



# UKRAINE

## TECHNICAL ASSISTANCE REPORT—TAX ADMINISTRATION REFORMS AND GOVERNANCE OPTIONS

February 2016

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**UKRAINE**

**TAX ADMINISTRATION REFORMS AND GOVERNANCE OPTIONS**

**Thomas Story, Enriko Aav, and Debra Adams**

**August 2014**



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**ACRONYMS**

CIT	Corporate income tax
FAD	Fiscal Affairs Department
GIZ	German Agency for International Cooperation
HNWI	High net wealth individuals
IT	Information technology
LTI	Large Taxpayer Inspectorate
LTP	Large taxpayer
MOF	Ministry of Finance
MRD	Ministry of Revenue and Duties
OECD	Organisation for Economic Co-Operation and Development
OTA	United States Treasury Office of Technical Assistance
PIT	Personal income tax
RA	Revenue authority
SFS	State Fiscal Service
STA	State Tax Agency
STI	State Tax Inspectorate
STX	Short-term expert
TA	Technical assistance
UAH	Ukrainian Hryvnia
USC	Unified Social Contributions
VAT	Value-added tax

## **PREFACE**

In response to the request of the Minister of Finance, a technical assistance mission from the International Monetary Fund's Fiscal Affairs Department (FAD) visited Kiev from June 19 to July 2, 2014. The mission comprised Messrs. Thomas Story (mission head), Enriko Aav, and Ms. Debra Adams (all from FAD).

The mission was financed with the support of the Canada Department for Foreign Affairs, Trade, and Development.

The purpose of the mission was to provide advice on short-term actions to improve tax administration and agree future technical assistance from FAD. The mission also provided advice on governance reforms.

The mission met with the Deputy Minister of Finance, Mr. Denis Fudashkin, First Deputy Minister for Revenue and Duties, Mr. Igor Bilous and senior advisors and staff of the Ministry of Revenue and Duties (MRD). The mission also held consultations with members of the European Business Association and liaised with Christian Doering and Alina Chernomaz from the Germany Agency for International Development Cooperation (GIZ).

This report consists of an Executive Summary and five chapters: (I) Tax Administration in Ukraine; (II) Measures for Tax Compliance; (III) Value-Added Tax Administration; (IV) Restoring Good Governance; and (V) Technical Assistance.

## EXECUTIVE SUMMARY

**The purpose of the technical assistance was to develop revenue enhancing measures that the Ministry of Revenue and Duties could pursue in 2014 and to provide support to MRD in meeting the government's commitments under the IMF program.**

### **Measures to support revenue enhancement**

**Immediate revenue measures need to be balanced with some attention to more fairness in tax collection.** The mission recommends to cease revenue deferral arising from trivial tax disputes by requiring at least a partial payment of disputed tax before the appeal goes forward; collect tax arrears by promoting installment arrangements that fit the crisis conditions; strengthen routine monitoring of filing and payment obligations to control tax discipline; and make mandatory that largest taxpayers deal with their tax affairs at the large taxpayer inspectorate (LTI) offices instead of local offices. Ineffective internal dispute resolution processes should be replaced with an independent and fairer administrative review.

**Unified Social Contributions (USC) is poorly controlled.** The potential base of payers needs to be validated; penalties for noncompliance sharply strengthened; and joint audits on personal income tax (PIT) and social security obligations prioritized.

### **Value-added tax**

**Extreme compliance problems in value-added tax (VAT) are only a temporary rationale for the proposed system of VAT bank accounts.** The detection of "tax pits" is a priority but the proposed administrative response is a system of mandatory VAT bank accounts which lacks proportion; it disadvantages all smaller enterprises and is of no help to exporters who experience chronic refund delays. We suggest a one year "sunset" on VAT bank accounts. Raising the VAT threshold to Ukrainian Hryvnia (UAH) 1 million will reduce the administrative load on MRD. Carefully screening new and voluntary (below the VAT threshold) registrants is a more targeted response to VAT frauds.

### **Institutional changes**

**The integrity and governance problems in the MRD are very serious and international precedents suggest that successfully building trust in the existing institution is not going to be possible.** A more fundamental governance and institution reform is required to promote voluntary tax compliance, down-size the tax collector, and remove large numbers of suspect officials. This is feasible for July 1, 2017. Strengthened audit and collection powers should be sought concurrently for the new institution. The existing organization top structure is incomplete and a deputy chairman position responsible for tax administration should be immediately recruited.



**FAD technical assistance is available to support these reforms.**

**The major recommendations are:**

***Measures to support revenue enhancement***

- Adopt a short term plan of actions to be completed over 2014 to:
  - remove an automatic waiver of payment of disputed debt;
  - require a share of tax in dispute to be paid before the dispute proceeds to the court system;
  - improve management of late and stop filers;
  - establish an administrative, centrally managed, and independent appeals unit in MRD for resolving tax disputes internally;
  - remove legislative obstacles for detecting under-declared wages;
  - expand the payroll audit program on USC and PIT obligations;
  - initiate partnering with business associations against under-declared wages;
  - provide an offer for installments to be paid on outstanding debts under a two year extended term; and
  - transfer all taxpayers meeting large taxpayer criteria to the specialized offices for large taxpayers (LTIs).
- Review management of largest debtors and assign the cases to a centralized and separate function from January 1, 2015.
- Commence a High Income Self Employed Program by January 1, 2015.
- Increase the VAT registration threshold to UAH 1 million.
- Develop a fast track de-registration procedure.
- Include a "sunset" clause on any VAT bank account proposal for no later than December 31, 2015.
- Commence a High Net Wealth Individual program from mid 2016 after the LTI has reached its full operational capacity.

***Governance***

- Announce the future model for governance arrangements for revenue administration by August 31, 2014 and commence preparations to launch a new agency from July 1, 2017.
- Appoint a new deputy head within MRD responsible for the tax administration by August 31, 2014.

## I. TAX ADMINISTRATION IN UKRAINE

### A. Background

1. **This technical assistance report is focused on revenue enhancing measures that are possible through administrative reforms over the next 12 to 18 months.** It also offers some preliminary advice on the governance reform for tax administration that is a structural benchmark under the IMF support program for mid 2014.
2. **In 2013, Ukraine tax revenues (inclusive of social security taxes) accounted for 37.9 percent of GDP.** The largest revenue component is social security contributions at 13.3 percent of GDP. VAT is close to 9 percent of GDP and income taxes are of similar magnitude. Revenues are under much pressure from the recent turmoil; excise and social security taxes are not meeting expectations and there have been recent government actions to halt large excise evasion schemes and reverse a planned cut in VAT rates.

### B. Reform Progress in Tax Administration

3. **A modernization program for the State Tax Agency (STA) was undertaken between 2001 and 2012.** It received World Bank support and it led to a major roll-out of information technology (the "Tax Block" system) across large parts of the STA. The Tax Block provided a much needed integration of computer systems across the core processes for the administration of major taxes (i.e., registration, tax accounting, tax assessment and tax audit). The mission has noted the positive impact of the Tax Block on the tax administration's controls and access to management information on the core processes.
4. **A 2010 review by FAD expressed reservations about the extent of business process re-development that was accompanying the Tax Block introduction.**<sup>1</sup> The concepts of operating and management activities (known as the "ConOps") that represented detailed processes describing operations of the STA across headquarters, regional level oblast and local and branch offices, did not provide the necessary level of simplification and process re-engineering. There was concern that the modernization would be an opportunity lost. Of the 19 "ConOps," four were fully adopted under the modernization program (registration, return processing, payments and accounting, and tax audit).

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<sup>1</sup> Peter Barrant, Thomas Story, and Mark Konza: *Addressing Tax Administration Reform Challenge*, December 2010.

5. **STA adopted a greater emphasis on taxpayer services.** Electronic interactions grew rapidly and walk-in enquiry facilities were upgraded at some locations.<sup>2</sup> Other significant reforms included the transfer of payment and collection responsibilities for USC to the tax administration effective from October 1, 2013.

6. **A modest program of office closures took place.** STA had a very large network of offices and the modernization agenda was for a small reduction to 400 local offices by June 30, 2012. Ultimately, the aim was for 120 local offices and 10 regional (oblast) level offices though the timeframe for this scale of change was not clear.<sup>3</sup> The office network is now 311 STI offices at local level, 25 regional level (oblast) offices, a central office and seven specialized STI for large taxpayers, plus the headquarters. There are plans for another 40 office closures in 2014. A compensatory increase has occurred in branch (satellite) offices. An additional 133 branch offices were opened since 2010 and the total number of branch offices is 315.

7. **The institutional settings and organization of the tax administration have not been stable.** A MRD was formed in late 2012 to subsume the STA. Institutional reforms proceeded to merge tax and customs administrations under a single head of MRD from March 2013. The tax police are also within MRD. A decision to reverse the ministry level status of the revenue administration has recently been taken. A new State Fiscal Service (SFS) is to be formed and it will be in place from July 2014. Tax policy functions are being returned to the Minister of Finance. Tax police and customs functions would remain within the SFS. Under the draft charter of SFS (still under development), the new body is to be coordinated by the Cabinet of Ministers. The head would be appointed and dismissed by the Cabinet of Ministers on advice of the Prime Minister. The Minister of Finance (MOF) will have oversight and/or responsibility in specific areas (e.g., tax policy and revenue estimates) though the reporting relationship is not settled.

8. **A moderate down-sizing in the staff of the MRD is planned.** Total staff of the revenue administration including all three services (tax and customs administration and tax police) is approximately 56,000. Though staffing numbers for the new organization are not final, the plans are for SFS to reduce its head-count across all three administrations by 8.6 percent at regional and local level and by 10 percent in the headquarters. In addition, the MRD has proposed to remove the legal entity status of some local tax offices. This is in order to subordinate these offices to oblast (regional) bodies and facilitate further staff reductions. This proposal is yet to be adopted.

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<sup>2</sup> In 2014: 98 percent of VAT returns are filed electronically to offices within Kiev; as are 87 percent of personal income tax, 67 percent of corporate income tax, and 58 percent of social contribution declarations.

<sup>3</sup> See Barrand (2010). At the last FAD review, the office network was 463 State Tax Inspectorate (STI) local offices, 10 specialized offices for large taxpayers and 27 Oblast offices.

### C. Integrity and Governance

9. **The MRD is widely observed as very vulnerable to structural and piecemeal corruption.** An over-reliance on revenue targets exacerbates the integrity concerns. Serious frauds involving chains of small and medium entities that exploited the VAT system (tax pits) were sponsored by senior members of the previous government. Detection of the fraudulent entities is a complex undertaking and there is concern that the system may re-emerge. State sponsored frauds have also been revealed in excise collection. Improper use of revenue targets to elicit contributions to the state are consistently complained about by business representatives and were confirmed by officials. Tax audit quality has declined while revenue generation has become more opportunistic. Tax dispute resolution processes are not regarded as fair and independent internal review is lacking.

10. **Confidence in the revenue administration has been undermined.** The scale of the fraudulent activity within the revenue administration and its public airing has raised concerns for the future viability of the tax collector. Re-building confidence to promote future voluntary tax compliance is seen as a critical concern.

### D. Enhancing Tax Collections and Fairness: Immediate Measures

11. **The mission proposes a set of actions that could be implemented over the balance of 2014.** The purpose is to bolster short-term revenue performance within the very difficult environment, address some key gaps, while offering balance through early action which begins to address the needs for fairness in the tax system. Box 1 summarizes the proposed measures. An overview of the planned measures follows and there is further discussion in Sections II and IV.

#### First stage organization changes

12. **An immediate priority is to provide an additional deputy head position in MRD that has responsibility for tax administration.** The position will also be key to delivering reforms in the future governance of the revenue administration. Considerations for the governance reforms are discussed in Section IV.

#### Late and stop filers

13. **A priority in an economic crisis is to stabilize return filing from those who are voluntarily complying with recurrent tax obligations.** For each of VAT, PIT, and USC, regular filers should be subject to early reminder of pending due dates and quick follow-up for late priority taxpayers. Examples from other tax administrations have included text messaging, automated email reminders and out-bound calling when filing due dates have passed.

<b>Box 1. 2014 Priority Actions—Revenue Enhancement and Restoring Fairness</b>		
<b>Completion date 2014:</b>	<b>Description</b>	<b>Measure</b>
August 31	First stage organization changes	Appoint a new deputy head of MRD responsible for tax administration; announce the governance reform.
August 31	Managing late/stop filers	Provide outbound call capability and advance mailings or electronic reminders of filing dates before submission deadlines as well as fast follow-up of late filers.
September 30	Clearing collectible tax arrears	Provide an offer for installments to be paid on outstanding tax debts under extended terms.
September 30	Tax postponement through court disputes	Require payment of a share of disputed tax in all new tax disputes referred to the court system.
September 30	USC enforcement	Remove legislative obstacles to USC audit and announce a partnership with business to improve USC compliance.
November 30	Reforming internal dispute resolution	Provide organizationally separate and independent internal review of tax disputes.
November 30	Payroll auditing	Expand on-site program of payroll auditing for USC compliance
December 31	Large taxpayers	Transfer large taxpayers from regional offices to LTIs.

### **Large taxpayers**

14. **The short-term reform plan proposes that 1,380 large taxpayers come under LTI management.** Problems associated with control of large taxpayers are long standing. Control within the LTI offices is optional and less than half (37 percent) of those meeting criteria for classification as “large” are managed within the specialized inspectorates. The short-term plan calls for this situation to be rectified. The details are discussed at Section II.

### **Tax arrears**

15. **An installment offer to provide a further opportunity to clear tax debts is included in the short-term actions.** Amounts of tax arrears that are currently under installment plans for large taxpayers, total UAH 2.641 billion. The standard term of the installment arrangements is 12 months and may be exceptionally extended to 24 months. Amounts of tax debts that are less than one year old, and which are likely collectible total UAH 5.456 billion. An additional UAH 4.425 billion is between one and two years old (see Appendix 1). An offer of a targeted installment plan of up to 24 months duration for taxpayers to clear arrears should be made. A term of 24 months is not unreasonable having regard to crisis conditions within Ukraine.

