Ukrainian Property Transfers between Non-Residents:

Ukrainian Tax Implications

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When the transfer of Ukrainian property (assets, shares, real estate, etc) by non-residents to other non-residents generally ceased to be something extraordinary from the Ukrainian legal perspective, the respective Ukrainian tax consequences remained uncertain. This was especially so when the selling non-residents are legal entities. Due to these uncertainties, non-residents often prefer to structure their deals outside Ukraine, for instance, at the level of foreign holding companies and, as a result, the Ukrainian state does not obtain taxes it desperately needs to finance its own expenditure. Even those non-residents that would like to pay the applicable taxes in Ukraine in order to have their transactions transparent from a Ukrainian tax point of view simply lack clear guidance on the relevant methods and procedures for doing so. The newly adopted *Tax Code of Ukraine* failed to bring any clarity to the issue and it now arguably amounts to a rather unorthodox way for stimulating foreign investments in Ukraine.

Capital gains and withholding tax

Both the newly adopted *Tax Code* (which came into force on 1 January 2011) and the previously effective tax laws stipulate that any income of non-residents derived from sources within Ukraine is subject to taxation in Ukraine, and such income includes, *inter alia,* proceeds from the disposal of real estate located in Ukraine, as well as profits from the disposal of Ukrainian shares and participatory interests (both incomes also known as capital gains). Therefore, where non-residents sell their Ukrainian assets, such transactions are basically taxable in Ukraine.

According to the *Tax Code*, if a resident of Ukraine, or a permanent establishment of a non-resident, transfers any income to a non-resident, they are obliged to withhold and transfer the withholding tax on such income to the state at the respective rate, unless the applicable double taxation treaty of Ukraine provides otherwise. The *Tax Code* further specifies that where a foreign individual obtains income originating from Ukraine from another non-resident (either individual or legal entity), for example in an asset sale, then such a non-resident firstly has to open an account with a Ukrainian bank and then to credit the respective payments from a buying non-resident thereto. A Ukrainian bank acting as a tax agent of the selling foreigner is obliged to withhold and transfer to the state the applicable Ukrainian personal income tax. Again, the Ukrainian tax may be reduced, even to zero, by an applicable double taxation treaty.

It should be noted, however, that currently neither tax nor any other Ukrainian legislation on foreign investments, contains a mechanism similar to the one mentioned above, that would allow the collection of the Ukrainian withholding tax in cases where the seller and buyer, both of which are foreign legal entities without a registered presence in Ukraine (e.g., permanent establishment), settle outside of Ukraine. In contrast, in accordance with the previously effective Ukrainian legislation on foreign investment (Regulation of the National Bank of Ukraine *On Foreign Investing in Ukraine of 10 August 2005, No.280*), the payment of withholding tax could be required by a Ukrainian bank, provided the settlements for the Ukrainian assets between two non-residents were made through Ukrainian bank accounts. Further to changes to this Regulation of 23 December 2009, a Ukrainian bank is not empowered to control the payment of taxes by non-residents any longer; and to date Ukrainian legislators have failed to introduce any procedure for taxation of incomes of foreign legal entities originating from Ukraine and payable by the other non-residents. Furthermore, even if a non-resident decides, for any reason, to pay Ukrainian withholding tax, there are no relevant procedures that would allow him to do so. One way, however, might be to change its registered address from abroad to Ukraine, thus creating a permanent establishment or, alternatively, to involve a Ukrainian intermediary; with the subsequent settlement taking place between non-residents either through such permanent establishment or Ukrainian intermediary.

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Double taxation treaties

Tax lawyers and advisers are aware that double taxation treaties of Ukraine provide protection against the Ukrainian withholding tax on capital gains in very limited cases. Thus, in accordance with most treaties (for example, treaties with the Netherlands, the UK and the USA), gains derived by a non-resident from the alienation of immovable property situated in Ukraine or from the alienation of Ukrainian shares (other than shares quoted on a stock exchange) or participatory interests, the value of which is derived principally from immovable property situated in Ukraine, are subject to taxation in Ukraine. The sale of shares and participatory interests not linked to Ukrainian immovable property is exempt from taxation in Ukraine provided that foreign sellers are able to confirm their entitlement to such exemption by complying with the tax residency and beneficial owner tests established by the *Tax Code*.

