# PRESUMPTION OF GUILT IN TAX AND CUSTOMS ADMINISTRATION IN UKRAINE

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**SUMMARY**

The primary objective of the report is to demonstrate that, despite its external resemblance to the tax systems of developed countries, the Ukrainian tax and customs administration operates on principles dramatically different from those familiar to developed societies. Due to the malfunctioning rule of law, Ukrainian authorities are unable to enforce fiscal discipline based on the certainty of punishment for tax evasion. Instead, the Ukrainian tax and customs administration has adopted highly discretionary practices centered on the presumption of guilt of taxpayers. Notably, Ukraine's tax and customs legislation mirrors the best practices of the EU and explicitly acknowledges the presumption of legality in taxpayers' decisions. This presumption appears straightforward when analyzing the written rules, i.e., legislation and regulations. However, the reality diverges significantly at the low-level administration practices, which often creatively interpret both national legislation and court decisions.

In the report, we comprehensively cover VAT administration, particularly focusing on the widespread practice of VAT credit (VAT deduction) rejection that authorities use to combat fraud involving fake VAT credit claims. Additionally, the report delves into customs administration. While the two examples we analyze are among the most notorious and problematic instances of presumption of guilt practices in Ukraine, they are not the only ones. The discretionary instruments we describe are not the sole issue. Moreover, in an environment where the presumption of guilt towards taxpayers prevails, authorities often quickly substitute the discretionary tools that were removed under business pressure with other forms of discretionary control. This suggests that targeting specific discretionary instruments may not yield the desired results until the prevailing attitude of presuming guilt among Ukrainian taxpayers is recognized as a core issue and effectively addressed.

One of the critical aspects of the presumption of guilt approach concerns which party bears the burden of proof. According to national legislation and even Ukrainian court rulings, state authorities are tasked with collecting evidence and establishing proof of taxpayers' guilt beyond reasonable doubt, in line with EU best practices. However, in both VAT and customs administration, officers often shift the burden of proof onto the taxpayers and assume the authority to intervene in business operations. Specifically, in customs administration, officers can detain an importer until they agree to a ‘suggested’ customs value, with the only recourse being lengthy and costly court litigation. In VAT administration, authorities may simply reject VAT credit claims, thereby directly disrupting the daily business activities of companies until the company flagged as risky provides sufficient proof of no ill intent.

The presumption of guilt approach in tax and customs administration is extremely distortionary for the economy and highly conducive to corruption due to the extensive discretionary power it involves. This practice should be eliminated, and all tax and customs administration procedures should be re-evaluated to ensure they do not contain discretionary instruments that presume guilt of taxpayers.

## Definitions

***The presumption of innocence*** is a legal principle that every person accused of a crime is considered innocent until proven guilty. Under the presumption of innocence, the legal burden of proof is thus on the prosecution, which must present compelling evidence to the trier of fact (a judge or a jury). If the prosecution does not prove the charges true, then the person is acquitted of the charges. The prosecution must in most cases prove that the accused is guilty beyond a reasonable doubt. The presumption of innocence serves to emphasize that the prosecution has the obligation to prove each element of the offense beyond a reasonable doubt and that the accused bears no burden of proof.

***The presumption of guilt*** is the legal principle that presumes every person accused of any crime is considered guilty of a crime unless or until proven innocent. The presumption of guilt shifts the burden of proof to the defense, who must collect and present evidence to prove the accused's innocence in order to obtain acquittal. The presumption of guilt is considered illegal in many countries and violates international human rights standards.

TABLE 1. **Presumption of guilt vs. presumption of innocence**

| | **The presumption of innocence** | **The presumption of guilt** |
|---|---|---|
| The burden of proof | On prosecution | On accused person |
| Unclear wording or ambiguity of the norm | Interpreted in favor of the accused person (defendant) | Interpreted in favor of the prosecution |

***The presumption of innocence is a fundamental principle of human rights and the rule of law*** in modern world. This basic principle must be respected and protected by all states and international organizations. The presumption of innocence principle in national criminal proceedings is enshrined in Articles 47 and 48 of the Charter of Fundamental Rights of the European Union, Article 6 of the European Convention for the Protection of Human Rights and Fundamental Freedoms, Article 14 of the International Covenant on Civil and Political Rights, Article 11 of the Universal Declaration of Human Rights and Directive (EU) 2016/343, and reflected in the case law of the Court of Justice of the European Union and the European Court of Human Rights.

It should be emphasized that in this report, the concepts of presumption of guilt and innocence are understood in a broad sense, encompassing not only the criminal legal context but also administrative and, particularly, financial contexts. Additionally, it is important to note that the presumption of guilt is permissible in private law and absolutely unacceptable in public law.

## Ukrainian tax legislation and the presumption of guilt

Ukrainian legislation, tax legislation in particular, upholds the fundamental principle of the presumption of innocence, as recognized in international legislation. Also Ukrainian legislation dismisses any potential application of the presumption of guilt. Official communications from Ukrainian authorities underscore that both in legislation and tax practices, the presumption of innocence is paramount.

In particular, the Tax Code enshrines the presumption of legality of the taxpayer's decisions in the event that the norm of the law or other normative legal act issued on the basis of the law, or if the norms of different laws or different normative legal acts assume an ambiguous (multiple) interpretation of the rights and obligations of taxpayers or regulatory bodies, as a result of which it is possible to make a decision in

favor of both the taxpayer and the regulatory body (subparagraph 4.1.4 of paragraph 4.1 of Article 4 of the Code).

Also, Clause 56.21 of Article 56 of the Tax Code establishes that in the case when the norm of this Code or another normative legal act issued on the basis of this Code, or when the norms of different laws or different normative legal acts, or when the norms of the same normative legal act contradict each other and assume an ambiguous (multiple) interpretation of the rights and obligations of taxpayers or regulatory authorities, as a result of which there is an opportunity to make a decision in favor of both the taxpayer and the regulatory authority, the decision is made in favor of the taxpayer.

