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TO: Clients and Friends of the Firm

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RE: Production-Outsourcing: Processing of Foreign Goods in Ukraine

I. Introduction

In these difficult economic times, some foreign investors are understandably reluctant to acquire costly factories in emerging markets to produce their goods. Instead, they employ the good old method of production outsourcing, and for several good reasons: when properly implemented, toll-manufacturing schemes enable foreign manufacturers to avoid Ukrainian customs taxes, reduce their cost of production, and realize greater profit margins in the West.

The concept of outsourcing is, quite predictably, absent from Ukrainian legislation. Instead, Ukrainian law provides for a “tolling transaction,” which is actually a specific type of outsourcing known traditionally as production outsourcing. Tolling transactions are described in the Customs Code of Ukraine as a specific regime called “processing on the customs territory”, pursuant to which foreign components or raw materials are provided to Ukrainian parties for processing and then the final product is re-exported.

Transactions involving the manufacture of products by Ukrainian producers by using raw materials imported by foreign customers have become surprisingly widespread in Ukraine. Many foreign companies currently employ a tolling strategy, which enables them to minimize the hefty investments otherwise necessary to manufacture finished products and to avoid the necessity to upgrade production facilities and hire workforce in the home country.

Prior to June 1, 2012, tolling transactions were governed in detail by the Law of Ukraine No. 327/95-VR “On Transactions with Tolling Raw Materials in Foreign Economic Relations,” dated September 15, 1995, and the Law No. 959-XII “On Foreign Economic Activity,” dated April 16, 1991. However, with the coming into force of the new Customs Code of Ukraine, No. 4495-VI, dated March 13, 2012, the aforementioned laws have become obsolete for purposes of toll manufacturing transactions. Now, toll manufacturing transactions, which involve the use of imported components and/or raw materials or goods, constitute a specific type of import-export operation, and are primarily governed by the Customs, Civil and Commercial Codes of Ukraine.

Notwithstanding the above, the terms and conditions of an agreement (contract) for processing tolling raw materials still must comply with the requirements of the Law “On the Procedure for Effectuating Payments in Foreign Currency,” the Decree of the Cabinet of Ministers “On the System of Currency Control and Currency Regulation,” the Presidential Edict “On Measures for Improving Settlements under Agreements Concluded by Subjects of Entrepreneurial Activity of Ukraine,” as well as the Joint Resolution of the Cabinet of Ministers of Ukraine and the National Bank of Ukraine “On Model Payment Terms for Foreign Economic Agreements (Contracts) and Model Forms of Clauses for Foreign Economic Agreements (Contracts) Which Provide For Payments in Foreign Currency.”

Below is a brief analysis of tolling transactions in Ukraine in light of the new Customs Code.

II. Discussion

According to the general principles of a tolling transaction, a customer supplies a producer with raw materials or components/goods for further processing and/or manufacturing of finished products. The relationship between customer and producer is that of a sub-contractor, and is based upon payment (either in cash or by a portion of finished products and/or raw materials or goods).

From a practical point of view, a foreign customer may either import the raw materials or goods or purchase “equivalent goods” on the territory of Ukraine. “Equivalent goods” are defined as Ukrainian or foreign goods, which are identical in description, quantity and technical characteristics to foreign goods that must be substituted for a one reason or another. The new Customs Code specifically permits the re-export of processed products (finished products) achieved by the use of equivalent goods prior to the import of foreign goods or prior to the completion of the tolling operations.

For example, if a tolling contract calls for the import of foreign raw materials, but such raw materials cannot be imported on time to meet the requirements of the contract, then the foreign customer may find equivalent goods in Ukraine for processing in order to avoid delays and penalties. In this case, products received as a result of processing equivalent goods, even if the equivalent goods are purchased in Ukraine, will be deemed to be processed from foreign goods.

After processing, the processed or finished products must be re-exported to the customer according to the terms and conditions of the specific agreement between the customer and producer. If all of the conditions provided by the Customs Code have been met, then the processing of goods on the customs territory of Ukraine will be fully exempt from customs payments.

Any foreign entity, which intends to carry out a tolling transaction in Ukraine, should keep in mind the peculiarities of Ukrainian law described below regarding transactions involving raw materials or goods for processing:

A. Financial Guarantee of Adherence

The Cabinet of Ministers has the right to impose bans or restrictions on the processing of certain types of goods on the territory of Ukraine. The Cabinet of Ministers also has the power to determine which finished products and/or goods are subject to mandatory re-export from Ukraine or prohibited for free circulation thereby disallowing their sale on the territory of Ukraine.

