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Contents

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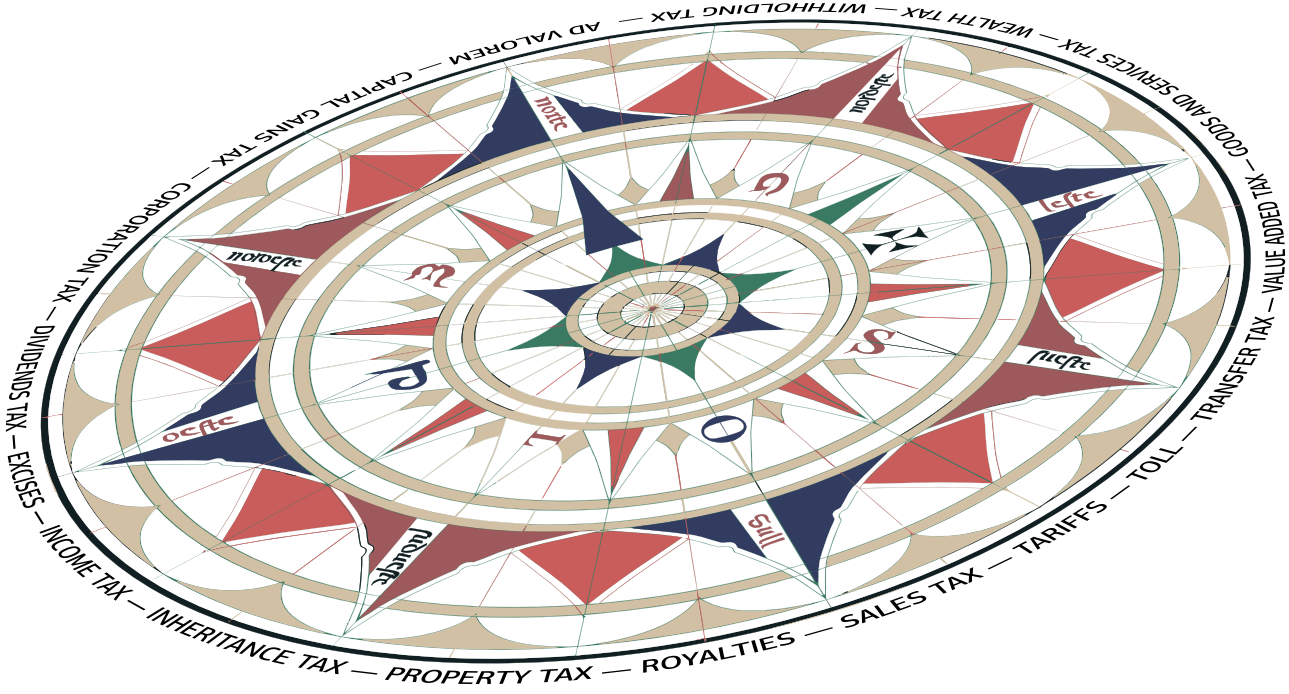

Topic of the Issue:

Treatment of Syndicated Loans in Ukraine from a Tax Standpoint

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Treatment of Syndicated Loans in Ukraine from a Tax Standpoint

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In view of the expansion of worldwide economic processes and coherence of local and international businesses market players appear to set up and be involved in large projects requiring high levels of financing for their satisfactory development and implementation. As long as lenders quite frequently may not handle substational loans and borrowers do not possess sufficient funds due to legal requirements or economic conditions syndicated loans seem to be a solution if large capital is needed.

According to the established practice and economic meaning assigned to syndicated loans, a syndicated loan is one that is provided by a group of lenders and is structured, arranged, and administered by one or several commercial or investment banks known as arrangers. In the Ukrainian context syndicated loans are usually provided to Ukrainian borrowers by a number of lenders from various jurisdictions through one arranger residing in a country having a most favourable tax regime with Ukraine. Such arranger accumulates funds from all lenders first and then transfers them to Ukrainian borrowers. Interest under such loans as well as return of the principal debt is effected by the borrowers to the arranger first who then distributes respective portions of interest to participating lenders.

So far, the legal nature of this financial instrument has not been defined by the Ukrainian legislation, regardless of the fact that syndicated loans are often attracted and used by Ukrainian banks. This, in particular, creates some uncertainty in how Ukrainian banks should determine tax implications when paying interest under syndicated loan agreements through the arranger in favour of lenders located in different jurisdictions that have varying tax regimes with Ukraine.

Till October 10, 2009 it was not clear how to tax interest paid by Ukrainian banks in favour of lenders under syndicated loan agreements through the arranger; and frequently interest was taxed by a withholding tax at the rate which was set by a double tax treaty of the country of such arranger's residence. For example, if the arranger of the syndicated loan was a Swiss bank and lenders were residents of other jurisdictions then interest paid by Ukrainian banks under the syndicated loan agreement to the arranger was only subject to 0% withholding tax pursuant to Subclause 3 c) of Article 11 of the double tax treaty between Switzerland and Ukraine. However, even before October 10, 2009 such approach was disputable.

