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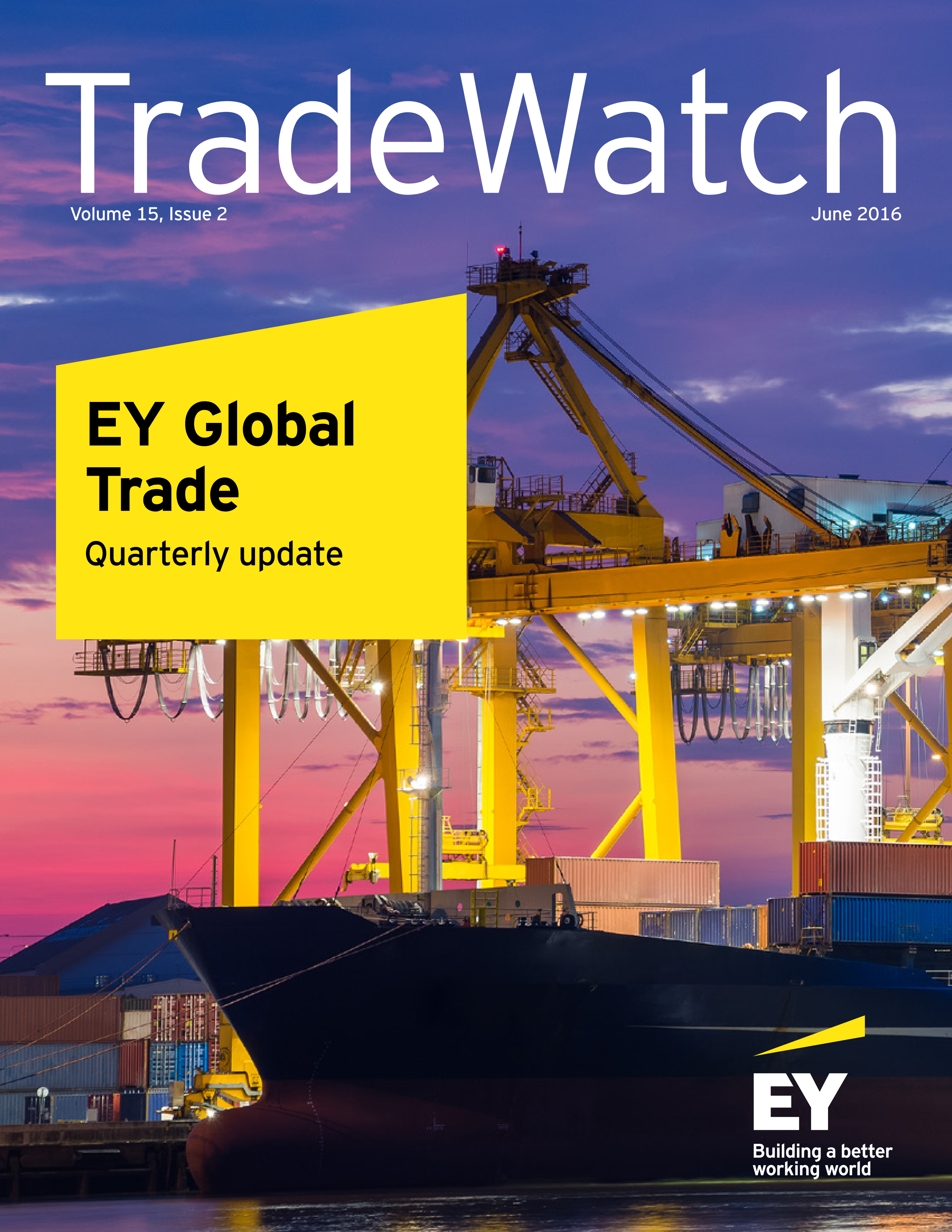