Most importantly, the Cabinet has the right to demand financial guarantees from the owner of foreign goods imported into Ukraine for further processing. The current list of such goods can be found in Resolution No. 461 of the Cabinet of Ministers, dated May 21, 2012. Foreign importers should check whether their goods (to be sent for processing in Ukraine) are subject to financial guarantees or other restrictions; otherwise, they may face delays in the importation process. If a ban or restriction is placed on goods after a foreign importer has already cleared them, then the processing of such goods may be completed on the conditions which were effective at the time of their placement into the customs regime of processing.

The new Customs Code sets forth the forms, conditions and methods for providing financial guarantees before the customs authorities that the goods imported into Ukraine will be processed in full adherence with the applicable processing rules. The owner of the goods or (its authorized representative) may choose one of the following methods:

- 1) a financial guarantee of payment for all customs payments in case of a violation of the rules for processing on the customs territory of Ukraine, including a breach of the agreement (contract) for the processing of goods;
- 2) a guarantee on the conditions set forth by the 1975 Customs Convention on the International Transport of Goods under Cover of TIR Carnets (TIR Convention);
- 3) a guarantee on the conditions set forth by the 1990 Convention on Temporary Admission (Istanbul) under cover of ATA Carnets.

In case of a financial guarantee, the guarantor pledges to pay all customs payments in case of the failure to adhere to the Ukrainian rules of processing. Legal entities, which intend to issue a

guarantee to pay customs payments, must be duly authorized to act as a guarantor and will be entered into a register of guarantors maintained by the central customs authority. The relationship between a guarantor and the responsible customs authority must be set forth in an agreement between the parties. Either the party responsible for making customs payments or another party in its favor may act as guarantors, unless otherwise provided by legislation. Banking institutions and independent financial intermediaries may also act as guarantors in all customs matters, provided that they meet the strict criteria set by the central customs authority.

In general, financial guarantees may not be issued if the amount of customs payments in question is less than 1,000 Euros. The amount of the financial guarantee is determined by the customs office based on the amount of customs payments that would have been subject to payment had the imported goods been cleared for free circulation in Ukraine. The guarantor should provide the customs office with as much information as possible about the goods imported for processing, including nature, name, quantity, country of origin, customs value and classification code. Otherwise, if the exact amount is not determinable, the customs office will base its decision on the highest rate payments, value and/or quantity that can be determined from the documents presented to the customs office.

Financial guarantees can be issued in the form of guarantee document (an irrevocable instrument in written or electronic form and payable unconditionally at the demand of the customs office) or a cash deposit into an earmarked account or the customs cash desk. Financial guarantees can be individual (one-time), multiple or general. Correspondingly, individual guarantees are issued for one-time customs declarations or operations, while multiple guarantees are issued for several customs declarations or control documents for transit goods or for goods in free circulation for one owner under one foreign economic agreement. General guarantees are issued for customs declarations or control documents which the declaring party plans to issue over the course of one year.

In case of a violation of the customs regime of processing on the customs territory of Ukraine, the guarantor is obliged to pay the required amount of customs payments within no later than three (3) banking days from receipt of a demand from the customs office and the documents confirming the said violation. A failure by the guarantor to make payment on demand will result in a tax debt which will be collected in accordance with the established legislation. Financial guarantees are subject to return (either in cash or reverse transfer) within one (1) banking day once the customs office has established that the customs regime of processing on the customs territory of Ukraine has been completed in full compliance with the law.



B. Permission to Process Goods on the Customs Territory of Ukraine

Should a foreign company wish to import goods to Ukraine for further processing or manufacture of finished products, such company must obtain written permission from the relevant customs office. The owner of the goods may also request a preliminary decision from the customs office regarding the possibility to import goods in the customs regime of processing on the customs territory of Ukraine. This novelty of the new Customs Code requires the submission of an application along with the following documents:

- 1) the foreign economic agreement(s) or duly executed equivalent document(s) on the basis of which the processing of goods will be carried out and which must contain (i) information on the obligatory volume of the resulting products of processing and (ii) the specific volume of works and the term for performing such works. This information may also be submitted in a separate document;
- 2) the technological scheme of processing (except cases of the import of goods for the purpose of repair, including modernization, restoration and regulation/adjustment). The technological processing scheme must contain the following:
 - a) information on all stages of processing and the process of transformation of the imported goods into processed products;
 - b) the qualitative indicators of the imported goods and other goods which are consumed by the processing party with a substantiation of production expenditures of goods at each stage;
 - c) information on the name and quantity of processing waste.
- 3) agreements on the processing of goods with other enterprises in case separate operations (or a full processing cycle) will be carried out by enterprises other than the principal processing party;
- 4) other documents at the initiative of the owner of the imported foreign goods or its authorized representative, including conclusions of state bodies, expert institutions and organizations, state standards and enterprise standards, technical conditions, descriptions or drawings of the processing procedure, etc.

