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Cross-border outsourcing – issues, strategies and solutions

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Summary and conlcusions

Ukraine is experiencing the fast development of outsourcing industry due primarily to IT outsourcing. This is supported by tax incentives introduced for the IT sector.

Ukrainian tax legislation embodies the international tax concepts of permanent establishment (PE) and transfer pricing (TP), which are based on OECD documents; however, the application of these concepts to outsourcing in particular does not follow the principles and commentaries contained therein. The OECD commentary is not a source of law in Ukraine, which narrows the interpretation of a PE to the domain of domestic legislation and practice.

Cross-border outsourcing arrangements are not given special attention tax-wise in the legislation. Nor are there any tax clarifications/rulings or jurisprudence which would address cross-border outsourcing from a PE perspective (as happens, for example, in India). Outsourcing will be viewed from the point of view of the standard provisions of corporate profit tax (CPT) law, VAT, and in part of PEs, TP and place of supply rules.

PE exposure is an important consideration for cross-border outsourcing in Ukraine; however, currently the tax authorities still have insufficient knowledge and international experience to trace and identify PEs.

1. Introduction

Ukraine can boast substantial growth in outsourcing industry in recent years. Both production outsourcing (toll/contract manufacturing) and business process outsourcing (BPO) are actively utilized by businesses within cross-border arrangements. The growth trend is primarily driven by the IT sector where Ukraine has become one of the world leaders, offering a skillful and educated workforce and competitive labor costs. Last year, legislation aimed at incentivizing the IT industry was enacted to further boost the development of the sector.

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Mostly Ukrainian companies and in many cases independent contractors act as service providers and are engaged in various outsourcing activities for non-resident customers such as toll manufacturing, R&D, IT services, etc.

Outbound outsourcing is also growing, *inter alia*, production outsourcing to jurisdictions with lower manpower costs like China, India, as well as outbound BPO. Outsourcing is usual where Ukrainian subsidiaries of multinationals receive centralized services from non-resident group companies (centralized financial services, accounting, HR, IT services, etc.).

The forms for outsourcing activities in Ukraine vary. Non-residents may operate through representative offices to which various activities may be outsourced (both back- and front-office functions). Depending on the scope of their activities, representative offices can either be commercial (taxable) or non-commercial (non-taxable). In many cases, representative offices claim non-taxable status (PE exemption) on the ground of the preparatory and auxiliary character of their activities resorting to double tax treaties (DTTs). Branches as legal forms are not allowed to be established by non-residents; a representative office is the only form for establishing a legal extension of a non-resident in Ukraine.

Also non-residents may establish a wholly owned subsidiary in Ukraine operating as a captive unit providing various services to a foreign parent or group companies. Typically, captive units work on a cost-plus basis remuneration which is most suitable for cases where the scope of services is not fixed and is subject to change (as in ongoing IT projects for software development).

Third-party arrangements and operation through captive units are the most used models upon outsourcing to Ukraine. Recently, foreign customers have tended to acquire the business of a Ukrainian service provider after a certain period of successful cooperation (a sort of "build–operate–transfer" business model).

Joint ventures are also quite common for outsourcing business where Ukrainian and non-resident shareholders own a Ukrainian legal entity acting as an outsourcing unit.

Since the 1990s toll manufacturing has been widely used by foreign multinationals which outsourced their production to Ukraine due to lower labor costs. The textile industry of Ukraine operated mainly on orders from non-residents under a tolling scheme. The tolling manufacturing legislation gave favorable conditions for tolling schemes, in particular via the provision of conditional exemption from customs duty and import VAT for materials imported for processing in the territory of Ukraine.

Ukraine has an extensive DTT network. Mostly, DTTs are based on the OECD model (see Table 1).

Upon structuring of cross-border outsourcing arrangements in Ukraine, it is necessary to consider the PE risk, application of withholding taxes (WHT), various deduction limitations on service fees, royalties and interest remitted to non-residents. VAT taxation should be of particular concern for cross-border outsourcing arrangements as non-residents are not allowed to obtain VAT refunds on fees payable to Ukrainian residents; thus, Ukrainian VAT (20 per cent) becomes a non-refundable cost. In certain cases, provision of services to non-residents may be structured so that Ukrainian VAT does not apply based on "place of supply" rules. Therefore, the type of services to be employed for a particular outsourcing activity must be carefully structured to optimize VAT impact.

