

TO: Clients and Friends of the Firm  
FR: Frishberg & Partners  
RE: Production-Outsourcing (Tolling) Transactions

## **I. Introduction**

When properly implemented, toll-manufacturing schemes enable foreign manufacturers to avoid Ukrainian import taxes, circumvent Ukrainian VAT, reduce their cost of production, and realize greater profit margins in the West.

Presently, the basic concept of outsourcing is, quite predictably, absent from Ukrainian legislation. Instead, Ukrainian law provides for a so-called “tolling transaction,” which is actually a specific type of outsourcing known traditionally as production outsourcing. Tolling transactions involving the manufacture of products by Ukrainian producers by using raw materials imported by foreign customers are surprisingly widespread in Ukraine. Many foreign companies currently apply a tolling strategy, which enables them to minimize expenses for the production of intended finished products and to avoid the necessity to upgrade their own production facilities and hire additional workforce in their home country.

Toll manufacturing transactions, which involve the use of imported raw materials, constitute a specific type of import-export operation, and are primarily governed by the Civil Code of Ukraine, 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. In addition, the terms and conditions of an agreement (contract) for processing tolling raw materials 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 Edicts “On Indicative Prices for Import and Export Transactions Carried Out by Subjects of Foreign Economic Activity,” “On the Application of International Rules for Interpreting Commercial Terms,” and “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.”

To spare you the above reading in its entirety, below we are delighted to provide you with a brief analysis of tolling transactions in Ukraine.

## II. Discussion

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

From a practical point of view, a foreign customer may either import the raw materials or purchase them on the territory of Ukraine. After production, the finished products are exported (re-exported) to the customer according to the terms and conditions of the specific agreement between the customer and producer. The imported raw materials and the finished products made from such raw materials are exempt from import taxes (with the exception of customs fees) and VAT under a tolling transaction, provided that such transaction meets the requirements of the applicable Ukrainian laws.

Pursuant to Ukrainian legislation, international tolling involves the processing (enrichment or use) of raw materials via a technological process resulting in finished products in exchange for an agreed upon compensation. A 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.

### A. Minimal Value of Tolling Raw Materials – The 20% Rule

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 (hereinafter the “Law”), prescribes that raw materials used in tolling transactions must have a value of no less than 20% of the value of the finished products made from such raw materials and must be supplied to the producer before commencing the manufacture of the finished products. If the value of the raw materials is less than 20% of the finished products’ value, then the transaction will not qualify by law as a tolling transaction.

When calculating the value of the raw materials into the value of the finished products, the value of all raw materials and the expenses incurred in connection with the transportation of the raw materials to the producer must both be taken into consideration. As an example, if the value of the finished products is 1,000 EUR, then all imported raw materials, as well as their transportation to the producer, must have a value of at least 200 EUR. If this test is not met, the customer will be required to pay the relevant import tax (customs duty) and VAT, which are imposed on the products imported on a common importation basis.

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