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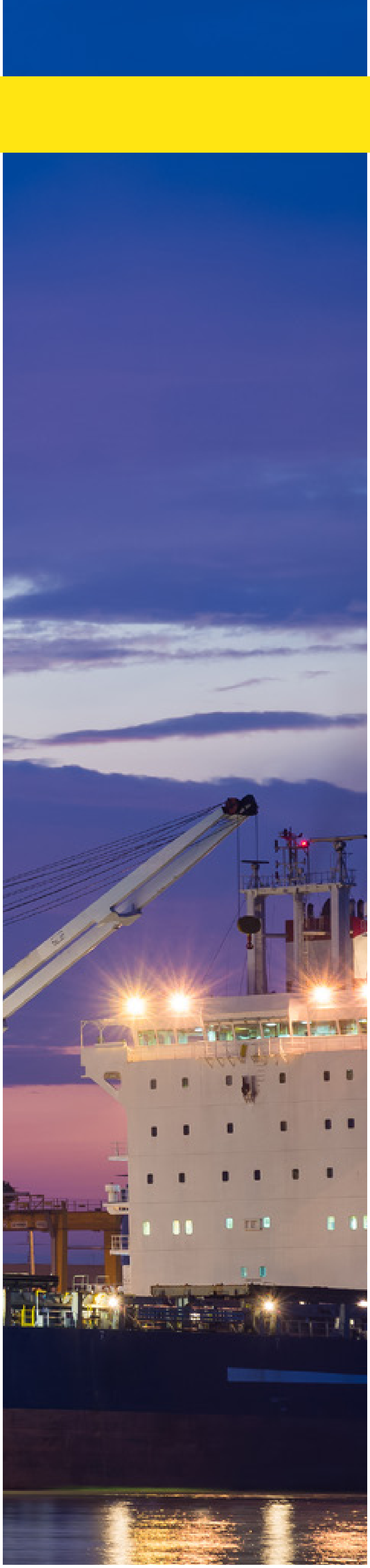

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Technical Committee on Customs Valuation approves case study on transfer pricing

The Technical Committee on Customs Valuation (TCCV) has approved a new case study demonstrating how a transfer pricing study may be used to support customs-related party pricing. Following approval by the World Customs Organization Council, it is expected to be released as TCCV Case Study 14.1. Notably, the case study explains how a transfer pricing study utilizing the Transaction Net Margin Method (a method analogous to the US Comparable Profits Method) testing the profits of the importer/distributor can demonstrate that the relationship between the parties did not influence the price, and consequently transactions priced using this approach qualify for the transaction value method of appraisal.

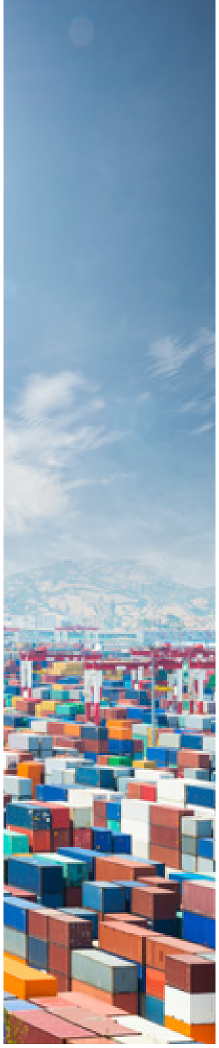
The TCCV is a committee of customs authorities created by the World Trade Organization (WTO) Valuation Agreement and tasked with providing interpretation and guidance on the Valuation Agreement. It is administered by the World Customs Organization (WCO), an intergovernmental organization of 180 customs authorities. While its guidance is not binding on any jurisdiction, customs authorities worldwide regularly cite its pronouncements.

Background

While the objective of both income tax transfer pricing rules and customs-related party valuation rules is the same — arriving at arm's-length prices — the rules are different. As a result, customs authorities worldwide have struggled with whether documentation prepared to support income tax transfer pricing may be considered to support customs valuation.

The vast majority of importers declare import values based on the transaction value methodology, the price paid or payable for merchandise. Ease of documentation and record-keeping are often primary reasons that a business prefers using transaction value.

However, when importers purchase from related parties, special rules apply to use transaction value. Transaction value is an acceptable appraisement methodology between related parties if either (1) an examination of the circumstances of the sale indicates that the relationship between the parties did not influence the price actually paid or payable, or (2) if the transaction value of the imported merchandise approximates certain test values. Test values are not commonly used, and importers usually attempt to demonstrate the acceptability of transaction value under the circumstances of sale test.



The circumstances of sale test examines the relevant aspects of a transaction to determine that the relationship between the buyer and seller did not influence the price. The Annex to the WTO Valuation Agreement provides three examples to demonstrate that the relationship did not influence the price:

1. The price was settled in a manner consistent with the normal pricing practices of the industry in question.
2. The price was settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related to it.

   Or

3. The price is adequate to ensure recovery of all costs plus a profit that is equivalent to the firm's overall profit realized over a representative period of time in sales of merchandise of the same class or kind (note that this example focuses on the exporter's costs and profit, not the importer's).

