Cover Story (#01-02 January-February 2019). Sensitive Area

The recent changes made to international taxation rules provided by base erosion and profit shifting (BEPS) and likely never-ending domestic tax reform in Ukraine, force taxpayers to live and operate in "waiting mode". Business in the coming year is likely to be not as usual, as domestic corporates and multinationals should carefully reconsider their business structures and international transactions. **Svitlana Musienko**, who recently joined **Sayenko Kharenko** as a tax partner, outlines what to expect from the increasingly complex set of regulations in the ever sensitive area of tax.

UJBL : How would you assess ongoing tax reform in Ukraine? Could you single out definite achievements and certain failures that have, in your opinion, taken place?

Svitlana Musienko: Tax reform in Ukraine generates a lot of interesting ideas, but many of them will never be implemented. There are no apparent achievements to date which are "tangible" or bold enough to be pointed out as quick victories. There have been some positive moves, such as the introduction of some useful electronic services for taxpayers. Besides, over the past couple of years, Ukraine has climbed up several places in the World Bank's 'Doing Business' ranking.
However, these improvements don't alter the overall picture. Clearly more remains to be done. It's fair to say that the business community and society in general are disappointed with the pace and quality of reforms in this sensitive sphere.

Recently, the government declared the upcoming separation of the State Fiscal Service into two institutions: the State Tax Service and the State Customs Service. Both of these state institutions will be supervised and coordinated through the Minister of Finance. This aims to "re-load" the bureaucratic and notoriously corrupt system, de-militarize the State Fiscal Service, and enhance the quality of services provided by the state to taxpayers. Ironically, moves in the opposite direction in 2012-2013 with the unification of two separate institutions within the Ministry of Fees and Revenues took place under the same slogans. Many experts are now urging a comprehensive institutional reboot reaching well beyond these formal but potentially superficial splits. It remains to be seen whether this exercise will result in any long-awaited improvements.

In addition, we have recently seen the organization of a dedicated department within the State Fiscal Service responsible for transfer pricing (TP) and international tax matters. This is a positive move. Ukraine has to follow international trends in tax transparency. Having a dedicated task force with a high level of technical expertise is crucial to bring TP and international cooperation on tax matters to a new level.

UJBL : What is the most challenging thing for business in terms of tax? What is the experience of your international and local clients?
S. M.: Among major challenges, our clients name the low quality of legislation, lack of predictability and consistency in enforcement of laws and common problems with the rule of law in general.
The first challenge is self-explanatory. Tax laws in Ukraine undergo changes much too frequently and the legal quality of those changes is not always high. This creates room for multiple interpretations. Moreover, although there is a general principle that tax changes will be made not later than six months before the start of a financial year, lawmakers routinely fail to comply with this principle and pass amendments in late November or even December. All this creates an environment of unpredictability and uncertainty.

The second challenge relates to implementation of existing tax rules by the tax authorities and courts. Generally, the procedure and culture of communication of tax authorities with taxpayers often upset our clients, especially international companies. Tax controversy is another area of complaints: it is common for the tax authorities to be inconsistent in their views and sometimes unreasonable in their requests. Hence, taxpayers have to defend their rights through the courts. Our tax litigation team remains very busy despite the declared intention of the tax authorities to reduce the number of tax audits.

Technically, many of the mentioned defects in tax legislation and in its practical implementation by the tax authorities might have undergone correction by the judicial system. Unfortunately, Ukrainian court practice features the same unpredictability and uncertainty, especially in the tax field. Practice is often inconsistent even at the level of the Supreme Court of Ukraine, despite the fact that the main task of this court is to harmonize existing court practice.

It’s fair to say that there are some positive developments in the practice of the Supreme Court of Ukraine, which recently underwent reestablishment as the result of judicial reforms. We hope this trend will prevail.

