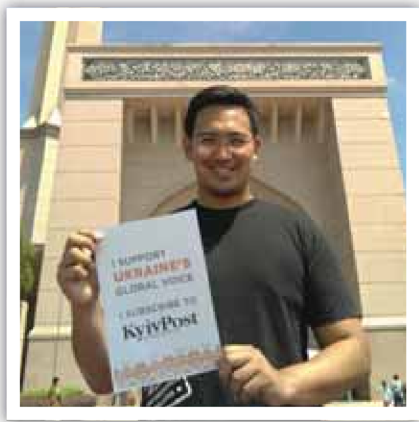
KyivPost | LEGAL QUARTERLY

December 25, 2015, Vol. 2, Issue 4

# A Taxing Situation

## The quest to raise and spend less than $40 billion in 2016





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# Editors' Note

By the time this Legal Quarterly went to the printer on Dec. 21, the fate of Ukraine's tax code and budget for 2016 was uncertain. Attempts were made to reconcile versions of Finance Minister Natalie Jaresko and another one promoted by lawmakers Nina Yuzhanina and Tetiana Ostrikova.

The Kyiv Post has not read the tax and budget proposals in detail and we doubt many people have done so. This is one of the problems with Ukraine's perpetual crisis management. A well-run country would not be debating next year's tax code and budget this close to New Year's Eve. However, even the United States shuts down its government on occasion because of partisan gridlock. By comparison, Ukraine's state budget is small – less than $40 billion compared to America's $4 trillion yearly. But Ukraine's public spending amounts to more than 40 percent of Ukraine's expected gross domestic product next year of $94 billion.

Transparency, policy and the public's right to know suffer when legislation gets rammed through at the last minute. Often, the public doesn't find out until later the effect of new laws. Absent effective budget watchdogs, the public often takes the side of the officials they trust. The International Monetary Fund, Ukraine's fiscal referee, sides with the version put forward by Finance Minister Natalie Jaresko because it would limit deficit spending to 3.7 percent of GDP. Since Ukraine still needs IMF and Western loans, adopting the Jaresko plan would seem to be the logical choice. But hopefully, if the crisis atmosphere ends, Ukraine's leaders will get around to constructing a durable, progressive tax code in which voluntary compliance is high, everybody pays their fair share and the money is well-spent.

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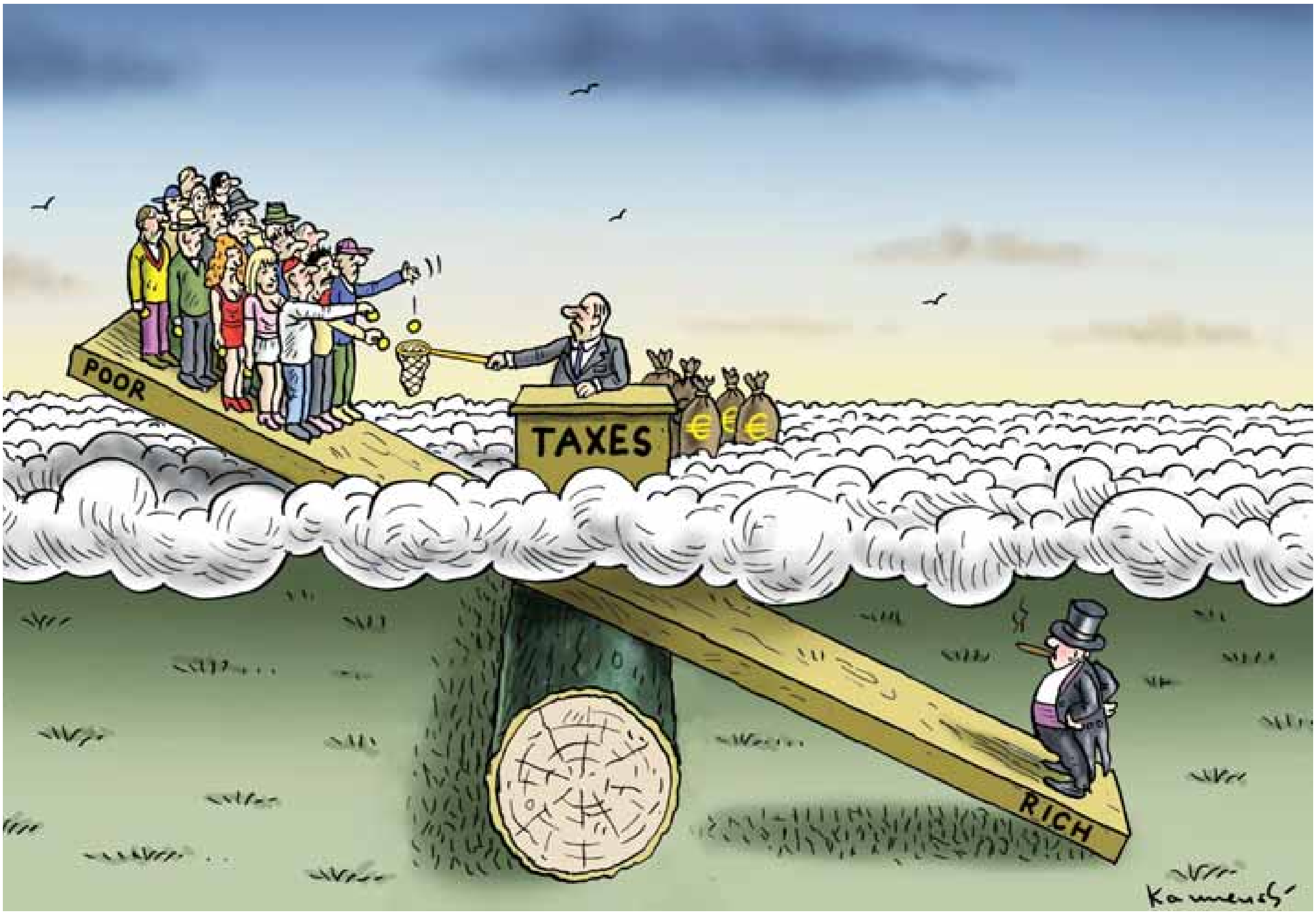
# Contents



**Cover: As of Dec. 21, Ukraine's politicians still had not agreed on a budget for 2016. To meet International Monetary Fund requirements for loans, the state budget deficit must be no larger than 3.7 percent of gross domestic product, which is expected to be $94 billion next year. (Depositphotos)**




In many societies, the poor end up paying more of their share of income in taxes than the rich. In Ukraine, tax evasion is rampant at all levels, including among the wealthiest citizens and largest businesses.

# Taxes, budgets reveal a nation's priorities, values and compassion

*Franklin Delano Roosevelt had it right: Taxation should be progressive, or based on the ability to pay – with the richest who benefit the most from the economy paying the largest share. But there are limits.*

**Brian Bonner**
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Most people have a hard time getting excited about taxes and government budgets. I love these discussions, but not because I am a policy wonk.

Show me a nation's tax code and I will show you its priorities – whether it favors the rich, the poor, promotes equal opportunities, whether it aims to increase economic opportunities for everyone or just the select few. In short, taxes and budgets reveal much about whether a society is fair, compassionate and just.

Taxes redistribute income – either up or down or just all around. They are the money we throw into the collective pot for public services. Elected politicians (if one is lucky enough to live in a democracy) decide where the money goes.

If a tax code favors the rich, they will become richer, income inequality will grow and the economy will become distorted in a way that works against the vast majority of people in every nation – the working classes who are poor or swimming hard to stay in the middle class.

Too often in nations, privileges for the rich are hidden in the tax code, through exemptions for certain types of economic activity, lower rates for type of income (investment versus payroll) and many other tailor-made favors.

It's often done on the tax side of the ledger, because it would be political suicide (one would hope) to support budgeting billions of dollars for billionaires or multinational corporations.

My country, America, never had an income tax until 1913 – allowing for great fortunes to amass for centuries without much going for the public good. Some people think this was a great era. I think it was horrific. I am a Franklin Delano Roosevelt Democrat and believe, as America's greatest president did, that the best way to tax is on the ability to pay – a progressive income tax in which those who benefit the most from the economy also pay the most in taxes.

There is a limit, however. Maybe there are studies that back me, but any time the tax burden is higher than 33 percent, people start looking for ways to evade taxes – perhaps even 20 or 25 percent is the trigger for this behavior in some people. Despite the liberal in me, income tax rates above 33 percent strike me as confiscatory and detrimental to the economy.

America in 1913, while on its way to becoming one of the world's great economic engines, would have been better with a progressive income tax in place much earlier. Public education didn't take hold until the 19th century – which, combined with the lack of income tax, allowed wealth and knowledge to accumulate for generations among the elite few. The pre-income tax era of America was also one of labor exploitation, legalized racial inequality and such extremes in wealth that growing old was frequently a sentence of poverty or dependence.

Those are not the good old days – yet many in Congress, which fronts for wealthy donors in my view, want to drag America back to those barbaric times. Not a chance, if my vote counts for anything. I support strong public education, so university students don't go into debt; equal opportunities and labor unions, so working people can get ahead; and a retirement in which the elderly's net worth increases, because of pensions, social security and private savings, so they can live out their golden years in dignity. I also believe in modest inheritance taxes for anyone with more than $1 million in assets.

So what do the tax-and-budget policies of Ukraine, my second homeland, say about its society?

It's not good. The portrait presented is one of an unfair, cruel nation.

First of all, most of the wealthiest businesses and people dodge taxes through offshore tax havens and accounting schemes – through abuse of transfer pricing and other ways – that minimize the taxes payable in Ukraine. This is a continuation of behavior that started when the oligarchs made their first fortunes in post-Soviet Ukraine on the cheap, through scandalous insider deals in the first wave of rigged privatizations.

Secondly, the way Ukraine treats many classes of people is simply awful. The elderly, government workers from school teachers


**Ukraine's economy has relied on exports of steel and agricultural commodities. Moving to diversify and modernize the economy has been difficult, considering vested interests that favor the status quo and keep obstacles in place to discourage foreign direct investment.**



to garbage collectors, and students – all are treated shabbily by public policy. It is hard to see a society advancing under such conditions.

Thirdly, the byzantine and corrupt tax collection system put in place by people like ex-President Leonid Kuchma and ex-Prime Minister Mykola Azarov encouraged capital flight, tax evasion and the explosion of a shadow economy, which hovers around 40 percent of gross domestic product. Those who pay their taxes look like fools who put themselves at a competitive disadvantage. Not enough has been done to erase the damage.

So Ukraine is left with the ability next year to levy taxes on $94 billion in official economic activity – the forecasted amount of gross domestic product, even though the real size of the economy might be twice that high but goes hidden in the shadows.

Ukraine's state budget comes to $38 billion, less than half of New York City's municipal budget, but 40 percent of its entire GDP. The big four sectors of the budget are almost untouchable: defense & security spending (given Russia's war), pensions, debt service and education. So public officials such as Finance Minister Natalie Jaresko are left with trying to weed out the fraud and privileges, simplifying matters and hoping for the best.

Ukraine has much to do to get out of this downward spiral – more fairness, more growth and more effectiveness in government spending are three keys. Only if these elements fall into place will more people and employers be willing to come out of the shadows and pay their taxes.

America has a high rate of voluntary tax compliance for two key reasons.

Firstly, people see how their tax dollars improve society.

Secondly, people are afraid of the Internal Revenue Service. I had a run-in with our tax collection agency 30 years ago and never forgot the lesson: Declare income and pay taxes or else, sooner or later, the IRS will find you and you will end up paying more. In most cases, tax evasion is not an option – the government deducts the taxes from the average employee's paycheck.

Compliance not only applies to income taxes.

> **Tax evasion is rampant in Ukraine because most people believe that their money will not be well-spent by the government. Meanwhile, the wealthiest in Ukraine have created many tax-optimization or tax-evasion schemes.**

The genius of the American tax system is that people cannot avoid taxes. They are broad-based and everywhere. We have income taxes – national, state and even local. We have sales taxes on all levels. We have real property taxes, not the nominal ones that Ukraine is only starting to introduce. We have excise taxes, so every gallon of gas purchased is already taxed. The list goes on and on. In the end, however, tax rates in America are low compared to many European countries. One reason is that everyone pays. It can be argued whether everyone pays their fair share or not, but everyone at least pays.