These examples are nonexclusive. However, because they are the only examples provided, they have tended to be the frame of reference for many customs authorities.

Case study facts

The case study deals with an importer of electrical relays manufactured by a related party. The related party pricing was determined in accordance with the Organisation for Economic Co-operation and Development (OECD) Transactional Net Margin Method (TNMM), which is very similar to the US Comparable Profits Method. Under TNMM, the profit margin of one of the related parties (the tested party) is compared with the profit margin of a group of benchmarked companies that have similar functions and risks to the tested party, but that transact with unrelated parties. In this case, the importer, which functions as a routine distributor, is the tested party, and operating profits of the importer were compared with those of the benchmarked comparable companies. This is the most frequent transfer pricing scenario, but has been difficult for customs authorities because the costs and profits of the producer/exporter are not relevant to the transfer pricing approach. The case study goes on to note that the transfer pricing study is used as the basis of a bilateral Advance Pricing Agreement.

Analysis

The case study makes the link between the transfer pricing study and the first example in the WTO Valuation Agreement annex, that the price between the related parties was settled in a manner consistent with the normal pricing practices of the industry. The case study focuses on the specific companies benchmarked in the transfer pricing study, which were distributors of electrical apparatus and electronic parts. The case study goes on to state that the term "industry" as used in the first example in the annex is meant to include the industry or industry sector that contains goods of the same class or kind as the imported products. In this case, the imported relays are considered part of the electrical apparatus and electronic parts industry. This is the same approach that was used by U.S. Customs and Border Protection in evaluating a transfer pricing study in a 2009 ruling given to Cardinal Health, HQ HO37375 (11 December 2009). Case Study 14.1, which was brought forward for consideration by the US, is loosely based on that ruling.

The analysis section of the case study explains that by working backward from the arm's-length range provided by the transfer pricing study, the transaction between the exporter and importer could be deduced to be at arm's length. The customers of the importer were unrelated parties, so the importer's sales could be assumed to be arm's length. The operating expenses of the importer were also considered reliable, as they were paid to unrelated parties. With the importer operating profit of 2.5% being within the 0.64% to 2.79% operating profit range determined to be arm's length by the transfer pricing study, the only remaining variable, the cost of goods sold (which includes the purchases of the importer goods), could also be considered arm's length.

Caveats

While the approval of this case study is welcome news to importers, there are several important cautions to note. First, with the focus of profits-based transfer pricing methodologies like TNMM being on the comparability of the functions, assets and risks of the tested party with the benchmarked companies, industry compatibility has not typically been a transfer pricing focus, and in some cases of integrated production, compatible companies are difficult if not impossible to find. The US has dealt with these situations by considering separate studies explaining the normal pricing practices of the industry in question. Of course, the case study does not address this situation.

Second, the case study makes a specific point of noting that the customs authority may, as it deems appropriate, examine the operating expense of the company. This stems from concerns expressed by some customs authorities that expenses may be paid to benefit the exporter or may be extraordinary and not reflect a presumption that the importer is rationally trying to reduce expenses. In fact, it is illustrative of a difference of opinion among customs authorities as to whether gross profits or operating profits present the better frame of reference for a customs analysis and serves as a good reminder for taxpayers that there may be customs considerations in the selection of a profit level indicator for transfer pricing.

Finally, many customs authorities have reminded importers that customs has an obligation to apply the WTO Valuation Agreement, and not simply accept a transfer pricing study without examination and analysis of how it demonstrates that the circumstances of sale test is met. This resulted in "disclaimer" language that the case study does not impose an obligation on a customs authority to rely on transfer pricing documentation.

Implications for taxpayers

Efforts by the TCCV, the WCO, and the OECD at convergence of transfer pricing and customs valuation approaches have been ongoing for a decade. Along with the release of the WCO Guide to Transfer Pricing and Customs Valuation in June 2015 (See TradeWatch Volume 14, issue 3, September 2015), Case Study 14.1 marks an important step forward in giving customs authorities comfort in assessing customs-related party pricing in an OECD transfer pricing context. Businesses, in turn, can more confidently approach supporting income tax and customs-related party pricing requirements with a consolidated approach. It is clear from the case study that this does not mean simply preparing transfer pricing documentation based on an OECD methodology and assuming that customs will be satisfied. Instead, there should be thought as to how the documentation can best be prepared with both an income tax and customs audience in mind, with appropriate explanatory information for each on why the documentation satisfies the separate income tax and customs requirements.

