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by Sergiy Melnyk,
Associate, Salans, Kyiv

www.ifa-ukraine.org
ifa@ifa-ukraine.org
+38 044 492 82 82
Oksana Borovska
IFA Ukraine Coordinator



Topic of the Issue:
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Clause in Ukrainian Tax Treaties**

The Application of the Non-Discrimination Clause in Ukrainian Tax Treaties



Contributed by
Sergiy Melnyk,
Associate,
Salans, Kyiv

1. INTRODUCTION

The main purpose and benefit of double tax treaties¹ is commonly considered to be the avoidance of international double taxation. At the same time, double tax treaties have a number of other purposes and benefits, which, in particular, include non-discrimination.

Ukraine has entered into more than sixty double tax treaties, which generally contain a non-discrimination clause prohibiting discrimination (i.e., broadly - the unequal tax treatment of similar cases) in a number of circumstances, discussed below. But has the non-discrimination clause proved to be an efficient mechanism for avoiding tax discrimination in Ukraine or it is merely a principle, not having any real practical effect on taxpayers in Ukraine? This article discusses how the non-discrimination clause can be applied in Ukraine and, in particular, addresses the legal and practical value (effect) of the non-discrimination clause from a Ukrainian perspective.

To provide a full picture, apart from double tax treaties, there are provisions in Ukrainian domestic law and international treaties dealing with non-discrimination in tax matters. In particular, the Ukrainian law "On the Taxation System in Ukraine" contains a non-discrimination principle which adopts the same approach to businesses (including non-residents) in terms of determining tax

liabilities. This article does not consider the non-discrimination provisions embodied in Ukrainian domestic law and international treaties (other than double tax treaties).

2. CONTENT AND SCOPE OF NON-DISCRIMINATION CLAUSE

Most Ukrainian tax treaties contain a non-discrimination clause which is based on the OECD Model Tax Convention. For that reason, this article analyses the non-discrimination clause mainly from the perspective of the OECD Model Tax Convention.

The non-discrimination clause (article 24) in the OECD Model Tax Convention currently contains six paragraphs:

- (1) the first paragraph deals with non-discrimination in relation to nationals of a contracting state ("Nationality Non-discrimination");
- (2) the second paragraph deals with non-discrimination in relation to stateless persons who are residents of a contracting state;
- (3) the third paragraph deals with non-discrimination in relation to a permanent establishment ("PE") which an enterprise of a contracting state has in another contracting state ("PE Non-discrimination");
- (4) the fourth paragraph deals with non-discrimination in relation to the tax deductibility of interest, royalties and other disbursements paid by an enterprise of a contracting state to a resident of another contracting state ("Deductibility Non-discrimination");
- (5) the fifth paragraph deals with non-discrimination in relation to enterprises of a contracting state the capital of which is owned or controlled by resident(s) of another contracting state ("Foreign Control Non-discrimination"); and

(6) the sixth paragraph deals with the scope of the non-discrimination clause.

As to the scope of the non-discrimination clause, according to Article 24.6 of the OECD Model Tax Convention, the provisions of the non-discrimination clause apply to taxes of every kind and description. However, Ukraine has set out its official position on this article to the effect that Ukraine reserves its right to restrict the scope of a non-discrimination clause only to taxes covered by a tax treaty. Thus, the non-discrimination clause in most Ukrainian tax treaties applies only to those types of taxes specifically covered by the respective tax treaties. Nonetheless, the non-discrimination clause in many Ukrainian tax treaties (around twenty treaties – e.g., the tax treaties with Switzerland, the Netherlands, Austria and the USA) applies to all types of taxes (e.g., VAT) levied by the contracting states.

It is also notable that in certain Ukrainian tax treaties, the non-discrimination clause does not contain all the provisions stipulated by the OECD Model Tax Convention or contains specific (additional) provisions which are not stipulated by the OECD Model Tax Convention. For example, the non-discrimination clauses in the USSR tax treaties which are currently effective for Ukraine (e.g., the tax treaties with Cyprus, Spain, Japan and Malaysia) contain only the Nationality Non-discrimination and PE Non-discrimination provisions. At the same time, the tax treaties with the Netherlands and France contain specific (additional) non-discrimination provisions dealing with the payment of pension contributions.

