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Taxation of Permanent Establishments in Ukraine: Unresolved Issues

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Abstract
This article deals with selected issues of taxation of permanent establishments in Ukraine that lack appropriate judicial and scholarly attention. It particularly focuses on the attribution of profits to permanent establishments according to OECD standards and Ukrainian law, taxation of dependent agent permanent establishments, and the State's taxing rights with respect to the permanent establishment's financing by its head office. The authors conclude that to improve the quality of permanent establishments' taxation in Ukraine, appropriate procedures should be clearly prescribed in the law and due regard be given to the already developed international standards that might be, in fact, directly applicable.

Key Words: permanent establishment, taxation, attribution of profits, Authorized OECD Approach, tax convention.

Introduction

For decades, Ukrainian tax legislation has contained a provision prescribing the taxation of permanent establishments (PE). Being a party to a range of double taxation treaties after the collapse of the Soviet Union, Ukraine was forced to implement the concept of PE as most developed countries had for about a century.[1] Since then, Ukrainian authorities have registered numerous representative offices of foreign enterprises as PEs and taxed them with Corporate Income Tax (CIT) accordingly. Yet, many PE tax issues have arisen that the tax authorities or the Ukrainian courts have not adequately considered.

The definition of a PE under the Tax Code of Ukraine (2010) (the Tax Code) is reasonably up-to-date if the 2017 OECD Model Tax Convention implementing the BEPS

1 Peter Harris and David Oliver, *International Commercial Tax* (New York: Cambridge University Press, 2010), 136.

Action 7 is disregarded.[2] Relying on the OECD and UN Models,[3] the definition incorporates the canonical concepts of a "fixed place of business," a "dependent agent," and even a "services PE," though the latter is a rather controversial concept from a tax policy perspective.[4] Indeed, in defining "dependent agent," the Tax Code, which covers even the negotiation of contracts, moved in a progressive direction because that definition arguably could be used to effectively combat aggressive schemes aimed at avoiding PE status through commissionaire arrangements and similar strategies.[5] Likewise, Ukraine's courts have properly developed the Tax Code's definition of PE, allowing it to serve as an effective means to legitimately tax a portion of the profits derived by multinational enterprises arising from Ukraine, including those originating in Ukraine.[6]

This article's purpose, however, is not to praise the accomplishments of the Ukraine's legislature, tax authorities, or courts. Nor is it aimed at explaining or commenting on the issues that commonly arise in PE tax disputes, such as the application of specific activity exemptions. Instead, this article is intended to shed light on those issues that either have been completely ignored by the legislature or that suffer from a disproportionate lack of attention relative to the common issues. Therefore, this article focuses on the following: (1) the rules on the attribution of profits to PEs in Ukraine; (2) the application of the dependent agent PE concept; and (3) the taxation of PE financing by its head office.

Attribution of Profits to a PE

The issue of the attribution of profits to PEs arguably is the most controversial issue in international taxation. This issue is so complex that the OECD Member States

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2 *Model Tax Convention on Income and on Capital: Condensed Version 2017* (OECD Library, 2017), accessed December 14, 2018, http://dx.doi.org/10.1787/mtc_cond-2017-en; *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7–2015 Final Report* (OECD Library, 2015), accessed December 14, 2018, http://dx.doi.org/10.1787/9789264241220-en.

3 *Model Tax Convention on Income and on Capital: Condensed Version 2005* (OECD Library, 2005), accessed December 14, 2018, http://dx.doi.org/10.1787/mtc_cond-2005-en, Article 5; *United Nations Model Double Taxation Convention between Developed and Developing Countries* (The United Nations Financing for Development, 2001), accessed December 14, 2018, http://www.un.org/ga/search/view_doc.asp?symbol=ST/ESA/PAD/SER. E/21&Lang=E, Article 5.

4 *Model Tax Convention 2017*, Commentary on Article 5, 154–64, paras 132–69.

5 Tax Code of Ukraine of December 2, 2010, accessed July 1, 2018, http://zakon2.rada.gov.ua/laws/show/2755–17, Article 14.1.193; *Action 7–2015 Final Report*, 15.

