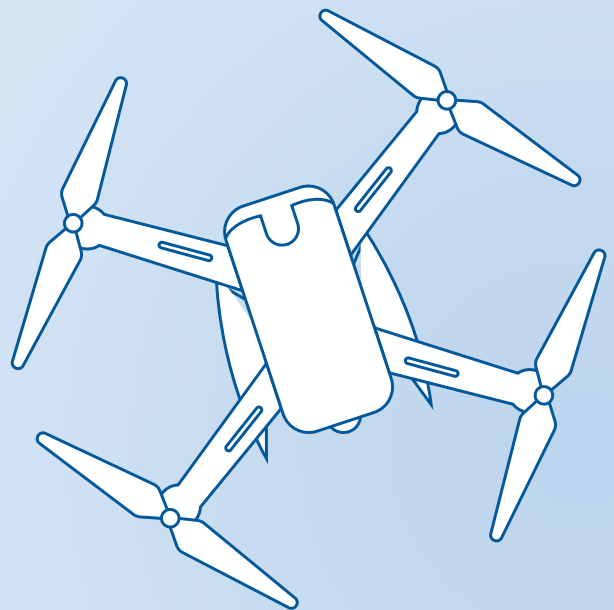
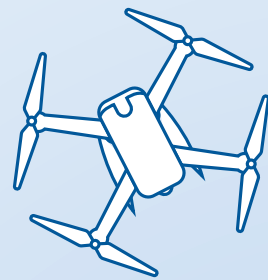
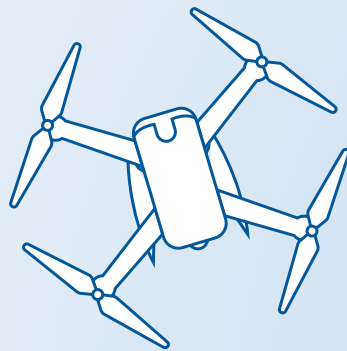


Own-initiative investigation results

Tax Incentives: How Can Ukrainians Preserve Their Defence Industry Market?

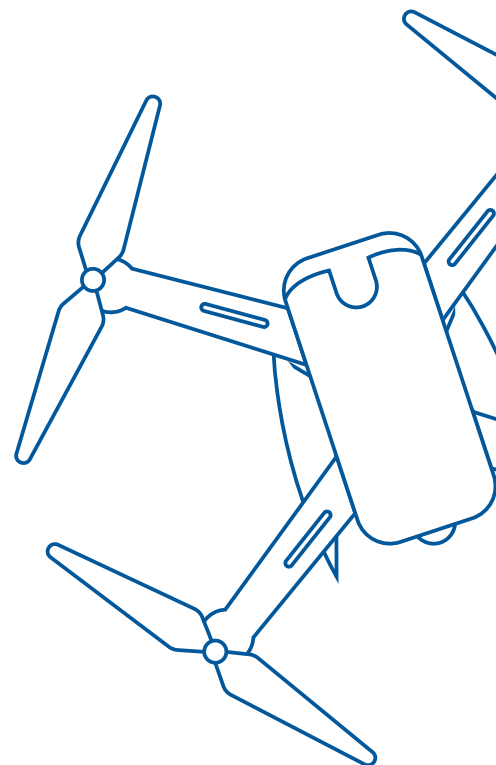
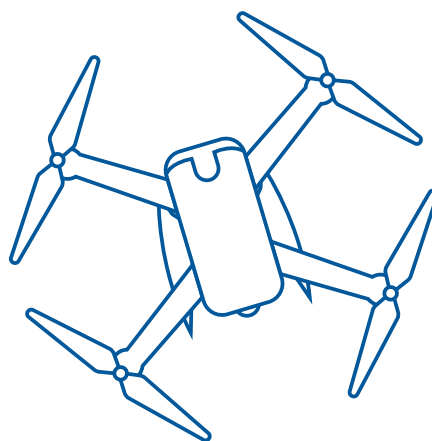
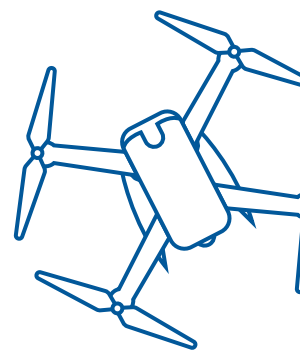


March 2025



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List of Abbreviations

UAV	unmanned aerial vehicle
VRU	Verkhovna Rada of Ukraine
MU	military unit
SCS	State Customs Service of Ukraine
STS	State Tax Service of Ukraine
USRCD	Unified State Register of Court Decisions
URPI	Unified Register of Pre-Trial Investigations
EU	European Union
SSC	Single Social Contribution
AFU	Armed Forces of Ukraine
ITC	individual tax consultation
CMU	Cabinet of Ministers of Ukraine
VRU Committee on Finance, Tax and Customs Policy	Committee of the Verkhovna Rada of Ukraine on Finance, Tax and Customs Policy
IMF	International Monetary Fund
Ministry of Economy	Ministry of Economy of Ukraine
Ministry of Defence	Ministry of Defence of Ukraine
Minstrategindustries	Ministry for Strategic Industries of Ukraine
Ministry of Finance	Ministry of Finance of Ukraine
City council	city (local) council
CCU	Customs Code of Ukraine
NBU	National Bank of Ukraine
UTC	united territorial community
LGA	local government authority
RMA	Regional Military Administration
WME	weapons and military equipment
VAT	value added tax
PIT	personal income tax
TC	tax credit
TCU	Tax Code of Ukraine
FL	fuel and lubricants
AD	Air Defence
TL	tax liability
Council	Business Ombudsman Council
EW	electronic warfare
RER	radio electronic intelligence
SPA rtillery	self-propelled artillery
SEA VAT	electronic VAT administration system
EUC	end-user certificate
Defence Forces	Security and Defence Forces of Ukraine
LLC	limited liability company
UCG FEA	Ukrainian Classification of Goods for Foreign Economic Activity
GTC	generalized tax consultation

Introduction

Ukraine's defence is currently an unconditional priority of state policy, and **the ability to provide the army with resources** is a determining factor of our national resilience. Against the backdrop of the ongoing armed aggression against Ukraine, the role of the national defence industry is growing not only **as a survival tool**, but also **as the foundation of future security and strategic autonomy**. It is the Ukrainian defence business – **manufacturers (including defence tech), importers, specialized service providers**¹ that become an integral part of this vision. Ensuring production, technological development and rapid adaptation to the needs of the front, this **business is not just an economic unit, but one of the country's stability guarantees**.

Since July 2024, the Council has held individual and collective meetings with **over 30 of industry business representatives, as well as specialized business associations and public organizations**. During the meetings, the Council was convinced that stakeholders were concerned about a wide range of issues associated with industry-related state policy and interaction with state bodies. The data obtained became the starting point in the Council's study of defence industry issues and the information basis of this report.

Among the concerns raised by businesses, one can note **the insufficient level of security data protection** were: disclosure of information about defence enterprises in public registers and commercial services, such as Opendatabot and YouControl, **closed export policy** for defence products, **margin restrictions** (markups) on the state order for UAVs (25%), employee **reservations**, outdated **standardization regulations**, issues regarding **of the state contracts terms compliance with market conditions**, and many others.

It is fair to note when the Council was working on this report, **the state resolved some of the problems identified by business**. These include, in particular, lifting deadlines for currency settlements for defence enterprises, deepening defence production localization, and **increasing the limit on charity for "large" corporate income tax payers** in favor of non-profit organizations (volunteer funds)².

However, most often, business raised issues with the Council related to **the state's tax and customs policy**, particularly issues related to **the preferential VAT taxation regime**. That is why, given the relevance of this topic for industry businesses, as well as the Council's significant expertise in the tax field (over the past 10 years, the Council has processed thousands of

¹ Business whose interests are covered by this report, is not limited to executors and co-executors of state defence procurement orders. It is a common knowledge that a significant number of goods/services for defence needs are supplied from financing sources other than the state budget.

² By the Resolution of the National Bank of Ukraine Board dated 09.07.2024 No. 84 "On Amendments to the Resolution of the of the National Bank of Ukraine Board dated May 14, 2019 No. 67", which entered into force on July 11, 2024, the NBU cancels payment deadlines for military and dual-use goods and equipment imported by state defense procurement contracts executors.

By Laws of Ukraine No. 4143-IX of 17.12.2024 and No. 4144-IX of 17.12.2024 the Tax and Customs Codes of Ukraine have been amended, providing for VAT exemption and import duty of components and materials for production of ammunition, unmanned systems (air, ground, water), demining systems, intelligence means and other defence goods.

Draft Law No. 12328-d dated 20.02.2025 on amendments to the Tax Code of Ukraine regarding the stimulation of charity during the martial law period was adopted by the Verkhovna Rada and is awaiting to be signed by the President of Ukraine. It increased the maximum non-taxable expenses amount for charitable assistance from 4% to 8%, starting from 2025 and until the end of the martial law regime in Ukraine for large corporate income tax payers.

tax complaints), this report focuses on analyzing **the balance of preferential VAT** both from the point of view of general approaches to state tax policy and in terms of preferential mechanisms administration and law enforcement practice.

In the recent past, Ukraine has expressed its intention to resist pressure on non-core spending categories and **prioritize national defence**³. The budget declaration for 2025-2027 identifies **spending on security and defence** as the main budget priority⁴.

The National Revenue Strategy of Ukraine until 2030⁵ states that at war, when since 2022 budget expenditures on security have increased by more than 10 times, when the indicators of the state budget deficit and state debt reach record values, state finances are under unprecedented pressure. In this study, the Council takes into account the importance of **preventing an unreasonable additional burden on the budget** during the martial law period. All the Council's ideas and recommendations for the state are formed with an understanding of the distributional role of taxes and the need to minimize the negative impact on the tax revenue base.

