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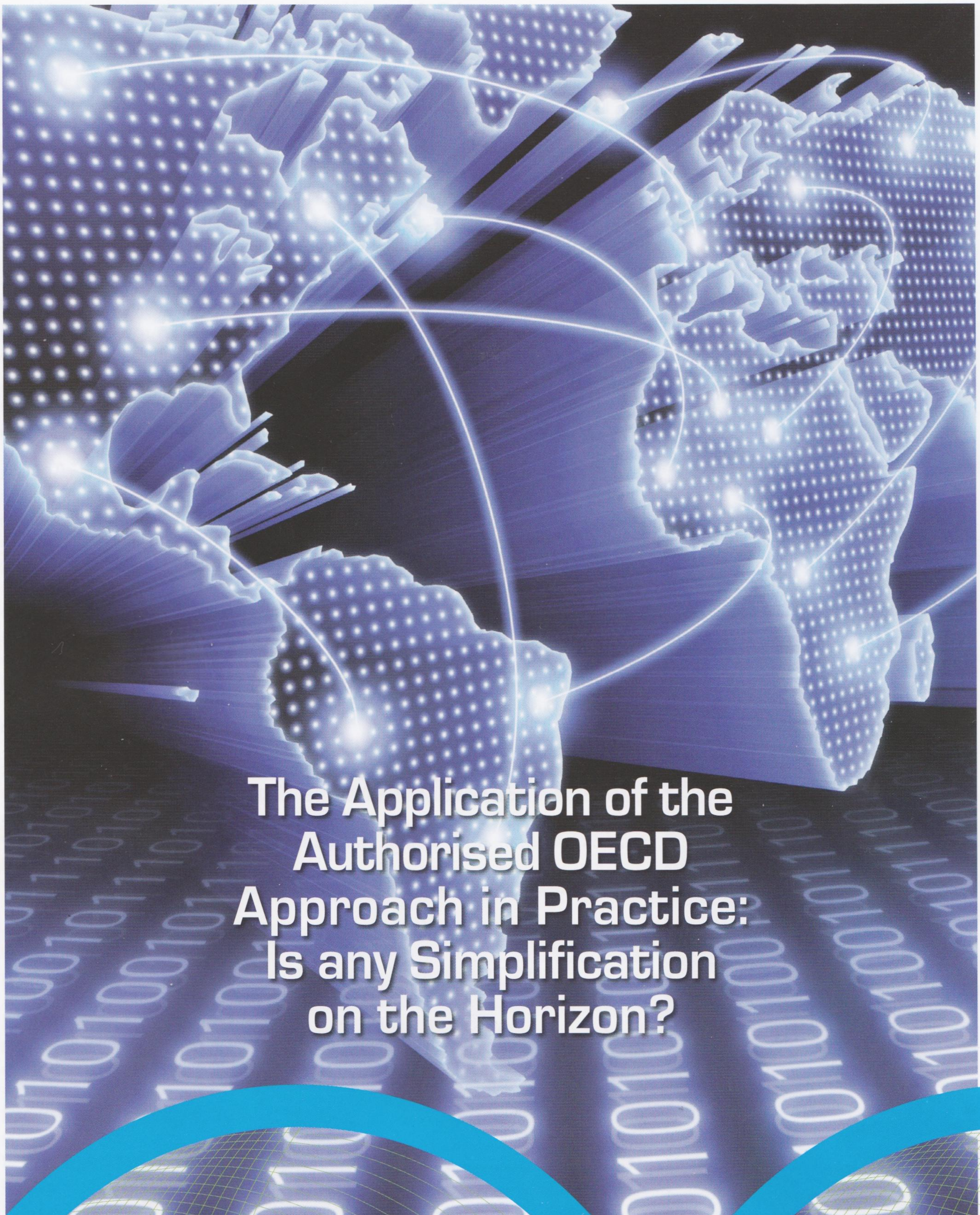

The Application of the Authorised OECD Approach in Practice: Is any Simplification on the Horizon?

Ukraine

UKRAINE IN LINE WITH AUTHORISED OECD APPROACH?

CHANGE OF LEGISLATION

The tax laws of Ukraine were reshaped entirely by the introduction of the new Tax Code at the beginning of 2011.

One noticeable change is the extension of the domestic definition of a PE to include the service PE, which may be created if a non-resident's personnel render services in the Ukraine, including consulting services, to a Ukrainian customer. The Tax Code also now sets the time frame for the provision of such service activities (6 months in any 12-month period), above which the PE is recognised.

The new Tax Code does not provide for general priority of the tax treaties of Ukraine in respect of domestic tax law provisions (where such provision was available in the tax law). Under the Constitution, such treaties duly ratified by Ukraine shall be a part of the national law. However, no practical change in implementation is observed.

GENERAL RECOGNITION OF AUTHORISED OECD APPROACH

The new Tax Code continues to formally acknowledge the authorised OECD approach (AOA) as it did with the preceding tax law. The Tax Code stipulates that principally a PE shall be treated as a separate taxpayer, i.e. as if it were a separate and distinct enterprise involved in that activity.

ISSUES OF IMPLEMENTATION OF AOA

Deemed profitability method (tax assessment based on imputed profit)

Practical implementation of the said method may be somewhat difficult. The Tax Code suggests that if it is not possible to do a direct tax assessment, then the taxable profit shall be assessed on the basis of imputed profit calculated on "inflow" and with use of a 30% profitability ratio.

The issue lies with the rate for calculating the deemed profit. The Tax Code (as with the preceding tax legislation) does not provide any flexibility in this respect: the 30% rate is fixed.

Previously some international companies operating in Ukraine have been in discussion with their home tax authorities in respect of this approach, to clarify whether the tax paid using this base figure may be accepted as a tax credit in the home jurisdiction. The answer was normally "no", as the home country business in general has significantly lower profitability (profit ratio in respect of turnover) and thus the above tax assessment would be rather excessive.

To take that view, taxation in Ukraine on the basis of deemed taxable profit calculated as 30% of "inflows" or turnover, could hardly be viewed as being in line with AOA because in the majority of cases it assumes the profits are significantly higher in the relevant industry than the business actually achieves.

The main issue in this respect seems to be such a high preset (30%) profitability ratio. Allowing a flexible ratio in line with respective industry ratios might be more in line with AOA. Yet, the Tax Code of Ukraine does not allow such flexibility at the moment.

What documents are needed for recognition of the expenses incurred abroad in respect of PE

One of the problems that PE are facing while working in Ukraine is the depreciation of fixed assets transferred from the head offices, e.g. heavy equipment provided for temporary use.

Although the tax authorities agree with Article 7 of the Tax Convention providing for deduction of expenses "incurred for the purposes of the PE whether in the state in which the PE is established or elsewhere", the authorities still require that the expense shall be confirmed in line with the requirements existing in Ukraine.

Merely making a statement on the depreciation expense from the home jurisdiction is not accepted because no "standard" documents are seen regarding depreciated equipment, and also because the depreciation may be calculated using different rules from the ones applicable under the tax laws of Ukraine.

As a practical solution in the abovementioned specific case, one approach could be to take the base for depreciation as the value of the equipment declared to the customs when imported on a temporary basis into Ukraine, and to further calculate the depreciation expense on that base under the Ukrainian depreciation schedule. However, there is still a clear difference in the depreciation expense recognised by the company as such and allocated to the PE in internal accounting, and the depreciation expense as calculated for Ukrainian tax purposes.

To sum up the above: While AOA is incorporated into the new Tax Code of Ukraine, technical implementation provisions seem to result in significant deviations from what may be reasonably expected under AOA in specific cases.

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