## **Tax disputes and payment postponement**

16. **Tax disputes are escalating and there is ample evidence of disputes on minor grounds to delay tax payment.** Disputes are referred for court resolution without any obligation on the taxpayer to make any payment of a proportion of disputed tax. Amounts of disputed tax exceed UAH 130 Billion at December 31, 2013 and the numbers of tax disputes have increased by 65 percent between 2011 and 2013 (see Table 7). Over 50,000 tax appeals are on hand and there are informal estimates that backlogs of cases in the court system are much larger. The action plan calls for legislative changes to require payment of 50 percent of tax in dispute before a dispute may proceed. The plan also envisages that tax dispute resolution is reformed to provide an independent administrative internal tax review as a necessary precursor to court based appeals.

## **Unified Social Contribution enforcement**

17. **Arrears of USC have risen by 36 percent since October 2013 and now total UAH 3.6 billion at May 2014.** Though there is a sharp spike in monthly arrears that appear as a consequence of the recent regional conflicts (see Table 4), there is a wider concern that USC compliance will continue to be adversely affected by weak enforcement. Business representatives inform the mission that around 70 percent of payroll costs are paid at the minimum wage and the balance is 'brown envelope' payments. A tacit acceptance of under reporting of registered worker entitlements in exchange for weak enforcement by the authorities is alleged by some business observers. The priority measures are to correct legislative gaps that prevent effective payroll auditing (see Section II) and to commence a well publicized program of payroll audits. Concurrently the authorities need to liaise with the business community on more effective measures to promote employer compliance.

## **Recommendations**

- Adopt the short-term plan of actions in accordance with Box 1.

## **II. MEASURES FOR TAX COMPLIANCE**

### **A. Managing the Largest Taxpayers**

18. **The administration of large taxpayers should be improved to focus better on the bulk of the revenue.** This can be done by removing voluntary admission to the large taxpayer program, refocusing revenue generation from a revenue target driven approach to a focus on quality of audit, and by launching a high net wealth individuals (HNWI) program.

### **The Large Taxpayer Inspectorate population**

19. **Most large taxpayers are not covered within the formal large taxpayer program.** The LTI is organized as a specialized inspectorate with a central office in Kiev and seven regional

offices (Table 1). There are 2,131 registered large taxpayers (LTPs)<sup>4</sup> in Ukraine. If a LTP is registered in a location where an LTI is not established, the LTP has discretion to be managed either by the closest local tax office or by the LTI.<sup>5</sup> As a result, many large businesses prefer to stay under local tax offices and only 35.2 percent of all LTPs are managed by the LTI. Out of the 1,295 taxpayers administered by the LTI 751 are LTPs and 544 are associated companies. Currently, 1,380 LTPs are administered by local tax offices. These offices lack sufficient industry-specific knowledge and skills to deal with the complexities of large businesses.

**Table 1. Large Taxpayer Inspectorate Revenue Collections in 2013**

(In UAH millions)

Name of Office	Number of Staff	Number of Large Taxpayers	Direct Taxes Collected	Indirect Taxes Collected	Other Revenues Collected	Total Revenues Collected
LTI Central Office	573	393	24,127.6	34,689.4	2,666.9	61,483.9
<b>Regional LTI offices:</b>						
Deniproperovsk	236	258	4,881	3,540.5	2,044.3	10,465.8
Donetsk	323	171	4,101.4	4185	1,583.5	9,869.9
Zaporizhya	159	53	1,538.2	1,761.5	565.0	3,864.7
Luhansk	173	96	528.6	1,724.1	539.6	2,792.3
Lviv	220	43	835.8	1,805.1	201.6	2,842.5
Odessa	149	118	1,667.4	1,927.2	462.0	4,056.7
Kharkiv	255	163	2,196.9	8,730.7	662.8	11,590.4
Unassigned	...	...	956.0	82.4	0.0	1,038.4
Total	2,088	1,295	40,833.1	58,445.8	8,725.8	108,004.7

Source: Ministry of Revenue and Duties.

20. **Tax affairs of all large taxpayers should be covered by the LTI.** Advanced tax administrations develop large taxpayer programs to respond optimally to the specific needs of a large taxpayer segment and have effective control over bulk of the revenue that LTPs generate. It is highly unusual that taxpayers can opt out of the LTI arrangement. This is an unnecessary waste of tax administration resources and results in weak administrative support and poor compliance management of LTPs that are out of the LTI. The discretion of taxpayers to choose which office

<sup>4</sup>A large taxpayer is a legal entity whose annual sales exceed UAH 500 million or whose annual amount of taxes paid to the state budget exceeds UAH 12 million. The MRD has proposed that the criteria be amended to provide for equivalent annual sales exceeding UAH 500 Million over 20 consecutive calendar months and an increase in the annual amount of taxes paid to UAH 20 Million.

<sup>5</sup> Ukrainian Tax Code Article 64.7.

will administer its tax affairs should be removed from the Tax Code and all LTPs should be transferred under the LTI.

### Large Taxpayer Inspectorate audit results

21. **The current revenue target -driven approach, through a negotiated revenue contribution from businesses, must cease.** Negotiations are no substitute for high quality audits. As shown in Table 2 the yield in all types of LTI audits has markedly decreased in 2014 compared to 2013. The mission is on the opinion that the LTI audit program is weak and the dominant audit/compliance management approach is based upon consultations with taxpayers on the amount of their contributions to meet the government-set revenue targets. The LTI should strengthen its audit quality and build its performance management on achieving compliance through quality and fairness of LTI operations instead of short-term revenue targets.

**Table 2. Large Taxpayer Inspectorate Audit Results**

	Desk Audits	Field Audits		VAT Refund Audits
		Scheduled	Unscheduled	
<b>2013</b>				
Audits completed	253	246	349	2,314
Additional tax and penalties assessed, (UAH '000)	283,082.9	3,592,914	3,859,552.6	2,887,504.4
Yield per audit (UAH '000)	1,118.9	14,605.3	11,058.9	1,247.8
<b>2014</b>				
Audits completed	112	168	228	755
Additional tax and penalties assessed, (UAH '000)	90,610.2	1,399,347.2	1,372,335.2	751,189.3
Yield per audit, (UAH '000)	809.0	8,329.4	6,019.0	995.0

Source: Ministry of Revenue and Duties.

### Large Taxpayer Inspectorate staffing

22. **The staffing of the LTI should be increased to ensure sufficient administration of all large taxpayers.** The LTI has reduced its staff from 2560 in 2012 to 2088 in 2014. Audit staffing has also decreased though the mission could not confirm the actual auditor staffing numbers.<sup>6</sup> If all LTPs will be brought under a large taxpayer program, the number of taxpayers under LTI will be tripled. To sufficiently administer LTPs, the staffing of appropriately qualified LTI auditors should be urgently re-examined. An injection of audit staff may be achieved by redeploying staff from regional tax offices who are currently managing LTPs.

<sup>6</sup> There is 657 staff within the audit function of regional LTI offices and another 218 persons attached to the audit function within the headquarters. These numbers include support personnel and the number of tax auditors is not confirmed.



## High net wealth individuals program

23. **The LTI should incorporate HNWI from 2016.** Currently, in addition to 751 LTPs the LTI administers 544 enterprises that are associated with LTPs. Such an approach allows the LTI to maintain better control of LTPs' tax affairs. The LTI should also prepare for managing tax affairs of high wealth individuals that execute de-facto control over large businesses in Ukraine.<sup>7</sup> These taxpayers will be complex to manage and building a HNWI compliance program for these very wealthy persons will take a number of years. However this is an important element of a well focused approach to the highest revenue risks.

24. **As a second stage, the HNWI population can gradually expand to other individuals with considerable wealth.** The HNWI segment has distinct risk indicators. Box 2 describes these. It is also advisable that the HNWI program be phased to commence *after* the LTI reaches full operational capacity under the recommended expansion to cover all large businesses. The HNWI program should therefore be planned for commencement from mid 2016. The independence of the tax administration from political interference, in addition to unbiased and balanced execution of administrative powers, will be critical preconditions for a successful HNWI program.

### Box 2. Indicators of Risk for High Net Wealth Individuals

- Low or no tax paid at the individual level;
- substantial losses claimed;
- involvement in aggressive tax planning;
- high levels of intra-group dealings;
- major restructures or disposals of group assets;
- flows of funds to and from other countries—especially tax havens and countries where the group has no known business operations; and
- holding of ordinarily private assets (e.g., houses, farms, boats and aircraft) within group entities.

## Recommendations

- Remove the discretion for large taxpayers to choose a tax office to manage their tax affairs.
- Transfer all taxpayers meeting the large taxpayer criteria to the LTI.
- Commence an HNWI program from mid 2016 after the LTI has reached its full operational capacity.

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<sup>7</sup> These may not be registered owners of the enterprises.

## B. Unified Social Contributions Compliance

25. **USC filing and payment compliance is deteriorating.** To tackle the issue, the authorities need to cleanse the contributor register, remove legislative obstacles (e.g., Article 77, item 77.3 of the Tax Code) to running an effective payroll compliance program, start systematically address under-declared salaries by enhancing cooperation with business society and other government agencies, introduce unannounced visits to the premises of businesses, and harmonize USC administration with payroll PIT administration.

### Contributor register

26. **The USC register of insurers is inflated.** The MRD commenced administering USC filing, payment and collection from October 2013, when responsibility was passed from the pension funds. Registers of contributors were maintained by the funds and have been cumulative since the early 1990s. As shown in Table 3 out of 3,872,517 persons registered as payers of USC, less than half (1,875,485) submit declarations for payment of USC. Approximately 1.2 million contributors that are still on the register have reportedly ceased their activities and are under liquidation. Another significant group of stop filers are contributors registered in Sebastopol and Crimea—regions annexed recently by Russia. Currently, the *potential* filing population cannot be accurately determined and the total number of contributors that are required to file may be substantially higher than presented in Table 3.

**Table 3. Unified Social Contributions Declaration Filing**

	Number	Filing Frequency
Total registered contributors	3,872,517	
Total filing contributors: <sup>1</sup>	1,875,485	
<i>Of which:</i>		
Legal persons in general tax system	194,658	Monthly
Legal persons in simplified tax system	160,472	Monthly
Private entrepreneurs in general tax system return on employees	80,900	Monthly
Private entrepreneurs in general tax system annual return	546,867	Annual
Private entrepreneurs in simplified tax system return on employees	142,142	Monthly
Private entrepreneurs in simplified tax system annual return	960,856	Annual
Self-employed professionals	1,869	Monthly
Self-employed professionals annual return	12,632	Annual

Source: Ministry of Revenue and Duties.

<sup>1</sup> Monthly filers (for employees) may also file annually in respect of their own obligations.

27. **The register needs to be urgently cleansed by removing invalid registrants.** Because this is potentially a highly labor-intensive and costly review process, a first step would be cross matching with other registers and databases (e.g., the PIT register, customs importer information, registers of motor vehicle owners), in order to detect truly active registrants. Following this step, a major follow-up campaign in writing and through personal visitations would likely be necessary. Only with an up to date register can the tax administration control and effectively manage delinquent contributors.

#### **Unified social contribution payment and filing compliance**

28. **As shown in Table 4, the number of submitted USC returns and respective monthly payments fell sharply during the last eight months.** At the same time, USC arrears have increased by 36 percent from UAH 2.6 million in October 2013 to UAH 3.6 million in May 2014. This can be partly attributed to the recent political difficulties and civil disturbance, but weakening compliance among those who may normally and voluntarily comply is also at play, and needs to be managed (see the filing management discussion in Section II. F).

**Table 4. Unified Social Contributions Filing and Payment**

	2013			2014				
	October	November	December	January	February	March	April	May
Number of actual USC filings	637,818	637,885	633,567	623,695	622,446	588,180	584,310	580,041
Amounts paid (UAH Million)	15,619.9	15,903.9	18,939.5	13,816.5	14,853.2	15,129.3	16,007.3	14,610.6
USC arrears (UAH '000)	2,658.4	2,844.8	2,660.2	2,874.2	3,106.1	3,040.3	3,561.1	3,624.8

Source: Ministry of Revenue and Duties.

#### **Legislative obstacles**

29. **The payroll audit program needs to be strengthened by adding unannounced visits.** Current payroll audits by the MRD are limited to formal comparison of declared payroll taxes with taxpayer accounts and are (largely) desk reviews. Such an approach cannot be successful in detecting undeclared labor or under-declared salaries. Advanced tax administrations regard unannounced visits to taxpayers' premises as a mandatory tool to detect undeclared labor. In the opinion of MRD the law does not provide legal authority to the MRD to perform such visits. If this is the true position, the legislation needs to be quickly changed to grant tax administration proper authority for detecting undeclared labor.

30. **Information from third parties is poorly utilized to detect under-declared salaries.** The mission was advised that the tax administration's ability to use information from employees or third persons as evidence for estimating real amounts of salaries is strictly limited. For

example, the mission is advised that it is impossible to use employees' assertions about their actual employment to prove under-declared salaries. The law needs to be amended to grant the tax administration sufficient powers to detect and prove under-declared salaries (e.g., the powers at Article 77.3 of the Tax Code). Detection of undeclared labor will be more successful if performed in close cooperation and coordination with other government agencies like the Inspection on Labor Affairs.

31. **The penalty regime for USC should be critically evaluated.** The authorities claim that the penalty regime for undeclared labor is too weak and that a number of penalty provisions are no longer available to enforce compliance. The mission could not confirm the suite of applicable penalties but in principle it supports strengthening the penalty regime, particularly for defaulting employers, given the nature of USC obligations.

### **Partnership with business**

32. **A partnership with business has to be established to break the ring of noncompliance in payroll taxes.** The mission was advised by business representatives that there is a "silent consensus" between business and the authorities that business may report minimum level salaries with a balance paid as cash (brown envelopes) to sustain employment levels while the tax administration would not perform enforcement actions. This is not sustainable and has to be changed.

33. **There is a need for stronger efforts by the MRD to improve USC compliance.** MRD has a small program to detect under-payment of USC or unregistered labor but a substantial scaling up of these programs is required.<sup>8</sup> The most effective way to change the compliance pattern is through partnering with the business community, as is done by many advanced tax administrations. As a rule, business operators are interested in government providing "a level playing field." Building partnership starts with initiating dialogue with different business associations, representatives of industry groups and agreeing on a common plan of activities to bring industry operators out of the shadow economy. The MRD should start such a dialogue with the business community on the basis of a "fresh start" for USC compliance and develop mutual action plans to improve compliance in payroll taxation.

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<sup>8</sup> For example, in 2014, MRD estimates that 35,000 individuals have been detected where USC was not paid. An additional UAH 16 million in USC was collected. Official estimates of the extent of "brown envelope" payments were not provided to the mission. Industry and media reports quote estimates of cash payments that are said to be on a massive scale—about \$17 Billion per year with one third of workers receiving "black salaries" (see for example *Reuters: How Scams and Shakedowns brought Ukraine to its Knees*," August 7, 2014.