Similar norms are also envisaged in the Customs Code. In accordance with Part 4 of Art. 3 of the Customs Code of Ukraine in the event that the norms of the laws of Ukraine or other normative legal acts on customs issues allow an ambiguous (multiple) interpretation of the rights and obligations of enterprises and citizens that move goods, vehicles of commercial purpose across the customs border of Ukraine or carry out operations with goods under customs control, or the rights and obligations of officials of customs authorities, as a result of which there is a possibility of making a decision both in favor of such enterprises and citizens, and in favor of the customs authority, the decision must be made in favor of the specified enterprises and citizens .

Ukrainian legislation for tax administration also clearly states that the burden of proof is totally on tax authorities when the state wants to punish taxpayer for misconduct. Specifically, clause 56.4 of Article 56 of the Tax Code claims that during the administrative appeal procedure, the duty to prove that any assessment made by the controlling body in the cases specified by this Code or the prove that any other decision of the controlling body is lawful, is the responsibility of the controlling body authority.

Law of Ukraine dated 16.01.2020 No. 466, which amended the Tax Code, established that the responsibility of taxpayers for committing tax offenses must be based on establishing and proving by the controlling authorities the guilt of the taxpayer and the presence of intent when committing a tax offense (except in certain cases) taking into account the circumstances that mitigate the responsibility of a person for committing such an offense or exempt from responsibility. A necessary condition for bringing a person to financial responsibility for committing a tax offense is the establishment of the person's guilt by the controlling authorities. In particular, the concept of a tax offense, guilt, intentional act, and the general conditions for holding someone financially responsible for committing tax offenses, as well as circumstances that relieve or mitigate such responsibility, are outlined in Articles 109, 112, $112^1$, and Clause 113.6 of Article 113 of the Tax Code. Also, the Tax Code explicitly mandates the controlling body to provide proof of these circumstances (as per Articles 39.2.2.12, 56.4, 111). The necessity of evidence of intent to hold a person financially responsible for committing a tax offense, as outlined in clauses 123.2 - 123.5 of Article 123, clauses 124.2 - 124.3 of Article 124, and clauses 125.1.2 - 125.1.4 of Article 125 of the Tax Code.

Additionally, the Ministry of Finance in its explanatory letter No. 11120-02-10/4219 dated 13.02.2023 (a response to the electronic petition "To recognize the right of the taxpayer (tax agent) to the presumption of innocence") noted that in the legal administrative appeal procedure, the obligation to prove legality decisions, actions or inaction, and, accordingly, the fact of a tax offense and the guilt of a person in committing it is entrusted to the controlling body, which is one more manifestations of the presumption of innocence of the taxpayer.

To sum up, Ukrainian tax legislation clearly stipulates that in cases of ambiguity, the taxpayer's interpretation of events should prevail. To hold taxpayers or tax agents financially accountable for tax evasion, the controlling body must present evidence of malicious intent. Furthermore, it is the duty of the controlling body to gather this evidence, not the taxpayer's or tax agent's responsibility.

## The presumption of guilt in tax and customs administration practices

While Ukrainian national legislation enshrines the fundamental principle of the presumption of innocence, actual tax and customs administration practices often adopt the opposite approach, heavily relying on various discretionary instruments. This section illustrates the real-world workings of tax and customs administration in Ukraine, demonstrating that, despite stated principles, the prevailing practice hinges on presuming the guilt of the taxpayer or tax agent.

While we highlight some of the most publicly recognized cases, it's worth noting that this list is not exhaustive. The presumption of guilt stands as the prevalent approach in interactions between the state and its citizens in Ukraine. Furthermore, the list of instruments promoting discretion is continuously evolving. It's not solely an issue of the processes described here, as these can be readily modified. For instance, while discretionary measures reportedly were eliminated in VAT-refund administration (the refunding of VAT for exporters was automated after years of reforms), a similar approach surfaced in VAT credit calculations, creating challenges for businesses reminiscent of the problematic VAT-refund mechanism.

In essence, given that the presumption of guilt is deeply embedded in the Ukrainian authorities' mindset when dealing with its citizens, the specific tools used to implement this approach can vary and often shift. These frequent changes may give the illusion of progressive reforms. However, as the overarching approach remains unchanged, any removed discretionary instruments are often replaced, ensuring the persistence of the dominating presumption of guilt practices.

*VAT administration*

A prime example of the presumption of guilt practice in tax administration is evident in the field practices of managing VAT tax collections. The Ministry of Finance asserts that Ukraine's VAT administration practices largely align with EU legislation. At a glance, one might observe a tax neutrally structured without cascading effect, bearing the same name, with provisions for VAT deductions or the so-called VAT credit, and VAT reimbursements for exporters. However, despite these similarities, the experience of VAT in Ukraine is distinctly different from what EU countries encounter in their daily practices.

The process of compiling and deducting VAT credit has been dramatically problematic for Ukrainian businesses in recent years. The mechanism of VAT credit deduction serves as a distinct example of how a tax, even with the same name and similar features, can operate differently in varied institutional environments.

Let's begin with some foundational definitions. A VAT deduction liability is the difference between VAT collected from sales and VAT paid on the purchase of production inputs. The VAT paid to suppliers, known as VAT credit, is deducted from VAT liabilities, thereby reducing the amount of tax due. In EU countries, this VAT credit is automatically calculated based on VAT-invoices with summary information on due deduction submitted to tax authorities. In contrast, Ukraine uses primary financial documents, distinct from invoices, due to its adherence to national accounting standards. VAT credit in Ukraine is determined from tax consignments, which are based on specific documents: deeds of transfers and acceptance for services, and waybills for goods. Unlike in the EU, where VAT invoices are typically accepted by default (if they comply with the predefined criteria like availability of VAT number and other information), in Ukraine, these tax consignments undergo overwhelming checkups by tax authorities i.e. the tax authorities question every single tax consignment submitted for VAT credit. If Ukraine were to align its national accounting with international standards, it would be challenging to explain to foreigners why VAT invoices undergo a discretionary verification process. However, as it currently stands, the Ukrainian tax administration follows its distinct national accounting standards which allow for the introduction of added complexities without embarrassing international partners, who typically don't delve into the nuances of national tax administration procedures.

