

Ukraine Ministry of Finance clarifies general tax consultation on deemed dividends

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The Ukraine Ministry of Finance on August 20, through Order 480, approved the general tax consultation covering various practical aspects of the application of new rules on deemed dividends' taxation and made important clarifications regarding the new rules.

Deemed dividends taxation

Law 466-IX of January 16, 2020, which entered into force January 1, 2021, extended the definition of dividends in the tax code of Ukraine. The new definition now covers – in addition to the dividends in their classical sense – income/proceeds which are deemed to be dividends for taxation purposes (deemed dividends). This change is at the core of the new and much-debated set of rules designed to tax non-residents' incomes which are treated as dividends for taxation purposes.

According to the definition (sub-para. 14.1.49 of the tax code), deemed dividends may include any payment by a legal entity to its shareholder or participant in connection with the distribution of its net profit. They also include income in the form of payment for shares (corporate rights in other forms) made in transactions subject to transfer pricing control and for an amount that is not in line with the arm's length principle. They further include the amount of a transfer pricing adjustment in a controlled transaction for purchasing and/or selling of goods (works, services). In addition, deemed dividends include monetary or in-kind payments by a legal entity to its shareholder or participant in connection with a reduction in share capital, buying out of shares by a legal entity, exit of the participant, or other similar operations for the amount that decreases the amount of retained profits.

In the same manner as with dividends to non-residents, according to the tax code deemed dividends are subject to withholding tax at the regular withholding tax rate of 15%, which is remitted to the state budget by the Ukrainian taxpayer making the payment.

According to the general rule, the tax shall be withheld from the amount of income that is paid to the account of the non-resident, which receives the payment. If such income is paid in-kind or the tax is not withheld from the income then the tax is calculated under a specified formula, according to which the tax base is effectively increased by the amount of tax that has not been withheld from the amount of income.

The new rules establish a special deadline for paying the tax on deemed dividends recognized due to a transfer pricing adjustment. Namely, the tax is payable by the deadline for submission of the report on controlled transactions, which is due October 1 of the year following the reporting one.

New guidance

According to the Ministry of Finance, the new rules apply to tax periods starting from January 1, 2021. The controlled transactions, for which a transfer pricing adjustment will result in deemed dividends recognition, will be declared for the first time in transfer pricing reports for 2021. The first deadline for payment of the tax on such deemed dividends distribution falls on September 30, 2022.



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The Ministry of Finance confirmed that double tax treaties will apply to deemed dividends if conditions for treaty relief are met – namely that the non-resident receiving the deemed dividends is the tax resident of a state with an effective double tax treaty concluded with Ukraine, which shall be confirmed by duly issued tax residency certificate. In addition, to ensure eligibility for the double tax treaty benefits, the non-resident must comply with any other conditions established by such treaty, such as legitimate purpose test, minimum investment amount, or beneficiary status.

As to which article of double tax treaties shall apply to deemed dividends, the Ministry of Finance admits the absence of a universal rule. The answer depends on the case and wording of the applicable double tax treaty.

In many cases, the article of a double tax treaty regulating taxation of dividends may be applied. While in other cases, the autonomous definition of dividends in double tax treaties will not cover transfer pricing adjustments on transactions with related parties other than direct owners of the shares in the Ukrainian taxpayer. In the case of types of incomes specifically regulated by double tax treaties, such as interest or royalties, special rules of the double tax treaty will have priority over the rule on dividends.

By applying provisions of applicable double tax treaties, taxpayers may reduce the additional tax liability in Ukraine triggered by new rules on deemed dividend recognition.

In the general tax consultation, the Ministry of Finance provides useful algorithms that may be followed to establish if deemed dividends are eligible for treaty benefits and under what article the relief shall be sought.

In addition, the Ministry of Finance provides illustrative examples of how the new rules may technically be applied in practice. Thus, conduct and tax implications for a Ukrainian taxpayer are different depending on whether the taxpayer manages to withhold the tax from deemed dividends by the deadline or pays the tax on its own account. Another alternative outcome will happen if later the non-resident agrees with the tax withheld and provides compensation.

Cases of transfer pricing adjustments on the sale of goods (works, services) from Ukraine are interpreted by the Ministry of Finance as deemed dividends paid in-kind. And for these cases the special formula shall be applied, effectively increasing the tax base by the amount of the tax which was not withheld. Still, the Ministry of Finance admits that application of the double tax treaty may allow overriding the rule on special tax calculation for “in-kind” deemed dividends provided that the respective article of the treaty limits the maximum tax rate.

The guidance of the Ministry of Finance, in general, creates the impression that the tax on such deemed dividends is not an unconditional liability of the non-resident, which is receiving such an “income”, but at least in some cases Ukrainian taxpayers may agree (or effectively be forced to) pay the tax from their own pocket. And there may be many such cases. For instance, in the case of transfer pricing adjustments happening long after the end of the year, it will hardly be an easy task to convince the non-resident counterparty that it has to pay some additional tax on its last year’s purchases from and/or sales to Ukraine.

Therefore, the designation of this tax in the tax code as “tax on non-resident’s incomes deemed to be dividends” seems to be misleading in terms of the main target of the new tax liability. At least, in the case of controlled transactions, Ukrainian taxpayers are likely to be the ones bearing a significant share of the burden.

Finally, the Ministry of Finance clarifies that control over the payment of tax on deemed dividends in the case of controlled transactions may be exercised only during special transfer pricing audits. And this is not good news for Ukrainian taxpayers as this also means application in such cases of the special extended statute of limitations of seven years.

At the same time, if a taxpayer implements a transfer pricing adjustment on its own but does not apply the new tax, this situation may be the subject of a regular desk (cameral) or documentary tax audit.

To sum up, the comprehensive tax consultation of the Ministry of Finance on deemed dividends is rather useful, as it covers many of the questions that will likely arise in practice. At the same time, the number of pages that the Ministry of Finance needed to outline various algorithms and practical situations with different outcomes offer a glimpse of the perils that the Ukrainian taxpayers will likely encounter when trying to comply with the new rules.

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