## Harmonization with personal income tax

34. **USC should be fully aligned with PIT administration.** The mission was advised that authorities intend to pursue harmonization of the USC and PIT base and of filing and payment rules across the taxes. This would allow a common declaration across the two obligations. The tax base for PIT is understood to be closely related to the base for USC and therefore, it should be a logical extension to apply similar filing, payment, and collection rules to both fiscal obligations in order to reduce compliance costs. The mission was not informed on the timeframe of harmonization, but it should be pursued as a medium term priority.

### Recommendations

- Cleanse the contributor register.
- Remove legislative obstacles (for example auditor access rules and inadequate penalties) for detecting under-declared wages and rapidly expand the payroll audit program.
- Initiate partnering with business associations to improve under-declared wages.
- Harmonize administration of USC with payroll PIT in the medium term.

## C. Tax Audit

### Cameral audit program

35. **An extensive automation of the cameral audit program was introduced in 2013, including an automated review of a very high proportion of all filed tax returns.** The program is mandatory under the Tax Code and is effectively automated desk verification involving cross-matching returns with declared transactions, the Annex V invoice registry, customs records and other data held by the MRD information technology (IT) system.<sup>9</sup> The system performs arithmetic checks, automatically generates electronic notices of detected errors and generates an electronic desk audit report. As seen in Table 5 (which is describing the cameral audit results for VAT), 35 percent of the screened returns are flagged as containing errors and these taxpayers are contacted to submit an amended return. Errors can range from incomplete and inaccurate returns to those with underlying invoice and documentary mismatches.<sup>10</sup> If a

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<sup>9</sup> The Annex V system is a VAT invoice matching system introduced in 2008 under which all VAT taxpayers are required to submit a statement of all transactions with each registered supplier or customer. Automated cross-matching of the invoices is undertaken as part of the cameral audit program. The 2009 FAD mission provided commentary and recommendations on the Annex V system.

<sup>10</sup> Although there appears to be no legal basis for the approach, where there is a documentary mismatch, a VAT taxpayer is expected to disallow any credit for VAT on a transaction that has not been reported by the counterpart to the transaction. The business community compared this to the MRD adopting a “joint and

taxpayer does not submit an amended return, an automated assessment of additional tax and charges is generated. The highest risk returns, where errors and issues cannot be resolved by notification or assessment, are referred for audit. In 2014, although only 0.3 percent of screened returns were referred for audit, officials estimate the tax at risk in these cases to be in the region of UAH 15 billion, although the mission could not validate this estimate.

**Table 5. Summary of Cameral Audit Activities (Value-Added Tax)  
January to April 2014**

Description	Number	% of Returns
Tax returns filed	968,930	
Tax returns screened	892,385	92
Notices issued seeking amended returns	334,260	35
Findings produced (tax risks present)	175,964	18
Amended assessments issued	9,760	1
Referred for audit	2,666	0.3

Source: Ministry of Revenue and Duties.

36. **There is a question whether the program is a proportional response to the levels of risk seen across the taxpayer population.** Under this program, the MRD is effectively responding to every tax risk identified on every filed tax return, with a relatively insignificant amount of additional revenue being directly generated. This return-based approach does not assist the MRD to achieve the “whole of taxpayer” view that is desirable in any comprehensive approach to risk assessment. More advanced systems do not require an attempt to investigate each mismatched invoice. Instead, and with the aim of better targeting resources to risk, these mismatched sales or purchases would be attributed to the files of the respective taxpayers and become one of the risk elements evaluated in the selection of audit cases. The related mismatched items would then be examined in the course of the next audit. Nor does the current standardized approach help with a move towards the adoption of a more advanced segment-based view of risk as no distinction is currently made between risks posed by small and medium sized businesses.

37. **An evaluation of the scale and performance of the cameral audit program is needed.** The system maintains records of the number of returns screened, additional tax assessed and collection rates. During the first four months of 2014, the program generated additional tax assessments of UAH 109.7 million, of which nearly 90 percent has been collected. It

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several liability” approach, whereby one taxpayer is held responsible for the compliance failures of any and all unrelated taxpayers in a chain of transactions.

is accepted good practice to work with taxpayers to improve the accuracy of filed returns and thus increase future voluntary compliance. However, there is no formal program in place to monitor whether compliance levels are in fact improving after interactions under the program. In its favor, the cameral audit system is highly automated and, according to MRD officials, relatively efficient in terms of resource requirements.<sup>11</sup>

### **Audit coverage**

**38. The audit coverage rate of the taxpayer population has dropped dramatically.**

The 2009 FAD mission noted a field audit coverage rate of 15.8 percent in 2008. As shown in Table 6 below, outside the large taxpayers audit program, the coverage rate fell to 3.44 percent in 2013, including planned and unplanned audits. This decrease is a result of both a greater risk orientation in scheduled audits, and a halving of audit resources.<sup>12</sup> However, as audit coverage has declined, the overall revenue assessed per audit has increased, with the 2013 rate 64 percent higher than in 2008.<sup>13</sup> This assessment rate has increased still further in the early months of 2014, although collected amounts have dropped in the same period.

### **Risk assessment**

**39. Risk assessment approaches are fragmented.** The two main factors contributing to this fragmentation are (1) the lack of a centralized risk assessment function; and (2) legal obligations that require audits to be conducted at the instigation of third parties. Risk assessment processes are currently scattered throughout the organization. As previously noted, the cameral audit program performs an initial sift of all returns. A further range of unplanned audits is selected automatically based on criteria laid down in the Tax Code (see details below). Large taxpayer risk analysis is performed by the central office for large taxpayers. Finally, the central audit function strives to apply a continually updated range of risk criteria to select the highest risk cases for planned audits. This fragmented approach raises the risks of potential gaps in coverage and duplication of effort.

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<sup>11</sup> The mission was unable to obtain accurate data on the staff numbers deployed on the cameral audit program.

<sup>12</sup> Over recent years, audit staffing has been reduced from 12,000 to current levels of approximately 6,500 staff. The mission was informed that MRD currently has around 500 vacant posts in the national audit function.

<sup>13</sup> Revenue per field audit was UAH 68,290 in 2008, increasing to UAH 112,273 in 2013 (for planned and unplanned audits combined) and UAH 380,575 in the first 5 months of 2014 (planned and unplanned).

**Table 6. Summary of Audit Performance**

(In UAH millions; unless otherwise specified)

	2013	January to May 2014
<b>Unplanned audits</b>	<b>32,496</b>	<b>12,348</b>
Total assessment of revenues, including fines and charges	2,122	2,559
Collected revenues	1,233	683
Revenue per audit	0.0653	0.207
Percentage of assessed revenue collected (in percent)	58.1	26.7
<b>Planned audits</b>	<b>4,886</b>	<b>2,272</b>
Total assessment of revenues, including fines and charges	2,075	3,005
Collected revenues	1,992	561
Revenue per audit	0.425	1.32
Percentage of assessed revenue collected (in percent)	40.8	18.7
Audit coverage (1,084,900 active taxpayers, June 20, 2014) (in percent)	3.44	1.34

Source: Ministry of Revenue and Duties.

**Audit program**

40. **Unplanned audits are not based solely on risk assessment.** Article 78.1 of the Tax Code lays down the circumstances that generate unplanned audits. Most of these grounds reflect tax risks: for example, selection may include a taxpayer who has not filed a return; who has submitted additional or corrected data; who has begun a re-organization or liquidation; or where third party information about a violation has been received. However, low yield reviews are also generated by other Article 78 grounds: for example, a requirement for a tax audit where a legal order has been issued from the court, or on instructions by crime investigators or prosecutors. MRD was not able to provide a breakdown of the number of these types of audit cases. Feedback to the mission is that these audits are mandatory under law but clearly crowding out higher yield unplanned audit work where there are more substantial tax risks. A further concern is that the list of circumstances for unplanned audits is laid down in the legislation and thus static. As a result, MRD is hampered in its efforts to respond quickly to the ever-changing business and economic environments and the dynamic risks these generate.

41. **The audit program therefore needs re-balancing.** MRD already employs a wide range of the typical types of audits seen in advanced tax administrations, including desk verifications (see cameral audit above), VAT refund, issue-based and comprehensive audits, and tax investigations. However, the routine audit program includes a dominance of unplanned work, most of which is not based on risk. This work has low yield—for 2013 and the first five months of 2014, planned audits generated seven times the assessed amounts of the unplanned audit



program. A re-balancing of the audit program to include more solely risk-based and planned audits would contribute towards the effectiveness of the program.<sup>14</sup> Any re-balancing will require an alignment of coverage targets for different segments of business (large, medium, and small), various industry and business sectors, identified compliance risks, available resources spread across these elements of the program and the use of a range of audit types.

### **High income self employed program**

42. **Declarations of the high income self employed appear to display sufficient risk to merit a targeted audit program.** Initial analysis of the 2013 return data for private entrepreneurs shows a clustering of declared net annual income at levels below UAH 20,000 (or approximately US\$1,800). Appendix 2 provides the detailed breakdown, with 87 percent of all private entrepreneurs declaring net income below this level. Certain categories of independent professional practitioners display even more extreme results with 91 percent of barristers and all forensic experts declaring net income below this level. Considering the professions involved, this data deserves further analysis. High income self employed professionals are not subject to the same tax withholding and reporting arrangements as ordinary salary and wage earners and are often involved in tax minimization schemes.

43. **Based on further analysis, a targeted program should be rolled out sending a clear signal that tax evasion will be tackled at all levels of society.** Part of the program would be a high profile audit campaign, which is contemplated within the audit program re-balancing recommended above and which should provide a deterrent effect on the wider population of self employed and private entrepreneurs. A task force comprised of auditors, supported by legal experts and financial analysis, could quickly identify the highest risk cases and a suitable program approach would include the actions in Box 3.

### **Recommendations**

- Evaluate the cameral audit program performance to determine the results of the program and, based on this evaluation, revise the approach by June 30, 2015.
- Centralize all risk assessment under one function and reduce obligations to undertake (non risk-based) audits required by third parties by December 31, 2015.
- Rebalance the audit program through reducing unplanned audit activities while increasing planned risk-based audits.
- Commence a high income self employed program by January 1, 2015.

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<sup>14</sup> See Toro, Brondolo, Arslanalp, Holland, and Donnelly: *Ukraine: Developing a Compliance Improvement Plan for the Economic Crisis*, August 2009.

### Box 3. High Income Self Employed Program

- *Make a public announcement of the intention to crack down on evasion by high income individuals.* This announcement may encourage taxpayers to make a voluntary disclosure.<sup>1</sup>
- *Identify the 50–100 highest risk cases* using the data available on owned assets and other evidence available from a search of media and internet articles, tax return data etc.
- *Conduct a comprehensive audit of each case* ensuring all avenues for secreting income are explored and that evidence is collected and properly managed at all stages of the investigation to support any subsequent prosecution or appeal action.
- *Issue assessments with full penalties* as soon as a strong business case has been established to support this action and engage the debt collection section in enforcing collection.
- *Prosecute the worst offenders* under the appropriate criminal offences.
- *Allocate the best available legal representatives* to defend the assessments in any appeal actions launched the taxpayer.
- *Widely publicize the results of the program* as a means of deterring others and promoting community confidence in the integrity of the tax administration.

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<sup>1</sup> MRD is currently planning a Tax Compromise program under which taxpayers can report understated amounts of VAT or Corporate Income Tax liability for the tax years 2013 and earlier with payment of only 15 percent of the actual liability. No penalties or interest will be applied. Many high income self employed may take advantage of this highly concessional offer. MRD's rationale for the extremely favorable terms of the amnesty is that they wish to signal a break with the past.

### D. Reforming Tax Disputes Resolution

44. **There is a major escalation of appeals volume.** The number of unresolved tax disputes has increased from 32,359 cases in the beginning of 2011 with disputed amounts of tax totaling UAH 70.2 Billion, to 53,529 cases by the end of 2013 with disputed amount of tax of UAH 129.5 Billion (Table 7). The number of objections received annually has increased from 15,290 in 2011 to 21,120 in 2013.

45. **Automatic waivers of disputed tax are driving the growing volume of disputes.** Article 56.15 of the tax code provides for the obligation to pay assessed tax to be suspended during the appeal process. This triggers the willingness of taxpayers to dispute every tax assessment. Business representatives confirmed that it is a usual practice to dispute tax assessments to postpone payment of assessed taxes and gain time to prepare the court appeal. As shown in Appendix 3, most developed countries require full, or in some cases partial, payment of disputed tax. Box 4 provides examples of selected administrative practices in collecting disputed tax.

**Table 7. Stock of Internal Appeals**

	2011		2012		2013	
	Number	Amount UAH million	Number	Amount UAH million	Number	Amount UAH million
<b>Appeals for LTI taxpayers</b>						
On hand at start of year	2,425	15,522.59	3,162	20,874.57	3,234	32,861.17
Received during year	1,069	11,061.15	1,022	23,498.06	1,267	21,596.21
Finalized during year	332	5,709.17	950	11,511.46	1,013	11,005.93
On hand at end of year	3,162	20,874.57	3,234	32,861.17	3,488	43,451.45
<b>Appeals for non-LTI taxpayers</b>						
On hand at start of year	29,834	54,718.48	33,518	49,861.49	40,689	73,824.40
Received during year	14,221	36,824.82	15,740	38,921.15	19,853	26,423.18
Finalized during year	12,399	12,876.38	7,088	9,474.66	10,500	11,150.50
On hand at end of year	31,656	78,666.92	42,170	79,307.98	50,041	89,097.08

Source: Ministry of Revenue and Duties.

#### **Box 4. Selected Administrative Practices in Collecting Tax in Dispute**

**In Australia**, the law requires that all tax debts, including those subject to dispute, be paid by the due date of assessment. The administrative practice, however, is to require payment of 50 percent of the disputed tax in non-high risk cases pending resolution of the dispute (100 percent is required in risky cases). Even when this concession is granted, the tax office may rescind and begin collection action at any time prior to dispute resolution where there are reasonable grounds to believe that the associated compliance risk requires such action. If the court finds in favor of the taxpayer, the tax office will refund the previously paid amount plus interest. If the decision favors the tax office, the taxpayer must pay the unpaid amount with interest.

