FRISHBERG &PARTNERS
ATTORNEYS AT LAW

CORPORATE LAW
IN UKRAINE

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Introduction

Ukraine has never been known for its friendly investment climate. In late 2004, however, a peaceful "Orange Revolution" captivated the world as ordinary Ukrainians flocked to the streets in protest of the mass falsification of the 2004 Presidential Elections (which was accompanied by a healthy dose of dioxin poisoning).

Upon his inauguration, the newly-elected President Viktor Yuschenko immediately issued an official statement that Ukraine's goal is to push forward with massive legislative and social reforms, and to move towards European Integration in the most expedient manner. Time has shown that doing business in Ukraine can be quite lucrative, though not always stable.

Today, Ukraine is one of the fastest growing markets. It has opportunities no longer available in other countries, and cheaper labor costs, too. However, the prevailing foreign investment legislation grants few advantages to foreign investors. In cases of free economic zones, the new government proved that it can arbirarily cancel tax privileges retroactively just as easily as it can re-instate them a few months later. Or that it can impose VAT on in-kind contributions to the charter fund (authorized capital) at a whim. Or re-privatize your steel mill.

Despite the above blows to the confidence of investors, rolling with the punches is often well worth the trouble. This dynamic East European nation is making giant leaps forward along its capitalistic path, undeterred by the constantly rotating carousel of Prime Ministers.

In this brief investment guide, we are pleased to share with you our analysis concerning the basic legal issues impacting any prospective business venture. We hope you will find it useful. Of course, should any questions arise, please feel free to contact us at your convenience.

Most Commonly Used Business Structures

The Ukrainian Civil Code (No. 435-IV, dated January 16, 2003, effective January 1, 2004) and Economic Code (No. 436-IV, dated January 16, 2003, effective January 1, 2004) in combination provide for virtually any type of companies. Despite the dazzling range of business structures offered under Ukrainian law, foreign investors typically choose one of the following four alternative business structures:

- representative office (which is not a legal entity, and can be either commercial or non-commercial);
- wholly-owned foreign subsidiary or enterprise (usually with limited liability provided in the founding documents);
- "joint ventures" — companies with foreign participation (either in the form of a closed stock company or a limited liability company); or
- agreements on joint cooperation and production, which do not require registration of a separate legal entity, including toll manufacturing or production outsourcing agreements.

Resident vs. Non-Resident Status

One significant consideration in selecting the appropriate business structure involves Ukrainian foreign currency legislation, which categorizes the above structures as either non-residents or residents, depending on the type of activities carried out.

Non-commercial representative offices are "non-residents" under currency regulations and tax legislation, while commercial representative offices, subsidiaries and joint ventures are classified as "residents" because they are legal entities, registered and residing in Ukraine for more than 183 days per year. While the distinction is not clearly expressed in other laws, it is significant in terms of tax consequences and the ability of foreign businessmen to effectuate transactions in foreign or Ukrainian currency.

Both subsidiaries and joint ventures have the status of separate corporate entities and, thus, both limit an investor's liability to its initial investment. As Ukrainian corporate entities, joint ventures and subsidiaries are considered to be "residents" under Ukrainian currency regulations and they are subject to a different financial regime than "non-residents" (such as representative offices). For instance, resident companies may only transact business in Ukrainian currency.

Representative Offices

By definition, a representative office of a foreign company is not a separate legal entity, but is viewed as an "arm" of a non-resident company. As such, a representative office is not incorporated under Ukrainian law. A representative office simply represents the interests of a foreign legal entity on Ukrainian territory and, consequently, there is flow-through liability for the parent company.

Another consequence: representative offices that are accorded "non-resident" status under the Ukrainian taxation system are subject to a special financial regime under tax laws and currency regulations. Foreign companies initially prefer to register their presence as non-resident representative offices, particularly in case of import-export activities or simple research of the market opportunities and conditions.

The key function of such non-resident representative offices is to service existing contracts between the non-resident company and a local customer, but not to engage in commercial activities on its own behalf. Engaging in the so-called "commercial activities" (executing contracts in its own name, accepting payment for goods, etc.) may result in a representative office's re-classification as a "resident," thereby being taxed based on local revenues derived from its activity in Ukraine.

Moreover, the Ukrainian corporate tax legislation places non-residents into two categories: those which effectuate profit- generating activities in Ukraine (a) through a permanent representative office (active), or (b) without a permanent office (passive). Different tax rates and payment procedures attach to each cat-

egory. This significant distinction is aimed at closing the loophole by which non-resident representative offices circumvented currency regulations and paid lower (if any) taxes in Ukraine on activities typically performed by resident companies.

Residents: Joint Stock and Limited Liability Companies

Wholly-owned foreign subsidiaries and joint ventures usually take the form of either closed joint stock companies or limited liability companies, depending on the particular requirements of the project. Both structures are considered to be "residents" under the Ukrainian currency regulations and tax laws, and both have the corporate shield, limiting the liability of founders or shareholders to the value of their contributions to the company.

Several differences exist between the above companies. For example, in a limited liability company, the founders own equity in the company, expressed by a percentage of ownership (i.e., such a company does not issue shares of stock). The main difference between a limited liability company and a joint stock company, however, lies in the degree of structural complexity. Limited liability companies are relatively simplistic and accommodate the interests of minority owners. In sharp contrast, joint stock companies can be extraordinarily complex, particularly in cases of highly negotiated joint ventures with state-owned enterprises, and do not give minority shareholders very much protection.

The management structure of a stock company and that of a limited liability company is very similar with a few minor variations. The three-part structure is headed by the "general assembly of shareholders" (or in case of a limited liability company, "general assembly of participants") which represents the interests of the company owners. The next level, the "supervisory council" (a.k.a. the "board of directors") is optional in both structures; it is commonly employed in the stock company structure, but smaller companies tend to disregard it. The final level, the management board, performs the company's day-to-day functions.

