Taxation of cross-border mergers and acquisitions

Ukraine

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Introduction

The Ukrainian tax environment is characterized by numerous tax filing requirements and frequent tax payments. Corporate and personal tax rates have been moderate for a long time, and so are social security rates, as of January 2016, as discussed later in this report. Tax laws are often ambiguous and subject to numerous interpretations and frequent changes.

Although Ukraine remains a document-driven jurisdiction where legal form still prevails over the economic substance of transactions, courts are starting to pay more attention to economic substance when considering tax disputes. Among other things, courts have developed and apply a valid business purpose test and certain other legal doctrines and principles to deny tax benefits derived from abusive tax-driven transactions. Tax practice is often limited or inconsistent, giving rise to numerous disputes with the tax authorities. The local courts often do not have sufficient experience to consider complex tax disputes and can be biased against business in favor of the tax authorities.

These factors combine to complicate tax planning, related business decisions and tax due diligence of local businesses.

These factors also result in additional tax risks in Ukraine, which are more significant than those typically found in jurisdictions with more mature and stable taxation systems. To some extent, the risks are mitigated by the tax authorities' usual entitlement to only assess additional tax liabilities within 3 years after the filing of the relevant tax returns, although a 7-year statute of limitations is prescribed for transfer pricing assessments.

Following a major tax reform in 2010, the government focused on enhancing the taxation system, fixing various controversies and ambiguities in new tax rules, and granting tax incentives to various industries.

Consolidation of four social security and pension charges into one unified social contribution, elimination and/or consolidation of certain other small taxes, and wider use of electronic tax filing contributed to a significant improvement in Ukraine's 'paying taxes' rating in the World Bank's Doing Business[1] survey. Overall, Ukraine's rating climbed from 181st place in 2012 to 83rd place in 2015.

Although the Ukrainian tax system is moving in the right direction by reducing the number of taxes, keeping the tax rates moderate and improving tax filing and administration procedures, more efforts and reforms are needed to overcome longstanding difficulties in administering taxes and reducing the number of tax audits and disputes.

Regarding the Ukrainian environment for mergers and acquisitions (M&A), high-profile acquisitions of Ukrainian businesses are usually structured as share deals by means of acquiring shares in foreign holding companies that hold shares in Ukrainian businesses. Asset deals and non-monetary acquisitions (including share-for-share exchanges) are relatively rare.

These and other important tax aspects of M&A transactions in Ukraine are discussed later in this report.

[1] "Doing Business 2016: Measuring Regulatory Quality and Efficiency", World Bank Group, 2016.

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Income tax

Ukraine's corporate income tax rate is 18 percent.

Special taxation regimes are prescribed for insurance companies and eligible agricultural producers.

Failure of the Ukrainian tax authorities to properly administer collection and refunds of advance income tax payments (installments) prompted the parliament to cancel the monthly income tax installments and annual income tax filings and replace them with quarterly income tax filings and payments, as of January 2016. But small and medium-size businesses that have annual revenues of 20 million Ukrainian hryvnia (UAH; about 769,000 US dollars — USD) or less can still file corporate income tax returns and pay corporate income tax annually.

The taxable income or loss is primarily based on and aligned with the accounting income or loss, and there are limited prescribed adjustments to the accounting income or loss to determine the taxable income or loss. The key tax adjustments involve tax loss carry forwards, thin capitalization limitations, depreciation, reserves and transfer pricing. Transactions with securities are subject to special income tax rules.

Value added tax

The general value added tax (VAT) rate is 20 percent. A 7 percent VAT rate applies to imports and domestic supplies of certain medicines and medical devices (equipment), and exports of goods and certain services are zero rated.

In an attempt to prevent VAT fraud and improve VAT refund practices, the Ukrainian government introduced electronic administration of VAT in 2005. Even though the new VAT administration mechanism helped tackle the Ukraine's VAT challenges to a large extent, this mechanism should be further improved to ensure that honest VAT payers are not facing additional financing costs and administration inefficiencies as a result of the new electronic VAT administration system.

Unified social contribution

The unified social contribution (USC) underwent significant change, as of 1 January 2016. Specifically, the rate for employers, which previously varied from 36.76 to 49.7 percent, depending on the class of professional risk prescribed for the relevant business, was reduced to 22 percent. The 3.6 percent USC rate for employees was cancelled. The USC does not apply to the portion of monthly wages and salaries that exceed the prescribed threshold (approximately USD1,300, as of 1 January 2016).

Beneficial ownership concept

The 'beneficial ownership' concept was introduced in the Tax Code in 2011. This tax concept primarily applies to payments of interest, dividends and royalties paid by Ukrainian taxpayers to non-residents of Ukraine. Currently, to enjoy tax treaty benefits, an eligible foreign income recipient must be both:

- a tax resident in a jurisdiction with which Ukraine has an effective tax treaty, and
- the beneficial owner of the Ukrainian-sourced income.

The tax authorities are actively applying the beneficial ownership concept to deny tax treaty benefits in the context of cross-border intellectual property (IP) sublicensing or subleasing structures, and financing arrangements where a foreign recipient of Ukraine-sourced income is viewed by the Ukrainian tax authorities as a financial intermediary.