The National Strategy stresses that the largest amount of money remaining in business due to tax benefits provision falls on VAT. Meanwhile, the document recognizes that industry benefits, by definition, are either social in nature and aimed at the end consumer of services, or they were introduced to stimulate economic activity in a certain industry. At the same time, the National Revenue Strategy questions the optimality of benefits as a tool for stimulating economic

activity. One of the cross-cutting tax policy topics is **introduction of a regular assessment of tax benefits** before their introduction and regular monitoring thereafter.

While preparing this report, the Council also took into account the provisions of **the EU Directive on the common VAT system**⁶. Harmonizing Ukrainian legislation with this Directive provisions is an important part of our European integration processes. However, it should be borne in mind that most of the VAT exemptions introduced during the martial law period, including goods for defence purposes,⁷ do not comply with the provisions of the Directive. At the same time, of **the EU-Ukraine Association Agreement** provisions⁸ stipulate that none of its provisions may be interpreted as preventing any Party from taking any measures that are taken during war, and **nothing in this Agreement shall prevent a Party from taking any measures which it considers necessary to ensure its own security**, particularly in time of war, or to fulfil obligations it has undertaken to maintain peace and international security. Therefore, the state, in its tax policy, was guided by these exceptions during both the martial law regime and the special period, and is moving towards liberalizing the VAT taxation regime in the defence sector.

During the war, Ukraine significantly **increases budget expenditures in the defence sector**: during 2022–2024, actual expenditures by year amounted to: UAH 1.53 trillion (31% of GDP in 2022), UAH 2.65 trillion (41% of GDP in 2023), UAH 2.1 trillion (in 2024). Estimated defence spending in 2025 is UAH 2.22 trillion (26% of GDP), but

³ [The Letter of Intent to the Memorandum between Ukraine and the IMF on Economic and Financial Policy dated June 17, 2024](#)

⁴ [CMU Decree dated June 28, 2024 No. 751](#)

⁵ [CMU Order dated 27.12.2023 No. 1218-r "On Approval of the National Revenue Strategy until 2030"](#)

⁶ [Directive 2006/112/EC of 28.11.2006 on VAT](#)

⁷ In the report, the Council deliberately uses the phrase "goods for defence needs", and not the term "goods for defense purpose", defined by para 29 of Article 1 of the Law of Ukraine "On Defence Procurement", since this term does not cover the entire range of goods imported/supplied for defence needs of Ukraine among those covered by the preferential VAT regime.

⁸ Articles 472 "Measures Related to Essential Security Interests", 143 "Exceptions Related to Security" of [Association Agreement between the European Union and the European Atomic Energy Community and their Member States, of the one part, and Ukraine, of the other part](#)

it is worth noting that in previous “war” years, actual spending was twice as high as estimated⁹.

At the same time, the state is going to continue preferential support for the defence sector next year. Thus, in 2025, **preferential taxation of transactions for the of defence products supply is expected** to account for the largest share among all tax benefits and is **supposed to result in budget losses of UAH 82.2 bn** (compared to UAH 75 bn in 2024). In addition, the benefits provided for the supply of electronic warfare, UAVs and armored vehicles will also reduce state budget revenues by UAH 3 bn (compared to UAH 2.8 bn in 2024).¹⁰.

However, we would like to point out once again that the subject of the analysis of this Council’s report in the context of preferential VAT is not focused on issues leading to a significant increase in budget expenditures, rather on issues that should contribute to **optimizing of such expenditures, more effective benefits administration**, and, last but not least, a gradual **import substitution and localization of Ukrainian defence production** by shifting the focus from preferential imports to domestic benefits for domestic manufacturers.

While such benefit as **VAT exemption** is aimed at reducing the defence goods cost, its consequences for business are not as clear-cut. For the buyer, this is a clear benefit, because it actually allows to purchase more products for the same budget. For the supplier, the situation is more complicated: if the goods are imported with VAT paid or are made

from components purchased with VAT, the supplier has already paid the tax and attributed its amount to the tax credit. After applying the benefit, this credit is adjusted, which actually eliminates the possibility of compensating for previously paid tax, creating cash gaps and reducing operations profitability.

Tax legislation allows **not to adjust the tax credit in supply of goods under defence procurement state contracts**, however, in transactions with preferential defence goods **going beyond state orders** – for example, those supplied at the expense of volunteer funds, within local government programs and directly to military units not within the framework of a state order – **the supplier’s position is less favorable**¹². Industry businesses also identified this as a problem to the Council, since businesses do not always work with state orders or even with state orders executors. This aspect was not included in the list of issues that formed the subject of this report (although it analyzes issues covering not only state orders), since one of the key aspects in it, is the financial aspect associated with budget losses. Nevertheless, it shows how important **a balanced and fair state policy** is in terms of tax benefits.

In this report, the Council focused on analyzing **three issues (blocks)** whose problems were reported to us by businesses representatives operating in the defence sector.

The first block deals with potentially important steps by the state towards deepening defence production localization, namely **component production localization**

⁹ Report on the implementation of the State Budget of Ukraine 2022
Source: https://mof.gov.ua/uk/news/uriad_ukraini_skhvaliv_zvit_pro_vikonannia_derzhavnogo_biudzhetu_ukraini_2022-3974
Report on the implementation of the State Budget of Ukraine 2023
Source: https://mof.gov.ua/uk/news/uriad_ukraini_skhvaliv_zvit_pro_vikonannia_derzhavnogo_biudzhetu_na_2023_rik_vidatki_na_oboronu_ta_bezpeku_stanovili_265_trln_griven-4576
“2024 Results: Security and Defense Spending”
Source: <https://www.facebook.com/minfin.gov.ua/posts/pfbid0TFzrK2cfWV9iUHvjzNUCtF2VXW5XbLYokuPYhasoPJMUKnoAKTuH4RF5aiC1yuGI>
“The Verkhovna Rada of Ukraine adopted the state budget for 2025: the country’s defense will be ensured”
Source: https://mof.gov.ua/uk/news/verkhovna_rada_ukraini_priinjala_derzhbiudzheth_na_2025_rik_oboronu_kraini_bude_zabezpecheno-4897

¹⁰ Appendix to the Law of Ukraine “On the State Budget of Ukraine for 2025”, “List of tax and fee benefits (mandatory payments) with calculation of budget revenue losses from their provision in 2024 and forecast of losses for 2025”; benefit codes 14060514 and 14060555.

¹¹ It concerns compensating tax liabilities accrual in accordance with sub-para b of para 198.5 of Article 198 of the Tax Code of Ukraine, as a result of which the tax credit is proportionally reduced.

¹² The last para of para 32, sub-section 2 of section XX of the Criminal Procedure Code

for these products. At the end of December 2024, the state took the next step in localizing production, normatively deepening it for manufacturers of such goods as UAVs, electronic warfare, demining machines and robotic systems. Meanwhile, as for individual components manufacturers of such goods, their **import still remains more profitable than local production**, particularly due to the current tax policy with preferential VAT.

The **second block** analyzes the **problems of law enforcement practice** in administering one of tax benefits types using the example of a considerable number of lawsuits initiated in favour of the state. These processes shine a light on a systemic problem increasing the administrative burden on the state apparatus and exacerbates financial uncertainty of manufacturers and importers. We are talking about cases of **charging VAT included in the supply contract as unreasonably paid from defence goods suppliers**. Such contracts with no preferential VAT regime applied, as case-law shows, were in many cases concluded by local authorities in different regions based on open tenders results, initially announced with VAT included in the expected cost of goods.

Third block of the report raises the issue of the state's tax policy in terms of the **VAT taxation regime for military equipment repair and upgrade services**. Currently, these services are not subject to preferential VAT. At the same time, since the financing source for such services is mostly state funds, from which a budget for repairs for Defence Forces units is allocated, the current taxation

regime gives rise to the phenomenon of the so-called state funds migration through “from budget to budget” VAT flow mechanism. This phenomenon requires assessing its impact on both the state's defence capability and position of business delivering these services.

For a better understanding, the Council **will illustrate each of the analyzed issues in the form of cases** from “A”, “B”, “C”. hypothetical companies activities. These are examples of situations faced by operating enterprises, however, to maintain confidentiality, all identifying features in the cases have been changed. Information about the cases was obtained by the Council when processing business complaints, as well as during communication and meetings with businesses.

The state's delay in resolving problems concerning defence business is catalyzing **risks associated, for example, with migration (relocation) of this business abroad**. Open sources contain data from one of specialized business associations, according to which in 2024, a significant share of the defence sector had intentions, plans or considerations to move business outside Ukraine. Most of the participants in that survey did not see the state taking steps to improve conditions for doing business inside the country, and some reported underutilization of their own capacities¹³. Of course, business emigration is not the only risk arising in Ukraine's struggle with present-day challenges. **Nonetheless, under any circumstances, the state should do its best to minimize these risks by conducting its defence policy in a balanced, proportionate, and fair way.**

¹³ “Forced relocation of weapons manufacturers abroad”: survey of the Technological Forces of Ukraine
Source: <https://techforce.in.ua/news/article/relocation-analytics-by-TFUA>

BLOCK 1.

Components burden = impact on localization = import dependence

Despite the state's declared support for defence goods production and its focus on localization¹⁴, the current tax regime **does not favor national component manufacturers for weapons and military equipment**¹⁵, and makes their products more expensive compared to imported counterparts.

