

Mergers and acquisitions in Ukraine: tax issues on the radar

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DESPITE THE FINANCIAL CRISES AND TURMOIL IN RECENT YEARS THERE HAS BEEN AN INCREASE IN M&A ACTIVITY IN THE UKRAINIAN MARKET. TAX ISSUES HAVE ALWAYS PLAYED THEIR ROLE IN MAKING DECISIONS REGARDING THE ACQUISITION OF UKRAINIAN TARGETS, AND NOWADAYS IS NO EXCEPTION. THE ADOPTION OF A NEW TAX CODE WHICH CAME INTO EFFECT IN 2011 DID NOT DRAMATICALLY CHANGE THE TAX LANDSCAPE FOR M&A. HOWEVER, SOME TAX NOVELTIES INFLUENCING M&A STRUCTURING WERE INTRODUCED. SINCE ITS ADOPTION, THE TAX CODE HAS UNDERGONE A NUMBER OF CHANGES AND IS EXPECTED TO BE AMENDED AND IMPROVED FURTHER. THIS CHAPTER AIMS TO OUTLINE KEY TAX ISSUES RELEVANT FOR THE M&A PROCESS, TO HELP A FOREIGN INVESTOR WHO IS CONSIDERING M&A DEALS INVOLVING THE UKRAINIAN TARGETS TO GRASP THE UKRAINIAN TAX LANDSCAPE AND TO NAVIGATE THROUGH THE COUNTRY'S CHALLENGING TAX ENVIRONMENT.

General overview

Corporate profit tax

In 2012 the corporate profit tax rate is 21% and will gradually be reduced to:

- i. 19% in 2013; and
- ii. 16% in 2014.

Ukraine offers quite a competitive corporate tax rate as compared to other European jurisdictions. However, the effective tax rate can be considerably higher due to deduction limitations and restrictions. Ukrainian companies are taxed on their worldwide income. Withholding tax (which is part of corporate profit tax) can apply to income derived by non-residents in Ukraine.

Withholding tax

The standard withholding tax rate is 15%. Dividends and interest paid to non-resident companies are subject to a

15% withholding tax. Withholding tax plays a major role for M&A tax planning and choosing a holding vehicle aimed to



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ensure tax-efficient repatriation of dividends and interest post-deal.

Double tax treaties usually reduce or eliminate withholding taxes. Ukraine has double tax treaties with other EU countries (excluding, however, Luxembourg, Ireland and Malta), as well as with the US, several African, Middle Eastern and Asian countries and CIS member states. Treaties are predominantly based on the OECD or UN model, however, the authorities seldom use the relevant commentaries for their interpretation.

Tax reduction or relief under a treaty is granted upfront, provided that a valid tax residence certificate is available. Starting from 2011, the Tax Code has introduced an additional requirement to verify that the recipient is the beneficial owner of the income to enjoy a reduced rate or exemption.

VAT

20% VAT applies to domestic supplies and imports (the rate is to be reduced to 17% in 2014). Export supplies are zero-rated. The VAT refund procedure is quite difficult and it may take few years to get a VAT refund.

Capital and stamp duties

Ukraine imposes no capital and stamp duties.

Acquisition structuring

The purchaser generally seeks to own Ukrainian target companies through treaty-protected countries to minimise withholding tax on dividends and capital gains. The most popular holding jurisdictions are Cyprus and the Netherlands with Cyprus being the most used one. Other treaty-protected countries are also used.

The tax structuring may vary depending on the type of the deal and industry involved.

An investment through an asset deal reduces the tax exposure. However, since capital gains on an asset transfer are subject to corporate profit tax in Ukraine and 20% VAT is applied on the value of assets sold, sellers prefer to

structure the transaction as a share deal, usually at an offshore level via sale of shares of a foreign special purposes vehicles.

For the buyer, the share deal may also be more attractive for VAT considerations: purchasing assets from the seller via a Ukrainian company may increase the financing required by a VAT component. Furthermore, a refund of VAT charged by the seller may take a long time resulting in cash outflow for the purchaser's group of companies.

Mergers with a tax-neutral status are very rarely used for acquisition purposes. Spin-offs are sometimes used by the sellers within pre-sale restructurings as a tool to transfer assets prior to share deal.

When purchasing shares of an existing Ukrainian company, a full-scale tax due diligence is recommended in all cases, as many companies would have material historical tax risks. Identification of such risks can be factored in the price of business being sold as well as serve as a reason for an asset deal structure.

Share deals taxation

The Tax Code envisages special rules for taxation of transactions related to purchase and sale of shares/securities/corporate rights.

The said rules envisage that the capital gain derived from the sale of shares is treated as taxable income in the reporting period of receipt/accrual of income. At the same time capital loss is deferred to decrease the capital gain to be derived in future from the sale of the same type of shares.

Capital gain is the positive difference between the income from the sale of the shares, less expenses incurred on purchase of shares of the same type. Capital loss is negative difference between the income from the sale of the shares less expenses incurred on the purchase of shares of the same type.