Why are we concerned about the mechanism for verifying tax consignments? Introduced in 2017, the system for verifying tax consignments for VAT administration is officially named the 'System to Monitor the Alignment of Tax Consignments/Adjustment Calculations with Risk Assessment Criteria' (commonly known by its Ukrainian abbreviation, SMKOR)[1]. This initiative was prompted by the significant number of fraudulent primary financial documents previously submitted to claim VAT credit. These fake documents, such as deeds of transfers and acceptance for services and waybills for goods, led to reduced tax liabilities. The Ministry of Finance established SMKOR to scrutinize all tax consignments related to VAT operations[2], aiming to identify suspicious activities based on predefined risk criteria.

At first glance, this risk-based approach might seem non-intrusive to honest entrepreneurs who have never engaged in tax evasion schemes. However, the challenge arises because SMKOR isn't solely a risk-based system; its results directly influence decision-making. Ideally, a risk-based approach should utilize tools to identify potentially suspicious cases that warrant further investigation. Tools processing vast datasets to detect unusual activities often produce both Type I and Type II errors[3]. This means they might flag non-evasive activities as suspicious while overlooking clear instances of tax evasion. Consequently, instruments for risk assessment should serve as supplementary tools in any risk-based policy approach, not as definitive evidence of guilt that triggers further procedural actions.

In Ukraine, the risk-based approach to VAT administration, grounded in SMKOR, is fundamentally different from the practices familiar to developed countries. Instead of using SMKOR's results to closely investigate potentially risky cases, the State Tax Administration's commission simply blocks tax consignments (does not allow to deduct input VAT) for businesses flagged for risky activities and requests entrepreneurs to provide evidence of their innocence. In other words, SMKOR's findings directly serve as evidence to justify blocking tax consignments prior to any deeper scrutiny of suspicious cases.

What does this mean for businesses facing suspension of tax consignments? They're tasked with providing supporting documents to prove their legitimacy. As entrepreneurs gather these documents and await the commission's review of the evidence, they effectively face a 20% turnover tax. This is because the VAT rate is 20%, and they've been denied the right to claim VAT credit and offset this credit against their tax liabilities. Businesses can claim VAT credit once the suspension is lifted, but there are no clearly defined rules for reviewing appeals and no set time limits for completing the review, which creates uncertainty for businesses.

The list of supporting documents required is inherently specific to each individual case, and the decision-making process by the State Tax Administration's commissions is, by nature, highly discretionary. With the current design of SMKOR's operations, these commissions have essentially been granted the authority of courts, tasked with assessing the evidence of an entrepreneur's innocence. However, this poses a

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[1] The procedure of scrutinizing tax consignments is primarily defined by Resolution No. 1165 of the Cabinet of Ministers of Ukraine, dated December 11, 2019, 'On the Approval of Procedures for Halting the Registration of Tax Consignments/Adjustment Calculations in the Unified Register of Tax Consignments'.

[2] The SMKOR system operates as a risk-based mechanism designed to monitor and control VAT administration. It employs automated algorithms and specific risk assessment criteria to flag suspicious tax consignments that may indicate VAT evasion. SMKOR applies these criteria to all invoices submitted for registration, using a combination of automated tools and human review.
While the system includes automated initial filtering, a significant portion of inspections requires human scrutiny, primarily through commissions established under tax authorities. This reliance on commissions for decision-making, despite automation, has reduced SMKOR's effectiveness as a purely automated IT solution.
The SMKOR system does not inspect every VAT deduction indiscriminately. Instead, operations are flagged under certain risk conditions, such as when transactions meet the criteria of operational risk criterion or when businesses submit claims for VAT refunds. These flagged transactions undergo closer review, focusing resources on potentially non-compliant activities.
See for mor details: Business Ombudsman Council. (2023). *SMKOR as VAT Administration System: Report on BOC's Own Initiative Investigation Results*. Kyiv, Ukraine: Business Ombudsman Council.

[3] In this context, a Type I error means that the SMKOR system fails to flag a fraudulent transaction (missing a suspicious operation that is actually fraudulent), while a Type II error means that a legitimate transaction is incorrectly flagged as risky, leading to unnecessary scrutiny or suspension.

challenge, as tax authorities are inherently biased in such disputes. Their primary objective is to collect more taxes and fees, which inevitably conflicts with a fair evaluation of a taxpayer's case.

The State Tax Administration intervenes in business activities based solely on suspicions. Notably, the administration does not seek additional information to gather solid evidence of ill intent from the taxpayer flagged as risky. Instead, it simply blocks a company's tax consignments, effectively halting the entrepreneur's business operations and shifting the burden of proof to the taxpayer or tax agent to demonstrate that they did not plan any tax evasion. If not for the blockages resulting from SMKOR signaling, the request for additional supporting documents might be seen as a thorough investigation under a risk-based approach. However, the current design of the monitoring system, which allows for direct intervention based solely on the State Tax Administration's discretionary decisions, positions SMKOR as a prime example of tax administration based on the presumption of guilt. This approach means that mere suspicions can impact an entrepreneur even before any formal investigation, placing the burden of proof on the taxpayer or tax agent. Furthermore, if a company is labeled 'risky' by SMKOR, its business partners automatically inherit this risk designation and may also face blocked tax consignments. Yet, information about companies with blocked tax consignments isn't publicly accessible, leaving entrepreneurs unaware of these risks during their regular business operations.

