

TAXATION MECHANISMS IN UKRAINIAN AGRICULTURE

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This work analyses the implications of taxation on profits of agricultural producers. The authors have identified major problems in tax legislation, analysed taxation mechanisms applied to different categories of farms, and proposed mechanisms to raise efficiency of taxation of agricultural producers.

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CONTENTS

INTRODUCTION	3
1. INCENTIVES IN TAXATION OF AGRICULTURAL ENTERPRISES	4
2. SPECIAL REGIME OF VALUE-ADDED TAX LEVY	10
3. TAXATION OF HOUSEHOLD PLOTS	19
4. LAND TAX	23
5. TAXATION OF BUSINESS ACTIVITIES IN RURAL AREAS	25
6. MAIN FACTORS CONTRIBUTING TO IMPROVEMENT OF THE TAXATION SYSTEM	27
ANNEX 1. RENT PAYMENT FOR LAND PARCELS (SHARES) CALCULATED PER 1 HECTARE PER YEAR, UAH ..	33
ANNEX 2. STRUCTURE OF REVENUES OF LOCAL BUDGETS' POOL AS PER EXAMPLE OF ZAPORIZHZHYA OBLAST (ON-LINE INFORMATION AS OF 1 JULY 2004)	34

INTRODUCTION

As previously, the Ukrainian taxation system is generally not reformed. The unreformed state prevents it from being transparent and impedes its integrity and consistency. Frequent changes and amendments to the effective taxation legislation do not facilitate increased investments in the economy's agricultural sector, which impedes further reformation of the agroindustrial complex and slows down development of rural areas.

Despite these circumstances, certain steps were made in the right direction. Thus, tax policy instruments have been employed in the recent years for support of agricultural enterprises' financial stability. In particular, these include the fixed agricultural tax, accumulation of value-added tax amounts on agricultural produce, which are further used for purchase of material and technical resources for its production, and value-added tax amounts paid by processing enterprises for the sold milk and dairy produce and meat and meat produce, as subsidies to agricultural producers for the sold milk and cattle. According to estimates of the Ministry of Agrarian Policy of Ukraine, 80 percent of the total amount of state support of agricultural commodity producers is formed through the privileged taxation regime, whereas the monetary value of such indirect support totals UAH 3.0-3.4 bln. per year.

The present work aims at:

- analyzing of the effective legislation in the agricultural sector and its influence on agricultural commodity producers' incomes;
- determination of the main problems connected with taxation of agricultural enterprises and other rural entities;
- drafting of proposals as to introduction of more efficient taxation mechanisms in the agricultural sphere.

1. INCENTIVES IN TAXATION OF AGRICULTURAL ENTERPRISES

The taxation system in the agricultural sector is part of the general taxation system in Ukraine, which is regulated by the Law of Ukraine "On Taxation System" No.1251 dated 25 June 1991. The aggregate of all taxes and duties (mandatory payments) to budgets of different levels and special-purpose state funds, form the taxation system in Ukraine. Payers of taxes and duties are legal entities and individuals, who are subject to payment of taxes and duties (national and local ones), pursuant to the effective legislation.

For over five years (1999-2004), the tax policy for agricultural commodity producers of various property forms has enjoyed privileges in comparison with the effective taxation system in other branches of the country's economy.

Changes in the tax legislation started for the agricultural sector when the Law of Ukraine "On Fixed Agricultural Tax" No. 320 was enacted on 17 December 1998. This tax was the substitute for 12 other taxes and duties. The mechanism for levy of this tax reduced the agricultural enterprises' tax burden (by UAH 1.4 bln. every year, according to calculations of the Ministry of Agrarian Policy of Ukraine) and simplified the procedure for its calculation and payment.

A vast majority of the enterprises engaged in production, processing and sale of agricultural produce, in which the amount received from sale of their own agricultural produce and its products exceeds 75 percent of the enterprises' gross revenues in the previous report (tax) year are payers of the fixed agricultural tax. Prior to 2004, this threshold had been set at 50% of the gross revenue.

The object of the fixed agricultural tax is the area of agricultural land, which has been transferred to ownership or use of agricultural commodity producers, including land lease agreements, as well as water fund lands used by fish-breeding, fishing, and piscatorial entities. If a land parcel is transferred for lease, this tax is paid by the lessee rather than by the lessor. The effective tax rates are set based on one hectare of agricultural land, as percentage of its monetary valuation: for plough-land, hayland, and pastures - 0.5%, for perennial plantations - 0.3%. For mountainous districts, the legislation provides privileged fixed tax rates of 0.3% and 0.1% respectively. Taking into account specific features of agricultural production, the main payments on the fixed agricultural tax have been moved to the second part of the year: only 10% in the first and second quarters, 50% in the third quarter, and 30% in the fourth quarter.

Apart from introduction of the fixed agricultural tax for agricultural commodity producers, changes were made to the Law of Ukraine "On Value-Added Tax" (No.442 dated 18 February 1999 to article 11 and No.1874 dated 13 June 2000) with the purpose of levy of the value-added

tax on privileged terms. First changes to the Law of Ukraine "On Value-Added Tax" gave agricultural commodity producers the right to accumulate the value-added tax amounts, which had to be paid to the budget by processing enterprises for the sold milk and dairy produce, for payment of subsidies to agricultural commodity producers for the milk and cattle supplied for processing. Subsequent changes to the Law provided VAT incentives for agricultural enterprises on sales of goods (works, services) of their own production, including the produce made of their own raw materials (excluding commodities subject to excise duty), except for transactions on sale of milk and cattle to processing enterprises. Pursuant to this law, agricultural commodity producers can dispose of amounts of the levied VAT for purchase of material and technical resources of production needs.

Because of the changes in the effective tax legislation in the period beginning with 1999, the tax burden on agricultural commodity producers has been significantly reduced. The amounts of taxes paid to the state are constantly growing, whereas the rate of return on agricultural enterprises' activities has been stabilized over the past years, although it is still rather low. Thus, in 2003, agricultural enterprises reported the average rate of return at the level of 1.6%.

In the period of 1999-2004, the total amount of taxes paid by enterprises of the Agroindustrial complex have increased from UAH 3.6 bln. to UAH 5.7 bln., or 58% up. Apart from that, payments of the fixed agricultural tax have more than doubled (Figure 1, Table 1). In total, agricultural enterprises paid UAH 372.6 mln. as fixed agricultural tax to the budget in 2003. The level of actual payment of this tax was equal to 82% of the accrued amount.

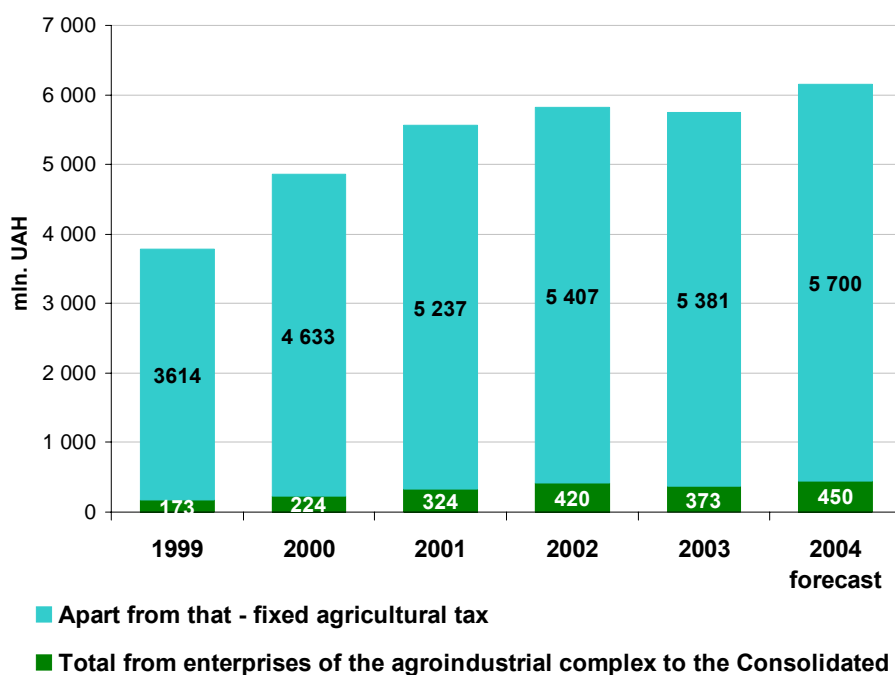


Figure 1. Tax payments by enterprises of the agroindustrial complex in 1999–2004, mln. UAH

Table 1. Actual payments to the Consolidated Budget by enterprises of the Ukrainian agricultural sector, 1999-2004 (mln. UAH)

Payments	1999	2000	2001	2002	2003	2004 (forecast)
Aggregate payments to the Consolidated Budget	3,613.6	4,632.8	5,237.4	5,407.4	5,381	5,700
including						
food industry	2,996.4	3,729.3	3,995.3	4,004.7	4,349.5	4,500
agriculture	617.2	903.5	1,098.0	1,252.1	914.1	1,200
fixed agricultural tax	173.1	223.9	341.6	420.4	372.6	450
Total paid	3,786.7	4,856.7	5,579.0	5,827.8	5,753.6	6,150.0

** Data with the State Tax Administration of Ukraine*

In the structure of tax revenues to the State Budget by enterprises of the agroindustrial complex, the excise duty accounts for the largest share (67%), profit tax accounts for 19%, and value-added tax - for 10.8% (Table 2).