Following provisions of the Tax Code, the seller will suffer tax on the sale of shares. Consequently, no immediate effect for the purchaser will arise upon the acquisition of

shares; the said expenses can be off-set further only against income from transactions with the shares.

Tax attributes and continuity of ownership of business

It is important to ensure that tax attributes of the target company such as tax losses, VAT credit, right to depreciation – can be utilised by the purchaser after the deal. To this end, full-scope tax due diligence is crucial to identify historical tax risks associated with tax attributes prior to the deal.

Unlike many other European jurisdictions, there are no ‘change of control’ rules which would restrict or disallow tax losses or VAT credit at the level of the Ukrainian target after control over the target company is assumed by the purchaser. Therefore, provided the tax attributes are legitimate as such, there are no further restrictions for the purchasers to utilise.

Pre-sale restructurings

It is quite typical that Ukrainian sellers undertake intragroup restructuring in anticipation of the deal. Usually the shares of the potential Ukrainian target are transferred under the ownership of the holding vehicle located in a treaty-protected jurisdiction with a friendly holding tax regime. In certain instances, pre-sale restructuring can involve both share and asset transfer where a new Ukrainian company is created under the roof of a foreign holding company and acquires the assets constituting the business to be sold.

As of now (September 2012), Ukrainian tax legislation does not envisage any specific exit taxes which can affect the restructurings made by sellers prior to the deal. Transfer of shares and assets within pre-sale restructurings is taxed under ordinary rules. Capital gain derived on sale of shares or assets is treated as taxable income. Sale of shares is VAT exempt while sale/transfer of assets (including via capital contribution) is subject to 20% VAT. In general, the basis for VAT taxation is an arms length price.

Importantly, no specific ‘business purpose’ tests are addressed in the tax legislation aimed at preventing those

pre-sale restructurings which are driven only by tax purposes. At the same time, the Tax Code contains the definition of business purpose but does not contain any further explanation or implications applicable if business purpose test is not satisfied.

Transfer pricing considerations should be carefully considered for intragroup pre-sale transfer of shares/assets in order to minimise the tax risks including the deal invalidation. Though transfer pricing rules are undeveloped in Ukraine, in many cases, professional valuation of shares/assets is highly recommended to substantiate the sale price for tax purposes.

In general, the current tax environment leaves room for pre-sale tax structuring, which requires careful tax planning and also the consideration of legal/regulatory requirements.

Reorganisations

Under Tax Code corporate reorganisations (mergers, acquisitions split-offs, spin-offs and transformation) are generally tax-neutral and can be used as an efficient tool within M&A deals. In practice, despite all the tax benefits, reorganizations are rarely used for M&A deals as such, but rather within pre-sale restructurings. Under certain reorganisations obtaining of tax ruling is recommended.

Financing the acquisition

Depending on the deal structure – whether it is done offshore or at the Ukrainian level, different financing scenarios may apply.

Typically, a foreign or Ukrainian acquisition vehicle would get the loan from an affiliated group, company or a bank to leverage the acquisition. In some instances, equity is used to finance the purchase. Equity financing in part of the nominal value of shares is tax-neutral. Share premiums can also be neutral and achieved tax-free. Ukraine does not impose capital duty on equity. Loans from non-residents are subject to registration with the National Bank of Ukraine and interest on such loans is capped with the maximum being 11% per annum for loans with maturity of over three years.



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Interest-free loans are also possible regarding tax for a limited period of time. To achieve it tax-free, the provision and repayment of the loan must be made within the same reporting quarter. Otherwise, negative tax implications may apply (imputation of income on the amount of the non-repaid loan or deemed interest charge). Under the Tax Code, the interest-free loan provided to a Ukrainian entity by its founder/participant (including non-residents) and repaid within 365 days from its receipt should not be taxable in the hands of Ukrainian entity.

Generally, when the deduction of the interest on the loan is attracted to finance, the acquisition is not disallowed. Unless special deduction limitation applies, deductibility of the interest would depend on the satisfaction of general criterion i.e. it must incurred within business (income-generating) activities of the borrower. Therefore, ensuring there is a connection between the interest paid and income received by the acquisition vehicle is crucial, especially for share deals where income stream in the form of dividends or capital gains is not immediate following the acquisition. For more convenience, tax ruling may be recommended to confirm the deduction of the interest on the share acquisition.

Interest deduction limitations (quasi thin-cap rules)

The Tax Code of Ukraine (reiterating the previous legislation) imposes certain limitation on interest deduction on a related party debt. The limitation is not linked to debt-to-equity ratio.

Limitations apply to those Ukrainian entities in which 50% or more of the statutory share capital is possessed or managed by non-resident(s).

If such a Ukrainian entity (at least 50% owned by non-resident/s) pays interest under loan to such non-residents (or their related entities), the interest deduction in the hands of a Ukrainian entity is limited

The formula for calculation of deductible interest of the reporting period is the following:

Deductible interest = 50% × taxable income (without interest income received) + interest income accrued

Interest expense beyond this calculated limit may be carried forward to future tax periods applying the same restrictions during each tax period without limitations.

