

Tax treatment of syndicated loans in Ukraine

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The State Tax Administration of Ukraine (STAU), recently issued a clarification regarding taxation of syndicated loans. Next, the country's State Tax Inspectorate issued a letter explaining the methods of calculation of tax payable on the interest in respect of a syndicated loan from foreign creditors to a Ukrainian bank, acting as a borrower. Yevgeniya Derbal and Dmitriy Isaev analyse the proposed changes in the tax treatments of the interest on such loans in the country.

I. Background

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. So long as lenders may not handle substantial loans as frequently and borrowers do not possess sufficient funds due to legal requirements or economic conditions, syndicated loans seem to be a solution, where large amounts of capital are needed.

II. Concept of syndicated loans in Ukraine

According to the established practices and economic meanings 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 the 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 as to 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.

III. Tax treatment of interest paid by Ukrainian banks.

Until 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. Consequently, interest was subjected to withholding tax at the rate, which was set by a double tax

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treaty of the country of residence of such arranger. For example, if the arranger of the syndicated loan was a Swiss bank and lenders were residents of other jurisdictions, the interest paid by the Ukrainian banks under the syndicated loan agreement to the arranger was only subject to 0 percent withholding tax as per sub-clause 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 October 10, 2009, the State Tax Administration of Ukraine (STAU) issued a clarification letter no. 23790/7/15-0517 regarding taxation of syndicated loans which introduced its approach to the tax treatment of interest there under. 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.

IV. Applicability of tax laws on interest paid to non-resident lenders

To examine the compliance of the proposed approach with the current Ukrainian legislation, 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”) need to be referred to.

Pursuant to clause 13.1 of Article 13 of the Law, any income received by non-residents and which 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.

V. Attributability of interest to arrangers or syndicate of lenders

Since the interest income originates in Ukraine and is 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 attributable to each lender.

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

pretation of the Ukrainian tax authorities clarifies with certainty the provisions of the law.

VI. Withholding tax on interest

The procedure and rate of withholding 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 authorised 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 percent unless otherwise is stipulated by international tax treaties.

VII. Rates of withholding tax applicable vis-a-vis beneficial ownership

Following the approach of the Ukrainian tax authorities, residents of Ukraine are advised to take a look-through approach and look at the ultimate lenders as the beneficial owners of interest payments and, accordingly apply different tax rates¹. 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 recipient of

“...a recipient of interest ought to be the beneficial owner of interest...”

interest ought to be the beneficial owner of interest. Thus, in case a company (recipient of interest), is not the beneficial owner of such interest, but merely receives it, the provisions of a double tax treaty cannot apply to such a scenario.

VIII. Concept of 'beneficial ownership' and the determination of applicable interest

As long as the concept of beneficial ownership is not expressly determined by the OECD commentaries on its Model Tax Convention on Income and on Capital, despite being up-to-date, it is still unclear as to what is meant under this concept, which leaves room for discussion and debate. However, it may be concluded that an arranger of a loan under a syndicated loan agreement cannot be considered as the beneficial owner of the interest arising on such a loan as the duty of the arranger is to merely collect and pay the final interest to the lenders, which is also provided for in 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 though the arranger residing in any country shall withhold a two percent withholding tax from the portion of interest belonging to the Belgian bank and 0 percent 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.

IX. Tax treatment of similar interest in Russia

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 no. 20-12/92167 where it stated that a Russian bank-arranger acting on behalf of the Russian organisation that received a syndicated loan shall transfer income to foreign lending banks net of the sum of tax withheld by the Russian organisation-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 commis-

sion fees, penalties and other payments under such agreements) depending on the group of foreign currency and term of the loan.

X. Special Purpose Vehicles (SPV)

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 these factors into consideration, those Ukrainian business entities, which need large borrowings, resort to the so-called special purpose vehicles (SPV) within the same group.

SPV is usually incorporated in a jurisdiction that has 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. Such borrowed funds are then provided to the Ukrainian business entity on agreed terms under loan agreements.

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¹ For purposes of this article, it is presumed that lenders participating in a syndicated loan are residents of countries that have a double tax treaty with Ukraine.