Table 2. Structure of tax revenues of the State Budget by enterprises of the Ukrainian agroindustrial complex, 2003

Type of tax	Paid, mln. UAH	Share, %
Total to the State Budget	3,738.1	100.0
including		
value-added tax	404.8	10.8
excise duty	2,507.3	67.0
profit tax	711.6	19.0
others	114.4	3.2

** Information with the State Tax Administration of Ukraine*

Out of the total amount of tax revenues from enterprises of the agroindustrial complex, food-making companies account for the lion's share of 95.5% (Table 3). This occurs, mainly, at the expense of enterprises that sell primarily the products subject to excise duty (alcohol drinks and tobacco products). Agriculture accounted for only 3% of all tax revenues from enterprises of the country's agroindustrial complex.

Table 3. Tax revenues to the State Budget from enterprises of the Ukrainian agroindustrial complex in 2003

Type of tax	Total	Including			
		agriculture	food industry	fish industry	flour milling, cereal-making, and compound feeds
Total, mln. UAH	3,738.1	95.2	3,575.3	3.21	64.4
including:					
value-added tax	404.8	-4.7	367.0	1.4	41.1
excise duty	2,507.3	19	2,488.5	0	0
profit tax	711.6	43.5	645.3	1.6	21.2
others	114.4	37.4	74.5	0.21	2.1

*** Information with the State Tax Administration of Ukraine*

Advisability of support measures through privileged taxation with VAT and fixed tax (taking into account the changes made to the Law of Ukraine "On Fixed Agricultural Tax" as to definition of the object of taxation for this tax) in the effective tax legislation was confirmed by a growth of agricultural enterprises' profitability in 2003. Thus, the effect of these mechanisms was extended to the year 2004 in respect of VAT incentives and to the year 2009 inclusive in respect of the fixed agricultural tax.

Thus, the Law of Ukraine No. 974 "On changes to a number of Laws of Ukraine as to regulation of activities in the agricultural sector" dated 19 June 2003 made changes to the Law of Ukraine "On Fixed Agricultural Tax" (entered into effect on 1 January 2004). The changes were as follows. The share in the total gross revenue was up for this taxpayer category from 50% to 75%. Also this category was extended to the legal entities formed as a result of reorganization of agricultural enterprises, which used to be payers of the fixed agricultural tax (irrespective of the time when the reorganization was completed), that are now engaged in production (growing), processing and sale of agricultural commodities. The newly-formed legal entities whose main activities include production (growing), processing and sale of agricultural commodities become payers of the fixed agricultural tax in the year of establishment. Thus, pursuant to the effective legislation, the report period, based on which the right to pay the fixed agricultural tax is granted after 1 January 2005, will be 12 consecutive calendar months preceding the month, in which payers of the fixed agricultural tax are registered (previously - a calendar year). These changes enable the already-operational enterprises to switch to the fixed agricultural tax in the middle of the year. Previously, only the newly-formed enterprises had such a right.

Also it is supposed that after 1 January 2005, in the event that a payer of the fixed agricultural tax fails to keep to the 75% threshold, he would have to be transferred to another taxation system already in the month, in which the threshold was passed. In this case he is

withdrawn from the fixed agricultural taxpayer status. Apart from that, during the next month, he would have to pay the amounts of taxes that substitute for the fixed agricultural tax, as well as the amount of the fixed tax.

As of 1 January 2005, the fixed agricultural tax is deducted fully to the local budget only, whereas the fixed agricultural taxpayers will be paying deductions to the Pension Fund at a special rate. At the same time, the pension deductions on the workers engaged in non-agricultural production have to be calculated based on the general tax rate.

Apart from that, the Law of Ukraine "On prolongation of the effect of certain clauses of the Law of Ukraine "On Value-Added Tax" has continued the effect of subclause 6.2.6 of clause 6 and clauses 11.21 and 11.29 of article 11 of the Law of Ukraine "On Value-Added Tax" for the year 2004. The effect was prolonged as concerns payment of the VAT at the zero rate on sale transactions by agricultural commodity producers of all property forms and economy management in respect of milk and live-weight meat sold to processing enterprises, as well as payment of subsidies by processing enterprises for the milk and cattle supplied for processing. Pursuant to the effective legislation, agricultural commodity producers who are VAT payers have the option of not paying VAT amounts to the budget. Instead they may transfer these amounts to a special bank account and use these means for development of their production (clauses 11.21 and 11.29 of article 11 of the Law of Ukraine "On Value-Added Tax" No.168/97 dated 03.04.1997). The effect of this special VAT taxation regime terminates on 1 January 2005 (the Law of Ukraine "On prolongation of the effect of certain clauses of the Law of Ukraine "On Value-Added Tax" No.1352 dated 28.11.2003).

The aggregate subsidies (the VAT amount subject to payment to the budget accrued by processing enterprises) to agricultural commodity producers for the milk and live-weight meat supplied by them in 2003 totaled UAH 848 mln., including UAH 504.4 mln. for milk and UAH 343.6 mln. for meat.

Figure 2 mirrors the dynamics of payment of subsidies to agricultural commodity producers for the meat and cattle supplied to processing enterprises. At the expense of subsidies, agricultural commodity producers were able to get higher prices for their raw materials from processing enterprises (around 20 percent higher).

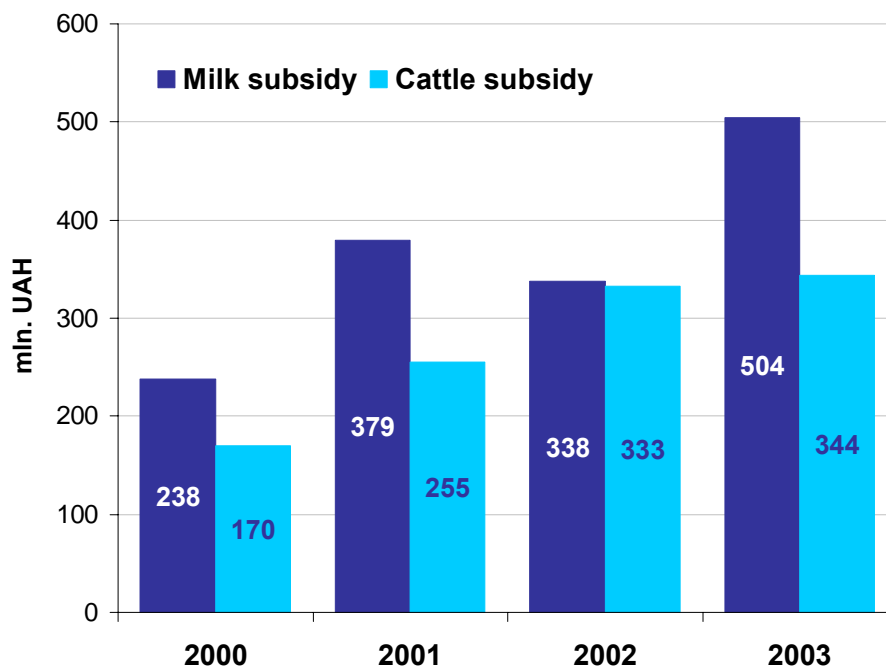


Figure 2. Dynamics of payment of subsidies to agricultural commodity producers for the meat and cattle supplied to processing enterprises (the chart contains data with the Ministry of Agrarian Policy)

Also there are certain negative factors connected with the VAT incentives' effect on agriculture. First of all, the most negative factor is the fact that there are many instances of abuses in the process of calculation and payment of subsidies at the expense of the VAT. The mechanism of calculation of subsidies is far from being transparent. Farms often fail even to find out that the state grants subsidies for dairy and cattle producers, because they get the same prices for milk and cattle (the amounts of subsidies are often not included in calculation of such a price).

It must be pointed out separately that agricultural commodities are exported through commercial structures (including intermediaries). In the Law of Ukraine "On changes to the Law of Ukraine "On the State Budget of Ukraine for the year 2004", Verkhovna Rada changed the procedure for payment of the VAT on export and import transactions with agricultural commodities. Pursuant to the law, tax promissory notes can be used for settlement of accounts with the budget during imports (movement) of commodities included in Groups 1-24 of the Ukrainian Foreign Trade Commodity Classification to the Ukrainian customs territory, except for wheat, rye, and barley. The zero rate is restored for the value-added tax payments on export operations for commodities included in Groups 1-24 of the Ukrainian Foreign Trade Commodity Classification from the Ukrainian customs territory, i.e. foodstuffs exports, excluding exports of wheat, rye, and barley, which are strategically important commodities for provision of the domestic consumers' market with foodstuffs.

2. SPECIAL REGIME OF VALUE-ADDED TAX LEVY

After 1 January 2005, instead of the special regimes for the VAT levy from agricultural commodity producers, a new regime was supposed to be introduced, with reduced rates and updated rules. However, the introduction of this regime was postponed until 1 January 2006.

Unlike the previously-effective privileged VAT taxation regime, the new special regime will concern not only legal entities but also individuals who are engaged in business activities in the sphere of agriculture (for example, growing of plants, animal husbandry, growing of fruits and vegetables, flowers, ornamental plants, mushrooms, seeds, and saplings).

The positive factor is the fact that a VAT payer is given the right to make independent decisions in respect of claiming the special taxation regime or staying within the general VAT taxation regime. Presently, the VAT rate is equal to 20%. The VAT rate is supposed to be gradually reduced to 17% at first and to 15% subsequently.

