Business
OMBUDSMAN
Council

SYSTEMIC REPORT

PROBLEMS WITH ADMINISTERING BUSINESS TAXES IN UKRAINE

OCTOBER 2015

1 FOREWORD

This report has been prepared by the Business Ombudsman Council (the "BOC") in response to the increasing [public] demands to rectify various systemic deficiencies in the activities of the Ukrainian tax authorities (the "Report"). The magnitude of the problem is, among others, evidenced by the fact that more than 30% of the complaints received by the BOC since May 2015 were filed to challenge alleged malpractice of the tax authorities at all levels.

Due to their sheer quantity and substantial variety the Report, however, does not purport to provide a comprehensive overview of all problems in the sphere of business taxation in Ukraine. Such an exercise merits separate investigation falling beyond the scope of this study. Instead, the Report will concentrate on a taxonomy of continuous problems with the administration of business taxes in Ukraine that affect day-to-day activities of the Ukrainian businesses and, hence, require prompt and effective response from the Ukrainian tax authorities.

We commence by studying recently introduced system of the VAT electronic administration – one of the most turbulent issues for the corporate taxpayers in Ukraine – followed by the analysis of the current situation with VAT cash refund, which has historically been one of the most significant problems in the Ukrainian tax system. The third issue we paid attention to in the Report is the practice at the part of the tax authorities to abuse their authority to verify the actual location of the taxpayers by assigning taxpayers' with the so-called "state 9 status", which triggers various negative ramifications to the latter. The fourth systemic issue described in the Report is the problem with the tax audits carried out by the tax authorities. The last systemic problem studied in the Report is the inefficient functioning of the procedure of the so-called "administrative appeal" aimed at enabling taxpayers to challenge the malpractice of the tax authorities.

Each of the foregoing problems with administration of business taxes have been addressed by (i) describing the nature of the respective problem (being illustrated, where appropriate, by the reference to the actual cases we came across in our practical work) and (ii) by elaborating the set of specific recommendations tailored to improve and/or resolve the situation.

In addition to addressing systemic problems in the Report, as the matter of the necessary follow-up, the BOC will continue working with the key process stakeholders (including the Cabinet of Ministers of Ukraine, the State Fiscal Service of Ukraine and the Ministry of Finance of Ukraine) on implementing the suggested recommendations in practice. From that perspective, given strong public interest to the on-going work of the Ministry of Finance on developing changes to the Tax Code of Ukraine (traditionally referred to as the "tax reform"), we trust the impact caused by this Report will end up being both tangible and timely.

Without going into details of our individual recommendation specified in the respective chapters below, it is worth noting here that our analysis of the foregoing systemic problems unveiled two major cross-cutting deficiencies attributable to the Ukrainian tax administration system as a whole. In our view, both of them require adequate redress, at least by ensuring that the contemplated amendments to the Tax Code are sufficiently effective.

First, it is the poor level of communication management of the Ukrainian tax authorities at all levels (including both the State Fiscal Service and tax authorities at the lower levels). It is too often the case that the local tax authorities, being driven by the fiscal approach, do not demonstrate willingness to build equal horizontal communication with the taxpayers. Furthermore, communication gaps are also very strong in relations between the State Fiscal Service and the public. Thus, a significant amount of the information, relevant and/or descriptive of the activities of the State Fiscal

Service, is not disclosed to public or disclosed in a rather limited form. Hence, there is a strong need to regularly disclose certain data and statistics to the public. Among other things it is expected that such an approach should enable the latter to better monitor the activities of the State Fiscal Service. The specific list of such information and/or data shall be elaborated in cooperation with the representatives of the public and non-governmental organizations. Yet, in our view, it may include, inter alia, amounts of incomings to the State Budget (with a breakdown into major taxes); amounts of VAT reimbursed and VAT outstanding for reimbursement; amounts of taxes overpaid by the taxpayers; amount of the taxpayers' tax debt; number of tax audits with breakdown into various types of audits; number of appeals against the decisions of the tax authorities (with a breakdown into successful and non-successful), etc.

Second, the contemplated "tax reform" shall be implemented with the view of the subsequent predictability (stability) of the revised tax legislation. The respective principle has been historically embodied in Ukrainian tax legislation, but rarely complied with in practice. Over the past year, the tax legislation has been amended and changed many times, thus, provoking the public outcry and disturbing the normal day-to-day operations of the Ukrainian businesses. Hence, it is expected from the Government, that once the "tax reform" is implemented, it will not undergo further significant change for a reasonably long period of time.

While preparing this Report, in addition to the inspiration we naturally found in the materials of the individual complaints we received, the BOC has also used information publicly available on the web sites of the State Fiscal Service of Ukraine and the Ministry of Finance of Ukraine Besides, many of the BOC's recommendations have been incorporated hereunder by taking into account (i) comprehensive document, prepared by the Federation of Employers of Ukraine; and (ii) the materials of the All-Ukrainian Forum on the Tax Reform, conducted on 20 August 2015. We also relied on the materials of the Reform Concept of Administrative Appeal of the Decisions of the Tax Authorities prepared by KPMG-Ukraine, as well as various materials prepared by the Ukrainian offices of Deloitte, PWC and E&Y.

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2 VAT ELECTRONIC ADMINISTRATION

THE PROBLEM

Having been introduced quite recently, the new electronic VAT administration system has already become the most turbulent issue for Ukrainian taxpayers.

Starting from 1 July 2015, the VAT electronic administration system was switched into full operational mode despite multiple complaints from the taxpayers, especially regarding the deficiencies in the formula for the calculation of VAT threshold amounts allowing for registration of VAT invoices, adjustment calculation, complications in the overall functioning of the system, etc.

On 16 July 2015, the Parliament of Ukraine passed amendments to the respective regulations aimed at correcting such deficiencies. However, not all deficiencies have been ultimately corrected. The tension towards the new system has been further aggravated by frequent changes of supporting legislation, which, has already been changed three times over the course of past 9 months.

Crediting (depositing) the balance of the VAT accounts with operational cash

The suggestion of converting VAT reporting into electronic format appears to be a move in the right direction, as it could potentially make reporting easier and more transparent for taxpayers. However, the new system has not proved to be sufficiently transparent and has been suffering from various technical and substantial deficiencies. Taxpayers note that, since many such deficiencies are firmly embedded in the system, in order to be able to register VAT invoices in the system, they usually need to credit the balances of their VAT accounts with cash, thus, decreasing their working capital. The amendments introduced to the Tax Code by Law No. 643-VIII, dated 16 July 2015, appeared to be generally helpful, but not to the extent when all deficiencies would be fixed.