In 2024, the Ministry of Defence approved of using over 1,300 samples (400 samples in 2023) of weapons and military equipment, with almost 75% (60% in 2023) of them domestically produced, and Ukrainian drones accounted for 96.2% of all UAVs supplied to the Defence Forces.¹⁶

However, in 2024, the State Customs Service recorded a significant increase in

import of defence goods using customs duty benefits, which amounted to UAH 100.8 bn (compared to UAH 60.0 bn in 2023 and UAH 28 bn in 2022).¹⁷

Amendments to the TCU and CCU in late 2024¹⁸ expanded tax and customs benefits for imports for certain finished products manufacturers, including UAVs and electronic warfare systems. Manufacturers were able to import a wide range of raw materials, materials, and components for their products without paying VAT and customs duties for use in their own production and/or repair.

At the same time, **these benefits do not cover specifically component manufacturers**. Therefore, component

¹⁴ From the annual message of the President of Ukraine to the Verkhovna Rada on November 19, 2024: "...Despite everything, despite the war, despite all the difficulties of this war, the Ukrainian economy retains basic stability. And it needs a new economic policy of our state. A policy that will be based on several key things. **The first is maximum support for Ukrainian entrepreneurship, localization and production in Ukraine.** We need to expand access for Ukrainian producers to public procurement market – **everything that can be produced in Ukraine must be produced in Ukraine and purchased first of all, with all due respect to partners, from Ukrainian producers** (...), source: <https://www.president.gov.ua/news/mi-mayemo-ne-dopustiti-shob-htos-u-sviti-zasumnivavsya-u-sti-94497>

¹⁵ In Ukrainian legislation, various terms are used to designate parts of military equipment, such as "a component part", "spare part" and "components", depending on the context and specifics of the legal act. In this report, for the purpose of simplicity, the generalized name "spare parts" is used to refer to WME components.

¹⁶ Ministry of Defence message, source: <https://mod.gov.ua/news/u-2024-rocz-minoboroni-dopustilo-do-ekspluatacziji-ponad-1300-zrazkiv-ozbroyennya-ta-vijskovoyi-tehniki>

¹⁷ Results of the fiscal function implementation by customs authorities in 2024, source: <https://customs.gov.ua/news/zagalne-20/post/rezultati-vikonannia-mitnimi-organami-fiskalnoyi-funktsiyi-u-2024-rotsi-1976>

¹⁸ The Law of Ukraine No. 4143-IX of 17.12.2024 (effective from 30.12.2024) amended **para 95**, sub-section 2, of section XX of the TCU, which **exempts from VAT the import by manufacturers of certain finished products of certain components** (from the list in paras 9-27 of section XXI of the TCU) for such products used by enterprises in their own production/repair. These amendments added certain types of unmanned and robotic systems to the list of finished products of this clause.

The Law of Ukraine No. 4144-IX of 17.12.2024 (effective from 30.12.2024) amended **paras 9-27** of section XXI of the CCU, which **exempts from import duty the import of certain components (materials/raw materials)** used by enterprises in their own production/repair of the above-mentioned finished products. These amendments significantly expanded such components list.

manufacturers continue paying import duties and VAT when importing raw materials. As a result, importing ready-made components becomes more profitable than their local production, which, in turn, slows down the Ukrainian component market development, thus making a dependence on foreign suppliers greater.

Trade in components between manufacturers is also common to avoid downtime in producing a particular batch due to a temporary shortage of

components or delays in delivery due to border blockades and other force majeure circumstances. Accordingly, eliminating discrepancies in VAT taxation for finished product importer and the Ukrainian components manufacturer will contribute to reducing the final price and the of the production cycle smoothness as a whole.

Enterprises in the industry complained to the Council about this problem, emphasizing the need to change the approach to component manufacturers operations taxation.

CASE

“A” LLC is a Ukrainian company specializing in producing components for unmanned aerial vehicles and other military systems. Its products include, in particular, carbon wings for UAVs, hulls, printed circuit boards and specialized control systems. In the last few years, the company has been trying to compete with foreign suppliers by offering localized production for defence enterprises.

In 2024, A LLC received an order from B LLC drone manufacturer, which sought to purchase carbon wings from the company for its new UAV models. However, producing such wings requires special materials, such as carbon fiber, special polymers, and electronic components not produced in Ukraine and must be imported.

However, in the course of work, it turned out that “B” LLC drone manufacturer had the opportunity to import these materials without VAT and customs duties in accordance with **para 95 of sub-section 2 of section XX of the TCU**, since it uses them in its own production to manufacture final products (drones). At the same time, **“A” LLC as the components manufacturer does not fall under this benefit**, since the norm applies to finished equipment manufacturers only. Therefore, the company had to pay **20% VAT and import duty** on imported raw materials and materials.

At the same time, clause 32, of sub-section 2 of section XX of the TCU provides for VAT exempt for certain defence equipment components supply, particularly those classified under code 8807. Therefore, when selling wings for UAVs, “A” LLC does not include VAT in the price of goods. Yet, **its products cost still increased due to the need to pay customs duties, as well as burden on liquidity due to paying import VAT.**

After comparing costs, B LLC concluded that it was cheaper **to import materials independently without VAT and customs duties and set up its own wings production** than buying them from A LLC. Another option is to import finished wings from China, which are also exempt from VAT and customs duties.

As a result, **“A” LLC lost the contract**, and the UAV manufacturer, which initially wanted to support local production, has to either invest resources in its own production or rely on foreign suppliers.

How does the taxation regime affect local component production?¹⁹

Drone manufacturer imports finished wing	Ukrainian component manufacturer produces wing ("A") LLC	Drone manufacturer produces its own components ("B" LLC)
<p>Cost price: \$1400</p> <p>Exemption from VAT and customs duties (para 95 of sub-section 2 of section XX of the TCU and paras 9-27 of section XXI of the TCU)</p>	<p>Raw material import: \$1000</p> <p>+10% import duty: +\$100 increases the cost price at once)</p> <p>+20% VAT: +\$220 (paid immediately from turnover included in the tax credit)</p> <p>Production costs and margin: +\$300</p> <p>Exemption from VAT (para 32 of sub-section 2 of section XX of the TCU)</p>	<p>Raw material import: \$1000</p> <p>Exemption from VAT and customs duties (para. 95 of sub-section 2, of section XX of the TCU)</p> <p>Production costs and margin: +\$300</p>
<p>Final price: \$1400</p>	<p>Final price: \$1400 (+liquidity burden +cash gap)</p>	<p>Final price: \$1300</p>

Photo credit
<http://www.avia.systems/uk>

¹⁹ These calculations are illustrative and may not take into account all indicators required for a comprehensive financial and economic assessment of the military equipment component market in Ukraine.

Lost incentive

For component manufacturers who do not fall under Clause 95 of sub-section 2 of section XX of the TCU, **the need to pay import VAT on raw materials and supplies becomes a problem.**

Although this amount is included in the tax credit and can be used to reduce future liabilities or refunded from the budget, the company has to withdraw funds from turnover first, which complicates its financial flexibility. While finished defence products manufacturers (e.g. drones) can import raw materials without VAT, component manufacturers are forced to

either wait for VAT refund from the budget (that can take months or years²⁰), lay down this cash gap into their financial model, which slows down their growth and limits competitiveness. In addition to the liquidity problem, import duties on raw materials and materials directly increase Ukrainian components production cost.

Thus, **a Ukrainian manufacturer has a worse position in the component production market** than a foreign manufacturer, despite the fact that they can sell the component at the same price.

Why do Ukrainian producers face so many more challenges?

The state's supportive and loyal approach to Ukrainian producers taxation is essentially important for the industry development, since, unlike foreign producers operating in stable conditions, **domestic producers spend more** resources on adapting to war conditions due to the following factors:

- **Energy risks:** blackouts and power restrictions causing production cycle disruptions, rising costs for autonomous energy sources and increasing energy costs itself;
- **Security risks:** shelling, air raids, production destruction risk, brining production processes to a halt during raids, logistics problems;
- **Personnel risks** due to general mobilization and the risk of losing qualified employees;
- **Risks of logistics problems** (particularly delays in customs clearance procedures) due to dependence on imports of most raw materials and components.

²⁰ Due to the fact that the state's recognition of the payer right to a budget VAT refund is preceded by a tax audit, and perhaps its findings appeal in administrative and/or judicial proceedings, the prospect of receiving these funds by the enterprise is usually remote in time, which also has negative inflationary consequences for the payer. For instance, after introducing martial law, entrepreneurs from various sectors of the Ukrainian economy faced an increase in refusals to receive budget refunds by over twice compared to the pre-war period. For more details about it, see the Council's own-initiative investigation into tax audits, source: <https://boi.org.ua/wp-content/uploads/2023/11/podatkovyi-perevirky-v2.pdf>

Does the preferential nomenclature need to be expanded?

A separate issue in question is the **extent to which the preferential nomenclature goods list, defined in clauses 9-27 of section XXI of the TCU, is exhaustive and meets the goal of stimulating military equipment local production.** Despite its significant expansion at the end of 2024, the Council received information about the legislator's failure to take into account some important components common in military equipment production classified, in particular, under codes **8409 (engine parts), 8411 (turbojet engines), 7019 (fiberglass).**

Another important aspect is **the preferential regime consistency in para 95 of sub-section 2 of section XX of the TCU with the provisions of para 32 of the same sub-section of the TCU, which determines VAT exemption for the import and supply of certain defence goods on the customs territory of Ukraine.** Since

these two mechanisms operate in parallel, it is important to ensure their correlation to avoid situations where finished products fall under the preferential regime, but **key materials and components for their production remain beyond the scope of tax incentives.**

As an alternative approach, one could consider expanding the list of UCG FEA codes in Section 32 (...) of the TCU to include critical components and materials. However, this approach has its **restrictions**, as Section 32 of the TCU regulates mainly **end defence products**, while raw materials and components for their production **are mainly covered by Section 95 (...) of the TCU.**

Since defence industry needs are changing dynamically, it is necessary to constantly monitor this issue and **promptly update the list** in accordance with the requests of manufacturers and the state's defence needs.

