MAKING IT LESS TAXING

VLADYSLAV SMELIK AND **DMYTRO SAKHARUK** DISCUSS THE TAX IMPLICATIONS OF DEVELOPING JOINT IMPLEMENTATION PROJECTS IN UKRAINE

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A lot has been said and written about the procedural issues for developing joint implementation (JI) projects, as well as the contractual mechanisms for the sale of carbon credits – emissions reduction units (ERUs). However, there has been little discussion about other important aspects of JI projects, such as taxation, which has a direct impact on the financial returns of projects. Due to ambiguities in Ukraine's tax law, taxation linked to the sale of ERUs and related activities remains a grey area in developing JI projects in the country.

In this article, we will aim to shed some light on the area by discussing various taxation issues arising at almost all stages of the JI project development process in Ukraine. This will include looking at taxing the proceeds of the sale of ERUs, tax deductibility issues relating to project developers' consultant expenses, and taxes on the fees paid to consultants based in Ukraine or other countries.

In Ukraine, all JI projects must be completed in accordance with the 'procedure of development, approval and implementation of projects aimed at reduction of anthropogenic emissions of greenhouse gases', which was approved by Decree number 206 of the Cabinet of Ministers of Ukraine in February 2006. The procedure was drafted in accordance with the recommendations of the JI supervisory committee (JISC) – the UN-appointed body that oversees

the JI process – and, in principle, provides a standard set of stages for JI project development (see box).

Payment of consultancy fees

As a general rule, Ukraine's tax authorities consider almost all services provided to Ukraine-based companies as suspicious transactions, due to the intangibility of services and difficulty in determining a fair price. The authorities try to prevent fictitious services and unwarranted deductions of service expenses.

Therefore, at stages one, three, four, eight and nine (see box) of a JI project, a project developer and a consultant should keep in mind five things:

- First, the parties should carefully prepare the documentation associated with the provision of services to prove, if necessary, that the services have been de facto provided;
- Second, the parties should ensure that the price of the services corresponds to their fair value;
- Third, a project developer should be ready to prove to the tax authorities that the services are associated with the company's business activity. This is important to ensure that the consulting expenses will be tax deductible;
- Fourth, if the services are provided by a consultant based outside the Ukraine, the price of the services is subject to a transfer pricing rule; and
- Fifth, the parties should avoid using free services, which will be considered taxable income for a project developer.

As a general rule, services provided in the Ukraine are subject to a 20 per cent value added tax (VAT). Services provided outside Ukraine should not be subject to VAT. So if a non-resident provides services to a project developer in the territory of a country other than Ukraine, such services should not be subject to VAT.

However, Ukraine's VAT law has a special rule regarding the determination of the place of delivery of services provided by non-residents. The place should be (i) a non-resident's representative office location, or (ii) the location of the Ukraine-based buyer (project developer) that is acting as the tax agent.

Thus, according to this special rule, if a non-resident consultant provides services to a project developer, such services will be subject to VAT and the developer will be acting as the tax agent and so liable for payment of Ukrainian VAT.

There is a contradiction between the general and special rules regarding taxation of services because Ukraine's VAT law uses different terms, such as "place of provision" and "place of delivery" of services. Ukraine's tax authorities have taken contradictory approaches in interpreting the "place of provision" and "place of delivery" of services.

According to recent rulings, the general rule against imposing VAT on services provided outside Ukraine is applicable if there is documentation proving that such services were actually provided abroad.

We believe, however, that such an approach may not be used for consultancy services for JI projects and a project developer will be liable for payment of VAT, as it is the tax agent of the non-resident consultant. However, if that is the case, the total amount of VAT paid is deductible for a project developer, which could help to minimise the negative tax consequences. Adopting such an approach would allow the project developer to avoid disputes with tax authorities.

The provision of consultancy services by non-residents may also trigger, in some cases, a withholding tax of 15 per cent. If such a tax payment is required and not withheld, then the project developer, acting as the tax agent, may be liable for a penalty of 200 per cent of the payment.

According to Ukraine's corporate profit tax (CPT) law, withholding tax should not apply to the sum of the proceeds from the sale of services except for special types of services, such as engineering. Thus, consultancy fees should not be subject to a withholding tax unless they fall within the scope of engineering services. If consultancy services are treated as engineering, a project developer will be responsible for deducting 15 per cent from the consultancy fees as payment to the government, and the consultants will receive only 85 per cent of their fees.

The CPT law provides a broad definition of engineering services. These include development and design of technical specifications, development of technical documentation, design of technologies, and legal and financial consultancy associated with such services. Taking into account the uncertain treatment of ERUs under Ukrainian law, the tax authorities may claim JI consultancy services are engineering services.

