Business
OMBUDSMAN
Council

SYSTEMIC REPORT

PROBLEMS WITH CROSS-BORDER TRADING in UKRAINE

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EXECUTIVE SUMMARY

This systemic report focuses on key issues in cross-border trade regulation in Ukraine by highlighting factors that have a substantial practical impact on transaction costs. Our report is based on comments and complaints received by the Business Ombudsman Council (BOC). The importance of these issues is determined by the Association Agreement and Deep and Comprehensive Free Trade Area (DCFTA) signed between Ukraine and European Union (EU).

In the first section,

we elaborate recommendations to develop a new version of the Law "On Foreign Economic Activities." The new law on foreign trade activities must establish a consistent legal framework that promotes the development of modern conditions of trade:

- To ensure that the law is fully compliant with WTO agreements and EU requirements, which should increase access to global markets.
- To ensure that all business meets the principles of freedom of entrepreneurship, competition, non-discrimination, consumer protection and legal security, as in the European Union.
- To bring the regulations governing foreign trade, export/import licenses and protection measures, in line with WTO rules and regulations.

The second section

includes various recommendations to improve current foreign trade regulation practices, including such issues as licensing, quota allocation, evaluation of dual-use goods, enforcement, and so on.

Specifically, many cross-border trade operations require licenses. This increases transaction costs and protracts the terms for conducting business. Ukraine's list of commodity groups facing restrictions is extensive, including a number of commodity groups already subject to export, import and circulation restrictions under domestic legislation. To ensure a rational approach to the export and import of specific goods, as well as the implementation of Ukraine's international trade commitments, this list needs to be reviewed and reduced. We strongly recommend that this issue be raised with business associations and the leading export and import corporations. To simplify trade regulation, it would be useful to reduce the number of documents, which must be submitted to obtain permission for export-import activities, and especially the number of documents requested and/or submitted in hard copy.

The practice of applying quotas remains a controversial issue, given the extent of corruption in Ukraine. In practice, the procedure for obtaining quotas fosters cutting backroom deals. We advise Ukraine to switch to the methods for export-import quota administration recommended by the WTO: "first-come, first-served," auctions for quota rights, and give-away quota rights.

To improve export control practice in Ukraine and raise it to EU standards while implementing best international practice, the BOC offers a number of proposals, including:

- To publish a single official list of goods subject to export control on the official website of the State Export Control Service.
- To adhere to timetables for state examinations.
- To improve the arrangement of the state examination system.

This section also looks at legislation governing imports and exports, including enforcement and sanctions. As a short-term solution, the BOC recommends two steps:

- To determine the minimal materiality threshold for failure to comply with the legislation.
- To decrease the maximum term for reviewing applications.

The third section

examines problems with Customs and offers four recommendations:

- To repeal Cabinet Resolution #724 dated September 16, 2015, which empowered the State Customs to apply indicative benchmarks for customs value at its discretion.
- To amend the Customs Code of Ukraine regarding post clearance procedures.
- To clarify the list of cases where customs authorities may challenge the accuracy of declared customs value.
- To organize regular training for customs officers to improve their skills regarding customs valuations. Customs officials must develop in-depth understanding of the methods for determining the value of goods and be able to apply official recommendations and clarifications of the World Customs Organization as well.

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1 INTRODUCTION

Background

On June 27, 2014, Ukraine and the European Union signed an Association Agreement that includes provisions for a Deep and Comprehensive Free Trade Area (DCFTA). The DCFTA offers Ukraine a framework for modernizing its trade relations, opening markets through the progressive removal of customs tariffs and quotas, and through an extensive harmonization of laws, norms and regulations in various trade-related sectors. This will establish the conditions for aligning key sectors of the Ukrainian economy to EU standards. Along with this, the EU Commission decided to temporarily reduce customs duties for Ukrainian goods exported to the EU. On April 14, 2014, the EU Foreign Affairs Council approved the unilateral abolition of customs duties.

The positive balance of trade in goods for January-June 2015 – excluding Russian – occupied Crimea and the Anti-Terrorist Operation zone in eastern Ukraine – was US $1.246 billion. Over this period, Ukrainian exports were worth US $18.53bn, while imports stood at US $17.283bn. Compared to the same period in 2014, this represented a 35% drop in exports or -US $9.98bn, and a 38.5% drop in imports or US $10.827bn. Ukraine traded with a total 207 partner countries.[1]

This year, Ukraine entered the top 100 of the influential World Bank rating, "Doing Business – 2015," rising 16 positions to occupy 96th place. However, in the category "Cross-Border Trade," Ukraine's rating actually fell one point, leaving the country in 154th place. The findings of respected international surveys of this nature really need to be taken seriously in Ukraine. Moreover, there are some additional aspects of the business climate and issues related to it that are of practical importance for investors and entrepreneurs in Ukraine.