Table 1. Ukraine's DTTs

Country	Withholding tax rate		
	Dividends (%)	**Interest (%)**	**Royalty (%)**
Algeria	5/15	10	10
Armenia	5/15	10	0
Austria	5/10	2/5	0/5
Azerbaijan	10	10	10
Belarus	15	10	15
Belgium	5/15	2/10	0/10
Brazil	10/15	15	15
Bulgaria	5/15	10	10
Canada	5/15	10	0/10
China	5/10	10	10
Croatia	5/10	10	10
Czech Republic	5/15	5	10
Cyprus [a]	5/15	2	5/10
Denmark	5/15	0/10	0/10
Egypt	12	12	12
Estonia	5/15	10	10
Finland	0/5/15	5/10	0/5/10
France	0/5/15	2/10	0/5/10
Georgia	5/10	10	10
Germany	5/10	2/5	0/5
Greece	5/10	10	10
Hungary	5/15	10	5
Iceland	5/15	10	10
India	10/15	10	10
Indonesia	10/15	10	10
Iran	10	10	10
Israel	5/10/15	5/10	10
Italy	5/15	10	7
Japan	15	10	0/10
Jordan	10/15	10	10
Kazakhstan	5/15	10	10

Table 1. Ukraine's DTTs (cont.)

Country	Withholding tax rate		
	Dividends (%)	Interest (%)	Royalty (%)
Korea (R.O.K.)	5/15	5	5
Kuwait	5	0	10
Kyrgyzstan	5/15	10	10
Latvia	5/15	10	10
Lebanon	5/15	10	10
Libya	5/15	10	10
Lithuania	5/15	10	10
Macedonia	5/15	10	10
Malaysia	15	15	10/15
Malta[b]	5/15	10	10
Mexico	5/15	10	10
Moldova	5/15	10	10
Mongolia	10	10	10
Morocco	10	10	10
Netherlands	0/5/15	2/10	0/10
Norway	5/15	0/10	5/10
Pakistan	10/15	10	10
Poland	5/15	10	10
Portugal	10/15	10	10
Romania	10/15	10	10/15
Russian Federation	5/15	10	10
Saudi Arabia	5/15	10	10
Serbia and Montenegro	5/10	10	10
Singapore	5/15	10	7,5
Slovakia	10	10	10
Slovenia	5/15	5	5/10
South Africa	5/15	10	10
Spain	18	0	0/5
Sweden	0/5/10	0/10	0/10
Switzerland	5/15	0/10	0/10
Syria	10	10	18

Table 1. Ukraine's DTTs (cont.)

Country	Withholding tax rate		
	Dividends (%)	Interest (%)	Royalty (%)
Tajikistan	10	10	10
Thailand	10/15	10/15	15
Turkey	10/15	10	10
Turkmenistan	10	10	10
United Arab Emirates	5/15	3	0/10
United Kingdom	5/10	0	0
United States of America	5/15	0	10
Uzbekistan	10	10	10
Vietnam	10	10	10

[a] The DTT is expected to become effective starting from 1 January 2014.
[b] The DTT was signed on 3 September 2013 and is currently pending ratification.

On 1 September 2013 new TP legislation entered into force introducing the obligation to provide TP reports and documentation on controlled transactions. Now Ukrainian service providers must carefully structure outsourcing activities with foreign related companies and companies located in the low-tax jurisdiction list which is approved by the Cabinet of Ministers of Ukraine. The threshold for controlled transactions is UAH50 million annually.

Currency/exchange control regulations are to be carefully considered upon investment and divestment due to a number of restrictions as well as for day-to-day cross-border cash flows.

2. Domestic law provisions

Legally, as a separate concept "outsourcing" is not developed in Ukrainian legislation, nor is there any special legislation to regulate outsourcing relationships. In most cases, the contractual relationships arising within cross-border outsourcing are regulated by the provisions of the Civil Code and Commercial Code on contracts for services/works, and foreign economic activity legislation.

The definition of outsourcing is given in some by-laws only for specific purposes (e.g. public procurement).[1]

[1] Outsourcing is defined as the transfer of certain public functions of state bodies to organization of any type of property with the control over the transferred functions being retained by state bodies (National Agency on Public Service, Order no. 155 dated 27 February 2012).

Outsourcing arrangements also are not addressed specifically in the Tax Code, nor are there any special rules which would cover cross-border outsourcing arrangements and allow them to be taxed aggressively.