This triggers considerable fiscal pressure on suppliers (of works, goods and services) acting in good faith as they become dependent upon the responsive and good faith behavior of third parties – i.e., their contractual party. Thus, if for some reasons, their contractual partners fail to properly register the VAT returns (acting in bad faith or merely due to the lack of sufficient threshold amount on their VAT accounts) or register them with mistakes, in order to be able to continue registering VAT invoices (and, thus, continue performing their ordinary business operations), the suppliers need to allocate their own funds to credit insufficient amounts to their VAT accounts. Very often taxpayers suffer from the foregoing circumstances even in case they paid properly and in full to their counteragents (including VAT), but cannot receive a VAT invoice because it was not registered by a third party. Recently introduced system of VAT account overdraft is often not sufficient to help fixing the issue.

The situation might improve starting from 1 October 2015 when fines will be introduced for late registration of VAT invoices. However, the issue with crediting of the insufficient balance of the VAT accounts remains outstanding as, given economic difficulties, certain taxpayers may, in any event, end up being unable to do this in a timely manner.

Significant administrative expenses for system support

Proper administrative support of electronic VAT administration system requires significant administrative resources and investment.

First of all, it requires day-to-day attention of the taxpayer's chief accountant. Sometimes the taxpayer need to allocate a separate person for this function only. As a rule, this person shall devote all his/her time for ensuring timely registration of VAT invoices, requesting and arranging receipt of registered invoices from suppliers in the timely manner, keeping track of the records on the VAT account, keeping track of the changes in the legislation, etc. In case any mistakes or differences between the records on the VAT account and the taxpayer's calculations are identified, this person shall ascertain the reason for the difference and make sure that it is properly reflected in the records of the VAT account.

Second, VAT electronic administration system requires proper IT support. Implementation and maintenance of the respective service solution adds to the overall administrative expenses of the taxpayer.

Needless to say that for small taxpayers and private entrepreneurs this administrative burden appears to be too heavy. To the extent very often they cannot afford hiring a qualified person to advise on the peculiarities of the electronic administration system as well as on the respective changes in the law, they are more exposed to the risk of making mistakes.

Discrepancies between the records in the system and the VAT returns

Under the general rule, the taxpayers are entitled to request information on the status and monetary flows on their VAT accounts[1]. But because the interface of the records available to the taxpayer does not allow to monitor the algorithm of calculations made by the tax authorities, and the taxpayer can only see the final figure of the threshold, it is difficult and time-consuming to trace whether the records are correct. As practice shows, mistakes can happen due to the alleged "loss" of VAT invoices and manipulations (manual uncontrolled operations) with the system. Because identifying and rectifying of the discrepancies takes time, the records in the VAT electronic administration system may differ from those submitted in the VAT return. Even though the mistakes are often caused by the tax authorities, the taxpayer is nevertheless forced to credit cash into its VAT accounts. Otherwise, its operations that are subject to VAT will be suspended.

In our view, the existing controversies with implementation of the VAT electronic administration could be somewhat mitigated if the local tax authorities were ready to support Ukrainian taxpayers by giving clear practical instructions how to work with the new system and how to act in non-standard situations. However, practice shows that the local tax authorities also have limited understanding of how this system works. Moreover, they appear to be reluctant to accept the risk of providing official explanations or clear guidance to the taxpayers.

[1] Pursuant to Article 100[1].5 of the Tax Code

Case No. 1

The Complainant, a trading company from Kyiv, performed valuation adjustment of its goods in stock. The goods were imported by the Complainant in mid-2014 during period of severe currency fluctuations. The valuation adjustment was performed in March and April 2015 when the UAH currency rate stabilized.

Later on the Complainant was surprised to find out that the balance on its VAT account was negative. The Complainant clarified that the negative balance arouse because the VAT on the re-evaluated goods was not included into the formula for the threshold amount's calculation. In particular, pursuant to Article 19 of the Resolution of the Cabinet of Ministers of Ukraine No. 569, dated 16 October 2014, adjustments made to VAT returns issued prior to 1 February 2015 shall not be included into the calculations of the formula.

Although the foregoing Resolution was allegedly adopted in furtherance of the respective provisions of the Tax Code,[2] by restricting the inclusion of the said VAT into the formula the Resolution, being a by-law, did so by frivolously interpreting provisions of the Tax Code.

Since the Complainant was unable to allocate more than UAH 5 million to credit its balance, it was forced to suspend its activities with 120 employees sent on vacation. The Complainant's activities were resumed only when the Law No. 643-VIII of 16 July 2015 was adopted, providing for a reset of the balance on the VAT accounts of all taxpayers.

Case No. 2

An operational production company located in Kharkiv Region properly submitted VAT return for February 2015. Subsequently, the Company submitted adjustments to the VAT return to correct certain errors it identified in the original VAT return. The company received a proper electronic notification about receipt of the adjustments. However, the company also received a letter from the tax authorities that its adjustments have not been accepted due to "absence of mandatory requisites". However, the tax authorities did not clarify which mandatory requisites were absent. As a result of such unlawful actions of the tax authorities, the taxpayer identified significant differences between the records on its VAT account and in the VAT return.

[2] See Article 200[1].3 of the Tax Code.

THE BOC RECOMMENDATIONS

(1) The requirement of depositing the balance of VAT accounts with operational cash shall be eliminated from the Tax Code due to its' non-compliance with the best international practices and harmful effect for the day-to-day activities of the taxpayers. Thus, VAT electronic administration shall cease to be employed as a tool for replenishing state budget through cash advances and start performing its core administrative function.

(2) The State Fiscal Service shall ensure proper technical functioning and maintenance of the VAT electronic administration system. Manual control and unauthorized intrusion into the system, resulting, inter alia, in a questionable "losses" of VAT invoices, refusals to register VAT invoices due to "state 9", etc., shall be eliminated. Same approach shall be employed in relation to those instances, when the records in the VAT return and the VAT administration system do not reconcile. This can be achieved, inter alia, by introducing personal disciplinary, administrative and financial liability of the officials of the tax authorities. In addition, the Tax Code shall be amended to provide for financial liability of third-party entities providing technical maintenance and support of the electronic administration system (for instance, sanctions shall be imposed if the taxpayer is unable to register VAT returns due to inaccessibility of the system or its' failure).

(3) The State Fiscal Service shall ensure that the local tax authorities are trained and prepared to effectively support the taxpayers with all kinds of issues arising in connection with the implementation of VAT electronic administration. Besides, the State Fiscal Service shall promptly collect information about typical problems arising in connection with the VAT electronic administration followed by the practice of issuing formal clarifications.

(4) Once the deficiencies in the VAT electronic administration functioning are eliminated, the State Fiscal Service shall ensure stability of respective laws and regulations, so that they will remain unchanged (or significantly unchanged) for a significant time. If the sense of predictability is achieved, it would enable the taxpayers to plan their activities accordingly and significantly decrease administrative expenses covering the cost of adjustment to the new rules and regulations.