**In Ireland**, pre-payment of 75–80 percent of the tax in dispute is required prior to the administrative or judicial appeal.

**In the United Kingdom**, generally all tax debts are expected to be paid in full. The administrative practice is to consider written waiver requests to postpone payment of some or all disputed tax. The revenue agency's practice is to limit waivers to documented cases of extreme financial hardship and may accept, reject, or propose an alternative payment amount based on compliance risk. Rejected waivers can be appealed to a special tax tribunal. If tribunal decision's favor the taxpayer, the tax administration must pay interest to the taxpayer.

46. **Decisions of internal dispute resolution processes are expected to overwhelmingly favor the taxpayer.** Dispute results for LTI taxpayers are summarized at Table 8 and indicate that in 2013 and 2014, the Complaint Committee had resolved 88 percent of cases in favor of LTI.

The MRD subsequently advised the mission that considering all taxpayers for the period January to June 2014, 20 percent of decisions were in favor of the taxpayer.

**Table 8. Large Taxpayer Inspectorate Administrative Disputes Resolved by Complaints Committee: 2013 and 2014**

Year	In Favor of Controlling Body		In Favor of Taxpayer		Partial Satisfaction		Total
	Number	Percent of Total	Number	Percent of Total	Number	Percent of Total	
2013	47	88.68	4	7.55	2	3.77	53
2014	27	87.10	1	3.23	3	9.68	31
<b>Total</b>	<b>74</b>	<b>88.10</b>	<b>5</b>	<b>5.95</b>	<b>5</b>	<b>5.95</b>	<b>84</b>

Source: Ministry of Revenue and Duties.

47. **More favorable outcomes for the taxpayer are likely when the matter is escalated to the court system.** LTI statistics shows that only 52 percent of 2011–13 court-based disputes were decided in favor of a taxpayer (Table 9).

**Table 9. Large Taxpayer Inspectorate Court Proceedings**

Period	Total Lawsuits Resolved		Lawsuits Resolved During a Reporting Period in Favor Taxpayer			
	Number	Amount (In thousands of UAH)	Number of Cases	Percent of Total Cases	Amount (In thousands of UAH)	Percent of Total Amount
2011	1,566	16,679,876.54	763	48.7	8,158,615.73	48.9
2012	1,726	22,846,657.92	996	57.7	13,662,100.70	59.8
2013	2,013	36,999,409.58	1,038	51.5	20,024,541.56	54.1
<b>Total</b>	<b>5,305</b>	<b>76,525,944.04</b>	<b>2,797</b>	<b>52.7</b>	<b>41,845,257.99</b>	<b>54.7</b>

Source: Ministry of Revenue and Duties.

48. **An independent internal appeals unit needs to be established.** Dispute resolution systems can be more efficient, timely and fair when an independent, internal re-consideration of the dispute is available within MRD. The authorities are concerned that the presence of such a unit presents corruption risks and hence the unit should report directly to the head of the tax administration. Nor are the unit's internal review decisions final—they can be subject to further appeal through the courts. Resolving first instance disputes internally by specialized group of independent experts is a cost-effective and sound international practice. Box 5 provides a description of how appeals are resolved by the specialized first instance unit.

### **Box 5. Features of an Independent Internal Appeals Unit**

- The appeals unit should be centrally managed and independent of the audit group.
- Appeals by the taxpayer against assessments should be in writing and set out the full grounds of the appeal, including the matters of fact and law that are disputed.
- Taxpayer appeals are considered by a single, technically qualified and experienced officer of the appeals unit.
- The appeals officer is able to interview the taxpayer and auditor to clarify matters subject to the dispute.
- The appeals officer makes a recommendation on the appeal to the head or deputy head of the appeals unit who makes the final adjudication on the appeal, which is binding on the tax administration.
- The decision and the grounds on which it is made are given to the taxpayer in writing.
- The goal is to resolve 50 to 90 percent of all disputes administratively without litigation.

49. **The deadline for submitting appeals is too short.** A deadline of ten calendar days to dispute a tax assessment is provided. This clearly limits a taxpayer's ability to prepare necessary documentation and evidence for an appeal. Good international practice is to offer a considerably longer period for a taxpayer to submit the appeal. Appendix 3 provides comparison information on appeal deadlines in Organisation for Economic Co-Operation Development (OECD) and EU countries. To improve the fairness of appeal procedure, the appeal deadline should be extended to at least 30 days and no more than 60 days.

#### **Recommendations:**

- Remove an automatic waiver of payment of disputed debt.
- Require a share of tax in dispute to be paid before the dispute proceeds to the court system.
- Establish a centrally managed, and independent appeals unit in MRD for resolving tax disputes under administrative procedure.
- Expand the timeframe for filing an appeal to at least 30 days.

### **E. Debt Collection**

50. **Table 10 provides a summary of the debt situation at January 1, 2014.** Debt levels remained stable over 2013, assisted by a substantial write off equivalent to 25 percent of the opening stock of tax debt. Further debt data is at Appendix 1. Of all debt owing at January 1, 2014 70 percent was more than one year old (see Table A.1). The central office for large taxpayers was able to reduce its overall debt levels during 2013 from an opening stock of UAH 1,340 million to a closing stock of UAH 764.8 Million at December 31, 2013 (see Table A.2).

**Table 10. Summary of Tax Debt<sup>1</sup>**

(In UAH million)

	Total Tax Debt	Of Which:			
		CIT <sup>2</sup>	PIT	VAT	Other taxes
Tax debt as of January 1, 2013	19,152.96	4,020.55	869.12	9,839.16	4,424.13
New debt	11,799.80	...	...	...	...
Tax debt written off	4,953.22	1,221.48	152.58	2,372.14	1,207.02
Tax debt at January 1, 2014	18,831.79	4,322.40	807.00	9,695.15	4,007.24
Tax debt considered collectible	2,954.90	...	...	...	...
Tax debt considered uncollectible	15,876.90	...	...	...	...

Source: Ministry of Revenue and Duties.

<sup>1</sup> By inference, debt collected during 2013 equaled UAH 26 million.<sup>2</sup> Corporate income tax.

51. **There are significant numbers of large debtors who need to be under active management.** The data at table 11 provides a strong case for developing an organizational focus on the specific management of large debtors. Of the 471,573 tax debtors, less than 1 percent or around 3000 debtors, account for 99 percent of tax debts. These largest cases need to be prioritized at the earliest stage, assigned to a particular team or unit, kept under tight control and be subject to very regular review.

**Table 11. Tax Debt By level at January 1, 2014**

(UAH million)

Tax Debt	Taxpayers	Tax Debt Amount	Of Which Large Taxpayers at Central Office	Of Which Large Taxpayer Debt Amount
More than UAH100 mn	13	2,216.2	5	802.4
UAH75–100 mn	7	599.1	2	159.7
UAH50–75 mn	12	740.4	9	472.9
UAH25–50 mn	35	1,215.6	2	91.6
UAH10–25 mn	163	2,446.7	16	267.2
UAH1–10 mn	2,618	7,181.1	68	261.7
UAH0.5–1 mn	2,039	1,427.3	27	19.6
UAH0.1–0.5 mn	8,190	1,855.1	51	12.1
Less than UAH0.1 mn	458,496	1,014.3	56	1.4
<b>Total</b>	<b>471,573</b>	<b>18,695.8</b>	<b>236</b>	<b>2,088.6</b>

Source: Ministry of Revenue and Duties.

52. **Many tax administrations create a centralized large debtor management function.** This is intended to create an expertise that is capable of addressing the complexities that can be unique to large debt recovery. Dedicated staff would be assigned to these cases which are kept under a very tight review cycle. This function should be separate from the management of large taxpayers—large debtors are not always the largest taxpayers. Of the 13 largest debt cases, each with debts exceeding UAH 100 million, only 5 relate to taxpayers currently under the management of the central office for large taxpayers.<sup>15</sup>
53. **Some revenue administrations have responded to the financial difficulties of their debtors following the global financial crisis by making available special arrangements for installment payments of their outstanding liabilities.** In this context, the amounts of tax debts that are less than one year old, and which should be collectible, total UAH 5.456 billion, including debt of UAH 1,344.7 million from large taxpayers under central office control.<sup>16</sup> An additional UAH 4.425 billion is between one and two years old.
54. **MRD recognizes that installment arrangements are an important part of the collections process.** Although the mission was not able to obtain universal data, the central large taxpayer office reported total tax debt for its cohort of UAH 2.641 billion under current installment arrangements with that office. The standard term of the installment arrangements is 12 months and may be exceptionally extended to 24 months, with an interest rate set at 120 percent of the National Bank's discount rate. Some eligibility criteria that reflect features of good practice for installment plans are already in place, including the requirement to submit financial statements, interest imposed at an appropriate rate, monitoring of defaulting debtors and exclusions from the arrangements where the taxpayer faces bankruptcy.<sup>17</sup> The mission has provided a summary of desired features for installment schemes at Box 6.
55. **Steps should be taken to relax the tighter requirements on terms of installment plans as a reflection of the current conditions.** A proactive installment offer to provide a further opportunity to clear tax debts is included in the short term actions in Section I. A special offer of a targeted installment plan of up to 24 months duration for taxpayers to clear arrears should be made. A term of 24 months for repayment is not unreasonable having regard to the crisis conditions within Ukraine.

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<sup>15</sup> MRD states that of debtors owing more than UAH 100 Million, 15.6 percent of debt is considered recoverable: 55.3 percent is subject to bankruptcy; 22.6 percent is categorized as status of the debtor is not known or the debtor is absent and 6.5 percent is categorized as debtor under "financial recovery."

<sup>16</sup> Further analysis is needed to reconcile these figures with the collectible figure in Table 10 to determine the debt that can be classified "collectible" for an installment arrangement offer.

<sup>17</sup> See Article 100 of the Tax Code and MRD Order No.574, of October 10, 2013.

**Box 6. Features of an Installment Scheme**

- The debtor must have filed all required returns and analytical reports.
- Different treatment should be provided to different debtors based upon the amount of their debts
- For the high number of debtors with debts up to UAH 0.1 million, a financial statement disclosure would not be required under a streamlined installment procedure.
- For debtors with debts greater than UAH 0.1 million and up to UAH 1 million, the debtor should provide to the authorities sufficient information to justify the payment arrangement and also provide a financial road map that would facilitate seizure and enforced collection action.
- For large debtors with debts with greater than UAH 1 million, comprehensive financial information should be certified by trusted third parties. Provision of security would be required to cover the amount of the outstanding debt including interest. For any large debtor who are due refunds during the term of the installments arrangement offsets of those refunds should be included as a condition of the arrangement.
- Debtors with a debt that is less than six months old would be excluded from this arrangement.
- The time in which debtors must pay the arrears would be a maximum of 24 months.
- Penalties would not be reduced.
- Interest would continue to accrue on the outstanding balance and for the duration of the phased payment arrangement.
- Uniform interest rates should be set one or two percent above commercial bank rates and those rates should be regularly updated. MRD's current application of 120 percent of the National Bank rate appears in line with this feature.
- All collection costs related to the installment arrangement are at the expense of the debtor and must be paid by the debtor at the time they are incurred.
- The Statute of limitation of the concerned debts should be legally suspended for the duration of the phased payment arrangement.
- A debtor must agree to monthly Direct Debiting of installment payments in order to qualify for this arrangement. The Direct Debit payments should cover all monthly payments (both installment and current contributions).
- Public entities, debtors that have been involved in fraud cases, and those who are insolvent or for whom an insolvency procedure has been launched should be excluded from the procedure
- In case of default any enforced collection procedure should commence immediately.
- Several levels of delegation limits should be provided to facilitate the management of these installment arrangements but only the highest authority of the administration should have the authority to handle the largest debts.
- A Case Decision Escalation Framework should be introduced to ensure that the initiative is fully transparent and to ensure that speedy and appropriate treatment of cases can be closely monitored.



## Recommendation

- Provide an offer for installments to be paid on outstanding debts under an extended two year term by September 30, 2014.
- Review management of largest debtors and assign the cases to a centralized and separate function by December 31, 2014.

## F. Filing Compliance

56. **Tax returns are a cornerstone of good tax administration.** The return provides the essential information for assessing liability, monitoring activity status and compliance both for individual taxpayers and for aggregate analysis. Compliance with and enforcement of return filing rules is vital. An administration that does not know which taxpayers should be filing, does not effectively enforce filing rules, and does not constantly monitor filing performance is essentially not in control of the tax system. For this reason, best practice administrations dedicate substantial staff and IT resources to the processes of filing enforcement.

57. **The MRD seem to have little focus on filing performance and there is no single point of responsibility for filing compliance.** As shown in Table 12, more than 30 percent of VAT returns from large taxpayers and almost 20 percent from other taxpayers were submitted late in 2013. The same trend continues in 2014. Only 89 percent of PIT returns were submitted on time in 2013. This figure may be misleading because except for VAT registered persons, the MRD does not know which taxpayers are expected to file their tax returns. The mission was not able to obtain comprehensive or reliable data to understand the current level of return filing compliance by the registered population. No particular unit is responsible for filing compliance. The MRD needs to consider the most appropriate location for a unit with responsibility for filing compliance management.

58. **Special attention has to be paid to late filers.** A tax administration has to monitor the behavior of taxpayers and immediately respond to the risks. A taxpayer that has failed to submit a return needs to be notified either by an e-mail or a text message. It is also possible to set up an automatic early reminder program—this could be universal or targeted at those taxpayers that tend to submit their returns late. For priority taxpayers, outbound calls or visits by a tax official should be used to find out what has been the reason for nonfiling. If there were temporary difficulties that forced a taxpayer not to file the return, the official can support the taxpayer and discuss available options for them to cope with difficulties and stay compliant. If a taxpayer has ceased its activities, the tax administration can update the active taxpayers register accordingly. Such active measures can help to keep taxpayers compliant and the tax register up to date.