As the beneficial ownership requirement is now part of the domestic taxation system, the Ukrainian tax authorities actively apply the beneficial ownership concept even where the relevant tax treaty does not include this special anti-avoidance rule.

Asset purchase or share purchase

Generally, an acquisition of a business can be structured by means of purchasing equity in, or assets of, a selected business or by means of business combination (reorganization). Acquisitions of shares or business assets are the most common forms of purchasing business in Ukraine.

There are many fundamental tax and legal differences between these two options. In practice, the choice between the asset and share deal depends on the findings of the due diligence assignment, pricing parameters, negotiations between the parties, timing, tax and legal considerations pertaining to each structuring alternative and other important factors.

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Both share and asset deals can involve significant costs associated with financing, documenting and implementing the acquisition.

Generally, sellers usually prefer to sell shares while buyers usually prefer to acquire assets.

Asset deals tend to be more time-consuming and expensive than share deals as there are needs, for example, to assign or renegotiate contracts, transfer employees, re-register legal title in land, real estate and certain other assets, and receive new licenses and permits. For regulated businesses (e.g. banking, insurance and telecommunications), an asset deal may not be feasible due to difficulties in obtaining the relevant license for a new entity.

Certain licenses and permits are not available to foreign companies or their branches in Ukraine. There could also be legal restrictions for foreign persons to directly own (control) Ukrainian businesses that are engaged in certain businesses or to own certain assets (e.g. land). Overall, share deals cause less disruption to the business as the target business typically continues to operate as it did before the acquisition.

Due to the specifics of the local tax and legal environment, share deals are more common in Ukraine. It is also typical for the Ukrainian M&A market to structure the acquisition of a Ukrainian business indirectly by means of purchasing shares in foreign holding companies that own the shares in the Ukrainian business. However, such approach causes foreign investors to perform due diligence of both a Ukrainian operating business and a foreign holding vehicle, which increases the acquisition costs.

The following sections discuss in greater detail the salient tax implications of purchasing shares in or assets of a Ukrainian business. The key advantages and disadvantages of asset and share deals are summarized at the end of this report.

Purchase of assets

A purchase of assets generally results in an increase to the fair market value in the cost base of the acquired business assets for both accounting and tax purposes. This tax treatment is favorable for the purchaser but affects the seller because the seller is subject to tax on income derived or capital gains (recapture of tax depreciation) realized on the disposition of assets. Most asset sales also trigger VAT at a rate of 20 percent, which is an important consideration for the purchaser.

In most cases, asset deals prevent the purchaser from assuming the inherent tax liabilities, tax losses and/or tax attributes associated with the assets of the selling business.

Ukrainian business assets are typically purchased by a special-purpose Ukrainian company that is specifically set up by the purchaser to accommodate the transaction. In theory, a foreign company also can purchase most assets, either directly or through a branch in Ukraine. In practice, these situations are rare, and there could be regulatory or other restrictions in terms of carrying on certain business activities or owning certain assets by foreign companies or their Ukrainian branches. Among other things, the Ukrainian tax authorities' view is that a foreign company that owns Ukrainian real estate should register a Ukrainian branch (permanent establishment) for purposes of renting this real estate.

In kind contributions to the share capital of Ukrainian companies are possible and can bring additional fiscal benefits in terms of deferral of or exemption from customs duties on importing assets (e.g. machinery and equipment) to Ukraine.

Purchase price

The seller and purchaser are free to negotiate the asset purchase price and to reasonably allocate the agreed price between the specific business assets.

Consideration should be given to signing two or more asset purchase agreements to separate supplies of business assets that are subject to VAT from supplies that are not. The same approach applies to purchases of assets that are subject to a notary deed, and, as a result, give rise to a state duty or notary fee.

After the enactment of comprehensive transfer pricing rules, the tax authorities can challenge and adjust the negotiated purchase price in the context of controlled (primarily cross-border) transactions.

Unlike many other jurisdictions where transfer pricing rules apply to controlled transactions between the related persons only, the Ukrainian transfer pricing rules also apply to transactions of Ukrainian resident companies with unrelated persons that are resident in the prescribed low-tax jurisdictions (see also the section on transfer pricing later in this report).

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Goodwill

The Tax Code defines goodwill as an intangible asset, the value of which is equal to the difference between the fair market value and balance sheet value of assets acquired as part of the purchase of a business as a going concern (so-called 'property complex'). Goodwill cannot be deducted or capitalized and amortized for corporate income tax purposes.

For statutory accounting purposes, positive goodwill should be allocated between the groups of assets that generate cash flows. Negative goodwill represents income.

Depreciation

With the exception of land and natural resources, the cost of other fixed assets used in business activities is capitalized and depreciated for corporate income tax purposes. In certain instances, businesses are required to capitalize interest expenses for both accounting and tax purposes.

A fixed asset with a cost exceeding UAH6,000 (approximately USD230) and useful economic life exceeding 1 year is allocated to one of 16 classes of fixed assets.

In many aspects, the computation of tax depreciation and amortization is aligned with the computation of accounting depreciation and amortization. Specifically, businesses can determine the period of useful economic life of fixed assets in their internal accounting policies, provided this period is not less than the minimum period prescribed in the Tax Code.