The most important trend of the year in cross-border trade has been the reorientation of export-import flows away from the Russian Federation towards the EU. Domestic producers are looking for new markets to compensate for loss of Russian markets. Among the most important trade barriers are the high transaction costs associated with import and export operations.

Report objectives and structure

This report considers various issues related to cross-border trade regulation, highlighting factors that have a substantial impact on transaction costs, based on comments and complaints received by the Business Ombudsman Council.

The Business Ombudsman Council is aware of the problems and obstacles connected to currency regulation in foreign trade. However, currency regulation has not been included in this report, as it warrants a separate, dedicated review, as well as serious discussion and revision by the National Bank of Ukraine and other regulatory authorities.

This report is not designed to counter or contradict the work of the Ministry of Economic Development and Trade, which has recently initiated plans to develop a new export strategy.

[1] http://www.ukrstat.gov.ua/

Methodology

Our analysis draws on complaints received by the BOC and case reviews, in combination with available literature and information provided by customs and trade experts from various international and regional organizations. It also makes use of reports on trade in the European Union, WTO and selected countries.

This report is also based on materials from and consultations with leading business associations, experts, and import and export companies.

This paper does not include any new econometric analysis of the effects of trade facilitation measures on informal trade flows.

2 REGULATION OF FOREIGN TRADE

This section focuses on various issues in the regulation of cross-border trade: export and import licensing, quota allocation, dual-use goods regulation, and enforcement.

International Practice

Trade between the EU and third countries is regulated by EU legislation within the framework of its common trade policy. There are no borders to trade among EU countries within the single trade area. Some EU countries operate entirely under EU legislation, with no related domestic legislation. Other countries develop domestic legislation that refers to certain EU legal provisions.

Countries with national export-import legislation include Austria, Belgium, Bulgaria, the Czech Republic, Finland, France, Germany, Hungary, the Netherlands, Poland, and Slovakia.

Countries with no national export-import legislation include Croatia, Cyprus, Denmark, Estonia, Greece, Ireland, Italy, Latvia, Lithuania, Luxemburg, Malta, Portugal, Romania, Slovenia, Spain, Sweden, and the UK.

The Problem

Realistically, Ukraine's Law "On Foreign Economic Activities" is extremely outdated. It was adopted by the Verkhovna Rada in 1991 and amended more than 20 times. In fact, Ukraine's regulation of foreign economic activity has the same drawbacks as much other domestic legislation:

- Instability and internal contradictions;
- Lack of consistency among laws and bylaws;
- Absence of an implementation mechanism.

Currently, the Law "On Foreign Economic Activity" is interconnected with 612 regulations governing various sectors. Moreover, the Law corresponds neither to international practice nor to EU legislation.

Being excessively detailed, the Law creates significant problems in cross-border trade relations. These problems have increased because of a tendency to approve legislation that focuses on specific issues related to foreign economic activities, such as the Laws "On Export Duty on Live Cattle and Leather Raw Materials," "On Export Duty on Ferrous Metal Waste and Scrap," "On State Regulation of Import of Agricultural Products," and so on.

Licensing Foreign Trade Operations

Licensing and quotas for foreign trade operations are governed by the Law "On Foreign Economic Activity" dated April 16, 1991. In market economies, the introduction of export and import licenses is frequently viewed as a step away from free trade towards more managed trade. In spite of this, the licensing of foreign economic activity was retained in the list of economic activities subject to licensing under the new Law "On the Licensing of Certain Types of Economic Activity." This Law regulates the licensing of commercial activities, sets an exhaustive list of economic activities subject to licensing, and establishes a consolidated procedure for licensing, supervision and control.

Current legal provisions on foreign trade licensing are unclear and subject to misinterpretation. For those commodities whose contract value does not exceed US $300 000, licensing of imports and exports is carried out by regional state administrations, except for those commodities on the list of goods subject to quantitative restrictions.

According to the law on foreign economic activity, there are two types of export and import licenses: automatic and non-automatic. The list of licensed and quota-based goods has to be approved annually. In 2015, this was done by Cabinet Resolution #1 dated January 14, 2015.

Automatic licensing is the granting of permission to export or import goods for a period, usually one year, where quotas are not set and there are no quantitative or other restrictions. According to the MoEDT, automatic export and import licensing rarely applies in practice.[2]

Non-automatic licensing is used to administer trade restrictions such as quantitative restrictions.[3]

Export is only subject for licensing in Ukraine when there is a imbalance in certain vitally important goods on the domestic market or when there is a need to protect the population, animals, plants, the environment, public morale, national wealth, intellectual property, or state security. The best examples are raw materials and mineral products, which remain underpriced on the domestic market in Ukraine. For example, the current list of licensed export goods includes precious metals, rare-earth

[2] Annexes 2,3,4,5 of Cabinet Resolution #1 dated January 14, 2015, list export and import goods subject to automatic licensing.
[3] Annexes 1 and 6 of Cabinet Resolution #1 dated January 14, 2015, list export and import goods subject for non-automatic licensing.

elements, colored metals, natural gas, materials and equipment for laser disk production, and ozone-destroying substances and goods containing them. Anthracite is also a subject for export licensing in 2015. On September 30, 2015, the Trade Ministry took a step towards deregulation in this area and canceled the licensing of exports of colored metal goods.