**Table 12. Value-Added Tax, Corporate Income Tax, and Personal Income Tax Filing**

	VAT		PIT (Individuals)		CIT 2013
	2013	2014 (by the end of March)	2013	2014 (by the end of March)	
<b>Large taxpayers</b>					
Quantity of tax returns:					
Expected to be filed	12,313	3,057	...	...	...
Filed in time	7,748	2,058	...	...	1402
Filed with a delay of up to 3 months	4,555	991	...	...	12
Filed with a delay of more than 3 months	0	0	...	...	0
Not filed yet	10	8	...	...	...
Percent of tax returns:					
Filed in time	63	67	...	...	99.2
Filed with a delay of up to 3 months	37	32	...	...	0.8
Filed with a delay of more than 3 months	0	0	...	...	0
Not filed yet	0.08	0.26	...	...	...
<b>Other taxpayers</b>					
Quantity of tax returns:					
Expected to be filed	2,828,022	715,466	...	...	...
Filed in time	2,187,420	560,014	647,773	563,505	511,726
Filed with a delay of up to 3 months	547,849	115,549	65,632	...	6,537
Filed with a delay of more than 3 months	2,771	62	14,410	...	252
Not filed yet	89,982	39,841	...	...	...
Percent of tax returns:					
Filed in time	77.35	78.27	89.00	...	98.69
Filed with a delay of up to 3 months	19.37	16.15	9.00	...	1.26
Filed with a delay of more than 3 months	0.10	0.01	2.00	...	0.05
Not filed yet	3.18	5.57	...	...	...

Source: Ministry of Revenue and Duties.

59. **The MRD has to start tackling filing compliance systematically.** There are no active measures applied by the MRD to detect nonfilers. The administration accepts returns submitted by taxpayers and considers those taxpayers as active. Then, the MRD applies excessive amount of resources to verify all the returns under the cameral audit program and asks a large proportion of taxpayers to change or explain their reported values. This unbalanced approach is burdensome for compliant taxpayers and may motivate many of them to cease tax reporting. The MRD should refocus its efforts towards filing enforcement with the aim of increasing the number of active taxpayers reporting their tax obligations on time.

## Recommendations

- Improve management of late and stop filers through:
  - designating unit responsibility for filing compliance; and
  - developing a proactive filing compliance enforcement program that includes outbound call capability and electronic reminders of filing dates by end August 2014.

### III. VALUE-ADDED TAX ADMINISTRATION

60. **This section highlights three key areas of VAT administration:** VAT registration (Section III. A.); VAT refunds (Section III. B.); and countering VAT fraud (Section III. C.).

#### A. Value-Added Tax Registration

61. **The VAT registration threshold remains unchanged at UAH 300,000.** FAD tax policy advice in 2013<sup>18</sup> recommended increasing the VAT registration threshold to UAH 1 million and aligning it to the threshold to qualify for the Simplified Tax System. Based on the 2013 data shown in Table 13, 62 percent of registered VAT taxpayers reported sales below UAH 1 million. Increasing the threshold would put the 164,000 small VAT taxpayers who contributed just 3.2 percent of total domestic VAT paid in 2013 below the threshold. Though voluntary registration would remain open for those below the new threshold, the shift would reduce the compliance and administrative burdens of the VAT system, releasing MRD resources to concentrate on the taxpayers in the large and medium segments with greater revenue risks.

62. **During 2013, new VAT registrations were equivalent to 13 percent of the active register.** The VAT registration base had declined continuously since 2007 until registration numbers started growing again in 2012. The current registration base is, however, still significantly smaller than the base in 2007. After adjusting for the number of VAT deregistration cases, the overall register only grew 3.25 percent in 2013, and so this volume of new registrations requires further analysis (Table 14). MRD needs to determine the drivers behind this registration increase using a breakdown of the data in terms of whether the registrations were mandatory or voluntary, from which main sectors and regions they arose and the size of the businesses.

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<sup>18</sup> De Mooij, Poghosyan, Schatan and Vulovic: *Ukraine: Tax Policy to Strengthen the Revenue Base*, April 2013, provides a summary of the issues surrounding a change in the VAT registration threshold.

**Table 13. Breakdown of Value-Added Tax Taxpayers (Legal Entities and Natural Persons)**

(In UAH millions)

Turnover UAH (million)	Taxpayers		Turnover Volume in 2013		VAT Paid in 2013	
	Quantity	Percentage	Quantity	Percentage	Quantity	Percentage
Over 1,000	505	0.2	2,003,472.2	49.9	42,368.8	50.4
800 to 1,000	152	0.1	136,899.9	3.4	2,463.4	2.9
600-800	195	0.1	134,047.8	3.3	1,760.4	2.1
400-600	392	0.1	190,588.6	4.7	3,190.6	3.8
200-400	1,040	0.4	289,280.5	7.2	4,505.7	5.4
100-200	2,068	0.8	285,563.8	7.1	4,982.1	5.9
50-100	3,648	1.4	255,412.7	6.4	4,374.8	5.2
20-50	8,812	3.3	274,813.1	6.8	5,667.8	6.7
10-20	10,961	4.1	154,157.2	3.8	3,818.4	4.5
5-10	16,414	6.2	116,021.2	2.9	3,298.2	3.9
2-5	30,079	11.3	96,221.9	2.4	3,426.7	4.1
1-2	27,729	10.4	39,699.0	1.0	1,741.2	2.1
0.5-1	30,024	11.3	21,688.6	0.5	1,145.8	1.4
0-0.5	134,452	50.5	15,985.6	0.4	1,481.0	1.8
<b>Total</b>	<b>266,471</b>	<b>100</b>	<b>4,013,852</b>	<b>100</b>	<b>84,225</b>	<b>100</b>

Source: Ministry of Revenue and Duties.

**Table 14. Value-Added Tax Registration Activities in 2013**

	2014 at January 1		Registration Activities	
	Registered Taxpayers	Active Taxpayers	New Registrations	Cancelled Registrations
Large taxpayers	1,030	1,027	1	9
Other taxpayers	265,441	234,546	31,471	23,794
<b>Total</b>	<b>266,471</b>	<b>235,573</b>	<b>31,472</b>	<b>23,803</b>

Source: Ministry of Revenue and Duties.

63. **Strengthened procedures are needed to ensure the establishment and maintenance of a clean and accurate taxpayer register.** Although registration procedures have been substantially updated, there remains a reliance on external parties to screen business registration applications, particularly the State Registrar at the Ministry of Justice and the de-registration

process remains complex and lengthy.<sup>19</sup> Initial steps in countering VAT fraud commence at the point of registration with careful vetting of all applications. MRD proposals to include a provision for registration audit and apply restrictions on voluntary registration in the 2011 Tax Code were rejected. The range of strengthened registration procedures would include (1) steps to carefully screen the quality of VAT registration applicants; (2) the introduction of minimum requirements for the granting and continuation of voluntary VAT registration; (3) regular refreshing of the register details; and (4) simplification and shortening of the de-registration process.

64. **The registration system needs to place sufficient focus on the identification of risky businesses at the pre-registration stage.** A registration process under which the intended activity and the identity of the taxpayer are verified is essential to prevent VAT fraud. The registration process should collect more information enabling MRD to detect and to stop VAT fraud and consequently to limit substantially the level of fraud. Many administrations apply a two-step approach. The registration form collects information making it possible to perform a basic risk analysis. For risky applicants, a supplementary questionnaire is used in assessing the wider risks of the taxpayer. In cases of suspicion of fraudulent intention and if registration cannot be refused, several tax administrations take precautionary measures and require securities as a pre-condition for registration.

65. **Registration applications need to be cross checked against other data sources.** In addition to verifying the information provided in the application form, it is essential that supplementary information is collected from a range of accessible data bases. MRD already has an established link to the State Registrar. Generally, tax administrations verify information against details held in other agency databases, such as a social contributions register, and customs declarations. The ability to cross-check on-line, and in real-time, the identity of a registrant with police information is also desirable. The ability to update registration data ex officio based on changes recorded by the State Registrar (e.g., a new location or change of directors) would also assist in keeping the registration database up to date.

66. **Any on-site visits to verify the economic activity of the applicant should be based on risk analysis.** Even if these visits must currently be undertaken after the registration has been processed, MRD has insufficient resources to conduct an on-site visit for all new registrations. Moreover, in order to ensure equal treatment of applicants at local and regional level, clear instructions, guidelines and manuals for risk analysis at the point of registration, as well as for on-site registration verification, should be issued from the central office.

67. **Post-registration monitoring programs for risky traders are lacking.** Modern administrations monitor 'from the start' VAT filing and payment compliance for risky registrations, embracing early and ongoing post-registration on-site visits. Some administrations

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<sup>19</sup> See Toro (2009) which made recommendations to grant additional powers to enable MRD to review applications, request additional information and decline registration applications.

have even set up monitoring and visiting programs for a wider range of traders and include intermediaries, brokers, main dealers, exporters and freight forwarders in high risk sectors. The main purpose of such programs is to gather as much information as possible on 'new players in the arena' and to provide educational and support interventions where poor compliance is detected.

68. **Deregistration procedures are too slow to stop VAT fraud at an early stage and not effective in quickly deregistering fraudulent businesses from the VAT system.** It is important to react quickly on detected fraud (e.g., that associated with fictitious businesses), in order to cease the VAT fraud. Therefore a short and rapid procedure should be in place to de-register or to cancel the VAT registration. Although MRD deregistered nearly 24,000 businesses in 2013, the process can be lengthy and taxpayers frequently fail to meet all the necessary requirements and they remain on the register.

69. **Modern administrations have a fast-track deregistration procedure.** MRD cannot currently launch the deregistration process. Typically, tax administrations have the power to deregister (or deactivate in the register) businesses that have failed to file VAT returns for a period (e.g., one year or more), or where a tax audit or site visit showed that there was no business activity or that false or inaccurate particulars had been furnished for the purpose of obtaining registration. In addition to deregistration powers, modern administration have the necessary legal competence to cancel a VAT registration in case of suspicion of missing trader fraud. Moreover, good administrative practice keeps the VAT register free of inactive taxpayers, which will reduce the possibilities to re-activate or replace a de-registered missing trader.

70. **In spite of the growth in new VAT registrations, concerns remain that a significant number of businesses are outside the VAT system.** Expansion of the register should therefore continue to be a priority compliance activity. MRD should proactively use third party information, including from income tax and customs, market surveys and a robust information technology system to monitor the potential VAT taxpayer base. Specifically, further development of cooperation levels with customs is a key element in such a compliance drive.

## **B. Value-Added Tax Refunds**

71. **MRD has made progress on the commitments made under the Stand-By Arrangement.** MRD has made the most significant progress on arrangements to address the build-up of VAT refund arrears through the issue of government bonds and the publication of VAT refund data. Progress has been slower on plans to relax the criteria for taxpayers to qualify for automated refunds without pre-refund documentary checks or audit and to revamp the criteria related to taxpayers' wage levels, both of which require amendments to the Tax Code. Appendix 4 provides a progress report on the implementation of the commitments under the Stand-By Arrangement relating to VAT refund management.

72. **The value of unpaid refund claims has escalated sharply.** As detailed in Table 15, at the end of 2013 the closing balance of accumulated refunds had doubled over the value at the close of 2012. By May 1, 2014, the figure had almost doubled again. This is of concern as the 2013 opening balance was 25 percent lower than that for 2012 and the value of new refund claims in 2013 grew only 15 percent over the size of new claims in 2012, indicating processing delays. The plan to resolve refunds accumulated up to the end of 2013 through the issue of government bonds will assist with these older amounts (see above and Appendix 4). The bond plan will not, however, address the refunds accumulated during the early part of 2014 and this aspect will need to be tackled through increased MRD effort.

**Table 15. Accumulated Refund Claims**

(In UAH millions)

Refund Item	2012	2013	% Change	2014 at May 1
Opening balance	4,597.7	3,427.5	-25	6,944.6
New claims	43,340.9	49,978.1	15	16,139.6
Closing balance	3,427.5	6,944.6	103	13,215.4
<i>Of which Central Office for Large Taxpayers:</i>				
Opening balance	2,749.5	2,177.7	-21	3,621.0
New claims	28,363.1	30,705.9	8	10,478.6
Closing balance	2,177.0	3,621.0	66	8,290.5

Source: Ministry of Revenue and Duties.

73. **Looking at the longer-term historical trends for VAT refunds, important aspects of the system appear more stable.** Details of the historical trends for refunds are at Appendix 5.

### C. Countering Value-Added Tax Fraud

74. **Tackling VAT fraud remains a major concern.** MRD continues to see challenging revenue risks arising from VAT and the most common types of VAT evasion are perceived as wide-spread in Ukraine. This includes nonregistration of businesses, under-reporting of gross receipts, nonremittance of VAT collected to the authorities, in addition to the pervasive use of fake invoices, frequently generated by fictitious companies through the “tax pit and conversion center” schemes.<sup>20</sup> Responses to these abuses of the system have had a major influence on the

<sup>20</sup> The tax pits and conversion centers are wide-spread, systematic and in many instances state-sponsored mechanisms that create fictitious businesses that generate fraudulent invoices. They are often operating in the agricultural sector. The proceeds are funneled to those running the fictitious firms. MRD has recently

shaping of the authorities' systems and processes of enforcement and the allocation of its resources, including the introduction of additional documentary filing requirements (the Annex V system), massive automated cross-checking and the adoption of the mandatory cameral audit program. These responses are, by nature, mainly concentrated on those businesses already operating within the VAT system.

75. **To further counteract VAT fraud, MRD is currently considering the introduction of a system of VAT bank accounts.** Appendix 6 provides more details on the proposed system, sometimes referred to as a split payment model.<sup>21</sup> The details are, however, still under discussion and the mission remains unclear about some aspects of the planned operation. This type of VAT bank account system was operating in Bulgaria, but was dismantled when Bulgaria joined the EU, and a similar approach is in operation in Azerbaijan. In the context of the EU, there is a broader consideration as to how far such a system deviates from the principles of modern taxation based on voluntary compliance, under which the authorities focus their resources on high risk cases, leaving the vast majority of taxpayers to trade with minimized administrative burdens and compliance costs.

76. **The VAT bank account system has two main objectives:** (1) to reduce fraud related to false claims for input VAT credits and refunds; and (2) to speed up the processing of VAT refund claims. Under the system, the authorities will open at least one VAT bank account for each taxpayer registered for VAT. The bank accounts will be held with the National Bank or State Treasury. It is likely that a requirement for all VAT transactions to be carried out using bank accounts or plastic card payments will be needed to avoid an excess of cash transactions outside this system.

77. **The practical aspects of the operation of the VAT bank account system are complex.** A purchaser registered as a VAT taxpayer must deposit VAT payments into a seller's VAT bank account. The VAT deposit must be completed at the time of delivery or when payment for the goods or service is made - this may require a change to the current time of supply rules in Ukraine. Banking software will apparently ensure that as a payment order is generated in the system, the payment will be split and the VAT element sent directly to the supplier's VAT bank account. Each taxpayer's VAT bank account will then contain a series of output VAT and input VAT transactions. The intention is that transactions will all be cross-matched. MRD indicated that

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announced that 18 conversion centers with a turnover of UAH 2.2 billion have been suspended and 338 tax pits closed with some now under criminal proceedings.