The minimum statutory periods vary from 2 years (for computers and similar electronic devices) to 20 years (for real estate).

A business can also apply an accounting method (except the production method) for tax depreciation purposes.

The cost of land and natural resources is added to classes 1 and 13, respectively, but cannot be depreciated.

The costs of repairing and enhancing of fixed assets (including leasehold) are usually capitalized and depreciated in accordance to the accounting principles.

Except for goodwill, intangible assets are allocated to one of six classes and are amortized over the period of their useful economic lifetime. The latter period cannot be less than the minimum period prescribed by the Tax Code and usually ranges from 2 years (for copyright and related rights) to 5 years (for patents and knowhow, etc.).

The minimum period of useful economic life is not prescribed for many types of intangible assets and is determined with reference to the relevant legal documents. If the legal documents are silent on such period, it shall be determined by the taxpayer, but it cannot be less than 2 years and more than 10 years.

Tax attributes

Tax losses, VAT receivables (credits/refunds) and other tax attributes are not transferred to the purchaser during an asset deal. Tax losses and attributes remain with the seller, which can generally use them to shelter the taxable income, gains and VAT liabilities that can arise on the disposition of assets.

Value added tax

No VAT exemption is available for a sale of a business as a going concern. As a result, a sale of business assets by a registered VAT payer is a supply of goods for VAT purposes. Supplies of goods are usually subject to VAT at a rate of 20 percent, unless the supply is VAT-exempt (e.g. supplies of securities, including shares, and equity interests).

In practice, foreign investors often set up a special-purpose Ukrainian company that purchases business assets from an operating Ukrainian business. The Tax Code provides a simplified procedure for applying for a VAT account number. Failure to obtain a VAT number before the asset transfer would prevent the newly created company from claiming a credit (refund) of VAT paid in connection with the asset purchase.

The amount of VAT that a purchaser incurs on local acquisitions of assets can usually be credited against the VAT liabilities of the purchaser in computing the final VAT payable to (or refundable from) the budget, provided the purchaser is registered as a VAT payer before the asset purchase. The input VAT in excess of the VAT liabilities may be used to offset VAT liabilities in subsequent tax periods, be refunded to the purchaser or credited against other taxes payable to the state budget.

Transfer taxes

There is no stamp duty, real estate transfer tax or similar transfer tax in Ukraine. However, the transfer of title in certain assets (i.e. land, real estate, vehicles, etc.) is usually subject to a notary deed and/or state registration. Notary deeds give rise to a state duty administered by public notaries or a notary fee administered by private notaries.

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A notary fee cannot be less than the state duty. The state duty rates depend on the type of arrangement (or deed) and are usually calculated as a percentage of the deed (transaction) value.

Specifically, the transfer of legal title in land and real estate is subject to a state duty of 1 percent of the purchase price.

In addition to the state duty, the purchaser may be required to pay the 1 percent pension fund duty on purchases of real estate. A pension fund duty of 3 to 5 percent of the vehicle's value applies to the purchases of vehicles that are subject to their first registration with the State Traffic Patrol Department in Ukraine (i.e. either new or imported vehicles).

Purchase of shares

Most business acquisitions in Ukraine are structured as share deals. High-profile acquisitions of Ukrainian businesses are usually structured by means of purchasing shares in a foreign holding company that owns shares or equity interests in Ukrainian companies. Traditionally, English law has governed most share purchase agreements involving foreign investors.

In a share deal, the purchaser of shares cannot pick and choose which assets of the target business to purchase, unless preliminary restructuring has been implemented to spin-off or dispose of unwanted assets before the contemplated share deal.

A share deal does not enable the purchaser to increase the tax base of the assets of the purchased Ukrainian business.

The purchaser can potentially benefit from available tax losscarry forwards of the acquired Ukrainian company (either directly or indirectly by merging the purchased Ukrainian company with a profitable Ukrainian group company). In Ukraine, there are no limitations that prevent the purchased company from utilizing tax loss carry forwards following a change of control. However, there are restrictions on tax losses carried forward in corporate reorganizations.

By acquiring shares in the target company, the purchaser effectively assumes inherent tax and other risks of the purchased company. To understand the tax position of the target business and the nature and quantum of the potential tax exposures, it has become a good business practice for purchasers to initiate pre-acquisition tax due diligence of the target Ukrainian business. Among other things, the tax findings help the purchaser decide whether a share deal is viable and whether the identified tax exposures are tolerable and/or manageable.

Prospective purchasers often use the following approaches to mitigate or manage the pre-acquisition tax exposures of the target companies:

— negotiating adjustments to the purchase price to factor in the identified tax exposures

— deferring the payment of the purchase price (either wholly or partially) or making such payment conditional on satisfaction of certain requirements

— incorporating protective provisions (so-called tax warranties and indemnities) in the share-purchase agreement.

The following sections discuss in more detail these and other important tax-related issues that sellers or buyers typically consider in the context of share deals.