(5) The State Fiscal Service and the State Treasury of Ukraine shall implement a transparent, informative and user-friendly interface of the electronic record system aimed at providing taxpayers with the information on the status of their VAT accounts. This could be implemented via a single electronic office of the taxpayer. Such electronic office shall provide comprehensive information to the taxpayer, so that the taxpayer could reconcile the information in the electronic administration system with the records of the VAT reports. It shall be ensured that the records made in the system cannot be changed manually. Besides, it shall also not only indicate the threshold amount calculated according to the prescribed formula, but also clearly itemize the algorithm of formation of the computed elements of the formula.

(6) The mechanism to return the excessive balance on the taxpayer's VAT account shall be enforceable in practice. In particular, there shall be no delays in communication between the tax authorities and the State Treasury regarding return of such excessive balance upon the taxpayer's request. This can be achieved, inter alia, by introducing personal disciplinary, administrative and financial liability of the officials of the tax authorities (for instance, in case of their failure to timely provide the State Treasury departments with the necessary information).

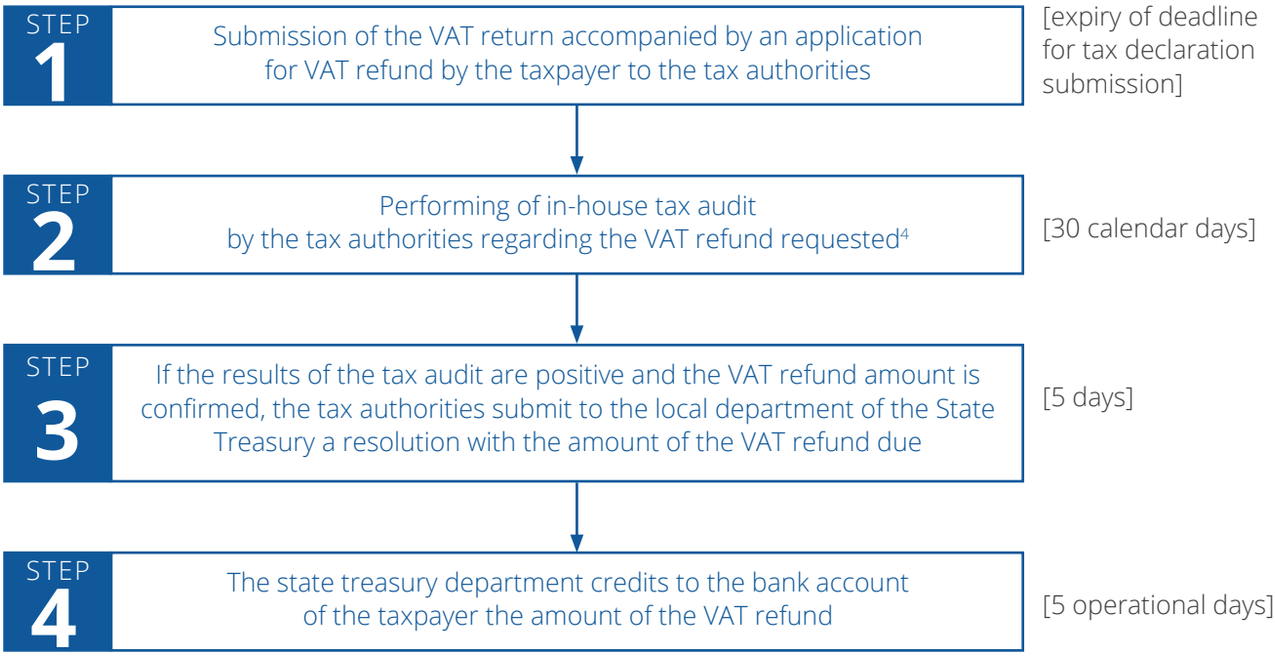
3 VAT REIMBURSEMENT

THE PROBLEM

Since VAT cash refund has historically been one of the biggest systemic problems in the Ukrainian tax system, the legal framework governing VAT refund has been continuously revised to simplify and clarify relevant procedures. Hence, an automatic VAT refund procedure has been introduced with the purpose to simplify the VAT refund for taxpayers acting in good faith. The objective of improving and expediting VAT refund procedure was also rationale behind introduction of the VAT electronic administration, however, unsuccessfully.

Therefore, the VAT refund failed to become an operational routine tool for Ukrainian businesses. While the legislation supporting VAT refund procedures appears to be generally reasonable, in practice the VAT refund became a time-consuming and burdensome procedure. In many cases where legislative provisions clearly enable a particular taxpayer to claim VAT refund, the tax authorities use vigorous tools to defer the VAT refund. Thus, such taxpayer finds itself forced to actually "credit" the state budget.

As at 1 September 2015, the outstanding confirmed amounts of VAT refund amounted to UAH 20,144,4 million[3]. As compared to 1 January 2015, this amount increased by UAH 6,644,7 million. Needless to say, this triggers negative impact on the efficiency of Ukrainian businesses, as they become stripped of operational cash (which could otherwise have been used to finance their day-to-day operations) and shall bear all losses suffered due to the national currency's fluctuations.



[3] According to the information on the official site of the State Fiscal Service of Ukraine www.sfs.gov.ua
[4] For VAT refund amounts of more than UAH 100,000

The foregoing demonstrates that the overall VAT refund procedure is supposed to last not more than approximately 1,5 months from the date of the end of the period for VAT return submission. Only in certain limited number of cases the Tax Code allows extension of the 30 calendar days' period of the tax audit for another 30 calendar days. However, in practice, due to multiple breaches in the procedure, the VAT refund process is significantly lengthier. For instance, the BOC is now processing a complaint where the VAT has not been refunded to the taxpayer for more than 9 years.

The problem of significant delays with VAT refund is further aggravated by the so-called "fiscal approach" employed by the supervising authorities (i.e., at the level of regions and the State Fiscal Service of Ukraine). Such fiscal approach is reflected in the practice whereby all decisions of the local tax authorities, - if favoring delay of any payment due from the state budget, - are, as a rule, supported at all supervising levels, often even if clearly unlawful. Hence, in the absence of an effective administrative appeal procedure, the only operational tool available to tax payers to confirm that they are entitled to claim VAT refund is to forward the matter for consideration in the court.

Breaches in the procedure of VAT refund

The most common arguments used by the tax authorities to defer VAT refund include allegations of taxpayer's breach of procedures prescribed by the law, namely:

(1) Refusal by the tax authorities to provide confirmation to the state treasury departments regarding the amount of VAT refund due

The tax authorities employ the practice of not providing the local department of the State Treasury (which is responsible for payment of VAT refund due to taxpayers) with resolution indicating the amount of VAT payable. The tax authorities often fail to provide such resolution even in case the taxpayer's right to VAT refund and amount thereof is confirmed by a valid court ruling.

