

“Substance over Form” in Ukrainian Taxation: Dream or Nightmare?

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Adopting best practices from other jurisdictions often makes a lot of sense. Ukrainian lawmakers and regulators are well aware of this and opt not to reinvent the wheel. Sooner or later we do get in our country the regulations and case law that we’ve heard about from our foreign colleagues. This is a positive trend, except for one “but” – the authorities often seem to be so eager to make full use of new instruments that use turns into abuse. This is true when it comes to taxes in Ukraine.

A good example is the “substance over form” principle, which is rather common in other jurisdictions. In short, one should take account of the real relations that characterize a transaction, and not only of what is stated in documents. We often have had to advise our foreign clients that Ukraine has been following quite the opposite approach. This has been both an advantage and a disadvantage.

While there is as of yet little legal basis for this, the “substance over form” principle is taking root, implanted and tended by the taxman.

One of the principle’s primary manifestations is the practice by the tax authorities of ruling contracts null and void if the authorities believe these contracts lack economic substance and were executed solely to attain an unjustified tax benefit (i.e., if the contracts are aimed at illegal tax minimization or even tax evasion). According to the authorities, such contracts contravene Ukrainian public order rules (Article 228 of the *Civil Code*) and state and public interests (Article 208 of the *Commercial Code of Ukraine*, which is a relic of the *Soviet Civil Code*).

(Admittedly, the technical reasoning of the tax authorities is not flawless and their creative interpretation of the *Ukrainian Civil and Commercial Codes*, which are often in conflict with each other, is disputable.)

The fiscal authorities are not much interested in invalidating a deal as such, but rather in refusing tax deductions, VAT credit or VAT refund and reassessing a taxpayer’s tax liabilities with the applicable fines and penalties.

The idea of achieving these goals by invalidating an agreement is not new. That the authorities no longer believe they need to go to court to invalidate an agreement, however, is an important novelty. Notably, they have gone even much further in their claims and have attempted to confiscate everything that parties have exchanged under their void deals (Article 208 of the *Commercial Code* and Article 10 para. 11 of the *On the State Tax Service Act of Ukraine*).

The authorities were quite artful in introducing this practice. They first piloted a number of rather unambiguous tax evasion cases, making sure that a practice that was positive for the tax authorities crystallized in the highest Ukrainian courts, including the Supreme Court. Along with this, the authorities obtained certain general clarifications from the Ukrainian Ministry of Justice, which, of course, they interpreted in their own favor (see letter of 30 October 2008 No. 1022-0-1-08-19). This work culminated in a string of court rulings by the Supreme Court in 2007 and 2008.



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Notably, the Ukrainian tax authorities draw heavily on relevant practice in the Russian Federation. The relevant instruments in Russia underwent their combat tests in well-known — indeed, notorious — tax evasion court cases against certain Russian business groups. The Ukrainian Supreme Court’s rulings and the guidelines of the tax authorities sometimes contain, verbatim, wording from the relevant Russian case law.

Now that pro-fiscal practice has been formed in Ukraine, and it is quite hard to overrule, the tax authorities have, during tax audits, started pursuing taxpayers regarding their “void agreements.” The authorities have also issued general guidelines on the matter (letter No. 2012/7/10-1017 of 3 February 2009).

As the guidelines declare, the tax authorities aim to destroy tax evasion schemes employed by mala fide taxpayers and to combat so-called “tax pits” (companies set up exclusively to take part in illegal VAT schemes). This is a noble goal.

The new “substance over form” and nullity approach seems to be quite efficient to achieve it. The relevant case law in Ukraine and practice in the Russian Federation show that this instrument, if applied in a proper and well-balanced manner, can be a good countermeasure against unscrupulous taxpayers.

Our only fear, when this practice gained ground in our country, was that the authorities might abuse it. Regrettably, this has turned out to be the case. The tax authorities have increasingly started to apply these practices against bona fide taxpayers without due grounds. They have made claims on these taxpayers regarding agreements formalizing actual business activity (where actual goods, works and services were supplied, with proper documentation).

This is quite understandable. During an audit, a tax inspector does not need to identify various numerous technical violations of Ukrainian tax law. Instead, he or she can just state in a tax audit act that a taxpayer’s material agreement is void and proceed with substantial tax reassessments. At that point, it is up to the taxpayer to challenge the tax audit results and reassessments. The burden of proof, therefore, effectively shifts to the taxpayer.

The tax authorities can simply ignore the business nature of many transactions and use their “boilerplate” instrument to achieve their goals. The result is that the validity of agreements formalizing the material commercial activity of many businesses depends on the discretion of the authorities, whose subjective assumptions are used to sustain their claims regarding the nullity of contracts without sufficient grounds.

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For example, the authorities have been making their nullity claims in situations characterized by the presence of an unscrupulous taxpayer in a supply chain. This taxpayer is not the final supplier of the goods – the party selling them to the final buyers. In most cases the final buyer, being a bona fide taxpayer, might be completely unaware that there is a tax pit in the acquisition chain, or even that there is a supply chain in the first place. It is this final bona fide buyer, however, who is refused tax deductions or VAT credit/VAT refund (in the worst case, the buyer might even suffer confiscation of money).

In substance, this means that the tax pit's liability is shifted to the bona fide taxpayer, who is held responsible for the third party's fault. Some practical examples could be interpreted to mean that the reason that the authorities are fighting tax pits is not to prevent their creation and long-time operation, but rather to make sure that the taxes that unscrupulous companies do not pay are collected from bona fide companies instead. Ukrainian beverage producers, among others, have much to say about this very practice, and much to complain about it.

Overall, the "substance over form" approach, when misused, as it is clearly being misused now, can create certain troubling issues. Taxpayers, for example, could be held liable for third parties in supply chains. It could be left to the discretion of the authorities to decide what commercial terms and conditions, especially when it comes to pricing, are acceptable in transactions and whether, indeed, a business needs to purchase certain goods, works or services. The authorities could also take issue with complicated transactions in which the results and benefits are not immediate and the substance of which, although it is obviously present and proper, is somewhat concealed by complicated legal structures and instruments. In the end, a misused "substance over form" principle could degrade commercial activity to a number of primitive transactions, those of a more complicated nature being under the excessive scrutiny of the authorities.

And that is why there are calls to change the practice and adjust the approach to it. Interestingly, this has already been done in Russia, where initially aggressive practice was subsequently changed to protect the interests of bona fide taxpayers (regarding both invalidity and confiscation claims). The Ukrainian authorities, unfortunately, have adopted only the initial practice in Russia, without the subsequent changes. This is so even though it is hard to believe that the authorities are unaware of the recent positive developments in Russia.

It is up to the authorities, of course, to change their attitude and approach. They might be quite reluctant to do so under the current circumstances, however. Taxpayers will, therefore, have to adjust and protect themselves effectively.

This requires understanding, first and foremost, that documents are not enough (as they were previously). A transaction must be devised with substance in mind, but it must then be formalized, performed and completed in a manner consistent with substance requirements.

A taxpayer might also need to adjust his defense strategies so that he can prove that he has actually benefited or will benefit from the transaction and that he will ultimately receive income (or, better, profit) in connection with the transaction and, ideally, pay taxes on it.

Overall, in the case of the "substance over form" approach, the dream of adopting best foreign practices has acquired a somewhat nightmarish tinge. Those not scared yet should take a look at recent government resolutions on tax matters. An inquisitive eye will notice abundant references to "unjustified" VAT credit and adjustments and to a mechanism to hold the purchaser liable for the tax liabilities of suppliers.

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