If consultancy services are treated as engineering services, and are therefore subject to a withholding tax, the consultant may be protected by double taxation treaties (DTTs). DTTs

Stages of JI project development in Ukraine

1. Project idea note: Development of a project idea note (PIN) by a consultant;
2. Endorsement letter: Obtaining a letter of endorsement from the National Environmental Investment Agency of Ukraine (NEIA);
3. Project design document: Development of a project design document (PDD) by a consultant;
4. Independent document determination: Determination of PDD by an accredited independent entity (AIE);
5. Approval letter: Obtaining a letter of approval from NEIA;
6. Registration of JI project: Registration of a JI project by NEIA (track 1)/ JI supervisory committee (track 2);
7. Registration of ERPA: Registration of an emissions reduction purchase agreement (ERPA) and opening an account for a project developer by NEIA;
8. Monitoring: Monitoring of emissions reductions by a consultant;
9. Validation: Validation of emissions reductions by an AIE;
10. Registration of monitoring and validation: Registration of a monitoring report and a validation report by NEIA;
11. Conversion into ERUs: Conversion of assigned amount units into ERUs and transfer ERUs to the account of a project developer by NEIA; and
12. Transfer: Transfer of ERUs to a buyer.

typically provide that the income from a non-resident's commercial activity should not be taxed in Ukraine unless it is obtained through the non-resident's permanent establishment – representative office.

In order to take advantage of DTTs, a non-resident consultant should provide a project developer with a certificate that shows the consultant is resident in a country party to a DTT signed with Ukraine. In this case, a withholding tax would not be applied, as the provisions of the DTT prevail over Ukraine's tax laws.

The provision of consultancy services by a non-resident to a Ukraine-based project developer may trigger a "permanent establishment" issue. According to Ukraine's tax rules, permanent establishments of non-residents are subject to CPT at a rate of 25 per cent. The CPT law defines a permanent establishment as the fixed place of business (place of management, factory, building site, mines, etc) through which a non-resident provides a commercial activity.

If a consultant's services are associated with a construction site or design, installation and construction work, a non-resident may benefit from provisions typically included in a DTT. For example, most DTTs provide that a construction site is treated as a permanent establishment if it exists for more than six months or, in some cases, more than 12 months. Thus, if the construction site exists for less time, the non-resident is not required to register the representative office with the tax authorities.

In some cases, an investor may decide to pay for the consultancy services for a project developer. The CPT law treats services obtained for free by a Ukraine-based company as income to be taxed at 25 per cent. Thus, such payment structures for consultancy services should be avoided.

Sale of ERUs

Ukraine's tax laws and accounting rules do not define ERUs. The tax authorities and the ministry of finance have no official position regarding this matter. Thus, there is a risk that the tax authorities might apply different taxation rules on ERU sales, which could lead to disputes. Most likely, the tax authorities will take an approach that increases payments to the state budget.

As for CPT and VAT, the main question is whether ERUs should be treated as goods or services. If ERUs are treated as goods, the sale of ERUs will be subject to the 25 per cent CPT and no VAT. If ERUs are treated as services, however, there will be a 25 per cent CPT and a 20 per cent VAT charge.

The CPT law defines goods as securities or tangible or

Ukraine's tax law and accounting rules do not define ERUs

intangible assets. ERUs are unlikely to be treated as tangible assets or securities under Ukrainian law – it is more likely that they will be considered intangible assets. The CPT law defines intangible assets as intellectual property rights or other comparable rights acknowledged as assets owned by the taxpayer in accordance with the law. Ukraine's accounting rules define intangible assets as non-monetary assets that do not have material form and can be identified. Accounting rules also provide for a broader list of intangible assets under the category "other intangible assets." Treating ERUs as intangible assets makes it possible to account for them on a project developer's balance sheet.

However, the treatment of ERUs as goods (intangible assets) may not apply to VAT, as the VAT law provides for a distinction between import and export sales of goods to be evidenced by export/import declarations. Therefore, one possible unfavourable treatment of ERUs for tax purposes is that the tax authorities will consider ERUs as goods for the purposes of CPT and as services for the purposes of VAT. There is no official interpretation or court decision, so far, regarding such an approach.

Another potential area of dispute is taxation of the free transfer of ERUs to the account of a project developer by the National Environmental Investment Agency, a government body that administers Ukraine's involvement in carbon markets. From a technical point of view, this stage of a JI project could be treated by the tax authorities as the free delivery of ERUs and subject to the CPT. However, as this situation has not been tested yet in Ukraine's courts, it is difficult to predict the approach the authorities might take.

The tax issues outlined in this article stem from the ambiguity of Ukraine's tax law and a lack of official interpretation of ERUs by the country's authorities. Tax risks arising from JI projects in Ukraine can be avoided by using DTTs, thoroughly preparing documentary evidence of fair prices for services, obtaining interpretations from the relevant authorities and gaining proper support from experienced tax consultants. ●

Vladyslav Smelik and Dmytro Sakharuk are associates with law firm Squire, Sanders & Dempsey in Kiev
Email: vlsmelik@ssd.com and dsakharuk@ssd.com

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