Likewise, the import of goods is subject to licensing in case of (i) specific fiscal problems; (ii) declining gold and currency reserves; (iii) the need to protect the population, animals, plants, the environment, public morale, national wealth, intellectual property, or state security; (iv) import of gold and silver metals, except banking metals; (v) the need to protect domestic production of certain goods, patents, trademarks and copyrights; and (vi) the fulfillment of international agreements committed to by Ukraine.

Currently, licensed imports include materials and equipment for laser disk production, ozone-destroying substances and goods containing them, which includes more than 30 commodity groups including pharmaceuticals, organic synthetic colorants, various colors and varnishes, cosmetics, hairdressing cosmetics, teeth treatment products, antiperspirants, lubricating materials, polishing materials, shoe creams, insecticides, herbicides, antifreezes, refrigerating machineries, cooling towers, fire-extinguishers, humidifiers and dehydrating breathers, and so on. There are also some imported goods licensed according to the Free Trade Agreement with Macedonia.

The procedure for licensing of exports and imports is defined by MoEDT regulations:

- Export licensing is regulated by MoEDT Order #991 dated September 9, 2009.
- Import licensing is regulated by MoEDT Order #302 dated September 14, 2007.

To obtain a license, the company has to submit: an application form, a letter of request to register the license with a guarantee of payment of state fees for its issuance, a notarized copy of the certificate of corporate registration, a notarized copy of the contract for cross-border trade and all annexes, and any other relevant official documents, such as different permits, the certificate for the manufacturing site, quality certificates, and so on.

Of course, a number of these required documents contain information that is already available in state registers and databases, especially those related to the status of the corporate registration and notarizing copies imposes additional costs on the applicant. Yet all the documents have to be submitted in a paper form.

The National Research and Information Center for Monitoring International Commodity Markets

One important player in the non-tariff regulation of foreign economic activity in Ukraine is the National Research and Information Center for Monitoring International Commodity Markets, a state enterprise.

Ukraine's domestic legislation allows the country to apply non-tariff barriers to trade. MoEDT Order #122 dated April 01, 2004, defines the procedure for licensing export-import operations as part of non-tariff regulation. Most cases of non-automatic export and import licensing fall under this procedure. When considering applications for licenses, the Ministry receives information on the conformity of contract prices with current market prices of specific products from the National Center.

Currently, the National Research and Information Center's functions include:

- Reviewing the price of foreign economic contracts when the total value of services, works and/or intellectual property rights exceeds €50,000 or its equivalent;
- Providing an evaluation of pricing conditions in export-import contracts;
- Providing other marketing and communication services.

The role and purpose of this institution is vague, and analysis of the regulatory framework, expert opinion and studies of international practice suggest that it is an atavism and provides an environment for corruption.

Licensing and Export-Import Quotas

Export and import quotations can be used according to the Law "On Foreign Economic Activities." Quantitative restrictions on foreign trade operations are determined in accordance with Ukraine's commitments under WTO, DCFTA, and other treaties. Having reviewed domestic legislation and analyzed complaints from business and court practice, we can highlight several issues.

Quite often business criticizes the lack of transparency in quota allocation, including lack of confidence in the competency of commission members, the untransparent approach to setting criteria for the "right" companies, and lack of information about decisions. In the past, there was a widespread practice of setting artificial bureaucratic barriers to limit the opportunities for a business to obtain export or import quotas for certain commodities existed, such as requesting additional documents or certificates. At present, informal procedures for quota allocation can be used, which raises the risk of corruption where the officials involved were prepared to behave unethically.

Case №1.

A complaint came in from the Ukrainian Association of Exporters of Scrap Metal against the Trade Ministry with regard to quota allocation procedures. After carefully reviewing the materials of the case, current legislation and international practice, the BOC recognized the complaint as substantiated. Under Sections 242-247 of the Schedule of Specific Commitments regarding the gradual elimination of scrap metal export restrictions, the decisions of the Government relating to the scrap metal export may not contradict the commitments undertaken by Ukraine when joining the WTO. These decisions must include the gradual liberalization of rules and procedures in this area of the economy, including the rejection of some elements of soviet practice.