Permissions for the processing of goods on the customs territory of Ukraine are issued by the customs body to the applicant free of charge within five working days from the date of registration of the corresponding application. In case the foreign economic agreement provides for processing in separate consignments within a fixed period of time under the same conditions, permission will be granted for the volume of goods and the term indicated in the agreement, but for a term of no more than one year. The permission itself will reflect the list of processing operations and the method of their effectuation. Importantly, the customs office may not refuse to issue permission due to country of origin, country of dispatch or country of destination of the imported goods. In addition, the customs office may not refuse permission due to the presence in Ukraine of goods which are identical in description, quality and technical characteristics to the goods being imported for processing.

Permission for the processing of goods on the customs territory of Ukraine may be modified or revoked by a customs office if it was issued on the basis of inauthentic information or the permission holder violates the provisions of the Customs Code and other customs legislation.

C. Minimal Value of Tolling Raw Materials

Prior to the passing of the new Customs Code in 2012, Article 1 of the Law of Ukraine No. 327/95-VR “On Transactions with Tolling Raw Materials in Foreign Economic Relations,” dated September 15, 1995, prescribed that components and/or raw materials used in tolling transactions were required to have a value of no less than 20% of the value of the finished products made from such raw materials. These raw materials had to be supplied to the producer before the commencement of the manufacture the finished products. If the value of the raw materials was less than 20% of the finished products’ value, then the transaction would not qualify by law as a tolling transaction.

The new Customs Code allows the Cabinet of Ministers to set the minimum ratio of the value of foreign and Ukrainian goods for certain categories of goods which are provided for processing operations. Note that the new rules do not limit processing operations to the use of raw materials only. Importantly, the current Tax Code of Ukraine (Article 14.1.134) still defines transactions with tolling raw materials as those “operations in which the raw materials of the customer at each specific stage of their processing shall comprise no less than 20% of the total value of the finished products. Accordingly, one can expect that the Cabinet of Ministers will bring these two Codes into compliance with each other by issuing a resolution with the required ratio of imported goods to local goods in processed products for specific categories of goods while the general ratio may remain the same at 20%.

D. Processing Operations

The Ukrainian government has placed no limits on the amount of possible operations involving the processing of goods on the customs territory of Ukraine. These operations may include processing, installation, de-installation, and the use of certain goods which facilitate or simplify processing operations. They may also include the repair of goods, including modernization, restoration, regulation and calibration.

The processing party may involve other enterprises to carry out separate operations or the full cycle of operations at the instruction of the enterprise to which permission to process goods on the customs territory of Ukraine was issued and upon the consent of the customs office. In such case, liability for adherence to the customs regime will remain with the permission holder. Permissions to conduct separate operations or a full cycle must be issued simultaneously with the principal permission to process goods on the customs territory of Ukraine. If necessary, however, the permission holder may later request such additional permissions to be added into the principal permission.

E. Customs Status of Goods Imported for Processing

Foreign goods imported into Ukraine for processing will retain their status as foreign goods throughout the processing operations until they are re-exported from Ukraine. Processed products and scrap (waste) resulting from processing also bear the status of foreign goods and fall under the customs regime of processing on the customs territory of Ukraine. If scrap or waste has commercial value or can be recycled, then it may be placed into another corresponding customs regime for sale or export. If Ukrainian goods were used during the processing operations, then they too will obtain the status of foreign goods once the resulting processed products are exported from Ukraine.

F. Processing Term

The term for the processing of goods on the customs territory of Ukraine is established on a case-by-case basis by the customs office during the permission issuance procedure. This term is based on the length of processing and the disposal of products during processing, and it commences from the day of the completion of the customs clearance of the foreign goods into Ukraine. The permission holder may petition the customs office to prolong the term for documentary confirmed reasons; however, in any case the term may not exceed 365 days, unless a longer term is established by specific laws for complex processing operations.