My hope for Ukraine is that its tax and spending policies in 2016 reflect the best of its values, not the worst of them. ■


**Few people love paying them, but taxes are essential to funding government services, including education, infrastructure, defense and pensions.**


A woman smokes and drinks coffee in Kyiv on Dec. 16. (Anastasia Vlasova)

# Ukrainian officials appear to be doing tobacco industry's bidding in keeping low taxes

*Lawmakers are looking at raising cigarette taxes by only 20 percent – about half the inflation rate – effectively decreasing taxes in a nation that still suffers from high smoking rates and where cigarettes remain cheap. Imposing high taxes on cigarettes is the best way to reduce smoking.*

By **Isobel Koshiw**
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Ukrainian officials appear to be lobbying on the side of the tobacco industry once again.

On Oct. 5, the Ministry of Finance proposed a 40 percent tax increase on cigarettes – bringing the price in line with inflation, like any other consumer product.

The parliamentary tax and customs committee, however, has countered the ministry's proposal, arguing for a 20 percent increase – about half of the official inflation rate.

In other words, such a small increase will effectively make Ukraine's cheap cigarettes even cheaper, which spurs smoking. Nearly 100,000 people die prematurely each year in Ukraine from smoking-related diseases.

The sharp currency devaluation – in which the Ukrainian hryvnia has lost two-thirds of its value in two years – has allowed lawmakers to promote a tax decrease as a tax hike.

In 2014, tobacco companies paid taxes of Hr 240 per 1,000 cigarettes and in 2015, this rose to Hr 300, according to a video released by industry expert Konstantin Krasovsky on Dec. 7.

The average exchange rate in 2014 was Hr 12/$1; thus far in 2015 it has been Hr 22/$1. This means the tax amounted to $20 per 1,000 cigarettes in 2014 compared with $13.6 in 2015.

Therefore, if the increase in 2016 is only 20 percent, $15.1 will be paid per 1,000 cigarettes at the current exchange rate of 23.75; for the 40 percent hike, the tax reaches $17.7 – raising the price of a cigarette pack by Hr 5 to Hr 8, or merely $0.21-$0.29.

"As a comparison, bread has seen a 70 percent price increase whereas cigarettes have only seen a 20 percent price increase. Therefore cigarettes have become more affordable," said Andrey Skipalskyi, president of the Ukrainian Center for Tobacco Control. "A 40 percent (tax increase) is already a compromise and doesn't include the real price increase."

In his video, Krasovsky argues that if the excise tax increases by 40 percent, annual revenues to the state budget will increase by Hr 7 billion – a figure he based on a 10 percent decline in the number of smokers. But if parliament decides on a 20 percent increase, the budget will receive Hr 4 billion, a figure which relies on demand remaining the same.

The tobacco industry is famous for its underhanded lobbying tactics.

One of the difficulties for anti-tobacco groups is that there is no definition of lobbying in Ukrainian law.

"You can't track the money or the members of parliament being paid…So what we do is monitor their statements and if someone is overtly pro-tobacco we shame them by calling them tobacco lobbyists," said Skipalskyi.

According to Skipalskyi, the tobacco companies in Ukraine in recent years have fought hard against any increases in taxation. Higher taxes on cigarettes have been proven to be very effective in getting smokers to quit and preventing people from even starting.

Skipalskyi said the tobacco industry is on good terms with parliament's tax committee head, Nina Yuzhanina, a member of the Bloc of President Petro Poroshenko, who defends her position as "pro-business," according to Krasovsky and Roman Nasirov, her predecessor who is now head of State Fiscal Services.

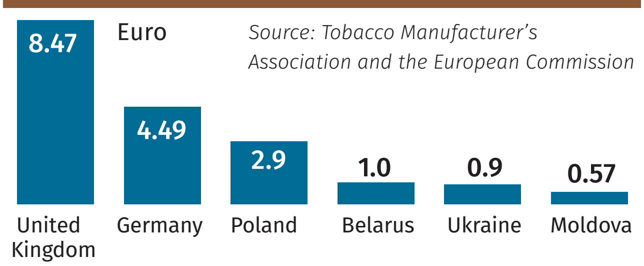
Nasirov has argued against sharp tax increases on cigarettes , saying they will exacerbate Ukraine's problem with illicit trade. But anti-tobacco groups accuse Nasirov and other officials of using this as an excuse.

"Every year they keep repeating the same mantra that it would increase illicit trade…It's very important to separate illicit trade and tax policy. It's up to the customs officials to police illicit trade on both sides. In Ukraine and in Poland," said Skipalskyi.

Likewise Krasovsky pointed out that the problem with illicit trade is with cigarettes manufactured in Ukraine, not cigarettes coming from abroad.

An investigation conducted by investigative journalist Vlad Lavrov in 2009 asserted that the cigarette manufacturers in Ukraine are complicit in the illicit trade - estimated to be worth $2.1 billion a year. The

**The average price for a pack of cigarettes 2015**




**Ukraine has some of the cheapest, lowest-taxed cigarettes in Europe, fueling illegal smuggling and contributing to higher smoking rates, poor health and early death.**


**A woman shows her passport as proof of age at a cigarette kiosk on Dec. 16 in Kyiv. (Anastasia Vlasova)**

investigation found that manufacturers produce a 30 billion cigarette surplus because of the country's cheap production costs, which they then sell to smugglers at the same price as to a legal wholesaler.

Skipalskyi told the Kyiv Post that only the introduction of expensive tracking systems would allow customs officials to trace cigarettes back to a particular factory.

Japanese Tobacco Incorporated, Philip Morris and British American Tobacco, three of the four biggest manufacturers in Ukraine, said they only sold to licensed distributors.

## Public health advocates: Ukraine needs higher cigarette taxes

"If tax represents 70 percent of the retail price, the number of smokers would decline by almost 2 million, and about 1 million tobacco-related deaths would be avoided. At the same time, the government would collect an additional Hr 5.8 billion ($246 million) in excise tax revenue per year."

*Source: Economics of Tobacco Taxation in Ukraine*

## Benefits of higher cigarette taxes

The enactment of progressive tobacco tax policy in Ukraine will:

- Save lives
- Slow the population decline
- Reduce the number of people using tobacco
- Increase labor productivity
- Boost economic growth

*Source: Economics of Tobacco Taxation in Ukraine*

The Ukrainian budget has benefitted significantly from tax increases on cigarettes. Between 2008 and 2015, the tax on cigarettes increased almost 10 times -- from Hr 29 to Hr 300 – and state revenue increased from Hr 3.6 million to Hr 18.1 million.

Besides the revenue boost, higher cigarette taxes improve public health. As prices rose, according to Ukrainian State Statistic Service, the number of smokers in Ukraine decreased from 10.1 to 7.7 million people.

Finance Minister Natalie Jaresko agrees. In a statement on Dec. 8, Jaresko told reporters:

"The question of tax increases is painful one. However, from the point of view of the country's health, I can't not talk about it, because in every country excise tax policy is considered together with the health policy of the country. Because money from our budget also goes to health care," said Jaresko.

This is a big step according to Skipalskyi: "Before Jaresko, I had never heard a minister view taxes in terms of health benefits."

Krasovsky, a veteran anti-tobacco activist, said the government's position is more important than that of parliament committees when lawmakers vote. Tobacco companies are producing more now in anticipation that the tax will go up next year, Krasovsky said, so Ukraine's state budget won't see benefits right away.

While Japan Tobacco International did not comment, Philip Morris and British American Tobacco said that tax increases should be gradual and take consumer income into account. ■

# Tax disputes trigger criminal investigations — current threats for taxpayers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Tax dispute after  tax audit is not the worst thing which faced by a taxpayer.

If additional tax assessments exceed a minimal threshold (currently UAH 609,000 now about $ 25,500) set by Article 212 (Tax Evasion) of the Criminal Code, then a criminal investigation will likely be opened. Internal regulations of the fiscal service require making submissions to investigation body, which under the Code for Criminal Proceedings shall open criminal investigation automatically. Since July of last year, such submission shall be done under this regulation after administrative appeal procedure is passed. Earlier it was due just after issuance of ab assessments-notification to a taxpayer.

Due to this practice, tax authorities, the tax militia and the militia (police), currently handle thousands of tax-related criminal cases, which in reality are bubbles and have no real basis for investigation. As a result, less than 5% of overall tax-related criminal cases go to courts. This percentage show that criminal investigations against business are mostly used by authorities as a means of pressure, rather than fighting real crime. For instance in March 2014, the General Attorney's Office reported closing as groundless 23 criminal investigations for tax evasion that had been opened against the Roshen group of companies. Therefore, this issue is known even to the current President personally, due to his link to this group of companies.

In 2014, we see practically some relief of this matter. Moreover, the issue was noted even in the Coalition Agreement of the current majority in Parliament signed November 2014. Section 3.5 of the Coalition Agreement declared refusal from punitive model of tax control, which shall be achieved, inter alias, by (subpara 3.5.6.) prohibiting at legislative level of criminalization of tax matters at least until additional tax assessments are finally confirmed through due process.

Yet, the above remains merely promises for the moment. In practice in 2015, we see return of the old practice. Virtually any substantial tax dispute automatically triggers criminal investigation launch on tax evasion.

Launching of criminal investigations in such cases is almost inevitable. But it does not mean that it not painful and cause no problems for businesses. To start, there is harassment of the businesses by calling officers of the company for interrogations, demanding provision of documents, etc. This makes businessmen nervous. Nobody is happy if a criminal investigation is in progress.

Even the fact of a criminal investigation may cause real problems for businesses. For instance, provision of documents in the course of criminal investigation under the Code for Criminal Proceedings shall be done normally based on approval of the respective court. Court resolutions allowing access to documents are public, available in electronic register of court awards. It becomes already routine procedure for businesses to check this electronic register for any negative information on potential counterparts. Court resolution allowing access to documents of a company for criminal investigation is considered negative information on the company. Under the Code, permission may be granted by the court only if the investigator proves that there are sufficient grounds to believe that the crime has occurred. Some companies have faced issues with potential clients or creditors (banks) who denied keeping contracts with the companies in respect of which the procedural awards were served due to such negative information.

That's not the end of the story. The main risk is that nobody can clearly predict where the investigation will rule finally. Tax police have their own interests in demonstrating 'achievements.' If the taxpayer loses a case in administrative court and pays assessments, chances are high that the case may end in criminal court. In such case, tax police often suggest to business to plead guilty to tax evasion and be relieved by the court of criminal responsibility, by virtue of para. 4 of Art. 212 of the Criminal Code due to payment in full before formal notice of suspicion is served. This brings 'points' to the tax police as one more 'evasion' disclosed, but it deteriorates the reputation of the taxpayer. And the next time, a tax dispute arises,  tax authorities may say that the taxpayer already has a record and therefore cannot be viewed up as good taxpayer.

It is not easy to fight in such situations and to mitigate risks even if it is obvious that there is no evasion but rather a common tax dispute. Instruments include relevant legal actions applying to various bodies, but mainly trying to defend the taxpayer on the substance of the tax dispute.

This criminal investigations-related environment looks dangerous for business. As experts, we spend hours scrutinizing  tax laws related to VAT or CPT of basic transactions of big multinationals in every day activity (marketing of imported goods, registration of a tax voucher in VAT Electronic Administration System etc.). Is it possible for an accountant, who makes thousands of operations in such conditions, not to make a mistake? However, even if there are no mistakes, the risk of criminal investigation still exists, due to different interpretations of the Tax Code by tax authorities.

Is there any recipe for Ukraine to help business forget the nightmare of criminal pressure? We believe that liquidation of tax police and decriminalization of tax disputes may significantly ease the issues. Yet, these steps are hardly possible in Ukraine, without pressure from business on the government. There is already a point existing for such a pressure: the Draft Law #3448 "On Amendments to the Tax Code of Ukraine regarding Peculiarities of Criminal Process in the Cases related to Taxes and Charges".

This Draft Law aims to settle problems from automatic initiation of criminal proceedings and application of plea agreements. To settle such issues, the Draft Law would narrow the scope of fiscal authorities to make illegal pressure o taxpayers. This would make a great contribution to developing Ukraine's business environment. More specifically, the Draft Law requires immediate the closing of tax evasion investigations if relevant assessments are not agreed by due legal procedure, or, if agreed, are paid in full, with applicable penalties, within terms of the Tax Code.

In Ukraine, registration of a draft law in the Verkhovna Rada of Ukraine does not mean that the instrument is on track to adoption. Thus, we call on representatives of foreign business to use all possible measures, including the International Monetary Fund, to make maximum pressure on the government and Verkhovna Rada to adopt Draft Law #3448.

This will really help to improve Ukraine's business climate.