6 Decision of the Kyiv Appeal Administrative Court in Case No. 826/244/15 of June 12, 2018, accessed July 3, 2018, http://www.reyestr.court.gov.ua/Review/74728831; Ruling of the Supreme Court in Case No. 2A-16434/12/2670 of June 13, 2018, accessed July 3, 2018, http://www.reyestr.court.gov.ua/Review/74785269; Ruling of the Kyiv Appeal Administrative Court in Case No. 826/18313/16 of June 20, 2018, accessed July 3, 2018, http://www.reyestr.court.gov.ua/Review/74879947.

decided against proposing detailed rules on it in the Model Tax Convention and in the Commentaries to the Model Tax Convention when issuing special Reports and Guidelines on this matter.[7] Nevertheless, 10 years ago they adopted the Authorized OECD Approach (the AOA) on the attribution of profits to PEs.[8]

What exactly is the AOA? To answer this question, this article first analyzes the basic principles underlying the concept of PE, starting with what a PE is. A PE, in short, is a legal instrument that allows a source State to tax business profits arising within its territory. In other words, under the standard rules of international taxation, a State may legitimately tax only those business profits of foreign enterprises that not merely arise within its territory but also satisfy a set of specific legal requirements, which in themselves form a concept of PE. These legal requirements represent a certain economic connection between an enterprise and the source State. This economic connection may be physical ("fixed place of business") or influential ("dependent agent"). Once the economic connection is established and a PE is deemed to exist, the source State receives the right to tax the PE, but the specific taxation model remains to be determined.

The right to tax an enterprise through its PE is not a right to tax any profits of this enterprise wherever and whatever their source. More notably, the source State does not even receive the right, as it is argued, to tax any business profits of an enterprise derived from its own territory. The source State receives the right to tax only those business profits that are attributable to the respective PE.

The question of attribution is dealt, generally, with three models: (1) the "force of attraction" model; (2) the "relevant business activity" model; and (3) the last, but not the least important, the "functionally separate entity" model.

The "force of attraction" model represents the most primitive view on the attribution of profits to PEs. That is, this model bypasses the attribution process as such, allowing the State to tax all profits of an enterprise with a PE that are derived from the source State, regardless of whether they are actually and economically connected with the PE. This model, however, does not correspond with the principles embodied in the OECD Model. In fact, it contradicts the precise wording of Article 7(1), which states that: "[t]he profits that are attributable to the permanent establishment… may be taxed in that other State."[9]

The "relevant business activity" (the RBAA) and the "functionally separate entity" (the FSEA) models are quite similar in that they attribute profits to a PE in contrast to

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7 *Report on the Attribution of Profits to Permanent Establishments* of July 17, 2008, OECD, accessed July 1, 2018, https://www.oecd.org/tax/transfer-pricing/41031455.pdf; *2010 Report on the Attribution of Profits to Permanent Establishments* of July 22, 2010, OECD, accessed July 1, 2018, http://www.oecd.org/tax/transfer-pricing/45689524.pdf; *Additional Guidance on the Attribution of Profits to a Permanent Establishment under BEPS Action 7*of March 22, 2018, OECD, accessed July 1, 2018, http://www.oecd.org/tax/transfer-pricing/additional-guidance-attribution-of-profits-to-permanent-establishments-BEPS-action-7.pdf.

8 *Report on the Attribution of Profits*.

9 Article 7(1), *Model Tax Convention*, 2005.

the “force of attraction” model. But, otherwise, they are fundamentally different from each other.

The RBAA is a widely used and discussed model of attribution. Although it does not derive from the explicit wording of Article 7, countries have successfully applied it; Australia, for example.[10] Under the RBAA, the PE’s profits are determined by apportioning the overall profits of the enterprise from its business activities that are derived from the latter’s transactions with third parties, i. e., separate independent enterprises and associated enterprises (with application of the transfer pricing rules).[11] In practice, the apportionment method may be either one that considers the participation in the “relevant business activity” (Article 7(2)) or another basis specifically determined by the State (Article 7(4)).[12]

According to the OECD, the RBAA’s essence lies in the limitation of attributable profits to those of the overall business activity in which the PE has somehow participated.[13]In other words, if an entity overall incurs losses for a certain period, its PE would be precluded from being treated as profitable for the same period.