Tax indemnities and warranties

As discussed earlier, a purchaser inherits historical tax liabilities and potential tax penalties of the target business. Thus, it has become a normal business practice for purchasers to require sellers to provide warranties on important tax matters and to indemnify any tax liabilities and penalties attributable to a period before closing.

Tax warranties and indemnities are usually extended to all businesses that are included in the deal perimeter. The specifics of indemnity coverage are an important aspect of negotiations between sellers and buyers of Ukrainian businesses.

Tax losses

Generally, Ukrainian companies can carry forward business losses and capital losses (i.e. losses realized on transactions with securities) indefinitely. However, from time to time, the Parliament restricts the utilization of tax losses carried forward.

Specifically, all unutilized business tax losses that arose in 2011 or prior years are divided in four equal parts, and each part could be utilized in 2012 through 2015 pursuant to a special procedure. Unutilized business tax losses can be utilized in 2016 and later years without restriction.

There are no restrictions on the carry forward and deductibility of business tax losses arising in 2012 or subsequent taxation years.

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No carry back of business or capital tax losses is allowed. Neither the change of control nor the related-party nature of the share deal affects a business's ability to carry over and utilize accumulated tax losses in subsequent tax periods.

The specifics of tax loss carry forwards in the context of reorganization transactions are outlined later in this report.

Corporate income tax

Capital gains realized by Ukrainian companies on the disposition of equity interests, other than securities, are subject to corporate income tax at a rate of 18 percent as part of regular (business) income.

No participation exemption applies to capital gains. There are special tax rules for calculating and accounting for capital gains or losses on transactions with securities.

Capital gains realized by non-residents of Ukraine on the disposition of Ukrainian shares or equity interests are technically subject to withholding tax (WHT) at a rate of 15 percent. This WHT can be fully eliminated or partially mitigated under a tax treaty.

Value added tax

In Ukraine, acquisitions of shares or equity interests are not subject to VAT. Generally, share-for-share exchanges and similar transactions with shares (equity interests) are also not subject to VAT.

Transfer taxes

There is neither a stamp duty nor a similar transfer tax applicable to transfers of Ukrainian shares or equity interests. Also, there are no capital or similar taxes applicable to or computed with reference to capital in general or share capital (increase in share capital) in particular.

A nominal registration charge applies for registering amendments to the corporate charter in connection with the change in ownership of equity interests. A state duty of 0.1 percent of the nominal value of shares issued (but not more than 50 minimum monthly salaries, which is about USD2,700 in 2016) applies to each issuance of securities (including shares and bonds).

Crystallization of tax charges

The general tax statute of limitations is 3 years (1,095 days) following either the deadline for filing the relevant tax return or the return's actual date of filing, whichever date is later. For transfer pricing assessments, the statute of limitations is 7 years (2,555 days).

The tax statute of limitations does not apply where:

— a company official is found guilty of tax evasion or criminal prosecution is terminated based on 'non-rehabilitation' grounds, or

— a return for a particular period is not filed.

Generally, tax underpayments identified after the tax statute of limitations has elapsed can no longer be enforced. Similarly, tax refunds can only be claimed within 3 years following the date of tax overpayment or tax refund entitlement.

Tax returns cannot be amended beyond the tax statute of limitations. Also, amending a filed tax return re-opens the statute of limitations in respect of such tax return.

Tax clearance

No tax clearance (either advance or after-the-fact) is required from the tax authorities for a direct or indirect change in ownership of a Ukrainian business. However, the tax authorities can audit Ukrainian companies prior to a corporate reorganization.

In practice, purchasers often require sellers to provide recent tax reconciliation statements or similar tax documents on the tax position of the target business. Such documents are issued by the tax authorities to notify businesses of the status of tax payments, refunds and indebtedness as per the records of the tax authorities. Some sellers manage to obtain such tax documents on or immediately before closing the share deal.

Note that these tax documents may not represent the actual status of tax payments, refunds and indebtedness. Thus, purchasers cannot rely on them as evidence that the target business does not have any outstanding tax liabilities. Also, such tax documents cannot substitute tax due diligence of the target business. Subsequent tax audits can reveal additional tax liabilities and trigger additional tax arrears interest and penalties that are not reflected in the tax reconciliation statements.

Choice of acquisition vehicle

Foreign investors can acquire Ukrainian businesses either directly or indirectly using one of the acquisition vehicles discussed below. Tax, legal and regulatory considerations typically affect the choice of acquisition vehicle.

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Local holding company

Foreign investors often set up a Ukrainian acquisition company for the purposes of acquiring Ukrainian business assets.

For share deals, the use of a local holding company could be beneficial for purposes of implementing the debt pushdown structure, unless certain fiscal and corporate considerations make a debt pushdown structure unviable. A local acquisition company (LLC) is usually chosen for share deals where a two-tier Ukrainian structure is required due to regulatory or other legal restrictions on direct ownership of Ukrainian assets or businesses by foreign investors.

Foreign parent company

Strategic investors often opt to invest in or acquire the Ukrainian shares, either directly or through regional acquisition vehicles. This can also be the case where a tax-efficient structure is already in place (i.e. where a Ukrainian business is acquired by the foreign parent company indirectly by means of purchasing the foreign holding company that owns the Ukrainian business).