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A soundproof steel vault is on the fifth floor of the government's tax collection headquarters. This room is where former chief tax collector Oleksandr Klymenko allegedly hatched fraudulent schemes that deprived the state budget of $11 billion over three years, according to Ihor Bilous, a former head of the State Fiscal Service of Ukraine. This picture was taken on April 18, 2014, two months after Klymenko fled Ukraine by rushing past border guards at the Donetsk Airport in February 2014, after the EuroMaidan Revolution drove President Viktor Yanukovych from power. (Pavlo Podufalov)

# Ukraine's massive shadow economy robs treasury and future of 44 million citizens

By **Mark Rachkevych**
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A major challenge for the architects of Ukraine's new tax system is how to uncloak about 40 to 60 percent of the economy that avoids government regulation, taxation or observation each year.

The Economy Ministry estimates that 42 percent of the nation's economy, or about $18 billion, was unaccounted for in the first six months of this year. In fact, since 2008, an average of 44.5 percent of the nation's gross domestic product has gone unregistered, according to Friedrich Schneider, an economics

professor at the Johannes Kepler University in Austria who has studied the phenomenon for more than a decade.

This equals $328 billion that will have escaped official detection in 2011-2015, when using GDP figures provided by Kyiv-based investment bank Dragon Capital. In his research, Schneider defines the shadow economy as "all market-based legal production of goods and services that are deliberately concealed from public authorities."

Tetyana Tyshchuk of the Institute for Economics and Forecasting at the Ukrainian National Academy of Science, in her research, said that "white" and "shadow" economies "don't exist as two parallel realities."

For example, an employee may receive a portion of their salary legally and the rest in an envelope that avoids payroll taxes and pension fund deductions. Either way, the money gets spent on items that get taxed.

"The list of these chains, which consist of white and gray operations, may go and on," Tyshchuk said.

Another factor of which policy makers should take notice, according to Schneider, is that certain aspects of Ukraine's shadow economy are"welfare enhancing" for the economy.

"Underground production is a vital branch of the overall economy. A shadow economy produces added-value goods and services, which are as good as officially produced ones," Schneider told the Kyiv Post. "What's bad is that social security and the pension fund loses, but the man on the street benefits, many have second jobs in the informal sector like driving a taxi or selling homegrown produce."

Businesses engaged in transactions involving foreign currency sometimes enter the shadow economy to avoid risks.

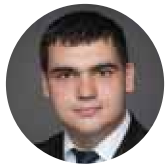
On a larger scale, undeclared work and illicit financial flows remain the principal problems. They include tax invasion, capital flight, money laundering, and misuse of budget revenues, according to the Kyiv-based International Center for Policy Studies.

Tyshchuk said the "most dangerous one is the shadow economy in the government sector…it is based on corruption and destroys our economy."

For Natalia Osadcha, partner at Syutkin



**Mykola Stetsenko**
Managing Partner



**Vadim Medvedev**
Associate

## "Horizontal equity" or how to achieve tax non-discrimination

Horizontal equity is the principle, under which people with the same income should be taxed equally. It means that two people earning UAH500,000 per year each should pay equal amount of tax. It does not matter whether the tax will be UAH100,000 or UAH100 — the amount must be equal for both tapayers. As opposed to horizontal equity, vertical equity says that people with higher wealth should pay more taxes.

One good example of how to achieve horizontal equity in administration of taxes is electronic system of VAT administration. It prevents tax evasion by some taxpayers and applies the tax similarly to everyone. If properly administered, such system could solve a number of problems with VAT administration and collection.

The Tax Code of Ukraine recognizes equality of taxpayers and non-discrimination as principles of taxation in Ukraine. Despite this and similar to the previously effective laws, the Tax Code contains quite a few deviations from horizontal equity principle. One of the most common of them is the simplified tax system or so-called single tax.

### Single tax and payroll taxes

The idea that an entrepreneur may be taxed with some notional amount per month regardless of actual income (tax base) seems incredibly attractive for promotion of small and medium enterprises.

The problem is that two people in similar positions earning the same amounts have different after-tax income. Looking at the example of a professional in IT industry, her role does not differ significantly whether she is employed by a company or is a freelance entrepreneur. Assuming pre-tax income of UAH1mln, the first scenario will result in the net amount of less than UAH800,000 whereas the second will arrive at UAH960,000. Additionally, the employer in the first case will pay approximately UAH100,000 of single social contribution per year. One can argue that assumption of additional entrepreneurial risk is being awarded with UAH260,000 tax economy per year. It might have been true if the risk in these two cases differed significantly. In practice, the "entrepreneur" will often work for one client being effectively the employee.

Draft tax reform considered by the Parliament these days makes an important step to solve this issue. The reform suggests that individuals eligible for simplified taxation are subject to the same 20% (or compromised 18%) income tax rate on their net income (income less business expense). The only concession available to them is the right to deduct deemed expenses of 85% of their income (to be gradually decreased to 45%). It still leaves significant inequality. Payroll employee is not allowed to deduct professional expenses (professional literature or software used at own expense) from his taxable income not to mention deemed expense. However, it is a step forward towards a fair system of taxation.

### Single tax and corporate income tax

Similar issue exists for legal entities subject to single tax as compared to those paying corporate income tax. Moreover, such tax regime has a discouraging effect on medium-sized businesses. If a company pays the single tax (within 3rd group) and has UAH20mln income, it will not be motivated to continue growth and increase its income to UAH21mln. The reason is that if the entity has 50% net margin, its net profit from UAH21mln after income tax will be UAH19.2mln. At the same time, the company would have UAH19.2mln profit after tax when it has UAH20mln gross income and used single tax regime. It means that business will have to put extra effort to get the same amount of after tax income. It is easier not to make this effort (and not produce additional UAH1mln of Ukrainian GDP), but to extract this UAH1mln from the budget as a tax benefit in the form of a single tax.

In both cases described above, overall cost of public expense is shifted from some preferential taxpayers to those having "ordinary" tax treatment. It does not matter whether this disadvantaged taxpayer (carrying extra public cost for the other guy) is the large multinational or an ordinary employee having his salary paid after all "ordinary" taxes. These taxpayers carry a part of the social burden of the other people for no justified reason.

Coming back to the underlying issue in this discussion, the Government will not be able to achieve proper administration of tax and eliminate abuse of tax regimes, unless it ensures horizontal equity in tax system.

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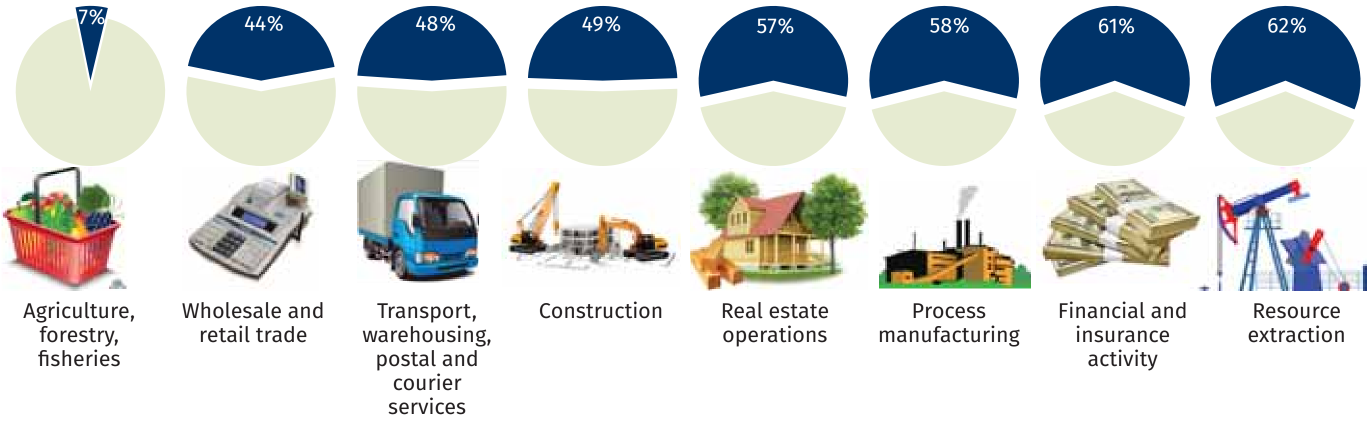
## Underground economy by industry, as a percentage of gross value-added




**When measuring the value of goods and services produced in an industry, the raw materials or resource extraction industry remains the most concealed from government regulation, taxation or observation. These segments are "highly monopolized," according to a report on the shadow economy published in December by the Economy Ministry.** *Source: Ministry of Economic Development and Trade of Ukraine*

& Partners, the "non-transparent system of taxation and high tax rates are the root of all evil."

Ukraine lost over $116 billion in 2004-2013 in "illicit cash flows," averaging $11.6 billion a year, according to a December report by Global Financial Integrity, a non-profit group in Washington, D.C. that analyzes the movement of money. Some $1.1 billion of this was "hot" money, "essentially cash that has disappeared from the economy" that wasn't registered with the central bank or another regulatory agency, according to Global Financial Integrity.

But more than 90 percent of the dirty money was due to what the group calls "misinvoicing," when the value or volume of an export or import is misstated on an invoice. Weak customs enforcement and tools, combined with graft allows "criminals, corrupt government officials, and commercial tax evaders to shift vast amounts of money across international borders quickly, easily, and nearly always undetected," the Global Financial Integrity reported stated.

Fraudulent value-added tax refund schemes also fall into this category.

"The same with VAT, it is illogical corrupted tax, the company pays it, and then tries to get it back for five years, what's the point, no one knows; the word 'corruption' comes to mind," Osadcha said.

Serhiy Kurchenko, widely believed to be a front man for ex-President Viktor Yanukovych, is accused of using similar fraudulent manipulation of invoices in the liquefied natural gas business, robbing state coffers of $2.2 billion. He has denied the allegations, describing himself as an "honest businessman."

The continued opacity of the global financial system makes it easier to shift stolen assets on the receiving end. "The opacity reveals itself in many well-known ways: tax havens and secrecy jurisdictions, anonymous trusts and shell companies, bribery, and corruption," according to Global Financial Integrity.

At the country of origin of illicit funds, "customs agencies should treat trade transactions involving a tax haven with the highest level of scrutiny," reads the American report. "Governments should significantly boost their customs enforcement by equipping and training officers to better detect intentional misinvoicing of trade transactions, particularly through access to real-time world market pricing information at a detailed commodity level."

Tax authorities in Ukraine estimated last year that cash payments for salaries total about $17 billion a year tax, with at least two million workers not appearing on any tax rolls. Moreover, "another five million report earning salaries that are below the minimum wage, which authorities say is a sign they are paid partly in cash," according to Reuters.

Authorities are on to the problem.

The Kyiv Post counted 15 large-scale busts of money laundering centers this year by the Security Service of Ukraine, totaling $160 million. About half were allegedly used to finance Russian-backed separatists in eastern Ukraine.

State Fiscal Service chief Roman Nasirov said at a Nov. 12 briefing in Kyiv that 50 conversion centers were eliminated this year without providing financial figures. In addition, thanks to the government's electronic administration of value-added tax, some $8 million each month is detected and registered that otherwise would have remained hidden.

There's also a correlation between which industries are most in the shadows and the extent to which they are regulated, said Tatiana Ignatenko and Rodion Teslia of the Poberezhnyuk & Partners law firm.

"For example, in the retail sector, the rank of the shadow economy is 60 percent, the pharmaceutical industry is 40 percent in the shadow…It is worth noting that the aforementioned industries are considered to be the most over-regulated sectors of business in Ukraine," the two lawyers wrote in comments to the Kyiv Post.

### Solutions

What governments like Ukraine can capture quickly is illegal trade, according to Global Financial Integrity: "Curtailing even a small portion of these illicit flows would have a catalytic impact on a government's ability to address the needs of its most vulnerable people."

Perhaps the trickiest part is what economists call "tax morale" – or more precisely, the lack of it in Ukraine.

"Taxpayers are more heavily inclined to pay their taxes honestly if they get valuable public services in exchange," Schneider said.

