

To What Extent Is the Cost of Insurance Deductible for Profit Tax Purposes?



by Alexander A. MININ

It seems that deduction of the cost of insurance for profit tax purposes by companies always arouses suspicion on the part of the tax authorities. Quite often the tax authorities reject deductibility of certain insurance-related expenses merely on the basis that the respective type of insurance is not explicitly listed in the *Profit Tax Act*. We can recall in this respect the quite long discussions and respective letters of the tax authorities aimed at defining what are ‘commercial risks’, that are literally listed in the said Act as one of the ‘permitted’ types of deductible insurance, thereby trying to set up the scope of the types of insurance whose cost is allowable for deduction. One of the main arguments made by the tax authorities in respective disputes was reference to the fact that the cost of insurance was included in section 5.4. of the *Profit Tax Act* containing the list of so-called ‘dual purpose expenses’ and that paragraph 5.2.1. of the *Profit Tax Act* allowed deduction of all business-related expenses with due account of limitations or exemptions established by paragraphs 5.3 through 5.7 of the *Profit Tax Act*. As such, the logic behind this restrictive approach was quite simple: as insurance-related expenses were included the list of

types of expenses that were potentially subject to limitation, they were allowed for deduction as a matter of practice only to the extent that the respective type of insurance was explicitly listed as allowable for deduction.

Yet, such a position was, in the view of the author, wrong and followed the same erroneous approach as generally applied earlier by the tax authorities in respect of merely all the expenses at the beginning of the learning curve on the new principal version of the *Profit Tax Act* as adopted in 1997. Just to remind you, even the Act allowed deduction of any and all reasonable business-related expenses. The tax authorities insisted on additional proof that respective types of expenses were, in fact, envisaged in the *Profit Tax Act* as allowable for deduction. This issue was discussed in greater detail in one of the publications by the author in the *UJBL* earlier this year (*UJBL No.5, 2005 “Deductibility of Expenses for Profit Tax Purposes”*).

The mere fact that a certain category of expenses is mentioned in the section on ‘dual-purpose’ expenses does not mean that respective expenses are given treatment which is different from the general treatment applied by the Act to expenses as such. Paragraph 5.2. allows deduction of all business-related expenses (except for the ones in respect of which limitations or exemptions are directly established by the Act), paragraph 5.4. dealing with dual-purpose expenses starts from a statement of the same basic approach that respective expenses are *allowed* for deduction (rather than prohibited for deduction except for ...). As such, neither of the said two general clauses provides for restrictive approach as such. Certain limitations are already contained in specific clauses dealing with specific type of expenses. In relation to the cost of insurance, paragraph 5.4.6. prohibits directly only deduction of the cost of life and health

assurance as well as insurance of other risks related to the activity of individuals employed by the taxpayer if such insurance is not mandatory under legislation, as well as the cost of insuring third parties (individuals or legal entities). If a certain type of insurance did not come into the said prohibitive list, it was already legally not relevant for deduction whether the respective type of insurance was mentioned in the first half of the said clause where some types of insurance were directly listed as allowable for deduction. Yet, in practice the tax authorities followed the other approach as mentioned above on the issue of the scope of ‘insurance of commercial risks’.

There are probably two reasons why such an approach was applied by the tax authorities: the first one was merely of a psychological nature, the same as to the deductibility of business-related expenses in general (i.e., how to answer the question: ‘how to discover the significance of respective expenses to business?’). The second one appears due to the inclusion of this type of expense in the list of ‘dual-purpose’ expenses. While the first reason is sufficiently considered in the preceding publications, the second one is worth additional consideration.

Yes, it seems somewhat illogical and excessive to list specifically certain types of insurance as deductible at the beginning of paragraph 5.4.6. if they are deductible by general definition of deductibility of business-related expenses; why not then limit the list of ‘dual-purpose’ expenses only to those types of specifically-defined expenses that are not deductible?

An explanation can be given by looking back to the development of the section dealing with the discussed dual-purpose expenses. As an example we may take another subparagraph, namely 5.4.2. addressing the issue of deductibility of the cost of audit and purchase and subscription for literature required

Alexander A. Minin is a senior partner with KM Partners law firm (Kiev)

for information support of business. Originally there was no such clause in the Act and the tax authorities tried back in 1997 to reject deductibility of the cost of audit and of professional literature by arguing that such expenses are not business-related. The interested reader may find a number of letters from the tax authorities and publications in the press on this issue dating back to 1997. In order to ease tension on this matter MPs confirmed, by inclusion, respective wording into paragraph 5.4.2. of the *Profit Tax Act* that such expenses are deductible. This amendment did not change the actual status of respective expenses in terms of their deductibility, it only confirmed that based on the general approach towards deductibility of expenses, such expenses are deducted as business-related. Other examples can be found when inclusion of a direct note on a certain type of expenses as allowable for deduction did

not mean a change in the actual position, but was aimed at preventing further disputes on this matter with the tax authorities, e.g., also the well-known question on the cost of so-called 'reactive flow of electric energy'. It seems that the same purpose followed MPs when providing, at the beginning of subparagraph 5.4.6., the 'positive' list in respect of some types of insurance where, in the view of MPs, conflicts with the tax authorities were likely to arise.