Also, the Ukrainian privatization requirements can leave strategic foreign investors no option but to acquire the Ukrainian business directly rather than through a special-purpose vehicle set up, say, in a tax haven jurisdiction.

Non-resident intermediate holding company

Foreign intermediate holding companies are common acquisition vehicles for share deals, especially where the Ukrainian shares are purchased directly. The choice of an intermediate holding company is primarily driven by the tax considerations to locate an acquisition vehicle in a jurisdiction that has a favorable tax treaty with Ukraine.

Ukraine has a broad network of tax treaties. Many of them exempt capital gains realized by foreign companies on dispositions of shares from taxation in Ukraine, provided the shares' value is not primarily derived from real property located in Ukraine. Tax treaties often exempt dividends, interest and royalties from Ukrainian income taxation or provide for beneficial WHT rates.

Although the use of an intermediate company in a treaty country can be fiscally beneficial, consideration should be given to treaty shopping and limitation of benefits provisions in tax treaties, and to the beneficial ownership requirement of the domestic taxation system.

Local branch

A local representative office (or branch) of a foreign company is subject to state and tax registration in Ukraine and is not commonly used for acquiring Ukrainian business assets or shares. The tax status of a local representative office depends on whether or not its activities give rise to a permanent establishment of the foreign company in Ukraine. Generally, taxation of a permanent establishment is similar to taxation of a regular Ukrainian company.

The key tax benefits of using a local branch are the absence of a branch tax and, in certain instances, advance corporate income tax on distribution of Ukrainian after-tax earnings. Ukrainian WHT may not apply to distributions of after-tax earnings based on a non-discrimination clause of the relevant tax treaty. But most of these tax benefits are of limited use as it is also possible to achieve nil WHT on distribution of Ukrainian dividends under certain tax treaties. Certain tax and regulatory considerations can make a local branch less attractive than a regular Ukrainian company.

A local branch can be a feasible solution where a foreign investor decides to purchase Ukrainian real estate directly and then rent it to Ukrainian and foreign lessees.

Joint venture

Where a foreign investor decides to invest in Ukraine together with Ukrainian and/or foreign business partners, such investments can be structured through a Ukrainian-incorporated vehicle or a contractual joint venture arrangement.

A Ukrainian LLC or, to a lesser extent, a joint stock company (JSC) is often chosen by foreign investors to incorporate a joint venture in Ukraine. The tax treatment and status of an incorporated joint venture is no different than that of a regular Ukrainian company.

A foreign investor can set up a contractual joint venture with a local partner by executing a joint venture agreement (formally referred to as 'a joint activity agreement', which can usually take the form of a classic joint venture agreement or a production sharing agreement).

A classic joint activity agreement should designate a partner (member) that is responsible for maintaining accounting records, filing tax returns (where required) and paying taxes for and on behalf of the joint venture, if any. All joint activity agreements must be registered with the tax authorities.

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The designated partner (member) is responsible for maintaining financial and, where applicable, tax records of the joint venture. Even though joint venture arrangements are registered for tax purposes, such arrangements are not payers of corporate income tax. Therefore, the members of the joint venture arrangement include in their corporate income tax returns the relevant share of the joint venture's profit or loss that is computed by the designated partner (member).

Taxation of joint venture activities is not adequately addressed in the Tax Code, and the relevant tax rules lack detail and clarity. In practice, foreign investors rarely use joint venture agreements to invest or do business in Ukraine. The use of a contractual joint venture is predominately limited to energy (oil and gas) and infrastructure projects (including private-public partnership projects).

Choice of acquisition funding

A Ukrainian acquisition vehicle usually can be financed by means of debt, equity or, in theory, a hybrid instrument that has attributes of both. Non-monetary acquisitions (including share-for-share exchanges) are rare in Ukraine.

Debt

Debt financing is more tax-efficient than equity financing as debt financing enables the borrower to deduct interest expense against taxable earnings and thus reduce corporate income tax payable.

In practice, Ukrainian acquisition vehicles often do not have sufficient earnings against which the interest on loans can be deducted. In many jurisdictions, various debt pushdown strategies are used to match business earnings of the purchased operating business with interest expense of the local acquisition vehicle. As of 2015, debt pushdown strategies are also viable in Ukraine.

Debt financing of Ukrainian businesses is usually structured through interest-bearing or interest-free loans. Foreign exchange gains or losses that arise on such loans and accrued interest are usually taxable or tax-deductible, as the case may be, for corporate income tax purposes.

Subject to the thin capitalization requirements discussed later in this report, accrued interest expense is usually deductible for corporate income tax purposes.

Interest-free loans do not give rise to imputed interest in the hands of Ukrainian borrowers. However, imputed interest, transfer pricing adjustments and/or other negative tax implications could arise in a jurisdiction of a foreign lender of an interest-free loan.

Deductibility of interest

Generally, accrued interest expense is tax-deductible where interest is deductible for accounting purposes and Ukraine's thin capitalization requirements are met.

If loans from related non-resident lenders exceed the net equity of the Ukrainian borrower by 3.5 times, the Ukrainian borrower could claim a tax deduction in respect of the accrued interest only to the extent this interest does not exceed 50 percent of the Ukrainian borrower's earnings before interest, taxes, depreciation and amortization (EBITDA). For financial institutions and leasing companies, the debt-to-net equity ratio is 10:1.