2.1. Toll manufacturing

Ukrainian legislation establishes special rules for toll manufacturing arrangements both inbound and outbound.[2]

In particular, importation of materials for processing may be exempted from customs duties, import VAT and excise tax on condition that the finished products will be exported outside Ukraine. The same relates to outbound tolling schemes where finished goods produced outside from Ukraine-originated materials may be exempted from import VAT, excise and customs duties either fully or in part depending on the degree of processing.

There is a special rule under which a sale of finished goods produced in Ukraine by a manufacturer and belonging to non-resident customers can only be made by non-residents through the representative office of such a non-resident registered in Ukraine. Effectively, this requirement obliges a non-resident to establish a representative office, treat it as a PE and tax the income derived from the sale of the finished products produced in Ukraine under the tolling scheme.

2.2. Incentives (special IT tax regime)

Following a number of legislative initiatives and active lobbying from the IT industry, the Ukrainian Parliament has adopted a law introducing a special tax regime for IT companies.[3] The special tax regime is temporary and will be in effect from 1 January 2013 to 1 January 2023.

This special IT tax regime provides for a substantial reduction of the CPT rate for qualified IT companies from the current standard rate of 19 per cent to 5 per cent.

A reduced 5 per cent rate can only apply to a ring-fenced income derived from qualified IT operations. Such activities are quite extensively defined and, in particular, include:

- computer programming; software adjustment; individual software development and software tailoring;
- consulting on IT issues, including computer systems planning and development;
- creation and implementation of IT complexes and webs, data transmission and data storage systems; licensing of software;
- data processing.

In order to be entitled to CPT incentives, a company must meet the following criteria:

- at least 70 per cent of the company's operational income for the last four tax reporting quarters is derived from the qualified IT operations;
- the initial value of the company's fixed assets and/or intangibles is more than 50 minimal statutory salaries (approximately US$ 7,500);

[2] Chapter 23 of the Customs Code of Ukraine.
[3] Clause 15 subs. 11 s. XX of the Tax Code of Ukraine.

- the company has no tax debts; and
- no bankruptcy proceedings have been initiated against the company.

A taxpayer is obliged to undergo a special tax registration in order to benefit from the special IT tax regime and to submit financial reports and primary documents proving its eligibility for tax incentives.

The tax authorities are empowered to perform non-scheduled field tax audits in order to check the eligibility of a taxpayer for CPT incentives.

Please note that a newly established company may opt for a special IT tax regime only upon two full reporting (tax) quarters of conducting activities. The newly established entity will be subject to an unscheduled documentary tax audit following two full reporting (tax) quarters for the purposes of checking its compliance with the requirements of the special IT tax regime.

The qualified IT companies must maintain separate accounting of IT activities falling within the scope of tax incentives (if the taxpayer has any other activities besides the qualifying ones).

Where the taxpayer fails to meet the qualifying requirements, penalties will apply and prohibitions may be imposed:

- such a taxpayer will be obliged to accrue tax liabilities at the standard CPT rate for the whole tax quarter when the non-compliance with qualifying requirements occurred;
- such a taxpayer will be obliged to pay a penalty on the tax underpaid;
- such a taxpayer will be banned from opting for the special IT tax regime for the following four tax quarters.

2.3. Additional benefits under consideration

In addition to the broad corporate profits tax incentives described above, Ukrainian lawmakers are currently considering introducing additional benefits for qualified IT companies with regard to personal income tax and social contributions. In particular, the draft law envisages a reduced 5 per cent personal income tax instead of the standard 15 per cent (17 per cent) and a reduced base for levying the uniform social security contribution (USSC), which is less than the general maximum cap.

2.4. Deduction limitation on services provided by non-residents

The Tax Code[4] establishes that expenses incurred for the purchase of consulting, marketing and advertising services from non-residents are allowed for deduction up to an amount which does not exceed 4 per cent of the income (revenue) of Ukrainian taxpayers from the sale of products/goods/services/works (VAT exclusive) for the previous reporting year (for CPT purposes the reporting year is a calendar year). Therefore, where Ukrainian companies outsource some of their functions abroad and these are formalized as consulting, marketing or advertising, the limitation is to be carefully considered as it bears heavily on the Ukrainian services recipient. In particular, other services may be considered to fall outside the scope of the 4 per cent deduction limitation. Arguably, Ukrainian services recipients may resort to non-discrimination clauses of DTTs to disregard the deduction

[4] Art. 139.1.13 of the Tax Code.

limitation; however, most probably, this will be decided by the court as the tax authorities do not accept the non-discrimination clauses as an argument not to apply a limitation on deduction.

2.5. Deduction limitation on royalties payable to non-residents

Outsourcing arrangements often envisage intellectual property (IP) flows for which royalties are payable by Ukrainian companies abroad.

