyalnist-/plani-ta-zviti-roboti-/398266.html

[278] https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/kontrolno-perevirochna-robota/

COUNCIL'S RECOMMENDATIONS:

To ensure proper exercise of taxpayers' rights within the procedure of consideration of taxpayers' objections to tax audit reports and to improve procedure of administrative (internal) appeal of decisions issued by tax authorities:

29. Enable taxpayers, representatives of the Business Ombudsman Council, the Ministry of Finance of Ukraine, as well as local controlling authorities and other authorities to participate in consideration of complaint's materials by teleconference or videoconference. For this purpose:

29.1. The Ministry of Finance of Ukraine — to ensure introduction of appropriate amendments to the Procedure for Registration and Filing Complaints by Taxpayers and Their Consideration by Tax Authorities, approved by the Order of the Ministry of Finance of Ukraine dated October 21, 2015 No. 916.

29.2. The State Tax Service of Ukraine — to implement the relevant technical capability.

30. The State Tax Service of Ukraine — to secure co-operation with key public authorities, whose representatives are worth being engaged in consideration of materials of taxpayers' complaints within the administrative appeal (such as, the Ministry of Finance of Ukraine, the NBU, the State Geological Cadastre; this list is non-exhaustive).

31. The State Tax Service of Ukraine — to publish decisions of the STS adopted following consideration of taxpayers' complaints on its official website. Publication should be in the form of the registry and subject to compliance with data confidentiality and protection requirements. The registry must contain information on subsequent appeal of the corresponding decision in court (if any) and its results.

32. The State Tax Service of Ukraine — to introduce a system enabling monitoring and systematization of results of tax disputes' consideration within administrative and judicial proceedings; as well as bringing them to the attention of other STS departments to unify approaches to both tax administration and employing case-law while considering taxpayer's complaints.

33. The Ministry of Finance of Ukraine — to establish new KPIs for the STS, which would measure results of consideration of taxpayers' objections to tax audit reports. Meanwhile, the STS shall ensure (1) collection of maximum amount of relevant information, including names and surnames of tax authorities' officials regularly rendering unsubstantiated decisions; and (2) publication of key indicators of such statistics on the STS's website.

34. The Ministry of Finance of Ukraine — to establish new KPIs for the STS in terms of administrative appeal — such KPIs to be set separately for each department involved and, accordingly, separately assess performance of these KPIs. The relevant statistics should be regularly published in full on the STS official website.

8 GENERALIZED TAX CONSULTATIONS

The principle of *ignorantia juris non excusat* (ignorance of the law is no excuse) is absolutely true for the tax sphere as well. Given frequent changes of the tax legislation of Ukraine, its complexity and numerous contradictions, the businesses face extremely high probability of issues due to misinterpretation of its provisions.

Ukrainian tax law contains a somewhat utopian rule, which, ideally, should make any vagueness of tax law a weapon in hands of the taxpayer, not his problem. This is the so-called "presumption of legality of taxpayer's decisions"[279]. This presumption is applied if the provision of law or other regulation issued pursuant to the law, or if provisions of different laws or different regulations allow ambiguous (multiple) interpretation of rights and obligations of taxpayers or tax authorities. If under such circumstances it is possible to make a decision in favor of both the taxpayer and the tax authority, a decision made in favor of the taxpayer is considered legitimate.

However, in practice, this rule is used only in courts. The number of cases in which tax authorities recognized the fact of ambiguity and inconsistency of certain provisions of tax legislation and voluntarily followed this principle is very small.

Therefore, given the diverse tax landscape of Ukraine, it is vital for business to be able to get an official interpretation of provisions of tax law, which can be safely followed, being sure that tax authorities will not interpret the same provisions in a different way later.

"Tax consultation" institution was introduced in the TCU since its entry into force at the beginning of 2011. Originally, those were ITCs only.

The corresponding articles of the TCU (52-53) guaranteed each taxpayer the right to receive a free ITC from the tax authority. Moreover, the taxpayer is exempted from liability in case of following the ITC[280]. The taxpayer was also given the right to challenge the unacceptable ITC in court.

In August 2011, during one of the first amendments of the new TCU, the institution of ITC was supplemented by the institution of GTC. The latter was supposed to be issued by a tax authority of a central level on matters relating to a significant number of taxpayers or tax liabilities of significant amount.

Tax consultations are progressive and useful tool for a forward-thinking business. This tool makes it possible to prevent tax disputes, or to initiate them preventively (to consider the issue of proper interpretation of certain provisions of tax legislation in the court before these provisions have been applied and certain tax consequences have occurred). However, with the spread of this tool in Ukraine, it gave rise to an increasing number of issues coming from businesses.

Firstly, some had well-grounded fears that ITCs could become an instrument for tax discrimination. Indeed, lack of sufficient transparency in the process of issuance of ITCs combined with the fact that the right to issue them belongs to regional tax authorities, led to concerns that some taxpayers are likely to receive more loyal ITCs than others– either due to a more skillful lobbying or due to corruption.

Secondly, biased and fiscal approach to issuance of ITCs and GTCs was criticized. Many representatives of business noticed that interpretation of certain provisions of tax legislation provided by tax authorities was so unfair and unfavorable for taxpayers that it was simply unreasonable and economically unprofitable to follow it. It seemed more

[279] Sub-clause 4.1.4 of clause 4.1 of Article 4 of the TCU.

[280] In addition to the direct provision in Article 53 of the TCU, clause 3 of Section VIII of Procedure No.916 also stipulates that, when considering taxpayer's complaint materials within administrative appeal, tax consultations and GTCs provided to such taxpayers shall be taken into account.

reasonable to live with court disputes with tax authorities (aimed either at receipt of more favorable ITC, or at challenging additional accruals already made by results of tax audits).

Given that tax authorities were sometimes reluctant to implement court decisions obliging them to issue ITCs favorable for taxpayers, or tended to implement such decisions in their own specific way (in the Council's practice there were complaints of this kind), many taxpayers preferred not to spend time on "preventive" disputes around ITCs at all. Issues (in form of controversial accruals of additional taxes and other payments by results of tax audits) were mostly resolved by businesses as they arose.

In 2017, in the context of these sentiments, the tax consultation as a legal institution underwent significant changes.

Firstly, a Unified Register of ITCs[281] was introduced, which still remains publicly available in the taxpayer's e-cabinet[282]. Taxpayers formally do not have a right to use someone else's ITCs and refer to them in tax disputes, even if circumstances of their cases are seen very similar or identical. Nevertheless, the Unified Register of ITCs has become a very valuable source of information for tax professionals, as well as a guarantee that it will become much more difficult to use ITCs for tax discrimination. Although on a much smaller scale, this Register has contributed to transparency of Ukrainian state apparatus, similarly as "Prozorro" public procurement system and system of e-declarations for public officials.

Secondly, the right to issue GTCs was transferred from the tax authority of central level (the SFS at that time) to the MoF. The idea of such a transfer was that the ministry is a somewhat more impartial authority having the opportunity to avoid a fiscal bias being too strong when working on GTCs. In addition, according to the law, it is the MoF that is competent to form state tax policy, while the SFS/STS powers are limited to implementation of such policy.

The MoF went even further towards transparency and inclusiveness of the process of issuing GTCs. At the end of 2017, an Expert Council on preparation of generalized tax consultations of the MoF (the **"Expert Council"**) was set up[283] composed of representatives of the MoF, the SFS, the Verkhovna Rada of Ukraine, as well as experts from business community, including the Council. The purpose of its creation was to provide proposals and recommendations for preparation of draft GTCs.

Although the Expert Council's function remained consultative and advisory, its establishment was accompanied by a rhetoric that sounded positively for business and remained clear impression that leadership team of the MoF has an intention to take the Expert Council's conclusions seriously. Therefore, establishment of this body and the beginning of its activities gave cautious

[281] The procedure for maintaining a Unified Register of individual tax consultations was approved by the Order of the MoF dated 24.05.2017 No. 523.

[282] Follow the link: https://cabinet.tax.gov.ua/registers/ipk

[283] The first composition of the Expert Council and its Regulations were approved by the Order of the MoF dated November 20, 2017 No.948. Changes to the composition of the Expert Council were made by orders of the MoF dated September 10, 2018 No.754 and November 15, 2018 No. 894. The Expert Council consisted of 35 members, including (the composition somewhat changed, but its core remained the same):

- representatives (officials and their advisors) of the MoF — from 4 to 7 members;
- representatives of the SFS — 6 members;
- representatives of the Verkhovna Rada of Ukraine (people's deputies, their assistants) — from 4 to 5 members;
- representatives of business associations, public councils under government agencies, the Business Ombudsman Council, tax experts from leading audit firms (including all Big 4 companies) and leading law firms, as well as scientific institutions — from 18 to 20 members.

optimism to many representatives of business and the expert community.

As an institution that had the opportunity to delegate its representatives to this body and participate in its activities, the Council should note the Expert Council's activities were indeed based on a fairly transparent and democratic principles. All of its members had the opportunity to be heard, while representatives of the SFS/STS — the authority that used to issue GTCs by itself — had no decisive vote or veto in the Expert Council.

Unfortunately, experience of over than 2.5 years of operation showed that transparency and democracy of the Expert Council were suppressed by a lack of its activity.

Although an obligation to hold meetings of the Expert Council at least once a quarter was clearly established in respective regulations, that pace of work was more or less maintained only during 2018. In 2019 the Expert Council met twice — on February 22, 2019 (i.e., in Q1) and on August 6, 2019 (Q3). No meetings during six months of 2020 were held.

Statistics on the number of GTCs issued by the MoF[284] demonstrates a rather small "capacity" of this body in terms of the number of problematic issues in the tax sphere, which it had the opportunity to explain, as well as a decline in its activity :

- in 2018, 5 orders approving 13 GTCs were issued;
- in 2019, 3 orders approving 4 GTCs were issued;
- in 2020, as at the end of July, no order was issued and no GTC was approved.

The ratio of issues that MoF is able to process and the total number of matters, resolution of which is relevant for business, can be well illustrated by the survey among Expert Council's members initiated by the MoF on March 22, 2019. Within the survey, out of 162 drafts GTCs, proposals for the issuance of which were submitted to the MoF, five primary ones should be identified to be considered at the next meeting. It is clear that such a strict selection inevitably left many relevant topics behind. And even among those "top-5" topics eventually selected following voting on April 17, 2019, currently the GTC was issued on one topic only.