The FSEA has been endorsed by the OECD for a long time, for it represents the correct interpretation of Article 7 of the OECD Model.[14] The FSEA forms the heart of the AOA to the attribution of profits to PEs that was developed in the 2008 and 2010 Reports.[15] In short, the FSEA (according to its AOA modifications) presupposes that profits attributable to a PE are:

> the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the

10 “Review of the Tax Arrangements Applying to Permanent Establishments” of May 24, 2012, Australian Government, The Board of Taxation, accessed July 1, 2018, http://taxboard.gov.au/consultation/tax-arrangements-applying-to-permanent-establishments/.

11 *Report on the Attribution of Profits*, 21–24, paras 61–68; Philip Baker and Collier S. Richard, “General Report on Attribution of Profits to Permanent Establishments,” Field Court Tax Chambers, 2006, accessed July 1, 2018, http://www.fieldtax.com/wp-content/uploads/2015/09/Attribution-of-Profits-to-Permanent-Establishments.pdf, 30.

12 Baker and Collier, “General Report,” 30.

13 *Report on the Attribution of Profits*, 21–24, paras 61–68.

14 *Report on the Attribution of Profits*, 25 para 69; *2010 Report on the Attribution of Profits*, 12–13, paras 8–12; *Model Tax Convention on Income and on Capital: Condensed Version 2010* (OECD Library, 2010), accessed December 14, 2018, http://dx.doi.org/10.1787/mtc_cond-2010-en, Commentary on Article 7, 177, paras 15–18.

15 *Report on the Attribution of Profits*, 25 para 69; *2010 Report on the Attribution of Profits*, 12–13, paras. 8–12.

> enterprise through the permanent establishment and through the other parts of the enterprise.[16]

This brief explanation of the FSEA is a direct quote, the explicit wording of Article 7(2) of the current OECD Model. Yet, most of Ukrainian double tax treaties are not based on the recent versions of the OECD Model and thus include an outdated rule that does not follow the FSEA as much as the provisions in the recent versions do.[17]

The FSEA provides that a PE located in a source State is able to earn profit regardless of the overall financial result of the enterprise.[18] This approach allows the source State to tax business profits much more effectively. The FSEA makes an enterprise' PE a truly separate entity for tax purposes. This is achieved through the application of the functional analysis, i. e., an analysis of a PE's functions in light of its assets, capital, and risks assumed, with the subsequent attribution of transactions with non-related enterprises, associated enterprises and internal dealings among the PE, its head office and other PEs of the enterprise.[19] These attributed transactions are the basis for determining the PE's profit.

To summarize, the profits may be attributable to a PE under three general models: "force of attraction," RBAA and FSEA (AOA). While the first one is rejected as being unjust the affected taxpayers and thereby disproportionately burdening them, the second and third models are applied by many countries all over the world. However, it is the third model, the FSEA that, as modified by the OECD, represents the AOA and is considered the most appropriate model of attribution. Which model is applied in Ukraine? We shall now turn to the discussion of this question.

Pursuant to Article 141.4.7 of the Tax Code, there are three models of PE's taxation: (i) the "general" model; (ii) the "separate balance sheet" model; and (iii) the "0.7 coefficient" model.[20] As one may infer from their names, these models *prima facie* have nothing in common with the traditional OECD attribution rules. Nevertheless, there are certain similarities and differences.

The "general" model presupposes that "[p]rofit of non-residents who carry out their activity in the territory of Ukraine through permanent establishments, is taxable according to the standard procedure."[21] This provision, if interpreted textually, implies that any profits of a foreign enterprise, regardless of whether or not they are attributable to the PE, may be taxed in Ukraine provided that the enterprise has a PE in Ukraine.

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16 Article 7(2), *Model Tax Convention 2017*.

17 The 2005 version of the OECD Model Tax Convention read as follows: "profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

18 *Report on the Attribution of Profits*, 25 para 70.

19 *2010 Report on the Attribution of Profits*, 20–21 para 47.