The Tax Code establishes a similar deduction limitation for cross-border royalties. Thus, the royalties payable to non-residents are allowed for deduction to an amount which does not exceed 4 per cent of the income (revenue) from the sale of products/goods/services/works (VAT exclusive) for the previous reporting year.

This limitation does not apply if payments of royalties are made to PEs of non-residents which are taxed in Ukraine accordingly.

Additionally, the Tax Code establishes four conditions under which royalties payable to non-residents are not allowed for deduction (if one of these conditions is satisfied, deduction is disallowed):

- the non-resident to which royalties are accrued is an offshore blacklisted entity;
- the non-resident to which royalties are accrued is not the beneficial (actual) recipient/owner of the royalties;
- the royalties are payable for the IP object ownership which initially belonged to a Ukrainian resident;
- the non-resident to which royalties are accrued is not subject to tax in respect of royalties in the state of its residence.

Therefore, where Ukrainian service providers or captives receive IP rights from non-resident licensors within outsourcing arrangements it is necessary to take into account the limitation on deduction of royalties and conditions under which the deduction can be claimed.

2.6. Pricing expertise

Ukrainian currency legislation envisages the obtaining of obligatory expert conclusions on the contract price if the value of a contract or series of contracts exceeds 100,000 euro or its equivalent in domestic currency. Expert conclusions are issued by the special state agency (Derzhzovnishinform). This requirement applies to payments due to non-residents under cross-border services and licensing contracts. The expert conclusion is not made for tax purposes and its obtaining does not mean that the tax authorities are automatically happy with the price confirmed by Derzhzovnishinform for tax/TP purposes. The main function of Derzhzovnishinform is to control the outflow of currency from Ukraine due to overstatement of prices under services and licensing agreements.

2.7. 90-day rule

Ukrainian currency control regulations provide for a so-called “90-day rule” applicable to the import and export transactions of Ukrainian residents. This regulation envisages the following two principles:

(a) all import transactions of Ukrainian residents, where the shipment of goods or provision of services is deferred, should ensure shipment of goods/provision of services within 90 calendar days from the date of advance payment made by Ukrainian residents; and
(b) the revenues of Ukrainian residents derived from export sales (or provision of the services to non-residents) should arrive in the bank accounts of such residents within 90 calendar days from the date of export (provision of the services).

Failure to satisfy this requirement attracts substantial penalties for Ukrainian residents.

3. PE

The Tax Code adopted late in 2010 extended the definition of a PE as compared to previous legislation and brought it closer to the definition contained in DTTs based on the OECD model. Previous legislation did not include a definition of a "building site" PE.

The agency PE definition though was changed as compared to previous legislation and deviates from the agency PE definition under the OECD model.

The new definition of PE now includes a service PE (based on the UN model). At the same time, the Tax Code introduces a list of exceptions where a PE should not exist. These include, *inter alia*, the following:

(a) sending a person to the disposal of a resident within services agreements on the provision of personnel. The Tax Code defines such agreements as agreements whereby a person puts one or several individuals at the disposal of another person for the provision of functions envisaged by the agreement;
(b) the maintenance of a fixed place of business solely for the purposes of purchasing goods or products or for collecting information for a non-resident;
(c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purposes of storage or demonstration;
(d) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
(e) the maintenance of a fixed place of business solely for the purposes of conducting for the non-resident any activity of a preparatory or auxiliary character.

Under the Tax Code, the rules envisaged by the duly adopted international treaties have priority over domestic legislation. Thus, applicable tax treaties should be considered when estimating the PE risk. Most DTTs define a PE in a manner similar to that of the Tax Code. One notable difference is that most DTTs do not refer to a service PE.[5]

[5] For example, the DTT between Ukraine and Kazakhstan includes a service PE which is defined as offering services, including consultative services, by residents through employees or other personnel hired for such purposes, provided such activity continues (for that project or one connected with it) within the borders of the country for more than six months.

The OECD commentary is not regarded as a source of law in Ukraine. Though currently there is a trend for the tax authorities to publicly refer to OECD documents, in particular on TP, the OECD commentary is not published or translated officially and has no mention in jurisprudence.

Ukrainian courts and tax authorities mainly derive their own interpretation of DTTs from domestic legislation without taking into account international practice.

3.1. Fixed place PE

There is no definition of fixed place for PE purposes in the tax legislation. Furthermore, the legislation and clarifications of the tax authorities do not expand on the location and duration tests for the determination of whether a fixed place of business exists in Ukraine. It is also not clear what the position is on how the right to use premises should be formalized in order to be qualified as a fixed place.