In some cases, the Council faced situations when issuance of the GTC on a certain issue was considered appropriate, but it was impossible to get it.

[284] Source: https://mof.gov.ua/uk/set-of-summarizing-tax-consultations

Case No. 27. Lack of sustainable approach of tax authorities to proper way of making proper amendments to the VAT invoice, erroneously issued only for a part of the required amount

In January 2019, Trade House LLC, a company from Ivano-Frankivsk oblast (**"Complainant"**), which found itself in a difficult and controversial situation, lodged a complaint with the Council. The company paid UAH 1,700,000 as prepayment for supply of goods to the supplier. The latter erroneously issued a TI only for a part of the amount of prepayment — UAH 170,000 (one zero missing). Later, the supplier corrected the error by issuing an AC to the TI for the rest amount of UAH 1,530,000.

The prudent Complainant, before putting the respective amounts of VAT in its VAT tax credit, decided to get an ITC. And, as it turned out, it was not in vain. Tax authority explained to the Complainant that the supplier had acted incorrectly. The supplier had to annul ("reverse", in an accounting language) an erroneous TI for UAH 170,000 and then issue a new one for the full amount — UAH 1,700,000. Since the supplier corrected its mistake in another (incorrect, according to the tax authority) way — the Complainant had no right to put these respective amounts of VAT in the VAT tax credit.

It is interesting that the SFS previously issued an ITC on a similar issue to another taxpayer and expressed the opposite approach.

Moreover, when the indignant Complainant began demanding that the supplier correct its mistake, the latter refused to, insisting that it had acted correctly. It seemed that only tax audit initiated by the Complainant by filing a complaint against the supplier could help to find out who is right. However, regional tax authority refused to perform tax audit stating it did not see any signs of violations in the supplier's actions (this approach directly contradicted the content of the ITC received by the Complainant).

The Council took a number of actions to encourage tax authorities to eventually make a final conclusion on the controversial matter (either found the supplier's actions correct and allowed the Complainant to form a VAT tax credit, or found its actions incorrect and imposed sanctions hereby urging the supplier to finally correct the error). However, all efforts were unsuccessful.

Tax audit of the supplier finally was conducted and, surprisingly for the Complainant, did not reveal any violations on the part of the supplier while issuing disputable TI and AC. But when the Complainant requested the ITC on the same matter again, referring to results of tax audit — it received new ITC with the same explanation that TI and AC were issued incorrectly and are not eligible for forming VAT tax credit.

In late December 2019, after making sure that there is no consistent approach to this matter even inside the SFS/STS, the Council informed the MoF about this case proposing to bring up the issue for the consideration of the Expert Council, and issue the GTC (draft was prepared by the Council).

In February 2020, the MoF requested the opinion of the STS, which replied that it did not object against issuance of the GTC on the respective topic (although it did object against the wording proposed by the Council).

And at the end of June 2020, this draft GTC was not discussed by the Expert Council (which hasn't held any meetings in 2020).

Meanwhile, the Complainant, waiting in vain for its issue to be resolved, faced a situation where it had to make a voluntary decision — to put disputed amounts in its VAT tax credit (realizing that it would result in a dispute with the tax authority) or to abandon this amount forever due to expiration of 1095-day period, during which it eligible for inclusion to the VAT tax credit.

According to the Council's observations, the MoF, despite the enthusiasm of some apologists of the Expert Council within this body, simply did not have enough "industrial capacity" to fully implement this function not common for this state authority. Officials of the ministry trivially lacked time for administering the Expert Council, taking into account that this was an "add-on" to their main diverse functions. According to observations of the Council, such situation contributed to the inactivity in issuing GTCs.

It is important to note that at the time of preparation of this section of the Systemic Report approximately 1 year passed since the last meeting of the Expert Council (August 6, 2019). Moreover, it's already more than 1.5 years passed since the last amendments to the composition of the Expert Council, available on the website of the MoF, took place (November 15, 2018). Over this time, the Minister and his/her deputy responsible for the state tax policy changed at least twice. Therefore, today both the business and the expert community do not have clear understanding that the MoF is ready to be a driver of issuance of GTCs.

In the first half of June 2020, the Council received from the MoF an information on existence of plans of newly appointed high-positioned officials of the MoF to intensify the activity of the Expert Council. Still, it is a lot of work to do before it can be concluded that this intensification really occurred.

The SFS/STS theoretically could be another driving force of issuing GTCs. After losing the opportunity to issue GTCs independently, in theory, it should actively encourage the MoF to perform this function. In practice, however, it turned out that the SFS/STS had no significant interest in "pushing" draft GTCs through the structure created within another public authority. After all, nothing prevented tax authorities from continuing their explanatory work in other legal forms, for example, through the so-called PIR[285], bypassing the Expert Council and the MoF.

As at July 24, 2020, PIR contains answers to 4033 FAQs, which is an impressive number compared to the number of GTCs approved by the MoF and a real indicator of a number of disputed provisions of tax legislation that really needs explanation.

Placing answers to FAQs in the PIR has proved to be a much more convenient tool for tax authorities than initiating GTCs. The GTC is a "sword" sharp at both edges (legitimizing a certain approach and at the same time protecting taxpayers against tax auditors' claims when following this approach), while answers to FAQs in the PIR formally do not have any legal force. Their non-binding nature, however, according to the Council's observations, does not keep regional tax authorities from treating points of view set forth in the PIR (usually without any references to it in official documents) as a very respectful source of information that does not leave a possibility of even slightest deviations. Taxpayers, on their turn, even if they strictly follow answers to FAQs in the PIR, do not enjoy any legal protection. A cherry on top, thanks to which answering FAQs in the PIR is a much more convenient tool for tax authorities than initiating issuance of GTCs, is the impossibility of challenging answers to FAQs published in the PIR in court.

[285] Source: http://zir.sfs.gov.ua/main/bz/view/?src=ques

Case No. 28. Following answers to FAQs from the PIR during tax audit of individual entrepreneur on general taxation system

In April 2020, an IE from Dnipropetrovsk oblast ("Complainant") turned to the Council. Significant volumes of the complainant's production activities made him non-eligible for simplified taxation system, so he used a general one.

Being on the general taxation system is currently a bad "headache" for IEs. Unlike legal entities on the general system, paying CPT based on their financial results calculated in accordance with the national GAAP or the IFRS and adjusted only for certain tax differences — IEs on general system, for the purpose of payment of PIT and MF, can deduct from their income only those costs which are stipulated by the TCU (i.e., actually IEs are in a position in which legal entities were before 2015). The list of deductible expenses established by the TCU is not exhaustive — the main point is that expenses should be connected with IE's business activity.

However, the SFS/STS significantly reduced this list answering FAQ in the PIR. For example, it stated that IEs have the right to depreciate only fixed assets purchased after January 1, 2017, although the TCU does not have such a limitation. It is also stated in the PIR that a PE is not entitled to deduct such expenses as interest and other payments on loans (it does not matter whether the loan was taken for business purposes), insurance payments (even if insurance is intended for business activities), amounts of MF paid by to state budget, etc.

Having participated in consideration of the Complainant's objections against the tax audit report, the Council articulated many arguments in favor of the fact that some of IE's expenses were groundlessly challenged by tax auditors. However, discussion rested on the existence of the mentioned answers to FAQs in the PIR, which (despite their formal non-binding nature) regional tax authority treated very seriously and did not see any possibility to deviate from them.

Following consideration of objections, tax authority nevertheless decided to conduct an additional tax audit. Some issues clearly needed further investigation. However, regardless findings of additional tax audit, the Complainant has high chances to get almost the same additional accruals, as answers to FAQs in the PIR remained unchanged.

In the Council's view, overestimation of importance of answers to FAQs in the PIR (which, in theory, should provide information on undisputed issues, but in no way explain indeed controversial norms) is a negative side effect of "lagging" of the institute of GTCs that almost completely lost its role over last years.

In light of the above, there is urgent need to intensify and boost the Expert Council effectiveness, as well as restoring the role of GTCs in tax administration.

COUNCIL'S RECOMMENDATIONS:

In order to intensify GTCs issuance activities, the Council recommends:

35. The Ministry of Finance of Ukraine:

35.1. To approve a new composition of the Expert Council with preserving current balance between public sector, business associations and expert community. To appoint at certain administrative position in the Expert Council (one of the deputies of the head, etc.) an official who will have an organization of the Expert Council's work among his/her key responsibilities and who will have sufficient powers to organize its effective operation.

35.2. Systemize issues requiring issuance of the GTC (based on proposals that received from members of the Expert Council and information from other sources about current problems in the tax sphere), approve and bring to attention of members of the Expert Council a plan of work of the MoF on issuance of GTCs. Such a plan should include, inter alia, a list of all draft GTCs (topics for GTSc) that MoF plans to process with establishing their priority (taking into account opinions of members of the Expert Council), the order and terms of consideration. Such a plan should be regularly updated or replaced by a new one for the next period (for example, a quarter or six months).

35.3. Increase the frequency of meetings of the Expert Council, bringing it at least to the figure specified in paragraph 11 of Regulation on the Expert Council on preparation of GTCs of the MoF, approved by the Order of the MoF dated November 20, 2017, No. 948 ("Meetings of the Expert Council are held as needed, but at least once a quarter".).

35.4. Increase a number of drafts GTCs discussed and voted in every meeting of the Expert Council up to at least 5.

35.5. Use extensively within the period between meetings of the Expert Council a practice of processing drafts GTCs remotely through exchange of amendments and comments and voting in the electronic form.

36. The State Tax Service of Ukraine:

36.1. Cease the practice of explaining important matters related to really controversial issues in tax legislation by publishing answers to FAQs in the PIR. FAQs in the PIR (which is an informational resource not intended for generating new legal positions) should relate only to indisputable matters, or to those regarding which GTCs were already issued, or those regarding which well-established and unambiguous practice of the Supreme Court has been formed. As for other controversial issues, issuance of GTCs should be initiated.

9 DISCLOSURE OF INFORMATION BY TAX AUTHORITIES

The STS regularly publishes a large amount of statistical and analytical data, namely:

1) Open data in the form of list of data sets pursuant to the *Law of Ukraine "On Access to Public Information"*[286];
2) Data for each area of activity published on the STS's official web portal (tax.gov.ua)[287];
3) Annual reports on all STS areas of activity .

