Nexia DK

Tax planning tendencies in the post-BEPS era:

Ukrainian aspects

Some Facts

April 28, 2016 – Order of the President of Ukraine “On Measures Countering Base Erosion and Profit Shifting”

Working Group on drafting relevant legislative norms

May 4, 2016 – Concept of BEPS Plan’s implementation in Ukraine

2016 – 2017 – draft legislation of CFC rules, CbC TP Reports, etc

January 1, 2017 – Ukraine undertook implementing BEPS Plan into domestic legislation: minimum standard (Action 5: Countering harmful tax practices; Action 6: Preventing inappropriate application of treaty benefits; Action 13: TP Documentation and CbC Reporting; Action 14: Dispute resolution mechanisms

Some Facts

July 23, 2018 Ukraine has signed MLI Convention with its further ratification by Verkhovna Rada by the end of 2018 – otherwise EU black list. MLI Convention will allow implementing BEPS Action Plan into all double tax treaties entered into by the signatory.

Ukraine is expected to start automatic exchange of tax information in 2020 for FY 2019 (according to the Ministry of Finance of Ukraine) – Multilateral Competent Authority Agreement is not signed yet

Main Tendencies _01

Taxation

It is no longer the main driver in international tax structuring.

Taxes should be paid in the country where the goods are produced / services are provided.

Domestic “privileged tax regimes” are expected to be abolished – BEPS Action 5 (holding/trading regimes, IP boxes, etc).

Fiscally transparent entities are less frequently used (LP, LLP, etc) – under thorough review by the UA tax offices, EU counterparties / foreign banks are not willing to work with them. Banks often do not open accounts to LP / LLP.

Main Tendencies_ 02

Substance requirement

- valid commercial reason (not with the mere aim of obtaining treaty benefits)
- management functions (managing personnel should have relevant expertise – physical movement of key management personnel)
- real office and employees (post office box does not work any longer)
- real business activities (not on paper only)
- sufficient capital

Main Tendencies _ 03

Transparency

The structures are becoming less complex – less companies are involved in the group, between the UBO and operational companies; companies which are not used are being liquidated.

Application of nominee shareholding is less frequent, direct shareholding by UA UBO (simplified procedure for NBU license obtaining).

Trusts, Funds and Foundations are less frequently applied – more applied for the originally designated purposes (e.g., inheritance).

Main Tendencies _04

Tax residency status

UA nationals are shifting their tax residency status to another jurisdiction where they live, where they have the centre of vital interest, where they perform effective management of their companies, accordingly they no longer qualify as tax residents in Ukraine and no liabilities arise in Ukraine (except for Ukrainian sourced income).

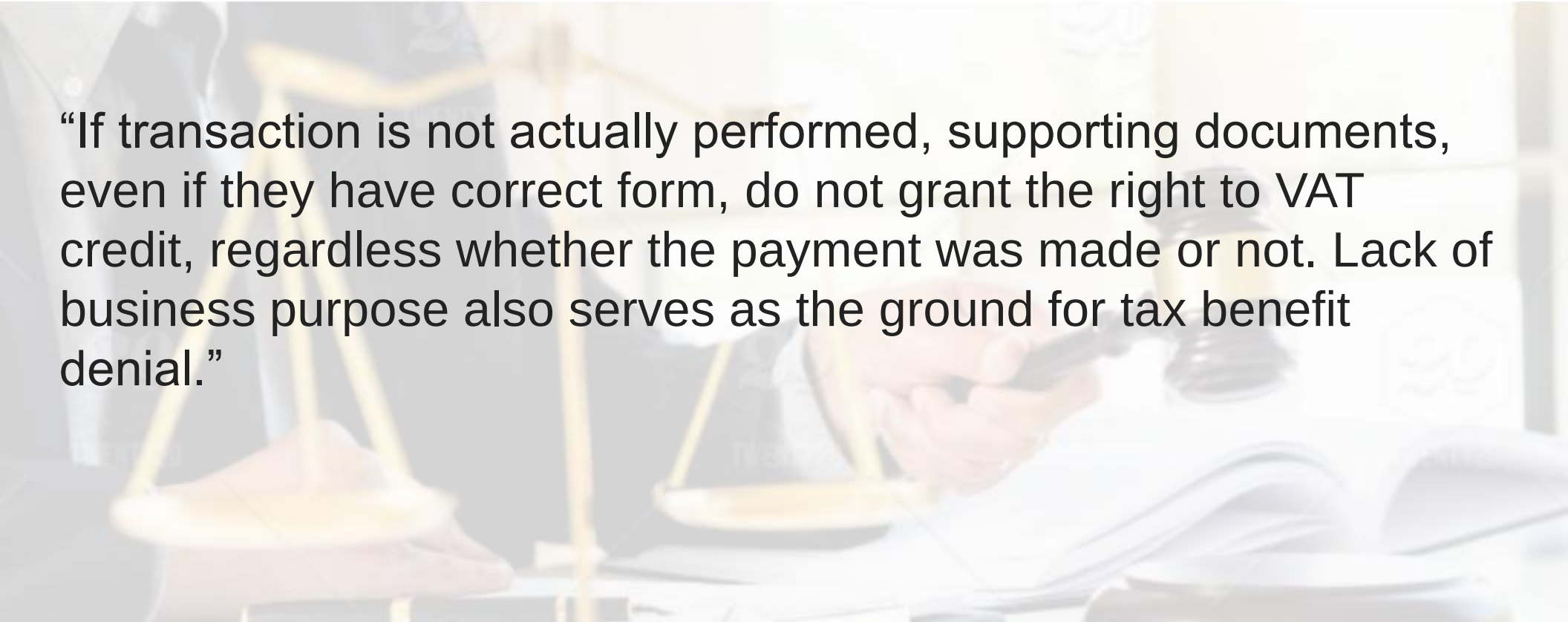
Practical issue: UA national individual left Ukraine in 2000 along with her parents and moved to Singapore, got married and gave birth to 2 children in Singapore, applied for citizenship in Singapore but was asked to provide a confirmation issued by the UA tax office that she does not have any outstanding lax liabilities in Ukraine. Such confirmation can be issued only to UA tax residents based on their PIT return submitted to the tax office (either annual PIR return or pre-departure PIR return). Since no Ukrainian source income was received by a UA national, there was no obligation for filing a PIT return in Ukraine.

