Significant Ukrainian tax changes for multinational companies

As updated on 22 January 2021

In brief

The new laws introducing significant changes in the area of international taxation and transfer pricing (**TP**) mostly related to the implementation of some BEPS Initiatives into Ukrainian tax legislation, entered into force.

A variety of new concepts, terms and obligations await Ukrainian businesses and Multinational Enterprises ("**MNEs**"). Existing financing/corporate structures may appear inefficient under the new rules. Non-compliance might result in **material fines for the businesses**.

The takeaway

For MNEs and Groups that have business in/with Ukraine it is advisable to adopt immediate measures to ensure compliance with the new rules and still retain the efficiency of the business:

- Make an assessment of the current corporate structures to conclude whether they comply with the new tax law and remain efficient;
- Identify if the activities of the Group create any taxable presence in Ukraine (either through a permanent establishment (**"PE**") or place of effective management ("**PoEM**")) and take possible mitigation measures;
- Assess whether controlled and some other types of cross-border transactions have a business purpose, i.e. are aimed at receiving certain economic benefits;
- Assess whether the Group can enjoy double-tax treaty benefits under the new rules and prepare a defense file, if needed;
- Identify whether there is any Ukrainian controlling person in the Group (either an individual, tax resident of Ukraine, or a Ukrainian legal entity) and there are any controlled foreign companies ("**CFCs**") subject to reporting and taxation in Ukraine at the level of such a controlling person, assess the related tax implications and assist in ensuring the compliance;
- Develop the transfer pricing ("**TP**") policy for commodities, as well as for calculating the permanent establishment(s)' ("**PEs**") income, which corresponds with the arm's length principle;
- Appoint a person responsible for the gathering and preparation of the information to comply with the new TP reporting requirements.

For a deeper understanding of how these issues might affect your business, please contact our Ukrainian office.

In detail

Taxation of controlled foreign companies (CFC)

CFC rules were introduced into the Tax Code: a Ukraine resident company/individual may be taxed on a proportion of the profits of certain foreign entities that are owned or controlled by such Ukrainian residents. The profits of a CFC are included into the taxable income of the controlling person and are taxed at standard income tax rates. There are specific tax rates for individuals.

An entity is deemed to be a CFC if it is not a Ukrainian resident for tax purposes or PE in Ukraine, but it is controlled by a Ukrainian tax resident. Foreign establishments without the status of a legal entity (such as partnerships, trusts, funds, foundations, etc.) are also equated to such an entity for CFC purposes.

A controlling person of a foreign company is a person who

- holds a share of more than 50%, or
- owns more than 10% (25% for years of 2022 and 2023), provided other Ukrainian residents hold 50% and more of shares, or
- exercises actual control over the foreign company.

Control is determined based on an ownership share and other criteria and may be established directly or through a chain of indirect ownership.

The Tax Code provides for specific rules and adjustments for calculating a CFC's taxable profits. It must be apportioned among the Ukrainian controlling persons in proportion to their interest(s) in the CFC. The profits of the CFC may be exempt from taxation in Ukraine if certain criteria are met.

The CFC rules in Ukraine come into force on 1 January 2022.T The first reporting period will be 2022. The first report is allowed to be submitted in 2024 for the first two reporting periods.

Application of double tax treaties (BO, PPT, LTA)

Similarly to the provisions of the Multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting ("**MLI**"), the Tax Code of Ukraine requires the application of the principal purpose test ("**PPT**") to transactions with non-residents. The tax benefits provided by the relevant double tax treaty ("**DTT**") will not apply if the principal purpose of the relevant business transaction with a non-resident was to directly or indirectly obtain that benefit.

The concept of the **beneficial owner** of income was amended. A legal entity or individual will not be regarded a beneficial owner of income, but rather an agent for such income if such person, for example:

- does not have enough authority to use and dispose of such income;
- transfers the received income or most of it to another person;
- is only a formal recipient of income, etc.

The possibility of applying the **"look-through approach"** was introduced. Ukrainian taxpayers could apply the provisions of DTT with a country whose resident is the beneficial owner of income, and not with a country whose resident directly receives payment.

These provisions became effective from 23 May 2020.