Are there risks of mass destruction finished weapons manufacturers' balance of interests negative shifting?

First of all, it should be borne in mind that with no sustainable local component production ecosystem in place, **Ukrainian defence-industrial complex manufacturers depend on even basic elements import** increasing supply risks and does not unlock full localization potential of.

Needless to say, stimulating components production must meet **the real market needs**, which should be the subject of a separate comprehensive study.

Not all defence-industrial complex manufacturers are ready and eager or interested in expanding their own production cycle²¹ – for many it may be

more profitable to buy proven components from trusted suppliers rather than manufacturing them from scratch. If the market for such suppliers is not formed due to tax distortions, **import remains the only option.**

The balance of interests is to create conditions for developing domestic component manufacturers without excessively burdening of finished equipment producers, **leaving them the choice to import or purchase locally.** It is especially important in the long run, when **Ukraine must move towards technological independence, minimizing dependence on foreign suppliers.**

²¹ The willingness of manufacturers to expand their production cycle is defined by a number of factors, including: 1) technological base and specialization: there are not always technical capabilities requiring separate equipment, qualifications and lines; 2) economic feasibility: for small or medium-sized enterprises, the costs of launching their own components production may be significantly higher than their purchase cost – even with VAT and customs duties; 3) risks: investments in expanding the cycle may not pay off, production equipment may quickly become obsolete, etc.

Who is more important – the importer or the manufacturer?

It may seem as if supporting one type of business (manufacturing) automatically puts the other at a disadvantage. However, it is not always the case. **A successful defence sector involves the coexistence of both types of business:**

- Importers grant access to critical goods and components that cannot yet be produced locally
- Manufacturers are gradually developing local production

The state's task is to balance the interests of different business segments through **correctly distributing tax incentives and a long-term strategy.**

What are fiscal benefits and risks for the state when redistributing tax incentives?

Advantages:	Risks (potential losses for the state)
1. Currently, the budget does not receive revenue from importing many types of defence equipment components, given the current tax and customs privileges. If localized production receives similar options, it will not significantly change the current balance of budget revenues, but may create new economic opportunities in Ukraine.	1. With extending import tax benefit to component manufacturers, there may be risks of abuse, particularly changing the business line for producing components solely for the sake of preferential import. By receiving raw materials and materials with benefits, they may be sold for purposes other than defence production. There is also a possible re-export risk, when preferentially imported goods are exported abroad for sale as a result of non-transparent pricing or relationships with counterparties.
2. If Ukraine starts producing more defence components, domestic economic activity will grow , particularly through new jobs, increased domestic operations, and increased revenues from personal income tax and social security contributions to the budget. Localizing the component market can also contribute to new technologies development and R&D , which will help strengthen the defence industry.	2. Additional benefits (even if they are offered with the aim of replacing preferential import) are always a complication in their administration and an additional burden on regulatory authorities²². Similarly, additional bureaucracy and control measures (in particular, tax audits) for the application of benefits will inevitably increase pressure on honest business.
3. The course on localization and import substitution helps reduce currency outflow , since each import is a withdrawal of currency from the country. If more components are produced in Ukraine, then part of these funds will remain in the national economy and circulate within, stimulating domestic demand.	3. The list of UCG FEA codes that are subject to tax benefits may quickly become outdated. There is a risk that the state will not be able to give the opportunity to flexibly update the preferential goods list in accordance with changes in military technologies. The same is true for communication mechanisms for businesses to promptly initiate changes in the preferential goods list.

²² **Explanation** of Zavodsk Territorial Community “On the quarterly submission of reports when applying the tax benefit “241”

Suggested next steps:

The Council sees the feasibility of developing a systemic approach to supporting local production of components for military equipment to minimize dependence on imports and create equal conditions for domestic manufacturers. It does not imply extending benefits to the whole range of materials and parts, but requires analytical work, creating criteria for optimal monitoring of the effectiveness of already adopted changes to the TCU and CCU, as well as new changes development.

1. **To explore local component production potential** (the Ministry of Economy, Ministry of Strategic Industry, Ministry of Defence): to determine the market size and pool of Ukrainian enterprises capable of producing important components; assess which production capacities already exist and which need to be created “from scratch”; investigate the investment attractiveness of this type of production.

According to the Ministry of Defence of Ukraine, the government plans a record \$35 bn worth of weapons production in 2025, of which \$17 bn will be financed by the government, and the remaining funds may come from allies.

If part of this funding is directed to stimulating domestic component manufacturers, a significant reduction in import dependence can be achieved. Otherwise, significant state defence spending will actually go to supporting foreign suppliers instead of developing Ukrainian manufacturers.

2. **To conduct an audit of the current preferential nomenclature effectiveness** (the Ministry of Economy, Ministry of Strategic Industry, State Tax Service, State Customs Committee): hold meetings with specialized manufacturers of certain types of defence products and assess to what extent the list of UCG FEA codes expanded in December 2024 (para 95 of the TCU, paras 9-27 of the CCU) is sufficient to ensure basic components production for military equipment in Ukraine; jointly with business representatives the possibility and need to expand the list of UCG FEA codes in para 95 of the TCU and paras 9-27 of the CCU, in particular to: 8409 (engine parts), 8411 (turbojet engines), 7019 (fiberglass).
3. **To investigate the feasibility of extending the benefits of para 95 of the Tax Code of Ukraine and paras 9-27 of section XXI of the TCU to military equipment component manufacturers** (the Ministry of Finance, Ministry of Economy, Ministry of Strategic Industry, State Tax Service) by expanding UCG FEA codes list for goods for production/repair of which a preferential import regime for components is established, and adding to this list UCG FEA codes corresponding to military equipment components for which there is domestic potential for local production.
4. **To introduce control and reporting on the use of benefits** (the Ministry of Finance, State Tax Service, State Medical Service, Ministry of Defence). To avoid abuse, it is necessary to take into consideration the existing reporting mechanisms under Article 95 of the Tax Code of Ukraine (quarterly reporting on the intended use of goods imported on a preferential basis) and introduce similar mechanisms for component manufacturers. In particular, 1) to establish cross-control: a component manufacturer submits quarterly reports on the use of raw materials; a finished products manufacturer confirms the components had been used for defence equipment, 2) to provide for control mechanisms for misuse of preferential raw materials.

²³ **Minister of Defence of Ukraine Rustem Umerov**, following the results of the meeting of the E5 group of countries uniting Poland, Germany, France, Italy and Great Britain, reported that one of Ukraine's defense key priorities in 2025 is: weapons for the front: artillery shells, long-range weapons, Western armored vehicles; strengthening air defence: new air defense systems and ammunition to counter russian missiles and drones; defense industry development: in 2025, Ukraine plans a record production of weapons for \$35 bn, of which \$17 bn will be financed by the Ukrainian government. The remaining funds can be provided by allies.

BLOCK 2.

Unclear preferential mechanism = problematic enforcement = impact on suppliers liquidity

The introduction of a preferential VAT regime for defence goods²⁴ was intended to reduce the cost of supplies for military needs. However, its implementation mechanism turned out to be imperfect, which resulted in discrepancies in law enforcement and litigation between the state and business. Several suppliers reported to the Council on an increase in cases of **judicial charging of VAT amounts included in the price of the goods supplied from suppliers who concluded defence goods supply contracts with local governments**²⁵.

Having examined these cases, we found insufficiently clear mechanisms for confirming the right to apply the benefit and variable approaches of the parties to the contracts regarding the end recipient of the defence product. It creates legal uncertainty and financial risks for enterprises, which, while being unable to use their input tax credit, have to compensate the customer for funds that have already been partially paid to the state.

²⁴ Law No. 1561-VII of 01.07.2014 sub-section 2 of section XX "Transitional Provisions" of the TCU was supplemented with para 32, according to which temporarily, for the period of the anti-terrorist operation and/or introduction of martial law in accordance with the law, operation of **import into the customs territory of Ukraine and supplying certain commodity codes within the customs territory of Ukraine was exempted from VAT**. The amendments entered into force on July 23, 2014. In the current version Law No. 3019-IX of 10.04.2023, the specified period is supplemented by the period of implementing measures to ensure national security and defence, repel and deter armed aggression of the Russian Federation.

Sub-paragraph 4 of this paragraph defines preferential codes for defence goods, **transactions with which comply with the Law of Ukraine "On Defense Procurement"**, i.e. those purchased **by state customers**.

Sub-paragraph 5 of this paragraph defines preferential codes of goods, the end recipient of which is a number of entities, including the Ministry of Defence, the Armed Forces of Ukraine and other military formations, executors (co-executors) of state contracts for defence procurement, etc.

²⁵ **These are contracts concluded based on the Law of Ukraine "On Public Procurement" dated 25.12.2015 No. 922-VIII and not state and defence procurement contracts. The Decree of the Cabinet of Ministers No. 363 of March 3, 2021 determined the list of state customers in the defence sector: the Ministry of Internal Affairs, the Ministry of Economy, the Ministry of Defence, the Ministry of Justice, the State Emergency Service, the Security Service, the Foreign Intelligence Service, the State Space Agency, the State Border Guard Service Administration, the State Service of Special Communications and Information Protection Administration, the Chief Directorate of Intelligence of the Ministry of Defence, the State Security Administration, the National Anti-Corruption Bureau, the National Guard, the National Police, the State Special Transport Service, the State Bureau of Investigation, the State Judicial Administration, the Ministry of Strategic Industry. Accordingly, local governments and/or municipal enterprises, which mostly act as customers in the procurement analyzed in this block, are not state defence customers and do not conclude state defence contracts. It is also important to understand that a contract where a military unit is directly a party hereto, unless it acts as an authorized structural unit of the Ministry of Defence, is not a state defense procurement contract and can be concluded in accordance with the Law of Ukraine "On Public Procurement" or without using tender procedures, depending on funding sources.**

CASE

In April 2023, “B” LLC concluded a contract with a resident of China for thermal imaging sights supply.