Ukraine's government officials have historically shown they are not putting taxpayers' money to good use. Until they do, much of Ukraine's economy will remain in the shadows where tax evasion flourishes. ■

## Ukraine's biggest taxpayers

| | Company name | Business activity | 2014. million hryvnia | Jan.-June 2015. million hryvnia |
|---|---|---|---|---|
| 1 | Naftogaz Ukraine | Oil & gas | 10,585.2 | 10,832.8 |
| 2 | Philip Morris Ukraine | Tobacco products | 7,851.5 | 3,282.3 |
| 3 | Japan Tobacco International | Tobacco products | 5,342.2 | 2,850.2 |
| 4 | British American Tobacco - Pryluky | Tobacco products | 4,227.1 | 2,553.1 |
| 5 | Imperial Tobacco Production Ukraine | Tobacco products | 3,502.8 | 2,367.8 |
| 6 | Energorynok | Wholesale electricity operator | 3,197.3 | 2,649.7 |
| 7 | Energoatom | Nuclear power | 3,078.0 | 2,072.5 |
| 8 | Kyivstar | Telecommunications | 2,622.8 | 1,140.5 |
| 9 | Ukrgazvydobuvanya | Natural gas extraction | 2,257.8 | 1,772.5 |
| 10 | Ukrtatnafta | Oil refining | 1,941.4 | 1,419.3 |
| 11 | Inguletsky Iron Ore Mining and Processing Plant | Natural resource extraction | 1,720.2 | 0.2 |
| 12 | Vodafone Ukraine (formerly MTS Ukraine) | Telecommunications | 1,520.7 | 849.4 |
| 13 | Southern Mining and Processing Plant | Natural resource extraction | 1,447.5 | 848.9 |
| 14 | Carlsberg Ukraine | Alcoholic & other beverages | 1,336.9 | 523.5 |
| 15 | Northern Mining and Processing Plant | Natural resource extraction | 1,235.6 | 2.7 |
| 16 | Ukrainian Distribution Company (Global Spirits) | Alcoholic & other beverages | 1,055.9 | 527.2 |
| 17 | DTEK Pavlogradugol | Coal mining | 1,017.5 | 1154.9 |
| 18 | Privatbank | Banking and finance | 986.1 | 1516.2 |
| 19 | Naftogaz-vydobuvanya | Natural gas producer | 938.5 | 535.7 |
| 20 | Dnipro Railway | Rail transportation | 906.7 | 676.2 |
| 21 | Imperial Tobacco Ukraine | Tobacco products | 899.6 | 348.3 |
| 22 | Sun InBev Ukraine | Alcoholic & other beverages | 873.4 | 334.4 |
| 23 | Obolon | Alcoholic & other beverages | 868.5 | 396.7 |
| 24 | Epicenter K | Home improvement | 846.3 | 472.1 |
| 25 | Ukrtelecom | Telecommunications | 841.7 | 493.7 |

**Twenty-five companies paid more than Hr 100 billion to state coffers in 2014. Some have even paid more in the first six months of this year than all of 2014, including state-owned energy giant Naftogaz Ukraine.** *Source: Ekonomichna Pravda*



**Iegor Sinitsyn**

Tax expert, EBS

# Does Ukraine Really Need Tax Reform?

In the last few years, the tax system has been in a state of permanent reform. We are increasingly hearing rhetoric that there is once again an urgent need to amend tax legislation.

Given the fact that a huge amount of changes have been occurred with respect to taxation in recent years, to which it has been virtually impossible to quickly and smoothly adapt, the question paradoxically arises: probably stability in tax legislation could be regarded as necessary reform?

It is clear that any reforms require significant resources, but these are currently not earmarked in the state budget. Carrying out reforms to the tax system by searching for ways to compensate to make up for revenue shortfalls in the budget is, in fact, like running in circles. It is impossible to implement reforms for free. A compensating force should act in a way so as not to increase the burden on businesses and citizens, namely by creating an attractive investment climate, by creating new jobs, and by combatting schemes in the shadow economy.

If we talk about developing the investment attractiveness of the country, this does not only relate to the provision of preferences, exemptions and reduced tax rates. Business entities are willing to pay taxes. First of all, what is needed is to create a simple, clear, transparent and level playing field, as well as the possibility of long-term planning. EBS experts have tried to find the actual wording of the Tax Code of Ukraine in English. This was not an easy task. Moreover, there exist "pitfalls" hidden within the obscure wording of the tax legislation.

**In fact, if you do not take the existing conflicts in tax legislation into account, the current taxation system would seem fairly balanced.**

According to EBS experts, the most burdensome element here is the burden on the wages. However, even without considering changes in legislation, starting in 2016, plans include reducing this load from an average of 56% to a more acceptable 41%.

The current Value Added Tax (VAT) rate in Ukraine of 20% is widely used in the world, with more than 80 countries having a VAT rate of 15%-20% and most European countries having a rate of 20% or more. To be realistic, it is virtually impossible to reduce this rate and especially to replace VAT on sales tax under current conditions, since this tax generates more than one-third of all tax revenue.

With respect to accounting for corporate profit tax, it is already as close as possible to regular business accounting. The existing tax differences are essentially safeguards against schemes for tax evasion, which are used in many countries. Hardly anyone could say that such tax differences, combined with a fairly liberal tax rate of 18%, would put a transparent business in a difficult position. In the structure of budget revenues, most of the corporate profit tax paid comes from large taxpayers. For instance, 95% of taxpayers have an annual turnover of up to 20 million UAH. It is for this reason that deregulation and simplifying tax accounting for small and medium businesses, while simultaneously increasing attention to transfer pricing among large taxpayers, is the right solution.

While searching for a balance between reducing the tax burden on business and the needs of the state budget during this time of crisis, it is necessary to carefully weigh the need for and timeliness of tax reforms. As stockbrokers say, one must think either faster or less. So perhaps opinions about making radical reforms regarding the basic principles of taxation are not really necessary at the moment? Of course, it is vitally necessary to make superficial changes to legislation should lead to clarity and the comprehensibility of tax regulations. As regards significant changes in the economy, it is necessary to, at least, slightly ease the pressure, to carry out total deregulation, and to stop considering taxpayers as law-breakers a priori.

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| +38 044 371 4007 | Aleksandr Peremezhko | Kyiv, Ukraine | 2010 | Litigation & Arbitration; Tax and Customs; Corporate and M&A; Competition and Anti-monopoly; Media and Communication; Intellectual Property; White Collar Defense | Bershka Ukraine, Sharp Electronics Ukraine, Lego Ukraine, B&H, UFD, LeDoyen Studio, Eurofins Food & Agro Testing Sweden AB, Ciklum Ukraine, AstraZeneca, Volyntabak | English, German, Polish, Russian, Ukrainian |

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| +38 044 501 2064 | Alexandrov Dmytro, Kryzhanivska Oksana, Sydorenko Oleksandr, Fedun Anton, Yankovych Vitaliy, Shein Kseniya, Ruchko Oleksandr | Kyiv, Ukraine | 2002 | Agribusiness; Land, M&A; Investment; Real Estate; Construction; Customized Services | Tigon Agri A/S, Ramburs Group, PariMatch, Bionic Hill, Scano, Pionerskiy Kvartal | English, Russian, Ukrainian |

## Ante Law Firm

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|---|---|---|---|---|---|---|
| +38 044 277 2300 | Andriy Guck, Kateryna Ishchenko | Kyiv, Ukraine | | Litigation; Corporate; White collar; Transport & Infrastructure; Aviation; Energy & Natural resources; Employment; IP; Tax & Customs | Emirates, Lufthansa, Austrian, British Airways, Atlasglobal, Zdravo | English, Turkish, Russian, Ukrainian |

## Arzinger

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|---|---|---|---|---|---|---|
| +38 044 390 5533 | Timur Bondaryev | Kyiv, Ukraine | 2002 | Litigation; Antitrust/Competition; Corporate/M&A; Real estate; IP; Arbitration; Tax; Banking & Finance; Bankruptcy; White Collar Defense | Astelit, Bayer AG, Bunge, Citibank, GlaxoSmithKline, Henkel, Lafarge, Porsche, SHARP, SCM, UNIQA AG, Ukrtelecom | English, German, French, Ukrainian, Russian |

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| +38 044 220 0335 | Mykola Stetsenko, Glib Bondar, Dmytro Marchukov | Kyiv, Ukraine | 2009 | Capital Markets; Corporate / M&A; Competition; Disputes; Employment; Energy and Infrastructure; Finance; Projects; Real Estate; Restructuring and Insolvency; Tax | The Ministry of Finance of Ukraine, PJSC Commercial Bank PrivatBank, Raiffeisen Bank International AG, PJSC Raiffeisen Bank Aval, MHP, Novartis, Lafarge, Ferrexpo, ING Bank, EBRD, FUIB, UBS, Kernel, DTEK, Nadezhda Group, AVK, PPF, UDP, Odeko, Mriya Agro Holding | English, Russian, Ukrainian |

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| +38 044 490 6000<br>+38 044 278 1000 | Bate C. Toms | Kyiv, Ukraine | 1991 | Agricultural Investments; Oil, Gas and Electricity; M&A; Banking; Finance and Capital Markets | WND | English, French, Russian, Ukrainian, Polish |

## BDO Ukraine

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| +38 044 393 2687 | Alla Savchenko, Sergey Balchenko, Victor Nevmerzhitsky | Brussels, Belgium | 1963 | A&A; Transfer Pricing; IFRS Reporting; Management Consulting; Accounting & Financial Outsourcing; Legal Services; IT & HR Consulting; Tax Compliance; Valuation; IR Reporting; IPO flotation | International & Ukrainian companies of the following areas: energy, pharma, insurance, manufacture, natural resources, non-profit, RES, retail, TMT, transport & engineering, banks. | English, Russian, Ukrainian |

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| +38 044 391 3377 | Daniel Bilak | London, UK | 2007 | Infrastructure; Corporate and M&A; Banking and Finance; Commercial; Tax&Customs; Competition; Dispute Resolution; Compliance; Employment; Property; Technology Media and Communication; Agribusiness; Lifesciences/Pharmaceuticals; Intellectual Property | WND | English, French, Ukrainian, Russian |
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| +38 044 494 4774<br>+38 044 494 1991 | Oleg Batyuk | Global law firm | 1992 | Banking and finance; Corporate/M&A; Dispute resolution; Investments; IP&T; Real estate and Construction; Restructuring; Tax | Multinational corporations, commercial and investment banks, energy companies, developers, hotel chains, investment funds, international organisations | English, Russian, Ukrainian |
| **EBS**<br>13A Universytetska St., Kyiv 03110, Ukraine; info@ebskiev.com, www.ebskiev.com | | | | | | |
| +38 044 249 7905 | Helen Volska | Kyiv, Ukraine | 1998 | Legal Services; Management Consulting; Accounting and Financial Management Outsourcing; Tax and Audit; IFRS Reporting; IT and HR Consulting; Transfer Pricing | 3M, Wizz Air, EBA, Dragon Capital, ABB, ACC, Alcon, Castrol, Florage, Michelin, Yves Rocher, Winner Automotive | English, German, French, Russian, Ukrainian |
| **ePravo**<br>28/9 Pushkinska St., 2nd floor, office 24, Kyiv 01004, Ukraine; welcome@epravo.org, www.epravo.ua | | | | | | |
| +38 044 235 0444 | V. Vlasiuk | Kyiv, Ukraine | 2012 | Litigation and Arbitration; Corporate and M&A; Intellectual Property; E-Commerce | Allta, Astrafit, Askertrade, Studway, Orion.Group, National Police of Ukraine *(pro bono)* | English, Russian, Spanish, Ukrainian |
| **FCLEX Law Firm**<br>14D Bekhterivsky Lane, Kyiv 04053, Ukraine; inform@fclex.com, www.fclex.com | | | | | | |
| +38 044 238 6420 | Viktor Barsuk | Kyiv, Ukraine | 2002 | Banking and Finance; Competition; Corporate and M&A; Dispute resolution; Intellectual property; Labor; Real Estate; Bankruptcy; Tax; White Collar Crimes | Ferrexpo AG, Concorde Capital, Azovmash, NEST Corp., ACME Color, Finance&Credit Bank; Terra Bank; NorYards AS; Arterium Corp.; AutoKraz; IC "Omega"; SOTA Cinema Group and others | English, Russian, Ukrainian |
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| +38 044 362 7909 | Dmitrij Nabugornov, Anita Yuschchak | Kyiv, Ukraine | 2009 | Corporate and M&A; Dispute Resolution; Tax & Customs; Accounting and Audit | Benish Group, Lindab, BTL Group, Emerald Group, Sanger, Northgas, Dasap, SEA, Ostec, Agro-Nafta, NSCglobal, Project People | English, German, Russian, Ukrainian |
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| +38 044 486 0047 | Igor Golovan | Kyiv, Ukraine | 1996 | Complex Business Protection; Crimea & ATO Zone Issues; White Collar Crimes; Litigation & International Arbitration; Investment Disputes; Copyright & Related Rights | Privileged | English, Russian, Ukrainian |
| **Gramatskiy & Partners**<br>16 Mykhailivska St., Floor 2-3, Kyiv 01001, Ukraine; office@gramatskiy.com, www.gramatskiy.com | | | | | | |
| +38 044 581 1551 | Ernest Gramatskiy | Kyiv, Ukraine | 1998 | Business-Advocacy; Foreign Investments; Foreign Trade; Business Protection; Real Estate&Construction; Agribusiness; IT; Litigation; Taxation; Business Restructuring; Due Diligence; Debts&Bankruptcy | City Capital Group, Seven Hills, Danfoss, De-vi, PlayTech, ClickMeIn, Keystone Trading Technologies, Skywind Tech UA, ULMA Ukraine, Celentano, Banka, Jeltok, Promkabel, Larsen, Graal, TOMAK, All-Ukrainian Advertising Coalition | English, Italian, Greek, Polish, Russian, Ukrainian |