In practice, simple joint ventures or 100% foreign-owned companies usually register in the form of a limited liability company. This company structure allows a relatively small

number of people to avoid a complex multi-layered management structure composed of a general assembly, supervisory council and management organs and to avoid the registration of shares of stock. It is particularly attractive in cases of 100% foreign-owned companies because the charter (by-laws) can provide for one executive organ where the founder has complete and unequivocal control.

Capitalization Requirements

The Law "On Economic Associations" governs the formation of joint stock companies and limited liability companies, and contains no limitations on the size of share capital for joint stock companies, provided however that the company's authorized capital is divided into shares of stock of equal nominal value.

The minimum capitalization for registration of joint stock companies is 1,250 minimum monthly salaries, while for limited liability companies it is 100 minimum monthly salaries. As of January 1, 2007, one minimum monthly salary is equal to UAH 400 (from July 1, 2007 it will increase to UAH 420 and from December 1, 2007 to UAH 460). Note that increases of the minimum monthly salary are common; therefore, please verify this information before calculating authorized capital, fines, fees, etc. Contributions to the authorized capital of a company may be either in cash or in-kind.

Shareholders of stock companies and founders in limited liability companies must make initial pre-registration deposits towards their contributions prior to registration. According to the Law "On Economic Associations," 50% of a shareholder's contribution must be paid prior to registration if the shares are originally distributed amongst the founders of a joint stock company or a limited liability company. The remaining sum must be paid, in its entirety, no later than one year after registration of both types of companies.

Company Registration

On July 1, 2004, the Law of Ukraine No. 755-IV "On State Registration of Legal Entities and Physical Entities-Entrepreneurs," dated May 15, 2003 (hereinafter the "Law"), came into force. The Law was specifically tailored to correspond with the Civil and Economic Codes of Ukraine, which simultaneously came into effect on January 1, 2004. The discussion below focuses on the registration of legal entities.

State registration in Ukraine evidences the creation or liquidation of legal entities, as well as any other registration activities which require an entry into the Unified State Register of Legal Entities and Physical Entities-Entrepreneurs (the "Register"). The Register should be fully up and running in 2006, including a "one-window" registration point.

Registration is performed by a duly qualified state registrar. They are responsible for registering legal entities, reserving names of legal entities (a novelty in Ukraine), providing information to various state authorities from

registration cards, creating and storing registration cards, filling out and issuing certificates of registration and extracts from the Unified State Register, registering amendments in the founding documents of legal entities, registering terminations of activity.

Document Preparation

All documents to be submitted for any registration activity must be personally submitted or sent by registered mail and must be written in Ukrainian. Registration cards must be typewritten or handwritten in print and signed (in case of dispatch by registered mail, the applicant's signature must be notarized). All founding documents (charters, founding agreements, if applicable, regulations) must completely conform to the requirements of Ukrainian legislation.

Please note that documents, which are executed and issued in a foreign country, must be duly signed, notarized with a certification of the notary's signature by the authority in the foreign country authorized to certify such signatures and, finally, legalized with the Ukrainian Consulate in the foreign country or certified by an Apostille, provided that the foreign country has recognized Ukraine as a member to the 1961 Hague Convention Abolishing the Requirement of Legalization for Foreign Public Documents.

After a legal entity or entrepreneur is entered into the Unified State Register, the relevant state registrar will create a registration file and assign it a registration number.

Registration Process

The registration of a legal entity usually entails submission of the following documents:

- a duly filled in registration card for carrying out the state registration of the company;
- a copy of the resolution of the founders or their authorized bodies on the creation of a legal entity;

- two counterparts of the founding documents (according to the Civil and Economic Codes, the charter is the founding document of most types of companies, including joint stock companies, limited liability companies and enterprises);

- the document evidencing payment of the registration fee for the state registration of a legal entity; and

- for legal entities established by a foreign legal entity (foreign legal entities), a duly legalized (certified by Apostille) extract from the trade, banking or court register in such entity's (entities') country of location, which extract evidences registration in such country.

Again, we stress that if the above documents are issued in a foreign country, then such documents must be notarized, certified and affixed with an Apostille stamp in accordance with the 1961 Hague Convention (or legalized in the Ukrainian consulate in the country of origin) to use them officially in Ukraine. Importantly, "state registration" does not include mandatory registration with the social security funds, the Pension Fund of Ukraine, the Employment Center and the tax authorities.

In addition, the state registrar must provide to the statistics bodies, the state tax authorities, the Pension Fund of Ukraine and the social security funds (hereinafter "Registration Authorities") notice on the state registration of the company with an indication of the number and date of registration and all information in the company's registration card. This act alone will be the basis for the inclusion of the company into the registers of the aforementioned state authorities.

Individuals, who carry out commercial activities including the manufacturing and sale of products, the rendering of services or the performance of certain jobs, must also register as entrepreneurs for tax purposes. As a brief overview, the state registration of entrepreneurs includes the submission of a duly executed registration card and a copy of the individual's certificate evidencing registration as a taxpayer and payer of other mandatory payments and the payment of the registration fee. Entrepreneurs are also entered into the Unified State Register and their information is publicly accessible with the exception of their tax identification codes.

Company Liquidation

While the legislation regarding liquidation has not changed significantly over the years, the procedure for the state registration of liquidations has changed as of July 1, 2004. The discussion below pertains only to the new Law "On State Registration of Legal Entities and Physical Entities-Entrepreneurs" and does not detail the liquidation procedure as contained in other legislation such as the Law "On Economic Associations."

According to the current legislation, the liquidation of a company can occur upon transfer of all of its rights and obligations as a result of its merger or by a decision of the founders (participants), by a court of law or by a state authority. A company is deemed liquidated from the date of the introduction of an entry on liquidation into the Unified State Register. An entry on liquidation will be introduced into the Unified State Register upon the submission to the state registrar of notarized copy of the decision of the company's founders (participants) to liquidate the company and the document evidencing payment for the publication of a notice on liquidation in the mass media.