The practices in the EU countries stand as a stark contrast, highlighting the deficiencies of the current tax administration practices in Ukraine. The actual practices regarding the right to deduct input value-added tax ('VAT') on transactions considered to be suspicious in the EU are well presented in court decisions of the EU member states. In particular, according to the European Court of Justice. (2012). Case C-142/11: Value added tax (VAT) – Right to deduct – Conditions for exercise – National legislation or practice prohibiting deductions – Invoice as the only valid document – Objective evidence of the transaction[4] the taxpayer's right to deduct VAT is a fundamental principle, and any restrictions or refusals by tax authorities must be based on objective evidence and in line with the EU directives (in particular, Council Directive 2006/112/EC). The court ruling emphasizes the importance of ensuring that taxable persons are not unfairly penalized based on the actions of others in the supply chain.

Specifically, the judgment emphasizes the fundamental principle of the common system of VAT for the right of taxable persons to deduct the VAT due or already paid on goods purchased and services received as inputs from the VAT they are liable to pay. This right is an integral part of the VAT scheme and, in principle, may not be limited. The right to deduct is exercisable immediately in respect of all the taxes charged on transactions relating to inputs.

On the refusal of the right to deduct the judges state that such refusal could be based only on an objective evidence. The ruling claims that the tax authority can't refuse a taxable person the right to deduct VAT from the amount he or she is liable to pay based on the improper conduct of the invoice issuer or one of his suppliers. The tax authority must establish, based on objective evidence, that the taxable person knew or should have known that the transaction was connected with fraud committed by the invoice issuer or another trader earlier in the supply chain.

What's more, the judgment states that the tax authority cannot require the taxable person to ensure that the invoice issuer had the status of a taxable person, was in possession of the goods, and was in a position to supply them. Nor can the authority require the taxable person to have other documents proving these conditions, especially if the conditions for exercising the right to deduct were met and there's no suspicion of fraud.

The document emphasizes that national practices that refuse the right to deduct VAT based on the improper conduct of the invoice issuer or one of his suppliers, without establishing evidence of the taxable person's knowledge of fraud, are not in line with the directives (i.e. Council Directive 2006/112/EC).

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[4] ECLI identifier: ECLI:EU:C:2012:373

**https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:62011CJ0080**

Put it differently, the European Court of Justice, in its judgment from 2012 in Case C-142/11, has explicitly stated that placing the burden of proof on taxpayers or tax agents, specifically in the issue of proving the right to deduct input VAT on transactions, contradicts EU legislation. The Court emphasizes that the tax authority cannot shift its investigative responsibilities onto taxable persons and must provide objective evidence if it intends to refuse the right to deduct VAT.

The key reason for the stark contrast between VAT practices in Ukraine and those in EU member states lies in Ukraine's suboptimal rule of law. Developed countries establish fiscal discipline and tax compliance primarily through the inevitability of punishment. There's no need for exhaustive checkups of everything and everyone, which is time-consuming and disruptive, when judicial and law enforcement systems efficiently chase and prosecute tax evaders. The high risk of being caught and prosecuted by functional systems deters most taxpayers from systemic tax evasion in developed countries. In contrast, where functional fundamentals are absent and the rule of law is unreliable, authorities like Ukraine's resort to proxy systems like SMKOR for overwhelming control, attempting to impose fiscal discipline in an environment of malfunctioning institutions. Surprisingly, under such a costly and disruptive VAT administration design, which openly contradicts EU practices, Ukrainian authorities pay little attention to establishing the inevitability of punishment for those failing SMKOR scrutiny, i.e., those spotted as suspicious and unable to prove no ill intentions. Open sources provide no clear information on what proportion of cases flagged by SMKOR were indeed involved in tax evasion. Moreover, in open sources there's no systematized information on the type of punishment these real cases received. Ideally, submitting fake financial documents for VAT credit should lead to criminal prosecution if ill intent is proven in court. However, we learned from legal practice overviews that criminal liability for fictitious activities has been abolished[5], and the main avenue for criminal responsibility for tax evasion is the suspect's admission of guilt in court[6]. It looks like the only punishment for those flagged by SMKOR and unable to prove innocence is extra tax deductions and penalties, which is an acceptable price for risk for actual tax evaders but an unacceptable burden for honest businesses. In summary, the current design of the SMKOR system lacks a critical element of punishment for actual VAT credit fraudsters, failing to discourage regular attempts of fraud while creating immense challenges for honest businesses due to the discretionary instruments granted to tax authorities.