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| +38 044 500 7971 | Danylo Getmantsev | Kyiv, Ukraine | 2003 | Taxation; Banking and finance; Media law; Intellectual property; Administrative law and licensing; Land law and real estate; Litigation and arbitration; International trade and investment | MSL,State Road Agency of Ukraine,Modnakasta,Travel Professional Group, Denval Fruit, NEFCO, Ukrainian Pay Card, Agrarian Investment Union | English, German, Greek, French, Russian, Ukrainian |
| **Koval & Partners, Patent & Law Company**<br>23 M. Raskovoy St., apt. 602, Kyiv 02660, Ukraine, info@koval-partners.com, www.koval-partners.com | | | | | | |
| +38 044 228 2552 | Koval Maxim, Koval Natalia | Kyiv, Ukraine | 2003 | Trademarks; Patents; Designs; Copyrights; IT law and domain name disputes; Licening and Franchising; Castoms and Border Enforcement; Anti-counterfeiting and anti-piracy operations | Naspers, Philipp Plein, ForexClub, Efes, SCM, Stoller, Teddy Mountain, Alpha Industries, Evyap, Coral travel , TicketForEvent | English, Russian, Ukrainian |
| **Kushnir, Yakymyak & Partners**<br>19B Instytutska St., Suite 40, Kyiv 01021, Ukraine; kypartners@kypartners.com, www.kypartners.com | | | | | | |
| +38 044 253 5939 | Yuri Kushnir | Kyiv, Ukraine | 2003 | Banking & Finance; Corporate; Energy; Investments; IT; Labour; Litigation; Real Estate; Tax; Trade Law | 3M, General Electric, Ecolab, Johnson & Johnson, UNIQA, LG Electronics, Emfi, Agroprosperis (NCH), Leimholzprofi, National Oilwell Varco, Sibelco, Araj, Voxel, Medfarcom, Television Industry Committee, Space IT | English, Polish, Russian, Ukrainian |
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| +38 044 494 2727 | Maksym Lavrynovych | Kyiv, Ukraine | 2004 | Banking & Finance; Tax; Corporate and M&A; Competition/Antitrust; Infrastructure; IP; Dispute Resolution; Public Private Partnership; Agribusiness | Canon, MoneyGram, Danone, Dragon Capital, Hyundai, Louis Dreyfus Commodities, MUK, Nova Healthcare, Peri Ukraine, UCAB, Winner Automotive | English, Italian, Russian, Ukrainian |
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| +38 044 228 6080 | Andriy Kolupaev | Kyiv, Ukraine | 2005 | M&A & Corporate; Antitrust & Competition; Litigation & Arbitration; Real Estate & Construction; Tax & Customs; Employment | AET, ArcelorMittal, Bridgestone, Chicago Mercantile Exchange, CRH, DuPont, East Metals, Evraz, Honda Trading, Gas of Ukraine, Interpipe, Intesa Sanpaolo, Lexus, Marubeni, Pfizer, Millhouse, Sojitz, Subaru, Sumitomo, Toyota, Ukrainian Ministry of Justice, VS Energy | English, Russian, Ukrainian |
| **Marchenko Danevych**<br>4B Ivana Franka St., office 49, Kyiv 01054, Ukraine; office@marchenkodanevych.com, www.marchenkodanevych.com | | | | | | |
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Meager pensions leave many retirees in poverty, forcing them to work to survive. (Volodymyr Petrov)

# Creaking Ukrainian pension system desperately needs overhaul, experts say

By **Olena Savchuk**
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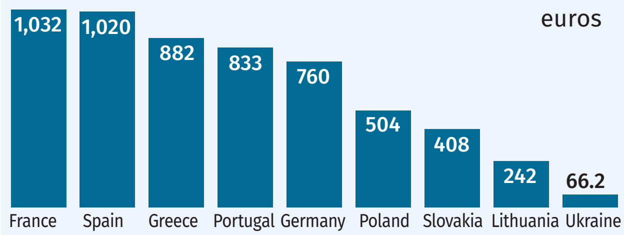
Ukraine's state pension system not only overburdens the tax system – it also fails to offer retired Ukrainians a decent life after they leave the workforce.

Amid the ongoing discussions on the final version of tax reform, there is consensus on lowering the unified social tax on salaries from 41 to 20 percent to avoid widespread evasion. That's the tax that feeds the ever-hungry pension fund.

"Of course this step will lead to a deficit of nearly Hr 100 billion in contributions to the pension fund. We plan to balance it with compensatory steps and a parametric reform of the pension system in the nearest future," Finance Minister Natalie Jaresko wrote recently in an op-ed for Ukrainian online newspaper Ukrainska Pravda.

Twelve million retired Ukrainians – a quarter of the nation's population – receive pensions, even though they are not high enough to live on.

### Average pensions in European Union and Ukraine, 2015



*Source: Eurostat*

**Ukraine's average monthly pension – 66 euros or $72 – is not enough to live on for the nation's 12 million retirees.**

The officially employed population pays a unified social tax to support the elderly. The qualifying age is 60 for men and 57 for women, but the age will be set at 60 for both genders by 2021.

A persistent recession in the last two years has made it difficult to fund pensions, cutting gross domestic product nearly in half in dollar terms – from about $180 billion to just more than $94 billion expected next year.

According to the State Pension Fund, the average monthly pension across the country as of October was Hr 1,691 or about $70. With 42 percent inflation in the country, and benefits increasing by only 13 percent in September, the majority of the retired population are now losing ground.

Paltry pensions force the elderly into poverty or propel them back into the workforce or to rely on friends or relatives.

Ukraine spends around 15 percent of its GDP on its elderly, a high percentage among nations.

The nation also has one of the heaviest tax burdens on businesses. It is ranked 107th among 180 countries in the tax burden rating compiled by auditors PWC and the World Bank.

But these tax rates motivate many Ukrainians to avoid official employment or declare lower salaries, robbing the government and pension fund.

## Pension reform

Attempts to fix the pension system have stuttered for more than a decade as the nation ran up significant deficits in its pension system.

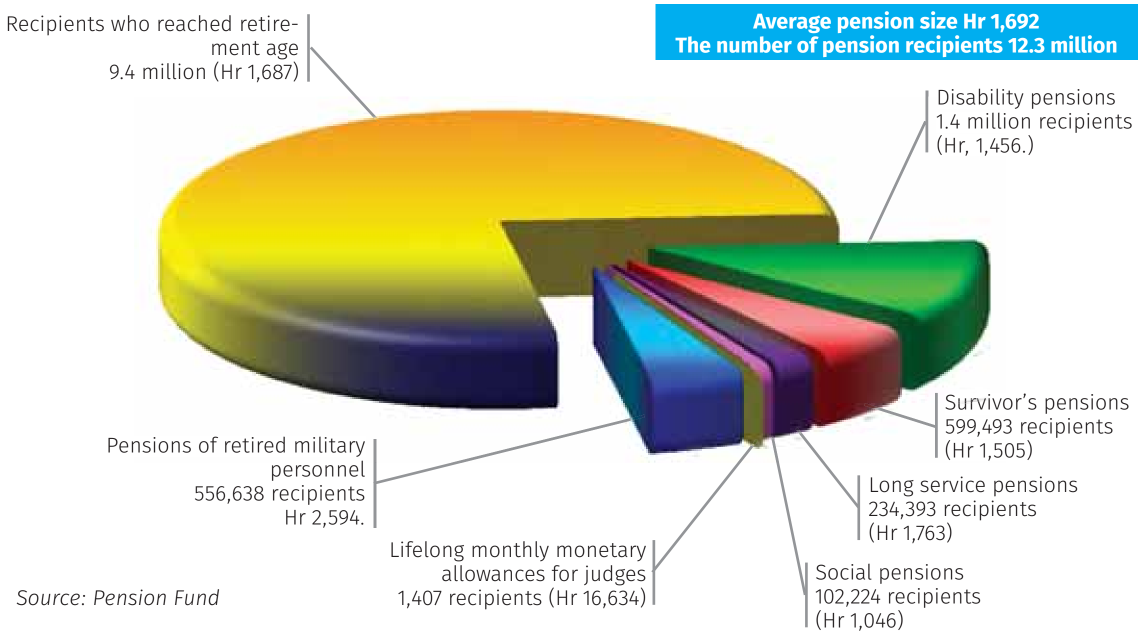
The Ukrainian government is now faced with a series of hard choices.

### Ukraine's spending on pensions

*Source: The Pension Fund of Ukraine*

**In 2015, the government will spend nearly $10 billion on pensions.**

**Recipients of pension payments by type and size of pensions as of Jan. 10.**




*Source: Pension Fund*

**Ukraine's pensions are low in general, averaging only $72 per month, but some categories of people – judges and military personnel – qualify for higher pensions.**

"We could easily optimize the expenditures of this fund," Deputy Minister of Finance for European Integration Artem Shevalev told the Kyiv Post. "We could drastically change the qualifying parameters, like increasing the retirement age. We could also decrease the benefits, but after devaluation and inflation those pensions are already very low."

Shevalev said the well-being of the retired population is crucial to the development of Ukraine's domestic economy. But the International Monetary Fund, Ukraine's key creditor, is insisting on cuts in state social security spending.

"The system has to provide resources for the people who need them most," IMF representative Jerome Vacher told the Kyiv Post. "That's why we need to push for things like means-testing ahead of anything else, because there's a lot of work to be done here."

Nevertheless, Ukrainian think tanks that research the country's pension system say there is room for improvement without decreasing pensions.

**The debate between flat-tax rates and progressive ones heats up when it comes to taxing the rich.**


"After the unified social tax cut, first of all, we need to start the verification of retired people and the recipients of social benefits, as no one has updated the registry for a long time," Pavlo Kukhta, a pension reform expert at Reanimation Package of Reforms think tank, told the Kyiv Post. "We need to resort to supporting only the poor, old people - that's all we can afford in our demographic and economic situation."

Kukhta also said that the pension fund needs an independent audit to cleanse it of corruption.

## Private pension funds

The national commission of state regulation of financial services market has registered 70 private pension funds.

Investing in private retirement plans is still not popular in Ukraine, but people are trickling in, Antonina Samoylova, director of the Administrator of Pension Reserves, which manages nine pension funds, told the Kyiv Post. The institution has been working since 2007 in many regions of Ukraine and has 4,500 clients across the country.

"We don't have a lot of clients considering the size of Ukraine, but our contributors are those who have deliberately chosen to invest in their retirement plan," Samoylova said.

"The government is now holding talks with the IMF and the World Bank on improving the pension system to make current and future pensioners feel that their country is taking care of them," said Lyudmyla Denysova, head of the parliamentary committee on social policy.

That process is likely to take years, however. In the meantime, a window of opportunity has arisen for those capable of convincing Ukrainians of the need to set up private retirement plans well in advance, because there's no guarantee the state will be able to provide adequate pensions for a long time to come. ■

# Transparency comes to real estate, land transactions

By **Isobel Koshiw**
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The government took a giant step toward transparency this year by opening up databases for land titles and real estate property to the public.

Doing business also got easier: most powers of the corrupt State Architectural and Construction Inspectorate – which issues building permits – were stripped.

Private notaries now have the rights to compete on equal footing with their state counterparts.

A property tax was introduced and the minimum lease term on agricultural land was extended to seven years, and 10 for irrigated land.

It will take the next year to provide a proper assessment of these measures, particularly those laws passed in line with decentralization.