Through amendments of 1 July 2004 the first 'permissive' part of paragraph 5.4.6. was given the extension 'and insurance of other risks of the taxpayer related to the business activity of the latter', thereby really putting the onus on an 'open end' rather than 'exhaustive' reading of the list of types of insurance permitted for deduction. In the author's view the aim of the motion was the same as including into the *Profit*

Tax Act specific listing of the cost of audit and subscription for business press, as discussed above. Thus, it was of a technical nature rather than one of principle. As to the overall conclusion, the author believes that both before amendments of 1 July 2004 and after the said amendments the cost of any insurance was disallowable for deduction by the taxpayer only in those cases when the case fell into the scope of any of the specifically prohibited types of insurance as mentioned at the end of subparagraph 5.4.6. For the sake of completeness it is worth mentioning that the new limitation on deductibility of the cost of insurance was established with effect from 31 March 2005 allowing deduction of such costs only to the extent that they do not exceed 5 % of total deductible costs for the respective period on an annual basis. Yet, newly introduced limitation requires separate discussion. ■

AMCU

News of the Antimonopoly Committee of Ukraine

AMCU: Oil & Gas

• AMCU Pours Oil on Oil Flames

The AMCU press conference held on 18 May was devoted to the widely discussed oil & gas problems. The Head of the AMCU, Oleksiy Kostusyev, decided to explain the actions of the Committee, which, actually, entailed serious instability on the Ukrainian petroleum market.

Mr. Kostusyev confirmed the position of the AMCU concerning the largest oil companies operating in Ukraine. The intention to shake their monopoly position on the market remains in force. Nevertheless, he stressed that obviously the structural monopoly on the wholesale market will exist in any case. The point is that the total share held by the Lysychansk, Odessa and Kremenchuk refineries on the market exceeds 50%. The current situation could be changed by buying a new refinery or through rapid growth in other plants facilities.

In the view of the AMCU, the cost increase was caused by objective and subjective factors. Objective reasons mean the rising price of oil on world markets, an increase in the export duty from USD 83 to USD 136 from the Russian side, abolition of VAT allowances on oil imports. Subjective rea-

sons consist of the grounds in the policies of separate market players.

Mr. Kostusyev drew the attention of those present to the proposals developed within the framework of the AMCU:

- to speed up the process of creating a national vertically-integrated company on the basis of Ukrnafta OJSC, aimed at strengthening competition on the oil market;
- to create a constant, state strategic reserve of oil products, which would support stability on the market;
- to stimulate the import of oil products by
 - abolishing the import duty and payments to the Pension Fund for the period of agricultural works;
 - optimizing excise tax, etc.

• "Kontinium-Galychyna" continues buying filling stations

The AMCU allowed Ukrnafta OJSC (Kiev), which is involved in oil & gas production and operates on the state oil market and regional markets of the oil products retail trade, to purchase two filling stations of Favorite Plus LLC (Dnipropetrovsk), which operates on the wholesale fuel trade market as well as buy and sell assigned for production and technical purposes.

Trade House "Kontinium-Galychyna" LLC (Lutsk), which is involved in the wholesale and retail sale of light oil products, received a licence to lease integrated

property complexes of two filling stations owned by the Joint Ukrainian-English Company "Western Oil Company" (Lutsk).

Moreover, the AMCU allowed "Kontinium-Galychyna" LLC to lease four filling stations of Ternopilnaftoproduct (Ternopil), which is involved in storing light oil products and their wholesale and retail sale in Ternopil Region. "Kontinium-Galychyna" LLC and the above-mentioned filling stations distribute oil products under the WOG trademark.

AMCU: Investments

• Ukraine Moving to Cyprus

The AMCU has granted a permit to "Ferndate Holdings Limited" (Nicosia, Cypriot Republic), which operates on the investment market, to purchase shares in "Ukraine Stores" OJSC (Kiev), involved mainly in the leasing of non-residential (business) premises. As the result of the deal, the share of the buyer will exceed 50% votes in the highest management body of the issuer.

• New Technologies in Banking

The AMCU has allowed the Closed non-diversified venture corporate investment fund "New technologies" OJSC (Kiev), which operates on the investment market, to buy shares in the JS Commercial Bank "TC Credit" (Kiev). The buyer will receive over 50% of votes in the issuer's highest management body.