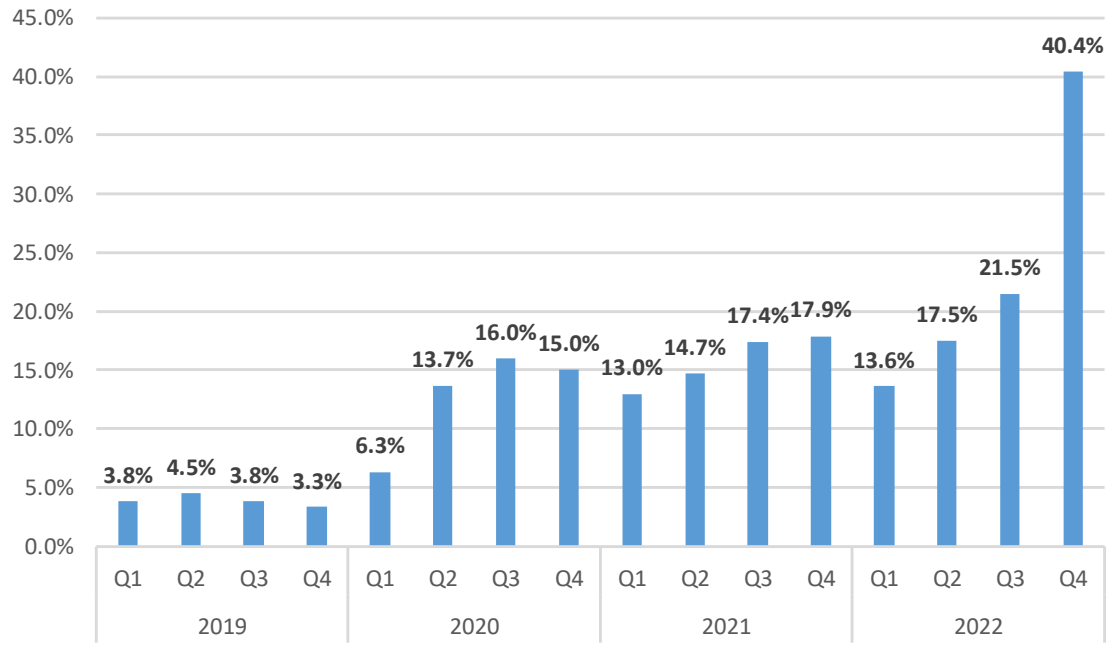
The magnitude of SMKOR-driven tax consignment blockages is truly staggering. Official reports from the State Tax Administration suggest that only a small percentage of tax consignments are blocked (temporarily suspended until additional proof of no ill intent is provided) after an SMKOR review. These reports show that about 1-2% of tax consignments are blocked each month, impacting just over 10% of companies during that timeframe (refer to Table 2 below). However, the real concern arises from the fact that SMKOR targets different companies each month (the aforementioned 1-2% of suspended tax consignments involves different businesses each month, thereby covering a much wider range of companies). At certain points in 2022, the Business Ombudsmen Council reported that up to 40%[7] of companies had experienced tax consignment blockages. Such widespread practice has severe repercussions for the business environment. It disrupts the cash flow of companies, making it difficult for them to fulfill their financial commitments. Let alone the added operational costs businesses incur when addressing and resolving these blockages. The economic losses arising from an environment where entrepreneurs face the risk of having their operations blocked, even when their companies have never mismanaged VAT credit, merit a separate, in-depth analysis.

GRAPH 1. **Percentage of Companies Facing Tax Consignment Blockages**

[5] https://kpmg.com/ua/uk/home/media/press-releases/2020/08/podatkovi-pravoporushennya-nayvazhlivsh-visnovki-sudv.html

[6] https://jurliga.ligazakon.net/analitycs/215638_ukhilennya-vd-splati-podatkv-dobrka-sudovo-praktiki-2022

[7] https://boi.org.ua/en/news-post/results-of-business-ombudsmans-own-initiative-investigation/




Source: The Business Ombudsmen Council

TABLE 2. **Percentage of suspended tax consignements**

| | | % of affected taxpayers | % of suspended tax consignments | % of suspended tax consignments by payment value |
|---|---|---|---|---|
| 2021 | Jan | 6.6% | 0.4% | 1.0% |
| | Feb | 6.8% | 0.4% | 0.8% |
| | Mar | 8.5% | 0.5% | 1.3% |
| | Apr | 9.3% | 0.5% | 1.1% |
| | May | 8.4% | 0.5% | 1.0% |
| | June | 8.8% | 0.5% | 1.0% |
| | July | 10.6% | 0.6% | 1.3% |
| | Aug | 10.7% | 0.5% | 1.1% |
| | Sept | 11.0% | 0.6% | 1.3% |
| | Oct | 10.6% | 0.5% | 1.2% |
| | Nov | 11.0% | 0.6% | 1.3% |
| | Dec | 11.4% | 0.6% | 1.3% |
| 2022 | Jan | 11.4% | 0.8% | 1.6% |
| | Feb | 8.9% | 0.6% | 1.1% |
| | Mar | n/a | n/a | n/a |
| | Apr | n/a | n/a | n/a |
| | May | 7.1% | 0.6% | 1.0% |
| | June | 17.1% | 0.6% | 1.1% |
| | July | 15.7% | 1.2% | 2.9% |
| | Aug | 13.0% | 0.8% | 1.7% |
| | Sept | 11.2% | 0.7% | 1.5% |
| | Oct | n/a | n/a | n/a |
| | Nov | n/a | n/a | n/a |
| | Dec | n/a | n/a | n/a |
| 2023 | Jan | 11.6% | 1.0% | 3.3% |
| | Feb | 9.7% | 0.8% | 2.5% |

| | | | | |
|---|---|---|---|---|
| | Mar | 10.8% | 0.8% | 2.5% |
| | Apr | 10.1% | 0.8% | 2.5% |
| | May | 10.8% | 0.8% | 2.5% |
| | June | 11.1% | 0.9% | 2.4% |
| | July | 10.1% | 1.3% | 2.4% |
| | Aug | 9.8% | 1.0% | 2.1% |
| | Sept | 10.2% | 1.0% | 2.3% |

Source: State Tax Administration

A notable characteristic of the current tax administration in Ukraine is the State Tax Administration's disregard for judicial practice and court decisions on certain common issues. Instead, the tax authorities give significant weight to so-called 'consultation letters' issued by the State Tax Administration itself. These consultation letters play a more influential role in tax relations compared to court decisions and even explanatory letters from the Ministry of Finance of Ukraine.

For instance, in accordance with Part 5 of Article 13 of the Law of Ukraine "On the Judiciary and the Status of Judges," the conclusions regarding the application of legal norms outlined in the Supreme Court's rulings are binding for all entities of power that apply a regulatory legal act containing the relevant legal norm in their activities. However, business representatives report numerous instances where, in cases related to VAT administration, the tax authority does not consider the legal position of the Supreme Court, forcing the taxpayer to repeatedly resort to legal action to defend their rights.[8]

The operations of the tax authorities and the regulatory legal acts governing these activities infringe upon the presumption of legality. Despite decisions from courts of various levels, the actions of the State Tax Administration ignore numerous court rulings. For instance, transactions with "risk counterparties" frequently lead to the blocking of tax consignments. However, the decision of the Administrative Court of Cassation within the Supreme Court, dated December 7, 2020 (case No. 140/1492/19), established that "the taxpayer's guilt is a necessary component of a tax offense." Furthermore, according to the decision of the Administrative Court of Cassation within the Supreme Court, dated December 18, 2020 (case No. 808/7333/14), "The taxpayer should not endure negative consequences due to the potential illegal activity of their counterparty, provided that they were unaware of such behavior by the counterparty and there was no collusion between them."