UJBL : Over the last couple of years, the Ukrainian government has pursued attempts to prevent the outflow of Ukrainian capital overseas. How does it affect international tax structuring?
S. M.: There are two dimensions to your question: currency control regime and tax measures. These are closely intertwined.
Ukraine had extremely strict currency control rules over the last 25 years. All cross-border payments were subject to severe controls and everything not explicitly allowed was subject to prohibition.

Despite these severe restrictions, Ukrainian businesses massively utilized offshore companies and offshore accounts. Typically, these were open with banks in Cyprus, BVI (and other British Overseas Territories) or other offshore havens. More often than not, these accounts were open in a non-transparent way. This was the normal course of business. A lot of Ukrainian businesses have been structured through holding companies located in Cyprus, BVI, the Netherlands, etc. Many of them had an offshore center within their structure, which accumulated profits shifted from Ukraine, typically in the form of interest/royalties/service payments with low substance.

Throughout the past decade, the Ukrainian government did try to prevent capital outflow using tax policy instruments. There were various types of anti-avoidance provisions in tax laws. Specifically, payments to companies located in offshore territories were limited in tax deduction; interest payable to foreign lenders as well as royalties payable abroad were limited too. However, these measures do not prove to be very effective. Even transfer pricing rules introduced in 2013 were not able to drastically alter the state of play.

Finally, things are now about to change. Ukraine is going to lift its outdated currency control restrictions, which do not make sense for a modern economy. The new Law *On Currency* (expected to start working February this year) already offers some degree of currency liberalization. There will be an interim period during which existing restrictions will be lifted gradually.
The National Bank of Ukraine declared its intension to eliminate restrictions altogether after BEPS-inspired tax novelties are introduced into the *Tax Code*.There is a strong reason behind this initiative.
The National Bank of Ukraine, as the market regulator, must ensure there is financial stability in the country. It is much easier to cope with this task if capital outflow to offshore jurisdictions is blocked or slowed down by BEPS measures.

UJBL : How does the global de-offshorization trend impact Ukrainian business? Which jurisdictions remained preferable for tax structuring?

S. M.: The Base Erosion and Profit Shifting (BEPS) project was begun in 2011 by the OECD under the auspices of the Big 20 and is changing the global tax and financial landscape. It will end "the offshore era". BEPS is all about introducing transparency, automatic exchange of tax information, and fighting against harmful tax practices.
Many Ukrainian businesses have already felt its direct impact on their overseas structures. Bank accounts opened by "shell companies" located in low tax offshore jurisdictions with Baltic banks and, lately, with Cypriot banks, went through a thorough cleaning campaign.

The BVI, Jersey, Caymans, and Bermuda recently announced new laws on economic substance. More islands and territories will follow. This is their response to OECD pressure to fight against harmful tax practices. Unless a business can prove there is real economic substance to the company, including physical offices, management, adequate workforce, and real business transactions, its bank accounts in these jurisdictions are likely to face closure either today or tomorrow.

Typical holding solutions structured through Cyprus, the Netherlands, Austria and other onshore jurisdictions will all remain in use. However, to enjoy the privileges of a beneficial tax regime, a business will need to set up a real economic presence in the respective jurisdiction. "Letter box" companies will not suffice any longer.

UJBL : What are the core goals of ongoing corporate and tax restructuring undertaken by Ukrainian business?
S. M.: With anti-BEPS measures unfolding both globally and locally, there is a strong need to re-evaluate existing tax structures. Those inherited from before BEPS will simply not fly any longer! In brief, BEPS measures make it costly and risky, if possible at all, to hide money in offshore jurisdictions. With stringent economic substance requirements, there are no financial benefits to keep multiple layers of offshore companies, which are getting rejections from foreign banks on KYC grounds. Additionally, newer and stricter rules for the application of benefits under double taxation treaties must enter consideration. So-called anti-treaty shopping measures are on the rise. In a growing number of jurisdictions around the world "letter box" or "empty shell" companies are no longer tolerated by banks, financial regulators or the tax authorities. Automatic exchange of tax information and various anti-avoidance regimes (e.g., Controlled Foreign Companies regime) will make it risky and simply non-beneficial to carry on with "offshore business as usual".