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Technical Committee on Customs Valuation fails to reach resolution on application software case

The Technical Committee on Customs Valuation (TCCV) could not reach agreement on a case study involving the licensing of application software and has removed the case study from the TCCV agenda. The failure to reach agreement is both disappointing to importers of technology products, who have been looking for guidance on current business models, and is a reminder of the differences in interpretation of customs authorities on royalties and license fees.

The TCCV is a committee of customs authorities created by the World Trade Organization (WTO) Valuation Agreement and tasked with providing interpretation and guidance on the Valuation Agreement. It is administered by the World Customs Organization (WCO), an intergovernmental organization of 180 customs authorities. While its guidance is not binding on any jurisdiction, customs authorities worldwide regularly cite its pronouncements.

Case study facts

The case study involved the importation of a copier with optional security software that was present on the imported product, but inactive. If separately licensed from the software owner (a party unrelated to either the buyer or seller of the copier), the inactive software may be activated with a key.

After importation, the copier is sold from the importer to a customer. The customer contracts directly with the software owner to license the software, pays a license fee and receives the key to unlock the optional security software.

Applicable rules

The WTO Valuation Agreement provides that the primary basis for customs value is transaction value, the price paid or payable on the sale of the product for export. Article 8.1(c) of the WTO Valuation Agreement provides that royalties or license fees must be added to the invoiced price of the product to determine transaction value when the royalty:

1. Is related to the imported product

   And

2. Must be paid as a condition of the sale to the importer

Unresolved issues

This type of licensing agreement is quite common. There is a firm price agreed between the exporter and the importer for a fully functional copier (including the value of all software that is needed for the copier to operate). Transaction value should apply. With transaction value applicable, an assessment of the need to add any royalty or license fee to the invoiced product price should be made under Article 8.1(c).

The security software license transaction between the customer and the software licensor is separate from the sale of the copier from the exporter to the importer. Additionally, the software license is optional — the software is application software, not needed for the copier to operate, which some customers may want and others may not. It is difficult to construct a scenario in which the payment of this software license fee from the customer to the licensor should be considered a condition of sale of the copier from the exporter to the importer. Moreover, as the software license transaction occurs after importation and does not involve the importer, the importer is not in a position to report (or even know about) the license, and enforcement by a customs authority would be similarly hindered.

Many customs authorities are in agreement with this view that optional, application software licensed post-importation in a separate transaction from the sale of product should not be considered part of the dutiable value of the product. The TCCV, however, operates by consensus; failure to reach a consensus view on this scenario is indicative of the significant concern of some customs authorities that revenue loss is occurring as a result of importers splitting payments for products into two streams, one stated on the invoice and another paid separately. In some cases, these concerns can lead to extreme interpretations.

We do note that there are limitations to applying transaction value. One of the limitations is that the sale must not be subject to some condition or consideration, for which a value cannot be determined with respect to the good being valued. Because the security software licensing transaction is unrelated to the sale for export of the copier, and is optional, it again would seem to be a contorted construction that could lead to a conclusion that transaction value would not be applicable. While this interpretation was not raised at the TCCV, we caution importers that the same concerns on revenue loss from splitting payments could lead to a customs authority questioning transaction value in similar situations.

Implications for importers

The inability of the TCCV to reach a consensus highlights the importance of understanding the local approach to technology products with embedded software of any sort. In some locations, the presence of the software alone may cause a customs authority to attempt to attribute value to it, even if no consideration is ever paid with respect to the software. The only safe course of action in these locations is to deliver application software over the internet after importation, rather than embedding it on the imported product. The WTO Moratorium on assessing customs duties on electronic transmissions, which has been in place since 1998, was again extended for two years at the Nairobi Ministerial Conference last year.

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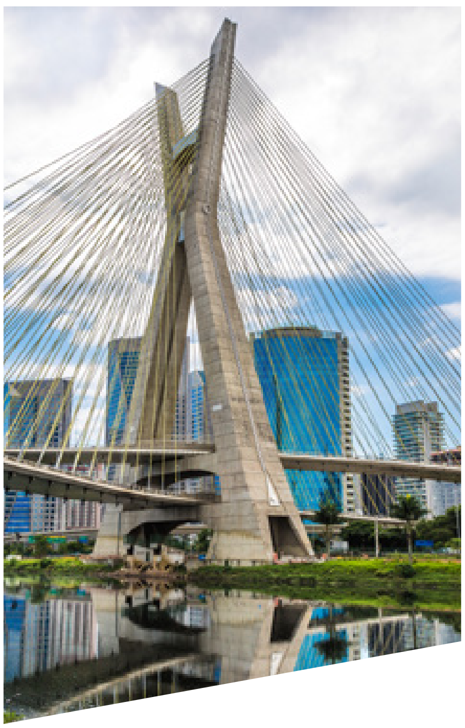
Brazil