## Public registries

Making the land and real estate databases open to the public in July also introduced a significant law enforcement tool. It helps identify the misappropriation of state funds and proceeds of bribery among state officials.

Public information on real estate transactions is also a normal part of a market economy, helping government officials assess the values of assets for taxation.

"A few years ago it was considered dangerous or impossible to build a registry and open it to the public. But that turned out to be political color," said Oleg Boichuk, counsel at Egorov, Puginsky, Afanasiev & Partners.

Searches can be made by individuals as well as property and is more transparent than databases in many Western countries, such as the British Land Registry where searches are limited to properties.

"It's good for prosecution. It's good for transparency," said Roman Drobotskiy, a senior associate at Asters law firm. "I understand there might be privacy issues but right now maybe it's necessary. Maybe in some time when we have change, it can be reduced."

## Assessing decentralization

As part of a wider policy to delegate more authority and functions to regional and local governments, parliament voted to transfer almost all land and real estate powers from the State Architectural and Construction Inspectorate to municipal authorities. The central body has been left to oversee "significant objects" such as power stations.

Rights to a land plot and a construction permit can now be obtained in the same local department. The idea is to channel the bureaucracy to

A woman walks over a bridge painted in the colors of the Ukrainian flag with a new apartment complex in the background on Dec. 16 in Kyiv. After years of secrecy, real estate ownership and transactions are now public records. (Volodymyr Petrov) local officials and make them more accountable.

However, not all local councils have applied for the rights to be transferred from Kyiv.

"We only expect to see (the effects) in the next year. Each city will be individual," Boichuk said. "There are some concerns that it might increase corruption…but I think we should try this because the previous system was definitely not effective."

**Ukraine's Economy Ministry has ambitions to place the nation in the top 50 of the World Bank's list of countries where it is easiest to do business by next year.**

Lawmakers also granted private notaries the same rights as state notaries this year. In the past only the Ministry of Justice could register land plots and buildings. This highly centralized system made it a "slow and corrupt process" and businesses usually paid "a lot of money," according to Aleksandra Fedotova, head of real estate at Spenser & Kaufmann law firm.

## Property tax, revenues

The introduction of property tax in January was supposed to fill the budgets of local governments, but many have failed to introduce the tax and it doesn't seem to have affected many property owners. Local authorities only saw a 0.3 percent increase in their budgets from the measure by October, according to research conducted by the Ukrainian Reform Monitor, a Carnegie Endowment project.

A security guard and a cement truck driver talk outside a construction site on Dec. 16 in Kyiv. (Volodymyr Petrov)

Apartment owners of more than 60 square meters, and houses of more than 120 square meters must pay the annual tax. Local authorities define the rate, which cannot exceed more than Hr 27.5 ($1.20) per square meter, 2 percent of the official minimum salary, and exemptions. In Lviv, for example, authorities exempted apartments of 80 square meters or less from taxation and 200 square meters for individual houses.

It also doesn't affect the majority of apartment owners in Ukraine, as a typical two-room apartment is less than 60 square meters, according to Dobrinskiy.

Reluctance on the part local authorities to use the tax for its intended purpose is due to its unpopularity.

"We consider this stance irresponsible," Artem Shevaliov, deputy finance minister on European integration issues, told the Kyiv Post. "Local communities should use this tax to help their local budgets. The reason for [not doing so] is populism."

The Finance Ministry is also seeking to introduce a luxury property tax on properties larger than 300 square meters, requiring payments of roughly Hr 20,000 per year.

## Land-sale moratorium goes on

Parliament's decision to extend the moratorium on the sale of agricultural land until Jan. 1, 2017 disappointed many legal experts.

"It's taken a lot of rights from owners who can't sell their plots," said Aleksandra Fedotova of Spenser & Kaufmann. "It's all been made very political."

Lifting the ban would mean that existing land owners and agricultural companies could use their land as collateral. But others argue that regulation should come first to assure the land is valued at market prices.

The Agriculture Ministry says it needed time, approximately a year, to prepare people for lifting the moratorium and in this way avoid "social tensions." This includes drafting new legislation to allow regulators to oversee the sale of land.

"This isn't the first time we've heard this. I understand that the land market law is important but it all depends on their intention and interest. Now they seem to be more interested," Boichuk said.

"Many of my colleagues disagree but I am actually satisfied with the extension. I don't feel we are really ready for this. We need to adopt proper legislation so that the land will be sold at market prices and villagers will be protected," said Yuriy Zaremba, an associate at Avellum Partners.

Still, other changes such as the extension of the minimum agricultural land lease to seven years have made a difference to businesses. "They used to have to renew them every two or three years, now this has made things much easier…it means they can plan for crop rotation," said Drobotskiy.

*Kyiv Post staff writer Olena Savchuk contributed to this story.* ■

# Closing the gap between taxes on official employees, entrepreneurs

By **Olena Goncharova**
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Tax fairness is a key principle of Finance Minister Natalie Jaresko's proposed tax plan, which seeks to shift the burden from some of the poorest to the wealthiest.

She has noted that teachers today pay a 20 percent income tax on their meager $170 monthly salaries while lawyers earning $4,000 pay only 4.5 percent – all because the teacher is an official employee and the lawyer is an independent entrepreneur.

Narrowing the tax gap, thus, is a much needed area of compromise, according to the Finance Ministry. "We need sweeping reforms that will decrease taxes for those who really need it," Jaresko told parliament during an emergency session on Dec. 17.

Tax preferences are to be slashed as well.

Measures would affect business owners who employ independent contractors whom tax collectors classify and register as "private entrepreneurs." They benefit from a simplified tax system. Jaresko aims to reduce the number of service providers who benefit from the system and raise the rates for those who use it by removing incentives.

But her vision didn't receive a warm welcome in parliament. Prime Minister Arseniy Yatsenyuk said the government will take into consideration parliament's feedback to improve the bill. "We will finish the budget and adopt it together," Yatsenyuk promised.

Until that happens, the simplified tax system remains in place.

The other tax categories are the 20 percent value added tax, corporate income tax and personal income tax. There's also the social security contribution.

Small business can register as single taxpayers if they don't make more than Hr 20 million a year. This tax was first introduced in 1998 to help small- and medium-sized businesses because they just have to pay a 4-percent entrepreneurial tax. Big businesses have abused this measure though.

There are four groups of single taxpayers depending on their revenue and size of workforce. Those who register as private entrepreneurs avoid paying VAT, corporate and personal income tax.

The new tax code proposes to merge the groups. They are:

Group A – individual providers of goods and services who do not hire help. They operate only on markets and/or provide consumer services to the public. Their yearly revenue does not exceed Hr 300,000.

Group B – individual entrepreneurs with up to 10 hired workers and annual revenue of up to Hr 2 million.

Group C – agricultural producers whose share of production doesn't exceed 75 percent of the previous fiscal year's volume. The tax rate for them remains at the level of the monetary assessment of one hectare of land and their annual revenue does not exceed Hr 2 million.

Starting in 2016, all private entrepreneurs in group B will pay a 5.7 percent tax rate. This rate will not change the following year, while in 2018 they are expected to pay 13.3 percent and up to 20.9 in 2019. Legal entities and those private entrepreneurs whose revenue exceed Hr 2 million will no longer benefit from the simplified tax system if the new tax code is approved.


**Local entrepreneurs rally in Kharkiv on Dec. 18, calling on government not to raise tax rates to 5.7 percent next year, as envisioned by Finance Minister Natalie Jaresko's proposal. (UNIAN)**

In 2014, the number of private entrepreneurs whose revenue exceeded Hr 2 million were 5,667 or 0.6 percent of all single tax payers.

According to experts, under the new system more taxpayers will migrate toward the general taxation system, take many businesses out of the shadow and increase budget revenues. Still it's too early to lift the simplified tax system.

Volodymyr Kotenko, head of tax and legal services in Ukraine for Ernst & Young and chairman of the tax committee at the European Business Association, believes the aim of the new tax legislation is to revive the competitiveness and balance between small and medium-sized businesses on the one hand and big business on the other.

The biggest problem, according to Kotenko, is bad timing – the proposed changes should have been introduced in parliament and to the business community at least six months before the vote.

"People need time to adjust everything to the new tax code, understand the specifics of accounting reports they will need to file," Kotenko told the Kyiv Post, adding that it's a crucial aspect for those businesses who don't evade taxes.

Calculating taxes would become complicated, according to Kotenko.

Iryna Kuzina, attorney and head of the Kharkiv office of Ilyashev & Partners Law Firm, agrees that the accounting becomes more difficult.

"The new code will significantly increase the tax burden for employers with low expenditures. Some of them could take advantage of 'inflating' expenses," Kuzina said. According to her, the newly proposed legislation would not become "easier" as the ministry claims it, because the private entrepreneurs should keep their record of expenses, and prove their feasibility during a tax inspection.

Kotenko of Ernst & Young is certain the simplified tax system should be kept, but it's really important to "decrease the number of those (legal entities) who should not use the system."

"First of all, the ministry should work out clear mechanisms to control non-taxable funds outflow, then the question of tax rates won't be that painful for business," Kotenko said. ■

# Ostrikova: Jaresko's plan will only bring more corruption

Lawmaker Tetiana Ostrikova, also a member of the Committee on Taxation and Customs Policy, says that the Finance Ministry's tax reform proposal will push more businesses into the shadow economy. (Kostyantyn Chernichkin)

By **Ilya Timtchenko**
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Tetiana Ostrikova apologetically said she had good reason for arriving an hour late to a Kyiv Post interview. She was in long discussions about tax reform in parliament.

She is the co-author of a bill that some critics have called too "radical" and "populist," a rival and – critics say – irresponsible counter to Finance Minister Natalie Jaresko's tax and budget plans.

Many lawmakers rebuked Jaresko's plan during a parliamentary session on Dec. 17, although speaker Volodymyr Groysman said parliament will try to find a compromise next week.

Jaresko's bill has the backing of the International Monetary Fund, the nation's chief financier and whose lending program has kept Ukraine from going broke.

Ostrikova's version is imperiling Ukraine's prospects of unlocking further lending – $1.7 billion from the IMF and $2.3 billion from other Western countries and institutions, according to critics.

The IMF might, indeed, cancel its lending program to Ukraine altogether.

Ostrikova is defiant, however.

She said Jaresko's tax plan will increase the nation's shadow economy, which is about 40 percent of the nation's gross domestic product.

Ostrikova also criticized the IMF, saying the lender only provides superficial analysis that ignores the harmful effects of Jaresko's plan.

Jaresko, however, has countered that critics with vested interests are spreading disinformation. She has said that an IMF-compliant budget is essential to keeping further lending and, hence, macroeconomic stability.

According to the IMF, the rival parliament plan creates an $8.7 billion deficit, or three times higher than the Finance Ministry's proposal, swelling the deficit.

Ostrikova said that's not true.

The IMF's main message to Ostrikova is to implement anti-corruption reform in the fiscal services administration, she said. Only after removing privileges should the Finance Ministry lower tax rates, she said.

She is convinced that Ukraine's IMF representative Jerome Vacher "didn't read in details the tax code of Jaresko," Ostrikova said. She doesn't believe that the IMF read the 700-page text proposed by the Finance Ministry. "I think that no one translated it into English… no one presented anything to the IMF," she said.

But the IMF said that it has been closely involved in the Finance Ministry's proposal.

"Following significant work at a technical level, a draft budget and supporting tax legislation were submitted to Parliament on Dec. 11," David Lipton, first deputy managing director of the IMF, said in a press release on Dec. 18. "Approval of a budget that deviates from program objectives for 2016 and the medium-term will interrupt the program and inevitably disrupt the associated international financing."

Ostrikova is in the Samopomich Party, which right after last year's EuroMaidan Revolution was viewed as a pro-Western, progressive party. That assessment came into question after the party voted against gay rights and kicked out member of parliament Hanna Hopko, considered one of Ukraine's strongest reformers.

If Jaresko's compromise package goes through, "corruption factors will be worsened," Ostrikova said. She said the bill lowers the social security tax rate, but at the same time puts more pressure on businesses.

"Our position is that we can't worsen… the situation for Ukrainian businesses compared with what the situation is like during this year," Ostrikova said.

More critically, according to Ostrikova, who co-authored parliament's version with lawmaker Nina Yuzhanina, is that the compromise bill doesn't address adminstrative issues. Samopomich "had a list of requirements…and they are all about the administration of taxation and not about the reduction of tax rates," Ostrikova said.