The limitation is quite restrictive and in certain cases may be avoided under proper structuring.

Post-deal tax considerations

Following the acquisition, typical issues faced by the purchaser are:

- i tax-efficient flow of dividends; and
- ii maximising tax deduction of the interest on the loans attracted for acquisition ('debt push down').

Dividends

Payment of dividends to certain jurisdictions (e.g. Cyprus and the Netherlands) can be achieved with the reduction of or exemption from withholding tax.

Ukrainian companies are unconditionally exempted from the taxation of dividends received from Ukrainian companies.

Dividends received from foreign (non-offshore-listed) controlled companies are also exempt with no further conditions. Controlled foreign companies imply *inter alia* ownership of at least 20% of share capital.

One of anti-avoidance measures introduced by Tax Code was the introduction of the beneficial ownership concept at a domestic level. Previously, beneficial ownership existed as a part of international double tax treaties and was not applied widely.

Beneficiary ownership test

Under the Tax Code treaty exemption/relief is only available to non-residents who are:

- i beneficial (actual) recipient (owner) of the income; and
- ii residents of the country which is party to the relevant treaty with Ukraine.

For the purpose of the above provision the Tax Code contains a definition of the beneficial owner. Beneficial (actual) recipient (owner) of Ukraine-sourced income is the person who has the right to receipt of such income.

The Tax Code also envisages that the following persons may not be treated as beneficial (actual) recipients even if they have the right to receive such income:

- (i) agents;
- (ii) nominee holders; and
- (iii) mere intermediaries towards such income.

The Tax Code contains no further explanations on what is meant by agents, nominee holders, or mere intermediaries leaving room for interpretation.

Moreover, despite the fact that drafters of the Tax Code probably resorted to international tax practice when drafting beneficial ownership clauses (e.g., use of terms, such as ‘agents, nominees and mere intermediaries’), Ukraine does not officially support OECD commentaries to MC, Report on Conduit Companies and the latter are applied selectively on a case-by-case basis. Therefore, the above sources can hardly be employed in practice at present as a reliable source of interpretation. Though it is not excluded that in future Ukraine will adhere to the MC Commentaries and Ukrainian tax authorities will use it as an official source.

Currently, tax authorities can resort to following interpretations of the beneficial ownership:

1. Interpretation of the concept based on domestic legislation where the definition of beneficial owner, agent, nominee holder, intermediary will be derived and analysed from civil and commercial law perspective looking into civil definitions, powers granted to agents, intermediaries under agency agreements of different type.

The question here is how domestic interpretation correlates with the treaty’s interpretation and which interpretation should prevail – a treaty one or domestic one? – or beneficial ownership should be satisfied under both treaty meaning and domestic one?

2. Interpretation of the concept based on the Vienna convention on the law of treaties (Article 31) under which a treaty shall be interpreted in good faith in

accordance with the ordinary meaning to be given to the terms of the treaty in the context and in the light of its object and purpose.

Such interpretation could lead to OECD MC commentaries and report on Conduit Companies or even to common law concept of beneficial ownership which was derived for the Model Convention.

Given the existing unclarity and lack of practice, the beneficial ownership issues must be taken care of in advance of M&A deals and defence files should be prepared afterwards.

Pushing the debt down

The post-acquisition acquisition vehicle financed with debt would face the issue where interest incurred on loan is not matched with income derived by an operating subsidiary of such acquisition vehicle.

Consequently, strategies allowing to push the debt down to the operating company are required.

Typical solutions elsewhere would include fiscal unity and upstream/downstream mergers of the acquisition vehicle and operating company.

Fiscal unity allowing to match interest and income of two entities for corporate profit tax purposes within the same group is not legally possible in Ukraine.

However, both downstream and upstream mergers are possible to achieve the deduction of the interest against the operating income. Mergers can legally be effected only between Ukrainian entities. Cross-border mergers are not allowed. In cases where a non-resident acquisition vehicle was debt-financed to acquire Ukrainian target, refinancing and restructuring may be needed to achieve the effect of debt-push-down. There are several precedents of such scenarios effectively implemented in practice.

Mergers are tax-neutral in Ukraine and the main risk arises from the interest deduction. Primarily, it must be ensured that a surviving entity post-merger is allowed to deduct the interest incurred by a legal predecessor. Tax ruling is highly recommended to confirm this position.

Also the decision on whether to undertake the merger for pushing the debt down would be dependent on legal/regulatory considerations and would not interrupt business during the merger.

Conclusion

Proper tax structuring is vital to get the maximum financial synergy out of the M&A deal and to minimise the tax leakage. Tax issues are mostly not deal breakers but must be carefully attended throughout the M&A process. This is

especially true for investing in Ukraine considering all the historic risks that Ukrainian targets typically possess.

Although Ukraine's tax climate is tough and often unpredictable the practice shows that the tax issues can be successfully managed. Not all tax solutions that are widely used in Western jurisdictions would work for Ukraine: there is clearly country-specific dos and don'ts. The authors hope that this overview will prove to be helpful to those who are planning to make a deal in Ukraine, by naming typical issues to watch out for and to consider.