Conclusion: pre-departure PIT return should have been filed in 2000.

Position of the UA courts as for the substance

Huge court practice on internal transactions (substance over form) – tax benefit (e.g., credit of input VAT / VAT refund) is denied provided there is no actual movement of goods / works, services.

Decision of the Supreme Court of Ukraine, March 14, 2017



"If transaction is not actually performed, supporting documents, even if they have correct form, do not grant the right to VAT credit, regardless whether the payment was made or not. Lack of business purpose also serves as the ground for tax benefit denial."

Position of the Russian court on BO _01

Facts

A Russian company (RCo 2) owns 100% of the shares in another Russian company (RCo 1)

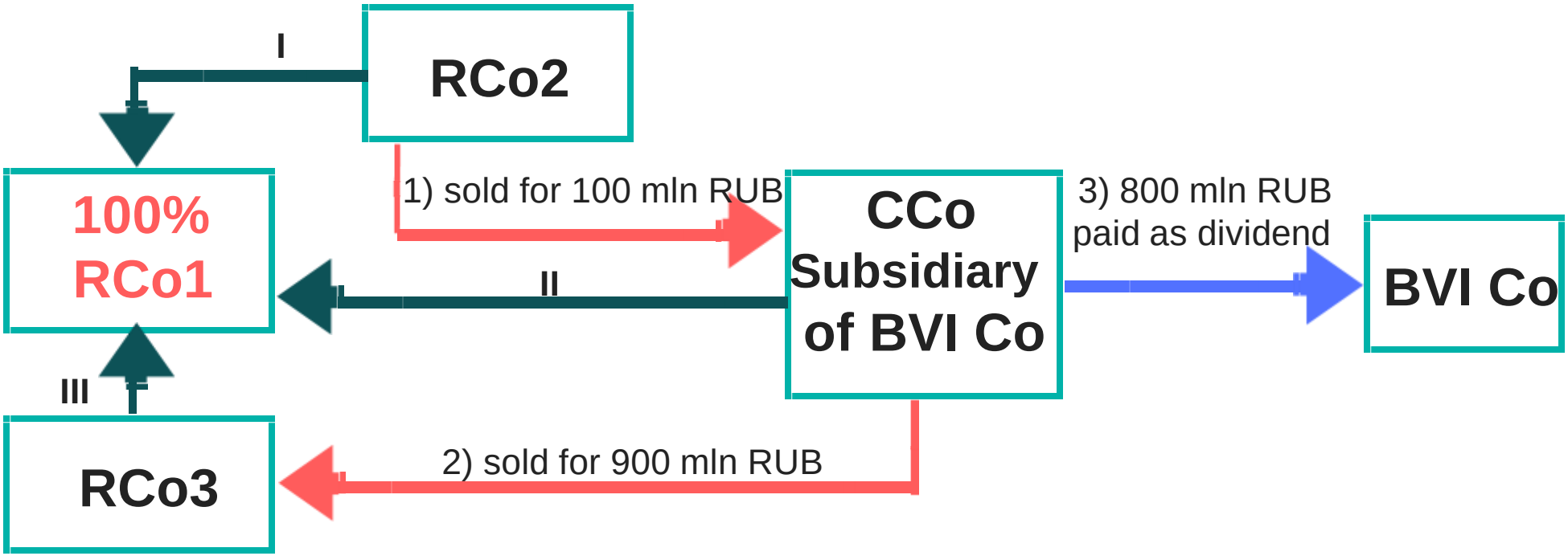
In May 2011, RCo 2 sold all of those shares in RCo 1 to a Cyprus company (CCo) for a price of 100 million rubles. CCo was a subsidiary of a BVI company (BVI Co).