New RECOF modality expected to attract more companies



The Brazilian government continues to implement tax incentives and other cost-reducing strategies for companies in effort to increase Brazil's global trade competitiveness and to stimulate local manufacturing and exporting. The evolution of Brazil's Special Regime of Industrial Warehouse under Automated System Control (*Regime de Entreposto Industrial sob Controle Aduaneiro Informatizado, RECOF*) is a prime example of this. Recently, the government has launched a new modality of the regime known as the Public Computerized System for Inventory Controls (*Sistema Público de Escrituração Digital, SPED*).

In the September 2015 issue of *TradeWatch* we discussed RECOF, the special customs regime that allows certified companies to import or locally acquire with tax suspension, raw materials, parts and inputs to be used in the manufacturing of goods both for export and for sale in the domestic market.

RECOF grants tax suspension for a period of 12 months, with option for an additional 12-month extension, for the following taxes:

- II – (*Imposto de Importação*) import duty
- IPI – (*Imposto sobre Produtos Industrializados*) – manufactured goods tax, Brazil's federal value-added tax (VAT)
- PIS – (*Programa de Integração Social*) – social integration program tax
- **COFINS** – (*Contribuição para o Financiamento da Seguridade Social*) – social security finance tax
- **AFRMM** – (*Adicional de Frete para Renovação da Marinha*) – additional freight for the renovation of the merchant marine
- **Airport fees** – 50% discount on certain airport storage fees (E*mpresa Brasileira de Infraestrutura Aeroportuária, INFRAERO*)
- **ICMS** – (I*mposto sobre a Circulação de Mercadorias e prestação de Serviços*) state (certain states only) VAT

The Brazilian government created RECOF in 1997, originally focusing on the technology and telecommunications industries. However, RECOF has evolved quickly and the newly introduced SPED modality extends coverage to any manufacturing company, including the automotive, aeronautical and other industries.

There are now two RECOF modalities: RECOF Standard and RECOF SPED. The main difference between the two is that RECOF SPED does not require pre-approval by the Brazilian Federal Revenue for software acquisition that grants continuous web access to the Brazilian authorities to official reports and data. Such access is a tax-reporting obligation, and most companies in Brazil already comply with it.

The main challenges related to both RECOF modalities are the accurate reporting of inventory and production control and goods receipt procedures. To mitigate these problems, the Brazilian government has implemented certain controls, such as the so-called K Block (Bloco K), an inventory and production control within SPED.

RECOF appears to have suffered from a lack of participation, largely due to the software and reporting issues, in addition to manufacturing companies' fear over whether they would be able to have control of the regime and provide the ongoing access to the Brazilian revenue authorities. RECOF's expansion, coupled with the effective facilitation of the reporting requirements through K Block implementation, has regenerated significant interest in the regime as a viable and more comprehensive (in terms of benefits) alternative to the well-known "drawback" regime in Brazil.

The table provides a summarized comparison between RECOF Standard and the new RECOF SPED modality:

	RECOF Standard	RECOF SPED
Resale of admitted goods in the local market	20% to 30% of imported goods under the regime can be sold in the local market	20% to 30% of imported goods under the regime can be sold in the local market
Minimum export commitment	50% of the total imported amount under the regime (at least USD5m per year)	80% of the total imported amount under the regime (at least USD5m per year)
Minimum exchange gain (CIF Import/FOB Export)	Not necessary	Not necessary
Potential beneficiaries	Assembling companies and manufacturing companies of products used on assembling processes (e.g., auto parts)	Any manufacturing company (chemicals, pharmaceutical, beverages, foods, etc.)
Software control	Imposed by the law	Not imposed by the law, but strongly recommended

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Canada

Dairy supply management in Canada and the challenge of diafiltered milk imports

Canadian dairy farmers recently reiterated their serious opposition to imports of US diafiltered milk[1] into Canada for use in domestic cheese production.[2] Under the current Schedule to the Canadian Customs Tariff, imports of diafiltered milk from the United States are duty-free in contrast to milk and cream imports that are subject to tariff rate quotas (TRQ) and high duty rates for over access imports. Since the Canadian International Trade Tribunal's (CITT) ruling in *Advidia*,[3] diafiltered milk imports are much less costly than domestically produced milk and cream used by Canadian cheese processors as inputs in cheese production. However, Canada's Dairy Products Regulations limit the amount of diafiltered milk and other processed milk products that can be used in production. The dairy farming industry is protesting because it alleges that certain domestic processors are using cheap, duty-free imports of diafiltered milk beyond the permissible limit for processed milk products.