Also, there are cases when the tax authorities take a unilateral decision to account the amount of VAT refund due as overpaid tax, although, based on the Tax Code, this can be done only at the request of the taxpayer.

Such unlawful actions of the tax authorities are supported by the poor culture of direct law enforcement by the state treasury departments. In particular, in violation of Article 124 of the Constitution of Ukraine stating that court rulings shall be enforced within all Ukrainian territory, the state treasury departments refuse to pay the due VAT refund amounts in the face of the valid court ruling referring to the absence of the respective resolution of the tax authorities. It is worth noting here that the obligation of the state treasury departments to pay on the basis of the resolution of the tax authorities is foreseen in a by-law[5], which, by default, cannot overrun the provisions of the Constitution of Ukraine.

(2) Refusal by the tax authorities to appoint and carry out tax audit

The Tax Code does not enable tax authorities to reject the calculation of the VAT refund made by the taxpayer. Instead, it obliges the tax authorities to accept and verify it as part of the in-house tax audit. However, in certain instances, the tax authorities return the calculations to the taxpayer instead of proceeding with the tax audit prescribed for the VAT refund procedures set forth in the Tax Code.

[5] Resolution of the Cabinet of Ministers No. 39, dated 17 January 2011 and Joint Order of the State Fiscal Service of Ukraine and the State Treasury of Ukraine No. 68/23, dated 3 February 2011

(3) Approval of the VAT refund with the supervising authority

Sometimes the tax authorities appeal to the necessity to approve the refund with the supervising tax authority. In this case they often refer to the Order of the State Tax Service of Ukraine No. 991, dated 6 November 2012. This Order, however, has never been made publicly available. Thus, in the absence of the respective ground to be expressly specified in the Tax Code, any additional conditions and grounds for delay cannot be treated as valid.

(4) Claiming absence of funds in the state budget

The Tax Code clearly states that the VAT refund cannot be limited or conditioned by availability or absence of income derived from the particular tax (VAT) in certain Ukrainian regions[6]. Moreover, the Tax Code does not contain grounds enabling tax authorities to defer VAT refund due to the absence of funds in the state budget.

One of the advantages of introducing VAT electronic administration was supposed to be facilitation of VAT refunds due aimed at ensuring sufficient accumulation of funds. However, as of today, due to multiple deficiencies in the system (please see the discussion in section "VAT electronic administration"), it has not facilitated VAT refund.

Absence of an effective mechanism for imposition of penalties for late VAT refund

In accordance with the Tax Code, the VAT amounts, which have not been refunded to the taxpayer in a timely manner, shall be treated as a debt owed to the taxpayer. Such amounts shall be subject to a penalty in the amount of 120% of the NBU rate[7].

While the foregoing rule appears to be quite fair, from the practical perspective, the taxpayers often have difficulties enforcing the penalty due to the absence of a clear procedure for imposition of penalty and collection of the amount due. The good news is that in one of the recent court cases[8] it was confirmed that, based on the wording of the Tax Code, the taxpayer is entitled to claim penalty irrespective of the receipt of reconciled VAT refund.

It is also worth noting that while the penalty should compensate the taxpayer for inability to use the funds, the law does not provide for any mechanism to reimburse forex losses [OR losses incurred as a result of devaluation of the national currency].

6 Article 200.23 of the Tax Code

7 Ruling of the Highest Administrative Court of Ukraine of 17.11.2014 Case No. K/800/38736/14; Ruling of the Highest Administrative Court of Ukraine of 24.11.2014 Case No. K/800/34577/13; Ruling of the Highest Administrative Court of Ukraine 24.11.2014 Case No. K/800/48867/13

8 Ruling of the Highest Administrative Court of Ukraine of 17.11.2014 Case No. K/800/38736/14; Ruling of the Highest Administrative Court of Ukraine of 24.11.2014 Case No. K/800/34577/13; Ruling of the Highest Administrative Court of Ukraine 24.11.2014 Case No. K/800/48867/13

Case No. 1

The Complainant, a company with foreign investments located in Lviv, applied for a VAT refund of almost UAH 300,000 by exercising procedure envisaged by the Tax Code. The VAT amount due to refund was properly confirmed by the results of the tax audit. However, the refund was not performed.

In response to the Complainant's request, the local tax authorities informed the Complainant that the matter was submitted for approval to the supervising authority (i.e., the Main Department of State Fiscal Service of Ukraine in Lviv Region). The supervising authority, in its turn, informed the Complainant that the Complainant's VAT refund was submitted for approval to the State Fiscal Service of Ukraine. In both instances the reference was made to the Order of the State Tax Service of Ukraine No. 991, dated 6 November 2012.

Case No. 2

In 2012 the Complainant, an international transportation company, properly confirmed the VAT refund amount with the tax authorities. Since the refund has not been actually paid, the Complainant applied to the court. Courts at all levels confirmed the Complainant's right to the VAT refund of UAH 92,262.

However, the State Treasury Department did not pay the VAT refund to the Complainant. Although the amount of the VAT refund was confirmed in the court ruling, the State Treasury Department did not find it sufficient to make the payment, but, instead, was waiting for the confirmation from the tax authorities.

Finally, in an informal communication with the tax authorities the Complainant discovered that the tax authorities were not going to confirm the amount of VAT refund to the State Treasury Department, but were accounting the VAT refund due as the Complainant's VAT overpayment.

Case No. 3

In the tax declaration for January 2015, the Complainant declared VAT refund in the amount of UAH 1,668,901. Having performed tax audit, the local tax authorities did not confirm the amount of the VAT refund, but claimed multiple breaches by the Complainant of the tax laws.

Whereas the Complainant did not agree with the conclusions of the tax authorities, it appealed to the supervising authority. While the case was under appeal, a criminal proceeding against the Complainant's officials was launched alleging misappropriation of state funds. Following the BOC interference, the criminal proceeding was closed.

THE BOC RECOMMENDATIONS

(1) The Tax Code shall provide for an effective procedure of administrative appeal (please see Section "Administrative appeal" for details) whereby the supervising tax authorities will monitor compliance by the lower-level tax authorities with all VAT refund procedures.

(2)The Resolution of the Cabinet of Ministers No. 39, dated 17 January 2011, as well as Joint Order of the State Fiscal Service of Ukraine and the State Treasury of Ukraine No. 68/23, dated 3 February 2011, shall be amended to clearly state that the state treasury departments shall promptly pay to the taxpayer the VAT refund confirmed by a valid court ruling and with no further confirmation from the tax authorities.