3. APPLICATION OF NON-DISCRIMINATION CLAUSE

Before discussing the application of the non-discrimination clause in Ukrainian tax treaties, let us first consider the legal value of international treaties in Ukraine, including tax treaties. Under the Ukrainian Constitution, international treaties form part of Ukrainian law. Further, the Ukrainian law "On the Taxation System in Ukraine" establishes a principle of prevalence of international treaties ratified by Parliament over Ukrainian tax

¹ In this article the terms "double tax treaty" and "tax treaty" are used interchangeably to refer to international bilateral treaties for the avoidance of double taxation.

laws. This means that, if certain provisions of Ukrainian tax legislation contradict the provisions of Ukrainian tax treaties, including the non-discrimination clause, then the latter provisions should apply. As a consequence, the non-discrimination clause can have an impact on Ukrainian domestic legislation.

To the author's knowledge, there are only a few Ukrainian court decisions which refer to the non-discrimination clause in their legal reasoning and no court decisions which would provide an interpretation of the provisions of the non-discrimination clause. In practice, the Ukrainian tax authorities do not seem to take the non-discrimination clause into account when applying tax legislation (e.g., when drafting tax rulings). In contrast, in certain EU countries and in Russia, the application of the non-discrimination clause in tax treaties has had a greater effect.

This article continues with a general description of the provisions of the non-discrimination clause and addresses the situations in which such provisions could be applied in Ukraine. Non-discrimination provisions regarding stateless persons are not discussed in view of their limited practical effect.

3.1. NATIONALITY NON-DISCRIMINATION

Under the Nationality Non-discrimination provision, nationals (individuals, legal entities, partnerships and associations) of a contracting state cannot be subjected in another contracting state to any taxation and related requirements to which nationals of the latter state are not subjected in the same circumstances, in particular, with respect to residence.

The Nationality Non-discrimination provision specifically stresses that "the same circumstances" also include the same residence i.e., this provision may be invoked only if taxpayers who are residents of the same contracting state are treated differently in the same circumstances solely by reason of having a different nationality. Since Ukraine applies a residence-based (and not nationality-based) taxation principle, the impact of the Nationality Non-discrimination provision is very limited in

Ukraine. For example, the imposition of personal income tax at a rate of 15% on Ukrainian residents and at a rate of 30% on Ukrainian non-residents cannot be considered as discrimination from the perspective of the Nationality Non-discrimination provision.

There are no Ukrainian court cases regarding the application of the Nationality Non-discrimination provision.

3.2. PE NON-DISCRIMINATION

According to the PE Non-discrimination provision, the taxation of a PE which an enterprise of a contracting state has in another contracting state may not be less favourable than the taxation levied on enterprises of that other state carrying on the same activities in that state.

Despite the existence of the PE Non-discrimination provision, under Ukrainian tax legislation PEs may be subject to less favourable tax treatment when compared with Ukrainian enterprises in a number of circumstances. For instance, PEs are sometimes required to apply the indirect taxation method (which presumes a deemed profitability of 30%), which disregards PEs' actual expenses and does not allow tax losses to be carried forward. In contrast, Ukrainian enterprises normally apply the direct taxation method. Another example is the tax treatment of funds received by a PE from its head office. Ukrainian tax authorities often take a strict fiscal approach (not taking into account the PE Non-discrimination provision), whereby funds received by a PE from its head office must be treated as taxable income for the PE, albeit that such funds would not be taxable for a Ukrainian branch if received from its Ukrainian head office.

There is only one court case, heard before a local administrative court, in which the court refers to the PE Non-discrimination provision in the Ukraine-Russia Double Tax Treaty (case #2-a-721/08). This case concerns the tax treatment of funds received by a PE from its Russian head office. In this case the court supported the taxpayer's position that funds received by a PE from its Russian head office should not be treated as taxable

income for the PE.

3.3. DEDUCTIBILITY NON-DISCRIMINATION

According to the Deductibility Non-discrimination provision, interest, royalties and other disbursements paid by an enterprise of a contracting state to a resident of another contracting state must, for the purposes of determining the taxable profit of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the former state.