Note that if the decision of the company's founders (participants) on liquidation is issued in a foreign country, then such decision must be duly notarized, certified and legalized with the Ukrainian consular office in such country or "apostillized" in accordance with the 1961 Hague Convention. In addition, if state consent is required for liquidation of the company, the document confirming such consent must be submitted.

Documents submitted for liquidation may be left without consideration if they were submitted to the improper place of registration, they do not meet the requirements of the Law or the full set

of documents was not submitted. Once the documents are accepted, the founders (participants) of the company and the state registrar must agree upon the appointment of a liquidation commission and the procedure and term for liquidation within 2 days from the acceptance of the documents. If the applicant fails to agree upon a liquidation commission, the state registrar will simply appoint the chief executive or a founder (participant) of the company as the head of the liquidation commission within 3 days from receipt of the liquidation documents and send a corresponding notice to the relevant person.

If there are no grounds to refuse an application on liquidation, the state registrar must introduce an entry into the Unified State Register regarding the decision to liquidate the company and send notice to the other Registration Authorities. Once the corresponding entry is introduced into the Unified State Register, the company will be prohibited from registering amendments to its founding documents, registering amendments to the Unified State Register with respect to its separate subdivisions and registering as a founder of another company.

From the date of its appointment, the liquidation commission has the authority to transact all company business, settle with all debtors and creditors, sell off assets and, finally, prepare the company's final liquidation balance sheet. In order to register the liquidation of a company, after the completion of the liquidation commission's tasks, but no later than 2 months from the date of the official publication of the notice on liquidation, the head of the liquidation commission must submit to the state registrar the following documents:

- a duly executed registration card on the liquidation of the company;
- the certificate of state registration of the company;
- the original founding documents;
- the act of the liquidation commission with the liquidation balance, which was certified by decision of the founders (participants) or their authorized body;
- a certificate of the corresponding body of the state tax authorities on the removal of the company from the register as a taxpayer;
- a certificate of the corresponding body of the Pension Fund of Ukraine on the removal of the company from its register;
- a certificate of the corresponding social security bodies on the removal of the company from its register; and
- a certificate of the archive institution on the acceptance of documents, which are subject to long-term keeping pursuant to law.

In certain cases, the law requires the submission of a conclusion of an auditor regarding the authenticity and completeness of the liquidation balance. The state registrar will refuse to consider liquidation documents if the liquidation balance was not confirmed by an auditor (if applicable), the full set of documents was not submitted. If the documents comply with the requirements, the state registrar will introduce a corresponding entry into the Unified State Register within 3 days and the date of such entry will be deemed the date of the state registration of the company's liquidation. Finally, the state registrar will send one counterpart of the company's founding documents and certificate of state registration to the head of the liquidation commission with a special note indicating the state registration of the company's liquidation. An original counterpart of the company's founding documents with such special note will remain in the company's registration file as well.

The above-mentioned procedure describes the general procedure of voluntary liquidation pursuant to the decision of a company's founders (participants). The procedure and

documentation requirements slightly differ in case of liquidation as a result of a merger, split up or reorganization and pursuant to a court decision (including bankruptcy). For example, in case of a merger, split up or reorganization, the following documents must be submitted:

- a duly executed registration card;
- the certificate of state registration of the company;
- the original founding documents;
- a notarized copy of the transfer act, if the liquidation is carried out as a result of a merger or transformation (reorganization), or a notarized copy of the separated (split) balance, if liquidation is carried out as a result of a split up (this document may require an auditor's conclusion as to authenticity and completeness and must be certified and notarized);
- a certificate of the archive institution on the acceptance of documents, which are subject to long-term keeping in accordance with the law;
- the document on consent to the plan of reorganization with the relevant tax authority;
- a certificate of the corresponding tax authority on the removal of the company from the register as a taxpayer;
- a certificate of the corresponding body of the Pension Fund of Ukraine on the removal of the company from its register; and
- a certificate of the corresponding social security bodies on the removal of the company from its register.

No later than the next working day from the date of the introduction of an entry on the state registration of the liquidation of a company, the state registrar must send notice to the other Registration Authorities with an indication of the number and date of liquidation as entered into the Unified State Register and the relevant information from the registration card. This notice will serve as grounds for the removal of the company from the above authorities' registers.

Shareholder Rights

Introduction

The rights of shareholders have been prescribed in the Law "On Economic Associations" since its inception in 1991. Although the Law is quite clear in determining the various rights of shareholders according to their shareholding percentages, in practice no shareholder was safe from share dilution as a result of the scandalous actions of the management bodies and the vagueness of Ukrainian legislation regarding the issuance of additional shares. In the past, for instance, the management of a Ukrainian company would routinely offer additional shares to outsiders without offering them to the existing shareholders thereby diluting the shares of its shareholders without their consent.

As a result, one of the vital issues for most foreign investors, interested in purchasing shares in Ukrainian open joint stock companies, is the extent of rights one acquires along with the company stock. Review of shareholders' rights in a Ukrainian publicly-traded company requires a review of the Law "On Economic Associations," and State Commission for Securities and the Stock Market of Ukraine's Decision No. 158 on "Regulations on the Procedure for Increasing (Decreasing) the Size of the Authorized Capital of a Joint Stock Company." While minority shareholder rights are still underdeveloped in Ukraine, the Law of Ukraine "On Economic Associations" provides certain minimum protection for shareholders depending on the amount of stock they hold.