According to the *Law of Ukraine "On Access to Public Information"*, **open data are** made publicly available for free with unrestricted access to them. Open data may be further used and distributed for free. Currently, in pursuance of the law, the STS publishes 51 sets of such data[288]. Each data set has its own periodicity of updates on information resources. For example, the Register of VAT Payers, information on VAT payer registration cancellation, the Register of Single Tax Payers, the Register of non-profit institutions and organizations and the Register of excise tax payers for the sale of fuel *are* updated *daily*. In addition, information is monthly updated on the VAT amount refunds from the state budget and on taxes and charges accrual and collection.

According to the information published on the Single State Open Data Web Portal, the STS is fully compliant with the requirements of Resolution No.835 and, therefore, is one of the leaders among other government agencies in complying with legislation in the field of access to public information[289]. Such high indicators unequivocally testify to the fulfillment of the requirements of the *Law of Ukraine "On Access to Public Information"* and Resolution No. 835 by providing automated access to the approved list of data sets round the clock.

A considerable part of information from data sets published by the STS is further duplicated by the data published on the **STS's website**. These include data from registers, information on collection of taxes and charges, accrual of taxes and charges, control work indicators, information on the number of scheduled/unscheduled audits and their results, information on the number and appeals outcomes, etc. At the same time, the STS's website also contains information on the STS's KPIs' target values achievement (since the beginning of 2019)[290], the STS's plans and reports[291], other data and activities results (for example, information and analytical materials on the current state of affairs)[292]. Although such a list of information is not included in the open data sets list, the STS apparently publishes the respective data on its own initiative given high public interest in such data. Undoubtedly, alongside the open data published in compliance with the law, such additional analytical data allows a third party to obtain more detailed information about the tax authorities' performance quality and efficiency, as well as to point out to areas that need improvement.

[286] *Resolution of the CMU dated October 21, 2015 No.835 "On Approval of the Regulations on Data Sets Subject to Open Data"* (**"Resolution No.835"**); *Order of the STS Ukraine dated November 25, 2019 No.181 "On Data Sets Subject to Disclosure (update) in the Form of Open Data"* (**"Order No.181"**).

[287] For example, the report for 2019 can be found at: http://tax.gov.ua/data/files/250851.pdf

[288] The list of data sets subject to disclosure (update) in the form of open data, as well as STS's structural divisions in charge and the Information and Reference Department of the STS approved by the Order No. 181.

[289] https://data.gov.ua/progress

[290] https://www.tax.gov.ua/diyalnist-/plani-ta-zviti-roboti-/398266.html

[291] https://www.tax.gov.ua/diyalnist-/plani-ta-zviti-roboti-/396505.html

[292] https://www.tax.gov.ua/diyalnist-/rezalt/

In order to objectively assess the STS's work on publishing statistical and analytical information, it is necessary to analyze those figures and information specifically published on the STS's web portal in more details.

Based on the experience of working with open data, the Council believes that data users (taxpayers, business associations, NGOs, international institutions, mass media representatives, as well as the Business Ombudsman Council itself) have access to a large amount of insufficiently structured and inconsistent information.

Thus, despite data accessibility as such, the form in which it is delivered to users does not allow to process it quickly and in a user-friendly format. Since data are available in different formats (Word, Excel, information in the browser window), the user is unable to compare, summarize, search for selected data sets without special technical knowledge and without spending a significant amount of time. Therefore, working with the published data appears difficult for the ordinary user.

For instance, if the user wishes to obtain data on the final results of the control and audit measures of the tax authorities (i.e., the amount of additional charges imposed by the tax authorities, which have been converted into taxes actually paid to the state budget), such user would need to separately download data from the website of the STS regarding each of the following:

1) the results of control and audit measures (in Word format regarding general indicators for Ukraine and in Excel format for data by oblasts),
2) the results of administrative appeal of additional charges by taxpayers (in Word format) and
3) the results of court appeal of additional charges by taxpayers (in free text format).

Thus, the user will need to download all data by hand into a single format (for instance, Excel) so that he/she can make the necessary calculations and identify, which amount of additional charges by the tax authorities ultimately appeared substantiated (i.e., were confirmed in administrative appeal and/or judicial proceeding).

By the way, paragraph 22 of the Resolution No. 835 stipulates that the STS, being information owner, must provide systematization (filtering) of data sets by subject, keywords, popularity of sets among users on its website, etc., as well as functionality to search among data sets. The Council failed to find official information about extent to which this paragraph of the Resolution No.835 is actually implemented by the STS. However, based on the Council's experts experience, who often use respective data in their day-to-day activity, compliance with this paragraph cannot be considered satisfactory.

In addition, the STS independently determines the level of details for the information due to be disclosed, as Resolution No.835 and Order No.181 define requirements for disclosed information only in general terms. Undoubtedly, it creates prerequisites for data manipulation. For example, the STS publishes data on activities results only "in a positive way" (as described below), avoiding publication of data that may in any way indicate negative results of tax authorities' work.

In view of the foregoing, the Council considers it appropriate to recommend the STS to publish data on the web portal in a way which would enable users to promptly obtain complete and accurate information on results of tax authorities' work without special skills and knowledge. It is also important to ensure that the user can work effectively with the published data, in particular, to perform "smart" search, group and compare them, which, given the current level of technology, seems reasonably achievable.

Thus, in this chapter we will demonstrate the respective problems in selected areas, which the Council considers critical to tax authorities' performance fair evaluation and which have a direct impact on taxpayers and their interaction results with tax authorities. This is the information on the results of (1) control and audit measures (Section 9.1); (2) administrative appeal (Section 9.2); and (3) court appeal (Section 9.3). Although each of these areas of activity is formally independent and governed by separate norms, together they form a single and consistent chain of actions based on which decisions taken by the tax authority translate (or do not translate) into actually paid taxes to the budget. Therefore, in the Council's view, it is important to fully, qualitatively and coherently disclose data on respective areas, so that taxpayers have access to complete information on the "life cycle" of tax authorities' decisions and their quality.

We will also separately focus on the need for making information public in the areas for which regular disclosure of data does not take place. These are primarily SEA VAT and SMKOR work results (Section 9.4). Unfortunately, the corresponding data are not published on a regular basis either on the STS's web portal or through other sources. Such information is selectively published in tax authorities' newsletters, which indicates that they are processed and can be published. Given a high public interest in these data, the Council will recommend the STS to ensure that the relevant information is disclosed on a sufficient level and on an ongoing basis.

9.1 Publication of data on control and audit measures

The STS monthly publishes the following data based on results of control and audit measures[293]:

1) Number of scheduled audits (whose results have been reconciled (approved)) separately for legal entities on general and simplified taxation systems and for branches;
2) Number of unscheduled audits (whose results have been reconciled (approved)) separately for legal entities on general and simplified taxation systems, as well as separately based on the grounds established by the TCU;
3) Total amounts of additional charges under scheduled and unscheduled audit reports, which are subject to settlement, including a breakdown by legal entities on general and simplified taxation systems;
4) The number of audits (whose results have been reconciled (approved)) and the accrued monetary liabilities amount to be settled by oblast.

It is worth noting that the STS publishes rather broad number of indicators pertaining to control and audit measures. However, the selectivity of the data is quite noticeable too. Thus, the approach appears to be one-sided — i.e., the data are published only on the number of audits, whose results have been reconciled, and, accordingly, additional charges due thereunder are subject to be transferred to the budget. That is, the STS does not deliver information that would allow to compare the quantitative (number of audits) and qualitative (additionally charged amounts) characteristics of all audits, regardless of the fact whether they were finalized in favor of taxpayers or tax authorities.

Users would benefit from a smart search and the ability to sort audit information by department. Currently, the data are published collectively on at least the results of the work of three departments, namely, tax audit, transfer pricing and international taxation departments. While certain audits are of special nature bearing their own peculiarities, it can be useful for users to get access to the selected data on such audits. This includes, for example, such a special type of audit as the transfer pricing audit on taxpayers' compliance with the "arm's length" principle. The corresponding data are managed by the transfer pricing department and will be useful for large payers which may be subject to respective audit.

Therefore, the Council considers it appropriate to recommend the STS to ensure publication of comprehensive information on results of control and audit measures (regardless of the fact whether audits were finalized in favor of taxpayers or tax authorities) in a single data format. It is also important to be able to sort information by department so that users can view data on specific types of audits.

[293] https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/kontrolno-perevirochna-robota/

9.2 Disclosure of data about administrative appeal procedure

The STS currently publishes on its website the following data on the administrative appeal procedure[294]:

1) The number of complaints received by the STS;
2) The number of TNDs (decisions, claims) challenged;
3) The number of TNDs (decisions, claims) left unchanged;
4) The number of TNDs (decisions, claims) completely canceled;
5) The number of TNDs (decisions, claims) partially canceled.

The data are published monthly on a cumulative basis.

What immediately catches the eye is that information is not analyzed by oblast. Disclosure of such information would allow obtaining objective data on tax authorities' local control and audit measures quality. In addition, data on the total amounts charged under the corresponding TNDs (decisions or claims) are not provided, which in no way allows a public data user to obtain quality data on outcomes of administrative appeal against decisions issued by tax authorities (i.e. the final effect of control measures for the budget). This approach of the STS is surprising, because in other areas of STS's activity the respective data are actually available (for example, information on control and audit measures results, as well as pre-trial appeal results containing information on the additionally charged amounts)[295]. Therefore, the tax authority's approach employed to disclosure of information on the administrative appeal procedure seems uneven and inconsistent with the disclosure of data on other (related) activities.

Meanwhile, the Council is convinced that all the relevant information is collected and processed (but not published) by the STS, since it is based on the same data that is collected for the assessment of KPI execution by the STS. Consequently, the Council finds it necessary to recommend the STS — in addition to data already published — to ensure publication of comprehensive information on the administrative appeal results on its official website, namely data regarding the additionally accrued charges for all kinds of TNDs, as well as information on TNDs (the number and additional charges thereunder) by oblast.