The BOC recommended that the Ministry:

- Amend the Law "On the Scrap Metal," which regulates export and import, to streamline procedures and improve the economic and legal provisions related to operations with scrap metal.
- Bring legislation on quota allocation of the scrap metal in line with Ukraine's WTO commitments and obligations connected to the implementation of the DCFTA schedule.
- Reconsider the approach to setting scrap metal export volumes to reflect industrial needs for scrap metal among iron and steel enterprises based on reliable statistical data for steel production in the previous year, projections for the current year and a detailed analysis of scrap metal consumption on the domestic market.
- Distribute scrap metal volumes based on supply and demand in accordance with the number of applications for export quotas from domestic enterprises.
- Increase export levels whenever domestic iron and steel enterprises are fully supplied and excessive surpluses of scrap metal build up.
- Change the collegial approach to quota allocation currently used by the Trade Ministry, using auctions as an alternative. Auctions can ensure minimal intervention by the regulator in the quota distribution process. Should the quota system be further used for scrap metal exports, reconsider the approach to forming the responsible Commission in the Ministry. Amend the current regulatory framework and establish public, clear and competitive procedures and rules for the allocation of export quotas for scrap metal.
- Amend Cabinet Resolution #155 dated February 15, 2002, to:

– draw up an exhaustive list of grounds for refusal to register export contracts to avoid any abuse of powers by Trade Ministry officials and misinterpretations of regulatory norms;

– set a time limit for the Ministry to decide on the registration of export contracts;

– introduce a procedure to appeal a negative decision;

– establish clear deadlines for re-registering export contracts in case of fluctuations in the world market, as provided in Para. 11 of the Cabinet Resolution.

- Prevent possible violations by unfair market players by no longer hand managing the business reputation of applicants; monitor international contracts by exchanging relevant information with the State Fiscal Service, including Customs.
- Study the requirements for obtaining formal conclusions on the classification of scrap metal, such as the Green List of waste materials prepared by the Trade Ministry in cooperation with the Environment Ministry. Provided that it does not contradict the Basel Convention on the Control of Cross-border Transportation of Hazardous Wastes and their Disposal, abolish the requirement for exporters to arrange such a certificate.

International Practice

According to international trade theory and policy, there are three basic methods used to establish import quotas:

1) First-Come, First-Served: The government allows imports to enter freely from the start of the year until the quota is filled. Once filled, customs officials prohibit the entry of the product for the remainder of the year.

Administered in this way, the quota is likely to lead to fluctuations in prices for the commodity over the year. During the open period, a sufficient amount of imports may flow in to achieve free trade prices. Once the window is closed, prices would revert to autarky prices.

2) **Auctions of Quota Rights:** The government auctions quota rights by selling quota tickets where each ticket presented to a customs official allows the entry of one unit of the good. If the tickets are auctioned or the price is set competitively, the price at which each ticket is sold will reflect the difference in prices between export and import markets. The holder of a quota ticket can buy the product at the low price in the exporter's market and resell it at the higher price in the importer's market. If there are no transportation costs, a quota holder can make a net profit, called quota rents, equal to the difference in prices. If the government sells the quota tickets at the maximum attainable price, then the government gains all the quota rents.

3) **Give Away Quota Rights:** The government gives away quota rights by allocating quota tickets to certain individuals. The recipient of a quota ticket essentially receives a windfall profit since, in the absence of transportation costs, they can claim the entire quota rent at no cost to themselves. Governments often allocate such quota tickets to domestic importing companies based on past market share. Thus, if an importer has imported 20% of all imports prior to the quota, then they would be given 20% of the quota tickets. Sometimes, governments give quota tickets away to foreigners. In this case, the allocation acts as a form of foreign aid since the recipients receive the quota rents. It is worth noting that because quota rents are so valuable, governments can use them to direct rents towards political supporters.

BOC Recommendations

(1) Draft and adopt the new edition of the Law "On Foreign Economic Activities" to reflect modern trade regulation trends and WTO commitments, and to cover all necessary provisions of EU acquis communautaire, in particular:

- Bring the law fully in line with WTO agreements and EU requirements, which should increase access to global markets: (a) simplifying formalities and procedures; (b) harmonizing applicable laws and regulations; (c) applying international agreements; and, (d) making a commitment to regulatory cooperation.
- Change the regulations for foreign trade, export/import licenses and protection measures in accordance with WTO rules and regulations. For instance, licenses should be required only for the import or export of goods that effect public security, the life and health of individuals, animals and plants and so on, in accordance with the definitions used by the EU.
- Based on stakeholder consultations, reduce (a) the number of cross-border trade operations subject to licensing and (b) the number of commodity groups subject to restrictions or limitations as to export or import.
- Implement methods for export-import quota administration according to best practices and WTO recommendations: First-Come, First-Served; Auction Quota Rights; Give Away Quota Rights.

(2) Reduce direct contact with applicants and the number of documents that must be submitted to obtain permission for export-import. Streamline the application process in favor of using e-information in state databases instead of hard copy documents.