(3) The Tax Code shall be amended to set out a clear procedure for calculation and payment of penalties imposed for late VAT refund. It shall be clearly stated in the Tax Code that the amount of penalty shall be paid to the taxpayer irrespective of the fact of its' receipt of reconciled VAT refund.

(5) The Tax Code shall be amended to provide for personal disciplinary, administrative and financial liability of the officials of the tax authorities for unlawful delays with processing VAT refunds.

(5) The State Budget of Ukraine shall reflect consolidated VAT amount (i.e., the difference between the income from VAT and expenses for VAT refund). For this purpose the Budget Code of Ukraine shall be respectively amended. In our view, if implemented, such an approach would allow overthrowing traditional argumentation of the tax authorities that VAT refund is effectively limited by the limits foreseen in the State Budget.

(6) It could be expedient to officially recognize the VAT refund amounts due to businesses as internal state debt. Such state debt shall be subject to restructuring according to mechanisms amicably agreed in negotiations between the tax authorities and businesses. The selection of the mechanisms should be flexible enough to allow restructuring with the account of specifics of particular case and business.

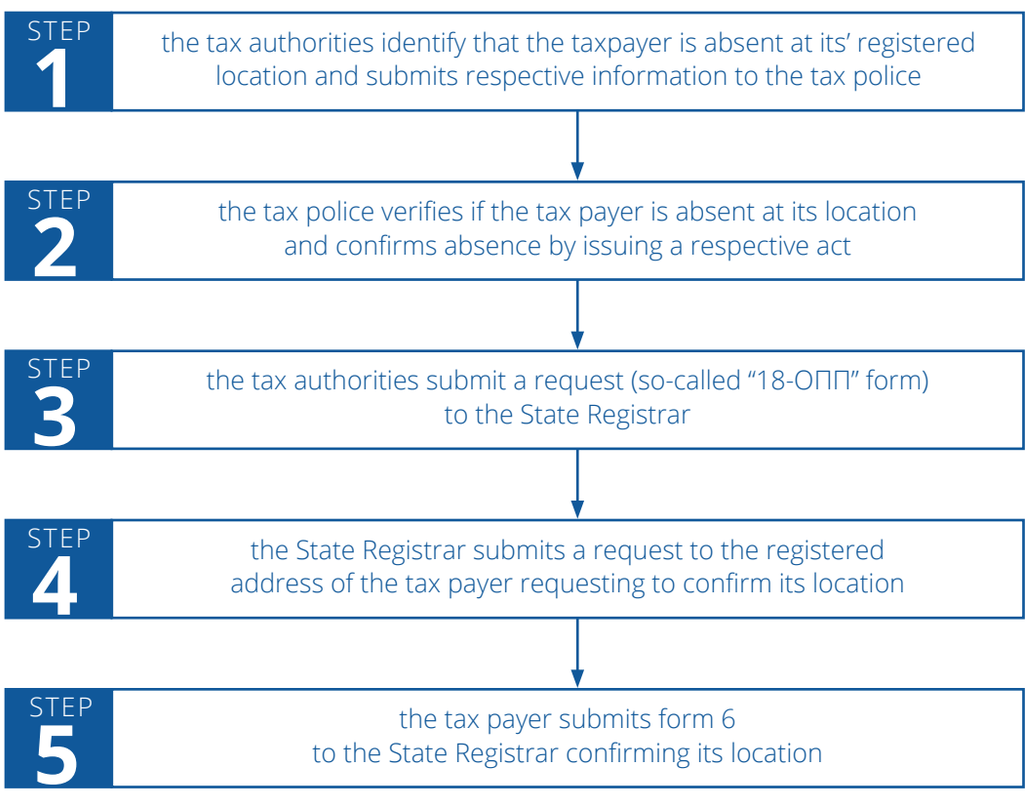
[9] Approved by Order of the Ministry of Finance of Ukraine No. 1588, dated 9 December 2011 ("Order No. 1588")
[10] See Article 12.1 of the Procedure.

4 THE "STATE 9"

THE PROBLEM

According to the Procedure of Taxpayers' Record Keeping[9], the tax authorities are entitled to verify the actual location of the taxpayers. Pursuant to the Procedure such an authority is vested with the tax authorities in order to eliminate obtaining of uncontrolled income by the taxpayers.[10]

The process of verification of the taxpayer's location can be illustrated as follows:



FOR REFERENCE

Pursuant to the Article 12.1 of the Procedure of Taxpayers Record Keeping, the tax authorities are entitled to verify the actual location of the taxpayer in the following instances:

- working with tax payers with outstanding tax debt;
- working with the tax payers who failed to submit tax reporting in a timely manner;
- performance of any tax audit; and
- performance of any other official duties by the tax authorities.

Unfortunately, the wording of the Procedure vests tax authorities with extensive discretionary powers, which often results in quite broad interpretations to the taxpayer's detriment. Following the logic of the Tax Code, which defines that the taxpayer's tax address shall be the location registered with the Unified State Register, the tax authorities shall theoretically remain satisfied once proper confirmation from the State Register is obtained. However, since there are no limitations prescribed for the number of such verifications, they often exercise this procedure in an abusive manner (i.e., many times in a row). Relevant court practice demonstrates that the tax authorities often do not undertake any actions in order to verify the absence of the taxpayer at its location as required by the Procedure.

For internal purposes, the tax authorities identify the taxpayers with respect to which procedures of verification of their location are being undertaken as falling under the so-called "state 9" category. For the taxpayers that got this status it means that various inconveniences may follow. Although such practice is clearly beyond the scope of their authority, the tax authorities nevertheless often employ "state 9" as a ground for refusal to register the taxpayer as VAT payer, to accept the VAT returns, or to cancel registration as VAT payer etc.

Quite often, the tax authorities attempt to use "state 9" as a ground for unilateral termination of agreements on recognition of electronic documents. Although all local tax authorities are obliged to strictly follow the approved template agreement[11], sometimes they route the taxpayers to unofficial sites with a different, "adjusted" version of the respective agreement. The adjustments often include an additional ground for unilateral termination of the agreement, i.e., assigning "status 9" to the taxpayers.

FOR REFERENCE

The BOC addressed the State Fiscal Service with an official request to stop such malpractice, as a result of which the State Fiscal Service examined all the web resources used by local tax authorities.

Case No. 1

The Complainant, a limited liability company located in Dnipropetrovsk, has been suffering from regular verifications of its registered location by the tax authorities. Since its' incorporation in December 2014, the Complainant confirmed its location to the tax authorities 7 times. Thus, each time the tax authorities received a proper confirmation from the State Registrar that the taxpayer's location is confirmed, they were submitted a new 18-ОПП request claiming alleged absence of the tax payer at its location. Consequently, the Complainant has been permanently recorded by the tax authorities as a taxpayer falling under the "state 9" category.