9.3 Publication of data on outcomes of judicial consideration

The STS publishes information on the results of judicial consideration of tax cases on a monthly basis[296]. Such data are presented in a free text form and include cumulative information on:

1) The total number of cases considered by courts and total challenged amounts;
2) The number of cases in favor of the STS, total challenged amounts and a corresponding percentage ratio;

294 https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/vregulyuvannya-podatkovih/apelyatsiyna-praktika/

295 https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/kontrolno-perevirochna-robota/

296 https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/vregulyuvannya-podatkovih/informatsiya-schodo-oskarjen-rishen

3) The number of cases in favor of the taxpayer, total challenged amounts, and a corresponding percentage ratio;

4) The number of cases in which final decisions have been made and the total challenged amounts;

5) The number of cases on TNDs appeals and challenged amounts.

However, while processing the corresponding data, the Council developed a number of substantive remarks regarding their quality and consistency.

Firstly, data on outcomes of judicial consideration appear to be the only category of information provided by the STS in a free, unstructured text format. We would like to emphasize that the purpose of information disclosure is to grant free access to **systematized data** with the ability to search and sort it. Information on results of judicial consideration is not a set of data which is subject to disclosure pursuant to Resolution No.835. However, since the STS publishes respective data in view of a high public interest — in addition to availability, their usability should also be provided. This involves publishing data in a user-friendly format enabling their further effective processing (particularly to enable the user to compare, sort them, etc.).

We believe that changing format from free to structured text would also eliminate instances of lack of proper consistency in the data published by the STS. For example, according to the information provided by the STS, as at June 1, 2020, during five months of 2020, courts considered 9.15 k cases. The final decisions were rendered in 3.3 k cases. The remaining 79.7 k cases are pending — no final decisions have been made[297]. Even not very attentive reader would notice that mentioned 79.7 k cases are cumulative not for five months of 2020, but for a longer period. Thus, while the user expects to get access to precise data for 5 months of 2020, he/she, instead, received cumulative data for a longer period (but unclear which exactly). Such inconsistencies could be avoided if the data were presented at least in a tabular format, which would allow to clearly track the number of claims, amounts and periods.

Secondly, to objectively assess the effectiveness of judicial consideration, one should clearly identify the categories of court cases. It is a positive trend that the STS separately provides the results of TND-related court cases, as such cases constitute a key category of tax cases in courts. However, other, perhaps less numerous, but not less important categories of cases have been overlooked, such as those related to registration of tax invoices, exclusion of taxpayers from risky taxpayers lists, VAT refunds and others. The Council is convinced that the STS should ensure disclosure of information about results of judicial consideration vis-à-vis main categories of cases.

Thirdly, it is important that such information shall also be made public with the reference made to judicial authorities adopting such decisions, since it will give a clear and qualitative picture of the full "life cycle" of the supervisory authority's corresponding decision. At present, since the disclosed information is not based on such differentiation, — we assume that a continuous data stream on results of judicial consideration comprises both decisions that have entered into force and those being at the appeal stage. Therefore, the real picture of results of judicial consideration of tax disputes may be somewhat distorted and untrue.

[297] https://www.tax.gov.ua/diyalnist-/pokazniki-roboti/vregulyuvannya-podatkovih/informatsiya-schodo-oskarjen-rishen/421620.html

Given the above, the Council recommends the STS to streamline the disclosed information on the results of judicial consideration in a format allowing to effectively handle such data (to compare, sort the data, etc), as well as to supplement them with information on the main categories of court cases under consideration and on the manner in which they are considered by various judicial authorities.

9.4 Publication of information on results of SEA VAT and SMKOR

Although the STS regularly publishes a large amount of data in many areas, there are some fields, bearing significant impact on taxpayers' activities, whose respective data is not published on a regular basis. These are, first of all, SEA VAT's and SMKOR's work results. Therefore, such issues as suspension of tax invoices' registration, non-acceptance of taxpayers' data tables, rendering decisions evidencing taxpayers' adherence with risk criteria, blocking taxpayers' registration limit in SEA VAT for several years in a row, cause a significant public response. Hence, it goes without saying, that disclosing such information is of great public importance.

The Council observes that such information is selectively published in the news or in the STS's reports[298], which confirms that the respective statistics are processed by the STS. However, unlike information on tax authorities' activities results in other areas, information on this area is not published on a regular basis and in a user-friendly manner on the STS's website. In practice, taxpayers exercise their right to get familiar with such information by sending requests for access to public information. However, we are convinced there is an urgent need for the STS to provide a regular disclosure of such information to demonstrate openness and transparency in this important social issue.

Therefore, the Council proposes to ensure a regular (at least monthly) publication of comprehensive data on SEA VAT and SMKOR work results according to the scope specified below in recommendation 37.5 in this Chapter.

[298] For example, STS 2018 report (http://sfs.gov.ua/data/files/240396.pdf) contains information dedicated to tax invoices registration suspension and taxpayers' data tables acceptance or rejection. However, in the STS 2019 report such information is missing.

COUNCIL'S RECOMMENDATIONS:

37. In order to enhance transparency and openness of the STS while disclosing data of public importance, as well as to provide users with access to comprehensive and high-quality data on results of tax authorities' work, the Council recommends **the State Tax Service of Ukraine**:

37.1. To ensure systematization (sorting) of sets of published data by subject, keywords, popularity of sets among users, etc. on its website, as well as to enable performing of a "smart" search among data sets. All data must be published in a single format;

37.2. To ensure publication of comprehensive data on results of control and audit measures — i.e. in addition to already published information on audits, whose results have been reconciled, to publish data on audits, whose results have not been reconciled. To provide the ability to sort data by departments, so that users have access to information on selected types of audits;

37.3. To ensure publication of comprehensive information on the outcomes of administrative appeal; in particular, to add information on the amount of additional charges for all types of TNDs, as well as information on TNDs (the number and additionally accrued amounts) by oblast;

37.4. To streamline publication of information on results of judicial consideration in a format enabling to effectively process such information. Supplement the data with information on the main categories of cases under consideration, as well as on the manner in which cases are considered by particular judicial authorities;

37.5. To ensure regular publication of the following data on the results of SEA VAT and SMKOR work:

1) Regarding SEA VAT:

- Information on the suspended registration limit amount in SEA VAT (through arrest or otherwise);
- Information on the registration limit amount, which was written off (reset to zero) in SEA VAT (to be broken down by grounds).

2) Regarding registration of tax invoices and adjustment calculations (TIs/ACs):

- The number of TIs/ACs submitted for registration with the URTI, their respective amounts, the number of VAT payers, who submitted them for registration;
- The number of TIs/ACs whose registration is suspended, their corresponding amounts, the number of VAT payers, whose TIs/ACs registration has been suspended (including risk criteria based on which they were suspended);
- The number of TIs/ACs against which the decision of the Commission for TI/AC registration suspension in the URTI on TIs/ACs registration was made, the corresponding TIs/ACs amounts, the number of payers for which such decisions were made. The data should be broken down by regional and central commissions.

- The number of TIs/ACs against which the decision of Commission for TI/AC registration suspension in the URTI on refusal to register TIs/ACs was made, the corresponding TIs/ACs amounts, the number of payers for whom such decisions were made. The data should be broken down by regional and central level commissions.
- The number of TIs/ACs registered pursuant to court decision, the corresponding TIs/ACs amount, the number of payers, court decisions, including, which out of them were:

  — registered with the URTI (TI/AC number, amount, number of taxpayers, number of court decisions);

  — not registered with the URTI (number of TI/AC, amount, number of taxpayers, number of court decisions) (to be broken down by reasons for which they are not registered).
- The number of TIs/ACs whose registration was denied by the court, corresponding TIs amounts, number of taxpayers, court decisions.

3) Regarding inclusion of taxpayers in the risky list:

- The number of taxpayers for whom decisions (including new ones made in the reporting period) on compliance with their risk criteria remain valid (to be broken down by regional commissions, reporting periods);
- The number of taxpayers for whom a decision on non-compliance with their risk criteria was made (to be broken down by regional commissions, periods) (including court decisions).

4) Regarding taking taxpayers' data tables into account:

- The number of taxpayers' data tables taken into account and taxpayers for whom such tables were taken into account (to be broken down by regional level commissions, reporting periods, UCGFEA/SCGS incoming and outgoing codes).

5) The number of taxpayers' data tables not taken into account and the number of taxpayers for whom such tables are not taken into account (to be broken down by regional level commissions, reporting periods, UCGFEA/SCGS incoming and outgoing codes).

10 TAXPAYERS' INTEGRATED CARDS

While interacting with the taxpayer, tax authorities constantly monitor the state of the former's settlements with the budget. The main tool they use is the so-called TICs created separately for each tax or other mandatory fee due to be paid by a taxpayer. *De facto*, TIC is the electronic form that accumulates information on amounts that have been paid or are due to be paid to the budget.

Although information in TICs is generally correct, errors sometimes occur significantly affecting the taxpayer's rights and interests[299]. **Usually, entrepreneurs are concerned about the appearance of tax debt record in TICs that should not be there. Actually, such an entry can occur for many reasons.**

For instance, if based on tax audit's results the taxpayer is facing an additional tax liabilities and challenges them with the court within ten days — then, according to TCU the tax liability is deemed "unreconciled" (non-approved) until the matter is settled by court and, thus, there is no tax debt[300]. In such cases, although tax authorities have to record the additional tax liabilities in their electronic system, — it does not have to be displayed as the "tax debt" in TIC. While this is true almost in every case, in rare cases information about the fact of a court dispute is not displayed in a timely manner and a record of a non-existent tax debt automatically appears in TIC. According to the Council's observations, existence of such "tax debt" even for a small amounts, creates trouble for taxpayers, as it blocks the overpayments refund and can also result in tax claims to be sent to the taxpayer, as well as imposition of tax pledge (lien).

The TIC's functioning is governed by the respective Procedure approved by the Order of the MoF No.422[301] (**"Procedure No.422"**). Based on systemic analysis of the Procedure No. 422, TICs contain **accounting indicators deriving** from **primary indicators** — i.e. indicators set forth in **primary documents**.

For the purposes of the Procedure No. 422 "primary documents" are documents drawn up by taxpayers, tax authority and other authorities, including: tax returns, customs declarations, adjustment calculations, TNDs, tax authority's decisions, claims for payment of debt (arrears) on a unified contribution as well as court decisions.