If the thin capitalization rule applies, then all interest payable to both the related foreign lenders and unrelated Ukrainian lenders (e.g., banks) would be subject to the tax limitation referred to above.

Interest expenses that are not tax-deductible in a taxation year due to the thin capitalization rule are carried forward indefinitely and could be deductible in a future taxation year in which the thin capitalization requirements are met. The interest carry forward amount is depreciated by 5 percent on an annual basis so that only 95 percent of the carried forward amount would be tax-deductible in the next taxation year.

Withholding tax on debt and methods to reduce or eliminate it

Interest payments to non-resident lenders are subject to WHT at a general rate of 15 percent. However, such WHT can be mitigated or eliminated where the foreign lender is a tax resident in a jurisdiction with which Ukraine has an effective tax treaty and the foreign entity is the beneficial owner of the Ukrainian-sourced interest. A valid tax residency certificate of the foreign lender is usually required to enable the Ukrainian borrower to access preferential treaty WHT rates.

Where an intermediary financing vehicle is used, consideration should be given to the beneficial ownership requirements.

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Checklist for debt funding

Loans from non-residents of Ukraine must be formally registered with the National Bank of Ukraine before Ukrainian corporate borrowers can actually receive the borrowed funds.

The currency control regulations establish certain limits (thresholds) on such borrowings. These limits depend on the type of currency and loan maturity. Currently, the maximum allowed interest rates for borrowings in first-class hard currencies (including commission fees and financial penalties) are as follows:

— short-term foreign loans (with maturity of less than 1 year) — maximum 9.8 percent

— mid-term foreign loans (with maturity from 1 to 3 years) — maximum 10 percent

— long-term foreign loans (with maturity exceeding 3 years) — maximum 11 percent.

Consideration should be given to the reduction of the 15 percent WHT rate under a relevant double tax treaty.

Significant devaluation of the Ukrainian currency (hryvnia) relative to major foreign currencies prompted the National Bank of Ukraine to introduce a number of painful currency control restrictions and limitations. In particular, subject to certain exceptions, Ukrainian companies could not repay the cross-border loans before their maturity dates or expedite the interest payments.

Equity

An acquisition of a Ukrainian business can also be financed by means of equity. Equity financing usually takes the form of cash or in kind contributions. Where a local company has retained earnings, the share capital can be increased by means of a stock dividend. Foreign shareholders can register their capital contributions to share capital of Ukrainian subsidiaries as foreign investments to enhance state protection of investments, the ability to return investments and earned income. The state registration of foreign investments is also required to claim customs incentives in connection with in kind contributions.

All capital contributions to the registered share capital are exempt from corporate income tax. A share premium (i.e. capital contribution exceeding nominal registered share capital) should also be exempt from corporate income tax.

Dividend payments are not tax-deductible. Return of equity is exempt from corporate income tax and is not tax-deductible.

Foreign exchange gains or losses that can arise in connection with equity financing are neither taxable nor tax-deductible for corporate income tax purposes.

Capital contributions in cash can be transferred either directly from a foreign bank account of the foreign shareholder or through a local currency investment account that a foreign shareholder can open in a Ukrainian bank.

In kind contributions are usually subject to VAT at a rate of 20 percent, unless the supplies of contributed assets are specifically exempt from VAT. The import VAT is usually paid by the Ukrainian company on the customs clearance of contributed assets and can be claimed by the Ukrainian company as a VAT credit in the same taxation period (month).

The tax cost of contributed assets can be depreciated (amortized) or deducted, as the case may be, for corporate income tax purposes.

Foreign investors can also benefit from a customs incentive available for in kind contributions of assets (typically, machinery and equipment). Specifically, no customs duties apply to the importation of assets that are contributed to the share capital of a Ukrainian business. The business must own the contributed assets for the following 3 consecutive years; otherwise, the unpaid customs duties become due.

Dividends paid to foreign shareholders are subject to the 15 percent WHT unless this tax is fully or partially eliminated under a tax treaty. Consideration should be given to the beneficial ownership requirement that is now part of the Tax Code, which can prevent a foreign shareholder from enjoying preferential WHT rates for dividends.

Due to the significant devaluation of the Ukrainian currency (UAH) relative to major foreign currencies, the National Bank of Ukraine has banned payments of dividends to foreign shareholders, payments of the share sale price to foreign sellers of shares (membership interests) and returns of capital to foreign shareholders. Even though this is a temporary ban that was introduced to prevent (minimize) the outflow of capital from Ukraine and stabilize the foreign currency market, it is not clear when this temporary ban would be lifted.

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In certain instances, Ukrainian companies are required to accrue and remit to the budget an advance corporate income tax at a rate of 18 percent before distributing dividends. In particular, this advance income tax could be paid in situations when the accounting profit distributable as dividends for a particular year exceeds the taxable income (profit) declared by the dividend payer for the same year. The paid tax can be credited against the corporate income tax liabilities of the Ukrainian dividend distributor.