For the Complainant it was not only a mere inconvenience in submitting regular confirmations of its location to the State Registrar. The tax authorities have actually paralyzed its' ordinary commercial activities. First, the tax authorities used "state 9" as an argument to reject the Complainant's application for registration in the capacity of a VAT payer. Second, having finally registered the Complainant as a VAT payer, the tax authorities refused to register the Complainant's VAT invoices by making yet another reference to "state 9".

[11] Order of the State Tax Administration of Ukraine "On Submission of Electronic Tax Returns" No. 233, dated 10 April 2008

THE BOC RECOMMENDATIONS

(1) Procedure of Taxpayers' Record Keeping shall be revised to significantly narrow down the scope of discretionary power currently vested with the tax authorities. In particular, the following amendments are worth being considered:

- the grounds for launching verification of the tax payers' location by the tax authorities shall be limited to include only limited and specific number of instances to be directly envisaged in the legislation (for instance, during a tax audit of a taxpayer deemed to be in violation of its duties);
- if the information on the taxpayer's location is properly confirmed through the State Registrar, this should be regarded as the sufficient proof for tax authorities; moreover, in this case tax authorities shall not be entitled to carry out such verification for certain reasonable period of time (for instance, one year).

(2) The State Fiscal Service of Ukraine shall ensure proper and effective control over regulatory practices employed by the local tax authorities, especially when they did not comply with the procedures, envisaged by the Procedure of Taxpayers' Record Keeping. Strict compliance therewith shall be ensured through personal liability of the officials of the tax authorities for malpractice.

5 TAX AUDIT

THE PROBLEM

Historically, for Ukrainian taxpayers the most problematic issues have arisen in connection with the tax audits performed by the tax authorities. In order to reduce pressure on the taxpayers in the current circumstances, the Ukrainian Parliament has introduced temporary moratorium on performance of tax audits, albeit with certain exceptions.

FOR REFERENCE

In the course of 2015 and 2016, tax audits of taxpayers with overall income of less than UAH 20 million in the preceding calendar year can be performed only in the following cases:

- if permitted by the Cabinet of Ministers of Ukraine;
- if requested by the taxpayer;
- based on the court decision or;
- according to the provisions of the Criminal Procedural Code of Ukraine.

However, the moratorium does not apply to

- taxpayers involved in import / production and/or sale of excise goods - regarding issues of licensing, Personal Income Tax, Unified Social Tax, as well as VAT refund and
- payers of unified tax of 2nd and 3rd groups (individual entrepreneurs), with certain exceptions.

Law of Ukraine "On Amending the Tax Code of Ukraine and Certain Legislative Acts of Ukraine Regarding Tax Reform", dated 28 December 2014

Limited impact of the moratorium and violation thereof by the tax authorities

While the public expected the moratorium to relieve the taxpayers from the administrative burden of the tax audits and concentrate on the day-to-day operations, its' impact turned out to be quite limited because of the low threshold and a number of exceptions.

While the moratorium applies to primarily small and medium businesses (whose income does not exceed UAH 20 million), large businesses claim even more pressure from the tax authorities, as compared to the situation in the past.

We observed that in many cases the tax authorities violate the moratorium even with respect to businesses falling under the scope of its' protection. As practice shows, for various reasons (ranging from ignorance to willingness to demonstrate cooperation) taxpayers protected by the moratorium allow the tax authorities to commence the tax audit. Consequently, they expose themselves to unlawful actions on the part of the tax authorities and find themselves involved into burdensome procedures of appealing such unlawful actions (through administrative and / or court procedures). Unfortunately, relevant court practice is still very limited and it remains unclear how Ukrainian courts will evaluate the circumstances where the taxpayer covered by the moratorium allowed the tax audit.

FOR REFERENCE

In order to omit any misunderstandings, the State Fiscal Service explained that the moratorium extends to any types of audits, including in-house.[12]

Procedural and other violations during appointment and performance of tax audits

Most common issues arising in connection with the tax audits include:

(1) appointment and performance of the tax audits in the absence of sufficient grounds

The Tax Code contains specific criteria for appointment of scheduled tax audits, as well as exhaustive list of grounds for the appointment of non-scheduled tax audits. In-house tax audits can be performed at the discretion of the tax authority and at any time (taking into account, however, the current moratorium). In practice, however, the tax authorities tend to interpret certain grounds for appointment of the tax audit quite broadly and formalistically.

[12] Letter of the State Fiscal Service of Ukraine No. 16102/7/99-99-15-02-02-17, dated 6 May 2015

FOR REFERENCE

The Tax Code allows the tax authorities to appoint an unscheduled documentary tax audit if:
the tax authorities identify facts evidencing breach by the taxpayer of tax and other laws and regulations based on the results of tax audit of other taxpayers or based on receiving other tax data;
AND
when the taxpayer does not furnish explanations and supporting documentary evidence in response to the tax authorities' request regarding the alleged breach within 10 business days.
Article 78.1.1 of the Tax Code

In practice, the tax authorities often submit a request for explanations and supporting documents to the taxpayer and, without going into specific details and substance of the taxpayer's explanations, appoint the tax audit. However, relevant court practice suggests that the tax authorities shall first scrutinize the explanations furnished by the taxpayer and shall not provide a request to the taxpayer purely for purposes of complying with the formalities prescribed by the Tax Code. If their doubts have not been cleared by the explanations and supporting documents furnished by the taxpayer, only then shall the tax authorities be empowered to appoint the tax audit[13].

(2) procedural violations during the tax audit

The Tax Code strictly regulates the procedures for the appointment and performance of the tax audit. In practice, the tax authorities often breach the procedures prescribed by the Tax Code. Such breaches are various and may include failure to inform the taxpayer about appointment of the tax audit, issuance of documents appointing tax audit in an improper manner (i.e., not by order, but by a simple letter), etc. From the practical perspective, it is of special importance for any taxpayer to be ready to filter and reject the unlawful requirements of the tax authorities once they have been identified.

Unfortunately, relevant court practice is not consistent. In many instances, the court supports the taxpayers and requires from the tax authorities to strictly follow the rules and procedures prescribed by the law[14]. However, at least in one instance the High Administrative Court of Ukraine ruled that the procedural violations of the tax authorities during the tax audit cannot be used as an argument to render the results of the tax audit invalid if the taxpayer actually allowed start of the tax audit by the tax authorities[15].

(3) taking groundless decisions by the tax authorities as a result of the tax audit

It is common knowledge that tax authorities adhere to the fiscal position. In practice, this implies quite formalistic approach in identifying breaches of the tax and other laws and regulations by the taxpayer without going into specific details or substance of the transactions. Very often, the tax authorities do not change the manner of determining the nature of the taxpayer's transactions even if there is a valid court ruling in favor of the taxpayer. Unfortunately, improper determination of the nature of the taxpayer's transactions sometimes occurs merely because of low professional qualification of the officials of the tax authorities.