Capital gain from the alienation of corporate rights

Indirect alienation of corporate rights, shares, stakes or other similar corporate rights in a Ukrainian company by a non-resident shall be subject to 15% withholding tax in case:

- at least 50% of the value of the non-resident company being sold by another non-resident consists of corporate rights in the Ukrainian company at any moment during the 365 days before alienation, **and**
- at least 50% of the Ukrainian company's value consists of real estate located in Ukraine at any moment during the 365 days before alienation.

Direct alienation of corporate rights, shares, stakes or other similar rights of a Ukrainian company by a non-resident shall be also subject to 15% withholding tax if at least 50% of the Ukrainian company's value consists of real estate located in Ukraine at any moment during the 365 days before the alienation.

The above rules take into account the real estate owned by the Ukraininan company as well as rented one (within both operating and financial lease arrangements).

These provisions became effective from 1 January 2021.

Taxation of permanent establishments (PE)

The concept of PE was clarified and expanded to follow the PE definition from the 2017 OECD Model Tax Convention, but with a stronger agency test.

Other changes include: the broadening of anti-fragmentation rules and definition of dependent agent, as well as conferring more powers to the tax authorities. In case the non-resident performs activities on the territory of Ukraine without registration, the tax authorities now have the right to initiate a tax audit of this activity and make the mandatory registration of a PE (if that is the case).

Now, all PEs should calculate their taxable income in accordance with the "arm's length principle"; other options were cancelled. TP analysis and developing a methodology for calculating the PE's income will be required.

Passive income paid by a PE will be treated as income with the source from Ukraine.

These provisions became effective from 1 January 2021.

Dividend and deemed dividend payments

Starting from 1 January 2021, the concept of dividends is expanded.The following transactions are treated as deemed dividends:

- payment of dividends in non-monetary form;
- payments to the non-resident founder or participant in a Ukrainian company that decrease the retained earnings of the Ukrainian company, and are made in connection with:

  - reduction of the Ukrainian company's charter capital;
  - redemption by the Ukrainian company of its corporate rights;
  - withdrawal of a participant from the membership of a Ukrainian company;
- transactions with a non-resident related party and/ or resident of so-called "low-tax" jurisdictions and/ or non-residents who do not pay corporate profit tax on the amount of the:
  - payment for securities and corporate rights in controlled transactions in excess of the the "arm's length" principle;
  - understatement or overstatement of the goods' (works, services) value in controlled transactions compared to the "arm's length".

These payments will be subject to 15% Ukrainian withholding tax, unless otherwise provided by the relevant DTT.

Place of effective management (PoEM)

From 1 January 2022, foreign legal entities which have an effective management in Ukraine, must pay corporate income tax in Ukraine on a general basis.

Ukraine should be treated as a PoEM of a foreign company if (i) bank accounts of a foreign entity are controlled from Ukraine, (ii) financial or managerial accounting, as well as (iii) personnel management are conducted in Ukraine.

The Tax Code contains a list of indicators of an effective management, including meetings of the executive body, making managerial decisions and performing actual control over the foreign entity, etc. The rule applies even if persons effectively managing an entity are not legally empowered for such actions.

Changes to the "thin capitalisation" rule

Starting 1 January 2021 the thin capitalisation rule is amended. The ratio of debt to equity remains the same as now (3.5:1), but the debt should be calculated taking into account the liabilities before all non-residents, not only related non-residents, as was previously the case. Also, the calculation of tax differences and other aspects of the rule were changed.

The thin capitalisation rule does not apply to (i) financial institutions and companies engaged exclusively in leasing activities; (ii) to loans from qualifying international financial organizations (e.g. EBRD, IFC), foreign banks and loans guaranteed by the state.

Three-tiered TP documentation

The core changes in TP are the implementation of a three-tiered approach to TP documentation for taxpayers with intercompany transactions, which are subject to TP control from the Ukrainian perspective, namely a Master file (further – **"MF"**), Local file (further – **"LF"**) and country-by-country report (further – **"CbCR"**).