In light of these changes, the goal for restructuring is to run a SWOT analysis, to cross out elements that are no longer beneficial, and to build a transparent, simple and sustainable structure, aligned with contemporary high compliance and anti-avoidance standards.

Time is pressing! There's still some time for Ukrainian businesses to re-invent their foreign structures and get themselves ready for these major challenges before Ukraine joins the automatic exchange of information standard.

UJBL : Another hot topic for taxpayers is transfer pricing and its evolving rules. Do you think it could be an efficient tool for preventing tax avoidance, or just coverage of fiscal needs?

S. M.: I believe that transfer pricing will gain more and more momentum soon. In the latest amendments to the *Tax Code* introduced by Law No. 2628-VIII, there were some important transfer pricing novelties. First, some inaccuracies and technical mistakes in applying transfer pricing rules have been eliminated. Second, the "substance over form" principle for transfer pricing purposes has been established. According to this principle, the characteristics of the controlled operation are to be determined in accordance with the actual actions of the parties and the actual circumstances of their conduct. Should the documented form be in conflict with the actual substance, the latter shall prevail. Now that the Ukrainian tax authorities have this anti-avoidance tool at their disposal, there are concerns whether it might be subject to abuse to pressure business and thus provoke a new wave of tax controversies. When planning business activities, companies are advised to pay particular attention to their biggest and/or non-typical transactions with related parties.

UJBL : When do you expect the launch of transfer pricing disputes in Ukraine?

S. M.: It is true that until now, transfer pricing disputes in Ukraine focused largely on procedural matters. Core substantive issues such as selection of the transfer pricing method, tested party, FAR analysis, and transfer pricing range were rarely if ever subject to explicit challenge or debate in court proceedings. Transfer pricing is one of the most difficult tax subject matters for all parties to tax controversy, including taxpayers, the tax authorities, administrative courts and court experts. It takes time to build up the requisite expertise. I'm sure that we will come to a point where transfer pricing will be used by the state as an effective remedy against tax leakage. My prediction is that we will see more transfer pricing disputes on substantive matters in 2019 and in the years to come.

**UJBL : There's a tradition that the Ukrainian Parliament adopts changes in tax legislation just before the new year.
The relevant changes introduced by Law No. 2628-VIII of 23 November 2018 come into effect from 1 January 2019. How would you comment on this initiative?**

S. M.: In addition to important TP changes discussed above, the Law introduced a number of technical and procedural changes. The most crucial changes are summarized below:

— the maximum court fee for filing a claim in tax disputes has been substantially reduced (UAH 19,200). This should facilitate access to courts for taxpayers as well as for the tax authorities. It's likely that this will increase the workload of courts that deal with tax disputes.

— VAT tax on international shipments — the non-taxable value of international shipments to be reduced from 1 July 2019 to 31 December 2020 from EUR 150 to EUR 100 per individual recipient.

— VAT exemption has been continued until 31 December 2022, for import into Ukraine of vehicles equipped exclusively with electric motors and certain equipment used in renewable energy, and until 1 January 2022 for operations on the import of waste and scrap of ferrous and non-ferrous metals, operations on the supply of coal and/or products of its enrichment on the customs territory of Ukraine.

— the obligatory use of payment transaction registrars (cash registers) for the sale of pharmaceuticals and medical products has been introduced. We encourage business entities to pay attention to products which they sell for their possible inclusion in the above categories.

— increased tax rates: excise tax on tobacco products; ecological tax; rent for the use of subsoil for oil and condensate extraction; rent for the use of subsoil for iron ore extraction; rent for special use of forest resources.

— improved fuel circulation administration and licensing of business entities engaged in manufacturing, storage, fuel wholesale and retail trade has been introduced.

— procedural terms have been extended and "working" days instead of "calendar" days have been introduced for the purposes of: submission of objections to rulings made by the tax authorities; submission of objections to tax audit reports; adoption of tax assessments.