20 Article 141.4.7, Tax Code of Ukraine.

21 Article 141.4.7, Tax Code of Ukraine.

In other terms, this provision allows the application of the "force of attraction" rule, which might be rather unfavorable from tax policy perspective due to a consensus among OECD Member States that this rule is inconsistent with the rules embodied in most double tax treaties.

Fortunately, this provision is followed by another one, which states the following: "[t]hus for the purpose of taxation, such permanent establishment is treated as a taxpayer who carries out his activity independently of such non-resident."[22] Although, at first glance, this provision may be considered as being inconsistent with the previous one, interpreted together, they can be read as the FSEA. In particular, if we consider the first provision as setting up a general rule — "foreign enterprise's business profits may be taxed if there is a PE in Ukraine" — and the second one as stating the rule that "such profits may be taxed only through hypothesizing a PE to be a separate and independent enterprise," arguably the FSEA is to be applied in Ukraine.

Yet, no matter how much we theorize and interpret, the application of this provision in practice does not correspond with the FSEA. In fact, the judicial practice with respect to attribution of profits is rather scarce, if not completely absent. Courts tend to avoid resolving this issue, and the tax authorities do not usually question the CIT returns filed by PEs. We are even aware of practices when foreign companies themselves successfully conclude contracts negotiated by their PEs in Ukraine, formalizing them in the name of the head office (rather than the PE), which leads to the associated income being completely omitted in the CIT return of the respective PE.

Furthermore, the application of the FSEA under Ukrainian law is practically impossible due to the absence of a clear recognition of internal dealings concluded within the enterprise, such as between a PE and its head office or between two PEs of a single enterprise. In 2018, however, the dealings between a PE and its head office were declared to be recognized for transfer pricing purposes.[23] This provision provides a reasonable ground to argue that one may apply the "general" model in Ukraine as if it represented the FSEA. Nonetheless, in the absence of any guidance in this respect, only further administrative and court practice will show whether this is, indeed, the case.

As a result, when a PE arises, the tax authorities require it to be registered and filed in an ordinary CIT return, but, as a rule, the additional income of a non-resident is not attributed. Tax authorities remain satisfied with taxing the financing of the PE, which is also done through rather questionable means, as will be discussed further. The "general" model leaves it to the taxpayer to decide which profits it wishes to declare in Ukraine in the absence of any formal guidance in that regard.

The "separate balance sheet" model, in contrast to the "general" model, is quite well-specified in the law but is rarely used in practice. The tax authorities even adopted a separate type of a CIT return specifically for purposes of this model. This CIT return clearly shows the model of attribution: the PE is attributed with a share of the overall

22 Article 141.4.7, Tax Code of Ukraine.

23 Article 141.4.7, Tax Code of Ukraine.

profits of an enterprise through apportionment with the application of a coefficient that is determined according to the expenses, personnel and capital assets of the PE.[24]

This model appears to represent the Ukrainian version of the RBAA. It is important to note, however, that it does not refer to a particular business activity of the enterprise. That is, as proposed by Philip Baker,[25] it should be rather called a "single enterprise" approach. Although this approach is well-formulated, we are not aware of it being used in practice. This lack of the practical application of the "single enterprise" approach may be explained by the requirement that the respective CIT return, by law, must be approved by the tax authorities, who do not, unfortunately, tend to demonstrate a clear and consistent understanding of this issue.

The third Ukrainian model of PE taxation, the "0.7 coefficient" model, also has a separate CIT tax return. Nevertheless, it is much less clear than the "separate balance sheet" model. The profits of a PE are determined as a difference between income and expenses of a PE, with the latter being calculated through multiplying the expenses of an enterprise by 0.7.[26] However, the question of how exactly the income of a PE is determined remains unanswered.

Consequently, Ukrainian tax law provides for three models of attribution: the "general" model, the "separate balance sheet" model, and the "0.7 coefficient" model. The first model is ambiguous, for the law does not provide clear guidance on how the profits are attributable. It may be interpreted, especially in light of the recent legislative amendments, as representing the FSEA, but it remains unclear whether the practice will follow this path. The second model ("separate balance sheet") is clearly a modification of the RBAA, with a rather well-formulated mechanism of application. Yet, this model is rarely applied in practice due to the tax authorities' restrictive position. The final model of attribution seems to be simple; it specifies a standard multiplying coefficient, but, in fact, it does not offer a clue on how the profits of the enterprise must be determined.