Given this lack of clarity, any office (whether a non-resident has the legal right to use it or not) through which a business is carried out by a non-resident can be potentially regarded by the tax authorities as a PE.

Ukrainian legislation does not give grounds to recognize a captive unit or contract manufacturer working under an outsourcing arrangement (a services agreement or toll manufacturing agreement) with a non-resident as a PE on the mere ground that the Ukrainian service provider or manufacturer is captive. For the determination of whether there is a PE of a non-resident the other factors that are to be considered are such matters as the presence of a non-resident's employees on the premises ("fixed place PE"), the authority to conclude contracts ("agency PE"), the provision of services by a non-resident to a Ukrainian service provider ("service PE").

There is no rule which would allow a captive service provider/manufacturer to be recognized as a PE on separate grounds driven by captivity only.

Therefore, for captive units being legal entities registered in Ukraine it does not matter which functions are contractually outsourced either back-office or front-office as relationships with a non-resident customer would be viewed as the business of a captive unit. If there is a service agreement or toll manufacturing agreement between a captive unit and a non-resident customer envisaging remuneration for services/works and there are no grounds to qualify it as a fixed place PE, agency PE or service PE, then legally it is hardly possible to treat such a captive unit as a PE irrespective of the functions (either back-office or front-office) it performs.

The different approach of the tax authorities towards the nature of functions outsourced would take place in respect of representative offices of non-residents registered in Ukraine. In this case, it is of crucial importance to differentiate core and non-core functions. If a non-resident has a taxable representative office in Ukraine which claims no PE exemption under DTTs, then the nature of functions outsourced by the head office would not matter as the representative office would in any case tax its income in Ukraine under one of the taxation methods applicable in Ukraine.

However, where a representative office claims exemption from a PE on the ground of the auxiliary and preparatory character of its activities, which is often the case

for outsourcing, it should be substantiated that the activities of the representative office do not coincide with the main activities of the head office. To this end, the tax authorities would take a rather formal approach and typically look into the activities of the representative office as reflected in its by-laws and compare them with the main activities of the head office envisaged in its founding documents. Therefore, in practice, the importance of the nature of functions outsourced mostly relates to the cases where there is a representative office claiming PE exemption. In this case, the non-resident should clearly outsource those functions which do not represent its main activities as envisaged in its founding documents. Given this approach of the tax authorities, outsourcing back-office functions which are not formally treated as the main activities of the non-resident according to its founding documents could be achieved with a PE exemption on the ground of auxiliary and preparatory character.

Ukrainian courts also support that approach and typically review and compare the activities of the representative office with the main activities of the head office[6] upon deciding upon the taxable vs. non-taxable status of the representative office.

In practice, the Ukrainian tax authorities so far have not been sophisticated in the identification of fixed place and other types of PE outside the registered representative offices or outside contractual arrangements which could lead to an agency PE, for example. The reporters have not identified in available legal databases court cases where tax authorities have established the existence of a fixed place PE of a non-resident based on the facts of a non-resident's activities but without the existence of a representative office of a non-resident registered in Ukraine. Also the reporters have not identified cases where a fixed place PE of a non-resident would be established in cases of captive units providing services to a non-resident.

3.2. Agency PE

The definition of an agency PE in Ukrainian legislation is similar to that provided by article 5 of the OECD model convention.

However, domestic law departs from the OECD definition by tightening the criteria defining the agency PE in Ukraine. Thus, in accordance with the Tax Code of Ukraine, an agency PE arises when a resident person has a right to act solely on behalf of a non-resident and such acts lead to civil rights and liabilities for the non-resident. The gray area in the definition of the agency PE is that the wording of the definition does not specifically exclude agents undertaking preparatory or auxiliary activities for non-resident entities. There is, however, a separate provision stating that activities limited to auxiliary or preparatory shall not lead to creating a PE. If treated fiscally, the presence of the two contradictory provisions may pose an additional risk for the taxpayer.

[6] Please see Decision of the Kyiv District Administrative Court on case no. 826/2263/13-a dated 3 April 2013, Decision of the Kyiv District Administrative Court of Appeal on case no. 2a-18377/11/2670 dated 14 June 2013.

3.3. Service PE

As mentioned above, the Tax Code introduced a modified definition of PE which envisages the possibility of a PE arising if the services (except for services for the provision of personnel), including consulting, are rendered by a non-resident via its employees or other personnel employed for this purpose if the activity is carried out in Ukraine (under one project or related projects) within a period(s) the duration of which exceeds 6 months in any given 12-month period.

