WHAT ARE THE NEW OPPORTUNITIES FOR SOFTWARE DEVELOPMENT AND OUTSOURCING IN UKRAINE?

Thursday, May 31, 2012  8:00 a.m. PDT

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WHY UKRAINE?
MARKET OVERVIEW
Why Ukraine?

Market overview for 2011
- The growth of IT-outsourcing industry has reached about 20-25%
- IT outsourcing market value is US$1.1 billion
- More than 1,000 IT-outsourcing companies operate in the market
- The number of IT specialists working in the industry has reached 25,000
- 16,000 IT specialists graduate each year from Ukrainian universities
- 6 outsourcing centers: Kyiv, Kharkiv, Lviv, Dnipropetrovsk, Odessa and the Crimea together make up 85% of all IT outsourcing resources in Ukraine

Key factors:
- Competitive prices
- High level of professional development and rich reserves of manpower
- Geographical location
Why Ukraine?

Recent recognitions:

- Winner, Outsourcing Destination of the Year – European Outsourcing Excellence Awards 2011, at the European Outsourcing Association Summit
- Included in TOP 30 Outsourcing Destinations by Gartner in every year since 2007
- Fourth among world leaders for software export volume, according to Gartner’s research
- First among 16 countries in the Central and Eastern Europe region in the report CEE IT Outsourcing Review by the Central and Eastern European Outsourcing Association (CEEOA) in 2008, 2009, 2010 by:
  - (1) number of IT outsourcing companies
  - (2) number of IT specialists
  - (3) volume of IT-outsourcing export
CORPORATE STRUCTURES
Structures available in Ukraine to support outsourcing and software development

Three ways:

- Formal business presence in Ukraine
- Cooperation with Ukrainian individuals
- Cooperation with Ukrainian companies
Structures available (1)

Formal business presence in Ukraine

- Establishment of a new company (subsidiary)
- Opening of a representative office of foreign (US or other) company
- Acquisition of / merger with an existing Ukrainian company
  - *IP due diligence is crucial*
Cooperation with Ukrainian individuals

- Direct employment of Ukrainian individuals by foreign (US or other) company
  **Tax implications**
- Co-operation with Ukrainian private entrepreneurs (services agreements)
- Outsourcing (staff leasing)
Cooperation with Ukrainian companies

Service agreement with Ukrainian IT company to perform particular project
IP ISSUES

HOW TO ENSURE IP IS OWNED
BY THE CUSTOMER
IT outsourcing to Ukraine: IP risk factors

**IP theft and mishandling**
- Copying of customer’s existing IP assets and know-how shared with the developer
- Disclosure (intentional or inadvertent) of customer’s confidential information to competitors

**Ownership of IP**
- IP generated by developer may incorporate customer’s IP
- IP generated by developer may incorporate the developer’s pre-existing IP
- Developer’s employees and/or sub-contractors may assert IP rights in the developed product

**Unfamiliar (and different from the US) Ukrainian IP, employment, contract law and business culture**
- Algorithms are not patentable in Ukraine; only copyright protection is available
- IP rights of employees are protected by employment law. When IP law and employment law are in conflict, employment law controls
- By default, 50% of IP rights to “work for hire” remain with the employee
- Unfamiliar and unwritten rules of doing business; language and cultural barriers

**Enforcement of IP rights in Ukraine**
- Corruption
- Unpredictable and inconsistent interpretation of the law by different courts
- Choice of law provisions in contract may not be enforceable in Ukraine
Risk mitigation: pre-engagement IP due diligence and contract negotiation

**IP due diligence:**
- When selecting local developer, consider:
  - Local company vs. individuals
  - Physical security of the developer’s facility
  - Developer’s other customers
  - Developer’s standard policies and agreements regarding confidentiality and IP protection

**Contract negotiations:**
- Limitations placed on the developer:
  - No use or disclosure of the customer’s IP for the benefit of other customers
  - Limitations on the scope of work the developer can do for other customers
  - Selecting mechanisms to ensure protection of IP inadvertent, accidental or willful disclosure of confidential information and trade secrets
  - Define whether the developer can sub-contract part of the outsourced project
- Ownership
  - Catalog existing IP assets and know-how of the customer and developer
  - Include a provision stating that any improvements made to intellectual property of customer by the developer are to be owned by the customer

**Ensure comprehensive IP protection under both US and Ukraine law**
- Make sure your legal team includes qualified Ukrainian attorneys
Engagement of Ukrainian software developing company

Option 1

(1) IP rights assignment from software developing company to foreign customer:
   - List of tangible IP rights
   - Only tangible IP rights are assignable
   - Identification of software
   - IP rights are assigned from the moment of execution of act of transfer and acceptance

(2) Non-disclosure regulation with software developing company

(3) Pre-engagement IP due diligence of potential contractors to ensure enforceability of IP rights assignment from software developing company to foreign customer
Engagement of Ukrainian software developing company: developer’s level

Pre-engagement IP due diligence:

(1) Peculiarities of IP assignment provisions on developers level to consider:
- IP rights are fully owned by software developing company
- List of tangible IP rights
- Remuneration for assignment of IP rights
- IP rights are owned from the moment software is developed