On that date the State Tax Administration of Ukraine issued a clarification letter # 23790/7/15-0517 regarding taxation of syndicated loans which introduced its approach to the tax treatment of interest thereunder. Particularly, the STAU stated that the arranger of the syndicated loan is regarded only as a mere collector of interest while the beneficial recipient thereof is each of the lenders – participants of the syndicated loan. Hence, a Ukrainian resident while paying interest under syndicated loan agreements should apply the provisions of the effective double tax treaty with each of those countries where lenders reside.

To examine the compliance of the proposed approach with the current Ukrainian legislation let us refer to the taxation rules applicable to interest received by non-residents of Ukraine under loan agreements that are provided for by the Law of Ukraine "On Corporate Profit Tax" (hereinafter – the "Law").

Pursuant to clause 13.1 of Article 13 of the Law, any income received by non-residents that originates in Ukraine from carrying on commercial activity is subject to withholding tax. Income received by non-residents that originates in Ukraine means, inter alia, interest and/or discount income payable **in favour of non-residents.**

There is no doubt that interest payable by Ukrainian borrowers under syndicated loan agreements to non-residents is regarded as income originating in Ukraine. Interest also comes within the definition of income from the commercial activity. The only question left is whether such income should be considered as income of the arranger as a whole or of each lender in parts.

" Following the approach of tax authorities residents of Ukraine should take a look-through approach and look to the ultimate lenders as the beneficial owners of interest payments and thus apply different tax rates.

In our opinion, since income originated in Ukraine means income payable **in favour of non-residents** the Law provides for the possibility to consider interest payable under syndicated loan agreements to lenders via the arranger as an income of each lender.

Consequently, income of each lender in the form of interest paid from Ukraine under loan agreements could be deemed as such that is subject to withholding tax.

Thus, we can opine that the clarification of the tax authorities clarifies and interprets provisions of the Law.

The procedure and rate of witholding tax applicable to such income are laid down in clause 13.2 of the Law which runs that a Ukrainian resident or permanent representative office of a non-resident while effecting in favour of a non-resident or its authorized person payment of income, originating in Ukraine and obtained by such non-resident from carrying on commercial activity, is obliged to withhold tax from the sum of such income and at its cost at the rate of 15% unless otherwise is stipulated by international tax treaties.

Following the approach of tax authorities residents of Ukraine should take a look-through approach and look to the ultimate lenders as the beneficial owners of interest payments and thus apply different tax rates[1].

This approach is supported by international double tax treaties. According to the general rule of application of preferential tax rates under double tax treaties a receiver of interest should be the beneficial owner of interest. Thus, in case a company – receiver of interest is not a beneficial owner thereof provisions of a double tax treaty cannot apply.

Though the concept of beneficial ownership is not expressly determined by the OECD commentaries on its Model Tax Convention on Income and on Capital and though up to date it is unclear what shall be meant under this concept which leaves room for discussion and debate; we believe that the arranger under a syndicated loan agreement cannot be considered as the beneficial owner of interest since his duty is to collect and pay interest further to the final lenders which is provided for by the concept of the syndicated loan.

As such, a Ukrainian bank is obliged to charge a withholding tax on interest paid under syndicated loan agreements with respect to each beneficial lender using different tax rates depending on the respective double tax treaty of Ukraine with the country of each lender's residence even if the whole sum of interest is transferred to the arranger. That is, if, for instance, lending banks of the syndicated loan reside in Belgium and the USA (countries that have a double tax treaty with Ukraine), the borrowing Ukrainian bank when paying interest to them through the arranger residing in any country shall withhold a 2% withholding tax from the portion of interest belonging to the Belgian bank and 0% withholding tax from the portion of interest belonging to the US bank.

Given that syndicated loan agreements are concluded between all parties participating in a loan and that the borrowing Ukrainian bank is aware of all lenders and their loan portions the above tax authority's viewpoint seems to be viable.

It is worth mentioning that the same approach is applied by Russian tax authorities. In particular, on October 13, 2006 the Moscow Federal Tax Service Department issued a letter # 20-12/92167 where it stated that a Russian bank-arranger acting on behalf of the Russian organization that received a syndicated loan shall transfer income to foreign lending banks net of the sum of tax withheld by the Russian organization-borrower on the basis of Chapter 25 of the Tax Code of the Russian Federation from the income of foreign lending banks.

However, in Ukraine syndicated loans are mostly attracted by banking institutions. Non-banking business entities do not directly use syndicated loans (do not receive them in favour of Ukrainian entities) which is explained by the fact that the National Bank of Ukraine establishes maximum rates of interest under foreign loan agreements (including comission fees, penalties and other payments under such agreements) depending on the group of foreign currency and term of the loan.

In view of the above interest rate limitations it is quite problematic for Ukrainian business entities to attract syndicated loans from foreign lenders that would agree on the maximum interest rates established by the NBU. Taking this into account, Ukrainian business entities when large borrowings are needed resort to the so-called special purpose vehicles (SPV) within the same group.

SPV is usually incorporated in the jurisdiction having a favourable double tax treaty with Ukraine, e.g. the Netherlands, and when a Ukrainian business entity is in need of large capital such SPV borrows funds from a number of lenders of various jurisdictions. Then such borrowed funds are provided to the Ukrainian business entity on agreed terms under loan agreements.

[1] For purposes of this Article we presume that lenders participating in a syndicated loan are residents of countries that have a double tax treaty with Ukraine