Thus, the Law of Ukraine "On changes to a number of Laws of Ukraine as to taxation of agricultural enterprises and support of their employees' social standards" No.1878 dated 24.06.2004 made changes to the Law of Ukraine "On Value-Added Tax". In particular, the law was amended with article 8-1 "Special regime for taxation in the spheres of rural economy, forestry, and fishery". Pursuant to this article, any legal entities or individuals that are engaged in business activities in agriculture, forestry, fishery, finishing or processing of such products made or grown by them, or render accompanying services, as defined by this article (hereinafter collectively referred to as 'agricultural production') may choose the special VAT taxation regime.

The sense of the special VAT taxation regime is as follows.

The special taxation regime suggests taxation of operations on sale (supply) of agricultural produce by an agricultural enterprise based on the following tax rates:

6 percent of the values of sold (supplied) goods originating in forestry or fishery or accompanying services;

9 percent of the values of sold (supplied) goods originating in agriculture or accompanying services;

The law provides that the article enters into effect on 1 January 2005. However, clause 8.14 states that the tax rates determined in subclause 'b' of clause 8.2 of the present article shall be effective at the level of 10 percent for the entities and individuals engaged in the mentioned types of business activities up to 1 January 2007. Thus, the tax rate of 10% will be effective for two years.

Apart from that, the tax amount received by an agricultural enterprise as a result of introduction of the above-mentioned rates shall be made available fully for the agricultural enterprise. It is not subject to payment (deduction) to the budget, according to the procedures described in the present law and has to be used for refund of the value-added tax amounts that have been paid or accrued by such an agricultural enterprise on the price of production factors, as well as for other purposes. It is not included in the agricultural enterprise's gross expenditures with the purpose of the profit tax levy. In accordance with this article, there will be no need to transfer the received VAT amounts to separate "special accounts". In the same way, there will be no requirements for the special-purpose usage of these amounts.

If the tax amount accrued (received) by an agricultural enterprise at these rates is less than the tax amount calculated on the factor prices at the rate determined in clause 6.1 of article 6 of the present Law (it is supposed to be at the level of 20% rather than 17%), the negative difference shall not be subject to a budgetary refund or inclusion in the list of the agricultural enterprise's gross expenditures with the purpose of profit tax levy from the enterprise.

It is also suggested that being the subject of the special taxation regime, an agricultural enterprise has the right to the budgetary refund on exports of agricultural commodities (accompanying services). At the same time, when an agricultural enterprise supplies goods or renders services, which cannot be classified as agricultural goods or services, according to the present article, the agricultural enterprise's tax liabilities shall be increased by the tax amounts calculated based on the rate determined in clause 6.1 of article 6 of the above-mentioned Law. Its tax credit is amended with the tax amounts accrued on the amount of expenditures that are not production factors in the sphere of agriculture, according to this article.

Besides that, an agricultural enterprise, as a subject of the special taxation regime, has to provide a buyer (upon his request) with a tax bill, which contains a tax amount calculated based on one of the rates mentioned above. The buyer of such agricultural produce has the right to include the tax amount mentioned on this tax bill into the aggregate amount of his tax credit.

It must be pointed out that this procedure of VAT levy concerns only the mentioned types of business activities, whereas non-agricultural transactions shall be taxed based on the general rules spelled out in the law on VAT. This means that when completing such transactions, agricultural commodity producers will have to calculate their tax liabilities based on the 20% rate. These deductions may be included in the tax credit as "incoming" VAT, which is paid in the price of goods (works, services) used in non-agricultural operations. The additional difference between tax liabilities and credit will have to be paid to the budget. The non-agricultural transactions that are subject to 20% VAT levy do not include sale of fixed funds of the agricultural purpose that have been used for 12 or more calendar months.

The intention to legislatively transfer agriculture in respect of VAT payment from the privileged taxation regime to the special taxation regime has not been sufficiently calculated and substantiated. It is necessary to analyze in detail the possible consequences of the state's approval of such changes in the taxation mechanism for agricultural producers.

A specific enterprise was used as an example for calculation of the tax burden on an agricultural enterprise, according to the effective VAT taxation system, as well as a calculation of the changes in the tax burden if a special VAT taxation regime is used (new conditions of VAT taxation), on the condition that the enterprise reports the same revenues from product sales in 2003 (Table 4). For calculation of the VAT rate under the special taxation regime, authors used the rate of 10%, whereas the regular rate is set at 20%.

Under the effect of the legislation in force in respect of VAT taxation of agricultural enterprises, the total tax credit amount is equal to UAH 182.5 ths., the accumulated VAT amount - UAH 92.8 ths., the amount of milk and meat subsidies accrued by processing enterprises at the expense of the VAT - UAH 212 ths. Thus, the total amount of support of the agricultural enterprise is equal to UAH 204.8 ths. (212 + 92.8).

If the same calculation is made for the special taxation conditions, the total support amount at the VAT's expense will come to UAH 46.4 ths. Thus, for the present specific example, if the enterprise is transferred from the privileged taxation regime to the special VAT taxation regime, the VAT amounts that the enterprise has the right to leave on the special account is 4.4 times lower than previously. This figure accounts for the assumption that the effect of subsidies for agricultural enterprises at the expense of VAT accrued by milk- and cattle-processing enterprises will not be prolonged.

Calculations for other specific examples (in particular, agricultural enterprises of different property forms and specializations in Zaporizhzhya, Vinnitsa, and Chernigov oblasts) indicate that the support level has been reduced significantly, especially because of the revocation of subsidies for supplied milk and cattle, which used to be paid by processing enterprises at the expense of VAT. Usually, consequences for each farm depend, first of all, on specialization of each enterprise, as well as on the level of technological and marketing costs related to product sales. According to calculations, the average accumulated VAT amount, which will be at disposal of agricultural enterprises, will be halved. This will depress the agricultural enterprises' gross revenues.

Table 4. Calculation of the tax burden on an agricultural enterprise 'A' located in Chernigov oblast in 2003, ths. UAH

Type of produce	Revenues from product sales, total	Tax credit (VAT)	Subsidy (VAT)	VAT accumulation
Plant production - total	349.7	—	—	—
including grains	290.9	—	—	—
Animal husbandry - total	1,533.4	—	—	—
including milk	450.5	—	72.0	—
cattle	1,063.8	—	140.0	—
Produce of subsidiary farms	38.6	—	—	—
Other (services)	72.0	—	—	—
TOTAL	1,993.7	182.5 (taking into account the amount of purchased resources at 912.5)	212.0	92.8

**the company's information*

Table 5 contains another example of calculation of the tax burden on an agricultural enterprise 'A' located in Vinnitsa oblast.

Table 5. Calculation of the tax burden on an agricultural enterprise 'A' located in Vinnitsa oblast in 2003, ths. UAH

Type of produce	Revenues from product sales, total	Total cost of the sold produce	Cost of purchased resources	Tax credit (VAT)	Subsidy (VAT)	VAT accumulation
Plant production - total	5,331	3,654	4,183	740	—	448
including grains	981	901	—	—	—	—
sugar beets	1,457	869	—	—	—	—
sugar	2,884	1880	—	—	—	—
other	9	4	—	—	—	—
Animal husbandry - total	3,599	2,176	1,835	267	508	—
including milk	311	222	—	—	57	—
cattle	3,163	1,836	—	—	426	—
pigs	119	108	—	—	25	—
other	6	10	—	—	—	—
Other (services)	199	304	—	—	—	—
TOTAL	9,129	6,134	6,018	1,007	508	448
Fixed agricultural tax	84	—	—	—	—	—
Other taxes	27	—	—	—	—	—

** the company's information*

Thus, the conclusion in respect of introduction of the special VAT taxation regime is as follows:

First of all, a significant portion of funds received by agricultural enterprises in the form of profit will be used for payment of VAT in the price of production factors, because the tax credit at the rate of 20% for purchased resources will be higher than tax liabilities on sale of agricultural products and services at the rate of 10% (the VAT paid by agricultural enterprises in the purchase price for the fixed assets will be covered at the expense of these enterprises' own current assets).

Secondly, the differentiated approach to VAT taxation will lead to discrimination of foreign partners, who are engaged in sale of agricultural produce on the Ukrainian market.

Thirdly, settlement of accounts between partners who will buy agricultural and non-agricultural commodities will become more difficult.

Fourthly, bookkeeping of VAT payers, who are on the special taxation regime, becomes more complicated because of the drawbacks in the declaration form.

Is the special VAT taxation regime beneficial for agricultural enterprises? It is possible to answer this question in the following way. It is only when the agricultural market situation is favorable will the VAT amounts received from buyers compensate for the VAT amounts paid by suppliers of material and technical resources and rendered services. As to a specific price situation with agricultural commodities on the domestic market, domestic prices for foodstuffs are primarily unfavorable for agricultural production. Proceeding from this, we can conclude that in reality, agricultural enterprises will be able to compensate for the VAT amounts paid for the incoming resources for their own production in the best case. The idea of support of agricultural producers through a reduction of the VAT rate will not lead to any result, whereas many enterprises will become loss-making ones.

Taking into account these problematic factors, the authors see the only way out in that most of agricultural enterprises will choose the general VAT taxation scheme, which will make cooperation with their partners easier. ***Thus, the general procedure for VAT levy at the rate of 20% will be the best scheme for agricultural commodity producers.***

It must be pointed out specifically that ***it is possible to reach a positive economic effect in development of the agricultural business only through a gradual reduction of the VAT rates in the national economy, without singling the agricultural sector out.*** For agricultural enterprises, one of the possible support methods is the fixed agricultural tax for a certain time period, which should facilitate their production. At the same time, the fixed tax should be connected to the taxation basis (the land), which simplifies the payment mechanism for this tax.