<sup>21</sup> Under the model, the purchaser pays the VAT due on a transaction directly to a blocked VAT bank account held with by the tax authorities; this account can only be used by the supplier for paying VAT to his suppliers' blocked VAT bank account or for the tax authorities to draw down the periodic VAT liability due directly to the State Budget.



legitimate credits will not be denied to a purchaser who has followed the procedures and paid VAT into a seller's VAT bank account.

78. **The VAT bank account proposal needs more detailed analysis as honest taxpayers are likely to be burdened with unnecessary compliance costs.** There are a range of technical and practical challenges still to be resolved for the model. The proposal has already prompted generally negative reactions from the business community and tax practitioners. They expressed concerns about the impact of the method on cash flow, compliance costs and commercial issues. To counteract concerns around access to working capital, the MRD is proposing a daily clearing or offset of the VAT bank accounts, whereupon the output and input VAT will be offset and any balance returned to the taxpayer. The mission is not convinced that this part of the proposal is feasible. A further issue is the system's potential for driving a certain element of business that currently interacts to some extent with legitimate businesses even further underground. The risk is that this system may cause them to avoid all interactions with legitimate business.

79. **It is unclear how significantly the system will improve the situation for taxpayers with legitimate refund claims.** The proposed system will not allow exporters or taxpayers who maintain a credit balance to access the funds in their VAT bank accounts on a daily basis, in the same way the daily offset is proposed for taxpayers who are regular VAT payers. Their daily cashflow position therefore remains the same as today. In addition, the basic VAT refund process currently in operation will remain unchanged. The main benefit for exporters appears to be that at the time of submitting VAT refund claims, any input VAT that can be automatically matched with the VAT bank account of their sellers will be eligible for immediate refund. This matching will be fully automated and so, although there is still in effect a pre-refund check on the underlying transactions, it should not result in any delay to the refund processing. Any input VAT that cannot be automatically matched to another taxpayer's VAT bank account will continue to result in further checks. This effectively retains the current mode of operation, under which genuine claims for input VAT credit are delayed or denied if the corresponding party has failed to comply with his/her filing or payment obligations.

80. **Compliance costs imposed by the VAT bank account and the current Annex V invoice matching systems are considerable.** A significant point in relation to the compliance burden arising from these systems is that the costs are disproportionately higher for small to medium-sized businesses. The discussion at section A above on increasing the VAT registration threshold should therefore be a part of any package of reforms for the VAT system. A further issue is to what extent should the taxpayer bear the costs of tax administration? The likely system compliance costs include the following:

- Loss of working capital—although the authorities are seeking to mitigate this burden through daily clearing of VAT bank accounts, this will not assist exporters or taxpayers in a net refund position.

- Set-up costs of transition—these include software and administration costs to adapt to the new systems.
- Ongoing administration costs—under the VAT bank account system, businesses incur additional costs in having to make two payments (instead of one) for goods or a service. The number of VAT invoices, payment orders, and bank account deposits and withdrawals could be doubled. Because mutual offsets between sellers and purchasers are not likely to be allowed under the system, unnecessary additional transactions result. Additional account-keeping fees and transaction costs also accrue. Businesses also incur ongoing administration costs associated with the Annex V invoice cross-checking, including the need to supply transactions details with monthly returns—although automation has reduced this burden.

81. **More effective measures need to be implemented to deal with VAT fraud.** VAT fraud is specific and complex in nature and there are many examples that will not be detected by the use of these types of control mechanisms. For example, the VAT bank account system will not, of itself, detect under-reporting of sales, false exporting, transactions occurring outside the VAT account system, bribing of tax officials, and false invoicing.

82. **Bank account controls and invoice cross checking are a poor substitute for effective audit programs.** These programs should be based on *selective* cross-checking, intelligence gathering and risk assessments, and proper tax fraud investigation, supported by sufficient legal powers to allow auditors to obtain information from taxpayers, banks, and other parties.

83. **The mission acknowledges that VAT compliance problems manifested in fraud devices, such as “tax pits,” are extreme but they present only a temporary rationale for these controls.** The proposed new system is not fully formed and the proposals need to be tested for implementation feasibility—particularly, the proposal for “daily” refunding lacks sufficient detail on how this could be achieved. The mission urges further evaluation before a decision to proceed is taken. The mission would also regard close monitoring of the impact on business as being essential and the scheme should be totally ceased after the existing compliance problems highlighted by the “tax pits” settle down. The suggested cessation date is July 1, 2106.

### Recommendations

- Increase the VAT registration threshold to UAH 1 million.
- Introduce a fast track de-registration procedure to support control of VAT fraud.
- Expand the off-site visitation program, based upon risk analysis, for selected new VAT registrants.

- Include a “sunset” clause on any VAT bank account proposal for no later than December 31, 2015.

#### IV. RESTORING GOOD GOVERNANCE

##### A. Background

84. **Ukraine has committed to conduct by July 2014 a diagnostic study of governance in tax administration.** The information below is intended to assist in identifying the governance options that Ukraine is facing. Ukraine has adopted a structure (see below) that incorporates a single head over tax and customs administration and the tax police. These bodies are collectively referred to in this Section as “revenue administration.”<sup>22</sup>

85. **Governance structures are increasingly important in the public sector.** Responsibility, authority, accountability, and transparency have become major themes of the past decade. Public organizations need clearly defined legal authorities and powers, and flexibilities to address modern management problems, as governments seek ways to improve operational results. Given its role in providing revenue for the State and its depth of interaction with citizens, these matters are particularly important for revenue administrations.

86. **In revenue administration, governance refers to an overall legal framework and mandate in which the administration operates.** Governance is assessed by looking at such features as independence and autonomy, levels of transparency and reporting relationships, and frameworks for integrity and risk management. In recent years many countries have moved to increase the autonomy and transparency of revenue agencies. The basic principle is that strengthening these areas can lead to better performance by removing impediments to effective and efficient management while maintaining appropriate accountability and transparency. This is clearly an important issue for Ukraine.

##### B. Autonomy

87. **To achieve its objectives, a revenue administration must have sufficient autonomy in the exercise of its powers to administer and enforce the laws.** Over the last few decades, the belief that reform and modernization of government institutions must be anchored by significant increases in autonomy and accountability has become widespread. Increased autonomy can lead to improved organizational efficiency, better human resources management, and overall improvements in effectiveness. Modern management principles and concepts can

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<sup>22</sup> See OECD, *Tax administration 2013: Comparative Information on OECD and Other Advanced and Emerging Economies*. Of 52 countries in the most recent OECD survey, 34 have separate bodies for tax and customs administration. The information on autonomy and governance is broadly applicable for both revenue administration or singular tax administration.

only be effectively implemented where autonomy is sufficient to permit the management of necessary organizational and cultural change. Box 7 notes key areas in revenue administration where autonomy is being increased.<sup>23</sup>

### **Box 7. Areas of Revenue Administration Where Autonomy is Increasing**

**Organization and planning:** the responsibility for internal organization structure, including the network size and geographical location of operational offices, and the authority to formulate and implement strategic and operational plans. Effective exercise of these powers could be expected to enable a revenue body to be more responsive to changed circumstances, contributing to its overall efficiency and effectiveness.

**Budget management:** the discretion to allocate/reallocate budgeted funds across administrative functions to meet emerging/changed priorities. In practice, this power should enable a revenue body to use its resources more wisely, obtaining "better value for money spent."

**Performance standards:** the discretion to set its own administrative performance standards (e.g., for taxpayer service delivery and turn-around of assessments).

**Personnel recruitment, development and remuneration:** the ability to set academic/technical qualification standards for categories of recruits, and to recruit and dismiss staff, the ability to establish and operate staff training/development programs; the ability to deploy staff as needed; and the ability to negotiate staff remuneration levels (often in accordance with broader public sector-wide policies and arrangements). In practice, effective use of these powers should enable the revenue body to make more effective use of its human resources.

**Information technology:** Authority to administer its own in-house IT systems, or to outsource the provision of such services to private contractors. Given the ubiquity of technology in tax administration, effective use of this responsibility could contribute enormously to overall organizational performance (including responsiveness).

**Tax law interpretation:** The authority to provide interpretations, both in the form of public and private rulings, of how tax laws will be interpreted, subject only to review by judicial bodies. The proper exercise of this power in practice can be expected to assist taxpayers by clarifying the application of the law and its administration.

**Enforcement:** The authority to exercise, without referral to another body, certain enforcement powers associated with administration of the laws (e.g., to obtain information from taxpayers and third parties and to impose liens over property in respect of unpaid debts.). The proper exercise of this power enables revenue bodies to respond quickly to taxpayers' noncompliance.

**Penalties and interest:** The authority to impose administrative sanctions (i.e., penalties and interest) for acts of noncompliance and to remit such sanctions in appropriate circumstances. This power would engender greater flexibility to the revenue body in its treatment of taxpayers' noncompliance.

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<sup>23</sup> See "Tax Administration in OECD and Selected Non-OECD Countries: Comparative Information Series (2013)."

88. **Increases in autonomy and independence are generally accompanied by higher accountability in terms of reporting, oversight and transparency.** Mechanisms to achieve this balance include the regular reporting of results to government, monitoring of activities by formal committees, oversight boards or the legislature, formal (semi-annual or annual) reporting to ministers, provisions for both internal and external audit, and high-level government control through budget allocation.

89. **Revenue administration requires a certain level of independence from the political level.** To achieve this, in many cases tax administrations are headed by an apolitical appointee who has chief executive officer-like responsibility for the entire organization. Individuals selected are qualified and experienced, and often appointed for a fixed period of time unrelated to the time horizon of any particular government. This aspect of governance provides a basis for independence, impartiality and consistency, all necessary characteristics of a modern tax administration.

90. **Under any governance model, the head of the revenue administration maintains a direct relationship with the government.** The Head is accountable to the Minister (of Finance) for the overall effective administration of the revenue laws, and for managing within the rules and authorities that govern tax administration operations. However, the political level does not normally become involved in specific cases nor in the day-to-day management of the administration.

### C. Institutional Options

91. **There are different means and models to achieve the governance framework described above.** The most common arrangements for revenue administration are:

- a. **Multiple Directorates in the MOF:** Revenue administration functions are the responsibility of multiple organizational units (e.g., separate directorates for tax and customs) located within the structure of the MOF (or its equivalent).
- b. **Unified semi-autonomous body:** Revenue administration functions are carried out by a unified semi-autonomous body, the head of which reports to a government minister.
- c. **Unified semi-autonomous body with board:** Revenue administration functions are carried out by a unified semi-autonomous body, the head of which reports to a government minister and oversight body/board of management comprised of external officials. (This is commonly known as the Revenue Authority model).

92. **A majority of tax administrations in the world today, including most OECD and EU countries, use one of these models as a governance framework.** Box 8 lists the models, the percentage of OECD and EU countries using them, and provides some world-wide examples. Moving from (1) through (3), these models are generally considered to provide increasing

degrees of independence and autonomy. Within EU countries, the unified semi-autonomous body is dominant. A unified semi-autonomous revenue administration with board, or revenue authority, is the least prevalent.

<b>Box 8. Examples of Governance Models for Tax Administration<sup>1</sup></b>			
<b>Structural model</b>	<b>(In Percent)</b>		<b>Examples (OECD, EU, and Other)</b>
	<b>OECD</b>	<b>EU</b>	
1. Single or multiple directorates in the MOF	33	39	Austria, Belgium, Czech Republic, Denmark, Estonia, France, Netherlands, Poland, Switzerland
2. Unified semi-autonomous body	44	46	Australia, Brazil, Finland, Greece, Hungary, Iceland, Ireland, Japan, Korea, Latvia, Malaysia, Norway, Romania, Russia, Slovak Republic, Slovenia, South Africa, Spain, Sweden.
3. Unified semi- autonomous body with board.	15	11	Argentina, Bulgaria, Canada, Colombia, Kenya, Mexico, Peru, Singapore, South Africa, Sweden, United Kingdom.

Sources: OECD (2013); and IMF reports.

<sup>1</sup> Percentages for OECD and EU do not add to 100 percent: some countries in these organizations have tax administrations under other models, sometimes characterized by more distributed arrangements where revenue administration is carried out in other ministries.

#### **D. Revenue Authorities**

93. **Establishing a Revenue Authority (RA) arises from a rationale relating primarily to effectiveness and efficiency:** 1) as a single purpose agency, it can focus its efforts on the single task; 2) as an autonomous organization, it can manage its affairs in a businesslike way, free of political interference in day-to-day operations; and 3) freed from the constraints of the civil service system, it can recruit, retain (or dismiss) and motivate staff to a higher level of performance.

94. **IMF research points to concerns ranging from effectiveness, through to managing high levels of corruption when deciding upon a RA.** The rationales were ranked by Kidd and Crandall (2006) and are summarized in Box 9 as follows:<sup>24</sup>

<sup>24</sup> Kidd, Crandall. IMF Working Paper. *Revenue Authorities: Issues and Problems in Evaluating their Success and Failure*. May 2006.

<b>Box 9. Reasons for Adopting a Revenue Authority</b>		
Rank	Reason	Average Ranking
1	Low effectiveness of tax administration and poor levels of compliance	1.80
2	Need for a catalyst to launch broader revenue administration reform (modernized operations, improved automation, integrated and function-based structures.	2.73
3	Impediments caused by poor civil service human resources policies (recruitment, remuneration, promotion, training, discipline)	2.90
4	Poor communication and data exchange among the existing revenue departments (e.g., income tax, sales tax, customs)	4.21
5	Desire to create “islands of excellence” within the public sector	4.54
6	Perceptions of political/ministerial interference	4.55
7	High levels of corruption	4.67

95. **Studies conducted to evaluate the success or otherwise of the “revenue authority” model have not drawn firm conclusions as to its overall impacts on revenue body efficiency and effectiveness.** There are difficulties with data and it has not been possible to establish causality between a change in performance and the model itself. Effective implementation of the model requires various types of support (e.g., good relationships with the MOF, strong leadership by senior management, and human resource policies for achieving good performance and addressing poor performance). Nevertheless, many countries that have applied the model see it as a catalyst for reform. As noted in Kidd and Crandall (2006):

*“Notwithstanding the lack of demonstrated basis for establishing a revenue authority, there is a strong perception held by those countries that have adopted the revenue authority concept that this particular governance model has made a significant contribution to reform and improved performance.”*

#### **E. Governance Characteristics of Revenue Administration in Ukraine**

96. **The proposed SFS retains some characteristics of a unified semi-autonomous body.** It incorporates the tax and customs administrations and the tax police.<sup>25</sup>

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<sup>25</sup> The proposed charter for SFS includes a management board of senior officials which is a coordinating mechanism across the three arms of SFS—although the charter envisages other persons participating in the Board, the mandate is not a means for exercising higher levels of accountability in accordance with the revenue authority model described previously.