G. Customs Control

Once goods are placed within the customs regime of processing on the customs territory, they are subject to constant customs control until such time as the resulting products are re-exported from Ukraine. Customs has the authority to conduct inspections at the premises of any party at any stage of the processing operation.

Customs also exercises control over the mandatory volume of resulting processed products created as a result of processing. They do so by comparing the volume output with the volume output indicated in the foreign economic agreement (or other equivalent document) submitted for permission to process goods. Customs may engage other state or expert institutions to confirm the volume data of the resulting processed products. The central customs office may also stipulate mandatory norms for resulting processed products in cases when processing operations are carried out pursuant to a model or identical technical conditions with constant characteristics of the goods and their resulting products.

H. Re-export, Export or Sale?

Upon re-export of processed products, a declaration must be submitted to the customs office with a list of Ukrainian goods used during the processing operations and an indication of their quantity and value. The declaring party has the right to declare the Ukrainian goods (except fuel and energy), which were completely used during processing, for export. The processed products may be re-exported in one or several consignments and may be done so via a customs office other than the one in which the foreign goods for processing were imported.

The parties to the processing agreement (contract) may also agree to conduct settlements by sale of a part of the processed products to the processing party. Such products will be subject to full customs clearance and subject to import taxes and customs payments. In case the owner of the processed products is a non-resident, the sale must take place via its duly registered representative or representative office in Ukraine, which will be charged with the declaration of the processed products at the customs office for free circulation in Ukraine.

The owner of the foreign goods may also import such goods for processing in Ukraine and further free circulation on the territory of Ukraine on the condition that (i) the customs office can ensure that the processed products were achieved as a result of the imported foreign goods and (ii) the imported foreign goods cannot be restored on an economically advantageous basis to their original

condition after processing. Upon completion of processing, the processed products must be placed in the customs regime of import (with payment of all relevant taxes and duties) or another permissible customs regime.

If permission to process foreign goods on the customs territory of Ukraine has been revoked by the customs office for valid reason, the permission holder will have 20 days from the date of revocation to complete the processing operations and export the imported goods or re-declare them in another customs regime within 30 days. If completion of the processing operation is impossible within 20 days without irrevocable damage to goods or technical equipment, the processing may be completed pursuant to the initially declared technological scheme of processing. In such case, the goods will be subject to export or re-declaration in another customs regime within 10 days from the date of actual completion of processing. Failure to adhere to these precise conditions will result in the mandatory performance of any financial guarantees issued to the customs office.

I. Form of an Agreement (Contract) for Processing Goods on the Customs Territory of Ukraine

Since one of the parties to an agreement for processing foreign goods on the customs territory of Ukraine will inevitably be a non-resident (a foreign business entity), such agreement will be deemed a “foreign economic agreement” under Ukrainian law. In accordance with Order No. 201 of the Ministry of Economy and Issues of European Integration “On Approval of the Regulations on the Form of Foreign Economic Agreements (Contracts),” dated September 6, 2001, the following terms and conditions must be incorporated into a foreign economic agreement (contract):

- (i) name of the agreement (contract), reference number of the agreement (contract), and its date and place of execution;
- (ii) a preamble, which must include the full name of the parties under which they are officially registered with an indication of the relevant country of registration, and the name of the persons who sign on behalf of the parties with an indication of the document based upon which the representatives of the parties derive their authorities;
- (iii) the subject matter of the agreement (contract);
- (iv) the quantity and quality of goods (volume of work to be performed);



- (v) the basic delivery terms for the supply of goods (acceptance/transfer of performed works);
- (vi) the price and total value of the agreement (contract);
- (vii) the payment terms;
- (viii) the terms for the transfer (acceptance) of goods (works);
- (ix) packaging and marking requirements;
- (x) force-majeure;
- (xi) sanctions and reclamation;
- (xii) arbitration; and finally,
- (xiii) the full legal addresses, postal addresses and bank account information of the parties.

III. Conclusion

Taking into consideration the low cost of skilled Ukrainian labor, an increasing number of large multinationals have realized that Ukrainian production outsourcing has vast potential. With comparatively little up-front investment, they have an opportunity to tap into this East European market where skilled labor costs are still relatively inexpensive, and sell finished products in the West, capturing payments directly into their foreign bank accounts. As added incentive, considering today's harsh economic climate, potential Ukrainian producers are highly interested in attracting foreign business to Ukraine not only for outsourcing, but also for establishing long-term links to international markets. A true win-win scenario.