Possible changes in the tax legislation. As it was stated above, the Law of Ukraine "On changes to a number of laws of Ukraine as to taxation of agricultural enterprises and support of

their employees' social standards" No.1878 dated 24 June 2004 was enacted with the purpose of introduction of alternative taxation mechanisms to the ones effective at the moment for agricultural commodity producers. The law was supposed to enter into effect on 1 January 2005. However, in order to prevent possible complication with practical realization of certain norms of that law, as well as to improve this law's effect, Verkhovna Rada of Ukraine **approved in the first reading** a draft law (**registration number 1665**)¹, the purpose of which is improvement of legislation as to definition of terms used in the Law of Ukraine "On Fixed Agricultural Tax". The need to make changes was caused by the fact that a number of regulations contained in the mentioned law narrowed down the circle of agricultural enterprises that have the right to incentives in VAT taxation.

Changes are also being made to the Law of Ukraine "On Value-Added Tax". These changes are aimed at prevention of value-added tax payment evasion by business entities, which will be using the special VAT payment regime but will not be engaged in taxed transactions with commodities (services) that are different from agricultural produce.

What specific changes does this draft law foresee? First of all, it suggests that the definition of "agricultural produce" contained in the Law of Ukraine "On fixed agricultural tax" be the same as that in the Law of Ukraine "On Value-Added Tax", point 8-1.13 of article 8-1, which states that agricultural produce consists of the goods produced as a result of activities in the sphere of agriculture, forestry, or fishery (except for the goods subject to excise duty payment).

Secondly, the draft law suggests changing of the definition of notion "fixed agricultural tax". Previously, the fixed agricultural tax used to be defined as a tax that is not changed over the time period determined in the law and is levied per unit of the land area. According to the most recent changes and amendments, this law was called to substitute for 10 other taxes and duties. Presently, a new definition is being offered: "the fixed agricultural tax is the national tax, for calculation of which a metric unit of land area shall be used". In this definition, the fixed agricultural tax is, in fact, the land tax. It now includes only 5 taxes and duties, in particular: payment (tax) on land, communal tax, the duty on special-purpose utilization of natural resources (mostly concerning water supply for the agricultural needs), and the duty on geological survey works done at the expense of the state budget. Among the mentioned taxes and duties, the main tax included in the fixed agricultural tax is payment (tax) on land. Company profit tax accounts for a minor share in the tax amount because profits earned in agriculture are small and a half of agricultural producers are loss-making enterprises. The other three taxes and duties are also insignificant in the aggregate amount.

¹ Regulation of Verkhovna Rada of Ukraine No.2271 dated 21 December 2004.

Apart from that, it must be pointed out here that if the communal tax is included in the fixed agricultural tax, local budgets will not have an opportunity to increase their budgets with contributions from this tax. The communal tax has to be paid to local budgets, whereas the fixed agricultural tax is a national tax (at least, this is suggested by the authors of the law). However, it is well-known from the world practice that the tax on land (or land tax) is usually referred to the local tax category.

Thirdly, the fixed agricultural tax now excludes social taxes (such as deductions for mandatory pension insurance and mandatory social insurance). It is not advisable to separate employers within one enterprise, for whom the deductions are made for mandatory state pension insurance, based on the special and general rates. Thus, due to complications in practical carrying-out, this norm should be excluded. Also these measures will enable the company to make deductions to the Pension Fund on the general conditions. This will increase this fund's revenues, which are used for payments to pensioners, who also reside in rural areas.

It is suggested that agricultural enterprises that are payers of the fixed agricultural tax will be paying insurance contributions to the solidary system for and in the name of the workers employed in production of agricultural goods (accompanying services) at the special rate. If a worker of a fixed agricultural tax-payer is engaged in an activity different from agricultural production, the insurance contribution to the solidary system shall be paid at the rate determined in abstract 2 of point 1 of article 4 of the Law of Ukraine "On the duty for mandatory state pension insurance". The time periods for payment of insurance contributions at the special rate shall be included in the insurance record as periods, for which insurance contributions have been paid at the general rate.

Changes in taxation of agricultural enterprises in 2005

Proceeding from the fact that after 1 January 2005, upon enactment of the Law of Ukraine "On changes to a number of laws of Ukraine as to taxation of agricultural enterprises and support of their employees' social standards" No.1878, it was supposed to revoke the existing incentives in taxation of agricultural commodity producers, and, also taking into account the fact that the State Budget of Ukraine for 2005 did not foresee refunds of a portion of agricultural commodity producers' losses (whereas most of agricultural enterprises will be loss-making in this year), Verkhovna Rada of Ukraine approved the Law **"On changes to a number of laws of Ukraine as to taxation of agricultural enterprises" No.2287 dated 23 December 2004** (this law has come into effect on 1 January 2005) .

This law provides for the following changes;

— to suspend (postpone) the effect of article 8-1 of the Law of Ukraine "On Value-Added Tax" until 1 January 2006;

- to continue the effect of subclause 6.2.6 of clause 6.2 of article 6 of the Law of Ukraine "On Value-Added Tax" until 1 January 2006 in respect of VAT levy at the zero rate on transactions connected with milk and live-weight cattle supplies from agricultural commodity producers to processing enterprises, as well as specific rules for VAT payment by agricultural enterprises, as spelled out in clauses 11.21 and 11.29 of article 11 of the same Law;

- to reduce the rates of the fixed agricultural tax (the rates of the fixed agricultural tax levied from each hectare have been reduced three times to the following figures: for plough lands, haylands, and pastures - 0.15 percent; for perennial plantations - 0.09 percent; for the water fund lands used by fish-breeding, fishing, and piscatorial entities for fish breeding, rearing, and fishing in the in-land ponds - 0.45 percent of the value estimation of the unit of agricultural land area in oblasts and the Autonomous Republic of Crimea);

- to clarify the procedure for payment of the duty on mandatory pension insurance by the fixed agricultural tax payers. The Law of Ukraine "On the Fixed Agricultural Tax" (part 2 of article 1) excludes the regulations about the duty for mandatory special insurance, duty for mandatory pension insurance, and duty for special utilization of natural resources (in respect of water utilization for the agricultural needs).

Notably, the Law of Ukraine No.1878 introduced a regulation concerning changes to the Law of Ukraine "On Value-Added Tax" that was discriminatory for large-sized agricultural enterprises. In particular, if an agricultural enterprise sold non-agricultural produce for the amount of UAH 61,200 during 12 calendar months it would not have the right to be registered as a subject of the special value-added tax regime or its registration as a subject of the special value-added tax regime would be cancelled. This is caused by the fact that agricultural enterprises are engaged in other types of business activities during the winter period, taking into account the specific seasonal production in agriculture. Apart from that, most of agricultural enterprises maintain social-infrastructure objects such as dormitories, clubs, canteens, and sports facilities.

The law also provides for the following discriminatory regulation: if an agricultural enterprise that is a payer of the fixed agricultural tax sells non-agricultural produce for the amount exceeding 25 percent of the total sales during at least one month, its registration as a payer of the fixed agricultural tax shall be cancelled. This regulation of the law will make impossible for an agricultural enterprise to make use of the fixed agricultural tax, because production in agriculture is seasonal.

It must be pointed out that when agricultural enterprises that are subjects of the special taxation regime, which is used for the produce sales to processing or trading enterprises, the VAT amount subject to payment to the budget by the latter will be significantly increased (due

to the difference in rates for the 'incoming' and 'outgoing' VAT). This may also lead to a growth of prices for the end product sold to consumers.

Taking into account the fact that 1 January 2005 is the date when the Laws of Ukraine "On the duty for mandatory state social insurance" and "On mandatory state pension insurance" came into effect, it is necessary to exclude corresponding payments from the fixed agricultural tax now. Pursuant to the enacted Law of Ukraine No.2287, beginning with 2005, deductions for the general mandatory state pension insurance will be paid by agricultural commodity producers at the rate of 6.4 percent, whereas deductions for the general mandatory state social insurance will be paid on the general conditions. According to calculations of the Ministry of Agrarian Policy, proceeding from the labor fund used for remuneration of fixed agricultural tax payers' employees in 2005, the total amount of the above-mentioned deductions will come to around UAH 540 mln. This means that agricultural commodity producers' tax burden will be increased by this amount. The local budgets' total revenues will not change, but 30 percent of this tax will be available as revenues for local budgets.

Also, for the payers of fixed agricultural tax in 2005-2006, this Law of Ukraine No.2287 has set a special rate on deductions for mandatory state pension insurance - in the amount of 20 percent of the general rate with subsequent annual increments of 20 percentage points until it reaches the general rate of deductions for the mandatory state pension insurance.

With this purpose, the State Budget has to provide annual funds for reimbursement of the Pension Fund's losses from usage of the special rate by fixed agricultural tax-payers in the amount that is equal to the difference between the funds transferred at the special rate and the funds that would be transferred if the general rate was used. The State Budget provides UAH 1.2 bln. for these purposes for the year 2005.

