

Ukraine: immovable property and taxation of capital gains

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1. Introduction

This article considers whether Ukrainian tax authorities may view certain rights to real estate in Ukraine, for example leasehold or easement to land, as constituting real estate for tax, in particular double tax treaty, purposes entitling Ukraine to assert its right to tax non-resident's capital gain from the sale of shares in a Ukrainian company possessing such rights.

Ukraine has a wide double tax treaty (DTT) network with around 70 countries all over the globe. The vast majority of such treaties provide that a gain derived by a resident of one Contracting State from alienation of shares deriving mostly their value directly or indirectly from immovable property situated in the other Contracting State [Ukraine] is subject to tax in that other Contracting State [Ukraine].

But what if a Ukrainian company possesses only a long-term land lease right over a land plot in Ukraine and an easement to enter such leased land plot? Will those rights qualify as immovable property for tax purposes allowing Ukraine to tax capital gain on sale of the Ukrainian company's shares?

2. Definition of immovable property

Ukrainian domestic law understands immovable property in a narrow sense, namely immovable property comprises only a land plot and any object attached to such land which cannot be removed without substantial harm to it. Under this narrow definition, land lease and easement rights do not qualify as immovable property.

At the same time, the majority of the DTTs, concluded by Ukraine, provide that the term immovable property shall in any case include, *inter alia*, *rights to which the provisions of general law respecting landed property apply*. This phrase, however, appears to be quite broad and unclear. Absence of any clarifications of Ukraine's tax authorities or court practice that would shed some light on the interpretation of this phrase in the DTTs also adds ambiguity in understanding that phrase.

Considering that provisions of DTTs constitute an integral part of Ukrainian law, the question of the proper understanding and interpretation of the mentioned broad definition of real estate becomes rather topic for practical application of the law.

Theoretically, the phrase "rights to which the provisions of general law respecting landed property apply" could be interpreted broadly to include both lease and easement rights related to land. However, in our view, the primary intention of Ukraine when negotiating the DTTs was somewhat different. Namely, most likely, the above-mentioned phrase Ukraine covers only rights *in rem* (as opposed to rights *in personam*) considered as such in the Ukrainian legal system. Let us explain the rationale for such view.

First of all, Ukrainian legislation does not use the term "general law", therefore it is unclear what legislative provisions regarding landed property should apply. Our analysis of the several Ukraine's DTTs in the language of the other Contracting State suggests that the term "general law" is sometimes equally referred to as "private law".¹

¹ For example, Ukraine/Italy DTT reads "...i diritti ai quali si applicano le disposizioni del diritto privato riguardanti la proprietà fondiaria" or, for example, Ukraine/France DTT reads "...les droits auxquels s'appliquent les dispositions du droit privé concernant la propriété foncière"

From the historical perspective, the foundations of private law in Ukraine formed as a result of fusion of a local legal custom, reception of Roman law and Byzantine law (influenced by Roman law too).² As a consequence of such influence, private law in Ukraine incorporated the main concepts of Roman law.

Roman law consistently suggested *in personam* legal nature of a lease agreement (*locatio conductio*).³ This means that a right to lease appertains to a person as opposed to an absolute right *in rem* that appertains to an object of lease (*rem*).

This approach is generally accepted in the modern Ukrainian legal doctrine, i.e., a lease right to a land is viewed *in personam* right, even if such right sometimes includes certain features inherent in a right *in rem* (for example, a tenant's right to seek *in rem* remedy against a new owner of a leased land plot if the latter impedes use of the land plot by the tenant until expiration of the lease).

OECD Commentaries to the Model Tax Convention⁴ is also of limited assistance for understanding the phrase "rights to which the provisions of general law respecting landed property apply". Nonetheless Claus Vogel Commentary⁵ does shed some light on its meaning. In particular, according to Claus Vogel "this involves *corporeal rights* in land treated as rights in real property".

Considering the above, we believe that in the context of a narrow domestic definition of immovable property the phrase "rights to which the provisions of general law respecting landed property apply" should be construed as referring to absolute rights appertaining to a land plot or any object attached to such land only, that is rights *in rem*, and should not cover rights *in personam*.

Therefore, lease rights, as *in personam* under Ukrainian law, should not qualify as immovable property for the DTT purposes. While easement right, being a right *in rem* under Ukrainian law, could qualify as immovable property under the DTT.

3. Taxation of a capital gains

As noted earlier, Ukraine will have taxing rights with respect to a capital gain on the sale of shares in a Ukrainian company if the shares in such company derive their value or the greatest part of their value, directly or indirectly, from immovable property situated in Ukraine.

However, even if easement right held by a Ukrainian company were to constitute immovable property under the DTT, establishing a correlation between such right *in rem* and value of shares for the DTT purposes would still be difficult from both legal and practical perspectives.

Ukrainian tax law does not provide any guidelines on how to determine whether shares of a Ukrainian company derive the greatest part of their value from immovable property held by such Ukrainian company. Such guidance, however, can be found in the OECD Commentaries to the Model Tax Convention and the OECD Commentaries appear to be the only authoritative source to rely upon for such determination. Despite the fact that Ukraine is not a member of OECD, it is likely that the OECD Commentaries can still be relied upon for interpreting the DTT given that the Ukrainian tax authorities acknowledged in some of their tax clarifications the possibility to use the OECD Commentaries for interpreting double tax conventions.

According to the OECD Commentaries, determination of whether shares of a company mostly derive their value from immovable property situated in a contracting state will

² Roman law, Pidoprygora O.A., Kharitonov E.O., Kyiv 2009, p. 160

³ Contract law: transfer of property, Braginskiy M.I., Vitryanskiy V.V., Moscow 2003, p. 382

⁴ OECD Model Convention with respect to Taxes on Income and on Capital.

⁵ Klaus Vogel on Double Taxation Conventions - Commentary to the OECD-, UN- and US-Model Conventions

normally be done by comparing (i) the value of such immovable property against (ii) the value of all the property owned by the company without taking into account debts or other liabilities of the company. In case immovable property constitutes more than 50% of the total property of a company, the shares of such company could be viewed as mostly deriving their value from immovable property.

The difficulty with the above approach is that under Ukrainian accounting rules lease or easement rights are not considered assets and are not reflected on a balance sheet of a company. Therefore, in practice, there will be no basis in a balance sheet of a Ukrainian company to make a comparison. Therefore, even if an easement were to be considered immovable property for the DTT purposes, it would not be possible to determine whether the shares of a Ukrainian company derive their value *mostly* from such immovable property.

4. Conclusions

The above capital gain taxation issue demonstrates that the proper construction of the term immovable property for the purpose of Ukraine's DTTs remains an issue in the law enforcement practices of the Ukrainian tax authorities and Ukraine's judiciary. This creates uncertainty as to taxation of capital gains from sale of shares in a Ukrainian company possessing rights associated with real estate. Therefore, it would be reasonable for Ukraine and the Contracting States to mutually clarify the scope of the phrase *rights to which the provisions of general law respecting landed property apply*.

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