In light of the Deductibility Non-discrimination provision, the following provisions of Ukrainian tax legislation appear to be questionable. Firstly, Ukrainian taxpayers can deduct payments made to non-residents only upon receipt of goods or services from such non-residents, whereas they are generally allowed to deduct payments under the "first event rule" (on the date of payment or on the date of receiving goods or services) when dealing with Ukrainian regular taxpayers. Secondly, there is a deductibility limitation² applying to interest payable under loans by a Ukrainian taxpayer to its non-resident shareholder (holding over 50% of the equity of the Ukrainian taxpayer), or a related party of such non-resident shareholder, while interest payable to Ukrainian regular taxpayers can generally be deducted in full.

There are no Ukrainian court cases regarding the application of the Deductibility Non-discrimination provision. However, in certain EU countries and in Russia the Deductibility Non-discrimination provision has been applied by the courts, particularly in the context of thin capitalization rules, and in certain cases (e.g., in Russia) thin capitalization rules were recognized as incompatible with the Deductibility Non-discrimination provision (and therefore discriminatory).

3.4. FOREIGN CONTROL NON-DISCRIMINATION

Under the Foreign Control Non-discrimination provision, enterprises of a contracting state, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of another contracting state, cannot be subjected in the former state to any taxation or any connected

² Under this limitation, a Ukrainian taxpayer is allowed to deduct interest payable to its non-resident shareholder, or a related party of such non-resident shareholder, in an amount that does not exceed any income received by the Ukrainian taxpayer on interest it earns (if any) plus 50% of its taxable profit (not taking into consideration interest income, interest expenses and depreciation charges) for the tax period. The interest not deducted in the tax period may be carried forward indefinitely, subject to the same limitation.

requirements which differ from or are more burdensome than the taxation or connected requirements to which other similar enterprises of the former state are or may be subjected.

Apart from the interest deductibility limitation described above, which apparently may also be challenged under the Foreign Control Non-discrimination provision, there is an issue as to whether the application of the Ukrainian transfer pricing regulations to transactions with non-residents may be considered as discriminatory. By way of explanation, ordinarily the Ukrainian transfer pricing regulations do not apply to transactions between Ukrainian regular taxpayers, while they seem to apply to transactions between Ukrainian taxpayers and non-residents.

Again, there are no court cases regarding the application of the Foreign Control Non-discrimination provision in Ukraine.

4. PROTECTION AGAINST DISCRIMINATION

Having discussed the Ukrainian domestic rules which appear to be disputable (discriminatory) vis-à-vis the provisions of the non-discrimination clause, this article now outlines the protection measures which may be invoked by taxpayers to combat discrimination in Ukraine ("protection measures").

The protection measures can broadly be divided into two categories: (1) treaty protection measures; and (2) non-treaty (or domestic law) protection measures.

Let us first focus on treaty protection measures. Ukrainian tax treaties generally contain a mutual agreement procedure clause, which allows a taxpayer to present its case to the competent authority of the contracting state of which the taxpayer is a resident if the taxpayer considers that the actions of one or both contracting states result or may result for such taxpayer in taxation not in accordance with the provisions of the tax treaties. Thus, if a taxpayer considers the actions of Ukrainian tax authorities to be discriminatory from the perspective of the non-discrimination clause, such taxpayer may file an objection³ with the competent authority of its state of residence.

For example, in a matter concerning deductibility discrimination (as described above), a taxpayer would need to file an objection with the competent Ukrainian authority (normally - the Ministry of Finance). However, if the matter concerns PE discrimination (as described above), apparently an objection would need to be filed with the competent authority of the other contracting state.

From the mutual agreement procedure clause, it appears that a taxpayer may file such objection regardless of whether a claim has been brought against such taxpayer by the tax authorities, i.e., a taxpayer may file such objection if it can be reasonably expected that a claim may be brought against the taxpayer (e.g., based on the tax authorities' practices or rulings).

