



# **IN FOCUS: TAXATION OF MARKETING CHARGES**

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Analytical Report issued by Tax Committee and Marketing Committee of the European Business Association to elucidate the problem of taxation of expenditures related to rendering marketing services and give recommendations to resolve it.

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This Analytical report is issued to elucidate the issue of tax administration of enterprise expenditures for rendering marketing services when accounting the income tax basis. Herewith, this Report focuses on the argumentation of referring justified expenditures of enterprises on certain types of services related to promotion of their products at the market to gross expenditures for taxation purposes. The Report studies experience in other countries and suggests alternative ways to resolve the subject problem in Ukraine.

The current level of economic system development requires new principal approaches to organization of business activities of any enterprise, since the duration and profitability of its operations in a certain market segment rely upon efficient management decision making system. In the course of development of market relations marketing, as a comprehensive system of enterprise production and sales management processes governing the product (work, services) promotion from vendors to customers, is gaining more and more significance. This is the very system, on which appropriate managerial decisions are based.

The purpose of operations of any enterprise is to receive profits resulting from selling goods or services to satisfy demand of populace in them. In its turn, a product (service) can be sold when the offer of this product (service) is competitive. Marketing bears the very function of management to ensure that the product (service) is competitive, and it involves evaluation, planning, implementation and monitoring of efforts aimed at the development and enhancement of demand for goods and services and growth of enterprise profits.

The current theory identifies four basic marketing components: product, price, distribution, promotion.

In this Report we focus on the latter marketing element, which is promotion, since the broadest range of disputable issues regarding referring specific marketing costs to enterprise gross expenditures evolve around promotion of products at the market.

It should be noted that the emergence of large and small trading networks at the Ukrainian market resulted in more rigid conditions of receiving planned profits in the competitive environment for product suppliers. For each supplier it is important to sell higher volumes of products than its competitors. One of the ways to reach this objective is a successful product strategy enabling to promote the product using appropriate marketing tools.

Such tool, for example, is merchandizing, which is a system of efforts conducted at points of sale to create a convenient, agreeable and beneficial environment for the customer to buy a specific product. The way the products are placed in a supermarket determines how promptly they are going to be sold to customers, and, therefore, the volume and celerity of the next order the supermarket will place with the supplier. In this connection, the market has produced a service rendered by trading networks, which is the service of placement the products in specific conditions, and without which it is impossible to sell products today. This service is dictated by the environment existing in trading networks, and each supplier understands that without such services it will not be able to compete with its competitors. These above mentioned services are marketing services, and they are directly related to supplier business activities.

Unfortunately, presently the companies supplying products to trading networks via distributors or directly face a number of problems related to referring marketing charges to gross expenditures and tax credit. Also, there are problems related to the situation where controlling authorities question the relation of marketing services to business activities of enterprises, which causes arguments in the course of audits.

Large retail network actors will only buy products from suppliers, if there is a marketing services agreement in place, either included in standard supply agreements or regulated by other supplementary agreements.

According to Item 18 “Accounting provision (standard) 16 “Expenditures”, approved by Directive No. 318 of the Ministry of Finance of Ukraine as of 31 December 199, sales related costs include the following expenditures that are related to supply (sale) of products (goods, works, services): advertisement and market research (marketing) expenditures.

According to Article 5 of the Law of Ukraine “On taxation of enterprise profits” total production and turnover costs are defined as a sum of any tax payer’s expenditures in monetary, tangible or non-tangible form, executed as compensation of the value of goods (works and services) purchased by such tax payer for their further use in its business activities.

Sub-item 5.3.1, Item 5.3., Art. 5 of the subject Law specifies that expenditures for the needs that are not related to business activities, i.e., receptions, presentations, parties, entertainment and recreation programs, purchase and distribution of gifts (except fundraising activities and contributions to non-profit organizations, as determined by Item 7.11 of this Law and advertisement related expenditures regulated by sub-item 5.4.4. of this Article) do not refer to gross expenditures.

In turn, Item 5.4.4 Article 5 of this same Law refers pre-sale and advertisement costs regarding the goods (works, services) sold (rendered) by an enterprise income tax payer (and here it should be emphasized that advertisement is one of the tools of promotion of goods or services) to gross expenditures, leaving the issue of other marketing charges administration behind.

