

TO: Clients and Friends of the Firm
FR: Frishberg & Partners
RE: Foreign Investment Legislation

I. The Sad History of Tax Privileges

Once upon a time, in the heady days of 1992, Decree No. 55 “On the Foreign Investment Regime” generously granted to any company willing to contribute “qualified foreign investment” of 50,000 US Dollars an automatic 5-year tax holiday. Moreover, Decree No. 55 guaranteed that such tax holidays would not be changed for a period of 10 years.

Soon after, however, the Law “On Taxation of Profits of Enterprises” cancelled the automatic 5-year tax holidays for all companies registered after January 1, 1995, emasculating one of the key benefits granted by Decree No. 55. Out of fairness, the Law “On Taxation of Profits of Enterprises” specifically preserved the tax holidays for companies, which registered their qualified investment under Decree No. 55 prior to January 1, 1995.

A year later, on March 19, 1996, the Parliament adopted a new and improved Law “On the Foreign Investment Regime,” which was conspicuously silent on the issue of tax holidays and granted no new privileges to investors. The new law merely reaffirmed many provisions contained in Decree No. 55. On October 23, 1997, the Parliament once again amended the law “On Taxation of Profits of Enterprises,” irreversibly canceling all tax holidays for foreign investors, once and for all.

Naturally, foreign investors with unexpired tax holidays felt cheated, and they fearlessly filed several law suits before the Ukrainian Constitutional Court, complaining that Parliament’s actions were unconstitutional. This embarrassing conflict was addressed by President Kuchma’s Edict No. 42/99 “On Certain Issues of Foreign Economic Activity,” dated February 26, 1999. This retaliatory Edict required the complaining thirty seven companies (some with foreign investments) to terminate their foreign economic activities until the Constitutional Court provided its official interpretation of the law on foreign investments.

The unfortunate thirty seven companies included such well-known enterprises as “Grand-Hotel” and “UMC.” To assure that the President’s intended goals were met, the banks, where the penalized companies kept their foreign currency accounts, suspended all foreign currency operations of these companies, as well as all LORO account operations used for transferring funds under foreign economic contracts.

In due course, having considered the legal issues concerning the reinstatement of tax holidays, the Supreme Court of Ukraine affirmed that foreign investors could not lose their rights and privileges after the Law “On the Foreign Investment Regime” was passed in 1996. In total, seven companies won their court case. This precedent alarmed the government sufficiently to pass the notorious Edict No. 42/99, which punished the fearless 37 companies.

The issue of reinstatement of tax holidays soon became over-shadowed by the quiet debate concerning the constitutionality of the President’s actions in punishing thirty-seven unlucky companies. According to the Law “On Foreign Economic Activity,” temporary termination of foreign economic activity can be effectuated only by special sanctions in case of violation of the law or any actions, which may damage the national interests of Ukraine’s economic security. Such sanctions must be accompanied by appropriate resolutions of judicial and/or arbitration bodies of Ukraine or by petition of the tax administration to courts, but certainly not by arbitrary and capricious Presidential Edicts.

Soon enough each of the dissident companies resolved its problems with the Ukrainian government, and continued to function without insisting on further tax benefits. In the meantime, foreign investments continue to be governed by the relatively useless Law “On the Foreign Investment Regime,” which was adopted on March 19, 1996, and subsequently amended on July 16, 1999, June 8, 2000 and May 15, 2003. For your convenience, below we provide an analysis of the current Law.

II. The Law “On the Foreign Investment Regime”

The Law “On the Foreign Investment Regime” (the “Law”) extends no favorable treatment and rather minimal guarantees to foreign investors, which includes physical persons and legal entities. The Law defines “enterprises with foreign investments” as having at least 10% foreign ownership in their authorized capital; no minimum foreign capitalization requirements are stated (instead, they are prescribed by other legislative acts).

The Law recognizes that foreign investment takes place in the following forms: (1) the formation of joint ventures; (2) the acquisition of stock in existing enterprises; (3) the creation of wholly-owned foreign subsidiaries (enterprise with 100% foreign investment); (4) the acquisition of real estate (including apartments, houses, land use rights, etc.); and (5) acquisitions of property rights by purchasing securities (shares of stock, etc.) of enterprises with such property rights.

Foreign investment, including any contributions to the authorized capital of an enterprise, is valued in both foreign convertible and Ukrainian currencies by agreement of the parties based on international or Ukrainian market prices (in the past, only international market prices were used for valuation criteria, a requirement often used to increase the value of Ukrainian contributions). Further, foreign investors may value contributions to the authorized capital of an enterprise in a

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