MLI: New International Tax Rules for Ukrainian Business

On 28 February 2019, the Ukrainian Parliament ratified the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (“Multilateral Instrument” or “MLI”) introducing significant changes to the effective double tax treaties (“DTT”) signed by Ukraine.

What is MLI and why it was created

Within the base erosion and profit shifting (“BEPS”) initiatives, the Organisation for Economic Co-operation and Development (“OECD”) designed a number of new tax rules. Some of these rules may work only after being introduced to the bilateral DT Ts. Amending more than 3,000 existing DT Ts bilaterally could take too much time and undermine the BEPS initiatives. To speed up this process the OECD designed the Multilateral Instrument allowing signatory countries to make necessary amendments to most of their DT Ts just in a few steps.

By signing and ratifying the MLI, Ukraine completes two out of four steps from its BEPS minimum standard commitment. Also, as clearly envisaged in the legislation, further currency control liberalisation in Ukraine is conditioned upon enforcement of the MLI as well as other BEPS initiatives.

Which DT Ts will change

The MLI may modify DT Ts only if both parties to a particular DTT have signed and ratified the MLI. Currently, there are 87 jurisdictions that have signed the MLI, 21 of which have already completed all the necessary ratification procedures, namely Austria, France, Ireland, Japan, Lithuania, Malta, Poland, United Kingdom (“UK”), etc. It is expected that during 2019 the MLI will be ratified by most of its signatories.

PwC Observation: If your business has transactions with residents of jurisdictions that have already ratified the MLI, we recommend you to start as early as now analysing how the MLI can affect your transactions.

Another requirement for the MLI to modify a particular DTT is that both signatories to this DTT should include it on their list of MLI-covered DT Ts. Ukraine decided that the MLI should cover all of its DT Ts (except for the recently signed and ratified DTT with Qatar), but not all other countries choose to apply the MLI to their DT Ts with Ukraine. See below the status of several DT Ts:

1. **Cyprus-Ukraine DTT** – both countries signed the MLI and listed this DTT as MLI-covered, but Cyprus has not ratified the MLI yet. Therefore, this DTT may change soon when Cyprus ratifies the MLI (Cyprus is expected to ratify the MLI in the second half of 2019);
2. **Netherlands-Ukraine DTT** - both countries signed the MLI, and as of today; only Ukraine has ratified the MLI. Ukraine listed the DTT as MLI-covered, but the Netherlands did not list the Ukrainian DTT.

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1 You may track the MLI ratification status for each signatory at the OECD’s official web-site (www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf)
Therefore, this DTT will not change even when the Netherlands ratify the MLI. The same is true for the Switzerland-Ukraine DTT:

**PwC Observation:** The fact that the Netherlands and Switzerland did not list the Ukrainian DTTs may be explained by the recent signing of protocols thereto, which de-facto implement some of the MLI-related BEPS initiatives.

iii. UK-Ukraine DTT - both countries signed and ratified the MLI, and listed the DTT as MLI-covered. Therefore, the MLI will modify this DTT;
iv. Ukraine-US DTT - Ukraine signed and ratified the MLI, the USA did not sign the MLI. Therefore, this DTT will not change until the USA signs and ratifies the MLI (to the best of our knowledge, the USA does not intend to sign the MLI).

**What are the new rules for Ukraine**

The MLI is a rather flexible instrument that allows signatories to choose which provisions apply to their DTTs and which do not. Ukraine did not choose all the new rules offered by the MLI. Ukraine’s choice is as follows:

i. Principal purpose test (PPT);
ii. Changes to the permanent establishment ("PE") definition;
iii. Anti-abuse rule for PEs situated in third jurisdictions;
iv. 365-day rule for capital gains;
v. Improvements to the mutual agreement procedure.

It is noteworthy that the new rules apply to a certain DTT only if the other signatory thereto also chooses the same rules.

See below more details on the provisions chosen by Ukraine:

**Principal purpose test (PPT)**

Similar to most other countries, Ukraine chose the PPT. According to this test, Ukraine may deny treaty benefits, e.g. reduced treaty rates, if the tax authorities have reasons to conclude that the principal purpose or one of the principal purposes of the particular transaction/arrangement was to obtain those benefits.

**PwC Observation:** The tax authorities get another powerful tool with which they may question the tax benefits in many transactions of the Ukrainian taxpayers. However, it is worth noting that the PPT is a rather subjective test; it does not set clear criteria of how to determine the principal purpose of the transaction/arrangement. Therefore, the outcome of PPT application will depend largely on the ability of the tax authorities / taxpayers to provide sufficient arguments and evidence to defend their position.