Ostrikova said that the Finance Ministry, for instance, did not propose a deadline period for when the value-added tax should be refunded to a company. Samopomich proposes a 60-day period.

Ostrikova also doesn't find it necessary for Ukraine's four main tax categories – value-added tax, social security, corporate income and personal income taxes – to be the same. This is what Jaresko had initially proposed.

Ostrikova's alternative is to introduce a tax on distributed profits, which would tax dividends and include taxes on transfer pricing, offshore operations and non-profit organizations.

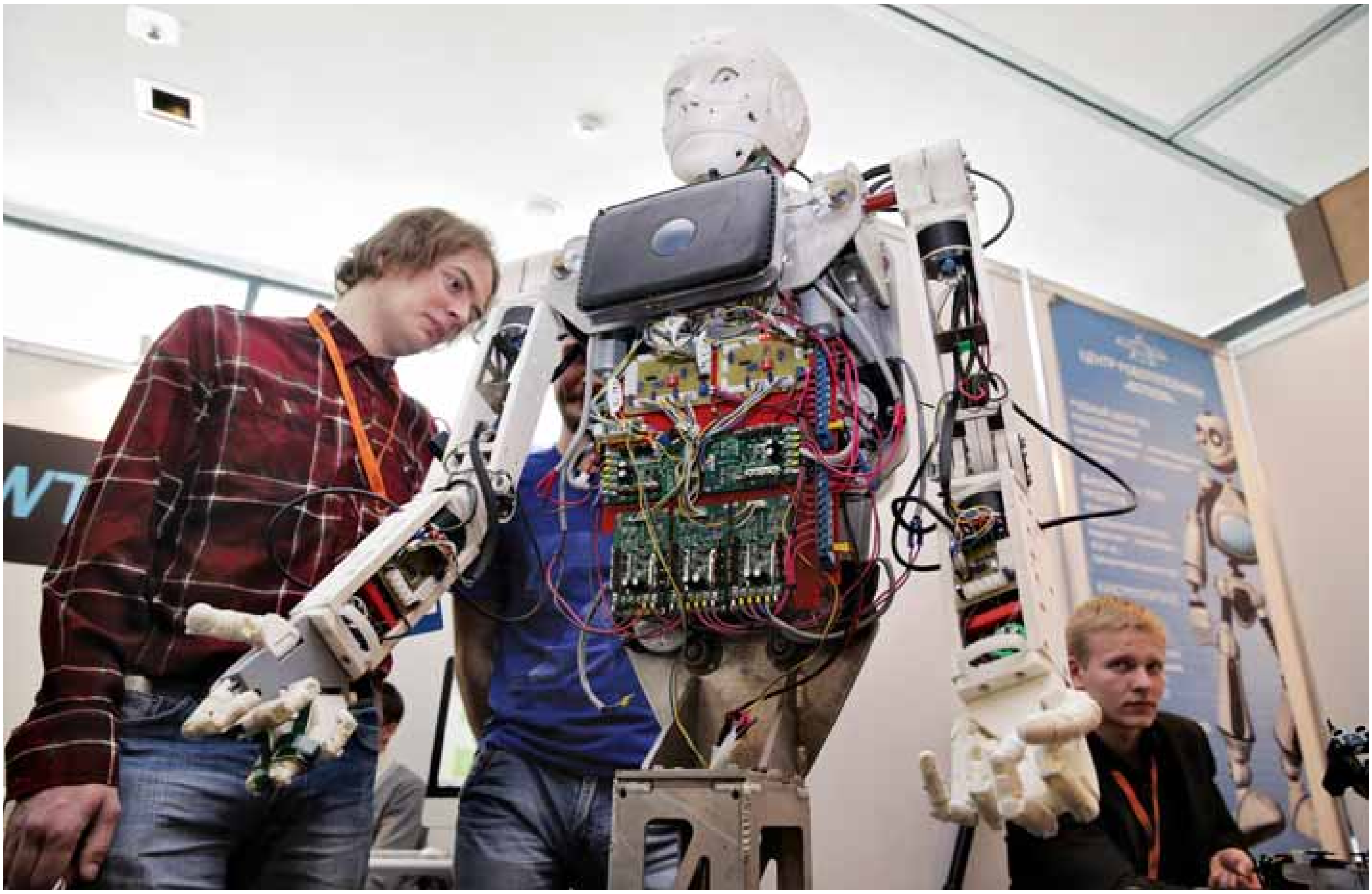
**Lawmaker Tetiana Ostrikova believes that the International Monetary Fund is ignoring the harmful effects of Finance Minister Natalie Jaresko's tax-and-budget proposal.**

"With this switch to the tax on distributed profits we close all of the loopholes of the schemes of money laundering that are used today," Ostrikova said.

She said that the Finance Ministry took too long to develop a tax bill, so parliament drafted its own version.

"We should have voted for the proposed package by Jaresko by July 1," Ostrikova said. "How could we have done this if it was registered in the Rada on Dec. 11?"

Instead, she proposes to start 2016 working on a new reform package "in a completely different direction" than what was proposed by the Finance Ministry. ■



People examine a robot at the InnoTech Ukraine conference at Olympic Stadium in Kyiv on April 9. (Anastasia Vlasova)

# While taxes to remain low for technology sector, business still worried about future

By **Denys Krasnikov**
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Even with Russia's war smoldering in eastern Ukraine, Ukraine has managed to make gains in international business rankings.

According to the World Bank, Ukraine this year ranked 87th out of 189 economies in ease of doing business. The country climbed 9 places in the ranking compared to the previous year.

The success of Ukraine's growing information technology industry contributed to the improvement. IT firms enjoy a much lower tax burden than in most advanced economies. Most who get hired in this field usually find employment as independent contractors or entrepreneurs. This allows them to take advantage of low tax rates and uncomplicated reporting regulations. That benefits both companies and employees.

In this arrangement, called the simplified tax system, employers don't have to pay taxes on salaries, while employees pay a fixed rate of only 4 percent of their earnings, unless they choose to pay value-added tax as well, in which case the rate is 2 percent.

However, the most recent tax reform bill on offer will end the convenient tax regime.


**Finance Minister Natalie Jaresko's tax bill proposes to close the gap over time between independent entrepreneurs, who pay only 4 percent, and official employees, whose employers pay more than 40 percent.**

## IMF requirements

According to Finance Minister Natalie Jaresko's tax bill, which has been designed to meet requirements set by the International Monetary Fund, independent contractors are to be placed in a different tax bracket.

Contractors who currently make less than Hr 20 million a year qualify for 4 percent monthly rate. Jaresko's bill implies that if entrepreneurs earn more than Hr 2 million annually, they will have to pay a general tax that adds up to almost 40 percent of their income – 20 percent income tax and 20 percent value-added tax.

"The incomes of companies and entrepreneurs will be taxed equally," Jaresko said. "This will help create one of the lowest tax burdens on salaries among European countries."

To calm the fears of IT businesses, the Finance Ministry met with industry representatives on Dec. 3, most of whom export their goods and services.

"We understand that the IT sphere is one of the industries related to Ukraine's 'new economy,' which has been showing considerable growth during the last few years and is now a leader in terms of export volumes," Jaresko said at a news conference on Dec. 3. "That's why we want to see the competitive recovery of the Ukrainian IT industry."

## Rapid tax hikes

Jaresko's plan could have the opposite effect, according to Konstantin Vasyuk, IT committee coordinator at the European Business Association.

"Jaresko promised the rates would stay at the same level, and independent contractors remain – at least for the next two years," Vasyuk told the Kyiv Post. "But then the rate will grow very rapidly. It is to be 13 percent for contractors by 2018, and 20 percent by 2019."

"That's what we're all fighting against. The taxes will have to be increased more gradually to save businesspeople in Ukraine," he said.

According to him, only if there is a smooth increase in tax rates will it be possible to plan a business to keep it developing, which in turn will support the tech industry's overall growth. "If abrupt change happens, it will force part of the industry to move its businesses somewhere else," Vasyuk said. There are signs that some companies are already contemplating a move. According to the director of NHL Audit Yevgeniya Vakulenko, IT companies started calling her and her colleagues for help in moving working capital abroad after learning of the new draft code.

"Clients from the IT sector came to me asking how to take their capital out of Ukraine," Vakulenko told the Kyiv Post. "This speaks volumes. This tells us that the Finance Ministry's draft will not favor the development of the IT business in Ukraine."

"There is much to gain from paying taxes – but only if they're understandable and don't kill off a business," she said

## Vote postponed

A compromise bill was presented to the Verkhovna Rada on Dec. 17, but did not receive enough support. The chances for passage by year's end are uncertain.

*The Kyiv Post's IT coverage is sponsored by Looksery, Ciklum, Steltec Capital and SoftServe. The content is independent of the donors.* ■


# Medicine VAT rate stays low even as benefits questioned

By **Alyona Zhuk** and **Isobel Koshiw,**
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Value-added tax on pharmaceuticals will stay at 7 percent in the government's proposed tax plan, despite previous intentions to raise it for all the industries to 20 percent.

Ilya Neskhodovsky, a tax expert from the public initiative Reanimation Package of Reforms, welcomed the decision.

"VAT is a consumption tax, the country should not make money on people who got in a difficult situation and need to buy medicine," he told the Kyiv Post. "A 7 percent rate's goal is to prevent drugs from being even more expensive than they are."

According to him, a lower tax rate for medicine is a common practice in many European

Medicine in a pharmacy in Kyiv on July 12, 2013. (UNIAN)

countries. What Europe has, and Ukraine does not, however, are lower rates for other staple products.

"The 7 percent rate could be applied to some utilities, food, but we need to consider how real it is in terms of keeping the budget balanced," Neskhodovsky said.

Pharmaceutical companies also welcomed the tax: "The average consumer won't be forced to give up the quality of European medicine," said Vladimir Mitin, director of Actavis Ukraine, a global pharmaceutical company. He further suggested that Ukraine should introduce differentiated tax rates for prescription and non-prescription drugs to make the system fairer.

The decision not to raise the tax, however, is unlikely to satisfy consumers. Prices for medicine have jumped considerably since the hryvnia devalued by two-thirds in the last year.

Tamara Malyzheva, a 72-year-old pensioner from Kyiv, has a heart condition and spends Hr 1,500 of her Hr 6,000 pension on medicine a month and she says the prices rise continuously. She believes the government should be to standardize prices for medicine. "Prices at one pharmacy can be higher than at another. The government should do it every month to make sure that these private pharmacies don't rob people," Malyzheva said.

Vladimir Rudenko, director of the Ukrainian Pharmacy Professionals Association of Ukraine, offered some explanation at a news conference at UNIAN on Dec. 9.

"Prices are formed depending on the exchange rate, as well as medicines in most domestic production produced from imported raw materials. So, most of all, the retail price paid by Ukrainians depends on producers and distributors."

But Oleg Musiy, a lawmaker, doctor and former health minister from February-December 2014, told the Kyiv Post that these price differences are a product of several different factors.

"Firstly, it's connected to the fact that 80 percent of medicine is imported and is affected by the U.S. dollar. If they bought it six months ago, that can explain the change. Secondly, it relates to import tax of 10 percent introduced recently which means wholesale mark ups are allowed to be up to 10 percent and retail between zero and 25 percent on any medicine," said Musiy. "And medicine wholesalers who monopolize the market have unwritten contracts with retailers."

Asides from legislation which relates directly to medical products, other structural changes such as pay rises need to be prioritized.

"The price of medicine is also affected by things like doctors pay. At the moment this is $100 which is very low. Pharmaceutical companies pay doctors to recommend certain medicines which can be more expensive and less effective," said Musiy.

**The normal value-added tax rate is 20 percent. Why is it only 7 percent for the pharmaceutical industry?**

The absence of medical insurance which is used in other countries to reimburse the costs, amongst other things, means there is less incentive to monitor and police pricing, according to Musiy. "The market mechanism would help monitor and reduce the price," he said.

Likewise, Mitin of Actavis also recommends an insurance-based system: "In the absence of compensatory mechanisms today, patients cover at least 90 percent of the cost of treatment themselves…(in developed countries) patients pay no more than 40 percent and the rest is covered by the insurer," said Mitin.

Finance Minister Natalie Jaresko is not convinced a lower VAT tax leads to lower drug prices. She has been on a quest to standardize VAT tax rates. But she says the Health Ministry does not yet have a mechanism in place to subsidize cost of medicine for poor people.