This provision in fact establishes the arising of a “service PE” for a non-resident service provider and exposes to risk, in particular, all consulting, supervisory, stewardship services which are provided by non-residents to Ukrainian counterparties under outsourcing arrangements, as in most cases such services are provided by employees of a non-resident customer.

The existence of a service PE should be reviewed from the point of view of DTT protection, i.e. whether the definition of PE in the DTTs in force for Ukraine overrules the provisions of Ukrainian domestic legislation on a service PE.

PE articles of almost all DTTs in force for Ukraine do not envisage separately a service PE. Therefore, in most cases, under DTTs a PE may arise either as a fixed place of business PE or as a dependent agent PE. Consequently, provision of services by a non-resident customer to a Ukrainian service provider should not as such automatically trigger a service PE based on the relevant DTT. Under almost all of the DTTs which have priority over the Tax Code, a PE may arise either as a fixed place or as a dependent agent PE but not as a service PE.

The existence of a service contract as such does not lead to a service PE; all the facts have to be analyzed in order to establish whether a PE exists and of which type (such as the presence in Ukraine, whether business activity is carried out, the availability of premises, degree of permanence, etc.).

Importantly for outsourcing arrangements the Tax Code excludes the provision of personnel from PE cases, thus making the provision of personnel a solution under the new Tax Code allowing PE exposure to be mitigated. Therefore, non-resident customers may employ the “provision of personnel” exemption from a PE as a tool to send employees for the performance of supervisory and stewardship activities over a Ukrainian service provider under outsourcing arrangements. In this case, a personnel provision agreement has to be concluded between the non-resident customer and the Ukrainian service provider/contract manufacturer.

Under the Tax Code agreement for the provision of personnel may involve the conclusion of an employment contract with the person at the disposal of whom the personnel were sent. So the Tax Code directly allows dual employment, which in practice means that the hosting company exercises full control over seconded employees on the basis of employment law, which can be used as another argument to minimize PE exposure by moving control functions over employees from a non-resident to a Ukrainian service provider/contract manufacturer.

3.4. Illustrations

3.4.1. Case study 1 – Outsourced contract manufacturing[7]

The set-up described would not as such lead to the taxable presence of CARCO in state S on the mere ground that SUBCAR is a subsidiary working on a cost-plus. The same conclusion can be reached for the situation where the parts and automobiles remain the property of SUBCAR.

A taxable presence/PE of CARCO may potentially arise under domestic laws in state S (Ukraine) if it is established based on the facts that there is a fixed place PE (e.g. employees of CARCO, for example, are present on the premises of SUBCAR in Ukraine, supervise the production process, give instructions on a regular basis) or an agency PE (if SUBCAR has a binding authority to sign contracts on behalf of CARCO). However, if there is no presence of CARCO's employees in the state and SUBCAR has no authority to bind CARCO, mere assembling of the automobiles under tolling arrangements with SUBCAR would not lead to a fixed place or agency PE.

It may also be the case that there is a service PE under domestic laws if the tax authorities identify that CARCO provides supervisory or stewardship services. However, as mostly these services are provided free of charge by CARCO, it is not clear based on the existing rules how the tax authorities would perform a profit attribution exercise in the case of the identification of a service PE.

Additionally, a PE will arise if CARCO sells the finished products (automobiles) in state S. Moreover, under Ukrainian legislation CARCO is obliged to sell the finished products (automobiles) in the case of contract manufacturing in Ukraine only through its representative office registered in Ukraine, which would effectively be a taxable PE.

Under typical DTTs it is also unlikely that either a fixed place or agency PE will arise against the background outlined in case study 1.

3.4.2. Tax treatment of CARCO in state R

The worldwide income of CARCO would be taxable in state R (Ukraine). If there is a taxable presence in state S and CARCO's profits are taxable there, CARCO would generally be entitled to credit the tax paid in state S against tax due in state R. Documentary proof of the tax paid, object and tax base would be required to obtain the credit. The amount of credit cannot exceed the tax due by CARCO in state R.