Tax–free reorganizations

Corporate reorganizations can take various legal forms, namely, a merger, acquisition (takeover), split-up, spin-off or transformation of a corporate body. Reorganization is usually initiated by a resolution of the general shareholders' meeting. However, in certain instances (e.g. where a company is abusing its dominating position on the market), the Antimonopoly Committee of Ukraine may force the company to split up.

In practice, corporate reorganizations are performed on a tax-deferred basis, even though the Tax Code is mute on the corporate income tax implications for the companies involved and their shareholders. To be on a safe side, the companies usually apply for and obtain private tax rulings to confirm the tax-neutral treatment of corporate reorganizations from a corporate income tax perspective.

Corporate reorganizations are specifically exempt from VAT. As a result, a transfer of assets from a reorganized business to a successor company as part of a corporate reorganization should be exempt from VAT.

Tangible and intangible assets are usually recorded in the balance sheet of the successor company using the book values of the predecessor company.

Special rules apply on allocating and/or settling tax liabilities and/or overpayments (refunds) of reorganized companies. Consideration should be given to the VAT position of reorganized businesses. The tax authorities' view is that VAT credits (receivables) of the predecessor companies cannot be transferred to successor companies in the course of corporate reorganization (except for corporate transformation). The authorities claim that such VAT credits (receivables) can only be claimed and utilized by the predecessor company.

Given that the Tax Code is mute on the corporate income tax implications of corporate reorganizations, the Ukrainian tax authorities are of the view that a surviving company cannot report and utilize business and capital losses of a predecessor company that is terminated in the course of a corporate reorganization.

Hybrids

The recent tax changes have effectively aligned the accounting and tax treatment of a transaction or instrument. Also, the tax definition of 'interest' and registration requirements for foreign loans make it difficult to successfully implement tax planning strategies that involve profit-sharing loans. A distribution of retained earnings is treated as a dividend payment, and the nature of such payment usually remains the same regardless of the type of the share (common or preferred) on which it is paid.

Even though preferred stock dividends paid to individuals are deemed to be salaries for tax purposes, it is doubtful that the tax authorities would allow a tax deduction in respect of such dividend payments as there is no clear rule in the Tax Code that would allow such tax deduction.

In general terms, an interest payment on a loan or other debt obligation is treated as interest for tax purposes as long as it is treated as such for accounting purposes.

Discounted securities

A discount on any kind of debenture or other security is effectively treated and taxed as interest. Thus, income derived by a non-resident of Ukraine in the form of a discount on transactions with securities should be subject to the 15 percent WHT unless this tax is eliminated or mitigated under a tax treaty.

Deferred settlement

An acquisition of a business often involves an earn-out mechanism or other form of deferred settlements where a portion of consideration can be determined and/or paid only at some point in the future. No specific tax rules address the tax treatment of deferred consideration in the context of acquisition transactions. The actual tax consequences usually depend on the specifics of the agreed price determination and the timing and payment mechanisms outlined in the share-purchase agreement, and they would usually be aligned with the accounting treatment.

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Other considerations

Concerns of the seller

The tax consequences for the seller largely depend on the seller's residency status, form of the transaction (i.e. asset or share deal), specifics of the price arrangement and certain other important factors.

Sale of assets

The seller would be primarily concerned with the possible income tax implications of the sale of assets, namely, recapture of tax depreciation where depreciable assets are sold and taxation of realized gains (income) on the disposition of other assets. Available business and/or capital losses can help to decrease the income tax liabilities.

The purchaser usually pays the VAT, pension tax and various state duties that can potentially apply to sales of assets. As a result, these taxes should not pose a concern for the seller.

The seller should also plan what to do and/or how to extract proceeds of disposition tax-efficiently. This is very important for Ukrainian sellers, especially in the context of the legislative ban on dividend payments, returns of capital and premature repayments of loans and interest.

Sale of shares

The seller should primarily be concerned with the Ukrainian income tax and WHT implications of selling the shares or equity interests in Ukrainian companies, as discussed earlier. Because sales of shares and equity interests are not subject to VAT, this tax should not be a concern for the seller.

The seller can consider whether it would be tax-efficient to sell a Ukrainian business directly or indirectly (i.e. at the level of the foreign holding company). An indirect sale often helps defer taxation of the realized capital gain unless and until the relevant proceeds are distributed to the ultimate beneficiary by the foreign holding company.

The seller should also pay attention to available tax shields (i.e., tax losses or attributes) that can be used to decrease the tax liabilities. A possibility to structure a disposition of the shares on a tax-deferred rollover basis can also be explored.

Company law and accounting

In Ukraine, common corporate forms are LLCs and JSCs. Unlike an LLC, a JSC is entitled to issue shares, which are subject to registration with the State Securities and Exchange Commission.

Similarly to a JSC, the liability of an LLC's shareholders (participants) is limited to their investment in the share capital. Requirements for the incorporation and operation of an LLC are simpler and more straightforward than those prescribed for a JSC.

A Ukrainian company (LLC or JSC) should be registered with the state registrar, tax, pension (social security) and statistical authorities.