A. General Rights of a Company's Shareholders

Generally, the rights of all shareholders in a Ukrainian company may be realized from the moment changes to the register of owners of

registered securities are officially introduced. In accordance with the Law "On Economic Associations" and the company charter that sets forth certain legal provisions etched in stone, a company's shareholders have the following general rights:

- to participate in the management of the company's affairs in the manner set forth in the company charter;
- to participate in the distribution of the company's profits and receive a share thereof (dividends) proportionate to the amount of shares belonging to each shareholder;
- to receive information on the activities of the company. Upon the demand of a shareholder (including annual balance sheets, the reports of the company concerning its activities, the minutes of any meetings and other information);
- in case of liquidation, to receive a portion of the company's property proportionate to the amount of shares held by each shareholder;
- to withdraw from the company as a shareholder by alienating its shares of stock;
- to exercise the right of first refusal to acquire additionally issued company stock;
- to submit proposals concerning the agenda of the general assembly of shareholders no later than 30 days before its convening; and
- to familiarize themselves with the documents concerning the agenda of the general assembly before convocation of the general assembly of the company.

The management of the company is responsible for including shareholders' proposals into the agenda. Proposals of shareholders, which own more than 10% of the votes at the general assembly, are mandatory for inclusion into the agenda of the general assembly of the company. All shareholders must be notified regarding decisions on changes to the agenda no later than 10 days before convening the general assembly pursuant to the procedure contained in the company charter.

Importantly, the general assembly of shareholders does not have the right to render decisions on issues that are not included into the agenda of the general assembly. Therefore, shareholders are protected from having to spontaneously decide issues without having the possibility to familiarize themselves, thereby avoiding any misinformed decisions.

B. General Obligations of a Company's Shareholders

Notably, along with the general rights of shareholders, the following obligations exist:

- to observe the company charter and fulfill all decisions of the general assembly of shareholders and other authorized bodies of the company;
- to fulfill all obligations as a shareholder before the company, including effectuating shareholder contributions, as well as paying for shares in the amount and according to the procedure provided by the foundation documents (in cases when a shareholder acquires additionally issued shares of a company); and
- to refrain from disclosing commercial secrets and confidential information on the company's activities.

C. Specific Rights of Shareholders Owning More Than 10% of a Company's Shares

In addition to the general rights described in Section A above, shareholders with more than 10% of the company stock have the following additional rights:

- to demand convocation of an extraordinary session of the general assembly of shareholders at any time and for any reason;
- to submit proposals for the agenda of an impending general assembly of shareholders;
- to appoint a representative (proxy) to monitor the registration of shareholders participating in the general assembly of the company; and

- to demand that the Audit Commission of the company carry out an audit of the financial-economic activities of the company's management body.

D. Specific Rights of Shareholders Owning More Than 25% of a Company's Shares

In addition to the general rights of shareholders described in Section A, shareholders, who own more than 25% of a company's shares, have the following additional rights:

1) to block decisions by the company's general assembly of shareholders regarding the following issues:

a) to introduce amendments to the company charter. In this case, a shareholder owning more than 25% of the issuer's shares can block a decision to increase or decrease the company's authorized capital, which requires an amendment to the company's charter. This gives the 25% + 1 shareholder the ability to prevent dilution of its shares. In contrast, a shareholder owning less than 25% of a company's shares does not have the ability to block a decision on the increase/decrease of the issuer's capital and therefore may face repeated attempts by the remaining shareholders to increase the company's capital. As a result, if a shareholder owning less than 25% of the company's shares does not exercise its right of first refusal to buy additional shares in proportion to its shareholding interest, its vote will be accordingly diluted.

b) adoption of a resolution on the termination of the activity of the company; and

c) establishment and termination of the activity of subsidiary enterprises, branches and representative offices of the company.

E. Specific Rights of Shareholders Owning More Than 50% of a Company's Shares (50% + 1 and 75% + 1 Shareholding)

A 50% + 1 shareholding in a Ukrainian joint stock company grants such shareholder the possibility to accept and influence all issues set forth by law and in the company charter that can be decided by a simple majority. These issues include determining the principal objectives of the company, electing and recalling members of the management and audit commission, approving the annual results of the company's activities, approving the company's rules, procedures and organizational structure, approving material contracts entered into by the company, among others.

Perhaps the greatest advantage for 50% + 1 shareholders is the possibility to appoint the General Director or management board of the company, which handles the day-to-day operations of the company. This advantage provides

such shareholders with the ability to tactically control the financial activities of the company. However, the general assembly of shareholders retains the ability to strategically control the financial activities of the company.

A 75% + 1 or higher shareholding in a Ukrainian open joint stock company gives a shareholder the widest range of control over such company. Specifically, such a shareholder is armed with all of the above-discussed rights plus the absolute power to block or accept all decisions of the company, including those decisions which require a qualified majority of votes. These "qualified majority" issues include approving amendments to the company charter, adopting resolutions on the termination of the company's activity and the establishment and termination of subsidiaries, branches and representative offices of the company.

Moreover, a 75% + 1 shareholder alone can meet or defeat the 60% quorum requirement for convening the general assembly of shareholders. Thus, by not showing up at a general shareholder meeting, the qualified majority shareholder can invalidate such meeting. Even in the event that shareholders holding more than 10% of the votes convene an extraordinary general assembly via the management, the 75% + 1 shareholder can defeat any issues raised by simply casting his/her vote against such issues.

The ability to block virtually all decisions can be particularly advantageous at various stages for issues which require a qualified majority. In particular, the qualified majority shareholder can use its power as leverage against all other shareholders with respect to the additional issuance of shares. For example, the 75% + 1 shareholder can agree to vote for an increase of the company's authorized capital via the additional issuance of shares at the general assembly of shareholders only if certain conditions are met. Thus, if the qualified majority shareholder's conditions are not met to its satisfaction, such shareholder can simply block the vote to increase the company's authorized capital (which requires a 3/4 majority vote), thereby rendering the additional issuance impossible.

Minority Shareholder Protection

Pursuant to the Regulations, all shareholders in a joint stock company have an equal right of first refusal to acquire additionally issued shares in proportion to their share in the authorized capital on the date of the decision to make the

additional issuance. If a subscription is to be carried out for the additionally issued shares, then the open joint stock company is prohibited from providing different terms and conditions for the right of first refusal of one investor than for other investors (except in cases when shareholders exercise their rights of first refusal).