First of all, this is caused by the lack of definition and description of what can be referred to marketing services in the current law. Based on common practices, marketing services are a set of efforts involving placement of certain goods in a specific location in a salesroom (merchandizing), supply of products to recently opened points of sale, product promotion services, display and popularization of a certain trademark (information and marketing services), generation and analysis of information for market research and product sales purposes, identification of customer demand factors in order to minimize the risks when taking strategic decisions in the course of enterprise business activities (marketing researches), etc. The largest suppliers, members of the Association, such as Bunge, Ferrero, Unilever, Slavutych and few others refer the following to marketing services:

1. Stimulation of demand in the product through selling this product via a network of supermarkets (payment is made in the form of bonuses (quarterly, annual) in % from sales volumes; the bonus of growth is paid if the total volume of goods sold via the network of supermarkets exceeds the scheduled volume as agreed upon by the parties; payment is made in % from sales volumes);
2. Services related to centralization of supplies – aggregate activities, enabling to supply products to a central warehouse saving on logistics operations rather than supplying it directly to each point of sale in an individual administrative territorial unit;
3. services related to entering information about supplier (manufacturer) and the product to the supermarket network database;
4. services related to placement of products on the trading floor (merchandizing), including a specific service of placing a product within the cashier’s area;
5. services related to clearing up, packaging, prompt replenishment of product volumes on

- the shelves;
6. services related to monitoring the expiration terms of products in a point of sale;
  7. services related to consumer demand study, research and analysis;
  8. monitoring and issuance of recommendations regarding adjustment of the range of products, packaging and labeling of the customer supplied products in the sales area;
  9. transfer of the range of products to new supermarkets;
  10. promotion of products to the market through generation of information about them, outreach to remind that they are available in the Customer's network of stores;
  11. placement of information about the product on billboards, equipment, shelves, carts in center(s) of sales;
  12. additional services in support of product promotions on annual anniversaries;
  13. etc.

As mentioned above, some suppliers regulate their expenditures on marketing services through individual agreements for marketing services rendered by trading networks or distributors. However, they can face the risk of the subject expenditures being not applicable under Item 5.4.4 Article 5 of the Law of Ukraine "On taxation of enterprise profits", which specifies what kind of costs of enterprise refer to gross expenditures. The risk of excluding such expenditures exists due to the fact that the title of ownership of the product is assigned to the networks, when the product has been delivered thereto.

Thereby, tax authorities may deem payment for promotion of the products, which are no longer the property of supplier, as such, which do not refer to business activities and, as a result, are subject to enterprise income tax.

Existing judicial practices proves that tax authorities have a biased approach to marketing charges and similar services and do not allow enterprises to refer these services to gross expenditures seeing the following in companies' efforts:

- **intent to evade taxation** by increasing gross expenditures and tax credit as a result of simulation of rendering/receiving services;
- **lack of documental proof** of provision of marketing services or recognition of work completion deeds void;
- **lack of relation of marketing costs to business activities** of the customers ordering such researches.

The arguments of tax authorities regarding tax evasions, as a rule, are connected with availability of certain evidence enabling them to question accuracy of the information contained in the documents supporting provision of marketing services.

As for the lack of documental proof, it should be noted that the law of Ukraine sets forth no special requirements regarding mandatory availability of certain documents to prove that marketing services have been rendered.

Thus, the Law "On taxation of enterprise profits", in paragraph 4, sub-item 5.3.9 is rather short-spoken in outlining requirements to supporting documents: "any expenditures, which are not supported by appropriate accounts, payment and other documents, which are mandatory to be maintained and retained according to the requirements of tax accounting administration rules do not refer to gross expenditures". Based on the content of sub-item 11.2.1 of the subject Law, gross expenditures can be supported by: 1) the document verifying writing off the money in payment for goods (works, services) or cash purchase thereof; 2) the document verifying posting of goods

or actual receipt of the results of work (services).