Currently, there is no minimum share capital requirement for an LLC. But if founders decide to make capital contributions and register share capital of an LLC, they should contribute 100 percent of the declared share capital in cash or in kind within 1 year from the date of LLC's incorporation.

The minimum share capital of a JSC is set at 1,250 minimum monthly salaries as set by the state as of 1 January of each year (for 2016, this amount approximates USD67,000). Shareholders of a JSC shall pay their shares in full before the company's state registration.

An LLC shareholder (participant) may alienate its equity interest in the LLC's capital to a third party, unless otherwise provided in the LLC's charter. In this case, other LLC participants are entitled to receive the first offer to purchase its share (equity interest).

Shareholders of a public JSC may sell their shares without any restrictions or commitments to other shareholders. Shareholders of a private JSC, however, may sell their shares subject to the right of first refusal granted to other shareholders.

The Ukrainian laws provide for other legal forms of doing business in Ukraine, including representative offices (branches) and joint activity agreements. However, these structures are rarely used to acquire a Ukrainian business.

Under Ukrainian law, International Financial Reporting Standards (IFRS) is compulsory for banks, insurance companies, other financial institutions and public JSCs. Other companies can choose to apply IFRS reporting.

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Group relief/consolidation

There is no tax consolidation in Ukraine, and each legal entity is taxed on a standalone basis.

Transfer pricing

In 2015, the transfer pricing rules were revised and amended.

Pursuant to the new rules, transactions are deemed to be controlled where the annual transaction volume (excluding VAT) between the two parties exceeds UAH5 million (approximately USD193 thousand) and the annual revenues of the taxpayer exceed UAH50 million (approximately USD1.9 million).

Transactions between the related resident companies do not fall within the ambit of controlled transactions.

The controlled transactions of a Ukrainian company encompass its transactions with the following persons, where the annual transaction volume (excluding VAT) of such transactions exceeds UAH5 million (approximately USD193 thousand):

— a related non-resident person

— an unrelated person resident in a prescribed low-tax jurisdictions.

For purposes of determining whether or not two persons are related, a person is deemed to exercise control over the taxpayer if they hold, directly or indirectly, at least 20 percent of the corporate rights of the taxpayer or 20 percent of the voting rights. For an individual, the total holding is determined as the total sum of the corporate rights that belong to the individual or their family members and the legal entities controlled by the individual or family members.

Controlled transactions should be reported by 1 May of the year following the reporting year.

There are significant penalties for failure to report or incomplete reporting of controlled transactions before the reporting deadline.

Dual residency

Ukrainian companies do not use intentional dual residency. Under Ukrainian tax laws, the place of incorporation (state registration) determines a company's tax residency. However, where management of a foreign company is located in Ukraine, this could give rise to a permanent establishment of the foreign company in Ukraine.

Foreign investments of a local target company

In Ukraine, there is no anti-avoidance legislation (controlled foreign company rules) with respect to controlled foreign affiliates of Ukrainian companies. As a result, income earned by foreign affiliates of Ukrainian companies is not subject to income taxation in Ukraine unless and until this income is actually distributed as dividends to the Ukrainian parent company. However, informational tax returns (forms) are still filed by parent Ukrainian companies in respect of their foreign affiliates.

Special tax rules and restrictions can apply to transactions of Ukrainian resident companies with foreign businesses that are located or have bank accounts in tax haven jurisdictions. The Ukrainian government periodically updates the official list of such tax haven jurisdictions.

Comparison of asset and share purchases

Advantages of asset purchases

— Possible to choose the required assets or acquire only part of the business.

— Purchaser does not usually assume tax liabilities and tax exposures of the target business.

— A loss-generating entity can acquire profit-generating assets to utilize tax losses.

— Possible to achieve a step-up in assets' cost bases for accounting and tax purposes.

— A portion of the purchase price can be depreciated or amortized for tax purposes.

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Disadvantages of asset purchases

- Asset deals are usually more time-consuming and expensive to implement.
- Asset sales may be taxable and less attractive to the seller, increasing the purchase price.
- VAT, state duty and pension charges may be payable, increasing the purchaser's costs.
- Tax losses remain with the seller, so the purchaser does not benefit from them.
- Acquisition of collateral assets can pose a problem.
- Transfer of licenses and permits to the purchaser is usually not possible.
- Deferred customs duties can be due on the sale of certain imported assets.

Advantages of share purchases

- Capital gains realized by foreign shareholders can be exempt from taxation or taxed at preferential tax rates.
- Share deals can be exempt from income taxation in Ukraine (e.g. where the Ukrainian shares are owned by non-residents of Ukraine).
- Share deals are exempt from VAT and not subject to other material taxes in Ukraine.
- Transfer of licenses and permits to the purchaser is usually possible.
- Often more attractive to sellers, so the purchase price may be lower.
- Purchaser can benefit from available tax loss carry forwards of the acquired business.
- Less disruptive for the acquired business.
- **Disadvantages of share purchases**
- Purchaser is liable for any claims and liabilities of the acquired company.
- Difficult to implement where there are numerous minority shareholders.
- Purchaser is often not able to deduct the purchase price until the acquired shares are subsequently disposed of.
- Capital gains realized by Ukrainian companies are subject to income taxation.

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