**Changes to PE definition**

The PE definition will be subject to a number of amendments designed mainly to prevent the artificial avoidance of PE status. The changes are as follows:

i. "The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise" and other similar activities will not constitute a PE only if such activity of the non-resident is of a preparatory or auxiliary character;

ii. The definition of so-called 'dependent agent', who concludes contracts on behalf of a non-resident or plays the principal role in the conclusion of such contracts, will be detailed;

iii. New rules against splitting-up of contracts/activities to avoid the PE status are introduced. For example, short-term activities of closely related non-residents at the same building site in Ukraine will constitute a PE if the aggregate period of such activities exceeds the statutory threshold for creating a PE at the building site (usually 6 or 12 months);
**PwC Observation:** The Draft Law on the Implementation of the BEPS Action Plan in Ukraine\(^2\) may introduce similar rules to the Tax Code of Ukraine ("Tax Code"). Simultaneous amendment of the PE definition in the Tax Code and DTT may result in greater scrutiny from the Ukrainian tax authorities in respect of the activities of non-resident representative offices in Ukraine and the activities of Ukrainian companies in favour of non-residents.

**Anti-abuse rule for PEs situated in third jurisdictions**

A new rule introduced to the DTTs will allow Ukraine to tax passive income paid to non-residents at maximum domestic rates if:

i. The income is exempt from taxation in the jurisdiction of the non-resident (the second jurisdiction), because the income is attributed to a PE situated in another (third) jurisdiction; and

ii. the tax rate in the third jurisdiction, where the PE is situated, is less than 60% of the standard rates of the second jurisdiction.

**PwC Observation:** This rule may give rise to complexities in practice. To be efficient, it will require an active exchange of information between Ukrainian and foreign tax authorities or an additional mechanism in the domestic legislation to control payments of passive income paid to non-residents.

**365-day rule for capital gains**

The majority of the DTTs signed by Ukraine stipulate that capital gains from alienation of shares in Ukrainian companies should be taxed in the jurisdiction of the non-resident except for cases when such shares derive their value principally from immovable property situated in Ukraine.

From now on, the exemption from the Ukrainian withholding tax will apply if this rule is satisfied not only upon alienation of shares, but also during the 365 days preceding the alienation.

**PwC Observation:** Currently, in many cases, the withholding tax arising upon alienation of shares in Ukrainian companies cannot be paid, e.g. for the alienation of shares between two non-residents there is no practical mechanism envisaged in the Ukrainian law to withhold the tax due. Therefore, the new rule will not be widely applied in Ukraine until the mechanism for non-residents to pay the Ukrainian withholding tax is introduced.

**Improvement of the mutual agreement procedure**

Mutual agreement procedure to resolve DTT-related disputes becomes more flexible. From now on, the taxpayers will be able to present the cases not only to the tax authorities in their jurisdiction, but also to the tax authorities of the other contracting state. Moreover, the minimum period for presenting such cases is set to be three years.

**PwC Observation:** The new rules create more opportunities for taxpayers to successfully resolve their disputes with tax authorities regarding application of DTTs. However, currently, we are not aware of many cases around the world, when taxpayers initiated the mutual agreement procedure. For Ukraine, such cases are even more rare, which makes it difficult to assess how the renewed mechanism will work in Ukraine.

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When the new rules will take effect

After ratifying the MLI, Ukraine has to deposit its ratification instruments with the OECD. The moment of the deposit launches the three-month period, following which the first day of the next month will become the date when the MLI enters into force for Ukraine.

For example, if Ukraine deposits its ratification instruments with the OECD before the end of this March, the MLI will come into force for Ukraine on 1 July 2019.

However, certain new rules will take effect later. The rules concerning withholding taxes (e.g. the 365-day rule for capital gains) may be applied not earlier than 1 January 2020. The changes to the PE definition will take effect six months after the MLI’s entry into force for Ukraine.

Takeaway for taxpayers

From now on, the taxpayers performing transactions with non-residents should consider not only the provisions of the DTT with the non-resident’s jurisdiction, but also how the MLI has modified this DTT.

Bearing in mind the number and complexity of BEPS and MLI novelties that may affect Ukrainian business, we recommend to start as early as now reviewing your business structures and assessing whether they are in line with the new tax requirements.

PwC Ukraine’s International Tax Services Team has extensive experience in advising Ukrainian and international companies on how to adapt to new tax rules. We are ready to arrange a meeting with you and discuss how these changes can affect your business and how to prepare for them in time.

We are also preparing a series of events dedicated to changes in international taxation. We will inform you about them in due course.
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