

## Ukrainian tax authority issued a comprehensive publication regarding the principal purpose test (PPT) application

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- ▶ Law No. 466-IX dated January 16, 2020 introduced the concept of the principal purpose test (PPT) into the Tax Code of Ukraine.
- ▶ The law enforcement practice on PPT application is just being developed in Ukraine. Despite these rules being adopted 5 years ago, there are still no comprehensive guidelines from the tax authority on their application.
- ▶ This publication can serve as a reference point for understanding how the law enforcement practice on PPT application may further develop.

Ukrainian PPT rules are generally aligned with the Model Convention. Also, the respective provisions have already been introduced into most double tax treaties (hereinafter DTTs) signed by Ukraine either through the MLI Convention or through bilateral amending protocols.

In its publication ([Application of the Principal Purpose Test \(PPT\) for paying non-resident income](#)), the State Tax Service refers to the Commentary on the Model Convention as the source for interpretation of both domestic PPT rules and those contained in DTTs.

The Model Convention for Avoidance of Double Taxation of the Organization for Economic Cooperation and Development (hereinafter Model Convention) sets out the following provisions regarding the PPT “Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention”.

Importantly for taxpayers, the tax authority refers to examples of the application of the PPT provided for by the Commentary. Some examples are highlighted below.

#### Practical cases of PPT application

The Commentary contains quite an extensive list of examples of PPT applications, analysis of which leads to the following conclusions.

*1) Upon analysis of whether obtaining tax benefits was one of the principal purposes of the transaction or arrangements, it is necessary to consider all underlying purposes and factors behind such transaction or arrangements.*

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The Commentary considers several cases where transaction or arrangement resulted in certain tax benefits. However, it is concluded that PPT was met in such transactions and arrangements since they still were mainly driven by commercial, legal or other non-tax reasons and the tax benefits were supplementary, non-decisive factor.

An illustrative is an example where a tax transparent real estate fund with a number of institutional investors establishes a holding company in country R for making investments into real estate projects. One of the purposes of setting up the holding company was simplifying the administration of claims for relief of withholding tax (there would be no need for each investor to claim WHT relief). Respectively, upon choosing the jurisdiction for holding company, the presence of extensive DTTs network was also taken into account. In this example the Commentary concludes that PPT should be met, because the holding company was established mainly due to a number of commercial and legal reasons (to protect the fund from the liabilities of and potential claims against the fund's immovable property assets, to facilitate debt financing and the making, management, and disposal of investments) and the country R was chosen apart from extensive DTTs network also due to its political stability regulatory and legal systems, lender and investor familiarity, access to appropriately qualified personnel. Importantly, it is separately emphasized in this example that setting up a holding company did not result in tax benefits that are better than those to which investors would be entitled without such holding company.

There are also many other examples showing that the mere existence of tax reasons accompanying a transaction or arrangement is insufficient to deny treaty benefits, provided that such transaction or arrangement was motivated primarily by other non-tax purposes.

*2) Even if obtaining tax benefits was one of the principal purposes of transaction or arrangements, it is also necessary to analyze whether granting such tax benefits would be in line with the object and purposes of the Convention*

In this respect, a telling is an example when after entry-into-force a DTT between country R and S stipulating an arbitrary threshold of 25% for application of the lowest tax rate on dividends, the shareholder in country R decides to increase its stake in the company from country S from 24% to 25%. The fact that such a shareholder owned a stake of 24% for the last 5 years and an increase in stake was followed immediately after entry-into-force DTT makes it clear that additional capital contribution was driven mainly by tax reasons i.e. to enjoy the lowest tax rate on dividends. However, in this example the Commentary concludes that despite obtaining tax benefits was the principal purpose of the transaction, such benefits shall not be denied based on the PPT, since granting tax benefits in such case would be in line with the object and purposes of the Convention, including to encourage cross-border investments.

The above examples demonstrate that comprehensive consideration and assessment of all motives behind setting up a structure or carrying up a transaction could help to successfully pass the PPT.

However, some cases of tax abusive transactions or arrangements when tax benefits shall not be granted are also illustrated. For example, the Commentary mentions situations where a party, when paying dividends to a non-resident residing in a less tax-friendly country, involves a counterparty from a more tax-efficient jurisdiction without any apparent commercial reasons other than to apply the exemption under the DTT.

Another example of abuse mentioned is the case of dividing a real estate construction agreement in a foreign jurisdiction into two separate contracts with related companies, each lasting 11 months, to avoid recognition of a permanent establishment (as a building site that exists for more than 12 months is deemed to be a permanent establishment under DTT). As noted, the parties had no rational motivation for making such a division, except for tax purposes.

**Impact on Business**

The publication of the State Tax Service indicates that the application of the Principal Purpose Test is in the focus of the attention of tax authorities.

The fact that the tax authority in their publication extensively refers to the Commentary can be interpreted with optimism. This could mean that in practice the tax authorities in their assessments will consider international practice, in particular the Model Convention and the Commentary, conducting proper substance analysis and taking into account all relevant facts and circumstances.

In any case, we recommend monitoring how the law enforcement practice on this issue will develop and we will keep you updated in case of any significant changes.

Also, if you have not yet conducted a comprehensive analysis of your own cross-border transactions and structures for their compliance with the PPT, we recommend doing this now, considering the conclusions and examples outlined above. If there are identified transactions or structures raising risks or doubts from PPT standpoint, we recommend preparing a so-called “defense file” in advance with arguments and justifications of commercial or other non-tax reasons for their performance / setting up.

**Support from EY Ukraine**

We are ready to conduct a comprehensive tax analysis of your structure/transactions to identify potential tax risks and problem areas, in particular those arising from the PPT and other anti-abuse regulations, as well as provide recommendations for their substantive mitigation and assist in their implementation, including the preparation of a "defense file".

If you have any questions regarding the PPT or other tax rules, we would be happy to clarify them and provide extensive support.

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**We are monitoring legislative updates and will keep you posted on any important developments.**

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