

VAT Exemption for Software Products Supplies. Changes Expected?



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Attention has recently been paid to Law 466 *On Amending the Tax Code as to Improvement of Tax Administration, Elimination of Technical and Logical Inconsistencies in Tax Legislation*, including to its effect on the IT industry.

Yet, there is another draft law which is expected to be adopted and to have an impact on IT sphere, namely the Draft Law *On Amending the Tax Code of Ukraine in Respect of Taxation with VAT of Digital Services supplied by Non-Residents to Physical Persons with the Place of Supply at the Customs Territory of Ukraine* registered on 19 December 2019 under No.2634.

Despite its title and purpose, as declared in the draft's explanatory note, Draft law No. 2634 not only implements the system of taxation of non-resident suppliers of digital services to individuals, but also may change certain rules for local suppliers of software and other IT product, particularly when such products are supplied to the resident entities and individuals.

Namely, if the Draft Law is adopted in the suggested wording, it will considerably narrow the list of transactions for which the regime of exemption from VAT is currently provided by para. 26¹ of subsection 2 of section XX of the *Tax Code*.

It is suggested that only the following transaction will be exempt from VAT:

- Creation at the request of the customer of software products,
- Making, at the request of the owner of exclusive intellectual property rights for software products, of any changes, updates, extensions of functionalities of such software products as well as alienation of exclusive intellectual property rights for such changes, updates, extensions of functionalities of such software products;
- Transfer of exclusive intellectual property rights for software products.

Compared with the version that is currently in effect, where exemption is pro-

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vided, inter alia, for supplies of exemplars of software, end-user licenses, supplies of updates or modifications, that are not specifically requested by the customers, Draft Law No. 2634 removes the mentioned transactions from the VAT exemption regime.

Moreover, exemption from VAT, as suggested by Draft No.2634, might be allowed only for those entities, which are registered in Ukraine as business entities.

The explanatory note to Draft Law No.2634 is silent in respect of changes introduced in the exemption regime, it does not explain the suggested selection of transactions that should be exempt from VAT.

A reminder that the exemption regime was at first introduced as early as 2013 with the declared purpose of creating basic economic conditions to develop IT industry by means of introducing changes to the *Tax Code*.

Since then the regime has had two versions: the first, being in effect starting from 2013 through 2017 and the second, which has been in operation since 2018, and remains valid at the present time.

At first, VAT exemption was provided for software products supplies, where the software products were specifically defined

as results of computer programming in the form of different types of software or software components, web-sites and/or on-line services; cryptographic means for information protection.

The wording of the adopted law was quite ambiguous and did not enable safe enjoyment of the exemption regime, since there was always a doubt as to what should be understood as a software product supply in terms of intellectual property legislation, providing for a variety of types of contracts and transactions with software products. In many cases, where such regime could be potentially applied, it was safer not to apply the exemption at all, as there was always a chance that the tax authorities could challenge it.

In October the then Ministry of Revenues even issued a general tax ruling as approved by the Order as of 7 October 2013 No. 536 where they tried to clarify their vision on certain aspects of the regime, though in some aspects managed to raise even more controversy than the law itself.

At the end of 2017 para. 26¹ of subsection 2 of section XX was restated by Law No. 2245-VIII of 7 December 2017 with the updated regime that came into effect in 2018. The tuned-up version of the regime provides for more clarity in the exemption regime, also introducing exemptions for those transactions which are not qualified as royalties under para. 14.1.225 of the *Tax Code*.

However, even this version is not crystal clear in respect of certain aspects, while the tax authorities continue to provide their understanding of how the law should be interpreted in the form of numerous tax rulings.

For instance, controversies still arise with on-line services, supplies of modifications and updates of software, where the tax authorities have their vision of terms and conditions under which respective supplies shall be VAT-able or exempt from taxation.

As an example, on 5 April 2018 the State Fiscal Service issued individual tax ruling

No. 1384/6/99-99-15-03-02-15/IIK, where the issue of taxation of access to on-line service on terms of end-user licenses was raised. The State Fiscal Service concluded that providing on-line service on search for, processing and obtaining information, which does not assume the supply of copies of software to the end-user, shall not be treated as a VAT-exempt transaction.

This ruling was later cancelled by the decision of Kyiv Administrative Court of 6 February 2019 in case No. 826/8167/18 initiated by YOU-Control Ltd due to lack of grounds for the mentioned conclusion.

It is interesting to note that in the decision the court took into consideration the scientific opinion of a TaxLink expert, member of European Association of Tax Law Professors, doctor of law, professor of the Department of Financial Law of Faculty of Law of Taras Shevchenko National University of Kyiv Hetmantsev D.O. The court decision mentions that according to the opinion, transactions on providing access to software are exempt from VAT starting from 1 January 2013 by virtue of direct rule of law.

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Obviously after the mentioned court decision, a new individual tax ruling was issued (5 December 2019 p. N 1741/6/99-00-07-03-02-15/IIK), where the State Fiscal Service extended the grounding and deliberated on the conditions under which on-line service can or cannot be exempted from payment of VAT.

The availability of numerous tax rulings on different aspects of software products

supplies evidence that the version of the VAT exemption regime, as currently suggested by the *Tax Code*, cannot be viewed as fully precise and foreseeable in its application, as is required by the “quality of law” principle under the Convention for the Protection of Human Rights and Fundamental Freedoms and respective practice of the European Court of Human Rights, including cases *Serkov vs Ukraine* (Application No. 39766/05), *Shchokin vs Ukraine* (Applications No. 23759/03 and 37943/06), *Shmushkovych vs Ukraine* (Application No. 3276/10), *Oleksandr Volkov vs Ukraine* (Application No. 21722/11), etc.

Hopefully, any changes in the VAT exemption regime for software products supplies will be introduced in line with the mentioned principle and will allow to apply or not to apply VAT exemption by virtue of the direct rule of law, rather than by means of trying to fulfill the conditions set by the tax authorities via numerous tax rulings issued by the latter.

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