Considering the above mentioned, it should be noted that presently tax authorities insist that the documents verifying expenditures for tax accounting should meet the requirements of Law of Ukraine “On accounting and financial reporting in Ukraine” of 16 July 1999 No. 996-XIV and the Provision on documental support of accounting records. However, neither the Law, nor the Provision contains a specific list of documents required to verify the right to gross expenditures on marketing services. Therefore, provided that other requirements of tax authorities have been met, enterprises may incorporate marketing charges in gross expenditures based on whatever original documents confirming the fact that such services have been rendered, including service acceptance/transfer deeds, invoices, payment orders, etc., containing the necessary information as specified in Part 2 Art. 9 of the Law “On accounting and financial reporting in Ukraine”. According to this article, original and consolidated accounting documents may be issued on paper or computer carriers and must contain the following compulsory information: name of document (form); date and place of issuance; name of the enterprise, on behalf of which the document has been issued; description and volume of business activity, unit of measurement of the business activity; positions of the officials responsible for the business activity and its appropriate execution; personal signature or other data enabling to identify the individual involved in execution of the business activity.

The relation of marketing charges to business activities requires a more detailed consideration. As noted above, marketing focuses on improvement of competitiveness of a product or service, and thus, the objective of marketing is to increase income of the enterprise using it.

Taking notice of this argument, tax authorities also verify the original documentation, i.e.: availability or lack of reports on services that have been rendered. But, unfortunately and as a rule, they provide no specific facts to confirm that there is no relation between marketing services and business activities, merely ascertaining these circumstances. Therefore, the responsibility for actual proof of the relation of services to business activities is vested in tax payers.

Thereby, in order to settle these issues tax payers have to refer them to judicial instances to challenge tax decisions and incur significant monetary costs and waste significant amounts of time proving the obviousness of business operations that have taken place and the lawfulness of their bookkeeping and tax accounting activities in accordance with provisions of the current law.

According to the response the State Tax Administration of 12.10.2007 provided to the question regarding a possibility to include the cost of services related to promotion of products at the market, pre-sale preparation and placement (display) of goods in shop windows and on special structures made available to suppliers by supermarkets, tax payers may refer the subject costs to gross expenditures based on sub-item 5.4.4, Item 5.4, Art. 5 of Law No. 334/94-VR (provided that this product is sold (provided) by such tax payer).

However, usually manufacturers sell their products through distributors, who, in turn, sell it to supermarkets offering the goods to end consumers. This enables supplier companies to do their job without spending moneys and time on supplementary logistics and sales processes, etc., and distributors to take the position of an interim unit rendering wholesale services. Stores, in turn render retail services from individual points of sale as physical persons/subjects of entrepreneurial activities (PPSEA) at markets to network supermarkets. Thereby, this creates a system of product delivery from manufacturers to end consumers where each entity specializes on what it can do best. This results in manufacturers’ growing and sustainable profits, improvement of the

quality of their products, possibilities to introduce new products. With such system distributors have opportunities to increase their profits enhancing their businesses and make money on the turnover. Supermarkets do the same. As a result, end users enjoying the choice of products and prices to their liking are the ones to benefit.

In this system we can track down relation of marketing charges to business activities. The subject relation is linkage of manufacturers/traders(wholesalers) with end customers through retail networks. It manifests itself in the fact that each actor benefits at the most, when performing certain functions reducing incremental costs. Manufacturers, wholesalers and retail networks are interested in accelerated turnover of their cycle: manufacturer – of the production cycle, wholesaler – of wholesales, retail network – of the retail cycle where the end result is to satisfy consumers' demand in specific products. The quickness of this turnover brings income, and specialization reduces incremental costs. In turn, budget receipts increase at all levels, employment rates grow, the range of products at the market and the range of prices grow wider.

Thus, to ensure transparency and settle the apparent problem that has become the focus of attention of the Association this time, the norms regarding the issue of referral of marketing charges to gross expenditures need to be detailed in the law, since the general norms do not catch up with the community development.