Many countries have already adopted the AOA (FSEA) on the national level, such as Germany,[27] the United Kingdom,[28] Denmark, Hungary, Italy, Japan, Lithuania, Luxembourg, Poland, the Netherlands, and many others.[29] A few countries, such as the

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24 "Calculations of Corporate Income Tax of Permanent Establishment of Non-resident Made on the Basis of Application of the 0,7 Coefficient Model to the Income" of June 13, 2016, accessed July 1, 2018, http://zakon5.rada.gov.ua/laws/show/z0923–16#n104.

25 Baker and Collier, "General Report," 30.

26 Article 141.4.7, Tax Code of Ukraine;"Calculations of Corporate Income Tax."

27 "Germany implements AOA for Permanent Establishments," VGD Beyond Partnership, accessed November 18, 2018, https://cn.vgd.eu/en/news/germany-implements-aoa-for-permanent-establishments.

28 "Corporation Tax Act 2009," accessed November 18, 2018, https://www.legislation.gov.uk/ukpga/2009/4/notes/contents, Chapter 4.

29 Ebner Stolz, "Application of the 'Authorized OECD-approach' (AOA)—Nexia Survey Questionnaire," accessed November 18, 2018, https://www.ebnerstolz.de/en/application-of-the-authorized-oecd-approach-125896.html.

Russian Federation,[30] leave their tax laws ambiguous as to the attribution of profits to PEs. Ukraine, as of today, is one of them.

Fortunately, Ukraine is expected to adopt the FSEA as a single uniform approach to the attribution of profits to PEs on the national level in 2019. Recently the Ministry of Finance of Ukraine published a draft law, amending the Tax Code of Ukraine and suggesting determining the profits of a PE as if it were a distinct and separate enterprise, with reference to the arms' length principle.[31]Yet, the specific rules of attribution are not offered in the draft law, leaving taxpayers without optimistic expectations in that respect.

The three models of attribution prescribed in Ukrainian law are applied only on the national level. The double tax convention, in particular, Article 7(2), if applicable, might override these models.[32] That is, Article 7(2) arguably should limit the taxing rights of the source State to only the profits that are attributable to the PE pursuant to the treaty interpretation rather than domestic rules.[33] In other words, if a source State, under its domestic legislation, attributes 50% of the overall profits of the enterprise to the PE, but the applicable treaty interpretation (the AOA) suggest that only 25% may be attributed, the treaty interpretation should prevail, and the State's taxing rights should be limited to 25% accordingly.

Therefore, regardless of the domestic attribution models, Ukraine should adhere to the AOA in applying the double tax treaties and limit its taxing rights to profits attributable to a PE as if it were a distinct and separate enterprise. Likewise, if a domestic attribution model suggests a more favorable result for a taxpayer, it should be still applied.

Overall, the issue of the taxation of PEs is extremely important for businesses operating in Ukraine and is particularly relevant for pharmaceutical companies, whose business model often includes a PE. The absence of defined attribution rules makes it unsafe and impractical to conduct business though a PE in Ukraine and, at the same time, prevents the tax office from assessing additional tax liabilities against those enterprises that declare attributable profits in bad faith. Thus, improving the PE taxation rules should be one of the priorities in the development of Ukrainian tax policy because of their direct impact on the investment potential of Ukraine.

30 Tax Code of the Russian Federation (second part), of August 5, 2000 No. 117-FZ (October 11, 2018 edition), Consultant Plus, accessed November 18, 2018, http://www.consultant.ru/document/cons_doc_LAW_28165/117ac53cb383c0fad9e23881f4b5e7f9c14bbe69/, Article 307.

31 Draft Law on BEPS Action Plan implementation, Ministry of Finance of Ukraine, accessed November 18, 2018, https://www.minfin.gov.ua/news/view/proekt-zakonu-iz-zaprovadzhennia-planu-dii—v-ukraini?category=novini-ta-media&subcategory=vsi-novini.

