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## Tax Code Overhaul in Ukraine

On 16 January 2020, the Parliament of Ukraine finally passed the heatedly debated Law "On Amendments to the Tax Code of Ukraine Purposed to Improve the Administration of Taxes, Eliminate Technical and Logical Inconsistencies in the Tax Legislation" ("Anti-BEPS Law").

The Anti-BEPS Law shall come into force once it is signed into law by the President of Ukraine and officially published. In the meanwhile, on 17 January 2020, a group of parliamentarians moved with the initiative to rescind the results of the vote on the Anti-BEPS Law, blocking thereby the completion of the legislative procedure. Only after the said initiative is formally denied by voting - which is likely to happen during the upcoming plenary session of the Parliament in February - the Anti-BEPS Law would be unblocked for its signing and promulgation into law by the President of Ukraine.

The Anti-BEPS Law introduces a number of fundamental novelties aimed at combating tax base erosion and profit shifting practices, improving transparency, tax compliance and administration, formally instituting the substance-over-form principle and other important anti-avoidance rules, generally modernizing the tax framework of Ukraine in vein with the OECD-driven initiatives.

The new rules substantially alter the tax landscape for both Ukrainian individuals and legal entities as well as for non-residents that carry on business in Ukraine.

Please note that no final draft of the Anti-BEPS Law is available thus far. This Legal Alert is based on the draft text of the Anti-BEPS Law prepared for the second reading by the Tax and Customs Policy Committee of the Parliament. Accordingly, we may not rule out certain discrepancies between the second reading draft and the final text of the Anti-BEPS Law passed by the Parliament on 16 January 2020.

### Key Tax Developments

#### Controlled Foreign Companies

- Effective 1 January 2021, the CFC Rules introduce taxation of income of controlled foreign entities ("CFCs") at the hands of Ukrainian "controlling" persons (individuals / legal entities) who would be responsible for, *inter alia*:
  - annual reporting and taxation in Ukraine of undistributed CFC's income pro rata to their stakes in the CFC;
  - annual reporting of existing CFCs, irrespective of whether there is any reportable income;
  - reporting of acquisition / alienation of shares in the CFCs or discharging other *de facto* control, as well as the establishment / liquidation of trusts or other transparent entities.
- Notably, the CFC Rules would also target business models that include foreign trusts and other transparent entities, while providing certain exemptions for, say, irrevocable discretionary trusts.
- CFC's income would be out of Ukraine's tax scope if, *inter alia*, the total income for the reporting period of all CFCs of a taxpayer does not exceed EUR 2 million.
- Otherwise, the undistributed income of CFCs would be subject to 18% PIT at the level of Ukrainian "controlling" persons-individuals. In comparison, dividends distributed to private individuals would continue to be taxed at 9% PIT rate.
- The actual effect of the implementation of the CFC Rules will significantly depend on Ukraine joining the network of countries that automatically exchange tax and financial information. To this end, the Ukrainian Government committed to join the Common Reporting Standard (CRS) on automatic exchange of information on financial accounts by the end of 2020. The first exchange of information for 2020 is expected to take place in 2021.
- Importantly, as a part of the earlier FATCA implementation procedures, the applicable law was amended in December 2019 to include specific provisions on lifting bank secrecy, broaden reporting obligations and tighten mandatory KYC procedures for Ukrainian financial institutions, laying thereby grounds for a smoother introduction of the CRS rules.
- While being not a part of the Anti-BEPS Law, the CFC regime is expected to be supplemented with the contemplated Voluntary Disclosure (Tax Amnesty) relief. Under the proposed Tax Amnesty Draft Law, Ukrainian tax residents would be pardoned for tax offences disclosed by such residents voluntarily. The disclosed qualifying income is proposed to be taxed at PIT rates varying from 2.5% to 10%.
- Finally yet importantly, the introduction of the CFC regime does not contemplate the introduction of "balancing" Exit Tax or a similar tax regime.

#### Corporate Income Tax

- Earning Stripping Restriction:** Presently, the restriction on deductibility of interest at 50 percent of EBITDA applies to debts owed to non-resident related parties provided the debt-to-equity ratio exceeds 3.5:1 (10:1 for financial institutions and leasing companies).

Effective 1 January 2021, the threshold of interest deductibility would (1) be lowered to 30 percent of EBITDA, (2) apply if a debt-to-equity ratio exceeds 3.5:1, and (3) extend to loans from any non-resident lender regardless of the "relation" status.

No earning stripping restriction, however, would apply to financial institutions and leasing companies.

- Business Purpose:** Albeit the Tax Code of Ukraine formally permitted the tax office to probe transactions on the subject of their economic (business) purpose, in enforcement practice this legal tool lacked efficient application due to the absence of a clear-cut guidance and framework for the application thereof.