In other words, although Ukrainian legislation and legal practice in the realm of VAT tax administration ostensibly reflect the EU legislation and the legal practices of EU member states, neither the legislation nor the rulings of Ukrainian courts hold sway over the daily tax administration practices of the State Tax Administration of Ukraine. This body adheres to the presumption of guilt as the fundamental principle of its operations. Furthermore, as reported by the Business Ombudsmen Council, even when an entrepreneur secures a favorable court decision overturning a previous decision of the State Tax Administration and mandating financial compensation from the tax authorities, businesses often encounter difficulties in the execution of these court decisions by the tax authorities[9].

In this context, for businesses, it is a very traumatic experience of tax audits in the environment of malfunctioning rule of law and dominating presumption of guilt principle in tax and customs administration. According to the State Tax Administration, the tax authorities charged extra tax deductions in 99% of tax audits in 2021. Legal practices observe that taxpayers often receive a tax notification decision, where the rationale for imposing fines is stated as "...failure to submit documents that refute the existence of guilt," rather than proving the taxpayer's unreasonableness, bad faith, and improper activity. Legal practice also notes that the conclusions of tax officials in tax audit reports are frequently successfully challenged in courts, primarily because they violate the presumption of legality of the taxpayer's

[8] https://supreme.court.gov.ua/supreme/pres-centr/news/1421744

[9] https://boi.org.ua/case-studies/569-rizikovij-postachalnik-podatkovij-kredit-pokupcya-vdalos-zberegti/

decisions[10]. It's noteworthy that tax authorities might penalize taxpayers not only for understating tax liabilities but also for overstatements and even for mere technical mistakes in tax declarations[11].

*Customs value administration*

The primary leverage within customs administration, regarding the presumption of guilt practices, is the ability of customs officers to enforce their determined clearance value for imported goods, regardless of any claims or objections from the importer. While Ukraine's customs administration, from a legislative and procedural standpoint, mirrors the best practices of the EU, issues arise from the excessive misuse by customs officers of their legitimate right 'to doubt' and other discretion instruments. According to a survey of exporters and importers, nearly 44% of importers[12] report an unjustified increase in the customs value of goods and a refusal by the Customs Office to recognize the contract price of the goods. This suggests that the Customs Office is overextending its legitimate right 'to doubt' and applying other discretionary tools in situations beyond just the risky cases of import operations.

The customs value is at the heart of the relationship between the state (State Customs Service of Ukraine) and businesses (exporters and importers). It forms the basis for determining tax liabilities for export/import operations, such as VAT deductions, VAT refunds, excise duties, and import duties. For import operations, the state prefers a higher declared customs value to increase customs collections, whereas for exports, the state is inclined toward a lower customs value to reduce VAT-refund obligations.

The mechanism of abuse of the legitimate right 'to doubt' at customs (i.e. the presumption of guilt leverage) operates as follows: An importer declares the customs value of imported goods. If the declared value does not satisfy the customs officer, they request documented proof of that declared customs value. Despite there is a clear and predefined list of documents that would be accepted as proof, the customs officer has the discretion to decide which documentation is sufficient. Even with an exhaustive list of suggested documents, the discretion to decide whether the documents are sufficient still remains. If the Customs Office determines that the imported goods should have a higher customs value, the goods can only be cleared at the customs value specified by the officer. An importer can challenge this decision in court, a process that can take several years. However, the goods must still be cleared, as leaving them at the temporary storage facility incurs daily storage fees for the importer. Consequently, an importer will not only bear the costs of legal services while disputing but also accumulate additional storage costs throughout the contestation period. Regardless of the outcome, an importer will face additional expenses this way or another as soon as a customs officer questions the declared customs value. There is also an internal procedure to contest the decision within the Customs Office but this channel is not very popular among importers (see the details below). There's no need to mention the vast opportunities for corruption that arise from so frequently invoking the legitimate right 'to doubt'.

The right of the customs authority to question the declared customs value (the legitimate right 'to doubt') is not unique to Ukraine. The Agreement on the Implementation of Article VII of the GATT 1994, better known as the WTO Agreement on Customs Valuation, establishes a fair, unified and neutral system of customs valuation of imported goods, which conforms to commercial practice and excludes the use of arbitrary or fictitious customs value.

The valuation of goods under this system typically relies on the price actually paid or payable for the goods when they are sold for export to the country of importation, with adjustments made in accordance with the provisions of Article 8 of the Agreement[13] i.e. with adjustments the customs service outlines.

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[10] https://kanon.ks.ua/blog-ukr/prezumptsiia-pravomirnosti-dii-platnyka-podatkiv/
[11] https://home.kpmg/ua/uk/home/media/press-releases/2020/09/vidshkoduvannya-pdv.html,
[12] http://www.ier.com.ua/files/Projects/2021/TFD/TradeSurvey/IER_FTC_survey_short_report_2_FINAL_FINAL.pdf
[13] https://zakon.rada.gov.ua/laws/show/981_011#Text

If the customs value cannot be determined using the transaction value method, the Agreement provides for five other methods that should be used in sequence. Customs authorities have the right to independently verify the truth or accuracy of the declared value.

The general authority of customs officials to request documents or information to validate a customs declaration is established in Article 15 of the Customs Code of the European Union (EU Regulation No. 952/2013 of the European Parliament and of the Council on the Establishment of the Customs Code of the Union)[14]. These provisions are universal and, consequently, have been incorporated into the Customs Code of Ukraine of 2012, with subsequent amendments and additions. The main difference for Ukraine is that the provisions that should be used in some exceptional cases are applied to a hefty part of operations.