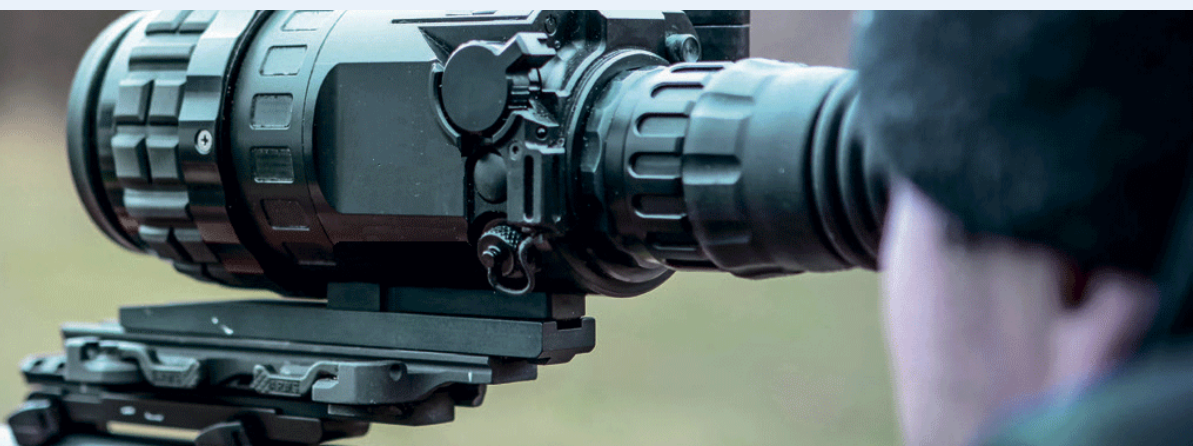
In June-July 2023, LLC “B” imported thermal imaging sights from China, paying VAT at a total rate of 20% upon importing goods into the customs territory of Ukraine.

In August 2023, amendments to the Tax Code of Ukraine became effective, according to which the relevant product subcategory fell under VAT exemption.

In October 2023, “B” LLC concluded an agreement with the Chortkiv City Council (City Council) for the supply of thermal imaging sights, including VAT in the price of goods, following an open tender. The purchase was made at the expense of the local budget for territorial defence program implementation and mobilization activities for 2023, approved by the decision of the City Council. “B” LLC delivered the goods, received payment from the City Council and reflected its VAT tax liabilities accordingly in the VAT declaration for October 2023.

In 2024, the regional Prosecutor’s Office filed a lawsuit with the commercial court to declare the clause of the agreement between LLC “B” and the City Council on inclusion of VAT in the total price of the agreement invalid and charge paid VAT amount from “B” LLC to the City Council budget due to the fact that the agreement was executed during the tax benefit extension period for the relevant product category.

Photo credit
<http://www.archer.ua/>



What happened?

The importer case described above is a situation which one of the Council’s complainants found himself in. However, according to the Unified Pre-trial Decisions State Register, similar lawsuits are initiated against Ukrainian producers even more often than against importers. From the point of view of tax consequences, there are no differences here.



As we can see from the diagram, the supplier’s benefit from including VAT in the price of goods compared to the scenario in which VAT exemption would have been applied was UAH 20. At the same time, in court he is required to return UAH 24 to the customer – 15% more. Of the customer’s potential overpayment, UAH 4 actually went to the budget in the form of the supplier’s tax liability. In the “state’s expectation” scenario, these UAH 20 would not have initially been received by the supplier, since he would have had to offset this amount with a tax credit through a compensatory obligation.

Let's compare the factual part of such cases with the “expectations” of the state.

Event 1 – Importing/Producing goods	
<p>An importer imports goods worth UAH 100. – At the customs, he/she pays UAH 20. VAT + duty – increases his TC by UAH 20.</p> <p>or</p> <p>A manufacturer spends UAH 100 on goods production. He/she pays UAH 20 in VAT when purchasing materials and increases his TC by UAH 20.²⁶</p>	
Event 2 – Preferential VAT taxation regime application	
<p>Transactions with imported goods begin to be exempt from VAT</p> <p>or</p> <p>A manufactured product is exempt from VAT at the time of its manufacture or at the time of sale.</p>	
Event 3 – Selling goods to a non-VAT payer	
Reality <ol style="list-style-type: none"> 1 An Importer/Manufacturer forms the price of the goods (cost price UAH 100 + margin UAH 20 + VAT (20% * (100 + 20) = UAH 24) = UAH 144) 2 The City Council buys goods for UAH 144. 3 An Importer/Manufacturer charges himself a TL on VAT of UAH 24 for the software. 4 Importer/Manufacturer reduces his or her TL on VAT by UAH 20 credit (ultimately: TL = UAH 4; TC = UAH 0) 5 An Importer/Manufacturer pays UAH 4 to the budget. 	State expectations <ol style="list-style-type: none"> 1 An Importer/Manufacturer sets the price of the product (cost price UAH 100 + margin UAH 20 + VAT UAH 0) = UAH 120) 2 The City Council buys goods for UAH 120. 3 The Importer/Manufacturer applies para 198.5 of the Tax Code of Ukraine and charges himself a compensating TL on VAT of UAH 20. 4 An Importer/Manufacturer reduces his PC by UAH 20 (ultimately: TL = UAH 0; TC = UAH 0)
Event 4 – Importer/Manufacturer “repays” VAT	
<ol style="list-style-type: none"> 1 The Prosecutor's Office demands that the Importer/Manufacturer return ~ UAH 24 to the City Council. 2 The Importer/Manufacturer returns UAH 24 to the City Council, of which UAH 4 was previously paid to the budget as. 3 The importer has a cash gap of UAH 4. 	
Funds received <ol style="list-style-type: none"> 1. State – UAH 20 (VAT payment at the customs from the Importer's working capital/ VAT payment by the Manufacturer when purchasing materials + unsold TC) 2. Manufacturer/Importer – UAH 20 (VAT in the price of the goods from the City Council) 3. State – UAH 4 (payment of TL by the Importer/Manufacturer after adjusting the TC) 4. City Council – UAH 24 (working capital of the Importer/Manufacturer at the demand of the Prosecutor's Office) 	Funds were to be received <p>State – UAH 20 (VAT payment at the customs from the Importer's working capital/VAT payment by the Manufacturer when purchasing materials + unsold TC)</p>

²⁶ The description of the situation is presented in a simplified manner, to provide a general picture of the chain of events. The manufacturer usually imports at least some of the raw materials and supplies for its production cycle.

²⁷ The last paragraph of para 32 of sub-para 2 of section XX of the TCU provides for the obligation to charge compensating VAT liabilities on transactions related to defence goods supply outside of state defence procurement contracts.

Where did it all start?

A typical instance of such cases began with the approval of a Program by a local government body²⁸, the tasks of which included providing individual military units and/or territorial communities volunteer formations. The source of funding for the Program was determined to be the local budget and other sources not prohibited by law.

To implement the Program, the Executive Committee of the local council²⁹ was instructed to purchase and transfer certain military equipment to the military unit free of charge upon a written request from the relevant military unit.

The Executive Committee, as the customer, published an announcement on the Prozorro platform about holding open tenders for the purchase of military equipment. In the announcement, the customer usually determined the expected cost of the purchase, **indicating its amount including VAT**³⁰.

Following open bidding results, **a supply contract was concluded between the customer and the winner of the bidding with VAT included in the total cost of goods**. Shipment of goods under the terms of the supply contract was usually carried out by the supplier's means to the customer's warehouse.

It is noteworthy that in the vast majority of cases (but not all) that were investigated, the tender documentation, including the draft supply contract³², did not contain data on the end recipient of goods³³. The customer's warehouse address (place of goods shipment) was not also usually associated with defence entities as the end recipient.

According to information received by the Council from some suppliers about their oral communication with customers, the latter did not consider the possibility of indicating the purchase price excluding VAT, arguing that such an approach could create discriminatory conditions for VAT payers compared to VAT non-payers³⁴. Customers also refrained from designating the entity specified in the list of subparagraph 5 of paragraph 32 of subsection 2 of section XX of the TCU in as the final recipient of the goods the contract due to the alleged lack of an end-user certificate from the relevant entity³⁵.

This implies, largely, it was the customers of goods that **did not create conditions for applying the preferential VAT taxation regime** in this kind of cases. At that stage, presumably, neither the customers nor the suppliers anticipated future tax risks, and the procurement scheme seemed standard.

²⁸ A typical name for the LGA program is "Program of Measures to Prepare Urban Territorial Community for National Resistance for 2022-2024.

²⁹ According to the USRCO, in addition to the executive committees of local councils, the customers in such procurements could also be municipal enterprises or directly local (city, town, village) councils.

³⁰ According to the official resource [Prozorro Infobox](#), Prozorro's toolkit, allows to indicate the estimated purchase price excluding VAT.

³¹ These are cases where in court documents one can track the procurement identifier on Prozorro and get familiar with the draft contract or the signed contract.

³² The Council selectively reviewed open tender announcements and procurement documentation that formed the basis of court cases described in this block.

³³ In some rare cases, the supply contract contains a reference to the end recipient of goods, particularly it is noted that the goods are supplied for the needs of the Armed Forces of Ukraine and other military formations, or a reference to the relevant program to support the Defense Forces.

³⁴ Para 4 of Part 1 of Art. 5 of the Law of Ukraine "On Public Procurement" dated December, 25, 2015 No. 922-VIII defines the public procurement participants non-discrimination principle and their equal treatment.