Effective from the date following the official publication of the Anti-BEPS Law, the principle of "reasonable economic purpose (business purpose)" would be considerably refined, suggesting its wide employment by the tax office while analyzing transactions. The new approach would suggest that transactions with non-residents would be deemed to lack business purpose if, *inter alia*:

- the principle or one of the principle purposes of a transaction is found to be tax evasion or underpayment;
- under comparable conditions, a taxpayer would not be able to purchase/sell same services/works from/to an unrelated party.

Should the cross-border transaction fail to meet the reasonable economic purpose test, no deduction would be allowed in such a case. Should a transaction purpose be challenged, the burden of proof would rest with the tax office.

#### Withholding Tax

- Principal Purpose Test:** Although the principal purpose test (PPT) - in line with the BEPS Action 6 - was introduced in the covered Ukraine's double tax treaties via the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS as of 1 January 2020, Ukraine resolved to transpose this concept into its domestic legislation.

Effective from the date following the official publication of the Anti-BEPS Law, Ukraine would be in a position to deny the application of double tax treaty benefits to transactions where it would be reasonable to conclude that "obtaining the benefit was one of the principal purposes" of the arrangement or transaction.

- Beneficial Owner:** Effective from the date following the official publication of the Anti-BEPS Law, the definition of "beneficial owner" would be revisited in Ukraine.

In particular, the recipient of an income would not be qualified as the beneficial owner but rather as an agent, nominee or intermediary with respect to the income when:

- the recipient does not have the right to dispose such income; and/or
- the recipient merely forwards the income further along the chain and performs no substantial functions in the transaction; and/or
- the recipient has no relevant resources (personnel, fixed assets, sufficient equity, etc.) necessary to perform the functions and manage the risks of the transaction.

- Capital Gains:** Previously, Ukraine had no effective legal mechanism to tax capital gains arising from the sale of real estate rich companies deriving their value from immovable property located in Ukraine. This would change effective 1 July 2020, with the introduction of a specific set of rules addressing such a transaction.

In particular, capital gains from the alienation of shares/participatory interest in a foreign company that directly or indirectly owns a Ukrainian real estate rich company would be subject to taxation in Ukraine, if for any period during the last 365 days:

- the foreign company's shares/participatory interest derive more than 50% of the value from the capital in the Ukrainian company; and
- more than 50% of the value of the Ukrainian company was generated by real estate located in Ukraine.

The non-resident buyer of the foreign company would be required to register with the Ukrainian tax office and withhold capital gains tax from the non-resident seller at the rate of 15%.

- Constructive Dividends:** Earlier unknown in Ukraine, a new concept of "constructive dividends" would be introduced starting 1 January 2021. Effectively, if the value of a transaction with a foreign related entity were to be found to be not at "arms-length", the difference would be re-classified into dividends and taxed accordingly in Ukraine. The same treatment would apply to cash or non-cash pay-outs by Ukrainian companies to non-resident shareholders in the case of (1) charter capital decrease, (2) shares buyouts, (3) shareholder's withdrawal from the company, (4) other similar transactions that effectively decrease the retained earnings of the Ukrainian company.

#### Personal Income Tax

- The Anti-BEPS Law specifically excludes investment profit, *e.g.*, *foreign-sourced capital gains*, from the definition of income derived from foreign sources. This amendment would ultimately allow private individuals to report and have taxed foreign-sourced capital gains on a net basis.

#### Transfer Pricing

- The three-tier approach to the transfer-pricing documentation will be introduced in Ukraine: (i) Local File, Report on Controlled Transactions and Notice of Participation in an International Group of Companies, (ii) Master File and (iii) Country-by-Country Report ("CbCR").
- The tax office can request the Master File from the Ukrainian taxpayer, if consolidated annual revenue of the relevant international group of companies amounts to at least EUR 50 million. The Country-by-Country Report can be requested if (i) consolidated annual revenue of the relevant international group of companies exceeds EUR 750 million and (ii) the Ukrainian taxpayer is an ultimate parent entity or there is lack of effective CbCR exchange mechanism with a jurisdiction of an ultimate parent entity.
- Such changes would affect multinational enterprises the most, for they would be ultimately required to comply with an additional set of rules, which may require allocation of additional professional resources.
- Separately, the threshold used for recognition of companies as related entities will increase from 20 to 25 percent.
- The vast majority of transfer pricing amendments shall enter into force on the next day following the official publication of the Anti-BEPS Law. At the same time, for example, the tax office would be in a position to request a Master File only for the financial year ending in 2021.
- Moreover, the Government of Ukraine has declared its intention to sign and implement into law the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports ("CbC MCAA") by the end of 2020. Once effective, the CbC MCAA would enable an automatic exchange of CbCR information.