A subscription for additionally issued shares must be carried out in two stages. In the first stage, the shareholders exercise their rights of first refusal in proportion to their existing shareholding. In the second stage, third party investors and existing shareholders may exercise their right to purchase additionally issued shares. At this point, the existing shareholders may purchase shares exceeding the amount of shares for which they exercised their right of first refusal in the first stage. Importantly, the existing shareholders have the right of first refusal over incoming investors to purchase the remaining shares. This second-stage right of first refusal gives the existing shareholders the power to exclude new shareholders from entering the company.

Procedurally, the term for holding the first stage of the subscription may not be less than 15 calendar days. The second stage of the subscription will begin after the completion of the first stage. On the day following the completion of the first stage, shareholders and other investors may demand information concerning the quantity of shares, which were subscribed for in the first stage.

Any shareholder, who wishes to exercise his/her right of first refusal for additionally issued shares, must file an application to acquire the shares and pay for such stock in accordance with the terms and conditions of the issuance. Upon the exercise of a right of first refusal, the open joint stock company cannot restrict the use of cash by a shareholder as payment for the shares. Any applications received from third-party investors (i.e., non-shareholders) will not be considered before the commencement of the second stage of the share subscription.

In describing shareholders' rights of first refusal, the Regulations set forth a mechanism which protects shareholders from dilution of their shares by prohibiting companies from selling shares to investors without offering shareholders an option to purchase the additionally issued shares first. Further, the Regulations also prevent open joint stock companies from selling additionally issued shares at steep discounts, thereby decreasing the value of existing shares.

Taxation

Ukrainian general tax principles are established by the Law "On the Taxation System of Ukraine," which classifies all taxes either as national or local. National taxes include Corporate Income Tax, Value Added Tax, Personal Income Tax, Customs Duties, and Excise Taxes account for the largest portion of budget revenues. Local authorities may also collect revenue from a number of taxes, such as advertisement tax, community development tax, hotel tax, parking tax, recreation tax, among others.

The Ukrainian system of taxation contains the following principle taxes and/or mandatory payments:

- Corporate Income Tax;
- Value Added Tax;
- Personal Income Tax;
- Customs Duties;
- Pension Fund and Social Security Fund Contributions;
- Excise Duties;
- State Duties;
- Land Tax;
- Vehicle Owners Tax;
- Payments for Licenses/Patents.

Below we summarize only the corporate income tax and value added tax laws.

Corporate Income Tax (Cit)

1. Tax Jurisdiction

Legal entities incorporated and operating under the legislation of Ukraine are normally treated as tax residents and are taxable on their worldwide income. Legal entities incorporated abroad and operating under the laws of another country are normally treated as foreign tax residents (non-resident) and are taxable on two sources of income:

- Business income received from carrying out trade or business in Ukraine; and
- Other non-business income received from Ukrainian sources.

According to the Law of Ukraine No. 334/94 "On Taxation of Profits of Enterprises," dated December 28, 1994 (hereinafter the "Profit Tax Law"), the tax on companies is known as corporate income tax. Currently, this tax is generally calculated at a flat rate of 25% as of January 1, 2004. Special tax rules may apply to certain companies, such as insurance companies.

2. Taxation of Resident Entities

(1) Tax Accounting Rules

Under domestic tax accounting rules, tax items (including gross income and gross expenses) are normally recognized on the basis of the cash-or-accrual method (e.g. first event rule). Under this method, income is recognized within the reporting period upon the occurrence of one of the following events, whichever occurs earlier:

- the date of the transfer of funds from the purchaser (customer) to the bank account of the taxpayer as payment for goods sold or services (works) rendered or, in case of payment in cash, the date of receipt of cash as payment for such goods, works or services; or
- the date of the unloading of the goods sold or, for works or services, the date of the fac-

tual provision of the results of the works or services by the taxpayer.

Expenses are recognized upon the occurrence of the one of the following events, whichever occurs earlier:

- the date of the write-off of goods from the bank account of the taxpayer as payment for goods, works or services and, in case of payment in cash, the date of the withdrawal of cash from the cash register or cash reserves of the taxpayer; or

- the date of the receipt of goods by the taxpayer or, for works and services, the date of the factual receipt of the results of such works or services.

The tax year corresponds to the calendar year. Taxpayers must submit tax returns for a calendar quarter, half year, three quarters, calendar year and make quarterly tax payments. Quarterly tax returns must be submitted within 40 days following the last calendar day of each calendar quarter, half year and three quarters and the fourth (i.e., last) quarter. There is no additional annual tax return.

(2) Taxable Income

Resident entities are taxable on their worldwide income received or accrued within a reporting period. The amount of taxable income is determined by subtracting allowable deductible expenses and capital allowance from gross income.

(3) Gross Income

Gross income is defined as any income from domestic or foreign sources received or accrued by the taxpayer from any activity. Such income may be in monetary, tangible or intangible form. The following items are specifically included in gross income:

- Overall income from the sale or exchange of goods, works or services, including securities (except with respect to their initial issuance or final extinguishment);

- Income from banking, insurance and other operations involving the provision of financial services, currency sales, securities and debt instrument sales;

- Property and services received free of charge;

- Income from joint activity and in the form

of dividends from non-resident companies, unlike dividends received from resident companies, as well as interest, royalties, debt instruments and income from leasing operations (lease),

The following items are specifically excluded from gross income:

- Amounts of VAT received (accrued) by the taxpayer on top of the cost of goods/services, except in cases when the taxpayer is not a payer of VAT;

- Income received from joint activity on the territory of Ukraine without the creation of a legal entity, including dividends received from resident companies, unlike dividends received from non-resident companies, which dividends are taxed according to a special procedure;

- Monetary or in-kind contribution of capital to an entity or partnership in exchange for an equity interest therein, irrespective of whether the investor acquires a controlling interest following such contribution.