3 DUAL-USE GOODS IN A CONFLICT ENVIRONMENT

The Problem

The Business Ombudsman Council regularly receives complaints from business about the difficulties that arise when exporting or importing dual-use goods. Export control of dual-use goods is intended to prevent certain goods normally used for civil purposes, from being employed in the development and manufacture of weapons, in particular weapons of mass destruction-nuclear, chemical or biological weapons-and missiles capable of delivering these weapons to their targets.

In Ukraine, export control of dual-use goods is regulated by the Law "On State Control Over International Transfers of Military and Dual-Use Goods."[4] Initially, multilateral export control bodies decide which goods are dual-use. Based on these decisions, the relevant agencies consolidate a special list of goods that the Cabinet then approves.

Unfortunately, Ukraine does not have comprehensive official informational sources where the full list of goods subject to state export control can be found. On the Export Control Service's website, legal acts are published chronologically without, however, providing:

- a full list of goods for export control;
- any certainty that published lists are still in effect;
- any indication that the published information is comprehensive; and
- a user-friendly site that can be easily navigated.

Evaluations of goods are carried out by the Export Control Service. In order to get permission and special registration to transfer dual-use goods across the border, a company has to approach this agency.

Case №1.

The BOC received a complaint that the Trade Ministry had ignored a request for information. The Complainant said there was a lack of information on current legal acts that establish the procedure for assigning the status of military goods allowed for civil use. The Complainant needed the requested information to be able to appeal decisions on the status of certain goods it was exporting.

[4] Dual-use items are goods, software and technology normally used for civilian purposes but which may have military applications, or may contribute to the proliferation of Weapons of Mass Destruction.

Case №2.

This Complainant stated that, on October 9, 2013, while exporting aviation radio equipment through Ukrainian Customs, the Security Bureau of Ukraine (SBU) expropriated the cargo and launched a criminal case against the Complainant. Later, the criminal case was dropped in the absence of a crime pursuant to Art. 284 of the Criminal Code of Ukraine. Despite this, the Trade Ministry – following the recommendation of SBU – applied a special penalty against the Complainant, requiring an individual license for foreign economic activity for an indefinite period.

In line with enforcement procedures, the Complainant applied to the Ministry for individual licenses, but the application was rejected a couple of times. The Complainant was forced to completely stop commercial activity. In addition, cargo was still at risk of being expropriated by the state after one year of being held at Customs.

The problem would be solved if the Complainant were to receive a new conclusion from the state dual-use goods review. Unfortunately, instead of arranging a review and drawing clear conclusions, the Export Control Service said it intended to avoid taking action or making a decision. Instead, it suggested that the Complainant apply to a Russian expert institution. All official deadlines have passed, however.

Case №3.

The Complainant claimed that the Export Control Service was delaying the review of application for a preliminary review and registration of spare aircraft parts. According to the Complainant, the Service was demanding that the application be signed by the company director, which is not required by the current instructions but will extend the review for another 60 days.

Complaints received by the BOC indicate existing problems in dual-use goods cross-border transfers: (1) failure to meet state review deadlines; (2) ambiguous answers that do not make decisions clear and leave applicants in doubt over the results of the review; (3) in some cases, there are problems conducting reviews inside Ukraine.

EU Practice

EU dual-use controls require that exports and brokerage of listed types of dual-use goods to be licensed by competent national authorities. EU sanctions can restrict the circumstances under which an exporter or broker can receive the necessary licenses, or extend the types of goods that are subject to these controls. For example, the EU's sanctions on Russia prevent a competent national authority from granting a license for any dual-use exports to Russia, where there are reasonable grounds to believe they might be delivered to a military end-user or that the goods might have a military end-use.

The EU also maintains a common list of military goods. Exporting or brokering such goods is subject to even more stringent licensing requirements, which are enforced at the national level. EU sanctions can include a full arms embargo against a targeted country, which prevents member states from licensing the export of any military goods to that country.

Regulations

The main legal basis for controls over dual-use goods is the EU Dual-Use Regulation, also known as Council Regulation (EC) #428/2009 and its associated legal amendments. This legislation is directly applicable in all EU countries. Regulation 428/2009 has also been further amended.

The EU introduced legislation to control exports of dual-use items and technology in 2000, with the EU Dual-Use Regulation - EC Regulation 1334/2000 (as amended). In August 2009, the EU re-issued this regulation as Council Regulation (EC) No 428/2009.

The EU Dual-Use Regulation is usually updated on an annual basis to reflect controls over new items or remove controls over certain items, following agreements in the international control regimes.

Trade controls on dual-use goods

A license is needed to broker or trade in dual-use items.

The control lists

The European Union then combines the lists of export control goods into Dual-use Regulation Annexes.