32 Article 3.2, Tax Code of Ukraine.

33 Article 7(2), *Model Tax Convention 2017*; *2010 Report on the Attribution of Profits*, 13, para 9.

Dependent Agent PE

The dependent agent is considered a "deemed" PE that is designed to deal with practices when foreign enterprises use local agents to sell goods or services in the source State without properly contributing to the latter's economy by paying CITs. The dependent agent PE is included into the domestic definition of a PE, but practices are insufficient in this respect. From this, one may reasonably infer that Ukrainian tax authorities rarely question the agent or commissioner arrangements of foreign companies. Yet again, the only possible good faith explanation for such an absence of practice may be the lack of adequate understanding of the dependent agent PE concept by Ukrainian tax authorities. More notably, it is not entirely clear how the dependent agent PE, if assessed, would be taxed.

Article 141.4.8 of the Tax Code establishes a special procedure for the taxation of dependent agent PEs. Specifically, the Tax Code prescribes the following:

> Residents who provide agency, fiduciary, commission and other similar services on sale or purchase of goods, works, services at the expense and in favor of only this nonresident (including negotiating essential terms and conditions and/or entering into contracts with other residents for and on behalf of this non-resident), shall collect and transfer the tax to relevant budget for income earned by such non-resident in Ukraine, determined as per procedure established for taxation of non-residents who carry out activity in the territory of Ukraine through the permanent establishments. Thus such residents are not subject to additional registration as taxpayers in regulatory authorities.[34]

Considering the absence of any practice with respect to this provision, determining how this provision corresponds with the generally recognized models of attribution of profits to PEs is important.

With regard to the first question, one may argue that this provision establishes a withholding tax (WHT) on payments made by dependent agents for the benefit of foreign entities on whose behalf they act. In this regard, the withholding nature of the tax may be implied from the fact that it is the dependent agent who "shall collect and transfer the tax to relevant budget." At the same time, the tax is levied on income of a non-resident who, in fact, has a dependent agent PE in Ukraine and such income is determined according to a specified procedure for taxation of PEs, if it were to exist at all under Ukrainian domestic legislation. This WHT on PE income, however, does not precisely follow OECD standards; nevertheless, it does not contradict them at all, either.[35] It appears, at least in theory, to be practical and simple from tax administration

34 Article 141.4.8, Tax Code of Ukraine.

35 *2010 Report on the Attribution of Profits*, 63 para 246.

perspective. Instead of requiring a PE to be registered as a separate CIT payer, the dependent agent is expected to file the relevant tax return.

However, no separate procedure for reporting this WHT charged on income of a deemed PE exists. Such payments are not mentioned in either the standard CIT return, which includes WHT payments,[36] or in the special CIT returns for PEs.[37] In the absence of any additional guidance, we may only infer that the dependent agent is expected to file a CIT return of a deemed PE (separately from its own CIT return) when the taxable income would be equal to profits attributable to the deemed PE in question. The attribution would be made analogously to the case of an ordinary PE as Ukrainian law, in contrast to the AOA, does not distinguish one from the other. At the same time, as already discussed, the AOA should be applied to limit Ukraine's taxing rights with respect to the income in question provided that the double tax treaty applies.

Considering the above, the dependent agent PE clearly suffers from a severe lack of attention in Ukraine. The tax authorities apparently refuse to combat even most aggressive schemes of avoiding Ukrainian CIT through commissionaire arrangements where only a small commission of a dependent agent is left to be taxed in the source State. More importantly, the absence of adequate legal provisions that clearly detail the procedure for dependent agent PE taxation blocks the further increase of governmental CIT revenues in this context.

Taxation of PE Financing

It has been long debated whether funds provided by the head office to its Ukrainian PE as financing are subject to CIT. Since such financing may be one of the primary sources of taxable income of PEs in Ukraine, this issue is vitally important for both tax authorities and for taxpayers. We strongly believe that the taxation of PE financing with CIT is incompatible with the basic principles of international taxation of business profits.

The advocates of taxation of PE financing argue that, because the Tax Code views a PE as a separate taxpayer, the transfer of funds from the head office to a PE is a provision of non-recoverable financial aid that increases the taxable financial result (profit or loss) of the entity.[38] This argument is based on two assumptions: first, that a PE is treated as a separate and independent enterprise for tax purposes, which is true both from national and international perspective; and, second, that the financing provided by a head office to a PE increases the latter's financial result (profit or loss) for CIT purposes, which is disputable.