97. **Ukraine currently does not have appropriate governance for revenue administration that will allow for effective compliance with the revenue laws and the achievement of fiscal objectives.** The mission notes that the governance for SFS is still under consideration. The draft charter for SFS is yet to be approved by the Council of Ministers. Based upon current understandings of the Charter and its observations, the mission considers that Ukraine has structural governance shortcomings manifested in the following areas:

- a. *High levels of corruption*—Public confidence in the revenue administration has been severely eroded by publicly exposed tax frauds that have misappropriated government revenues and that have involved the previous political leadership and management of the revenue administration. Feedback to the mission is that past managerial and operative positions within revenue administration were commonly procured through payment of substantial sums. Collusion across the revenue administration to conceal illicit activities was considered endemic.
- b. *Overly complex laws and regulations (decrees)*—Legal frameworks for revenue administration are regarded as unclear and court interpretation is inconsistent. Powers of the tax administration flowing from the revenue laws for core business processes (assessment, collection, accounting, payment, audit, appeals, etc.) are generally weak or are incomplete (such as powers relating to enforcement of tax debts).
- c. *Mixed mandates*—The current mandate of the proposed SFS include functional areas which should not be the prime responsibility of the administration and where revenue administration responsibility should be clearly secondary or supportive to the mandate of the MOF (e.g., formulation of tax and customs policy, drafting of revenue legislation and revenue forecasting based upon macroeconomic projections); as well as activities that require clarification as they appear not normally associated with the administration of national taxes (e.g., control of timeliness of foreign exchange settlements). The level of reporting to the MOF is unclear.
- d. *Insufficient autonomy*—Sufficient autonomy does not exist in the areas of internal structure, performance standards, the tenure of the head of SFS and human resource management. The revenue administration accepts ad hoc revenue targets as the dominant performance standard for judging operational performance. Internal structure changes require approval of the Ministry of Finance (MOF). There is insufficient flexibility with respect to hiring, dismissal and remuneration policies. The head of SFS has no fixed term appointment; the person is appointed and dismissed by the Cabinet of Ministers on advice of the Prime Minister.
- e. *Substantially over-manned administration*—Business processes need major streamlining. The FAD (2010) mission noted that the total staffing of the revenue administration, including its *oblast offices* for overseeing delivery of tax operations, and the size of the office network, appeared substantially out of proportion to the number of taxpayers. A major down-sizing would be necessary but existing laws



constrain the work force adjustment. Local tax offices need to have their legal status modified so that they can be subordinated to oblast level bodies and office closures may then be facilitated. The magnitude of the down-sizing is in the order of 30 percent of the workforce.

- f. *Fragmented tax administration responsibility*—There is no official (Deputy Head) singularly responsible for the tax administration organization headed by a nonpolitical appointee (currently, there are deputy heads responsible for tax police and customs but not for tax administration; and a coordinating head is across all three administrations).
- g. *Unclear authority over field operations*—There is a lack of clarity in respect of authority of the SFS headquarters over the network of territorial offices, a critical component for effective management. The level of discretion that lies with regional heads to allocate resources and which may not accord with headquarters directives needs confirmation.

98. **In the mission’s view, fiscal commitments related to tax revenues and tax compliance generally are highly unlikely to be optimized if the revenue administration governance framework for Ukraine remains as it is today.** It is not likely that public confidence in the proposed SFS can be restored. Nor can a substantial down-sizing be affected.

99. **The existing arrangements proposed for the new SFS cannot provide a basis for the ‘quantum leap’ necessary to turn the situation around.** There is a general consensus within business that existing revenue collection apparatus should be dismantled. *It is therefore proposed that government agree in principle to implement a new governance framework for revenue administration.*

## F. Decisions Required

100. **By the end of August 2014, the government should table its plan for revenue administration (it must decide on governance arrangements for either strengthening a semi-autonomous agency represented by SFS, or introducing a revenue authority).** There should also be an implementation timetable that would see a launch of the new organization by July 1, 2017. This plan would need to include the following:

- An assessment of options considered and rationale for the option selected.
- A summary of potential legislative requirements.
- A proposed organization structure.
- A discussion of transitional issues, including the preliminary projections for initial down-sizing and the approach to staffing of the new revenue administration.
- A communications strategy.

101. **As a first step, the authorities should appoint a new deputy head who is exclusively responsible for the tax administration.** This position is a major gap in the current organization of SFS. The new appointee will be critical to designing the reformed governance arrangements for revenue administration.

102. **The political and other risks associated with institutional reforms are acknowledged.** In particular, there can be uncertain political support for the reforms. There are risks of delays in implementation because of the low capacity within the administration; there are highly sensitive human resource management decisions concerning a major retrenchment of staff and migration of those re-hired to a new agency; there will likely be adverse short term revenue consequences arising from a loss of productivity in the work force, during the transition phase, which may extend to the loss of some key personnel; and there will be information technology and office accommodation implications that can have substantial lead times.

103. **The institutional reform will require expert leadership, and guidance from other experienced organizations.** International experience is that institutional reforms will be achievable if the following is in place:

- ✓ Total political support—a strong commitment to reform and clear decisions about direction of the reform and the early provision of the necessary resources.
- ✓ Stable leadership of the organization.
- ✓ Modern project governance with a management framework, project steering committee, dedicated work teams and close monitoring by senior management.
- ✓ Effective communications with all stakeholders, including accounting and professional and staff associations, business chambers and lobby groups.
- ✓ Comprehensive human resource and training strategies.

104. **The timeframe for implementation of an institutional reform of this magnitude is likely two years from passage of enabling legislation.** The mission has provided the authorities with published guidance on the steps required to implement an autonomous agency.<sup>26</sup> Implementation periods vary across the 40 or so countries that have adopted this reform in the last 25 years and depend on the model of reform adopted. In general, there are advantages for the administration and reduced risks in not overly extending an implementation period. A maximum of two years from approval of enabling legislation should be the aim.

105. **The overall project to establish a semi-autonomous agency would have two main phases which would proceed simultaneously: (1) a legislation phase; and (2) an operational**

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<sup>26</sup> See William Crandall and Maureen Kidd: *A Tool-Kit for Implementing A Revenue Authority*.

**readiness phase.** The legislation phase would include the critical policy choices such as degree of autonomy, governance framework, accountability, and scope, as well as legislative drafting and transitional provisions such as initial staffing of the new organization. The operational readiness phase comprises organizational structure, position descriptions and accountability statements, human resources policies, and other management policies and practices.

### **Recommendations**

- Announce the future model for governance arrangements for revenue administration by August 31, 2014 and commence preparations to launch a new agency from July 1, 2017.
- Appoint a new deputy head within SFS responsible for the tax administration by end August 2014.

## **V. TECHNICAL ASSISTANCE**

106. **MRD will need technical assistance to implement its planned reforms.** The Department of Foreign Affairs, Trade and Development of Canada has agreed to fund a TA program for Ukraine to be delivered by the IMF. The high level aim of the program is to help restore macroeconomic stability and lay the foundation for robust and equitable growth in Ukraine. Within this overarching framework, the proposed TA in the fiscal area aims at reinforcing fiscal adjustment reform efforts, achieving fiscal sustainability and bringing budget institutions and practices in line with international standards. The proposed fiscal TA consists of three components—expenditure management reforms, tax policy advice and reforms to tax administration. The proposed fiscal TA activities will cover the May 2014–April 2016 period, but additional TA, the financing of which remains to be identified, is already envisaged for the remainder of 2016 and 2017.

107. **The tax administration component envisages a graduated approach to reform that prioritizes some short-term measures.** The immediate measures that have been identified as part of this mission’s diagnostic work, and where it is anticipated that MRD would benefit from targeted TA support and technical advice, include clearing collectible tax debt, reforming the dispute resolution system, developing USC compliance management and strengthening audit. The TA program will be initially targeted at these operational areas.

108. **In the medium term, the tax administration component will also address institutional and organizational barriers to reform progress.** This second wave of more fundamental reforms to tax organization would depend upon greater evidence of reform “traction” materializing in 2014/15. These longer term reforms would aim to ensure that a strong tax administration headquarters is in place; sufficient autonomy in operational decision making for tax administration is evident and local office delivery networks are streamlined.

109. **The project will be based on a full range of TA delivery modalities.** This initial diagnostic mission will be followed by short-term expert (STX) support in priority areas and staff

visits to monitor progress and provide back-up advice in respect of core tax operations during 2014/15. In year two of the program (2015/16), a follow-up FAD mission will again assess the status of reforms and provide further advice. Subject to satisfactory progress, a resident advisor for the second year may be assigned under the program to assist in steering the medium-term institutional reforms. The resident advisor would coordinate with other partners, and support the more complex institutional reforms. STX and staff visits would continue in year two covering core tax operational areas and providing detailed advice on structural reforms.

110. **This TA program will be coordinated with other active development partners.** The TA will be integrated into the core operations of the IMF under the IMF-supported program for Ukraine, and coordinated with that of other key TA providers to avoid duplication and enhance synergies. Both the World Bank and the GIZ are currently providing support to the MRD and all TA activities will be need to be coordinated with and involve frequent interactions with these other institutions. Current World Bank support is focused on transfer pricing and tax policy issues. In addition to supporting study visits to Germany for the authorities to observe advanced tax administration practices, GIZ are also providing technical advice on certain aspects of transfer pricing. GIZ has indicated that it would wish to support future organizational restructuring. The United States Treasury Office of Technical Assistance (OTA) has also expressed interest in providing future support for MRD in the priority reform areas identified by this mission; OTA will also consider funding a future resident advisor.

111. **The proposed TA delivery plan to support the project priorities for 2014/15 is set out in Table 16.** The program of STX visits will be supported by a staff visit from FAD headquarters to monitor progress and provide back-up advice. The STX visits are designed to support MRD to implement the identified priority areas and detailed terms of reference will be drawn up for each STX visit.

112. **The TA delivery plan for FY2015/16 will be drawn up based on reform progress made during year one of the project.** The aim will be to support the tax administration with its broader restructuring and governance reforms, improving USC compliance management and the development of a High Net Wealth Individuals program. This support would be delivered through headquarters missions, staff visits and up to 10 STX visits.

**Table 16. IMF Planned Technical Assistance Resources (FY2014/15)**

Priority Area	Planned TA Activities	Type of TA	Proposed Timing
Large taxpayer management	Support to bring all large taxpayers under the LTI	STX visit 1 X 14 days	October 2014
Large taxpayer management	Support to bring all large taxpayers under the LTI	STX visit 1 X 14 days	February 2015
Large taxpayer management	Support to improve large taxpayer audit methodologies and quality	STX visit 1 X 14 days	March –April 2015
Payroll tax compliance	Advice on strengthening compliance management of the Unified Social Contributions and other payroll taxes (registration, filing, audit)	STX visit 1 X 14 days	October 2014
Payroll tax compliance	Follow up visit on strengthening compliance management of the Unified Social Contributions and other payroll taxes	STX visit 1 X 14 days	March 2015
Debt collection	Support to improve debt collection management—large debtor program and review of operation of installment scheme	STX visit 1 X 14 days	November/December 2014
Dispute resolution	Support to improve the internal dispute resolution system	STX visit 1 X 14 days	April 2015
General	Review of progress and ongoing advice	Staff visit 2 X 5 days	November 2014 and March 2015

## Appendix 1. Ukraine: Selected Tax Debt Data

### Table A1. Current Debt by Maturity at January 1, 2014

(In UAH millions)

	CIT		PIT		VAT		Total	
	Quantity	Volume	Quantity	Volume	Quantity	Volume	Quantity	Volume
Up to 1 year	14,340	1,633.3	18,977	150.4	18,268	2,650.3	204,500	5,456.2
1-2 years	14,201	1032.1	14,377	205.8	13,958	2,119.6	147,309	4,425.6
Over 2 years	17,682	1,789.5	12,945	377.3	18,207	4,054.3	132,826	8,154.0
<b>Total</b>	<b>46,263</b>	<b>4,454.9</b>	<b>46,299</b>	<b>733.5</b>	<b>50,433</b>	<b>8,824.3</b>	<b>484,635</b>	<b>18,035.8</b>

Source: Ministry of Revenue and Duties.

### Table A2. Summary of Large Taxpayer Debt

(In UAH millions)

	Total Tax Debt	Of Which:			
		CIT	PIT	VAT	Other taxes
Tax debt as of January 1, 2013	1,340.0	223.0	0.5	824.8	291.6
New debt	229.1	76.4	0	148.0	4.7
Amounts collected	1,846.4	825.4	0.1	699.1	321.8
Tax debt written off	143.9	82.1	0	57.6	3.9
Tax debt at December 31, 2013	764.8	235.0	0.5	460.7	68.5
Tax debt considered collectible	262.6	74.6	0	153.1	35.0
Tax debt considered uncollectible	502.3	160.4	0.5	307.7	33.7

Source: Ministry of Revenue and Duties, Central Office for large taxpayers.

### Table A3. Current Large Taxpayer Debt by Maturity (Provided June 2014)

(UAH million)

Tax Debt Maturity	CIT	PIT	VAT	Other	Total
Up to 3 months	336.2	0.0	615.9	140.5	1092.6
3-6 months	88.2	0.0	11.9	2.3	102.4
6-12 months	43.3	0.0	102.1	4.3	149.7
1-2 years	83.9	0.0	18.6	10.5	113
Over 2 years	153.7	0.5	390.2	86.5	630.9
<b>Total</b>	<b>705.3</b>	<b>0.5</b>	<b>1,138.7</b>	<b>244.1</b>	<b>2,088.6</b>

Source: Ministry of Revenue and Duties.