(4) Deductible Expenses

Any current business-related expenses are deductible unless such deduction is restricted or disallowed by the Profit Tax Law. The following items are specifically included as deductible expenses:

- Compensation for goods or services to be used by a taxpayer in its business;

- Any current expense in connection with starting-up, managing and carrying out of business;

- Capital asset improvement costs of up to 10 percent of the total book value of all capital assets at the beginning of the reporting year. Excess costs are capitalized.

Deductions of certain expense items is specifically prohibited, including penalties and fees paid, dividend payments, corporate and personal income tax payments, as well as VAT amounts included in the price of purchased goods (services) and amusement, entertainment, or recreational expenses. Of course, this restriction does not apply to expenses incurred by the taxpayer whose main business activity is furnishing amusement, entertainment, or recreation.

3. Corporate-Shareholder Taxation

The Profit Tax Law entitles Ukrainian resident companies to pay dividends to its shareholders regardless of whether the paying entities have recorded income or losses for the tax period. Moreover, the Profit Tax Law further provides that there is no distinction between accounting and taxable income/loss for the purposes of this rule.

Ukrainian tax law treats taxes on dividends as a constituent part of corporate income tax and not as a separate tax.

(1) Corporate Income Tax

Corporate income tax is paid on dividends distributed to residents and non-residents alike at the rate of 25 percent as of 1 January 2004. The tax is accrued on top of a dividend payment and is made from the funds of the issuing company (e.g. corporate entity's funds). This means that when the distribution is made (or before such distribution is made) a tax payment of 25 percent of the dividend is remitted to the State, and the full value of the dividend is paid to the shareholder.

At the end of the tax period, the taxpaying company is entitled to use the amount of previously contributed tax on dividends as a credit against its corporate tax liabilities. If the taxpayer does not have a sufficient corporate tax liability for the period, the amount of remitted tax on dividends may be carried forward indefinitely into future taxable periods.

(2) Withholding Tax

Unless there is a better rate provided by the respective tax treaties, dividend payments made to non-resident taxpayers are subject to a 15 percent withholding tax described above (e.g. Taxation of Non-business income). The amount withheld should be remitted to the State at the time of the dividend distribution.

Currently, there is no withholding tax for resident shareholders.

Value Added Tax

1. Taxable Transactions

In accordance with the Law of Ukraine No. 168/97 "On Value Added Tax," dated April 3, 1997, value added tax ("VAT") is imposed on:

- Domestic sale transactions of goods or services, including payment for services under lease agreements and operations involving the transfer of ownership rights to pledged objects to a creditor to extinguish debt;
- Import of goods or services for use or consumption in Ukraine, including the import of property under leasing agreements, pledge agreements and/or mortgage agreements;

- Export of goods or services for use or consumption outside of Ukraine.

VAT is levied at a rate of 20 percent of the taxable amount for domestic sales and imported goods or services. For exported goods or services the VAT rate is zero percent. The general rule is that the taxable amount is defined on the basis of the contractual value of the goods or services supplied.

2. Exempt Transactions

(1) Transactions Specifically Exempt from VAT

Certain transactions subject to the provisions of the "Law on Value Added Tax" ("the VAT Law) are exempt from VAT. These include, but are not limited to:

- Sale of domestically produced baby food products;
- Sale and delivery of domestically published periodicals, student notebooks, textbooks, books, and supplementary study materials;
- Provision of educational services by institutions with special permission (license) for provision of such services;
- Sale of special-purpose goods for disabled individuals;
- Delivery of pensions and monetary assistance to the population;
- Public transportation services, among others.

(2) Transactions Not Subject to VAT

According to the VAT Law, certain transactions are not subject to VAT. These include, but are not limited to:

- Issuance of securities by enterprises, the National Bank of Ukraine, the Ministry of Finance of Ukraine, and by local authorities;
- Insurance and reinsurance services, including social and pension insurance;
- Transfer of lease property by a resident lessor to a lessee and the return of the lease property by the lessee to the lessor; the payment of interest or commission in lease (leasing) payments calculated on the value of the leased object (without calculating the portion of leasing payments provided as compensation of a part of the value of the leased object pursuant to agreement);
- The pledge of property to a creditor pursuant to a credit agreement and the return of the property; the transfer by a resident creditor of a mortgaged object into possession or use by a

borrower; and cash payments of the principal amount and interest under a mortgage;

- Payment of salary, pensions, stipends, subsidies and other cash or in-kind payments to natural persons at the expense of budgets or social and insurance funds;
- Payment of dividends and royalties in monetary form or in the form of securities;
- Provision of commission (brokerage) and dealer services for the sale or management of securities;
- Transfer/import of fixed assets as a contribution to the authorized capital of a legal entity in exchange for equity interest therein, provided that these assets are used to form a business (or part thereof) as a going concern.

3. Taxable Persons

There are several types of taxable persons defined as VAT-payers, based on the kind of business activity they perform. These VAT-payers include, but are not limited to, any person/entity which:

a) carries out or plans to carry out commercial activity and voluntarily registers as a VAT-payer;

b) is subject to mandatory registration as a VAT-payer, including but not limited to, the following cases:

(i) If the total amount from the carrying out of operations involving the supply of goods (services), including via the use of a local or global computer network, subject to taxation pursuant to the VAT Law, is transferred (paid, provided) to such person/entity or as payment of obligations to third parties within the last 12 calendar months exceeds in aggregate 300,000 Ukrainian Hryvnia (without taking into account VAT);

(ii) The person/entity is supplying goods (services) on the customs territory of Ukraine with the use of the global or a local computer networks. In this case, a person/entity-non-resident may only carry out such activity via its permanent representative registered on the territory of Ukraine;

c) imports goods (accompanying services) in volumes subject to taxation by VAT in accordance with the law.

d) any person/entity which imports (for natural persons — imports or sends) goods

(accompanying services) into the customs territory of Ukraine for their use or consumption on the customs territory of Ukraine, regardless of which regime of taxation it uses pursuant to legislation, with the exception of (a) natural persons, who are not registered as VAT-payers and which import (send) goods (objects) in accompanying luggage or receive them via post office within the limits of non-trade turnover in volumes not subject to taxation in accordance with customs legislation (except the import of transportation means or spare parts thereto by such natural persons) and (b) non-residents sending postal packages pursuant to the rules of the International Postal Union into the territory of Ukraine and receivers of such postal packages.