As previously noted, 44% of importers reported facing an unwarranted increase in the customs value of goods, with the Customs Office refusing to acknowledge the contract price of the goods. Notably, a majority of the decisions that were contested —concerning the amount of additionally accrued payments— were subsequently overturned by court rulings. Specifically, in 2022, 77% of such contentious cases were resolved in favor of importers, both in terms of the number of cases and the amount of additional payments accrued (see Table 3 below).

*Table 3. The outcomes of appealing the customs office's decisions pertaining to the adjustment of the customs value in court*

| Year | Decisions pertaining to the adjustment of the customs value of goods have been contested | | Decisions were rendered not in favor of the customs authority | | The proportion of decisions rendered against the customs authorities | |
|---|---|---|---|---|---|---|
| | Number of cases | Customs payments additionally accrued according to the appealed decisions, mln UAH | Number of cases | mln UAH | By number of cases | By the amount of the overcharged payments |
| **2020** | 4 117 | 559,15 | 2 183 | 492,67 | 53% | 88% |
| **2021** | 4 565 | 688,76 | 2 654 | 633,25 | 58% | 92% |
| **2022** | 2 191 | 403,09 | 1 683 | 311,09 | 77% | 77% |

*Source: The State Customs Service of Ukraine's response to the deputy's request*

Moreover, examining the efficiency of the widespread application of discretionary questioning of declared customs values reveals that all overcharged sums from these 'right to doubt' procedures constitute only a negligible portion of customs collections (refer to Table 4 below). Specifically, in 2022, adjustments to customs value contributed merely 0.04% to customs collections.

*Table 4. The efficiency of the customs office in controlling the accuracy of determining the customs value*

| Year | receipt of customs payments, mln UAH | decisions made on adjusting the customs value | customs payments additionally accrued, mln UAH | share of cutoms collections |
|---|---|---|---|---|
| 2020 | 359 905,0 | 15 817 | 889,4 | 0,25% |
| 2021 | 481 270,5 | 21 411 | 228,6 | 0,05% |
| 2022 | 310 818,2 | 13 924 | 108,9 | 0,04% |

*Source: The State Customs Service of Ukraine's response to the deputy's request*

[14] https://zakon.rada.gov.ua/laws/show/984_009-13#Text

The number of cases involving adjustments to the customs value of imported goods represents only a segment of the overall picture. Given the widespread practice of overcharging for imported goods and the informal obligation understood by all importers to maintain favorable relations with the State Customs Service, customs officers often resort to informal, extralegal practices initially. They communicate informally, suggesting importers adjust the declared customs value voluntarily to align with the officers' perspectives, before implementing formal adjustment procedures. As indicated in the Table 5 below, voluntary adjustments by importers considerably exceed the cases of enforced ones, although the sums involved in voluntary adjustments are not discernible from available statistics. We only possess data related to the declared customs value following the voluntary revision of declarations. The absence of viable means to contest the arbitrary decisions of customs officers and the unwillingness to encounter clearance delays compel importers to conform silently to the imposed behavioral norms.

*Table 5. Instances of independent retraction of the customs declarations due to the necessity of adjusting the customs value of goods*

| Years | Number of cases with forceful adjustment of the customs value | Number of customs declarations voluntarily retracted | Declared customs value in voluntarily retracted customs declarations, mln USD |
|---|---|---|---|
| 2020 | 15 817 | 20 825 | 296.8 |
| 2021 | 21 411 | 24 626 | 371.8 |
| 2022 | 13 924 | 28 336 | 3 249.1 |

*Source: The State Customs Service of Ukraine's response to the deputy's request*

The Customs Service maintains an internal procedure to contest questionable decisions made by customs officers, aimed at preventing the need for importers to embark on a lengthy and expensive legal process. However, as evidenced by Table 6, this channel for resolving disputes seems unpopular among importers. A plausible explanation for this avoidance is the low percentage of rulings in favor of the importers, suggesting a perceived bias and resulting in diminished trust in this dispute-resolution mechanism.

*Table 6. The efficacy of the appeal process to the higher-level customs authority.*

| Years | Contested to a higher-level customs authority | | Resolved complaints in favor of importers | | | The proportion of decisions rendered against the customs authorities by number of cases |
|---|---|---|---|---|---|---|
| | Number of customs declarations | mln UAH | Number of customs declarations | mln UAH | Share of resolved complaints by the number of customs declarations | |
| 2020 | 260 | 269,6 | 38 | 412,5* | 15% | *53%* |
| 2021 | 196 | 436,6 | 9 | 81,9 | 5% | *58%* |
| 2022 | 76 | 103,5 | 8 | 12,9 | 11% | *77%* |

** - the number includes resolved complaints from previous reporting periods.*
*Source: The State Customs Service of Ukraine's response to the deputy's request*

Attempts to spot some procedural loopholes that allow pervasive discretion in customs administration will not bring results. The Customs Code (article 55) clearly defines how the adjustment of customs value should be processed and the procedures are in line with GATT/WTO and the EU Customs Code procedures.

In particular, the Customs Code of Ukraine defines the following algorithm of customs value adjustment which looks quite reasonable and sound:

1. Justification for the reasons the declared customs value by the declarant cannot be accepted;
2. The necessity to provide the declarant with information available to the customs office, which led to doubts regarding the accuracy of the customs value declared and resulted in a decision to adjust the customs value;
3. The presence of a comprehensive list of requirements for providing additional documents, upon submission of which the customs value can be acknowledged;
4. The obligation of customs to justify the numerical value of the adjusted customs value of goods by the customs authority and the evidence that influenced such an adjustment;
5. The responsibility of the customs office to inform the declarant about the option to agree to the adjusted customs value and make the corresponding payments, or the option to release the goods into free circulation under security, as well as the ability to appeal the decision of the customs office.