³⁵ The end-user certificate (EUC) is usually used in the field of foreign economic activity to control international transfers of military and dual-use goods. The EUC form was approved by the [Decree of the Cabinet of Ministers of Ukraine No. 920 dated May 27, 1999](#). The current legislation does not set the EUC form for domestic deliveries in Ukraine. According to information received by the Council from industry enterprises, the use of EUC in the context of defence benefits is not widespread. Including a provision on the end recipient of goods in the contract is a simpler and more sufficient way to confirm the legitimacy of the preferential VAT regime application coinciding with the position of the STS set out, particularly in the ITC dated October 04, 2024 №4701/ІПК/99-00-21-03-02 ІПК.

What does the situation look like now?

According to the data of the USRCD, the cases described above are not infrequent – in 2024 and already in 2025, prosecutors from various regions of Ukraine are filing lawsuits against enterprises supplying goods for defence needs to declare invalid the clause of the supply contract regarding inclusion of VAT in the price of goods and charging this VAT as unreasonably paid³⁶.

Currently, such court cases are being considered at the appellate level, but new proceedings are emerging in 2025, which are being considered in the courts of first instance. Judging by the court decisions available in the USRCD, **the courts mostly rule in favour of the state**³⁷ and charge enterprises VAT amount “unreasonably included” in the price of the supply for the benefit of local budgets.

Ruling in favour of the state, the courts are guided by several arguments. Among them are (1) the presence in the supply contract/purchase announcement of information regarding the needs of the Armed Forces of Ukraine or other military formations, (2) confirmation by other evidence of the fact that goods were actually purchased at the request of military units, (3) the norms of the legislation on local self-government indicating that the customer is classified as an entity providing financing for defence measures within the limits of local budget expenditures, (4) proven exact knowledge of the supplier at the stage of concluding the supply contract regarding the actual end recipient of goods.

As for the few instances of resolving the case **in favor of the supplier**, the decisive argument is the court’s failure to confirm the entity of the end recipient of goods, including failure to provide a certificate of

the final consumer. Under these conditions, the court did not see grounds for applying preferential VAT taxation regime in the respective transactions³⁸. Another argument is that satisfying the claim will actually oblige the supplier as the seller to refund VAT from its own funds without appropriate compensation from the budget, which will violate one of the basic principles of business, which is to ensure equal protection of all business entities by the state, and will put an excessive burden on the defendant³⁹. Thus, in a separate case, the prosecutor tried to prove that the goods corresponded to the UCG FEA code, which fell under the preferential VAT regime, but the court chose to be guided by the customs declaration information⁴⁰.

As of February 2025, there is no final legal position of the Supreme Court in such disputes regarding goods, the end recipient of which is the Defence Forces. However, when satisfying claims, courts often refer to the position of the Cassation Economic Court of the Supreme Court in the case regarding supply of goods intended for preventing and spread of coronavirus disease⁴¹, where **the cassation instance supported the decision in favor of the state** in the dispute on the invalidation of the clause of the supply contract regarding VAT inclusion in the price of goods and charging VAT as unjustly acquired and provided a legal assessment, according to which there was a circumstance of unjust enrichment of the supplier.

Similar, but not identical, are case specifics on invalidating VAT inclusion in the price of goods and its charging **in purchases of fuels and lubricants, where the customers were directly military units**. In this case,

³⁶ The Council’s sampling is 32 court cases (No. (№910/8235/24, 914/2234/24, 922/1398/24, 910/9368/23, 916/2704/24, 914/1695/24, 916/2689/24, 918/564/24, 925/1182/24, 916/2574/24, 910/8079/24, 910/9550/24, 925/696/24, 910/8080/24, 910/6912/24, 914/2230/24, 914/2176/24, 916/2852/24, 905/714/24 (there are court decisions of the 1st or 2nd instance), 914/2177/24, 911/3008/24, 910/12975/24, 910/12163/24, 910/12103/24, 914/1555/24, 918/447/24, 911/3008/24, 904/5782/24, 910/114/25, 910/115/25, 910/116/25, 910/151/25 (proceedings in the case were opened in the court of first instance))).

³⁷ Of court decisions that have entered into legal force, 75% were ruled in favor of the plaintiffs (9 out of 13); of the entire sampling of court decisions, including those that have not yet entered into legal force, almost 80% were ruled in favor of the plaintiffs (15 out of 19).

³⁸ In case №910/8235/24 the court of appeal sided with the supplier (importer), overturned the decision of the court of first instance and dismissed the claim. This case is currently being considered in the cassation instance (in January 2025, the Supreme Court opened cassation proceedings on the prosecutor’s cassation appeal).

³⁹ Case №922/1398/24 was closed in favor of the business in both instances.

⁴⁰ Case №925/1182/24, the prosecutor’s office was denied a claim to charge VAT from the supplier.

⁴¹ Case №916/707/21 was considered in all instances and closed in favor of the state.

parties to the contract did not apply zero VAT rate to such transactions introduced after the introduction of martial law⁴². In addition to the actual VAT amount, in these cases the courts decide to also collect inflationary charges from the supplier and 3% per annum. **The Supreme Court usually sides with the state in this category of cases⁴³.**

It is noteworthy that lawsuits are filed by prosecutors in the interests of the state (in this case, local councils as local self-governments), while the local councils

themselves do not always consider their interests violated and do not always support this approach of prosecutors. Thus, one of the Council's Complainants, as part of his appeal to the Council, provided a letter from the local council to the district Prosecutor's Office, according to which the latter did not specify which interest of the state required prosecutorial protection in court, while the local council was not authorized to influence goods pricing formation and inclusion of certain taxes in its structure.

Criminal procedural consequences

According to the Council's information obtained as a result of communication with businesses, the situation with VAT inclusion in the price of supplies for the Defence Forces also creates criminal and legal risks.

Thus, law enforcement bodies initiate criminal proceedings on the fact of neglect of duty that caused significant harm to

state interests, committed by managers of customers in such procurements as persons vested with organizational and managerial and administrative and economic powers⁴⁵. Naturally, the pre-trial investigation process in such criminal proceedings creates an additional organizational burden not only on the customer, but also on suppliers.

What are possible root causes of this situation?

1. Unawareness. Thus, misunderstanding by customers and/or suppliers of the specifics of the preferential VAT regime application in terms of the end recipient confirmation, as well as the lack of clear official explanations from the State Tax Service, could have led to customers and enterprises acting according to the usual tax schemes, including VAT in the contract, as it was before.

2. Negligence. Customers, as non-VAT payers, could ignore the fact that the price was formed with VAT included, because it did not affect their tax reporting. Suppliers, in turn, had no leverage to change public procurement terms.

3. Corruption arrangements. Deliberate goods overpricing scenarios under agreements between the procurement parties to obtain an undue advantage cannot be ruled out.

⁴² CMU Decree No. 178 of March 2, 2022 established a zero VAT rate for operations on fueling (refueling) or providing ground military transport or other special contingent (in accordance with sub-paragraph "g" of para 195.1.2 of the Civil Procedure Code).

⁴³ Cases No. 911/1870/23, 916/3864/23, 910/12151/23, in which the Ministry of Defence, represented by the Prosecutor's Office, charges the VAT amount groundlessly included in the price of fuel and lubricants supplied to military units.

⁴⁴ From the practice available in the USRCD and from the Council's information of from enterprises that have encountered this situation, it is evident that before filing a lawsuit, the Prosecutor's Office sends a request to the relevant local government body first to establish the violated interest of the state. The local council sent the said response in reply to such a request from the Prosecutor's Office. At the same time, in judicial practice, it can be seen that some LGAs, on the contrary, support the position of prosecutors and are the first to send claims to enterprises for VAT refunds, to which the enterprises usually respond with a refusal.

⁴⁵ Law enforcement bodies classify such actions under Part 1 of Article 367 of the CCU (neglect of duty).

What actions could contribute to the state's correct response to this situation?

Explanation

It is obvious the preferential VAT regime imperfect enforcement subsequently results in a significant bureaucratic and administrative burden on both business and the public sector.

In the open access, you can find quite a lot of STS ITCs with explanations of norms peculiarities on preferential VAT application for defence goods⁴⁶. It shows a tangible demand from businesses for additional interpretation of mechanisms and algorithms, particularly the way of displaying and confirming the end recipient of goods.

In 2023, the Council considered a complaint from a UAV importer regarding its request for an IPC to clarify the preferential regime specifics in the context of defence goods supply to volunteer/charitable organizations. In response to its requests, the importer received two ITCs from the State Tax Service citing provisions of the Tax Code of Ukraine, but not clear enough, in the opinion of the company, explanation of these provisions application.

Considering the above-mentioned request from the business community, as well as the resource-consuming and long-term procedure and the occurrence of legal consequences caused by shortcomings in applying the preferential regime, there are reasons to consider it appropriate for the Ministry of Finance to publish a generalized tax consultation (GTC) on these issues⁴⁷.

In the Criminal Procedure Code, it would be important to cover the following points:

1. Algorithm for confirming the end recipient of the goods status;
2. The mechanism for issuing and obtaining an end-user certificate in the context of preferential VAT taxation of transactions with defence goods;
3. Tax credit use specifics and its adjustment as a result of applying para 198.5 of the Tax Code of Ukraine regarding compensatory obligations accrual;
4. Preferential VAT taxation regime peculiarities application for transactions on defence goods supply to executors/co-executors of a state contract (particularly in terms of this status interpretation).

Planning

We have already noted above when a product becomes exempt from VAT, it is usually beneficial for the buyer, but not always good news for the supplier (particularly, when the product is not supplied under a state defence procurement contract). **For the buyer (e.g., a military unit or a charitable foundation), the abolition of VAT means that the product will cost 20% less than before.** This is important when purchases are made with volunteer or charitable funds: lower tax costs = more WME can be purchased for the same budget.