Meanwhile, the Procedure No.422 (para 2 of Section I) contains such concepts as "information system indicator's reliability", "information system data correctness", "twisting (distortion) of indicators". The analysis of these definitions shows that TIC's accounting indicators are not the primary source of information on accounting and payment of taxes and fees. Therefore, change of accounting indicators in TIC in itself does not create, change or terminate taxpayers' as well as the supervisory authority's rights and obligations related to accounting and payment of taxes and fees. In other words, **by its functional purpose TIC is effectively designed to only display information collected from primary documents**.

[299] Given that TICs are generated for each payment, the Council does not single out complaints related to incorrect functioning of the TICs when compiling statistics on complaints received. Therefore, we cannot accurately determine the total number and dynamics of such appeals. It is estimated that the Council has received several dozens of such complaints in total.

[300] *See* para 56.18 of Article 56 of the TCU.

[301] *See* the Procedure for prompt accounting of taxes and duties, customs and other payments to the budget, a unified contribution for compulsory state social insurance by the SFS approved by the Order of the MoF dated April 7, 2016 No.422 (**"Procedure No.422"**).

However, as it follows from the Procedure No. 422, **appearance of unreliable and incorrect indicators, their twisting (distortion) is not excluded**. In such cases, the following rules of para five of Section I of the Procedure No.422, which provide for data adjustment in TIC, come into force:

1) General **control over the accuracy** of accounting indicators reflected in TIC is exercised by the tax authorities' department carrying out accounting of payments and other receipts.

2) If **incorrectness is detected in basic records — the correcting document** with mandatory reference to a primary document whose indicators are corrected is prepared. Data correction in the SFS information system is carried out by departments responsible for entering such data from primary documents as at the current date.

3) If it is necessary to adjust TIC's accounting indicators **manually**, such adjustment is performed only **by the decision of the STS head (deputy head)** prepared by the corresponding department in charge of the respective stream of work.

Thus, although Procedure No.422 enables TIC's accounting indicators adjustment on the STS officials' initiative, it does not provide procedures for correcting data upon the initiative of a concerned taxpayer.

Therefore, the main systemic problem this chapter refers to is the difficulty of correcting incorrect TIC's data on the taxpayer's initiative. It is impossible to predict all situations that may cause incorrect data reflection in TIC. However, whatever the reason for the erroneous record, there must be a general procedure for its detection and correction. Based on the Council's practice, we below will consider two examples of occurrence of such an erroneous record. One concerns the case of tax amounts not delivered to the budget due to insolvency of the servicing bank; another is a dispute over the exemption from payment of a single contribution of entrepreneurs in the territory of Donetsk and Luhansk oblasts controlled by Ukraine for the period of ATO and Joint Forces' Operation[302]. The Chapter ends with a set of recommendations aimed at making TIC's correction procedure more accessible for concerned taxpayers.

[302] *See* in detail Section 3.3 "USC privileges: relief from payment on the ATO territory" of this Report discussing legal grounds for charging USC in respective cases.

Case No. 29. Failure to enforce court decision ordering amendments to the TIC

In October 2018, Sklyarenko, Sidorenko and Partners Attorneys at Law (**"Complainant"**) lodged complaint challenging malpractice of the MD SFS in Kyiv, which unreasonably accounted for the CPT tax debt and failed to make changes to the Complainant's TIC.

On March 2, 2015 the Complainant submitted CPT return for 2014, where amount of payment obligation was equal to UAH 33 219.

In order to pay the tax liability, the Complainant — pursuant to respective cash settlement servicing agreement — sent payment orders to the "Bank "Finansy i Kredyt" PJSC with a payment description "income tax for 2014" under a cash settlement servicing contract signed with the bank:

- dated January 22, 2015 No.14 amounting to UAH 15 000;
- dated January 30, 2015 No.28 amounting to UAH 15 000;
- dated March 24, 2015 No.54 amounting to UAH 3 219.

The payment order dated January 22, 2015 No. 14 was executed by the servicing bank. Payment orders dated January 30, 2015 No.28 and March 24, 2015 No.54 were accepted for execution by the servicing bank, but not executed.

Subsequently, on September 17, 2015, the Board of the NBU adopted Resolution No.612 "On Classifying "Bank "Finansy i Kredyt" PJSC as Insolvent".

At the end of the deadline for the Complainant's payment of the CPT monetary liability for 2014 his TIC **had a record on a tax debt in the amount of UAH 18 212.59** (which is approximately equal to the amount of payment orders not executed by the servicing bank dated January 30, 2015 No. 28 amounting to UAH 15 000 and March 24, 2015 No.54 amounting to UAH 3 219).

However, disagreeing with this state of affairs, the Complainant went to court and received a court decision by which the **STI in Shevchenkivskyi District of the MD SFS in Kyiv was obliged to exclude information about the negative income tax balance totally amounting to UAH 18, 212.59 from the TIC.**

This court decision is in line with the Supreme Court's customary case-law, namely:

- The Ruling of the ACC/SC, dated February 20, 2018 in the case No.816/59/17[303] (quotation: *"The Supreme Court agrees with the conclusion of lower courts that the taxpayer's fulfillment of tax obligation to transfer the tax liability amount to the budget is linked to the moment of submission to the bank of a payment order to transfer respective tax liabilities, in particular, to the moment of acceptance of the payer's settlement document for execution by the bank"*);

[303] http://www.reyestr.court.gov.ua/Review/72338517

- The Ruling of the ACC/SC, dated April 3, 2018 in the case No. 809/3851/15[304] (quotation: *"Therefore, with submission of a payment document for transfer of tax to the budget to the banking institution by a taxpayer, according to which the payer initiates payment and the bank accepts such a document, such taxpayer's obligation to pay such tax is terminated. Therefore, the tax payment day to the budget shall be deemed the day when the bank accepted the document for transfer of tax to the budget for execution"*);
- The Ruling of the ACC/SC dated May 3, 2018 in case No.826/11432/17[305] (quotation: *"Thus, the fulfillment by the taxpayer of tax obligation to transfer the tax liability amount to the budget and its payment, is exactly linked to the moment of submission to the bank of a payment order to transfer respective tax liabilities amounts and initiating transfer is deemed final and the bank is responsible for further tax liability amounts transfer"*).

However, the tax authority neither actually enforced the court judgment nor introduced changes to the Complainant's TIC, referring to peculiarities of real-time accounting system's operation apparently not allowing to make changes to TIC without confirmation from the State Treasury Service on revenues flow to the budget.

The Council understands the willingness of the SFS to reflect the state of receipt of taxes and fees to the State Budget of Ukraine in its accounting and reporting as accurately and reliably as possible. Thus, it is indeed seen that the amount of UAH 18,219 paid by the Complainant, but not received by the State Budget of Ukraine due to the fault of "Bank "Finansy i Kredyt" PJSC (and other similar amounts in similar situations), should be specially re-ordered in the SFS and STS statistics and accounting information, as amounts not considered taxpayers' tax debt and at the same time not credited to the State budget (depending on circumstances, such amounts may be accounted as losses of the State Budget or as banks' debt to the budget). The Council is ready to support any reasonable initiative to amend the relevant legal acts to help properly account such amounts (but without affecting prompt restoration of the Complainants' rights and legitimate interests — i.e. complainant's rights must be restored immediately and should not become dependent on legislative changes designed to solve this problem in the future).

On January 2, 2019, a decision was made by the Business Ombudsman, who recommended the MD STS in Kyiv to ensure correction of the unreliable accounting indicator in the Complainant's TIC, which does not correspond to the primary document (court decision) on the tax debt in his TIC.

The court decision has not been enforced for 1.5 years, so as at the date of publication of this Report, the Council is still monitoring implementation of the foregoing recommendation.

It is worth noting that on July 1, 2020, the Grand Chamber withdrew from the Supreme Court's legal position on the untimely payment of taxes. However, those court decisions that have already entered into force and whose appeal is exhausted will still have to be enforced[306].

[304] http://www.reyestr.court.gov.ua/Review/72338517

[305] http://www.reyestr.court.gov.ua/Review/73811358

[306] http://www.reyestr.court.gov.ua/Review/90228193

There are frequent cases of supervisory authority issuing several tax claims pursuant to unreasonable records of tax debt in TICs. Meanwhile, the cancellation of such claims in court does not automatically exclude information about the existence of tax debt from TICs. Reasons for the existence of such situations lie, *inter alia*, in the legal nature of the debt's payment notice, as discussed above in the Section 3.4.1 *"The legal nature of the payment notice on USC debt (arrears)"* of this Report.

Case No. 30. Issuance of new tax claims upon cancellation of previous claims by court

In March 2020, the Council received a complaint from IE (**"Complainant"**) in which it was reported that the STS in Donetsk oblast issued a repeated claim for payment of unified social contribution debt (arrears) dated November 20, 2019 amounting to UAH 33,780.40 (hereinafter — **"Claim 2"**) on the same grounds as the claim for payment of debt (arrears) dated May 13, 2019 No. Ф-13247-46 in the amount of UAH 28,272.04. (hereinafter — "**Claim 1"**), which was declared illegal and cancelled by the decision of Donetsk District Administrative Court dated September 16, 2019, which entered into force on November 28, 2019.

The Complainant particularly emphasized that despite the fact that Claim 2 was under judicial appeal (proceedings were initiated on a case by a ruling of Donetsk District Administrative Court dated January 29, 2020), it was unreasonably sent by the MD STS in Donetsk oblast for enforcement to the Central Department of the State Enforcement Service in the city of Mariupol of the Eastern Interregional Department of the Ministry of Justice of Ukraine. It resulted in groundless launching of enforcement proceedings on February 24, 2020 by the state enforcer. The foregoing actions of the STS in Donetsk oblast, in accordance with the terminology employed by the Council, will be hereinafter referred to as the **"alleged Business Malpractice 1"**.

During preliminary assessment of the Complaint, the Council's investigator in charge found out that the problem reported by the Complainant (alleged Business Malpractice 1) in fact derived from another problem, namely allegedly inaccurate information about a possible debt (arrears) under a unified contribution in the Complainant's TICs. Alleged illegal inaction of the MD STS in Donetsk oblast, which is about not making corrections to Complainant's TICs, in accordance with the terminology adopted by the Council, will hereinafter be referred to as the **"alleged Business Malpractice 2"**.

In result of the Council's request, in March 2020 the MD STS in Donetsk oblast withdrew Claim 2 from the Central Department of the State Enforcement Service in Mariupol city of the Eastern Interregional Department of the Ministry of Justice until the judgment entry into force — i.e. alleged Malpractice 1 (that was the subject of the Complaint) ceased to exist.