## Appendix 2. Ukraine: Analysis of Self Employed Individuals Who Declared Income in 2013

Declared Net Annual Income (UAH) for 2013	Number of Private Entrepreneurs (Annex 5, Heading 7 to Tax Declaration on Property and Incomes)	Number of Independent Professional Practitioners (Tax Declaration on Property and Incomes Section IV Line Code 06) Of Which:				
		Declarations in Which Section IV Line 06 <>0	Notaries	Barristers	Forensic Experts	Bankruptcy Commissioners
<0	386	114	33	42	0	12
< 19,999	71,622	5,798	1,154	3,719	5	151
20,000 to 39,999	6,089	1,050	733	205	0	14
40,000 to 59,999	1,486	590	498	42	0	7
60,000 to 79,999	654	482	424	19	0	7
80,000 to 99,999	379	324	290	11	0	1
100,000 to 149,999	580	600	546	16	0	1
150,000 to 199,999	278	377	350	2	0	1
200,000 to 249,999	146	253	237	3	0	1
250,000 to 299,999	114	161	148	5	0	0
300,000 to 399,999	147	213	199	2	0	0
400,000 to 599,999	154	220	205	8	0	0
600,000 to 799,000	61	101	94	3	0	1
800,000 to 999,000	51	61	58	0	0	1
> 1 million	134	150	143	1	0	0
<b>Total</b>	<b>82,281</b>	<b>10,494</b>	<b>5,112</b>	<b>4,078</b>	<b>5</b>	<b>197</b>

Source: Ministry of Revenue and Duties.

### Appendix 3. International Comparison of Appeal Processes

Country	Administrative Appeals			Judicial Appeals	
	Is admin appeal mandatory prior to litigation?	Filing period	Amount of disputed tax that must be paid	Filing period	Can taxpayer request admin appeal and also litigate?
Australia	Yes	28 days	50%	60 days	Yes
Belgium	Yes	180 days	100%*	90 days	Yes
Bulgaria	Yes	14 days	unavailable	30 days	Yes
Cyprus	Yes	30 days	unavailable	45 days	Yes
Denmark	Yes	90 days	100%*	90 days	Yes
Estonia	No	30 days	100%*	unavailabl	Yes
Finland	Yes	5 years	unavailable	5 years	Yes
France	Yes	60 - 180	100%*	60 days	Yes
Germany	Yes	30 days	100%*	30 days	Yes
Greece	No	60 days	25%*	60 days	Yes
Hungary	Yes	30 days	unavailable	30 days	Yes
Ireland	Yes	30 days	75-80%	30 days	Yes
Italy	Na	NA	unavailable	60 days	No
Latvia	Yes	30 days	unavailable	30 days	Yes
Lithuania	Yes	unknown	unavailable	20 days	Yes
Luxembourg	Yes	90 days	100%*	90 days	Yes
Malta	Yes	30 days	unavailable	30 days	Yes
Netherlands	Unavailable	45 days	none	45 days	Yes
Norway	Yes	21 days	unavailable	180 days	Yes
Poland	Yes	14 days	100%*	30 days	Yes
Romania	Na	30 days	unavailable	180 days	No
Slovak Rep.	Na	15 days	unavailable	No appeal	No
Spain	Yes	30 days	100%*	60 days	Yes
Sweden	No	5 years	unavailable	5 years	Yes
Switzerland	Yes	30 days	unavailable	30 days	Yes
Turkey	Yes	before/after	unavailable	30 days	Yes
United	No	30 days	100%*	30 days	Yes
United States	No	30 days	none	90 days	Yes

Sources: IMF; and OECD.

\* While the law requires full payment of the disputed amount, all or part may be waived by the tax agency in cases of proven financial hardship (bankruptcy; receivership etc). Security over assets may be sought in these situations.



#### **Appendix 4. Ukraine: Progress on Stand-By Arrangement Commitments for Value-Added Tax Refunds**

Commitment	Progress at June 2014
Implementation of an automatic VAT refund system to low-risk taxpayers without pre-payment inspection or audit of refund claims by June 30, 2014	This requires an amendment to the Tax Code. All automatic refunds are currently still subject to desk audit at a minimum. A VAT working group is drawing up revised eligibility criteria for automatic refund, including for low risk taxpayers without prior inspection or audit.
Resume publishing the amounts of VAT claims, outstanding refunds, settlements (including amount released automatically), and arrears by June 30, 2014	Lists of VAT taxpayers receiving refunds in May and June 2014 were published by the State Treasury Service.
Explore the possibilities of upgrading IT systems to manage such refunds	With very high levels of electronic filing, all VAT refunds are processed through IT systems, including the cameral audit program.
Revamp VAT refund criteria related to taxpayer's wage levels to directly address the under-reporting of wages	This requires an amendment to the Tax Code. A VAT working group is drawing up revised criteria to reduce the impact of the taxpayers' wage levels criterion on access to automatic VAT refunds. However, this criterion is seen as having social significance as well as an impact on compliance. The authorities have noted a desire for time to undertake further analysis of the issue.
Ensure that all large taxpayers administered by the LTI are by default included in the automated system (initially the current taxpayers administered by the LTI)	Large taxpayers are eligible for the current automatic refund system if they meet the eligibility criteria.
Consistent with the Tax Code the practice of requesting CIT advance payments in exchange for VAT refunds will be prohibited—STS will issue instructions to all tax offices to confirm this by June 30, 2014	Instructions have been drawn up for the issue of the instructions.
Issue up to UAH 16.7 billion in government bonds to address build up of VAT refund arrears accumulated through end-2013	A resolution by the Cabinet of Ministers has been prepared in this regard and government has issued a decision approving the budget resource required. MRD has been stock-taking refund arrears and interacting with taxpayers on the scheme. Applications are now being accepted for the bonds and it is estimated that refund amounts up to UAH 7 billion will be requested.

## Appendix 5. Ukraine: Selected Value-Added Tax Statistics, 2007 to 2014

(In UAH millions)

The data in the table below provide an historical summary of VAT collections, VAT return declarations, and VAT refunds. Page 2 of this Appendix includes brief observations on the visible trends for VAT refunds.

Item	2007	2008	2009	2010	2011	2012	2013	2014 <sup>1</sup>
<b>Revenue</b>								
1 VAT collections	59,383	92,083	84,597	102,743	126,565	136,987	127,321	51,884
2 o/w Domestic VAT	36,548	45,016	45,927	53,637	76,175	81,342	84,225	34,300
3 o/w Import VAT <sup>2</sup>	41,703	81,475*	73,207*	73,342	93,168	101,604	96,544	35,613
4 o/w VAT Refunds	18,869	34,409	34,537	24236	42,779	45,959	53,448	18,029
<b>Return Items</b>								
5 Taxable sales reported	2,582,618	3,336,630	2,806,340	3,350,824	4,875,088	4,644,941	5,124,892	2,021,546
6 Zero-rated sales reported	252,350	338,853	385,897	362,537	410,526	355,210	362,926	171,391
7 Standard rated sales reported (20%)	2,338,028	3,023,567	2,524,798	2,740,978	3,653,118	3,450,901	3,949,072	1,491,496
8 Exempt sales reported	128,493	151,978	141,552	173,729	321,842	316,353	373,990	154,755
9 Total input VAT credit claimed	477,077	586,545	467,137	507,467	686,877	645,172	729,481	275,553
10 o/w Vat on imports	39,670	73,910	62,101	63,465	90,444	85,045	90,184	35,451
11 o/w VAT on domestic purchases		512,635	405,035	444,002	596,434	560,127	639,297	240,102
<b>Refunds Claims</b>								
12 Submitted VAT refund claims	29,285	48,655	58,309	63,182	52,805	57,480	56,963	23,632
13 Refund claims by other than exporters	4,886	6,617	6,001	16,490	7,939	11,779	11,103	4,917
14 Refund claims on hand at end of year		12,786	21,812	11,114	4,598	3,428	6,945	13,166
15 Submitted VAT refunds as % of VAT input credit	6.1	8.3	12.5	12.5	7.7	8.9	7.8	8.6
<b>Registrants</b>								
16 Registered VAT taxpayers at 31 December	358,219	335,934	304,554	276,734	234,824	241,257	266,471	240,715

Sources: Ministry of Finance; Ministry of Revenue and Duties; and staff calculations.

<sup>1</sup> As of June 1, 2014 (based on December 2013 to June 2014 tax returns)

<sup>2</sup> For 2007, MRD provided updated import VAT figures for years 2007 to 2009, however, the original figures are included here to maintain the logic of the table.

After a dramatic increase in 2010, overall VAT refund claims dipped in 2011 and by 2013 still remained below the 2010 claim levels. The data in the table above clearly indicate 2010 as a watershed year and the following general observations can be made:

- The proportion of the VAT refund claims to the total VAT input credit claimed has declined sharply from a high of 12.5 percent in 2010 and has remained below 9 percent since 2011 (refer to line 15).
- The proportion of import VAT being claimed as an input tax credit has fluctuated from between 97 percent in 2011 to 84 percent in 2012. In 2013, it was 93 percent (refer to lines 3 and 10).
- After peaking at 26 percent in 2010 and dropping to 15 percent in 2011, the value of refund claims by non-exporters has remained at round 20 percent of total claims submitted over the last 2 years. The value of the underlying claim amounts have, however, fluctuated dramatically (refer to lines 12 and 13).<sup>27</sup>
- Since reaching a peak of 11 percent in 2010, zero-rated sales as a proportion of total taxable sales have remained at around 8 percent (refer to lines 5 and 6).

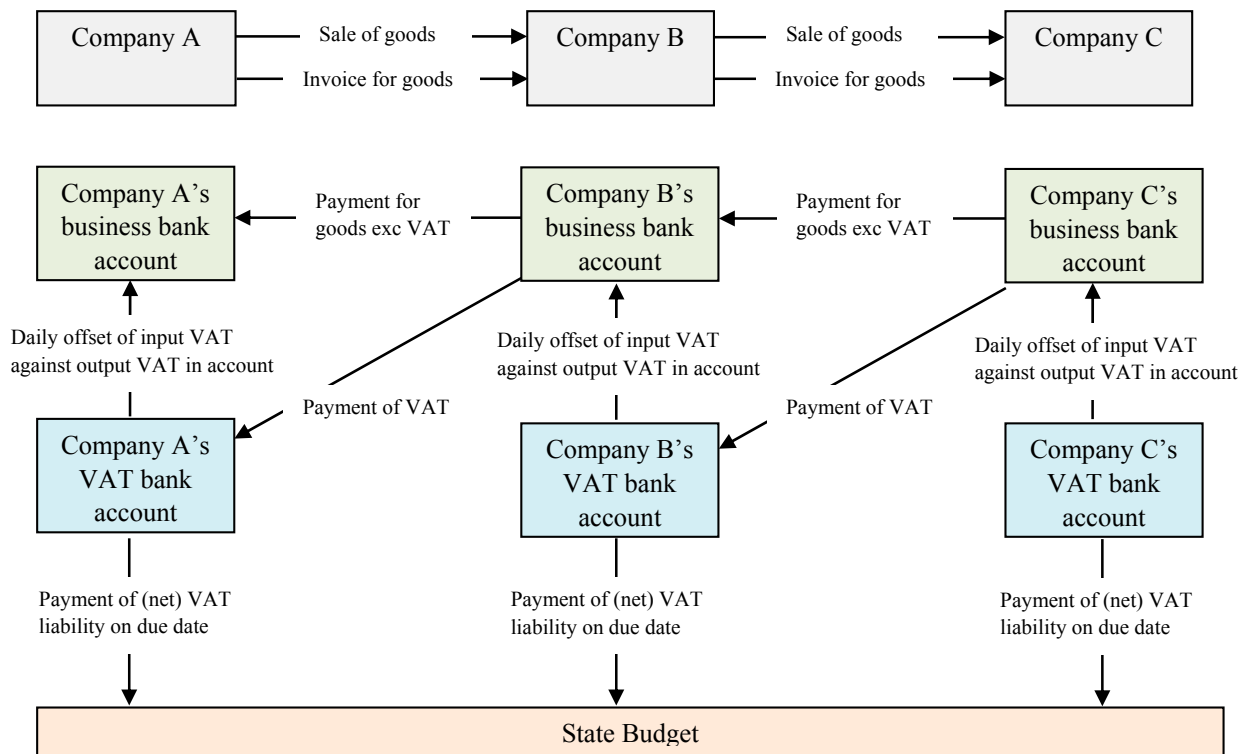
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<sup>27</sup> The VAT refund claim amounts for nonexporters increased 175 percent in 2010, decreased 52 percent in 2011, increased 48 percent in 2012 and finally decreased 6 percent in 2013.

## Appendix 6. Summary of Value-Added Tax Bank Account Proposal

A basic example of how the VAT bank account system is proposed to work (as described by MRD officials) is provided in Figure 1 below.

**Figure 1. Value-Added Tax Bank Account System**



In this example, Company A sells goods to Company B, who then sells the goods to Company C. In paying for the goods supplied by A, B must make two payments—one for the VAT exclusive price of the goods, and the other for the VAT that is payable on the goods. Payment of the VAT by B must be deposited into A's VAT bank account. The procedure is the same for Company C in paying for goods supplied by B. At the close of the VAT period, A, B and C can use monies held in their VAT bank accounts to meet their VAT liabilities due and payable to the government.

For Company B, because he can demonstrate that the VAT due to A has been deposited into A's VAT bank account, B can be confident that input VAT credits will be allowed for the amount paid. Likewise, C can also be confident that credits will be allowed for VAT credited to B's VAT bank account.

The Ukraine proposal includes a daily clearing or offset of the VAT bank accounts. Where there is a positive balance, it is proposed that any input VAT paid will be "refunded" to the taxpayer daily. This is aimed at removing the problem in other systems that funds held in these blocked VAT

bank accounts are effectively frozen, and lost as working capital of the business. If Company A only has output VAT on sales, he will not received any daily "refund" as there is no input VAT for offset.

It was explained that if Company C is an exporter or taxpayer in a net refund position, there will be no daily access to the credits in their VAT bank account; they must wait until the end of the tax period and they will still be required to file their refund claim for processing. There appears to therefore be no immediate advantage for exporters. The intention is that since it will be automatically confirmed that the VAT they paid on their purchases has been deposited into another taxpayer's VAT bank account, exporters can be confident that their input VAT credits will be allowed for the amount paid. This should help to reduce or remove the current requirements for mandatory pre-refund documentary and audit checks. It is expected that automated cross-matching of data from all VAT bank accounts will, however, take place before any refund is issued.