3.4.3. Case study 2 – Outsourced call centre services[8]

The arrangement described should not lead to a fixed place PE under domestic legislation and DTTs. An agency PE under domestic laws is likely to be established only if there is a legal power of OCO to sign contracts, which is not the case under the scenario. As the OECD commentary is not a source of law in Ukraine, the negotiations and agreeing the terms – though without formal right – to sign and

[7] For a full discussion of the facts, please refer to the General Report.
[8] For a full discussion of the facts, please refer to the General Report.

bind on behalf of a non-resident would be unlikely to lead to an agency PE under domestic laws and DTTs in force for Ukraine. However, even if the Ukrainian tax authorities assert the existence of an agency PE, it should also be established whether there are any other non-resident customers of OCO as the domestic definition of the dependent agent PE envisages the constitution of a PE for residents of Ukraine which are providing services solely for one non-resident. Moreover, it should be established whether OCO is acting in the ordinary course of business. Upon assessment of whether OCO is acting in the ordinary course of business the tax authorities may consider whether OCO is legally dependent on ICO (i.e. whether it is captive or not) – legal dependence test.

If ICO is held to have a taxable presence in state S and state R is Ukraine, CARCO would generally be entitled to credit the tax paid in state S against tax due in state R. Documentary proof of the tax paid, object and tax base would be required to obtain the credit. The amount of credit cannot exceed the tax due by ICO in state R.

4. Attribution of profits

As a general principle, PEs should be taxed according to the rules established for resident legal entities. For tax purposes, a PE should be regarded as an entity independent from its head office. These principles are established both in domestic tax law and in DTTs.

Based on the Tax Code, PEs may opt to use three methods of taxation of their profits:

- a direct method (like any standard Ukrainian taxpayer and under more or less the same rules regarding tax base and tax reporting);
- an indirect method (a specific method ignoring the actual expenses of the PE and providing for a deemed profitability of 30 per cent based on actual income). Under the indirect method, a PE's expenses are deemed to constitute 70 per cent of its taxable income. In accordance with domestic tax legislation, the indirect method applies whenever a non-resident company carries on business in several jurisdictions and it is not possible to directly compute the profit derived from Ukraine. To the reporters' knowledge, the tax authorities often prefer this method, as it guarantees that a PE pays tax in Ukraine, based on a deemed 30 per cent profitability and many PEs are taxed in this way. If the authorities insist but a PE does not agree with the proposed indirect method, it would have to go through a tax dispute, potentially involving a court trial. However, the indirect method relieves a PE from the obligation to keep a record of its expenses, which makes compliance much simpler;
- a split balance sheet method (where the profit is allocated to the PE pro-rata to its share of expenses, fixed assets and personnel of the whole enterprise). As a matter of practice this is used on a very limited basis, if at all, due to the onerous documentation and procedures requirements.

In practice, there is no clarity in the taxation of PEs. The major issue is the lack of rules concerning attribution of income and expenses to PEs in Ukrainian domestic

law and ignorance of, and unwillingness to apply, the rules of DTTs on the part of the tax authorities. A typical approach of the tax authorities is to:

- allocate all income derived by a non-resident company from its Ukrainian operations to the PE; and
- to allow as a deduction only the locally incurred costs, disregarding any expenses borne by the head office.

This approach is clearly in contradiction to the DTTs concluded by Ukraine, which envisage that the expenses relating to a PE may be deducted even if they are incurred outside the country where the PE operates. Yet there is no established procedure for applying the DTT provisions in computing the taxable profits of PEs. A lack of clarity exists as to what documents the tax authorities would request in order to support the amount of expenses incurred abroad and to determine the portion of these expenses attributable to the representative office.

A PE which intends to perform commercial activities in Ukraine is obliged to register with the Ukrainian tax authorities prior to commencing its commercial activity. Once registered for tax purposes, a PE will be obliged to submit corporate tax returns. The type of returns to be filed actually depends on the method of taxation of the representative office (direct, indirect methods and method of split balance sheet).

Claiming, in particular, auxiliary and preparatory activities exemption under the applicable DTT is not automatically accepted but is performed through filing a special form addendum (a statement) to the tax return submitted by the PE.

No peculiarities from the TP standpoint are envisaged for PEs.

5. Transfer pricing

On 1 September 2013, comprehensive new TP legislation was enacted in Ukraine. Generally, the Ukrainian TP rules are based on the OECD TP guidelines. They provide for the same methods, principles and approaches.

The peculiarities of the Ukrainian TP legislation lie in the field of application of the TP rules:

(a) no safe harbor is envisaged by the Ukrainian laws;
(b) no special rules for PEs in general, including those engaged in outsourcing activities;
(c) advance pricing agreements are possible for "large" taxpayers only. These are taxpayers whose revenues for the last four quarters exceed UAH500 million, or the amount of the taxes paid for the same period exceeds UAH12 million;
(d) no special provisions on the TP issues arising due to restructuring.