Note that foreign legal entities are able to register as VAT-payers in Ukraine only if they carry out business in Ukraine through a permanent establishment.

4. Taxable Amount

(1) Domestic Sales

For any taxable domestic sale, VAT is chargeable on the contractual value of money, goods/services or any other consideration received or accrued in connection with the sale.

Should a taxable supply be made to a related person, to a non-registered VAT person, or for any consideration other than money (in-kind consideration), VAT is chargeable by the supplier on normal price ("fair market value") of goods or services being sold or provided.

(2) Imports

i) Import of Goods

For import of goods, VAT is chargeable on the contractual value of the goods imported. However, if their contractual value is less than their customs value, the taxable amount is their customs value.

The customs value of any imported goods is equal to their value in terms of the customs laws of Ukraine, including expenses for transportation; loading, unloading, reloading and insurance up until the customs crossing point of Ukraine; payment of brokers, agency, commission and other

fees connected with the import of such goods, payment for use of related intellectual property, excise duty, import duty, and other fees and duties included into the price of such goods.

ii) Import of Services

Should services be imported for use or consumption within Ukraine, VAT is chargeable on the contractual value of services received under the "reverse-charge mechanism". This mechanism is defined by the VAT law as follows: "For services provided by non-residents on the customs territory of Ukraine, the basis for taxation is the contractual value of such works or services taking into account excise duty and other taxes and fees (mandatory payments), which are included into the price of such works or services, excluding VAT. The determined value is recalculated into Ukrainian Hryvnia according to the currency exchange rate of the National Bank of Ukraine effective at the end of the operational day preceding the day on which the act certifying the fact of receipt of the services was executed."

5. VAT Administration

(1) Remittance

VAT on domestic supplies and importation of services is administered by the tax service, while VAT on the importation of goods is administered by the customs service.

Any taxable person should assess the amount of VAT to be remitted to the budget by reducing ("crediting") its output VAT liability (VAT collected on outward taxable sales) with input VAT credit (VAT incurred on inward taxable sales and import sales).

VAT on imported goods is payable by the importer in cash at the customs border. A taxable person responsible for paying import VAT and meeting certain requirements may defer such payment by issuing a VAT promissory note. This VAT promissory note should either be settled within a 30-day period or included in output VAT liabilities.

(2) VAT Credit

Any input VAT incurred by a taxable person on inward domestic sales and import sales is creditable against output VAT liabilities pro-

vided that such input VAT was incurred:

- In connection with the acquisition or production of goods (including upon their import) and services for purposes of their further use in taxable operations in the context of the business activity of a VAT-payer; and

- In connection with the acquisition (construction, erection) of fixed assets (capital assets, including other non-turnover tangible assets and incomplete capital investments in non-turnover capital assets), including upon their import, for purposes of further use in production and/or the supply of goods (services) for taxable operations in the context of business activity of a VAT-payer.

If a VAT-payer acquires (produces) goods (services) and fixed assets, which are not intended for their use in operations not subject to VAT or exempt from VAT, such VAT is not creditable, but may be deductible or depreciable/amortizable for CIT purposes. If produced and/or acquired goods (works, services) are partially used in taxable operations, then that portion of the paid VAT is creditable upon their production or acquisition which corresponds to the portion of use of such goods (works, services) in taxable operations of the reporting period.

If a VAT-payer acquires (produces) tangible and intangible assets (services), which are not intended for their use in the business activity of such taxpayer, then the amount of VAT paid in connection with such acquisition (production) is not creditable.

(3) Tax Refunds

Since export sales are zero rated, any taxable person making sales of goods/services for use or consumption outside of Ukraine may claim as a credit its input VAT incurred in connection with exported supplies.

Although the excess credit is refundable, very strict requirements for such refunds are established. In fact, such requirements make VAT refunds very difficult to obtain or at least delay them considerably. Needless to say, some very entrepreneurial Ukrainians have made a profitable business out of the refund of VAT; however they do charge high percentages in achieving the return of VAT in a quick manner.

Guarding Against Hostile Takeovers

Holding your ground against a brutal hostile takeover is never easy. In Ukraine, defending against hostile takeovers is an especially challenging task, which requires comprehensive strategic and tactical steps not only in the legal arena. In addition to increasing internal and external security measures, in today's corporate world a company's management must perform careful market analysis and public relations campaigns, while undertaking all the necessary legal steps to solidify its position in the face of a hostile takeover. Below we shall limit our discussion to the legal arena only.

From a legal point of view, strategic (and thus, the most effective) steps may include inter alia:

(i) choosing a corporate form that provides the effective owner with more control over the company's business activities (LLC or closed joint stock company);

(ii) creating a corporate structure subordinate to the owner (accumulation of at least 51% or, where possible, 76% of the stock);

(iii) limiting management authority (by means of meticulous charter drafting) to effectuate principal decisions concerning the company's assets and debts without the owner's consent;

(iv) transferring principal assets of the company (land, buildings, equipment, etc.) to friendly (usually non-resident) companies that are completely controlled by the owner with due regard to corporate legislation in relevant foreign jurisdictions in such cases;

(v) providing a strict mechanism of control over the company's debts, etc.

Relations between the owners should be formalized in relevant corporate documents, as conflicts between owners are often used as a tool in a hostile takeover.

In such cases, a few simple tactical measures could prove to be highly effective, such as:

(i) counter-purchasing minority shareholders' shares;

(ii) issuing additional shares to dilute any shares controlled by the aggressor;

(iii) fixing the controlled stock by investing it in the authorized capital of a friendly LLC or CJSC;

(iv) subjecting the company's assets to encumbrance by friendly entities, which are controlled by the owners;

(v) alienating assets to friendly entities, etc.