As usual, the taxation treaty with Cyprus holds a unique position providing that gains derived by a Cypriot resident from the alienation of any Ukrainian shares or participatory interests are not taxable in Ukraine. This provision, together with the overall favorable domestic tax regime, is one of the reasons why Cyprus is frequently used in structuring share deals involving Ukrainian assets. For the sake of completeness, it is worth mentioning that the treaty with Cyprus is not the sole treaty exempting gains from alienation of the Ukrainian shares from taxation in Ukraine. These also include some other jurisdictions, for example, Turkey and Slovakia.

Having said the above, it appears that transactions between non-residents which do not qualify for any treaty benefits remain potentially questionable by the Ukrainian tax authorities, even if there is no effective mechanism for the payment of a Ukrainian withholding tax.

Sale of immovable property and VAT

Whereas the sale of shares, participatory interests and land plots (except those located under buildings and forming the part of their value) does not amount to a VATable transaction in Ukraine, the sale of other immovable property, including commercial, is subject to payment of 20% VAT. Under the *Tax Code*, an obligation is imposed on the seller to charge the VAT in addition to the sale price, provided that the seller is or has to be registered as a payer of VAT in Ukraine.

As there is no procedure for VAT registration of non-residents, unless these non-residents operate in Ukraine through their permanent establishments, this generally results in a situation similar to the one described above, i.e. there may be taxable transactions and a taxable base, but the Ukrainian tax legislation fails to impose a positive obligation on a non-resident to pay the VAT and there is simply no effective mechanism providing for such tax payment. All this, however, does not reduce the risk that the Ukrainian tax authorities may want to question respective particular transaction and to request from the respective non-resident to register for the Ukrainian VAT purposes. Such risk, *inter alia*, is the reason why asset deals are not common in Ukraine as jurisdiction is simply not conducive towards them.

Tax recovery

Among the novelties introduced by the *Tax Code* are new powers vested with the Ukrainian tax authorities providing them with assistance to collect foreign tax debts on the territory of Ukraine. Generally, if an international treaty provides for the possibility for Ukrainian tax authorities to collect a foreign tax debt from the respective Ukrainian taxpayer, then there is a positive obligation on the authorities to collect such foreign tax debt. For example, the Netherlands–Ukraine double taxation treaty directly provides assistance and support in recovery of taxes between Ukraine and the Netherlands. Given this, even in the absence of an effective mechanism that would allow the Ukrainian withholding tax to be collected in cases where the seller and buyer, both of which are foreign legal entities without a permanent establishment in Ukraine, settle outside Ukraine, there is a risk that the Ukrainian tax authorities may want to seek the recovery of Ukrainian tax claims in foreign jurisdictions and there are already precedents of such performance by the Ukrainian tax authorities. This mainly concerns non-residents from no tax treaty jurisdictions, or that cannot, for any reason, enjoy Ukrainian tax exemption under the applicable tax treaty.

Summary

Analysis of applicable Ukrainian legislation confirms that there is no effective mechanism enabling the collection of Ukrainian withholding tax in cases where the seller and buyer, both of which are foreign legal entities without registered presence in Ukraine, settle outside Ukraine without the involvement of any Ukrainian intermediary. The *Tax Code* did not bring any clarity to this issue and there is still no clear guidance for a non-resident that considers paying of a Ukrainian tax. Notwithstanding this, and where a non-resident is seeking a tax transparent transaction, it should consider structuring a share deal through Cyprus or any other jurisdiction, where a double taxation treaty with Ukraine exempts gains derived by a qualifying non-resident from the sale of Ukrainian shares and participatory interest from taxation in Ukraine. Otherwise, there may be a risk of recovery of Ukrainian taxes in foreign jurisdictions.

There is a risk that the UKRAINIAN TAX AUTHORITIES may want to SEEK THE RECOVERY of Ukrainian TAX CLAIMS IN FOREIGN JURISDICTIONS and there are ALREADY PRECEDENTS of such PERFORMANCE by the Ukrainian tax authorities

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