⁴⁶ ITC dated October 27, 2023 No. 3795/IPK/99-00-21-03-02-06;
ITC dated March 12, 2024 No. 1270/IPK/99-00-21-03-02 IPC;
IPC dated April 2, 2024 No. 1739/IPK/99-00-21-03-02 IPC;
ITC dated 16, 2024 No. 2105/IPK/99-00-21-03-02 IPC;
ITC dated April 22, 2024 No. 2267/IPK/99-00-21-03-02 IPC;
ITC dated September 16, 2024 No. 4482/IPK/99-00-21-03-02 IPC;
ITC dated September 27, 2024 No. 4655/IPK/99-00-21-03-02 IPC;
ITC dated October 4, 2024 No. 4701/IPK/99-00-21-03-02 IPC;

⁴⁷ A generalized tax consultation is **publication of the central executive body's position** ensuring formation and implementation of state financial policy based on practical use of individual norms of tax and other law, control over compliance with which is entrusted to regulatory authorities, **which is formed based on the of individual tax consultations generalization results** provided by regulatory authorities to taxpayers, and/or in the event of the identification of circumstances indicating the ambiguity of individual norms of such legislation (para 14.1.173 of the TCU).

However, the situation is less favorable for the seller – if goods are imported, the seller has already **paid VAT at the customs, included it in the tax credit, but after applying the benefit**, he or she has to reduce this credit. This actually means that he or she **loses the opportunity to compensate this tax. The situation is similar for local manufacturers** – they purchase components or materials with VAT, but cannot take this tax credit into account when selling VAT-exempt goods, which results in cash gaps and reduced profitability.

While this configuration can apply to any industry, it is currently **most relevant and tangible for the supply of goods in favor of the Defence Forces**, since the preferential goods list is periodically expanded⁴⁸, the legislator exempts new commodity codes from VAT. A supplier may purchase or import goods with VAT, not planning that in a few months they will fall under exemption. In this case, he actually finds himself in a situation where he or she has to sell goods **at a lower price than he expected** (excluding VAT) and cannot compensate the previously paid tax.

It is worth noting that para 4.1.9 of the Tax Code establishes the principle of “stability”, according to which changes to any elements of taxes and fees cannot be made later than six months before the beginning of the new budget period, in which new rules and rates will be in effect. Taxes and fees, their rates, as well as tax benefits cannot be changed during the budget year. And according to para 4.5 of the Tax Code, when establishing or expanding existing tax benefits, such benefits are applied from the next budget year.

The Council and society understand the priority of ensuring the needs of the Defence Forces, therefore, asks the Ukrainian Government to regulate the negative enforcement practice at the level of explanations of the relevant ministries, tax and customs authorities, which arises due to new taxation rules application in the reporting period in which they were adopted.

Therefore, planning VAT exemption for defence goods requires attention and a careful approach.

Suggested next steps:

1. **To prepare and publish a generalized tax consultation** (the Ministry of Finance, State Tax Service) on preferential VAT taxation regime issues for transactions on goods supplied to ensure national security and defence, repel and deter armed aggression of the Russian Federation against Ukraine, particularly application specifics of the provisions of sub-paragraphs 4 and 5 of para 32 of sub-section 2 of section XX of the Tax Code of Ukraine.
2. **To improve the analytical approach to planning the expansion or narrowing the list of preferential commodity codes for defence needs goods** (the State Customs Service, State Medical Service, Ministry of Economy, Ministry of Strategic Industry, Ministry of Defence), including the preferential VAT regime effectiveness and balance overall assessment for defence goods, potential business losses assessment when changing the VAT regime for specific goods, forecasting the consequences for the state budget (including the impact on the liquidity of enterprises), determining the transition period for applying the benefit if the goods have already been imported or purchased with VAT, and monitoring business requests for preferential nomenclature expansion with evaluating consequences for the defence sector.

⁴⁸ By laws № 1658-VII від 02.09.2014, № 2628-VIII від 23.11.2018, № 2120-IX від 15.03.2022, № 2173-IX від 01.04.2022; № 3019-IX від 10.04.2023; № 3287-IX від 28.07.2023; № 3522-IX від 20.12.2023; № 3853-IX від 16.07.2024 the list of goods exempt from VAT by para 32 of sub-section 2 of section XX “Transitional Provisions” of the Tax Code of Ukraine has been expanded. The largest expansion was introduced by the Law No. 3019-IX of April 10, 2023, which entered into force on May 3, 2023.

BLOCK 3.

VAT on repairs = more expensive services = impact defence capability

In the last few years, **the state has gradually increased expenditures for the purchase, upgrade and repair of military equipment.** During the martial law regime, these expenditures increased 19 times compared to 2021, and amounted to: UAH 26.4 bn (in 2021), UAH 294.7 bn (in 2022), UAH 370.3 bn (in 2023), UAH 480.2 bn (in 2024) and UAH 488.4 bn (according to the forecast in 2025)⁴⁹.

Apparently, the state's expenditures on procurement and repair were combined in one program due to the fact that some of the equipment purchased or transferred under international technical assistance projects is supplied after dismantling some of the modules/kits or requires technical repair and upgrade.

Unlike new military equipment and some of its spare parts supply⁵⁰, **their repair and modernization services are subject to VAT⁵¹.** It creates financial pressure on the main repair customers – military units and state institutions, which are not VAT payers and have to pay it as part of the repair price – due to the limited budget allocated for repairs to such a customer by the state. As a result, it is possible to repair fewer pieces of equipment for funds allocated by the state, and repair companies lose some of their orders. Therefore, the question arises whether this way of budget filling is indeed of higher priority than providing the front during the war.

⁴⁹ Appendix 3 “Distribution of Expenditures of the State Budget of Ukraine”, item of funding of the budget program under code No. 2101150 “Development, Procurement, Modernizing and Repair of Armaments, Military Equipment, Means and Equipment” to the Law of Ukraine “On the State Budget of Ukraine for 2025” dated November 19, 2024 No. 4059-IX, the Law of Ukraine dated November 9, 2023 No. 3460-IX, the Law of Ukraine dated November 3, 2022 No. 2710-IX, the Law of Ukraine dated December 2, 2021 No. 1928-IX, the Law of Ukraine dated December 15, 2020 No. 1082-IX.

⁵⁰ In accordance with para “g” of para 195.1.2 of the TCU, transactions for the supply of goods for fueling (refueling) or providing ground military transport or other special contingent of the Armed Forces of Ukraine participating in peacekeeping operations outside Ukraine, or in other cases provided by law, are taxed at a zero VAT rate ; CMU Decree No. 178 of March 2, 2022 (Decree No. 178), which entered into force and is applicable since February 24, 2022, established a zero VAT rate for goods (spare parts, batteries, coolants, etc.) for vehicles and fuel and lubricants for the Armed Forces of Ukraine and other structures for the needs of ensuring the national security and defence of Ukraine, protecting safety of the population and interests of the state.

⁵¹ The zero VAT rate is not applied to transactions for delivery of services, including vehicle maintenance and repair services. Transactions for these services provision are subject to taxation at a rate of 20%, regardless of the category of entity to whom such services are provided.

CASE:

“B” LLC is a Ukrainian company specializing in heavy weapons and self-propelled guns repair. In 2024, the military unit announced a tender for the repair of two self-propelled guns that required major restoration after damage received as a result of hostilities. The state allocated UAH 1 mn for these works.

“B” LLC calculated the cost of repairing one self-propelled gun at UAH 500k excluding VAT. However, this amount required adding VAT (20%), which increased one gun repairing cost to UAH 600k. The total repair cost of two units of equipment would have been UAH 1.2 mn, which exceeded the tender budget. As a result, the military unit had to reduce the order to repair only one self-propelled gun for UAH 600k.

For “B” LLC it also had negative consequences. The order for one unit of equipment instead of two led to a drop in total revenue by UAH 500k. Although the company continues operating under current tax rules, the restriction of orders due to VAT reduces its production facilities utilization. This affects the overall ability of the company to participate in new defence projects and scale up its own activities.

Spare parts for repairs – is there a zero VAT rate?

According to the current regulation established by the Decree No. 178, spare parts for repair of military equipment (goods) are not subject to VAT, however, repair works (services) must include the VAT amount. The “transport provision” legal category” not defined in current legislation, creates room for questions and ambiguous interpretation. Does the supply of materials/spare parts fall under this category together with the service or as part of military vehicles repairing service?

In professional circles, there is an opinion that the term “transport provision” means the supply of goods to equip vehicles with everything necessary for them to perform their tasks. The definition of

“repair” refers to restoration of working order (functionality) or working capacity of products or their component parts resource restoration, therefore, it does not fall under “transport provision”.

In our view, whether the respective legal categories overlap depends on the approaches of fiscal authorities and the answer to the question: “the essence of ensuring transport – so that it **works** or exclusively **starts working**?” If the second option is true, then these are incompatible categories.

However, the State Tax Service has now formed a position in its individual tax consultation on whether the zero VAT rate

⁵² “What VAT Rate Should Be Applied When Providing Maintenance and Repair Services for Vehicles for the Armed Forces of Ukraine Needs?” Debit-Credit No. 03 dated 01/16/2023.

⁵³ Order of the Ministry of Transport No. 102 dated March 30, 1998 “On Approval of Technical Maintenance and Repair Regulation of Road Vehicles of Motor Transport”.

applies to operations for supplying spare parts used in the repair and maintenance of vehicles of military units and other customers listed in the Decree No. 178.

Thus, if **spare parts or other goods are an integral part of a certain service** (particularly for vehicles maintenance and repair), and **their cost is included in the total cost of such service, supplying each of the individual components of such service is not considered a separately determined transaction for the purposes of VAT taxation**. The transaction for delivering a service as a whole, and not its individual components, is **subject to VAT in the generally established manner at a rate of 20%**⁵⁴.