Despite the clearly defined procedures outlined, there's a 'creative' application of legislation that permits considerable discretion at the ground level, as seen from the tables above. From a legislative standpoint, Article 30 of the Customs Code might be viewed as the trigger for the aggressive use of the legitimate right 'to doubt.' This article states that customs authority officials who make decisions unlawfully favoring third parties can be held liable in accordance with the law. Although the legislation presupposes the legality of a taxpayer's decisions (i.e. the presumption of innocence), the Article 30 introduces ambiguity. It often prompts customs officials to act even outside legal parameters, primarily to prevent underpayment of customs duties. This behavior is driven by a fear that such underpayment could be interpreted by law enforcement agencies as abuse of an official position. While this provision may aid in the widespread discretionary actions of the State Customs Service to prevent budget collection losses, it hasn't curbed large-scale smuggling. This suggests that Article 30 of the Customs Code isn't the sole root of the issues described above.

While the main objective of this report is to highlight and provide evidence of the presumption of guilt practice in tax and customs administration in Ukraine rather than to offer specific solutions, we present a detailed breakdown of the procedural steps involved in customs clearance and customs value adjustment. From Table 7, we can identify potential procedural steps vulnerable to creative interpretation of the legislation. Points labeled as discretionary can be addressed. However, it's essential to emphasize that removing specific discretionary tools doesn't necessarily eliminate the overall presumption of guilt practice. Authorities often introduce similar discretionary measures elsewhere or devise more complex rules that still enable the presumption of guilt practice in tax and customs administration.

As illustrated in Table 7, the primary challenges arise during the State Customs Service's verification of the customs value accuracy and when importers submit supporting documents to validate the declared customs value. At first glance, this process seems appropriate, as identifying discrepancies in the declared customs value inherently involves discretion. However, the authority granted to customs officers significantly outweighs an importer's ability to defend their position. Importers bear the cost of delays when their goods are held at customs as they gather the necessary supporting documents. The decision of whether the provided documents are satisfactory rests solely with the customs officer. If the State Customs Service determines that the customs value should be increased, the importer cannot resume business activities until they comply with the demand and make the specified payments to the budget.

The procedure allowing goods clearance under financial guarantees is only applicable until additional supporting documents are submitted. In other words, an importer can express disagreement, offer financial guarantees, and proceed with clearance based on the initially declared value. However, once the supporting documents are submitted, the State Customs Service may deem the provided documentation insufficient and deduct the necessary additional payments from the financial guarantees. Ultimately, the declarant will pay whatever amount the customs officer determines. Only then can the importer consider a lengthy legal battle against the State Customs Service, assuming they're willing to invest the time and resources.

Currently, there's no political push to address the misuse of the so-called 'right to doubt' in customs or to reconsider the contentious Article 30 of the Customs Code, which encourages customs officers to overlook the principle of legality of a taxpayer's decisions. High-ranking Ukrainian officials have historically favored a presumption of guilt approach toward Ukrainian taxpayers. This mindset evidently permeates field operations, fostering harmful practices and overlooking clear misuse of discretionary powers.

The primary objective of this report is to highlight the issues associated with the presumption of guilt practices and demonstrate the existence of these problems. Addressing specific procedures without acknowledging these overarching issues is futile. Simply removing select tools without reevaluating the foundational philosophy of presumption of guilt will only lead to the emergence of new discretionary practices in other stages of the clearance process, maintaining the status quo.

*Table 7. Decomposition of procedural steps of customs clearance and customs value adjustment.*

| # | **Procedural steps description** | **Actor** | **Comments** |
|---|---|---|---|
| 1. | Independently determining the customs value of goods | Declarant | |
| 2. | Declaring the customs value to the customs authority | Declarant | |
| 3. | Verification of the accuracy in determining the customs value of goods using the primary method based on the contract price. | Customs | |
| 3.1. | - recognition of the declared customs value | Customs | |
| 3.2. | - in cases where there are doubts about the accuracy of the customs value determination and the Automated System of Analysis and Risk Management (ASARM) identifies such a case, the declarant is prompted to provide additional documents | Customs | |
| 3.2.1. | provides a comprehensive list of required documents, upon submission of which the customs value can be recognized | Customs | |
| 3.2.2. | the declarant provides the customs authority with documents that confirm both the declared customs value of the goods and the selected method of its determination | Declarant | |
| 3.2.3. | - recognition of the declared customs value | Customs | |
| 3.2.4. | - *release of goods with the potential for post-audit application* | Customs | |
| 3.2.5. | - when there are reasonable grounds to believe that the customs value has been declared inaccurately or incompletely, a written decision to adjust the customs value is made | Customs | |
| 3.2.4.1. | provides written information explaining why the declared value cannot be recognized; | Customs | |
| 3.2.4.2. | provides written information detailing the reasons for the value adjustment, as well as the procedure and method used to determine the customs value; | Customs | |
| 3.2.4.3. | provides justification for the numerical adjustment to the goods' customs value | Customs | |
| 4. | The goods are released into free circulation : | Customs | |
| 4.1. | if the customs authority recognizes the declared customs value of the goods, they are released on the condition that customs payments are made in accordance with the declared value; | Customs | |
| 4.2. | if the declarant agrees with the decision to adjust the customs value, they must make customs payments based on the value determined by the customs authority; | Customs | |

| | | | |
|---|---|---|---|
| 4.3. | if the declarant disagrees with the decision on adjustment made by the customs body, they must make customs payments based on the declared value of the goods and provide financial guarantees until additional supporting documents are submitted (this financial guarantee mechanism is not available during the court contestation period); | Customs | |
| 5. | Appealing the customs authority's decision on customs value adjustment (optional) | Declarant | |

*Source: national legislation*

## *Clarifications on procedural steps:*

| | | |
|---|---|---|
| | - | complies with the legislation and is expedient; |
| | - | the actual requirement of the law is not followed; |
| | - | highly discretionary powers; |
| | - | is not applied in practice |