Unfortunately, in many cases there is very little chance of avoiding the hostile blows after the attack has already commenced. Sometimes a hostile takeover is accompanied with an arrest of the company's assets by a court, taking the owners completely by surprise. In such cases, an aggressor probably already controls the minority shareholders, management and/or stock of the company. In situations like this, nothing can be done.

In today's uncertain legal and political climate, no measure can provide an investor with 100% guaranty protection from a hostile takeover attempt. As a starting position, however, we advise our clients to make their target business both inconvenient and too expensive to attack, going as far as making it worthless from an economic point of view to merit the upcoming takeover better.

The Firm's Clients Include:

- Advanced Logic Solutions, Inc.
- Amadeus Global Travel Distribution, S.A.
- Baltic Beverages Holding;
- Bank Austria Creditanstalt
- British Energy
- Bruhn Internationale Transporte GmbH
- BT Global Services
- Chumak
- Commerzbank Aktiengesellschaft
- Credit Commercial de France
- CTB, Inc.
- Deloitte
- Direct EDI Inc
- DUROPACK
- Emilceramica SpA
- Fiat Auto
- FL Smidth & Co.
- Freshfields Bruckhaus Deringer
- Hewlett-Packard Company
- INDEVCO
- Jahn General Products Ukraine
- Jabil Circuit, Inc.
- Quality Schools International
- KLM Royal Dutch Airlines
- KPN Royal Dutch Telecom
- Linklaters
- Notaro & Michalos
- Philips Electronics
- Robert Fleming & Company, Ltd.
- SCL Corporate Finance SA
- Sealed Air Limited
- Skanska East Europe OY
- Stragen Chemical SA
- Sun Microsystems
- Theeuwes de Jong B.V.
- The Danish Investment Fund for Central and Eastern Europe
- Thornkild Kristensen Properties AS
- Tyco Electronics AMP GmbH
- Van Oostveen Medical B.V.
- Vetropack Holding Ltd.
- The Embassy of Austria
- The Embassy of Sweden
- The US Embassy
- Vimpel Communications, among others.

References

▶ *"Since 1992 we have the pleasure of being the client of Frishberg & Partners, and recent results just confirm that this was and still is a very right choice for KLM Royal Dutch Airlines."*

Sergey Fomenko, KLM Royal Dutch Airlines

▶ *"Frishberg & Partners' advice and services are of excellent quality, very timely, reliable and to the point, and with a good understanding of our business interests."*

Christoph Zeyen, Tyco Electronics

▶ *"We are very satisfied with the services of your law firm and especially appreciate the quick, accurate and business- minded responses and analysis."*

Dr. Brigitte Carbonare-Hartsleben, BT Global Services

▶ *"As always, thank you for your immediate attention to our needs. Your assistance will help enable us to successfully complete a very large contract and to keep a very good customer."*

Lori K. Rose, CTB, Inc.

▶ *"I really appreciate the capability and professionalism of your lawyers and the efforts your company successfully put in the defense of ours. We thank you for your assistance and cooperation."*

Flavia Smiraglio, Fiat Auto S.p.A.

▶ *"Emilceramica appreciates Frishberg & Partners' professional collaboration in supporting the project "Joint Venture Zeus Keramik" with Ukrainian participation. In this regard, Emilceramica hopes to have Frishberg & Partners' assistance in future."*

Dr. Efrem Montepietra, Emilceramica SpA

▶ *"We at Sun and I am personally as legal counsel for Sun operation in CIS region, are very pleased with a level of expertise and service which were and are provided to our company in Ukraine by Frishberg & Partners. I would like to particularly mention also a constant effort of F&P lawyers to keep its clients updated on the most recent developments of Ukrainian legal environment and their responsiveness to our needs in that country."*

Dr. Andrei Zalivako, Sun Microsystems

▶ *"Thank you and the colleagues at Frishberg & Partners for your assistance and the very valuable input you provided. We are all happy with the outcome of the matter that was handled well, based on a good sense of judgment, lots of wisdom, good decision making and good use of past learnings from previous experiences in this country."*

Elias N. Ashkar, INDEVCO Group

▶ *"You did an excellent job for Joss Chemicals BV, and you prepared an excellent report on our behalf. This was very positive for us, and it allowed us to set up our business in Ukraine. Now we are actively pursuing this business thanks to your excellent lawyers."*

Jan Huijbregts, Joss Chemicals BV

▶ *"We hired Frishberg & Partners to analyze certain issues in the Ukrainian legislation in the process of acquiring a company in Ukraine and were very happy with the services we received. All your lawyers we worked with are extremely professional, competent and helpful. Thank you for a job well done."*

Dmitriy Kasyanenko, Vimpel Communications

About the Firm

Over the last 15 years, **Frishberg & Partners** has served as corporate counsel to multinational companies and banks (see our list of clients). We have registered a multitude of joint ventures, subsidiaries and representative offices in Ukraine. By now, the registration process is well- established, as is liquidation.

Acquisition of controlling blocks of shares in Ukrainian companies, however, is an entirely different game, requiring knowledge and experience of local corporate legal specialists. Because each target company is unique, there is no standard approach. That is why our lawyers provide a comprehensive analysis of alternative corporate and tax-efficient acquisition structures in light of the client's specific goals.

Strategic investment is often structured around real property, and sometimes land plots. Together with our real estate specialists, we can set up turn-key operations on industrial greenfield sites, from land right allocations and construction permits to the finished enterprise, fully commissioned and ready for use. Just turn the key.

After the acquisition has taken place, we continue to work closely with our clients to resolve the day-to-day issues, including employment law, capital increases or decreases, tax and customs matters.

At the corporate law firm of **Frishberg & Partners**, our clients truly benefit from getting the most complete package of corporate legal services available on the Ukrainian legal market.

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