Meanwhile, the MD STS in Donetsk oblast refused to correct information in TIC regarding the amount of debt (arrears) under the unified social contribution. Thus, as at May 2020, information in TIC remained unchanged, and in the future there might have been grounds for issuing new claims for payment of debt (arrears) under a unified social contribution, such as the Claim 1 and the Claim 2.

Having comprehensively investigated the foregoing matter, the Council ascertained that the Complainant was dealing with a systemic problem, which is contradictory regulation by the current Ukrainian legislation of the issue of relief of the USC's payers located in the Ukrainian-controlled Donetsk and Luhansk oblast for the period of ATO and Joint Forces' Operation from payment of a unified social contribution. The Council found out that tax authorities had a specific approach to application of the relevant legislation, which differed from that followed by the Complainant and many other business entities. By recording the Complainant's disputed amount of debt (arrears) under the unified social contribution and refusing to correct information about it in TIC (i.e. assuming omission, which is considered as the alleged Malpractice 2 by the Complainant), — the MD STS in Donetsk oblast follows a well-established approach also supported by the highest tax authority — the STS.

In view of the above, in May 2020 the Council dismissed investigation of the complaint in the part of the alleged Malpractice 2 due to exhaustion of all reasonable means to address the issue for the Complainant in the pre-trial manner.

It is also worth noting that when declaring tax claims unlawful courts quite often reject taxpayers' claims for correcting the TIC's information by removing information on tax debt. Tax officials, despite unequivocal conclusions of the court on illegality of debt accrual, treat lack of specific obligation in the language of the court decision on TIC's correction as the opportunity not to make any changes to TIC and continue issuing new tax claims[307].

The foregoing examples illustrate such a systemic problem as the **lack of an effective mechanism to protect the taxpayer's interests in case of detection of incorrect information in the TIC. As practice shows, at present it is impossible to ensure 100% error-free automated systems operation as well as indisputability of information recorded therein**.

It is also impossible to predict and resolve all possible situations that lead to appearance of incorrect data in automated systems (including TICs). In this regard, it is important to establish a common and accessible procedure for correcting the data of TIC in some specific cases, regardless of the reason for the incorrectness of such data for all taxpayers concerned. Currently, a taxpayer may apply to the supervisory authority in a general manner. Yet, unlike, for example, the TND administrative appeal, there is no special procedure in the legislation for considering such appeals within established terms, appointment of persons in charge, possible decisions and obligation to correct information in TIC based on outcomes of the appeal consideration or a court decision.

It is worth noting that disputes between taxpayers and tax authorities regarding corrections made by the latter with the TIC exemplify situations where legitimate interests

[307] *See*, in particular, decisions: http://www.reyestr.court.gov.ua/Review/84400128 and http://www.reyestr.court.gov.ua/Review/88491098

of business are violated by illegal omission of the state body. Meanwhile, in Ukraine currently appeals against such omission at the administrative (internal) level are virtually not addressed at the legislative level, the tax sphere being no exception[308]. This state of affairs significantly narrows possibilities for pre-trial settlement of such issues and implies their resolution exclusively in courts.

Meanwhile, as at the date of this Report publication, the *Draft Law of Ukraine "On the Administrative Procedure" No. 3475 dated May 14, 2020* (**"Draft Law No. 3475"**) was registered with the Verkhovna Rada of Ukraine. The said Draft Law, whose numerous provisions are actively supported[309] by the Council[310] provides, inter alia, for the right of a person to employ administrative appeal procedure to challenge omissions of state bodies[311].

Currently, it is difficult to accurately predict the perspectives of the Draft Law's No.3475 adoption as well as the manner in which it will be implemented in the actual practice of state (and particularly tax) authorities. However, cautious optimism is justified as upon implementation of innovations (novelties) provided by this Draft Law taxpayers would be vested with more opportunities for pre-trial protection of their legitimate interests in case of illegal omissions at the part of tax authorities (such as failure to make corrections to the TIC).

[308] Even Article 56 of the TCU, a basic norm that guarantees taxpayers' right to appeal, applies to of tax authorities' decisions only, not their actions and omissions. The Procedure No.916, which establishes a relatively high-quality and detailed procedure for administrative appeal in the STS, also applies only to appeals against supervisory authorities' decisions (not all of them). In practice complaints about their omission are considered by the STS as appeals of citizens (The Procedure for consideration of appeals and organization of personal reception of citizens in the State Fiscal Service of Ukraine and its regional divisions approved by the Order of the MoF dated March 2, 2015 No. 271). This method of consideration presupposes the mandatory response to the author of the appeal, but does not allow the latter to actually participate in the procedure of consideration of his/her complaint. In practice, the effectiveness of handling such complaints, according to the Council's observations, is low.

[309] As at July 1, 2020, the Draft Law No. 3475 is included in the agenda of the Parliament, but has not been considered even in the first reading yet.

[310] *See* the Council's System Report "Administrative Appeal: Current State and Recommendations" (July 2019). https://boi.org.ua/media/uploads/system_aug2019/2_2019_sytem_ua.pdf

[311] The respective provisions are contained in para 8 of Part 1 of Article 29, part 2 of Article 33, part 1 of Article 74, part 4 of Article 74 of the current wording of the Draft Law No.3475.

COUNCIL'S RECOMMENDATIONS:

38. In order to enable correction of TIC's data upon the taxpayer's initiative, the Council recommends **the Ministry of Finance of Ukraine** to amend the Procedure No.422 as follows:

38.1. to establish a special procedure for submission and consideration of taxpayers' appeals to correct TICs' accounting indicators that the taxpayer considers false (incorrect) by the STS;

38.2. to oblige controlling authority either to correct respective controversial TIC's data (information) within the established term or to substantiate its correctness in writing;

38.3. to establish procedure for prompt and unconditional TIC's data correction enabling enforcement of court decisions directly related to the disputed TIC's data (e.g. decisions recognizing calculation of the tax liability — which appears in TIC as debt — as being groundless), including court decisions, whose resolutory parts does not expressly oblige tax authority to make such a correction.

11 REFERENCE MATERIALS

11.1 Annex 1. How VAT evasion “schemes” work

11.1.1 What are "conversion centers"

“Conversion center” usually operates in Ukraine as follows (model of its operations has undergone some changes at the present stage, which will be discussed below):

1) The organizer of the “conversion center” creates a large number of fictitious (sham) companies. Such enterprises are registered as newly established, or acquired from former owners as already existing ones. Nominal owners and directors of such companies who are specified in the USR are front persons, who do not intend to run business through these companies. They are usually individuals who have either agreed to become nominal owners and directors for a certain remuneration, or do not even know that they were registered as owners/directors of such companies (the so-called “registration for lost/stolen passports”). Since registration of companies in Ukraine is currently quite simple (and this fact once contributed to strengthening the country's position in the “Doing Business” ranking conducted by the World Bank), it takes only a few days to register a sham company and to make it a VAT payer.

2. In fact, these companies’ seals and electronic keys (with which they can sign electronic documents, submit reports, manage their bank accounts, etc.) are held by organizers of “conversion center”, who are not formally involved in these companies’ activities. Thus, organizers of “conversion center” have the opportunity to perform a wide range of actions on behalf of any of these fictitious companies. For example, they can draw up financial and economic documents (contracts, invoices, certificates of performed works, etc.), submit tax and financial statements, manage funds on their bank accounts. Nominal owners and directors of companies do not participate in this activity. They may be engaged from time to time to put their signatures on hard copy of documents when necessary (agreeing to do that for a certain remuneration), otherwise their signatures on hard copies of documents can be forged.

3. “Conversion center” managers organize sham companies created or acquired by them into structured networks, each company having its own role inside necessary to implement the fraudulent scheme. Traditionally, there are two types of sham company: “tax pit” and “transitor”.

4. A “tax pit” is a sham company on behalf of which production and/or sale of goods or services, the price of which includes VAT, is performed on paper, although in fact the enterprise does not produce or sell anything. The “tax pit” issues tax invoices for the name of its imaginary buyers, which give the latter the right to a VAT tax credit in the amount of VAT included in the price of imaginary (non-existing) goods or services. At the same time, the "tax pit" becomes obliged to pay

significant amounts of VAT to the state budget. However, it does not declare and/or pay the tax to the state budget, while it is impossible or extremely difficult to collect it (the company has no property or money, its owners and directors are fictitious persons, or they cannot be found, etc.).

5. A "transitor" is another type of sham company created primarily to "confuse" traces in the chain of sham transactions. It performs (on paper) sham purchase of goods or services from the "tax pit", or from the previous "transitor" in the chain of sham transactions, and their subsequent sham resale to the next "transitor" in the chain or directly to the "beneficiary" (a real business that wants to use services of "conversion center" to evade taxation and convert funds into cash).

6. A real business transfers funds from its bank account to a bank account of sham company being a part of a "conversion center" ("transitor" or "tax pit") allegedly for purchase of goods or services. However, in fact no goods and services are delivered and the transferred amount of funds is later secretly returned to business in cash (with a deduction of the so-called "commission for conversion" kept by organizers of "conversion centers").

7. Everything is documented on paper so that it looks like a real transaction. For example, if a business is a construction company, the "conversion center" can sell it a VAT tax credit and cash as subcontracting construction works (which such a business does not need in fact, because it performs all the work on its own). If the business is an agrotrader selling grain for export (which it unofficially bought from small farmers on the "black market" for cash), then the "conversion center" can sell a VAT tax credit and cash to such company imitating supplying the grain. The same is true for other industries.

8. In case of successful implementation of this fraudulent scheme, the business using it usually gets a triple benefit:

- receives a VAT tax credit allowing it to pay less VAT to the budget or refund more VAT from the budget;
- includes the value of allegedly purchased goods or services in expenses which deducts from its taxable income, from which 18% of CPT is paid;
- receives cash it needs for transactions in the shadow sector of economy (payment of salaries "in envelopes", purchase of goods on the "black market", illegal payments, etc.).

9. When implementing the scheme, the business incurs expenses (pays a commission to "conversion center" organizers) and assumes risks (the tax authority may identify this scheme, accrue underpaid taxes and impose fines). However, many businesses are ready to put up with these expenses and risks, as it is often more cost-effective than working officially.