The Law of Ukraine "On changes to a number of laws of Ukraine as to taxation of agricultural enterprises" No.2287 dated 23 December 2004 made changes to the Law of Ukraine "On Fixed Agricultural Tax". In particular, article 2 defines differently a person or entity that can be registered as a fixed agricultural tax-payer. Namely, the definition reads as follows "such entities are agricultural enterprises of various organizational and legal forms as provided by the Ukrainian legislation, **private farms** and other farms engaged in production (growing), processing, and sale of agricultural produce, as well as fish-breeding and fishing entities engaged in fish-breeding, rearing, and fishing in in-land reservoirs (such as lakes, ponds, and water basins), in which the amount received from sale of their own agricultural commodities and their products exceeds 75 percent of the total gross revenue in the preceding report (tax) year". In the list of entities that have the right to registration as fixed agricultural tax-payers, this article

should change peasant farms to private farms, which will be in compliance with the legislation in force.

Apart from that, article 2 of the law states that the newly-formed economic entities (except for those reformed through a merger, acquisition, partitioning (allotment), transformation, or separation, pursuant to corresponding requirements of the Civil Code of Ukraine) whose main business activities are processing and sale of agricultural produce are payers of the fixed agricultural tax.

This Law also prohibits classifying the following entities as fixed agricultural tax-payers: entities that are carrying out investment or innovation projects in special (free) economic zones and on priority-development territories with special investment regimes; under technological park conditions; are carrying out innovation projects pursuant to the Law of Ukraine "On Innovation Activity", or that are registered as single tax-payers or small business entities.

3. TAXATION OF HOUSEHOLD PLOTS

In the recent years, the main producers of most of agricultural produce are owners of household plots. According to official information of the State Statistics Committee of Ukraine, they accounted for the following production shares in 2003: 80% of milk production, 70% of poultry and cattle, 99% of potatoes, 87% of vegetables, 76% of fruits and berries, 36% of grapes, 28% of grains, 23 % of sugar beets, and 16% of sunflower seed production. Thus, not only are owners of household plots engaged in self-provision with foodstuffs, but they also account for significant shares in the total production. This means that in order to grow agricultural commodities, they also use certain resources (first of all, land), as well as buy seeds, young livestock, mineral fertilizers, plant and animal protectants, and other material resources. As a result of their activities, they get a certain profit from sale of their goods, which can be an object of taxation. Thus, a question arises as to what taxation system to use in respect of this category of commodity producers.

Presently, household plots are registered, in most instances, as personal peasant farms, which pay the following taxes: land payments, individual income tax, and market dues if they sell their grown agricultural commodities at special trading floors. The average land tax is about UAH 0.40-0.50 per each one-hundredth of one hectare.

Owners of household plots receive subsidies from processing enterprises for the supplied milk and cattle (at the expense of VAT amounts accrued by processing enterprises for the sold end products). It was pointed out above that there have been many instances when owners of household plots, which sold milk to dairy factories, did not receive the VAT subsidy.

Incentives in respect of profit taxation are extended to personal peasant farms as concerns taxation of their profits. Thus, pursuant to the Law of Ukraine "On changes to article 4 of the Law of Ukraine "On Individuals' Income Tax" (in respect of taxation of personal peasant farms' profits)" No.1594 dated 4 March 2004, personal peasant farms' profits received from sale of agricultural produce grown (made) on land plots, which were made available for personal peasant farming activities (on the condition that their sizes were not expanded as a result of obtaining of a land parcel (share); on land plots, which were made available for construction works and servicing of a dwelling house, farm structures and installations (or land plots adjoining the farmhouse), shall not be included in the total monthly or annual taxed profit.

Most of owners of household plots also receive payments for the leased land shares. According to official data, the average rent for lease of 1 hectare of land parcels (shares) in 2004 was equal to UAH 116 in the monetary equivalent. In general, the total payment amount, according to the signed lease agreements (the total leased land area was 19.9825 mln. hectares) was UAH 2.336 bln., including UAH 1.1542 mln. paid out to pensioners (49.4% of the total amount).

Annex 1 contains data on rent payments for leased land parcels (shares) calculated per 1 hectare of the leased land in Ukrainian oblasts in 2004. The highest rent per 1 hectare of leased land is paid by enterprises of Cherkasy (UAH 166.5), Dnipropetrovsk (UAH 143.8), and Kirovograd (UAH 140.8) regions. Farmers in 8 oblasts pay less than UAH 100 per 1 hectare of the leased land: Volynska (UAH 91.7), Zhytomyr (UAH 72.9), Ivano-Frankivsk (UAH 95.9), Lugansk (UAH 91.7), Lviv (UAH 72.7), Rivne (UAH 69.2), Sumy (UAH 92.2), and Chernigiv (UAH 76.3). The lowest land rent has been registered in Rivne region - UAH 69.2/hectare.

Annex 2 contains data on the filling structure of revenues of the local budgets' general pool. Districts of Zaporizhzhya oblast were used as an example. The main taxes are individual income tax, land payment, single tax on small-business subjects, and the fixed agricultural tax.

Local budgets of most of village councils are formed at the expense of three components: general pool (taxes, dues, and payments), leveling subsidies (funds from the state budget), and the special budget funds. The following taxes account for the largest contributions to the local budget pool: individual income tax (12%), land payment (10%), fixed agricultural tax (11%), and the other taxes (67%) (Table 6).

Table 6. Formation of the budget revenues of a village council (Chernigiv oblast)

Revenues	UAH	%
General pool		
1. Citizens' income tax	9,246	12.1
– income tax on workers and employees	274	0.4
– tax on profits from business activities and individuals' other incomes	—	—
– tax on agricultural workers' incomes	9,028	11.8

Revenues	UAH	%
– fixed tax on individuals' profits from business activities	—	—
2. Payment for subsoil resources	—	—
3. Land payments, total, including	7,796	10.2
– land tax on legal entities	1,412	1.8
– lease payments from legal entities	4,307	5.6
– land tax on individuals	2,074	2.7
– lease payments from individuals	—	—
4. Tax on trade	—	—
5. Trade patent	495	0.6
6. Local taxes and dues:	465	0.6
– advertisement tax	—	—
– communal tax	150	0.2
– trade tax	275	0.4
– market duty (UAH 1.20)		
– parking charge	40	0.1
7. Fixed agricultural tax	8,310	10.9
8. Single tax	1,537	2.0
9. State duty	71	0.1
10. Administrative fines and other sanctions	—	—
11. Other revenues	1,049	1.4
– from horses	357	0.5
– from tractors	408	0.5
– from machinery	68	0.1
– from issuance of certificates	216	0.3
AGGREGATE REVENUES	28,969	37.9
Leveling subsidy (from the state budget)	23,300	44.6
TOTAL REVENUES	52,269	68.4
Special fund		
1. 50% charge from the transportation means owners	2,335	3.1
2. In-house revenues from lease agreements concluded by budgetary entities	—	—
3. Land sale	—	—
4. Special funds for the management personnel's needs - total, including	21,774	28.5
– revenues for milk	17,322	22.7
– revenues for meat	165	0.2
– for cattle pasturing	3,500	4.6
– other	787	1.0
Total revenues for the special fund	24,109	31.6
TOTAL revenues for the pool and the special fund	76,378	100.0
Apart from that, donations for village improvements	1,068	—

** information with the village council*

Figures 3-5 exhibit (based on on-line information) the structure of tax deductions to budgets of different levels (oblast, district, and village councils) with the example of Khmelnytskyi oblast.

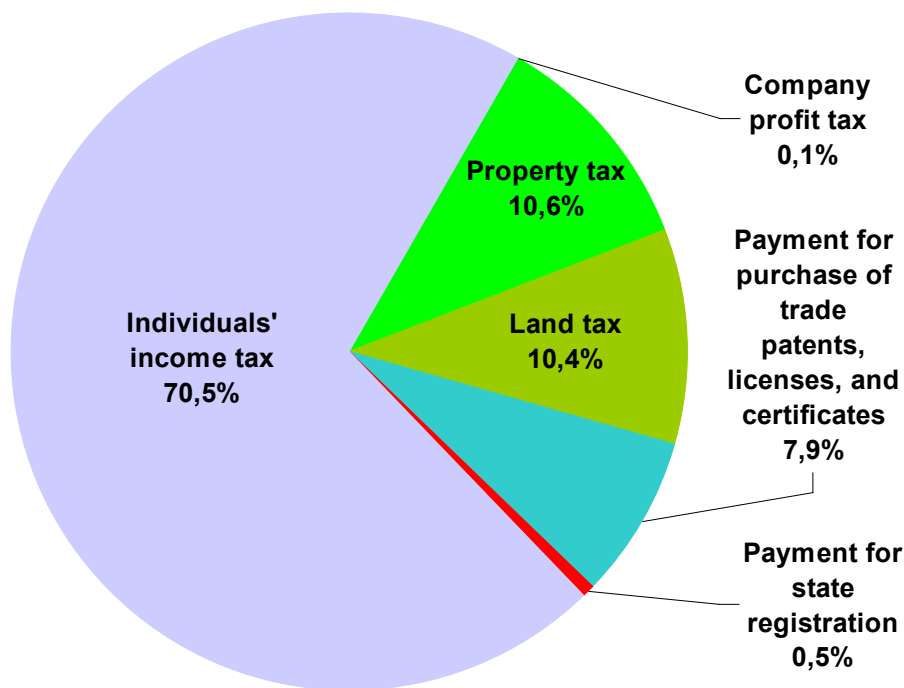


Figure 3. Structure of tax deductions to the oblast budget of Khmel'nitskiy oblast (online information for the 1st half of 2004)