36 Order of the Ministry of Finance of Ukraine No. 897 "On Approval of the Form of the Corporate Income Tax Return" of October 20, 2015, accessed July 3, 2018, http://zakon2.rada.gov.ua/laws/show/z1415–15.

37 "Calculations of Corporate Income Tax."

38 Ruling of the Kyiv Appeal Administrative Court in Case No. 2A-16434/12/2670 of December 7, 2017, accessed July 3, 2018, http://www.reyestr.court.gov.ua/Review/70894409.

Recently, Ukrainian courts and tax authorities have more or less agreed that the financing provided by the head office to its PE is, in fact, taxed only if it increases the financial result (profit or loss) of the PE as such.[39] In Ukraine, the profit or loss for CIT purposes equals the profit or loss calculated under the generally recognized accounting standards adjusted for certain differences, which are not applicable in relation to PE financing.[40] For this reason, this question should be dealt with by qualified professional accountants.

At the same time, we understand that the contribution of funds by a head office to its own PE should not be treated as "income" under Ukrainian and international accounting standards. In particular, "income" for accounting purposes in Ukraine does not include contributions by the business's owner.[41]For CIT purposes, the relations between a PE and its head office are similar to those between a subsidiary and its parent company.[42] Thus, by analogy, PE financing should be accounted as "contributions to capital," thereby being completely neutral from CIT perspective.

Separately, the taxation of PE financing by its head office would contradict the principle of non-discrimination in tax matters. This principle, embodied, *inter alia*, in Article 24(3) of the Model Tax Convention prescribes that:

> [t]he taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities.

Taxing PE financing from its head office would arguably be discriminatory because it would deprive the head office of the possibility of making non-taxable capital contributions to a PE, which is possible in a parent-subsidiary case.

Furthermore, arguably contributions to a PE by its head office should be disregarded at all for tax purposes. The rationale for this is that such a transaction

39 Letter of the State Fiscal Service No. 1060/6/99–99–15–02–02–15/ІРК of July 10, 2017, accessed July 4, 2018, http://sfs.gov.ua/baneryi/podatkovi-konsultatsii/konsultatsii-dlya-yuridichnih-osib/72309.html; Letter of the State Fiscal Service No. 295/6/99–99–15–02–02–15/ІРК of May 23, 2017, accessed July 4, 2018, http://sfs.gov.ua/baneryi/podatkovi-konsultatsii/konsultatsii-dlya-yuridichnih-osib/72188.html; Ruling of the Kyiv Appeal Administrative Court in Case No. 826/13953/15 of April 17, 2018, accessed July 4, 2018, http://www.reyestr.court.gov.ua/Review/73482025.

40 Article 134.1, Tax Code of Ukraine.

41 National Accounting Regulations (Standards) 15 "Revenue" of November 29, 1999, accessed July 3, 2018, http://zakon2.rada.gov.ua/laws/show/z0860–99; International Financial Reporting Standards 18 "Revenue" of January 1, 2012, accessed July 3, 2018, http://zakon3.rada.gov.ua/laws/show/929_025.

42 Peter Harris and David Oliver, *International Commercial Tax* (New York: Cambridge University Press, 2010), 164.

would never exist between independent enterprises and thus should be disregarded in attributing profits to a PE.[43]

Recently, Ukrainian courts also developed a view that such financing of a PE may not be taxed as it is a mere transfer of cash from one "pocket" to another.[44] The rationale of the administrative court was that the funds are transferred within one entity. Although we generally understand the logic of this statement, we contend that further application of such a precedent would be rather dangerous, undermining the very essence of the FSEA.