BOC Recommendations

To improve Ukrainian export control practice regarding dual-use goods and raise it to EU standards, the BOC recommends that the Government:

(1) Publish a consolidated Official List of Goods Subject to Export Control on the official website of the Export Control Service. The Service must ensure that the List is updated regularly.

(2) Ensure that the Export Control Service complies with timeframes for state reviews and consideration of documents. To achieve this goal, complex measures can be recommended, together with the MoEDT, including:

- introducing an integrated e-system of document flow to streamline the review process. The MoEDT, as the supervisory body, can control timeframes;
- implementing the practice of having the causes of each delay in a state review justified before the supervisory body;
- applying fines to responsible managers based on monitoring by the Ministry.

(3) Organize the system of state evaluations of goods subject to export control in a way to optimize costs, resources and time for businesses. Businesses should have access to licensed expert organizations on the territory of Ukraine. The Export Control Service should ensure the optimal infrastructure for dual-use goods evaluations, which includes (a) licensed expert organizations in export control for all types of dual-use goods, (b) information on the official web-page, (c) awareness-raising events for the business community that engage in foreign economic activity involving dual-use goods.

(4) Draft comprehensive User Guide on Strategic Goods and Services and have it adopted by the State Export Control Service. The guide should include: (i) a description of special international regimes; (ii) an outline of the regulatory base; (iii) a list of authorized agencies; (iv) a description and categories of special goods; (v) the policy and regulations on the export, import and transit of special goods; (vi) a detailed description of licensing procedures, and so on.

4 FISCAL ISSUES RELATED TO EXPORT-IMPORT OPERATIONS

The Problem

There are many cases involving fiscal issues in export-import operations, including problems with VAT refunds and exaggerated customs fees.

Detailed recommendations on this issue have been presented in the BOC Report on Systemic Tax Administrations Issues.

5 ENFORCEMENT: SANCTIONS AND INDIVIDUAL LICENSING

Currently foreign trade enforcement issues are the most problematic for Ukrainian business. The application of sanctions on foreign trade activities is regulated by Art. 37 of the Law "On Foreign Economic Activity." Many bylaws control the practice of enforcement, including MoEDT joint regulations with the State Tax Administration – now called the fiscal service – , the SBU, and the Interior Ministry. There are several types of sanctions, including:

- Fines;
- Individual licensing regime;
- Temporary suspension of foreign trade activity.

The Problem

As noted by many business representatives the problem is not the severity of penalties but their application by various agencies. The BOC office received several complaints related to this but the typical situations when sanctions were applied are much broader. Ukrainian law does not stipulate any official procedure for notifying foreign or domestic companies about the possible application of special penalties. Usually, companies discover the penalties only after they have started to be applied. The only way to find out in advance whether sanctions are being applied is to constantly monitor the Ministry's official database.

Case №1.

When contract terms have been violated, the Ukrainian company applies to international arbitration through the Ukrainian Chamber of Commerce. To avoid responsibility for the illegal actions of foreign entities, Ukrainian legislation provides for certain actions.

If a foreign contractor violates the terms of payment, the only way for residents to avoid liability is to stop that term by filing a claim. This way to handle the problem works only if the court accepts the application. The penalty for a case during the time it is in the court does not have to be paid. However, sometimes the minimum fee for a trial is bigger than the debt that was occurred as the result of a special penalty. If the resident does not apply with the corresponding claim to international arbitration or another court, liability cannot not be avoided. The sanction would be applied in the form of penalty (0.3% of the unpaid revenue).

Case №2.

There are many cases when correspondent banks charge off their commission against the transferred contract payment. This fact is often qualified as incomplete currency returns. It is also a formal subject for sanction.

Case №3.

When export goods crossed the customs border of Ukraine, but the income has not come to the exporters as the carrier lost it. Damage may be reimbursed by an insurance carrier, but only in the national currency on the territory of Ukraine.

Meanwhile, this export transaction is still under bank control and the bank cannot cancel this control, due to the lack of direct references in the legislation.

Case №4.

Quite often the SBU sends the MoEDT letters with a list of companies that are "in discrepancy with national legislation, which could affect national economic security." Actually, legislation does not provide any clarification as to which actions in foreign economic activity might actually do so! This definition is legally vague and is very harmful for business development, especially in terms of establishing a rule-of-law state.

BOC Recommendations

(1) As a long-term solution, develop a special section in the new edition of the Law "On Foreign Economic Activity" that follows WTO rules[5], EU legislation, and best EU practice at the national level:

- Publish information on penalties and sanctions. This information should include the penalties and sanctions that apply, the reason for such penalties and sanctions, the responsible authority, and when and how payment is to be made;
- Shorten the grounds for applying sanctions and review the variety of such sanctions, where practicable;
- Limit specific penalties and sanctions in connection with foreign trade to the approximate cost of the services rendered in connection with a specific import or export operation;
- The penalty imposed should depend on the facts and circumstances of the case and should be commensurate with the degree and severity of the breach.