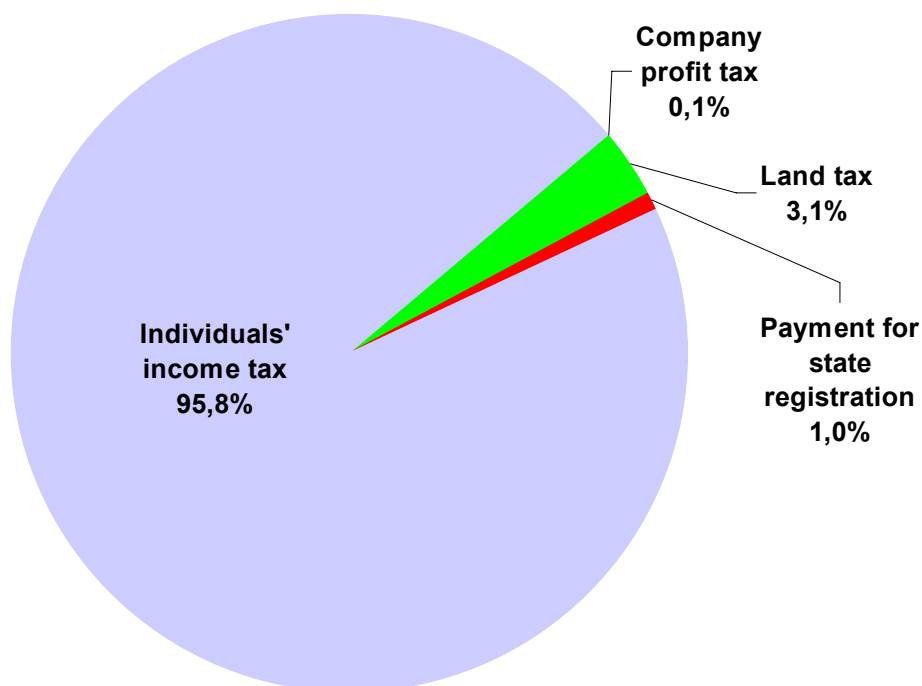


Figure 4. Structure of tax deductions to the budget of district 'A' of Khmel'nitskiy oblast (online information for the 1st half of 2004)

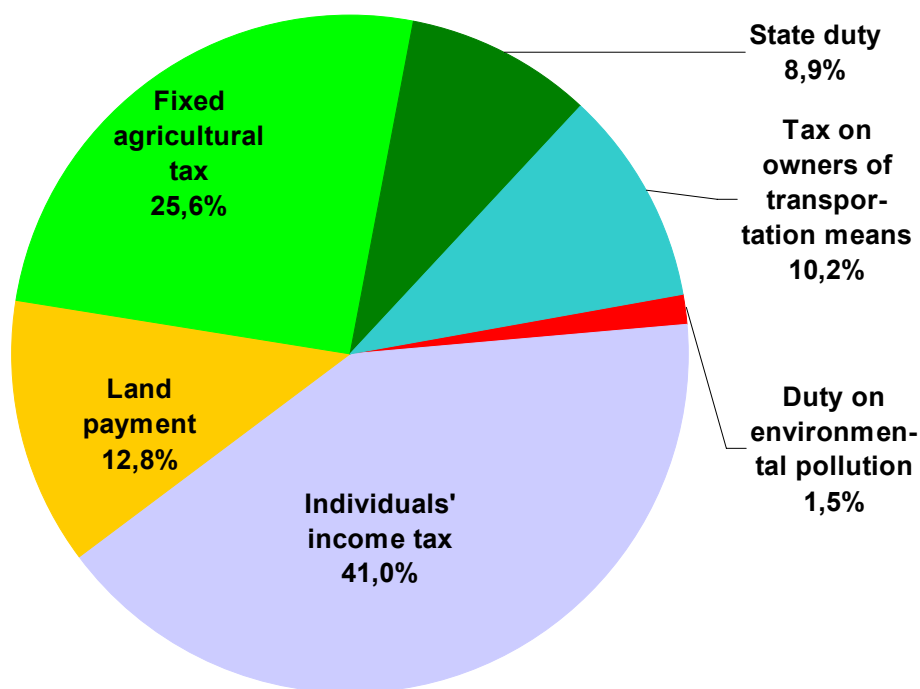


Figure 5. Structure of tax deductions of village council 'A' of Khmelnytskyi oblast (online information for the 1st half of 2004)

4. LAND TAX

There is no free land use in Ukraine. Payment for land is levied in the form of a land tax or a land rent, which is calculated based on the land's monetary valuation.

Land taxation is carried out in accordance with the Law of Ukraine "On Land Payments" No.2535 dated 3 July 1992. The present law determines the rates and procedure for payments for use of land resources, as well as purposes, for which the funds received from land payments can be used, payers' responsibility and control over correct calculation and levy of the land tax.

The object of a land payment is a land plot, as well as a land parcel (share), which is being owned or used, including lease agreements. The subjects of land payments (payers) are owners of land plots, land parcels (shares), and land tenants (including lessees).

Land tax rates for land parcels (excluding agricultural cropland) are differentiated and approved by corresponding village, town, or city councils, proceeding from the average tax rates, functional purpose, and location of the land parcel but not higher than doubled average tax rates, taking into account the coefficients set forth by the present law. Land tax rates per one hectare of the agricultural cropland are set as percentage of their monetary valuation at the following rates: for plough-land, hayland, and pastures - 0.1% and for perennial plantations - 0.03%.

For the period of the effect of the Law of Ukraine "On Fixed Agricultural Tax", owners of the land plots, land parcels (shares), and land tenants are made exempt from fixed agricultural tax

payments, on the condition that they lease out their land plots or land parcels (shares) to fixed agricultural tax-payers. Apart from that, incentives in respect of land payments are granted to the newly-formed farms for the time period of three years and to the hard-to-reach inhabited areas - for five years after the date of transfer of the land parcel to them. No payments shall be collected from agricultural cropland within the radioactively-contaminated territories, as determined by article 2 of the Law of Ukraine "On the legal status of the territories under radioactive contamination resulting from the Chernobyl disaster".

Funds received from land payments are placed on special local budgetary accounts and should be subsequently used for the following purposes: designing and fulfillment of state programs as to rational land use and protection, improvement of soil fertility, maintenance of the state land cadastre, land management, and land monitoring; institution of land innovation funds, and other special purposes.

According to article 7 of the above-mentioned law, tax rates shall be set at one percent of the monetary valuation amount. The land tax amounts are determined by tax inspections, which issue payment notifications to the tax payment prior to 15 July of each report year.

Land tax shall be paid to the budget by citizens in two equal parts - before 15 August and before 15 November.

A fine is accrued for untimely payment of the land tax, pursuant to article 16 of the Law of Ukraine "On the procedure for repayment of taxpayers' liabilities to the budget and state special-purpose funds" No.2181-III dated 21 December 2000.

There are certain privileges as to land tax payments. Pursuant to article 12 of the Law of Ukraine "On Land Payments" No.2535 dated 3 July 1992, no payment shall be collected for land plots, within the limits set forth by the Land Code of Ukraine, from group I and II invalids, citizens that are rearing three and more children, citizens whose close relatives are on the military service for a fixed period, pensioners, other individuals enjoying privileges, and citizens who were issued, according to the set procedure, a certificate confirming that they had suffered from the Chernobyl disaster.

Notably, it must be pointed out that privileges are extended only to owners of land plots, land parcels (shares) and land tenants, except for lessees and investors that participate in product distribution agreements.

Oblast, city, town, and village councils can introduce privileges as to land payments in the form of the partial exemption for a certain time period or reduction of the land tax amount only at the expense of funds put on corresponding special budgetary accounts. If a payer obtains the privilege right in the course of the year, he shall be made exempt from the tax payment beginning with the month following the month, in which this right has emerged. In the event

that the privilege right is lost in the course of the year, the tax shall be levied beginning with the month following the month, in which this right was lost.

Table 7 contains the land tax amounts to be paid by land tenants and owners with the specific example of one of the village councils of Chernigiv oblast.

Table 7. Land tax amounts to be paid by land tenants and owners (according to the monetary land valuation for 2004)

	Tax amount, UAH/hectare
Housing facilities	0.38-0.49
Pastures	0.05-0.27
Land adjoining farmhouses	0.07-0.18
Hayland	0.05-0.62
Plough-land	0.07-0.18

** Information with the village council*

5. TAXATION OF BUSINESS ACTIVITIES IN RURAL AREAS

In the recent years, the number of intermediaries engaged in various types of business activities has expanded significantly. The most widespread service is purchase of agricultural produce and its resale to processing enterprises, wholesalers, and retail traders. In most of instances, intermediaries are registered with tax authorities as business entities paying a fixed amount every month, which is called single tax. Its amount is regulated by local executive authorities responsible for the place where the entity is registered, depending on the type of business activity. The tax amount varies between UAH 20 and UAH 200 per month.

The procedure for application of the single tax shall be regulated by Decree of the President of Ukraine "On the simplified system of taxation, book-keeping, and reporting of small business entities" No.727 dated 3 July 1998. Pursuant to this Decree, on the next day after receipt of funds, a corresponding department of the State Treasury of Ukraine shall transfer single tax amounts in the following shares: to the local budget - 43%, to the Pension Fund - 42%, for mandatory social insurance - 15% (including 4% to the State Fund of Employment Assistance to the Population).