#### ***NB (European experience)***

*Evolvement of European tax legislation has not left aside the taxation of marketing expenses. Business traditions in Europe testify that successful marketing is closely tied with profit of companies.*

*For example the **Polish** legislature considers as tax deductible costs not only those spent in aim of achievement of income but also ones spent in aim at preserve or secure the source of company's income (goods or services, the selling of which actually generates this income).*

*Another fresh-EU member state – **Romania** – has a legislative provision according to which costs related to the advertising, promotion and marketing on old or new markets, market research, participation in fairs and exhibitions, leaflets and advertising materials, business exercise are all fully inclusive into the tax-deductible outflows.*

*A number of European states, namely **Italy**, allow including marketing expenses to the tax-deductible outflows, meaning that these marketing expenses will not necessarily generate certain income in the given fiscal period.*

***Slovak** tax legislation treats expenses, planned to ensure and maintain the future profit, as legitimately tax-deductible. One argues that a company bears marketing expenses with the purpose of "insurance" of the profit-to-come, bearing in mind that marketing strives maximum customer satisfaction.*

The following can be alternative ways of settling the problem as outlined:

#### **Option 1:**

Provide a more clearly defined list of operations related to advertisement activities, the cost of which is not to be included in gross expenditures. This subject list needs to be exhaustive. This

proposed way will ensure that economically justified costs (including the cost of marketing services) will be referred to gross expenditures.

### **Option 2:**

Give legal definition of charges for marketing services that will prove unambiguously their relation to business activities in the Law “On taxation of enterprise profits”. In particular, indicate that marketing services are the services ensuring functioning of activities of enterprises in the area of market research, stimulation of sale of products (works, services), price policies, organization and management of product (works, services) flow to consumers and after-sale services to consumers. Marketing services include the following: services related to placement of products in sales areas, services related to study, research and analysis of consumer demand, services related to entering products (works, services) to databases of sales areas, services related to display of products at sales areas, services related to generation and distribution of information about products (works, services), merchandizing services and other services, which are in no conflict with paragraph 2 Item 5.4.4 of the Law “On taxation of enterprise profits”. Establish an exhaustive legislative list of documents required to confirm rendering of the marketing services, charges for which are included in gross expenditures of enterprises.

### **Option 3:**

Tax administration should provide an explicit and comprehensive explanation that marketing services refer to gross expenditures of enterprises and, accordingly, are not subject to income tax of enterprises.

#### **Expert opinion:**

##### **Taras Koval, senior lawyer, international law firm Baker&McKenzie**

The government agencies’ current practice of applying operative tax legislation to marketing services, which with the development of a competitive environment in Ukraine are being offered by business entities in the broad understanding of the term marketing (i.e. a set of measures of organizing the management of production and sale so as to meet as much as possible the requirements of consumers), are restrictive and of a fiscal nature, in spite of the direct ban of setting additional restrictions, as stipulated in Item 5.11, Article 5 of the Law On Taxation of Company Income.

This is the result of the lack of a clear understanding of the issues of taxing marketing services by the government in general and by the tax agencies in particular, as well as by narrowing this understanding only to the practice of pre-sale and advertising measures relative to goods that are sold (provided) directly to the taxpayer. Such a narrowed understanding restricts the entrepreneurial initiative of business entities in the currently developing competitive environment. And, accordingly, it restricts the opportunities of Ukraine’s economic growth.

The referred to problems can be resolved in two ways: legislatively – by introducing corresponding amendments to tax laws (expanding the existing list of marketing services and the range of business entities), sublegislatively-regulatively – by providing generalized explanations for the practical application of existing provisions of tax legislation with allowance for the constantly changing economic environment (broader interpretation of the list of marketing services and range of business entities). The second way is the most appropriate, since it is aimed at securing the stability of operative legislation. It would be more agreeable

to introduce amendments to legislation when the relations it creates do not accord with the existing practice of these relations.

We would like to hope that the Ministry of Finance or the State Tax Administration of Ukraine will forthwith give a corresponding generalizing explanation for the practice of applying operative tax legislation on marketing services so as to develop entrepreneurial initiative instead of tightening it with restrictions and immoderate fiscal policy.