(2) Non-disclosure provisions with developers

Curing identified defects by executing:
- Amendments to agreements with existing developers
- Template agreements with new developers
- Stand-alone assignment agreements with terminated developers
Direct engagement of Ukrainian developers

Option 2

Contractual regulation:

(1) IP provisions:
- List of tangible IP rights
- IP rights are fully owned by foreign customer
- Remuneration for assignment of IP rights
- IP rights are owned by the foreign customer from the moment software is developed

(2) Non-disclosure issues
Key IP issues to consider:

- To make sure all IP is owned by the company who should own it – IP due-diligence is key
- To conduct IP “clean up” to ensure the proper IP flow for future operations
- To catch the rights for previously developed IP, both on inter-company and developers level
TAX ISSUES

RISKS AND THEIR MITIGATION
Ukrainian tax system: rates

- Corporate profits tax (CPT) - 21%
- Value Added Tax (VAT) - 20%
- Personal Income Tax (PIT) - 15%/17%
- Single tax –
  - 5% on turnover (VAT exemption) or
  - 3% on turnover (plus 20% VAT)
- Social payments
  - 36.76% (capped) – at cost of employer
  - 3.6% (capped) – at cost salary (when employed)
  - 34.7% (capped) – at cost of individuals - private entrepreneurs
  - Currently cap for social security payment is approx. US$2,300
Issues to consider – type of presence

Choice of presence type in Ukraine is important

- Ukrainian sub is most recommendable

- RO option is also workable
  - PE risk if purchasing IT services/IP rights through RO
  - Usually work via claiming exemption under applicable treaty – tax authorities generally accept
  - Irregularities due to corporate form and currency control limitations
Issues to consider – relationships with developers

- Developers (individuals)
  - **Pro**: easy management
  - **Con**: significant employment taxes mostly born by employer

- RO/ Ukrainian Sub
  - Employment
  - Services contracts

- Developers (private entrepreneurs)
  - **Pro**: non-significant single tax paid by private entrepreneurs
  - **Con**: deemed employment payments assessment if reclassified
Avoiding Ukrainian 20% VAT:

- Ukrainian VAT is non-recoverable for foreign companies = cost
- Hence, IP flow needs to be structured VAT-free up the chain to a foreign company:
  - No VAT charged by private entrepreneurs working on a 5% single tax
  - Avoided upon cross-border transfer of IP if structured as supply of IT services
Issues to consider – remuneration structure

Foreign Co

Remuneration for services INCLUDING payment for IP rights

IP rights

Remuneration for services PLUS payment for IP rights

Ukrainian sub/ Ukrainian Co
(1) Transfer of IP rights from developers to the subsidiary/RO

(2) Rendering IT services to foreign company with all IP rights attached to the IT services (service fee encompassing fee for IP rights)
Most commonly used structures (IT developers – customers)

- Foreign Co
  - RO
  - Ukrainian Sub

- No VAT (if single tax payers)

- IT developers
  - (private entrepreneurs = single tax payers)

Service fee

IT services

IP rights
Most commonly used structures
(IT developers – IT companies – final customers)
(1) **CPT implications to Ukrainian sub**
- Purchase of IT services/IP rights – tax deduction
- Sale of IT services/IP rights – taxable income
- Some margin must be left in Ukraine to achieve overall profitability

(2) **Transfer pricing (income model/margin level):**
- Currently, TP rules are not well developed
- Cost-plus arrangements widely used - 5% mark-up – safe-harbor rule accepted in practice
- Starting from January 1, 2013, new TP rules are likely to be introduced (based on OECD model)
Contractual wording to be carefully considered:

- Possibility to avoid VAT if rendering to non-residents services on software development, consultations in IT sphere (if Ukrainian VAT is incurred by non-resident – no refund possible!!!)
- Transfer of IP rights to non-residents is under VAT risk (provision vs. transfer of IP rights)
  - Solution-services on custom development of software (service fees encompassing transfer of IP rights)
Direct vs. non-direct engaging of developers – pros and cons

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<th>Direct engagement</th>
<th>Non-direct engagement</th>
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<td><em>(foreign customer – IT developer)</em></td>
<td><em>(via local entity/RO)</em></td>
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**Pros:**

- No VAT cost (if private entrepreneurs = single tax payers)
- More efficient management on the ground

**Cons:**

- Difficult to manage many people without presence (effective for small-scale projects)
- Deemed employment risk = 15/17% PIT and social security payments
- Currency control issues
- VAT risk (20%) upon IP rights transfer
Current tax incentives

- No specific tax incentives are currently available for software developers

- Exploiting regular favorable tax provisions (specifically, no VAT on supply of IT services abroad)
New law on IT taxation

Key features:

(1) Specific favorable tax regime for IT industry participants:
   - 5% CPT (instead of 21%) from January 1 2013, until January 1, 2023
   - VAT exemption for supplies of software products (domestic and cross-border)
   - 5% PIT (instead of 15%/17%) on salaries of IT industry participant's employees

(2) List of criteria to be met specific and registration with tax authorities in order to benefit from introduced incentives

(3) Favorable for working through a Ukrainian subsidiary employing the developers

➢ The adopted draft law has not been signed into law by the president yet

➢ Expected to be signed and promulgated in coming weeks
QUESTIONS?
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