#### Permanent Establishment

- With the effect on the next day following the official publication of the Anti-BEPS Law, the definition of permanent establishment ("PE") would be elaborated and detailed in line with the OECD's recommendation as per the BEPS Action 7.
- The key change concerns the methods of PE taxation, introducing the Authorized OECD Approach (AOA). The AOA suggests applying the transfer pricing methods for determining the profits that would be deemed earned by the PE as if it were an independent local company rendering / selling the same or similar services / goods on the same or similar terms.
- Harsh penalties are envisaged for carrying out business activities in Ukraine without formal tax registration as a PE.

#### Tax Administration

- Mutual Agreement Procedure ("MAP"):** The Anti-BEPS Law would introduce a procedural mechanism enabling the Ukrainian tax office and the relevant foreign authority to resolve controversies regarding the application of provisions of the relevant double tax treaty. The MAP was also introduced in the covered Ukraine's double tax treaties via the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS.
- Tax Audits:** Effective on the next day following the official publication of the Anti-BEPS Law, the Anti-BEPS Law would:
  - grant the tax office additional authorities to enforce the permanent establishment rules on non-residents that fail to properly register while conducting business activities in Ukraine. The automatic registration and possible penalties would now be available in the tax office's toolkit.
  - extend the maximum tax audit period for the CFC, transfer pricing rules, and Payroll Taxes from 1095 days (three years) to 2555 days (seven years).
  - introduce the concept of "guilt" for the purposes of some tax evasion offences and other tax in compliance matters.
  - place the burden of proof on the tax office in tax offence matters, obliging the latter to demonstrate that, in violation of the tax rules, the offender acted "unreasonably", "dishonestly", and with the lack of "due prudence", none of which concepts is much known as matter of present-day practice.
  - revamp the legal framework of electronic (virtual) cabinet of taxpayer, permitting to limit "human factor" in communication between the tax office and the taxpayer.
  - enable the tax office to send documents, *inter alia*, tax audit acts and tax assessment notices in electronic form to the taxpayer's electronic (virtual) cabinets, which in such a case would be deemed to be duly delivered to the taxpayer.
  - specify that tax audit results should not *per se* be viewed as a legal ground for initiating criminal prosecution procedures.
- Tax Penalties:** The Anti-BEPS Law also significantly extends the list of the existing tax penalties, widens their application, and revises some of the penalty rates as follows:
  - CFC.** Generally, penalties under the CFC Rules would include fines for the violation of the reporting obligations of Ukrainian "controlling" persons (e.g., non-submission of the CFC Report would result in a fine of 100 times of the subsistence level (to exemplify, based the subsistence level in 2020, the fine would be UAH 210,200 - c. USD 8,400)).
  - Transfer Pricing.** Transfer Pricing penalties would be mainly supplemented by the fines for the violation of the requirements to the newly introduced types of the transfer-pricing documentation (e.g., non-submission of CbCR would be punishable by a fine of 1000 times of the subsistence level (to exemplify, based the subsistence level in 2020, the fine would be UAH 2,102,000 - c. USD 84,000)).
  - Permanent Establishment.** Presently, there are no financial penalties for non-resident entities conducting business in Ukraine without formal registration of a PE. Effective from the date following the official publication of the Anti-BEPS Law, failure to register a PE may result in the non-resident being fined for UAH 100,000 (c. USD 4,100).

#### Simplified Tax Regime

- Effectively from the next day following the official publication of the Anti-BEPS Law, the annual revenues limits for the Single Tax payers would be increased as follows:
  - First Group:** from UAH 300,000 (c. USD 12,500) to UAH 1 million (c. USD 41,000);
  - Second Group:** from UAH 1.5 million (c. USD 62,000) to UAH 5 million (c. USD 200,000);
  - Third Group:** from UAH 5 million (c. USD 200,000) to UAH 7 million (c. USD 290,000).
- If exceeded, the Single Tax payer must migrate to the general taxation regime.

#### Actions to consider

The enactment of the Anti-BEPS Law will significantly affect most international corporate structures as well as domestic companies. In light of the upcoming changes in taxation, you may wish to consider the following actions to mitigate possible transition stress:

- review your corporate structure and identify companies that may be recognized as CFCs in Ukraine;
- consider the tax efficiency of the existing structure and the potential for restructuring if necessary;
- review the current model of attribution and taxation of profits, if you have a PE in Ukraine;
- assess the PE regime, if you act through a dependent agent or have individual contractors working in Ukraine;
- consider establishing corporate presence to align your activities in Ukraine with the new tax rules.

We will be following up with special legal alerts covering the Controlled Foreign Company Rules and the new Permanent Establishments rules, the changes to the Transfer Pricing Rules, Corporate Income Tax and Withholding Tax.

#### Additional notes

This LEGAL ALERT is issued to inform Baker McKenzie clients and other interested parties of legal developments that may affect or otherwise be of interest to them. The comments above do not constitute legal or other advice and should not be regarded as a substitute for specific advice in individual cases.

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