Legal business entities that have transferred themselves to the simplified system of taxation, bookkeeping, and reporting can independently select one of the following single tax rates: 6% of the receipts from product sales (commodities, works, and services), without taking into account the excise duty when the value-added tax is paid, according to the Law of Ukraine "On Value-Added Tax"; 10% of the receipts from product sales (commodities, works, and services), without taking into account the excise duty when the value-added tax is included in the single tax.

On 1 January 2004, the Law of Ukraine "On Individuals' Income Tax" No.889 dated 22 May 2003 came into effect. Clause 22.10 of article 22 of this law states that Decree of the Cabinet of Ministers of Ukraine "On Citizens' Income Tax" No.13-92 dated 26 December 1992 has terminated its effect except for part IV in respect of taxation of individuals' profits from their business activities, which is to continue being applied taking into account regulations of clause 9.12 of article 9 of the present Law and shall be effective until a special law on taxation of individual business subjects enters into force.

On 1 January 2004, the Law of Ukraine "On Entrepreneurship" was terminated (except for article 4). Business activities are regulated by Chapter 4 (articles 42, 44, and 47) of the regulations of the Civil Code of Ukraine No.436-IV dated 16 January 2003, according to which definition of notion "entrepreneurship" and its principles are not changed. At the same time, equal rights and opportunities are guaranteed, irrespective of the chosen organizational forms of business activities.

Pursuant to article 2 of Decree of the President of Ukraine "On the simplified system of taxation, book-keeping, and reporting of small business entities", profits earned as a result of business activities subject to the single tax levy are not included in the aggregate taxed profit of such a tax-payer and individuals that are in labor relations with it, according to the report year's results. The already-paid single tax amount is final and shall not be included in the list of general tax liabilities incurred by both the tax-payer and individuals that are in labor relations with it.

Concerning the taxation rate, in order to tax profits of business entities that have not chosen the simplified taxation system (the single tax, according to the Decree of the President, or the fixed tax, according to the Decree of the Cabinet), based on clause 22.3 of the Law of Ukraine, as of 1 January 2004, the tax rate shall be set at the level of 13 percent of the taxed object.

Data of Chernigiv oblast indicate that as of 01.07.2004, the average fixed tax was equal to UAH 74.7, whereas the average single tax amount (for individuals) was UAH 104. In 2003, the average tax amounts were equal respectively to UAH 74.7 and UAH 104, and those in 2002 – respectively to UAH 74 and UAH 100.

As of 01.07.2004, the total number of registered individual subjects of business activity (SBA) was equal to 29,801 persons. In 2003, there were 29,157 SBAs registered, and in 2002 – 25,309 SBAs.

The differences between the simplified taxation system and the general taxation system are as follows. A business person can be transferred to the single tax system if the number of people that are in labor relations with him/her, including his/her family members, does not

exceed 10 persons, and the receipts from product sales (commodities, works, and services) does not exceed UAH 500 ths.

Private entrepreneurs that trade in alcoholic drinks, tobacco products, and combustive-lubricating materials do not have the right to be transferred to the single tax-payer category.

Based on their own will, citizens who are subjects of business activity can choose a method for their income taxation through fixed tax payments on the condition that: 1). the number of people that are in labor relations with him/her, including his/her family members participating in business activities, does not exceed 5 persons; 2). the citizen is engaged in such business activities as market sale of commodities and rendering of accompanying services and is a payer of the market duty, according to the legislation in force; 3) this citizen's gross profit from his independent business activities or with usage of employed labor has not exceeded seven thousand untaxed incomes (UAH 119 ths.) over the past 12 calendar months preceding the month in which the patent is purchased.

6. MAIN FACTORS CONTRIBUTING TO IMPROVEMENT OF THE TAXATION SYSTEM

The effective Ukrainian taxation system is imperfect. It has a number of contradicting tax laws, which impede fund accumulation, slow down investment processes, and negatively affect formation of the fiscal policy in the country. This prevents domestic producers' adequate reaction to a growth of consumers' demand resulting from the population's increased incomes and slows down expansion of the market for products of investment and production purposes. Thus, the present-day tax policy leads to risks for the national economy' development in the long-term outlook.

Presently, construction of a more efficient taxation system is one of the most urgent problems for the Ukrainian agricultural sector. Formation of favorable taxation policy for agricultural commodity producers has to be carried out taking into account the sector's specific features and the need for support of social standards for agricultural enterprises' workers. Improvement of the tax system should be targeted at transition of taxes from the fiscal purpose to incentives. All developments will depend on both the quality of tax legislation and the macroeconomic state of the country' economy, based on the monetary-and-credit and financial system and social policy.

The main directions for reformation of the Ukrainian tax system are as follows:

- reduction of the general tax burden level;
- securing of the tax system's investment and social orientation and taking the corresponding measures;

- improvement of administrative taxation and tax discipline.

Reduction of the tax burden. A real reduction of the tax burden may be the main incentive for more active development of businesses in rural areas and an incitement to the investment process.

The new taxation system should be simple both in terms of administrative management and tax accrual and payment. It must change itself based on the predictability principle and avoidance of double taxation. Taxes and tax rates must be economically substantiated. The main difficulty is that, on the one hand, it is necessary to reduce the tax pressure on producers, whereas, on the other hand, it is necessary to provide revenues for budgets and special-purpose state funds.

With these purposes in mind, it is necessary to introduce lower VAT rates or (as a possible scenario for future discussions), to substitute VAT with a sales tax, which must correspond to interests of most of producers and create favorable environment for the economic entities, as well as for efficient resolution of existing social problems in rural areas.

Consistent policy on de-monetization of the national economy, expanded accessibility of credit resources, and increased availability of enterprises' current assets will contribute to the reduction of the tax burden (first of all, concerning indirect taxes).

Taxation basis and incentives. From the theoretical point of view, the taxation basis is defined as the legislatively-fixed portion of taxpayers' profits or property (taking into account the possible privileges) that is taken into consideration when the tax amount is calculated.

The object of taxation is the income (profit), products' added values (or those of works or services), value of certain commodities, special utilization of natural resources, and legal entities' and individuals' property. There also are other taxation objects.

The main taxation basis for the agricultural sector should be land and profit. This is confirmed by the world's experience: around 80% of all revenues from direct taxes paid by agricultural commodity producers is provided by only two taxes: land tax and profit tax (levied on legal entities' and individuals' incomes). Apart from that, most of the countries worldwide have differentiated income taxes. Agricultural commodity producers enjoy such privileges as lower tax rates, untaxed minimal incomes, full exemption from tax payment if the income level is lower than the minimal taxed income.

The main directions of macroeconomic activity of the Ukrainian tax policy should be its capability of determining the acceptable (optimal) taxation basis. Clarity in this issue will provide the needed tax revenues under relatively low tax rates. If the taxation basis is excessively narrowed, the state has to introduce higher tax rates, in order to provide higher tax revenues.

However, this may lead to a reverse effect because taxpayers will be more likely to try to evade tax payments.

Ukraine still has a large number of tax incentives, which often result from lobbying of group interests. This is an indication of the growing fiscalization of the tax policy and the state's gradual withdrawal from tax regulation under the pressure of the need to find a fiscal balance.

The system of tax incentives in Ukraine weakens the tax system's fiscal function and almost does not strengthen its regulatory function. Apart from that, tax incentives may spur up development of the shadow sector of the economy, because these incentives are easily transformed into complete tax evasion schemes. It is necessary, where possible, to withdraw tax incentives from specific sectors of the economy. This especially concerns the incentives that are unfair or inefficient, distort the taxation system's sense, or impede the national economy's development.

Stability of tax policy. Stability of the country's tax policy suggests unchanged legal regulation of tax and duty levy during a certain taxation period. Under these conditions, economic subjects have more opportunities for efficient organization of their businesses. On the other hand, state taxation authorities will achieve an improved tax collection procedure.

It must be pointed out that the tax policy must be stable only during a certain taxation period. It also has to account for some flexibility criteria, which would make it react to social and economic changes in the society.

Types and structure of taxes. In the process of setting and payment of taxes, there must be a good balance between the national and local interests, which is a prerequisite for discharge of the legislatively-defined functions by the state in general, as well as by each administrative and territorial unit.

Collection of the national taxes is mandatory for all of the country's territory, irrespective of the budget (national or local), to which these taxes are to be deducted. According to distribution between the chains of the budgetary system, national taxes are subdivided into three groups: revenues of the state (central) budget, revenues of local budgets, and revenues distributed between the state budget and local budgets.

With the purpose of development of rural areas, special attention should be paid to the process of determination of local taxes, which are set by local authorities and governments. There can be several scenarios in setting of local taxes. They can be in the form of extra charges to the national tax rates (the levels of such extra charges are to be determined by local authorities, according to the set restrictions); institution of local taxes from the list approved by the supreme state authorities. Tax selection is a responsibility of local authorities. This means

that introduction of local taxes is up to local authorities, without any restrictions on the part of central authorities.

Complications connected with Ukraine's tax system are connected with sophisticated and unstable tax administration system, deformation of the monetary sphere, as well as the tax rate levels. However, it is clear that the reduction of tax rates alone (to which the sense of the tax reform is often reduced) will not produce the expected positive results. Under the reduced tax rates and modified tax structure, the new tax system has to prevent a curtailment of tax revenues. With this purpose in mind, it is necessary to expand the taxation basis and refrain from inefficient tax incentives.