There are also transitional provisions establishing special TP rules for certain kinds of goods (agricultural, chemical, metallurgical and some others). These rules provide that the transaction price may differ from the stock price by 5 per cent maximum.

It must be emphasized that at the time of drafting this report, the new TP rules in Ukraine have been in force for a month and a half only; therefore there is no practice on their actual implementation and it is expected that during the rest of 2013

and 2014 there will be certain changes in the TP legislation to adapt them to the current economic circumstances and needs.

5.1. Case study 3 – Location savings through outsourced contract manufacturing[9]

There are no special provisions addressing the TP issues arising while restructuring businesses. Therefore, from the state A perspective, Ukraine would tax company A's income on a worldwide basis. However, the purchases from company B would be subject to TP rules, meaning that the deductible expenses should not exceed arm's length prices. Ukraine would seek to tax all the local savings of company A.

From the state B perspective, Ukraine would tax the affiliate of company A based on the income attributable to such an affiliate. Since the PE is treated for taxation purposes as an ordinary resident taxpayer, its taxable profits would be calculated based on the income determined at arm's length. There are no special provisions as regards adjusting the arm's length price for intangibles, nor are there special rules for TP in the case of a PE. Therefore there is room for tax planning as well as for a fiscally based approach of the tax authorities.

As for the local savings in country A, it is rather doubtful that Ukraine would seek to tax them since there are no legal means of achieving this.

5.2. Case study 4 – Location savings through subcontracting services[10]

From the country X perspective, Ukraine would tax company X's profits determined at arm's length in both cases: whether company X is doing business as one entity, or establishes a subsidiary in country Y. All local savings arising in country X would be subject to taxation in Ukraine.

From the country Y perspective, Ukraine would tax the subsidiary as an ordinary taxpayer, determining its profits under the TP rules.

6. Withholding tax (WHT)

The Tax Code of Ukraine establishes the items of a non-resident's Ukraine-sourced income which must be taxed in Ukraine.[11] This income is subject to Ukrainian WHT (the general rate is 15 per cent) unless the respective DTT provides reduction or relief.

The Tax Code provides the following mechanism for WHT payment. In particular, a Ukrainian resident or non-resident's PE that remits any Ukraine-sourced income abroad must withhold WHT upon the remittance and at the expense of the remittance.[12]

9 For a full discussion of the facts, please refer to the General Report.
10 For a full discussion of the facts, please refer to the General Report.
11 Art. 160.1 of the Tax Code.
12 Art. 160.2 of the Tax Code.

Dividends, interest and royalties paid to non-resident companies are subject to a standard 15 per cent rate of WHT. The same applies to capital gains, lease payments and certain types of service (engineering, agency services). Income from transportation (freight) is taxed at 6 per cent. A separate tax, payable at the expense of the Ukrainian entity (i.e. on top), is levied on advertising fees (20 per cent) and certain types of insurance income (4 per cent or 12 per cent depending on the circumstances).

Service fees (except for engineering and agency fees) and payments for goods remitted by Ukrainian taxpayers to non-residents are excluded from WHT under the Tax Code.

DTTs usually reduce or eliminate WHT on service fees payable under cross-border outsourcing arrangements, but arguably not the tax on insurance and advertising income. Tax reduction or relief under a treaty is granted upfront, provided that a valid tax residence certificate is available. The Tax Code has introduced an additional requirement to verify that the recipient is the beneficial owner of the income.

Gross-up clauses obliging the remittance to the non-resident of the income net of any WHT are not allowed in the contracts with non-residents.

Generally, if Ukrainian companies outsource some functions abroad and the outsourcing arrangement is structured as services provision, Ukrainian WHT may apply only to certain types of service fees which can in any case be relieved under relevant DTTs in force in Ukraine.

Ukrainian residents are allowed to credit the WHT paid abroad against Ukrainian CPT provided the relevant documentation formalities are observed.

7. Impact of the anti-deferral regime

There are no special anti-deferral or controlled foreign company rules in Ukraine. The income of the Ukrainian entities is taxed on the worldwide basis, and if a Ukrainian company has a PE in a foreign country, the profits of the PE would be included in the tax base of the Ukrainian company. However, means of avoidance of double taxation may be applied as provided for in the relevant DTTs.

If the Ukrainian entity is doing business in the other country through the subsidiary being a legal entity, no Ukrainian taxes may be levied on the subsidiary's profits.