And then, only 4 months later, in September 2011, CCo sold all of the shares in RCo 1 to yet another Russian company (RCo 3), for a price of 900 million rubles.

CCo's profit of 800 million rubles was paid out as a dividend to BVI Co shortly thereafter.

More than 50% of the assets of RCo 1 consists of immovable property located in Russia

RCo 2, RCo 3, CCo, and BVI Co were all related parties.



Position of the Russian court on BO _02

The court's decision indicates that the transactions were undertaken to obtain a tax-free step-up in the cost base of the shares in RCo 1.

RCo 3 did not withhold the 20% withholding tax from the 900 million rubles it paid to CCo - its position being that CCo was exempt from Russian tax under paragraph (4) of Article 13 of the treaty, and therefore it (RCo 3) was not required to deduct withholding tax.

Court's conclusion on beneficial ownership

- Participants in the sale and purchase transactions in relation to 100% of the shares on RCo 1 were related parties
- CCo's director was provided by a local corporate secretarial firm
- Acquisition of the shares in RCo 1 by RCo 3 from CCo had been approved long before CCo acquired the shares in RCo 1
- CCo did not have sufficient funds to acquire 100% of the shares in RCo 1. The transaction was financed by a loan from a related party, who controlled the relevant companies
- During the entirety of its existence, CCo did not own any intangible / tangible assets or financial assets, did not employ any personnel and did not conduct any profit-seeking business operations, other than the purchase and sale transactions of the shares in RCo 1
- CCo's profit from the disposal of RCo 1's shares was not taxed in Cyprus
- CCo's sole shareholder was a company incorporated in BVI, and the quantum of dividends paid by CCo to its sole shareholder was equivalent to the profit derived on the disposal of the shares in RCo1
- The bank accounts of CCo and BVI Co were opened at the same time with the same Cyprus bank
- The same address was used for both bank accounts
- CCo was liquidated a few years after the sale of the shares in RCo1

Position of the Russian court on BO _03

That conclusion is interesting for two reasons

Firstly, there's the retrospective aspect. The domestic tax law provisions introducing the "beneficial ownership" concept became effective only in 2015. The facts in this case occurred in 2011. Nevertheless, the court applied the "beneficial ownership" concept, because (it said) the new provisions merely codified the pre-existing rules - an interesting viewpoint.

Secondly, there's the interaction between the domestic law position and thetreaty position. By determining that CCo is not the relevant taxpayer (for domestic tax law purposes) in regard to the profit of 800 million rubles, the court effectively rendered the Cyprus / Russia treaty irrelevant : CCo is not sought to be taxed, and therefore treaty benefits for CCo are irrelevant.

One of the interesting aspects of this case is that, although the court determined that CCo was not the beneficial owner of the profit and therefore was not the relevant taxpayer, the court did not have to determine who the beneficial owner of the profit truly was.

In the absence of a treaty exemption, RCo 3 had an obligation under domestic tax law to deduct withholding tax from the payment which it made to CCo. Based on the court's conclusion that CCo was not the beneficial owner and therefore not the relevant taxpayer, there was no treaty exemption - and thus, RCo 3 was liable for the withholding tax it had failed to deduct.

The court ruled without identifying the beneficial owner

Position of the UA courts on BO status

A number of court cases in Ukraine on entitlement to treaty benefits based on BO criteria (typically in sublicense arrangements and loan arrangements, a few on dividend payments)

Decisions of the High Administrative Court of Ukraine with its legal position on BO criteria: March 24, 2014 (case К/800/52155/13)

Decisions of the Supreme Court of Ukraine with its legal position on BO criteria: March 21, 2018 (case No 803/1005/17)

“BO should not be treated in narrow technical sense, its meaning should be determined based on the purpose of the DTTs “avoidance of double taxation” and the main principle “preventing inappropriate application of DTTs.

To qualify as a BO the recipient of income should not only have the right to receive such income, but should determine subsequent economic fate of such income and enjoy the benefits of such income.”

Both courts stated that subsequent use of the funds by their recipient should be thoroughly analyzed, whether their use is restricted by a law or an agreement, relevant functions and risks should be also analyzed.

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