However, clear PE financing must be distinguished from a payment that, in fact, may be regarded as a remuneration for services provided by a PE to its head office. For instance, if a PE constantly renders marketing, R&D, management services, and the like to its head office and the only source of the PE's income constitutes "financing" provided by such a head office, the "financing" per se should be qualified as services remuneration rather than an actual capital contribution. In other words, "dealing" should be recognized between a PE and its head office and the fair remuneration under such "dealing" would ultimately absorb the so-called "financing." This view was supported by certain letters of the State Fiscal Service of Ukraine.[45]

However, the views expressed by the State Fiscal Service in its official letters (rulings) may vary significantly, depending both on the period when they are issued and on the specific department of the tax office that is responsible for its preparation. In other words, these tax rulings cannot be relied upon as a conclusive representation of the tax authorities' position; instead, they merely indicate the current trend. As a result, businesses cannot rely on such tax rulings because of the uncertainty about the future legal position of the State Fiscal Service, and this negatively affects the practical application of the PE concept as such in Ukraine.

To sum up, Ukrainian tax authorities have tried for a long time to tax PE's financing to avoid the complicated procedures and mechanisms for attributing profits to PEs. Although such practices, at first glance, appear to comply with the "separate entity approach," they are unlawful because they violate the principles of non-discrimination, the nature of a PE itself and even, arguably, the generally recognized accounting standards. At this juncture, the Ukrainian courts and tax authorities should further develop practices of fair attribution of profits to PEs rather than taxing cash contributed for the purposes of investment.

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43 Harris and Oliver, *International Commercial Tax*, 164.

44 Ruling in Case No. 826/13953/15 of April 17, 2018.

45 Letter of the State Fiscal Service No. 2628/6/99–99–15–02–02–15/ІPK of February 15, 2018, *Buhgalter 911*, accessed July 6, 2018, https://buhgalter911.com/normativnaya-baza/pisma/gfsu/schodo-viznachennya-ob-1037944.html; Letter of the State Fiscal Service No. 2323/6/99–99–15–03–02–15/ІPK of October 20, 2017, *Buhgalter911*, accessed July 6, 2018, https://buhgalter911.com/normativnaya-baza/pisma/gfsu/pro-reestraciyu-platnikom-1032911.html.

Conclusions

In this article, we have discussed the three most neglected and important issues relating to the taxation of PEs in Ukraine: attribution of profits, dependent agent PEs, and taxation of PE financing by a head office. These issues, although not the only ones relevant to PEs, have been carefully selected as having particular importance for the understanding and further development of the PE concept in Ukraine.

As of today, the legislation of Ukraine lacks appropriate rules that detail the process of attribution of profits to PEs in line with international (OECD) standards. This is especially unacceptable in such a formalistic country as Ukraine. It leads to a complete misinterpretation of the attribution concept by the tax authorities and administrative courts. The three models available in Ukrainian law, the "general" model, the "separate balance sheet" model, and the "0.7 coefficient" model, hardly correspond with the internationally recognized models of attribution — the RBAA and the FSEA. Unless a clear and detailed procedure of attribution is adopted at the national level, taxation of PEs in Ukraine will probably remain at the primitive stage, which is where they are today. Possibly, however, that without such a detailed procedure the taxpayers, tax authorities and courts would still develop a practice of directly applying the AOA as a correct interpretation of Article 7 of the double tax conventions.

In respect of the dependent agent PE, it appears that, despite the active application of aggressive tax avoidance schemes involving commissionaire arrangements and similar strategies, the tax authorities turn a blind eye on dependent agents. In part, this may be provoked by the absence of a clear mechanism of dependent agent taxation. Ukrainian tax law proposes a rather untraditional WHT model that, unfortunately, is not appropriately regulated from the reporting perspective.

Regarding PE financing by its head office, it is unclear from the practice of PE taxation in Ukraine whether such financing is subject to CIT. Yet, we contend that such taxation would contradict Ukrainian and international law, for it would be discriminatory and contrary to the nature of a PE and accounting principles.

To conclude, the issues raised in this article are rather broad, covering some of the most discussed and important issues of international taxation. It is a pity that after more than 20 years of Ukraine's independence they still suffer from lack of regulation and are not even widely discussed among Ukrainian scholars. Before these issues will be resolved on the legislative level, taxpayers, tax authorities, scholars and policy makers must discuss these issues and bring them to the foreground. Only such approach might guarantee the correct and objective implementation of international PE taxation standards into Ukrainian tax law.

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