[13] Judgement of the Supreme Court of Ukraine, dated 27 January 2015, case No. 21-425a14
[14] For instance, Judgement of the Supreme Court of Ukraine, dated 27 January 2015, case No. 21-425a14
[15] Judgement of the High Administrative Court of Ukraine, dated 27 November 2013, case No. K/800/34216/13

Based on the materials of cases processed by the BOC in the course of past 4 months, most common issues challenged by the tax authorities include:

- challenging the taxpayer's transactions (and, as a result, imposition of additional tax liabilities, penalties and fines, depriving the tax payer from the right to VAT reimbursement or VAT credit) merely on the basis that its' contractual partners (or one of the contractual partners in the chain) acted in bad faith or in violation of tax laws;
- refusal to set off the amounts of tax excessively paid by the taxpayer against the tax due and, as a result, claiming late payment of tax by the taxpayer;
- claiming absence of economic viability in the taxpayer's transactions;
- as well as many other issues caused by the formalistic approach employed by the tax authorities.

Unfortunately, the assumption of the taxpayer's good faith envisaged in the Tax Code[16], which could theoretically help resolve many disputable issues in an amicable manner, appears non-operational in practice. This assumption suggests that any ambiguous provisions in the tax laws and regulations shall be interpreted in favor of the taxpayer.

There are instances where the tax authorities use the results of the tax audits as a ground to launch criminal investigation against the taxpayer's officials (for instance, charging negligence or document forgery). Hence, the taxpayers claim, often quite reasonably, that a criminal investigation is used by the tax authorities to put pressure on the taxpayer and its officials. Quite often, the tax authorities abuse the right they have to initiate a criminal investigation "based on fact". This gives them greater flexibility in terms of timing of the investigation and limiting procedural rights of the taxpayer – i.e., having no procedural status thereunder, the taxpayer has no procedural rights (for instance, to get acquainted with the materials of the case), but is obliged to cooperate with the criminal investigator.

Case 1

In the period of January through June 2015 the Complainant, - a production company located in Kharkiv Region, - was audited by the tax authorities three times. The Complainant's income for year 2014 did not exceed UAH 20 million. In January 2015, the Complainant permitted the tax authorities to perform documentary on-site audit and provided full support to the tax inspectors, although the Complainant was not informed about start of the audit as required by the law.

Having received no immediate reaction from the taxpayer regarding the unlawful nature of the audit, later in that year (in April and May 2015) the tax authorities also performed two in-house tax audits. Following the results of the three audits, the Complainant was charged with additional tax liabilities and penalties. As a result, the Complainant had to get involved into administrative appeal procedures in order to challenge the results of the tax audits, which should not have taken place in view of the moratorium.

[16] Article 4.1.4 of the Tax Code

Case 2

The tax authorities performed scheduled on-site tax audit of a Ukrainian subsidiary of an international e-commerce operator. Based on the results of the tax audit, the tax authorities claimed "multiple breaches" of tax laws by the Complainant. Among other things, the tax authorities challenged the Complainant's right to decrease its taxable income by deducting marketing and advertising expenses. Later on, although the Complainant's business model has not changed, the tax authorities took a similar position during the latest tax audit of the same Complainant, which was subsequently challenged by the Complainant in court with the decision issued in its' favor.

Nevertheless, the reasoning and the conclusions of the court were not taken by the tax authorities into consideration. Following completion of the tax audit, the tax authorities requested from the Complainant the entire background documentation for three preceding years. The requests were provided in the form of simple letters. The Complainant refused to provide the documentation to the tax authorities due to a number of reasons:

- the request of the tax authorities was groundless as that it was not issued within the framework of the tax inspection;
- all the respective documents were already audited by the tax authorities during the latest inspection and provision of the requested documents to the tax authorities would be extremely time-consuming.

Case 3

The Complainant, a privately owned small company, was audited by the tax authorities. Whereas the Complainant did not agree with the conclusions of the tax authorities, it challenged the results of the tax audit in court.

While the tax dispute was considered by the court, the tax authorities launched a criminal proceeding based on the factual circumstances identified in the act of the tax audit. Since the criminal proceeding was initiated based "on the fact" (по факту), the Complainant and its officials had limited procedural rights. As a result, the tax authorities used the criminal proceeding as an instrument for putting pressure on the Complainant and summoning its officials for questioning on a routine basis. In the course of the criminal investigation the tax authorities also imposed arrest on the Complainant's bank accounts and property. The criminal proceeding was not closed even when the competent administrative court resolved the tax dispute in the Complainant's favor. As at the date of this Report, the pre-trial criminal investigation has been lasting for more than 3 years already and has not been closed or transferred to court.

Case 4

The Complainant, a fully-functioning company based in Kyiv, was audited by the tax authorities. Based on the results of the tax audit, the tax authorities imposed additional tax liabilities on the taxpayer. The respective resolution of the tax authorities was challenged by the Complainant in court. Based on Article 56.18 of the Tax Code, the financial liability challenged in court, shall be deemed "non-agreed" until the respective court ruling becomes effective. Thus, the taxpayer's registration card did not reflect the challenged amount as the Complainant's tax debt. However, it showed penalty on this challenged amount as a tax debt. This information was available to the Complaint's business partners on publicly available web-site of the State Fiscal Service of Ukraine "Know More About Your Business Partner".

THE BOC RECOMMENDATIONS

(1) The tax authorities shall perform tax audit procedures in strict compliance with the established "audit tests" (i.e., clear guidance on "what and how" shall be audited). Such tests are expected to be developed as part of the deregulation process currently implemented by the Ministry of Economic Development and Trade of Ukraine. The practice of guidance by internal regulations issued by the State Fiscal Service which are not available to public shall be eliminated.

(2) The obligation of the tax authorities to apply and interpret tax laws and regulations with the due regard being given to common court practice shall be communicated by the State Fiscal Service of Ukraine to the tax authorities of all levels. The practice when, despite existence of similar cases (or even regarding the same taxpayer) the tax authorities continue embarking upon questionable argumentation which have been routinely assessed by courts in the taxpayer's favor, shall be eliminated.

(3) The administrative appeal procedures available to the taxpayers willing to challenge the results of the tax audits shall be effective and time-efficient, rather than formalistic as it often appears to be (please see Section "Administrative appeal" for details).

(4) While appointing and performing the tax audit, the tax authorities shall strictly comply with the procedures prescribed by the law, and the supervising authorities shall ensure such compliance in an effective manner. The Tax Code shall be amended to specify particular sanctions to be imposed on the officials of the tax authorities for procedural and other violations during appointment and performance of the tax audit. Such sanctions shall be personalized and variable (from reprimand to dismissal and fine) depending on the degree of violation by the particular official.