Generally, Ukrainian tax treaties provide a 3-year limitation period for filing objections under the mutual agreement procedure clause. However, certain Ukrainian tax treaties do not contain a limitation at all (e.g., Cyprus and the USA), or provide a 2-year limitation period (e.g., Italy, Lebanon, Canada, Indonesia and Iran), or provide that a domestic limitation period should apply (e.g., Turkey and Brazil).

Although a taxpayer is entitled to present its objection to the competent authority, the latter will initiate a mutual agreement procedure only if such objection appears to it to be justified. The competent authority is also not required to initiate the mutual agreement procedure if it is itself able to arrive at a satisfactory solution to the case presented.

Even if the mutual agreement procedure is initiated, the competent authorities are not obliged (they must only endeavour) to reach a solution. Furthermore, there is generally no time limit within which the competent authorities must endeavour to resolve the case presented. If the competent authorities reach a solution, such solution must be complied with by the contracting states, subject to the acceptance of such solution by the taxpayer.

In Ukraine, the mutual agreement procedure has not proved to be an efficient protection measure in general and, in particular, in relation to discrimination. To the author's knowledge, only a few mutual agreements have been actually reached in connection with objections received from Ukrainian taxpayers.

Unfortunately, there is no public access to such mutual agreements in Ukraine.

Thus, the practical efficiency of the mutual agreement procedure as a treaty protection measure against discrimination appears to be doubtful in Ukraine.

It is significant that the mutual agreement procedure clause in the latest version of the OECD Model Tax Convention was amended to include an arbitration mechanism for the resolution of taxpayers' cases, if the competent authorities are unable to reach an agreement to resolve such cases within a two-year period. The implementation of the arbitration mechanism in Ukrainian tax treaties would provide more certainty and would facilitate the resolution of cases presented by taxpayers to the competent authorities.

Of the Ukrainian tax treaties, only the treaty with the Netherlands includes the arbitration mechanism for the resolution of taxpayer disputes, if such cases cannot be resolved by the mutual agreement procedure.

In addition to (or instead of) the mutual agreement procedure, a taxpayer can use non-treaty (or domestic law) protection measures (i.e., remedies provided by Ukrainian domestic law).

Under Ukrainian domestic law, if a claim is brought against a taxpayer by the tax authorities, the taxpayer can dispute such claim through the administrative procedure (up to the level of the State Tax Administration) and/or through litigation (in the administrative courts). For example, if a taxpayer does not comply with the interest deductibility limitation as described above and the tax authorities challenge such approach, the taxpayer may file a lawsuit with a local administrative court arguing that the interest deductibility limitation contradicts the non-discrimination principle. As mentioned above, there are a very limited number of court cases regarding the application of the non-discrimination clause in Ukraine.

Another domestic law protection measure could be to obtain an official interpretation of the relevant provisions of Ukrainian law from the Ukrainian Constitutional Court (e.g., whether the interest deductibility limitation contradicts the non-discrimination

³ In Ukraine there are no specific guidelines or practices as to the form of such objection.

clause in Ukrainian tax treaties). An official interpretation of the Constitutional Court is obligatory in Ukraine. In order to get the official interpretation, an applicant would need to provide the Constitutional Court with some substantiation of the necessity for such interpretation from the perspective of protection of the applicant's rights. In practice, the Constitutional Court tends to reject the majority of requests for an official interpretation of Ukrainian laws.

5. CONCLUSIONS

Ukraine has a relatively extensive tax treaty network. Each Ukrainian tax treaty generally contains the non-discrimination clause which prohibits tax discrimination in a number of circumstances (as discussed above).

At the same time, there are the Ukrainian domestic rules (as discussed above), which appear to be disputable (discriminatory) vis-à-vis the provisions of the non-discrimination clause. Furthermore, although in case of conflict the provisions of the non-discrimination clause, being

part of Ukrainian law, should prevail over such discriminatory Ukrainian rules, it seems that so far the Ukrainian courts, tax authorities and, more interestingly, taxpayers have not paid adequate attention to this state of affairs.

It follows therefore that, in years to come, the non-discrimination clause could have a more serious practical effect for taxpayers in Ukraine, as it has had in certain EU countries and Russia. To this end, taxpayers should probably rely more on the non-discrimination clause and invoke the protection measures against discrimination wherever necessary.



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