**Dmytro Levchenko, Legal Office, LKI**

Since on the territory of Ukraine the market of products offered to consumers during the past few years consist mostly of foreign products whose owners (manufacturers) represent the European countries, the requirements to the networks of distribution and sale of the products are based on the requirements and experience of these owners (manufacturers), and the system of measures of organizing the management of the manufacture and sale derives from the practice of promotion of products elaborated by the networks of the European trading companies.

In its current trading environment, Ukraine lacks its own experience in marketing (merchandising) and in the majority of cases marketing relies on the experience of these representatives of the European countries.

However, the issues of taxing marketing expenses, as set forth in the analytical report, concern mostly enterprises, which at the stage of accounting consumed marketing services encounter the ambiguities and indeterminateness in the actions and arguments of Ukraine's tax agencies on the procedure of referring the sums of funds to gross expenses.

A rather simple arrangement, under which one enterprise that receives income for the pursuance of its activity, provides for another enterprise that consumes the goods (works, services) of the first to incur certain expenses. Thus, in accordance with Item 16 of the Regulation (Standard) of Accounting 16 "Expenses," expenses for advertising and market research (marketing) are included in the sales, yet Ukraine's tax agencies resort to all sorts of ways and methods of interpreting other provisions of Ukrainian legislation to avoid applying the fundamentals of accounting.

So to date, relying on the contemporary development of the economic system, we have to demand the introduction and application of fundamentally new approaches to accounting marketing expenses – both at enterprises that provide them and at enterprises that consume them – on the basis of market conditions and world expertise in organizing trade.

**Natalia Skrebets, tax manager, JSC Slavutych**

During the past few years supermarket chains have become one of the most influential sales channels in the country. No manufacturer or supplier can disregard such a sales channel, what with the tense competition for the consumer. Therefore, market relations make it possible for the supermarket chains to dictate their conditions and rules of sales that include provision of marketing services as one of the binding elements of beneficial cooperation of two business entities, which aim to sell the products to the end consumer. The way a supermarket chain organizes sales depends the speed of sales and the volumes of the next orders, the share of the

market held by a given product, as well as the profits received by both the supermarket chain and the manufacturer or supplier of this product.

Every enterprise aims to gain profit from its economic activity, and so when drawing up a budget, the enterprise estimates its expenses, marketing expenses included, either as expedient or as a means of achieving its sales targets. Every manufacturer or supplier, who is unaware of the need for and expediency of marketing services, will not expend funds for this purpose. The importance of marketing services today has been confirmed by world practice that is recognized by Ukraine as well, since every higher educational establishment specializing in economics introduced instruction in such a subject as marketing. Every enterprise has its own marketing department or enlists the services of relevant organizations providing marketing services, because practice has proved that a good marketing policy can make an enterprise or its products a leader on the world market, or the other way around – bad marketing can foredoom an enterprise to destruction.

All economists, Ukrainian included, agreed with such an important instrument as marketing. How did it happen then that tax agencies have a biased attitude to the expenses of enterprises for acquiring marketing services? Every enterprise that has experience in protecting its marketing expenses before tax officials must confirm its marketing expenses not only by documents, as stipulated in item 2, Article 9 of the Law of Ukraine On Accounting and Financial Reporting in Ukraine, but also by other documents, the list and form of which are not defined legislatively.

In accordance with the explanations of the State Tax service, expenses for services to promote a product on the market can be charged only on the basis of Item 5.4.4 of the Law On Taxation of Company Income, provided this product is sold (provided) by such a payer. But the main argument of tax officials as to the absence of gross expenses during the receipt of marketing services is that they are provided in relation to those products that are already sold in the supermarket chain, and the ownership right to it passed from the supplier to the supermarket. Yet Item 5.4.4 grants the right to charge expenses for advertising measures by all sellers of this product, from manufacturer to the retail outlets. Everyone involved in the process of sale gains an economic effect. Therefore, it is impossible to identify what and whose measure and in what amount impacted on the process of sales the most and whether the manufacturer or the supermarket gained the greatest advantage.

Therefore, tax legislation should provide a clear definition and list of marketing services, along with an unambiguous definition of their relation with economic activity, which are included in gross expenses in order to do away with an ambiguous interpretation of legislation and a fiscal approach on the part of tax agencies during inspections.

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