*Kyiv Post staff writer Veronika Melkozerova contributed to this story.* ■

A worker at the Darnytsa pharmaceutical company in Kyiv, Nov. 11, 2011. The company planned to increase production in line with government policy at the time to decrease Ukraine's reliance on imports. (UNIAN)

# Lawyers don't agree on what to do about Ukraine's problematic VAT

By **Ilya Timtchenko**
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Not only is there no consensus among the parliament and government on Ukraine's tax reforms, there is also disagreement between Ukraine's lawyers on how to restructure the most problematic tax for businesses – the value-added tax.

The VAT tax is the main headache for businesses when it comes to taxes.

The Cabinet of Minister's proposal is to keep the VAT rate the same but eliminate other possibilities to avoid paying the tax, whereas the parliament simply wants to bring down the tax by 5 percent. While some lawyers say that the Rada's proposal is more business friendly, others say that the government tax reform will bring more profit for the country in the long run.

Natalia Osadchaya of Syutkin and Partners law firm, says that she is not happy with the government's proposal.

"I was so surprised when I saw it… I was actually shocked," Osadchaya said. She thinks that Ukraine's current system, despite all of its loopholes, is still much easier for businesses since it is more predictable.

Osadchaya says the VAT exists for corruption and prefers the single tax which consists of four groups. She finds it more clear and transparent. "The VAT exists for corruption because the businesses think how to avoid it and the government thinks how to catch the business," Osadchaya said.

Her clients are mainly agricultural companies who receive VAT refunds. The clients complain that the refund can take up to two years to receive the refund and even if they do receive it, the amount is much lower because of the local currency depreciation.

"One should either pay a bribe or pay in advance profits, or go to the courts and maybe in 2-3 years they will get it back," Osadchaya said.

The finance ministry's proposal is "killing" businesses, Osadchaya said.

Alexey Khomyakov, a partner at Asters law firm, says that the sales tax would be a good alternative to the VAT tax.

"Instead of having a lot of taxes… the

**Asters' lawer Alexey Khomyakov is skeptical of the value-added tax system altogether. Instead, he prefers the sales tax which he believes will be easier for businesses to implement. (Volodymyr Petrov)**

government doesn't receive sufficient resources from the corporate income taxes while the businesses spend a lot of time on bureaucratic procedures," Khomyakov said. "I think the government and the parliament should concentrate on the possibilities to improve the business environment through the implementation of the sales tax."

He says that this will be much easier for businesses since they will pay only one tax immediately at the point of sales. In addition, the government will not be spending millions of hryvnias on administering the system.

But Sergiy Gryshko from Redcliffe Partners law firm says that he thinks it is unrealistic since the European Union only has the VAT system.

But he finds the current VAT tax system incredibly difficult to administer.

"Tax authorities tend to change their minds quite often every now and then," Gryshko said. "It makes the life for businesses quite difficult."

It is very complicated to submit VAT tax returns because there are very unclear rules.

For example, the electronic tax system for paying the VAT is still causing businesses headaches.

"They have to submit for every client, they have to submit a declaration for every single payment they make in electronic form, they have to separately send the VAT money to the special accounts which again makes it incredibly complicated," Gryshko said.

Gryshko is for the electronic VAT system since it will take care of the human factor. However, so far it is not working well where much improvement is needed. "The VAT declaration is just a nightmare," he said. " The problem is that it looks like there is no coordinated effort within the government about what it should look like, at what rate, pace we should reach this full-fledged e-government."

While Gryshko finds the two proposed tax reform packages to be similar, he says that parliament's proposal will serve private interests.

"I am afraid that there are quite a few vested interests involved in the parliaments draft so we have to watch very closely what's in there," Gryshko said.

Gryshko doesn't see either proposal to take care of corruption of the tax authorities. This also has to do with a week court system which does not hold the fiscal services responsible.

Roman Blazhko, senior associate at Lavrynovych and Partners law firm says that Jaresko's package didn't provide any major changes to the VAT tax except for canceling the reduced 7 percent VAT rate for pharmaceutical companies. The finance ministry also proposed to cancel the VAT refund for agricultural companies.

In either case, Aster's Khomyakov says that both proposed tax reform packages are late since the two laws should have been drafted at least 6 months ago.

The parliament's proposal was submitted back in October whereas the Finance Miinistry's was submitted on Dec. 11. ■

# Jaresko adviser says flat tax will trim corruption

By **Ilya Timtchenko**
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Slovakian lawmaker Ivan Miklos is bringing his flat-tax, less-government regulation advice to two ministers – Finance Minister Natalie Jaresko and Economy Minister Aivaras Abromavicius.

He comes with top credentials. Miklos, 55, was named as a top business reformer by the World Bank's Doing Business report in 2004. In Slovakia, he served as deputy finance minister and privatization minister.

He's a believer in less government involvement in the economy. "All of my professional life is about reforms," Miklos told the Kyiv Post in an interview on Dec. 8.

Ukraine's cumbersome tax system today is similar to what Slovakia had before 2005.

"Which means it's very complicated, it's full of exceptions, deductions, special rates, special tax regimes, it is very distorting… very low tax administration efficiency, very high corruption," Miklos said.

For Miklos, price deregulation, liberalization and privatization are even more important than overhauling courts and prosecutors. His reasoning is that by closing down corruption in business, there will be less lawbreaking.

Ukraine's army of 54,000 tax officials will be trimmed by 32 percent by year's end, if Jaresko's tax reform package will follow through.

But the best way to simplify life is through introducing a flat income and corporate tax rate, which will make tax administration simpler and less corrupt.

After reform, Slovakia's flat rate became 19 percent. Before, rates ranged from 10 to 38 percent. It did not hurt the poor because the government raised the income threshold to qualify for exemptions of taxes.

"We tripled it… and we reduced the marginal tax rate," Miklos said. "The low income people in the new system are paying in reality zero, because their income is lower than the tax-free income."

**Ivan Milos, the former deputy finance minister of Slovakia and current lawmaker, speaks in Ukraine's Cabinet of Ministers on Dec. 12. (Volodymyr Petrov)**

From 2004 onward, 40 percent of Slovaks didn't pay any personal income tax, whereas the rest paid only 19 percent.

This is the direction that Jaresko is taking, Miklos said. Instead of having approximately 100 tax rates in Ukraine's four main tax categories – value-added tax, social security, personal income and corporate income taxes – the current ministry is proposing one.

*To read the full article, go to kyivpost.com* ■

# Laffer brings conservative advice to Ukraine's leaders

By **Ilya Timtchenko**
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Conservative economist Arthur Laffer rocketed to fame in the 1980s, advising U.S. President Ronald Reagan and United Kingdom Prime Minister Margaret Thatcher on tax policies.

Today Laffer is offering his views to Ukraine's Finance Minister Natalie Jaresko.

His Laffer Curve invention – a slope that shows how the government could actually save by cutting its higher tax rates – was what ultimately brought Laffer fame in the world of economics.

Laffer is the founder and chairman of Laffer Associates, an investment research and consulting firm, and advises Republican presidential candidates.

"The pomp, and pageantry, and the big pictures and the great dinners… that's not where Ukraine is going to get its answers," Laffer told the Kyiv Post in a Skype interview from his office in Nashville, Tennessee.

Whether it is the U.S., Great Britain or Ukraine, Laffer looks at five areas when he analyzes countries: taxes, government spending,

**Arthur Laffer speaks at the 12th Yalta European Strategy conference on Sept. 11 in Kyiv. (Volodymyr Petrov)**

monetary policy, trade policy and regulations.

In all of these sectors, Ukraine is weak compared to its Western neighbors, he said.

"What one wants to do is collect taxes in a way that does the least damage to the economy," Laffer, 75, said. "We tax people who speed on highways to get them to stop speeding. We tax cigarettes to stop people from smoking. Why on earth do we tax people who earn income and businesses that employ people or entrepreneurs that invest?"

Post-Soviet economies have generally performed poorly, with population declines serving as unhealthy indicators.

Ukraine is ranked second among countries with the highest death rates by the U.S. Central Intelligence Agency World Factbook.

Ukraine's output production is also very low relative to other European countries. Ukraine's $3,083 gross domestic product per capita in 2014 was about one-eighth of the average European one, Laffer said.

How the tax system works can bring prosperity or further plundering, he said.

That's why he favors going back to the basics of "having the lowest possible tax rate on the broadest possible tax base" as the best route to people declaring their incomes and paying their taxes.

*To read the full article, go to kyivpost.com* ■

### What is the difference between two tax reform proposals?

**The table is a side-by-side comparison of two tax bills, one proposed the Finance Ministry, and the other by parliament's tax committee. There was a compromise version proposed on Dec. 11 and rejected by parliament. The International Monetary Fund backs the Finance Ministry's version while Ukraine's business interests favor the rival plan. An IMF-compliant budget would unlock $4 billion in low-interest Western loans next year.**

| | The Ministry of Finance draft law | Verkhovna Rada Committee on Taxation and Customs Policy |
|---|---|---|
| Corporate tax | Base rate: 20 percent (18 percent now) | Base rate: 15 percent |
| Value added tax (VAT) | Base rate: 20 percent, export 0 percent (current 20, 7, 0 percent) | Base rate: 15 percent |
| | Special VAT regime for landowner is cancelled | Special VAT regime for landowner is canceled (except animal husbandry) |
| | Mandatory registration of VAT payers with an annual turnover of more than Hr 2 million (currently Hr 1 million). | The electronic VAT administration with depositing funds on VAT accounts is preserved (amount of the overdraft for registration tax invoices increased) |
| | Electronic VAT administration with depositing funds on the VAT accounts is preserved | The ban on the cancellation of the tax credit on formal grounds |
| | | Automatic VAT compensation. Applications through the newly created public register. |
| Income tax | Base rate: 20 percent (current 15, 20 percent) | Base rate: 10 percent |
| | Non-taxable minimum is equal to one minimum wage.<br>Military tax retained for 2016. | Three types for entrepreneurs, depending on annual income:<br>1) small individual entrepreneur (up to 250 minimum wages): a fixed tax of 10 percent of minimum wage<br>2) the general system (up to 4,000 minimum wages) 10 percent of the profit and simplified accounting of revenues and expenses on a cash basis<br>3) standard common system: 10 percent of the profit, a full accounting of income and expenses |
| Single Social Payment | Base rate: 20 percent (current 32.3-49.7 percent) | Base rate: 20 percent |
| | The maximum value: 25 minimum wages (current 17) | Maximum value is canceled |
| | Deduction from wages is canceled (current 3.6 percent) | Deduction from wages is canceled |
| Single Tax | Only entrepreneurs with an annual income: | First and second groups will stay unchanged |
| | Group A: up to Hr 300,000 (current first group) | |
| | Group B: up to Hr 2 million (merging of the second and third groups) | |
| | The right to use the simplified system for companies will be canceled. | The first and second groups are not changed. |
| | Group C: for farmers with an annual income up to Hr 2 million (current fourth group) | Third group: Yearly revenue decrease up to Hr 5 million (current Hr 20 million). |
| | Foreign economic activity forbidden for A and B groups. | Rate increase:<br>For 2016: 3 with VAT, 6 without VAT<br>For 2017: 4 with VAT, 8 without VAT<br>For 2018: 5 with VAT, 10 without VAT |
| | Rates:<br>Group A: up to 20 percent of the minimum wage.<br>Group B: up to 20 percent of taxable income.<br>Group C: the same as current fourth group | Fourth group: Farmers with an annual income up to Hr 100 million and the land up to 3,000 hectares. |
| Vehicle Excise Duty | Cars worth more than $1 million.<br>Rate: Hr 25,000 per year | The same |
| Real estate | Up to 3 percent of minimum wage for one square meter (currently, up to two percent).<br>Benefits for industrial and agriculture buildings are canceled. | No changes compared with the current system |
| Excise tax | Growth rates for different types of goods: from 25 percent to increase five times | Improvement to the administration of excise duty, implementation of excise tax bill |
| Administration | Simplify tax filing procedure | Function separation – the Ministry of Finance will form while the State Fiscal Service implement fiscal policy. |
| | Taxpayers, acting in accordance with tax advice, are exempted from administrative liability and from penalties, but not from additional taxation | Online access to an electronic taxpayer's office.<br>The new system of appeal. |
| | Reduction of the base for the initiation of tax audits | The new structure of the fiscal authorities: State Fiscal Service will perform only service functions. |
| | Single-level administrative appeal procedure | Elimination of the tax police |
| | Consideration of complaints by the Appeal Council | Establish Institute of Tax Consultants |

*Sources: Jurliga.ligazakon.ua website, Verkhovna Rada, and Ministry of Finance*


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