(2) As a short-term solution, the MoEDT should:

- Develop working mechanisms to immediately notify companies about special sanctions imposed against them. The mechanism of mediation should be foreseen prior to the application of special sanctions, which can include any explanations and/or objections regarding the alleged violations.
- Approve a clear minimum materiality threshold for failure to comply with Laws and Regulations on foreign trade activities and formalize this through an executive Order.
- Reduce the maximum timeframe for reviews of individual licensing applications to any rationale number of working days, reflecting the types of foreign trade activity.
- Delegate individual licensing responsibilities from the Ministry to its regional offices.

[5] https://www.wto.org/english/tratop_e/tradfa_e/tradfa_e.htm

6 CUSTOMS ISSUES

In recent years, Ukraine's customs regulations have continued evolving towards greater compliance with international practice. One key document regulating the legal treatment of goods moving through the customs border of Ukraine is the Customs Code of Ukraine, which has been harmonized with the Kyoto Convention on the Simplification and Harmonization of Customs procedures, the International Convention on Harmonized Commodity Description and Coding System and the Istanbul Convention on Temporary Admission.

The Problem

However, there are several problems in current Ukrainian practice. The BOC has received various complaints on customs authorities.

Determining customs valuation

The BOC has received many complaints on customs authorities regarding unjustified adjustments to declared customs value (DCV), leading to additional duty payments. Current practice informally divides customs valuation methods into two categories:

The Basic method. Based on the transaction value of the imported goods, i.e., the contract price.

Additional methods, i.e. on the basis of: the transaction value of identical goods; the transaction value of similar goods; the cost deduction; value added; the fallback method.

In general, legislation does not limit the use of this method, except for cases:

- when the value is established by law or specially implemented by public authorities;
- when the value is based on a limited geographical area in which the goods may be resold;
- when the value does not have a significant economic impact.

Despite Customs Code provisions that the next method applies if the previous one cannot be applied, in day-to-day customs evaluation practice, Ukrainian Customs used to immediately resort to the highest level of the customs value – the fallback method – and force importers pay more VAT and duty, thus themselves violating the procedure prescribed by the Customs Code.

The most common argument is "in our database we have other prices on similar cargo." So Customs is more oriented not on proving or rejecting a contracted value, but on consulting customs brokers regarding indicative prices and using the sixth method with the remark "after verbal consultation." The other five methods are generally not used, which fosters corruption.

When dealing with Ukrainian Customs, an importer has to know the rules: all signatures and stamps have to be the same in all documents, as no discrepancies are accepted. Because all indicative prices in the Customs database are in the format "USD per kg," Customs pays attention to checking the cargo weight and noting the difference between net and gross weight. If goods are labeled by trademark, this has to be noted in the commercial documents.

Raising the customs value and forcing the sixth method unfortunately remains rather common practice with Ukrainian Customs, with the declared aim of filling the state budget or the undeclared purpose of blackmailing importers. Even according to official information, 20% of all import declarations are subject to customs value adjustments.

In practice, valuation issues can lead to significant delays and disputes. Despite

the obvious difficulties that currently exist in establishing the customs value of goods imported to Ukraine, and related conflicts with Customs, a careful and responsible approach to the preparation of necessary documents, consulting with certified customs brokers as well as a timely, if necessary, appeal to specialized lawyers, can help avoid unnecessary problems. All these issues arise because of absence of post clearance procedures in Ukraine, although such procedures have to be one of the fundamental components of customs procedures.

Unfortunately, currently, the system of post clearance control does not work or provides just formal processes due to the lack of implementation of proper goods control and taxation during the entire cycle from the importer to the final consumer.

Very recently, the practice of indicative customs value (ICV) was introduced in Ukraine, based on customs value benchmarks were defined by Cabinet Resolution #724 dated September 16, 2015. According to this resolution, Customs authorities can apply customs value benchmarks to goods in the risk management system. However, this approach does not consider the features of each type of good – novelty, reputation in the market – or the specifics of commercial relationships. In addition, the mechanism for calculating the benchmarks remains unclear. At present, the implementation of this instrument has de facto set up a significant barrier for foreign trade. It should be revised immediately.

Interference by Ministry of Internal Affairs, State Security Service and Prosecutor General Office in customs procedures

There are many complaints about the interference of various enforcement agencies in customs procedures. Among the complaints are numerous inspections at Customs, the removal of financial documentation and computer equipment, which paralyzes business activities. Another problem is the launch of criminal proceedings for alleged economic crimes. Such investigation process can last for years without final decisions, and so entrepreneurs have been more and more frequently called in for investigative procedures: interrogation, search, seizure, and the arrest of property.

Case №1.

A complaint about abuse of powers was filed against the Volyn Customs Service, which refused to properly perform customs formalities with respect to goods imported from one of EU countries.

