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FR: Frishberg & Partners

RE: Relationship Between a Foreign Founder and its Ukrainian Subsidiary

In order to conduct their business on the territory of Ukraine, foreign investors are increasingly turning to wholly-owned subsidiaries or daughter companies in which 100% of the authorized capital belongs to the foreign investor. This form of investment in Ukraine allows foreign investors to legally commence activity in Ukraine without the need for strategic alliances with Ukrainian partners and without a large amount of capital investment into the authorized capital of a company. Needless to say, foreign investors also enjoy the right to fully control the activity of their subsidiaries.

There are a number of advantages inherent in the legal form of a subsidiary in comparison with the registration of a representative office. In particular, the registration of a representative office requires the payment of a significant state fee in the amount of 2,500 USD, whereas the registration of a subsidiary requires a miserly state registration fee. In addition, a subsidiary, as a legal entity, has more extensive rights in carrying out commercial activity than a representative office of a non-resident. For example, a subsidiary has the right to receive a license to carry out licensed types of activities in Ukraine, the right to receive quotas and preferences, the right to have various types of property, including various types of constructions without limitation, the right to work on a large scale with consumers and to receive payment from them for services rendered, etc.

With respect to their legal capabilities, subsidiaries with foreign investment practically do not differ from subsidiaries of residents with Ukrainian capital. The only limitations on the legal capacity of a subsidiary with foreign investment is the acquisition of agricultural land and the right to participate in certain branches of the economy which either limit the percentage of foreign capital (i.e., insurance) or require a different legal-organizational form of company (for example, pawn shops or investment companies). Importantly, there is an increasing tendency that as Ukraine gets closer to joining the WTO and the EC, the amount of limitations on foreign investors in certain sectors of the Ukrainian economy decreases (and vice-versa). Moreover, the Ukrainian authorities are currently applying most, if not all, of their efforts towards the attraction of foreign investment.

Ukrainian legislation does not contain any special legal mechanisms which regulate relations between a parent company (foreign investor) and its subsidiary or daughter company, which is a full-fledged resident of Ukraine. At the same time, there are significant factors that influence the relations between a parent company and its subsidiary which are universal for most countries.

There are four such factors: (i) special regulation of agreement forms between a parent company and its subsidiary; (ii) the peculiarities of the taxation of transactions between a parent company and its subsidiary; (iii) antimonopoly (anti-trust) regulations; and (iv) legislation against terrorism and money laundering.

We take a look at each of these factors in detail immediately below.

1. The special regulation of agreement forms in import-export transactions is a universal norm of foreign economic activity of Ukraine. Accordingly, relations between parent companies and their subsidiaries involving import-export transactions fall under such special regulation. In general, a foreign economic agreement, even if it is concluded between a parent company and its 100% controlled subsidiary, must be concluded in a specific form. Such agreements must be concluded as a complete agreement, containing a specific list of provisions, which are material for such types of agreements, and must be signed by specially authorized representatives.

As a rule, foreign economic agreements must be in writing; however, Ukraine recently passed a law on electronic signatures and is currently developing a mechanism for implementing electronic signatures, especially with respect to import-export transactions. Thus, any relations between a parent company and its Ukrainian subsidiary must, from a legal point of view, be formalized in the form of foreign economic agreements regardless of the commonality of capital.

2. From the point of view of Ukrainian tax legislation, a parent company and its Ukrainian subsidiary are “affiliated” companies. As such, the Law “On the Taxation of Profits of Enterprises” provides that “usual” or average market prices must be applied in agreements between such affiliated entities. If prices in such agreements greatly differ from the average market prices, then the tax rules deem that the enterprise, which received goods or services at a price less than the average market price, received income which is calculated as the difference between the average market price and the agreement price. According to the rules drafted by the legislators, this income must be taxed at a rate of 25%, which is the usual rate of the current corporate profit tax.

Moreover, if a parent company provides to its Ukrainian subsidiary a loan or credit, then, in addition to the requirement to register such loan or credit with the local department of the National Bank of Ukraine, the interest rate of the loan or credit may not exceed the average interest rate in Ukraine. In case the interest rate on a loan is less than the average interest rate of Ukraine, the tax rules state that the Ukrainian subsidiary received income in the amount of the difference between the average interest rate and the interest rate established by the loan agreement between the parent company and its subsidiary. Once again, this difference will be subject to profit taxation at the rate of 25%.

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