The implementation of three-tiered TP documentation is associated with the following requirements for the Group members:

- Submission of a notification of participation in an international group of companies (further – "**IGC**") by 1 October of the year following the reporting year. **The first time a notification in an IGC must be submitted no later than 1 October 2021 for the 2020 reporting year**;
- CbCR - must be submitted if the taxpayer belongs to the IGC, in particular, but not exclusively, within twelve months after the end of the financial year established by the parent company of the IGC, if the aggregate consolidated income of the IGC, which includes the taxpayer, for the financial year

preceding in the reporting year, calculated in accordance with the accounting standards applied by the parent company IGC (and in the absence of information - in accordance with international accounting standards), exceeds the equivalent of 750 million euros and in the presence of one of the exhaustive list of circumstances the financial year ending in 2021, but not earlier than the year in which the competent authorities concluded a multilateral agreement on the automatic exchange of interstate reports (Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports));

- MF- must be submitted within 90 calendar days at the request of the tax authorities in particular, but not exclusively, not earlier than twelve months and not later than thirty-six months from the end of the financial year established by the IGC to which such taxpayer belongs, if the income of the IGC exceeds 50 million euros (the norm comes into force on 01 January .2021).
- the requirements for the content of the TP documentation have been expanded, in particular, information on the taxpayer's beneficiaries, supply chain (value creation), as well as other information if the company is a part of an IGC should be reflected;

The list of penalties is extended. The penalties for non-compliance are as follows:

- for failing to submit a notification on participation in an IGC, 50 subsistence minimum wages (further – "**SM**") (approx. USD 3,800);
- for failing to submit a CbCR, 1000 SM (approx. USD 75,000).

Companies should comply with the TP reporting deadlines not to raise additional attention from the tax authorities, analyze the need to submit CbCR by Ukrainian companies, and be prepared to provide a MF in Ukrainian upon a request of a tax authority within 90 days.

Justification of business purpose

The rules on "business purpose" apply to:

- Starting from 1 January 2021 for all types controlled transactions; and
- Starting from 1 January 2022 to uncontrolled transactions with residents of so-called "low-tax" jurisdictions as well as non-residents who do not pay the corporate profit tax (according to the Decrees of the Cabinet of Ministers № 1045 of 27 December 2017 and № 480 of 4 July 2017, respectively), as well as uncontrolled transactions with non-residents for royalty charges (please consider, that from 23 May 2020 till 1 January 2021 the presence of business purpose (economic benefit) was mandatory for all types of transactions with non-residents).

It should be noted that tax authorities will be able not only to disallow expenses, but in some cases (sale of goods / services to residents of "low-tax" jurisdictions) to assess additional income within the transaction.

Presently, the analysis of the justification of business purpose (economic benefit, obtained as a result of a controlled transaction) and the presence of a business purpose (economic benefit) in the TP documentation is mandatory for all controlled transactions (please consider, that from 23 May 2020 till 1 January 2021 the legislation was applied only to"non-goods" controlled transactions on purchase). In case the tax authority proves the absence of a business purpose (economic benefit) in the aforementioned transactions, the tax authority may not consider such a transaction for the purposes of calculating the taxpayer's financial result (i.e. not recognize expenses) or replace the transaction with an alternative option.

Transferring functions abroad

The definition of business transactions for TP purposes is extended. The transfer of functions abroad without compensation can be a taxable event if they reduce the amount of income and / or profit of the taxpayer.

The provision became effective from 23 May 2020.

New TP rules for commodities

When performing an economic analysis by applying the comparable uncontrolled price (further - "**CUP**"), companies should consider the following changes in the TP legislation:

- A new list of commodities, approved by the Decree of the Cabinet of Ministers № 1221, dated 09 December 2020;
- The approach to economic analysis when applying the CUP method for controlled transactions with commodities is changed:
- in the case of applying the CUP method to a controlled transaction, such internal uncontrolled transactions must be regular, with several counterparties and in amounts comparable to those used in the controlled transaction;
- the taxpayer has an option to use the recommended list of sources of information for quoted prices for the application of CUP method. The recommended (non-exclusive) list of sources of information for obtaining quoted prices is published on the official web portal of the State Tax Service of Ukraine by the beginning of the reporting year (the list published 30 December 2020 is available via link);
- quoted prices used for comparison with the prices within controlled transactions must meet the comparability conditions.

Companies that perform controlled transactions with commodities should carefully conduct an economic analysis of both potentially comparable uncontrolled transactions performed by the companies themselves and the transactions performed by counterparties (of any), taking into account the introduced innovations.

The provision became effective from 23 May 2020.

Let’s talk

For a deeper discussion of how this issue might affect your business, please contact:

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