10. The prospect of criminal liability for tax evasion is usually not too intimidating for businesses using "conversion centers" services. After all, currently the

corresponding article of the Criminal Code of Ukraine (Article 212) provides for a relatively lenient punishment (only in the form of a fine)[312], which in practice threatens the company's CEO and/or a chief accountant only in the event of a rather unfortunate coincidence. In practice, such criminal proceedings are very rarely end up with a conviction[313]. Typically, qualified attorneys-at-law are able to successfully defend business and its officials against such allegations, even if they have a certain basis.

11. "Conversion center" organizers, upon successful implementation of the scheme receive their "commission" making their activities quite profitable, despite the fact they often have to pay corruption payments to representatives of tax and/or law enforcement agencies, which sometimes cover "conversion center" activities.

12. Theoretically, organizers of "conversion centers" bear significant risks, as they may face criminal liability under many articles (including Articles 191, 205[314], 205-1, 209, 212, 358, 364, 366 of the Criminal Code of Ukraine, etc.), providing for punishment more severe than fines. However, in practice, only executors (nominal owners and directors of sham companies, who usually easily plead guilty) rather than organizers, are usually brought to liability. This liability is usually not too strict. Despite tax and law enforcement agencies often report on "conversion centers" closure, many are still operating. It is a widely-spread reason of criticism of the current system of combating financial crimes (here it is appropriate to refer to the lengthy discussion around the establishment of the Bureau for Financial Investigations currently underway in Ukraine).

[312] Since January 1, 2020, based on Article 212 of the Criminal Code of Ukraine, tax evasion amounting to less than UAH **3 153 000** is not considered a criminal offense at all. Tax evasion for larger amounts is subject to the following penalties:

- evasion amounting from UAH 3 153 000 up to 5 255 000 — a fine in the amount from UAH 51,000 up to 85 000, or deprivation of the right to hold certain positions or engage in certain activities for up to three years.
- evasion amounting from UAH 5 255 000 USD up to 7 357 000 (or the amount of UAH 3 153 000 up to 7 357 000, if prior conspiracy among a group of persons is proved) — a fine amounting from UAH 85 000 up to UAH 119 000 and deprivation of the right to hold certain positions or engage in certain activities for up to three years.
- evasion amounting to over UAH 7 357 000 (or over than UAH 3 153 000, if a person was previously convicted of this crime) — a fine amounting from UAH 255 000 up to UAH 425,000 and deprivation of the right to hold certain positions or engage in certain activities for up to three years with forfeiture of property.;
- In this case, a person who evaded taxes (except for those previously convicted of this crime) is released from criminal liability if he/she paid taxes, fees (mandatory payments) prior to being brough to liability, as well as compensated damage caused to the state by their untimely payment (financial sanctions, fines).

[313] According to the tax police official information (link: http://sfs.gov.ua/data/material/000/105/156743/12_2018.pdf), in 2018 **645** such criminal proceedings were closed, **121** sent to courts with a request for release from criminal liability, and only **104** were sent to courts with an indictment.

According to the same data for nine months of 2019 (link: http://sfs.gov.ua/data/material/000/105/156743/09_2019.pdf) **414** proceedings were closed, **131** were sent to the courts with a request for release from criminal liability, and only **90** — sent to courts with an indictment.

It should be borne in mind that most proceedings sent to courts with indictments do not end with a court conviction. The court may also issue an acquittal, close the case under various rehabilitative or non-rehabilitative circumstances, or return it for additional pre-trial investigation (where criminal proceedings may be subsequently closed).

[314] Article 205 of the Criminal Code of Ukraine "Sham Business Activity" (which meant the creation or acquisition of business entities (legal entities) to cover illegal activities or activities that are prohibited) is excluded from the Criminal Code of Ukraine on the basis of the Law of Ukraine "On Amendments to the Criminal Code of Ukraine and the Criminal Procedural Code of Ukraine to Reduce Pressure on Business" No. 101-IX dated September 18, 2019, which entered into force on September 25, 2019.

11.1.2 How have schemes changed in an era of SEA VAT

Introduction of SEA designed on the VAT deposit principle, has made it virtually impossible to implement a common fraudulent scheme with the “tax pit” in the center. After all, from now on the “tax pit” could not issue a TI/AC without guaranteeing payment of the VAT to the state budget in the way of depositing the respective amount.

However, non-compliant entities quickly found a way to adapt to this innovation.

1) The biggest amounts of VAT (for example, in 2019 — UAH 289.76 bn) are paid at customs when importing goods into Ukraine. A taxpayer, who imported such goods into Ukraine and paid VAT upon their customs clearance acquires the right to a VAT tax credit in the respective amount. Such a taxpayer can exercise this right if it subsequently sells imported goods in Ukraine by including VAT in the sale price.

2. However, in practice, many importers actually sell goods they import into Ukraine on the “black market” without including VAT in the price and without declaring income from sale of such goods at all.

3. On paper, such importers have significant stocks of goods pending sale and significant amounts of unused VAT tax credit. In fact, these goods are not in importers’ warehouses, but have been sold out long ago. In turn, such importers have significant amounts of cash on hands received from sales on the "black market”, the origin of which would be difficult to explain. At the same time, they need money on a bank account to buy new consignments of imported goods abroad.

4. Such importers have found a way of mutually beneficial cooperation with “conversion and transit centers” within a scheme often referred to as a “two-ways transit”.

5. The essence of this scheme is that the importer (called “a supplier in the scheme of two-way transit”) sells goods that, according to documents, are still in its warehouse (actually sold out long ago) to a sham company — “transitor” being a part of the "conversion and transit center”.

6. In fact, sale of goods does not take place. The importer transfers cash to the "conversion and transit center" and receives non-cash funds on its bank account in exchange masked as payment for the supply of goods. The "transitor" being a part of the "conversion and transit center" along with the goods existing only on paper receives a VAT tax credit from the importer, which (the credit), through a chain of trans sham transactions, is planned to be subsequently sold to the "beneficiary" ("a buyer in the scheme of two-ways transit”).

7. There are often a number of non-existent goods resales between several sham companies — “transitors” within the “conversion and transit center”. In the course of such resales there is often a substitution of goods — the so-called “resorting” or "twisting". For example, another sham company can buy bananas (existing only on paper) and subsequently sell metal pipes (also existing only on paper).

8. Such substitution of goods is necessary to give the VAT tax credit, which the “conversion and transit center” is going to sell together with cash, to the “beneficiary” (a real business) such a form that will be suitable, convenient and safe for the “beneficiary”. For example, if the beneficiary is a construction company, it would be

difficult for it to explain the purpose of purchasing a large batch of bananas, but it would be much easier to justify purpose of purchase of metal pipes.

9. The end and outcome of this new scheme is the same as in the old scheme described above starting with the “tax pit” — the "beneficiary" gets a triple benefit in the form of: 1) a VAT tax credit; 2) expenses (reducing its declared profit, and, accordingly, the amount of CPT amount); 3) turning (conversion) of their funds into cash.

"Two-way transit” — business entity making substitution of goods

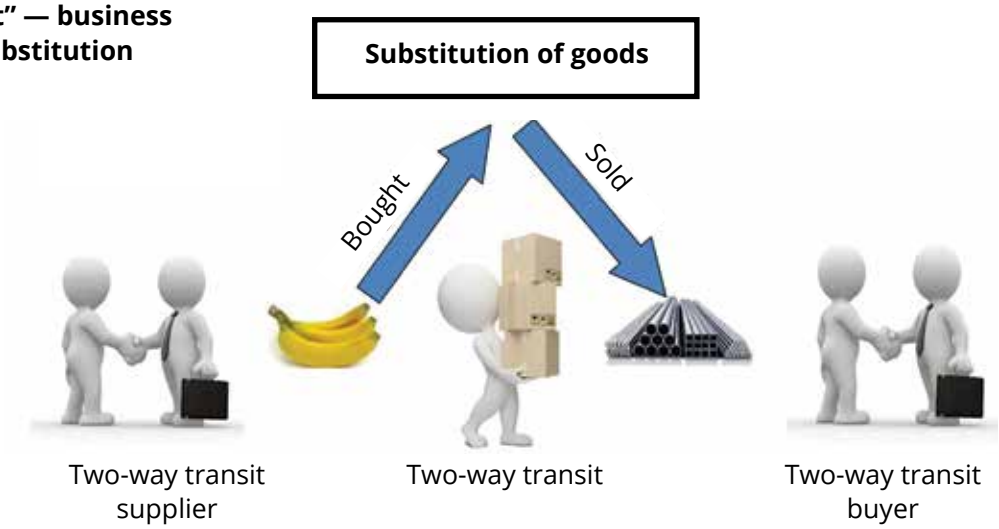

Fig. 7.
How “two-way transit” scheme works
Source: https://www.slideshare.net/artemrada/ss-79344466

11.2 Annex 2. What is registration limit in the SEA VAT

The registration limit (∑Inv indicator) is the amount of VAT for which the taxpayer is entitled to register the TI/AC in the URTI.

The registration limit is calculated according to the formula established by law — directly in clause 200-1.3 of the TCU:

∑Inv = ∑InvRcvd + ∑Cust + ∑DepAc + ∑Overdraft — ∑InvIssd — ∑Refund — ∑Excess.

Each component of this formula is defined in clause 200-1.3 of the TCU, and is described in more detail in the Procedure No. 569.

A simplified description of these components is as follows:

- the ∑InvRcvd component increases the VAT payer's registration limit by the amount of "incoming" VAT (specified in the TI/AC drawn up and registered in the URTI by suppliers of goods/services it purchases);
- the ∑Cust component increases the VAT payer's registration limit by the amount of "incoming" VAT paid by it at the customs when importing goods;
- the ∑DepAc component increases the VAT payer's registration limit by the amount deposited (pre-paid) by the VAT payer to its electronic account in SEA from which VAT is subsequently paid to the budget;
- ∑Overdraft component creates a certain positive cushion for some VAT payers (deviation from the basic formula towards increasing the registration limit) in the amount, a way of calculation of which is determined in detail by the TCU;
- ∑InvIssd component reduces the VAT payer's registration limit by the amount of "outgoing" VAT (specified in the TI/AC issued and registered in the URTI due to supply of goods/services);
- ∑Refund component reduces the VAT payer's registration limit by the amount it claimed for a refund from the budget;
- ∑Excess component has an auxiliary (technical) nature and it is aimed at prevention of artificial increase of their registration limit by certain taxpayers in the way of non-registration of certain TIs/ACs with the URTI. This component reduces the VAT payer's registration limit, if such a VAT payer did not register TI/AC with the URTI (which would trigger application of the ∑InvIssd basic component), but declared VAT tax liabilities related to the respective business transaction in its VAT tax return.