Case №2.

A complaint was registered regarding an unjustified increase in the DCV by the Zaporizhzhia Customs Service. This complaint referred to (1) an allegedly unlawful increase in the customs duties on imported goods; and (2) a critique of the existing state of the customs laws. The Complainant reported that, on several occasions, the matter of the illicit increase in DCV was submitted to the court. The Complainant also mentioned some 30 instances of DCV upward adjustments, which were successfully appealed in the courts in 2013.

Case №3.

The complaint refers to the abuse of power by Zaporizhzhia and Volyn Customs, that is, their unlawful refusal to perform customs duties and redundant customs checks. These caused delays with timely delivery of the Complainant's product, leading in loses and damages.

Case №4.

The Complainant is a pharmaceuticals distributor located in Kyiv. The Complainant made a mistake in the customs declaration currency, thus paying excessive duty of UAH 325,217.55 to the state budget. After submitting its declaration, the Complainant submitted a request to the Kyiv Customs Office for a correction in the customs declaration and the return of the excessive amount to the company account. However, the adjustment has not been made an, no reimbursement has been paid for 5 months. The unofficial explanation from the Kyiv Customs Office was that there was no proper procedure to support such returns.

Case №5.

The Complainant is a major oil importer who challenged an allegedly unreasonable increase in the DCV of imported oil products. Specifically, customs authorities applied indirect valuation methods instead of direct valuation, without providing sufficient reasonable grounds or discussing it with the Complainant, as required by law. The BOC's request to the State Fiscal Service was answered formally but without substance. The application of alternative methods to calculate customs value appears to be a systemic problem, as they are often applied by the customs authorities quite frivolously.

According to experts, Ukraine's customs agencies refuse to determine customs value using the first basic method more often than their colleagues in the European Union does.

Case №6.

The Complainant is a Kyiv-based exporter who challenged the actions of the Odesa Customs Office, which led to the unlawful arrest of the Complainant's cargo of coal. The customs clearance of the Complainant's cargos was stopped and the cargos were seized by Odesa Customs without providing any explanations or grounds to the Complainant. Further to the Complainant's written request, the Office replied that the cargos were arrested at the request of the Odesa Oblast SBU. The SBU, in turn, claimed that the cargos needed to be verified to confirm that they did not originate from anti-terrorist zone area. Further on, the Complainant clarified that Odesa Customs Office did not have legal grounds to stop customs clearance procedures and retain the cargos as the valid court ruling allowing arrest of cargos was issued after the cargos had actually been detained. The complaint is currently being processed by the BOC.

International Practice[6]

In countries with developed economies, post clearance audits (PCA) usually provide more 30% of all customs revenues.[7]

In France, for example, customs officers just inspect around 5% of import. Other 95% are subject to inspection during 1-3 years after customs procedures.

In Taipei, using fiscal year 2010-11 as an example, with no additional expenditure required on IT infrastructure as mentioned, the total personnel and training cost was US $2,621,900, yet the estimated revenue from recovery of evaded duties and fines amounted to US $26,579,778, almost 10 times the cost of human resources allocated to implementing the PCA system.

6 Paper submitted by the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu for the July 2012 World Trade Organization (WTO), Symposium on Trade Facilitation.
7 OECD, WTO, and other resources.

BOC Recommendations

(1) To the Cabinet of Ministers: Repeal Cabinet Resolution #724 of September 16, 2015, by which the State Customs is empowered to apply indicative benchmarks to import customs value arbitrarily.

(2) To the State Fiscal Service: Adopt amendments to the Customs Code to implement post-clearance control procedures. The main idea is to transfer control from the customs declaration stage to the stage after the release of goods for free circulation.

(3) To the State Fiscal Service: Update the list of cases when the customs authorities may have concerns regarding the accuracy of declared customs value (DCV). In case the customs officer requires additional consultations regarding the customs value of goods, the information source has to be single and clear. In case the customs officer has doubts, he must justify causes of these doubts based on documental evidence.

(4) To the State Fiscal Service: Reduce the number of inspections during customs control and clearance of goods in the national system of customs standards; strengthen the role of risk management and post-audit control.

(5) To the State Fiscal Service: Provide regular training for customs officers in order to improve their capacity for customs valuation. It is critical that Customs officials develop an in-depth understanding of the methods of goods valuation and be able to apply official recommendations and clarifications from the World Customs Organization.

(6) To the State Fiscal Service: Reload the post clearance control system in Ukraine and provide effective coordination, planning, implementation and execution of the procedure according to Arts. 345–354 of the Customs Code, put in place the appropriate database, audit schedule, tracking system, and so on.

(7) To the Cabinet of Ministers: Prepare and adopt a Law on compensation for damage caused by the unlawful actions of customs officials, to strengthen the role of administrative pretrial settlement of disputes and prevent the abuse of power.

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