The reduction of taxation levels and a growth of enterprises' liquidity through granting of tax preferences will not resolve the problems connected with domestic products' competitive capacities on the domestic and external markets, which will be the key developing factor in the long-term outlook. Securing of the tax reform's strategic efficiency will require that special attention be paid to the taxes' regulatory function and introduction of incentives for enterprises' investments and innovation activity.

During determination of the tax structure, it is necessary to take into account the assignments given to the tax system, namely: creation of optimal conditions for economic entities, minimization of the social destabilization danger caused by cutting down of social programs, and curtailment of the shadow sector of the country's economy.

The taxation basis for agricultural commodity producers should be simplified through setting of stable and substantiated tax rates.

Writing-off of tax debts. In order to avoid budgetary losses from possible writing-off of tax indebtedness accrued by agricultural enterprises that incurred losses as a result of force-majeure circumstances (clause 18.2.1 of article 18 of the Law of Ukraine "On the Procedure for clearing-off of taxpayers' tax liabilities to budgets and special-purpose state funds" No.2181 dated 21 December 2000), the following principles shall be applied for determination of the bad debt amounts subject to writing-off:

- VAT and profit tax indebtedness on non-agricultural activities cannot be written off.
- The fixed agricultural tax amount shall be calculated based on the areas, on which the harvest was lost as a result of the force-majeure circumstances' effect.
- The profit tax amount, deductions to the Pension Fund, and the Social Insurance Fund. Deductions to the other funds shall be calculated based on the wages' share in the lost harvest's cost.

Pursuant to Regulation on the procedure for levy and record-keeping of the fixed agricultural tax, which was approved by regulation of the Cabinet of Ministers of Ukraine No.658 dated 23 April 1999 (with changes and amendments made in 2003), the gross revenue is defined

as the total amount of a taxpayer's revenues from all activities, which were received (accrued) during the report period in the monetary, material, or non-material forms on the territory of Ukraine, its continental shelf, exclusive (sea) economic zone, as well as beyond them.

The gross revenue from sale of own agricultural produce includes: the value of the sold plant and animal goods of own production; the value of the sold products made from plant and animal goods of own production at the in-house processing capacities; the value of the sold plant and animal products made from own raw materials on tolling schemes, irrespective of the processor's territorial location; and the value of the rendered services connected with agricultural production (services rendered by machinery and tractor parks, construction and repair works, etc.).

When a fixed agricultural tax calculation is submitted to a state tax authority, the legislation in force does not spell out to which report period the taxpayer has to refer advance payments received in 2003 for the own agricultural produce sold in 2004.

Thus, in order to avoid the conflict of interests, it is necessary to make changes to Regulation on the procedure for levy and record-keeping of the fixed agricultural tax, as concerns reflection of receipts from sales of agricultural produce for cash or based on the date of the actual shipment of such produce.

Conclusions and proposals

1. There are both objective and subjective reasons for the slow reformation of the Ukrainian taxation system. The objective reason is the fact that the Ukrainian tax system was being formed during the state's coming-into-being and a lengthy economic crisis and was aimed primarily at discharge of the fiscal function. The subjective reason is lack of understanding of the nature of taxation in the market economy and even the taxation ideology. The effective tax system suggests the state's active regulatory role. It is necessary to change the economic nature and sense of taxation in order to secure the principle of the state's noninterference in business entities' economic activities.

2. It is necessary to determine the priorities for the tax reform in 2006-2007. For this purpose, a set of the following measures must be developed:

- The fixed agricultural tax should be in force for a certain time period. In the medium-term outlook, it should be substituted for the land tax.
- Agricultural commodity producers and processing enterprises should move from settlement of accounts between them through the mechanism of subsidy payments at the VAT's expense for the supplied milk and live-weight cattle to pure contract relations. The mechanism of subsidy payments at the VAT's expense for the supplied milk and live-weight cattle should be substituted for the adequate support provided through special budgetary programs.

- Personal peasant farms should not be subject to double taxation when they pay the land tax and the profit tax.
- The state must not employ selective approach to refunds of value-added tax amounts to exporters.
- Objects and basis of taxation must be clearly defined.
- A flexible system of depreciation charges has to be put in place. This system must be suitable, first of all, for tax-payers.
- Legislative norms that facilitate investments, scientific research and developments should be enacted.
- The newly-formed enterprises that have shown interest in agricultural production and/or rendering of services in rural areas should enjoy favorable conditions for their operation.
- Special taxation regimes in free economic zones must be cancelled.

3. In the medium-term outlook (2-3 years), it is also necessary to reduce the value-added tax rate to 15-16%, complete the transition to taxation of the real estate (as real estate markets are developing in corresponding regions), and revoke inefficient local taxes.

The part of enterprises' profits that they use for payment for information and consulting services in rural areas, advanced training and re-training of the personnel for rural areas, and social expenditures (pension, medical insurance, recreation, etc.) should be made tax-exempt.

4. Along with theoretical and practical aspects of the tax reforms, developed countries' experience in tax regulation should also be taken into account. Notwithstanding specific features of each country's economic system and each economically-developed country's traditions, the reformation processes exhibit common tax system construction principles. Almost the same types of direct and indirect taxes are effective in different countries. In fact, all countries provide their agricultural sectors with privileged taxation regimes.

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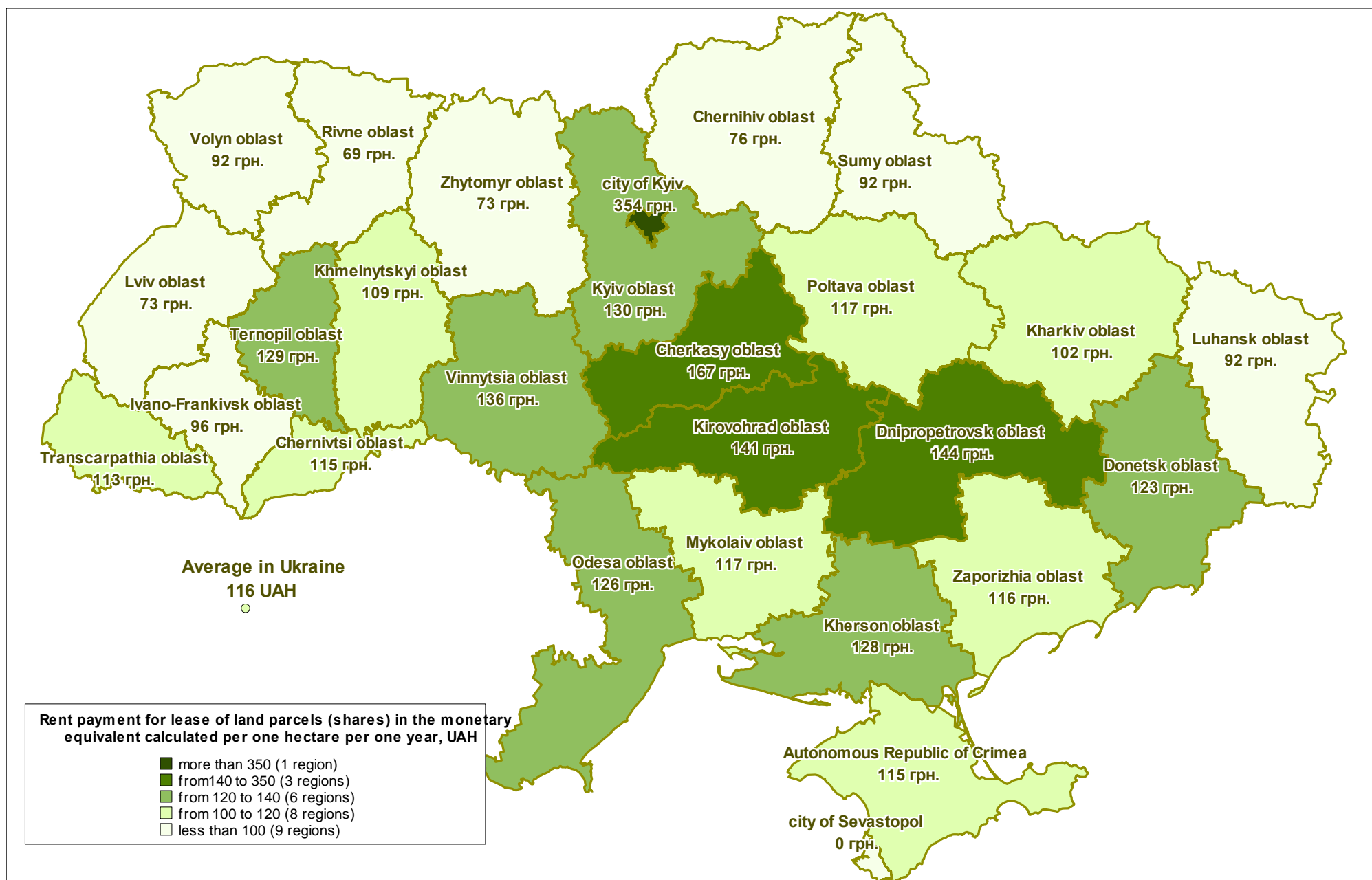
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ANNEX 1. RENT PAYMENT FOR LAND PARCELS (SHARES) CALCULATED PER 1 HECTARE PER YEAR, UAH



ANNEX 2. STRUCTURE OF REVENUES OF LOCAL BUDGETS' POOL AS PER EXAMPLE OF ZAPORIZHZHYA OBLAST (ON-LINE INFORMATION AS OF 1 JULY 2004)