11.3 Annex 3. How SMKOR works

11.3.1 How automated monitoring of VAT invoices works

The essence of SMKOR is that each TI/AC submitted for registration with the URTI is subject to instant automated monitoring.

As part of such monitoring, an artificial intelligence (computer) checks certain key parameters of the taxpayer and a particular business transaction according to clearly defined algorithms.

The purpose of such monitoring is to identify whether there is a significant risk that a business transaction for which the respective TI/AC is issued is sham and being a part of the of the “sham” VAT turnover.

Risk criteria are predetermined by respective regulations.

The algorithm works as follows.

1) First of all, the SMKOR checks whether the so-called "cut-off criteria" are met — parameters by which the TI/AC is considered “safe” and excluded from further monitoring.

The "cut-off criteria" have been changed and narrowed several times, and are generally reduced to two: 1) a very small amount of transactions with the same taxpayer within a month (this criterion is so narrow today that it works very rarely); 2) a very heavy tax burden on the taxpayer (a significant number of various taxes and fees paid to the budget for the last year in relation to turnover for this period).

If “cut-off criteria” are met, a TI/AC is freely registered with the URTI.

2) If “cut-off criteria” verification fails, then (this monitoring level was introduced on March 22, 2018 and is the most debatable one) SMKOR checks whether the taxpayer, who issued the TI/AC does not meet the taxpayer’s risk criteria.

Taxpayer’s risk criteria (at least some of them) contain a certain subjective element and leave room for discretion. Compliance/non-compliance of certain taxpayers with such criteria is verified manually by respective commissions within local tax authorities. This aspect, in fact, arises the most of discussions.

If the taxpayer's risk criteria are met, this is bad news for the taxpayer. In this case, the registration of TI/AC is always suspended regardless parameters of particular business transaction.

3) If the taxpayer's risk criteria are not met, the SMKOR checks whether the specific business transaction specified in the TI/AC meets the business transaction risk criteria.

Business transactions’ risk criteria are clearly established by law. The most common is the criterion referring to considerable differences between the volume and range of goods/services purchased and sold by the taxpayer. This criterion aims to identify traditional “twists” (such as the purchase of bananas and sale of pipes). It is quite easy to identify such discrepancies, because the mandatory detail of each TI/AC in Ukraine is the classification code of a type of goods/services in accordance with the respective state classifier (Ukrainian Classification of Goods for Foreign Economic Activity (“UCGFEA”) for goods, the State Classifier of Goods and Services (“SCGS”) — for services).

Meanwhile, this criterion is dangerous for the real business, because it can affect manufacturers, which, quite naturally, have different ranges of “incoming” and “outgoing” goods and services. To protect manufacturers, an additional instrument was invented — the so-called “taxpayer’s data tables” (to be discussed below).

If none of business transaction risk criteria was met, the TI/AC is registered with the URTI.

4) If the main business transaction risk criteria (related to discrepancies between "incoming" and "outgoing" volumes and nomenclature of goods/services) is met, the SMKOR additionally checks whether the respective commission under the tax authority has accepted the so-called "taxpayer's data table" submitted by a taxpayer.

The data table is a document of the established form which the taxpayer, if it wants to, can submit through its e-cabinet to the tax authority. It contains two columns — the first one listing UCGFEA and SCGS codes for goods/services, which, under normal circumstances of economic activity, are purchased by the taxpayer, and the second one — UCGFEA and SCGS codes for goods/services usually sold.

For instance, a farm will probably indicate UCGFEA codes corresponding to diesel fuel (used to fill agricultural machinery), mineral fertilizers and seeds in the first column, while crops grown and sold — in the second one.

The data table may be accompanied by explanations and supporting documents by which the taxpayer proves its activities (for example, shows availability of fixed assets and employees), based on which tax officials, who study the data table can conclude it is about a real production, and not about the "twist".

The corresponding commission under tax authority decides on each data table submitted for consideration whether to accept it or reject. Subsequently, based on observations of the taxpayer's activities, the same commission, or a higher-level commission may change its decision, withdraw its own previous decision on acceptance of the table.

If the taxpayer's data table has an "accepted" status, then SMKOR will ignore differences in the "incoming" and "outgoing range and volume of goods/services in terms of those UCGFEA and SCGS codes listed in such a table. Accordingly, in this case, the main business transaction risk criterion is not met.

5) If business transactions' risk criteria were met, SMKOR additionally checks whether the taxpayer has indicators determining a positive tax history (in the normative sense, including a number of features, ranging from certain amounts of taxes and fees paid to the budget, to availability of certain volumes of agricultural land plots).

A positive tax history "rescues" the TI/AC from suspension of registration resulting in its registration with the URTI.

In case if the taxpayer does not have a positive tax history (in the normative sense), the registration of TI/AC is suspended.

SMCOR mechanics

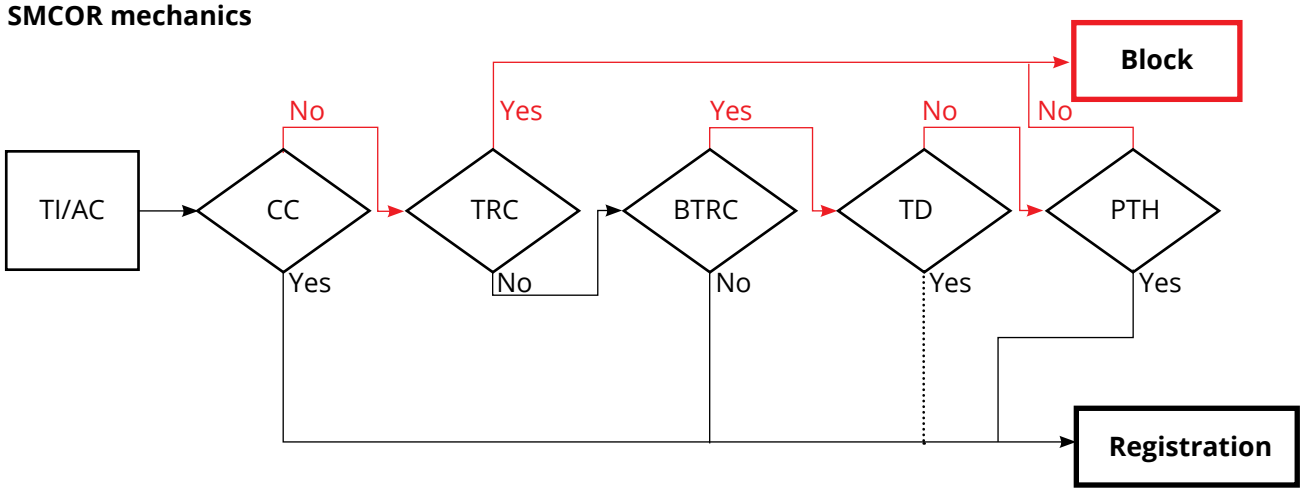

Fig. 8.
SMCOR mechanics. Abbreviations in the diagram: "TI/AC" — tax invoice/adjustment calculation; "CC" — "cut-off" criteria"; "TRC" — Taxpayer's risk criteria; "BTRC" — Business transactions' risk criteria; "TD" — Taxpayer's data table (this element is relevant only in case of application of the 1st BTRC); PTH — positive tax history; "Reg" — TI/AC is registered with the URTI; "Block" — registration of TI/AC with the URTI is suspended.

11.3.2 Consequences of TIs/ACs suspension (blocking)

If SMKOR suspends registration of TI/AC, the taxpayer receives the respective notification (receipt) through its e-cabinet. The receipt contains a reference to the taxpayer's risk criterion(a) or business transaction risk criterion(a), which became the basis for suspension.

TI/AC registration suspension means that the buyer for whom such TI/AC is issued, will not have the right to the VAT tax credit in the amount of VAT[315] specified in such a TI/AC until it is registered (unblocked) by the supplier. At the same time, the supplier must include the suspended TI/AC in the VAT tax return and accrue corresponding VAT tax liabilities.

The buyer with the help of its e-cabinet learns that the TI/AC issued by its supplier is suspended. Naturally, it can lead to a deterioration in the relationship with the supplier. In practice, it may lead to buyer's refusal to pay the supplier's bills and cooperate with the supplier in the future.

In order to unblock the TI/AC, within a year from its suspension, the supplier may submit explanations and a package of documents confirming the reality of the business transaction specified in such a TI/AC for consideration by the respective commission under the tax authority (such commissions are currently formed under Main Departments of STS in oblasts, Kyiv city and under OLT).

[315] It should be reminded that a VAT tax credit (also called **"incoming VAT")** is the amount of VAT included in the value of goods and services purchased and subsequently resold by a VAT payer (by including VAT in their price) or used for production of other goods or services to be sold with VAT included in their price. A VAT tax credit is desirable for every VAT payer because it reduces the amount of VAT that this VAT payer must pay to the state budget for a certain period (or increases the amount of VAT it is entitled to refund from the state budget for that period).

Based on the received explanations and package of documents, the commission performs a kind of “micro-audit” within a short term and makes one of possible decisions as a follow-up: on registration (unblocking) of TI/AC or refusal to register it.

In the latter case, the supplier may challenge the commission’s decision administratively (to a higher-level commission formed under the STS) and/or in court.

If the regional or central level commission, or the court decides on the TI/AC registration, such a TI/AC is registered with the URTI and in this case the buyer acquires the right to form a VAT tax credit against it.

According to the TCU, the TI/AC registered with the URTI, is an indisputable proof of the buyer's right to form VAT tax credit (to find out whether it is that simple with “indisputability”, read more in the Section 2.5 of this Systemic Report).

Business
OMBUDSMAN
Council

Podil Plaza Business Centre,
30A Spaska St.,
04070 Kyiv, Ukraine
(entrance from 19, Skovorody Str.)

Phone: +380 (44) 237-74-01
Fax: +380 (44) 237-74-25
E-mail: info@boi.org.ua

www.boi.org.ua
www.facebook.com/BusinessOmbudsmanUkraine