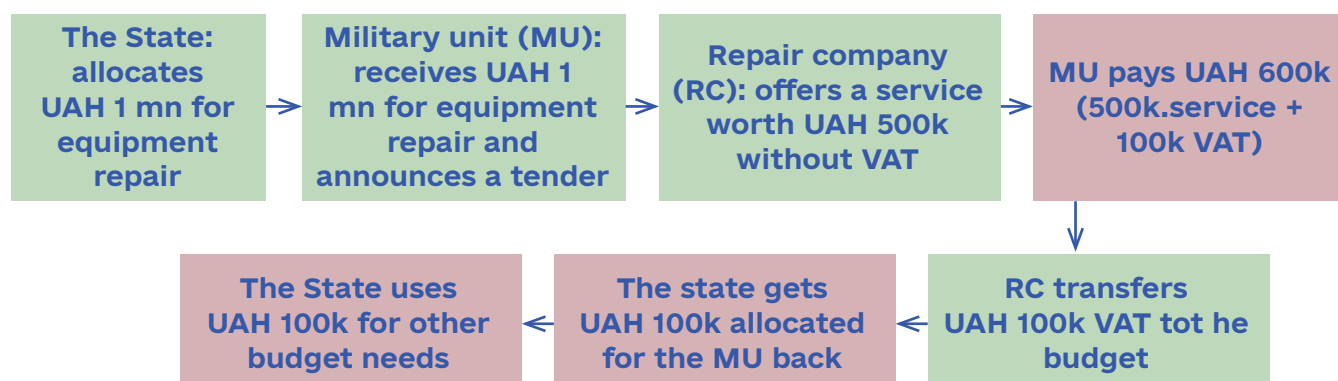
From the above explanation of the State Tax Service, we can conclude that the rules for

VAT taxation for these transactions are as follows: 1) parts supply – 0% VAT; 2) repair services provision – 20% VAT; 3) parts supply as part of a repair service – 20% VAT. In the Council's standpoint, to increase the repair works volume and reduce their cost, it is expedient to provide a preferential VAT taxation regime for both repair goods supply and services delivery.

Repair companies representatives informed the Council in their activities they encountered cases of refusal or reduction of orders due to an increase in the cost of services by the VAT amount, and also confirmed the willingness of customers and their own technical ability to increase the repair works volume upon introducing zero VAT taxation.

The mechanics of VAT “flow” from one pouch of the state to another:

Since renovations are financed mostly from budget funds, paying VAT actually means redistributing funds within the public sector without creating additional value.



⁵⁴ ITC dated November 12, 2024 No. 5226/IPC/99-00-21-03-02 ITC.

What are the advantages and disadvantages of this approach for the state?

Pros:	Cons:
1. Use of funds flexibility: funds returned to the budget in the form of VAT can be used to finance not only defence needs, but also other areas, such as social payments.	1. Reduced defence funding efficiency: funds that could be used to repair or upgrade an additional piece of equipment are effectively “dropped out” of the defence funding cycle.
2. Transparency and control over finances: VAT on services allows for better tracking of funds flow and control over their use.	2. Administrative costs for “self-service”: making VAT payments, their administering, control and their transferring back to the budget create an additional burden on the state apparatus.
3. Keeping budget revenues: returning part of the defence budget in the form of VAT allows maintaining the overall level of budget availability	3. Economic efficiency distortion: The MU and other customers may make decisions based not on rational criteria such as speed of execution, quality, or current front-line needs, but on financial considerations and tax rules.

How do current tax conditions affect the working capital of a repair company?

Working capital is the funds and assets used by a company for current financing of its activities, for example, for purchasing materials, labor paying, paying suppliers, etc.

By delivering repair and modernization services, mostly to a state customer⁵⁵,

the enterprise actually “freezes” its working capital for a certain period of time. Thus, when purchasing components and materials for equipment repair, the enterprise pays VAT (20%) and recognizes it as part of the tax credit.

⁵⁵ According to the Council’s personal communication with repair companies representatives, 90% of orders are financed by state orders.

However, when selling services to a military unit (which is not a VAT payer), it is impossible to offset this VAT against the tax liability. It turns out that the funds are actually “stuck” in the tax credit, which cannot be used immediately – you have to wait for an order from VAT payers, or refund VAT from the state budget. Specialized enterprises confirmed to the Council problems with the budget VAT refund, so the management in charge decides to credit VAT amounts paid to cover liabilities in subsequent periods.

Accordingly, it reduces the working capital that the enterprise can use for its

activities. However, “freezing” of part of the enterprise’s funds in the form of a tax credit alongside with the risk of delays in paying for a state order creates significant cash gaps in the business cycle, and is covered by external borrowings (credits, financial loans). Despite the above-described problems with the enterprise’s funds turnover, it is obliged to pay VAT in a timely manner and in full in the reporting period from its own funds until the moment of receiving payment for the state contract. This again creates a burden on the liquidity of the enterprise (the funds “came out”, but have not yet returned to turnover).

Preferential VAT regime for services – is it practiced in Ukraine?

As a general rule, the zero VAT rate does not apply to transactions for the provision of services (unlike goods for the Defence Forces in accordance with the above-mentioned CMU Decree

No. 178) within the territory of Ukraine. Almost all services within the country are taxed at the standard VAT rate (20%). The only exceptions are certain services related to international transactions (e.g., international transport services⁵⁶).

Preferential treatment for repairers – what’s up with the chain?

If the state considers the option of introducing a preferential VAT taxation regime for military equipment repair and upgrade services, the first question to arise is whether this taxation regime applies to the entire supply chain as part of the relevant service.

As a rule, the main contractor (repair company) to perform repair or modernization works on WME involves subcontractors supplying parts, components or perform works partially

(e.g., repair of electronics, armor, engines, etc.).

Let’s consider two scenarios:

1. Zero VAT rate is not extended to transactions with “subcontractors”

This scenario involves the following algorithm: (1) a repair company purchases spare parts from a supplier (“subcontractor”); (2) the supplier charges 20% VAT on spare parts; (3) the repairer pays VAT as part of the cost of the spare parts and increases his or her tax credit;

⁵⁶ Para 195.1.3 of the TCU, example: a repair company provides maintenance services for a cargo ship transporting goods internationally.

(4) when the repairer provides a service at a zero VAT rate, he or she does not transfer this amount to the budget, but retains the right to refund the input VAT paid when purchasing spare parts.

The current tax conditions are technically closer to this scenario – currently the tax credit actually “sinks” with the repair company as the final contractor. The latter pays the VAT tax liability accrued for repair services at a rate of 20%, but this directly affects the price of these services for the customer by increasing it.

2. Zero VAT rate is applied to transactions with “subcontractors”

In this scenario, the algorithm is slightly different: (1) a repair company buys spare parts from a supplier (“subcontractor”); (2) the supplier sells spare parts at a zero VAT rate; (3) a repairer receives spare parts without charging VAT, therefore, he or she does not generate a tax credit; (4) when the repairer provides a service at a zero VAT rate, he or she does not pay VAT to the budget either.

The main difference: in the second scenario, no participant in the supply chain pays VAT and does not generate a tax credit, which simplifies the funds flow, but at the same time complicates control over the use of goods.

From the point of view of administration and tax control, **the first scenario may be potentially optimal for the state**, given the following:

- **All previous suppliers operate under VAT system (20%)** – therefore, there is no need to separately check their status or confirm the military use of goods;
- **The tax credit is not “dispersed” throughout the supply chain** – it is consolidated by the final contractor (repair company), which submits a request for a budget refund.
- **There are fewer risks of “disguising” civilian products as defence products**, because only those having a **direct government contract for defence repairs can receive a tax credit**.

Potential alternative

Among the solutions that do not involve changing the VAT rate or VAT exemption, one could consider introducing a special VAT taxation regime⁵⁷, particularly for military equipment repair services.

The main objective of the special regime is to maintain the current VAT rate (20%), but allow the customer to pay the cost of repairs without VAT, and the repair company to issue an invoice without VAT, while maintaining the tax credit for purchased materials (the SEA VAT automatically “counts” the VAT paid by the repairer for spare parts as a tax credit, allowing him to use it in future transactions).

⁵⁷ As an example, until 2017, Ukraine had a special VAT taxation regime for agricultural enterprises, which operated through special accounts in SEA VAT. Its essence was that agricultural producers did not pay VAT to the budget, but left it in a special account for use in their activities.

Suggested next steps:

- 1. To investigate the impact of the current VAT taxation system on the of defence financing effectiveness** (the Ministry of Finance, Accounting Chamber, Ministry of Defence, Ministry of Economy): (1) to do a comprehensive analysis of the financial effect of VAT payment by repair companies (the amount of VAT paid, its actual use in the budget, and impact on the total number of repaired/modernized equipment); (2) to assess whether it is advisable to redirect part of these funds directly to additional military equipment repair instead of returning them to the budget; (3) to audit cash gaps that enterprises face due to “freezing” of funds in the tax credit and delays in budget payments; (4) to determine what percentage of all defence spending is spent on VAT in the repair and upgrade area.
- 2. To study the possibilities of introducing a zero VAT rate or special taxation regimes for the period of martial law for military equipment repair and/or upgrade** (the Ministry of Finance, State Tax Service, Verkhovna Rada Committee on Finance, Tax and Customs Policy, Ministry of Defence): (1) to prepare legislative amendments to Article 195 of the Tax Code of Ukraine to introduce a zero VAT rate for military equipment repair and modernization transactions under state contracts; (2) to conduct a legal assessment of such a decision in the context of Ukraine’s agreements with international partners (particularly the EU and the IMF); (3) to define clear criteria for enterprises that can benefit from the zero VAT rate to avoid possible tax schemes.

Eliminating barriers to doing business in Ukraine



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