(5) Instances of abuse of power by the tax authorities in launching criminal proceeding based on the results of the tax audit or against the taxpayer's officials shall be eliminated. Prevention of fraud and malpractice in the course of launching and performing of tax criminal investigations could be guaranteed by "checks and balances" system and personalized liability of the tax authorities' officials. The BOC will address these issues in its systemic report for the forth quarter of 2015 on abuses of criminal procedural law by law-enforcement agencies.

(6) It shall be directly prohibited for the tax authorities to initiate criminal proceedings against the taxpayer's officials based on the results of the tax audit until the taxpayer's tax obligation is duly acknowledged (i.e., until the administrative appeal and / or consideration in a court are finished). If the results of the tax audit are successfully challenged by the taxpayer in court, the criminal proceedings initiated merely based on results thereof, shall be immediately ceased.

(7) The approach evidenced by a widespread judicial practice, whereby minor mistakes or deficiencies in primary documents cannot be used as a ground for charging additional tax liabilities, penalties and fines on the taxpayer, shall be reflected in the Tax Code and enforced in practice.

(8) A systemic risk-based approach shall be implemented to conducting unscheduled tax audits. Such approach shall ensure comprehensive evaluation of the particular taxpayer and the necessity of subjecting its activities to unscheduled tax audit to the contrary of the current approach whereby the tax authorities are empowered to launch unscheduled tax audit even if a single (and often casual) criterion pops out.

6 ADMINISTRATIVE APPEAL

THE PROBLEM

Pursuant to the Tax Code, the taxpayers are vested with the discretion to challenge an allegedly illegal decisions of the tax authorities either in court or via an administrative appeal procedure. Given the availability of court appeal even in case of unsuccessful administrative appeal, most taxpayers prefer to start with appealing through administrative procedure.

In order to ensure independency and objectivity, the administrative appeal system includes two levels: first appeal level comprises controlling authorities in oblasts and the city of Kyiv, and the second level – the State Fiscal Service. However, given traditionally fiscal approach of the Ukrainian tax authorities, the above system has not shaped into an effective appealing tool.

The taxpayers argue that, very often, it is difficult to challenge through administrative procedure even clearly unlawful decisions of the tax authorities (i.e., when common court practice and official rulings from the State Fiscal Service supporting the taxpayer's position are available).

The Tax Code provides that if an administrative appeal against the decision of the tax authorities is launched, the burden of proving that the decision of the tax authority was substantiated and justified rests with the tax authority[17]. In the real life, however, the tax authorities limit their efforts in proving their position only to providing their arguments without trying to rebut the taxpayer's arguments.

Limited timing available to the taxpayer to challenge

The taxpayer has only 10 calendar days following the date of receipt of the tax decision to challenge it.[18] This timing is objectively insufficient for the taxpayer to prepare a well-grounded complaint, especially if the issues raised by the tax authorities are numerous. Whereas middle and big companies may have more professional resources, which they could mobilize for prompt preparation of the complaint, for small companies it could be difficult to prepare a proper complaint within such short timing.

By way of comparison, the controlling authority has 20 calendar days for official response to the taxpayer's complaints.[19] By the decision of the head of the controlling authority, it may be, and usually is, extended up to 60 calendar days. [20]

[17] Article 56.4 of the Tax Code.
[18] Article 56.3 of the Tax Code.
[19] Article 56.8 of the Tax Code.
[20] Article 56.9 of the Tax Code.

Formalistic approaches of the tax authorities

The Tax Code obliges the tax authority to justify its decision. In practice, however, while the tax authorities generally provide arguments in support of their position, they usually do not take into account and/or address the arguments made by the taxpayers. Such an approach is quite descriptive of "fiscal approach" mentality prevailing in the actions of tax authorities in Ukraine.

The Tax Code also envisages that, in case of a doubt, any ambiguous provision of the tax laws shall be interpreted in the taxpayer's favor. This principle, however, is not adhered at all levels of the tax authorities as, in practice, it is typically replaced with more formalistic one. The latter becomes possible due to the absence of personalized professional liability, limited involvement of public in monitoring the activities of the tax authorities, as well as monopolization of appeal procedure by fiscal authorities, currently not permitting involvement of independent observers/ experts.

Limited liability of the officials of the tax authorities

Personal liability of the tax officials in the instances of malpractice is quite limited. The tools available to the taxpayer are generally limited to filing complaints challenging actions (inactions) of the respective officials with the respective tax authorities and law enforcement agencies (Prosecutor's Office and/or the Ministry of Internal Affairs). Yet, in the absence of specific sanctions prescribed in the Tax Code, the taxpayer may expect an internal investigation with little hope for holding officials acting in bad faith liable. Moreover, given the prevailing culture when supervising authorities extend informal support to tax officials at the lower levels, given the absence of personalized professional liability, the latter do not feel obliged to follow the law properly.

THE BOC RECOMMENDATIONS

(1) The State Fiscal Service shall disclose to the general public statistics on the administrative appeal procedure on a regular basis (for instance, on a quarterly basis). Such information shall include, inter alia, information regarding the total number of complaints, the results (positive and negative) of administrative consideration of complaints at each appeal level, etc.

(2) The transparency and objectivity of the administrative appeal procedure shall be guaranteed by mandatory involvement of experts to be engaged in consideration of the taxpayers' complaints. Such experts shall be independent from the State Fiscal Service and the Ministry of Finance. Involvement of experts shall be mandatory irrespective of the amount of additional tax liabilities charged and fines and penalties imposed.

(3) The timing for administrative appeal by the taxpayer shall be increased, while the timing available to the tax authority for providing feedback to the appeal shall be decreased. This timing could be fixed at traditional 30 calendar days for both parties.

(4) The Tax Code shall be amended to foresee personal administrative and financial liability of the officials of the tax authorities for instances of malpractice and non-professional behavior.

(5) The State Fiscal Service shall ensure that the principle of interpreting ambiguous provisions of the Tax Code in favor of the taxpayer shall be consistently complied with by the tax authorities at all levels. An effective "checks and balances" system and introduction of personalized liability for the malpractice committed by the officials of the tax authorities shall be used as tools to achieve this.

(6) The tax authorities shall be prohibited from founding their conclusions (formalized in the act of the tax audit) on internal biased information, which is not available to the taxpayer and the public. Further, the tax authorities cannot be motivated by informal internal instructions regarding the fines and penalties to be collected from the taxpayers.

(7) The decisions of the tax authorities to appeal in the court of law shall be subject to "second-eye review" (for instance, by the supervising tax authority) from the perspective of expediency and legal feasibility. Such approach appears to be timely given the recent changes in the procedural law whereby the court fee relief enjoyed earlier by the tax authorities was further discontinued.

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