— significant changes have been introduced to the collection of a tourist tax with respect to taxpayers, tax rates and payment procedure.

UJBL : How does the global trend for transparency change the tax agenda in Ukraine? What changes in tax legislation do you predict in 2019?

S. M.: Mostly I expect changes inspired by the BEPS implementation commitments undertaken by Ukraine. These are likely to happen in 2019. Secondly, changes related to the enhancement of tax information exchange — but these are likely to take more time to reach implementation; in 2019, we might see some interim measures taken in this respect.
In 2017, Ukraine joined the Inclusive Framework on BEPS and committed itself to a BEPS minimum standards package consisting of four measures. These are as follows: measure 5 — counter harmful tax practices; measure 6 — prevent treaty abuse; measure 13 — re-examine TP documentation; and measure 14 — make dispute resolution more effective.

The OECD will monitor Ukraine's progress on this matter. A progress report is expected in early 2019.

So far, there is progress in respect to three measures out of four. Measures 6 and 14 were already addressed by Ukraine when signing the BEPS Multilateral Instrument (MLI) in 2018. However, for MLI to become effective it must undergo ratification by the Ukrainian Parliament, which we expect to take place in 2019. Joining MLI is an extremely important step for Ukraine. It will enable to amend, on a multilateral basis, many of Ukraine's double taxation treaties, by adding a "principle purpose test". A principle purpose test is an anti-avoidance instrument whose role is to ensure that double taxation treaty benefits are not abused. If it's proven that one of the principle purposes of a transaction was to gain treaty benefits, benefits would be denied. In practice, this means that it would be more difficult for business to apply treaty benefits upfront. Though the burden of proof stays with the tax authorities, we recommend that businesses should evaluate their circumstances in advance to see if the treaty benefits would be present under the new rules, and what kind of confirmatory documentary trail would be required.

Measure 13 from the BEPS minimum package (i.e. transfer pricing documentation change) is yet to be addressed by Ukraine. In short, Ukraine should introduce 3 level Transfer pricing reporting, adding Master File and country-by-country (CbC) reporting levels to the local reporting which already exists under Ukrainian law. The CbC Report is of particular importance. In essence, this is a spreadsheet listing all the entities of an international group, indicating the jurisdiction of their incorporation, revenues, taxable profit, tax paid, assets, and employees. Once introduced, it will provide the Ukrainian tax authorities with the bigger picture. They would be able to relate the results of the Ukrainian entities of an international group to those of its foreign affiliates. For instance, they would be able to identify "red flag" situations, where payments from Ukraine are made to an empty shell foreign vehicle with huge turnover but low taxes are actually paid.

UJBL : What changes in tax legislation do you predict in 2019?

S. M.: In autumn 2018, the government presented a comprehensive draft law on BEPS implementation which addresses the Transfer pricing measure mentioned above, and also covers a variety of BEPS inspired anti-avoidance tools such as the CFC regime, new interest deduction limitations, new stricter PE regime, enhanced beneficial owner concept, deemed dividends, and business purpose doctrine, to name a few. The draft law goes well beyond the BEPS minimum package. The draft is expected to progress into law in 2019. It remains unclear which of the measures suggested in the draft will survive parliamentary debates.

The topic of exchange of information is much more difficult to proceed with.

At present, Ukraine is a party to the "exchange of information on request" format. Automatic exchange of tax information (CRS) is the next step; Ukraine is on the list of developing countries that have not yet committed themselves to this standard, which include countries like Macedonia, Ecuador, Tanzania, Togo and Uganda, to name a few. This would be the most crucial step towards tax transparency. Here we're not only talking about the necessary political will needed for this standard to apply. The secured IT infrastructure audited by the OECD is a pre-requisite for proceeding. This has not been built yet in Ukraine, and this process is likely to take time. There are expectations that the first exchange of information under CRS might happen for Ukraine in 2021, with 2020 as a reporting period.