The issue stems from the interplay of two specific policy provisions: the classification of milk protein products in the Tariff Schedule, and the compositional cheese standards of the federal Dairy Products Regulations as administered by the Canadian Food Inspection Agency. In this article, we provide a discussion of these technical provisions as a backdrop for understanding the competing interests of Canadian dairy farmers on one hand and Canadian cheese processors that source imported milk products on the other. We also consider the broader question of the interplay of free trade with Canada's agricultural supply management policy.

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1 Diafiltered milk refers to dried milk protein concentrate made using a combination of ultrafiltration and diafiltration.

2 "Imported Diafiltered Milk," Dairy Farmers of Canada press release,12 April 2016; Address of the Chairman of *Les Producteurs de lait du Quebec* (PLD), 26 November 2015, available at PLD Website. (Dairy Farmers of Canada press release, 12 April 2016).

3 *Les Produits Laitiers Advidia Inc. v. Commissioner of the Canada Customs and Revenue Agency and the Dairy Farmers of Canada* (AP-2003-040, decision and issues rendered 8 March 2005) (Advidia).

TRQ regime and the classification of diafiltered milk and other milk protein products in the Tariff Schedule[4]

During the 1994 WTO negotiations, an agreement was reached to remove agricultural quotas in international trade among WTO member states.[5] Instead, TRQ were permitted as a form of tariffication of the previous prohibitive measures. Canada has since been making use of TRQ provisions to protect its dairy industry from the influence of the international dairy market. It is one of various policies that fall under the broader umbrella of protectionist supply management policies meant to stabilize the domestic dairy farming industry. Under Canadian dairy TRQ provisions, market access to foreign milk and cream is restricted and goods imported over market access quota amounts are subject to intentionally trade-prohibitive tariffs, often in excess of 200%.

Diafiltered milk is a milk protein substance resulting from the diafiltration of milk, having a very high concentration of proteins. In Canada, the jurisprudence on the appropriate customs classification of diafiltered milk is found in the CITT's Advidia decision. The CITT determined that the diafiltered milk product at issue (PROMILK 872 B imported by Advidia) was appropriately classified in heading 35.04 of the Customs Tariff Schedule. The Canada Border Services Agency (CBSA) and the Dairy Farmers of Canada had argued that diafiltered milk should be part of Chapter 4 dairy produce (heading 04.04), which would have made the imports subject to a TRQ duty rate of 270%, but not less than CAD3.15 (approximately USD2.42) per kilogram (tariff item 0404.90.20).

The case was decided in Advidia's favor on the technical merits of the product at issue. As a high-protein concentration product (more than 87.5% protein), the CITT determined that PROMILK 872 B was more specifically covered by "protein substances" (heading 35.04) than by "products consisting of natural milk constituents" (heading 04.04) under the Tariff Schedule.[6] While the CITT took into consideration a rule in the European Union tariff that directed the classification of milk protein substances with less than 85% protein concentration in heading 04.04 and other milk protein substances in heading 35.04, the CITT noted nevertheless that such a rule was not necessary to allow the classification of diafiltered milk under heading 35.04. The CITT's decision was upheld by the Federal Court of Appeal (FCA) on appeal.[7]

Canadian tariff policy reactions to Advidia

Following the FCA decision, Canada adjusted its tariff policy to limit any possible influx of milk protein substances that could create unfair competition to the price-controlled domestic dairy supply. Canada took two discernable measures to do so, as follows:

First, in June 2008, Canada adopted a Supplementary Note to Chapter 04 of the Customs Tariff Schedule that is similar to the European Union rule discussed in *Advidia*.[8] According to the Canadian Supplementary Note 3 to Chapter 4 in the Schedule (currently in force), "Milk protein substances with a milk protein content of less than 85% by weight, calculated on the dry matter, are classified in tariff item No. 0404.90.10 or 0404.90.20. Milk protein substances with a milk protein content of 85% or more by weight, calculated on the dry matter, are classified in Chapter 35 (subheading 3504.00)." Because of its high protein content, diafiltered milk is typically classified under subheading 35.04.

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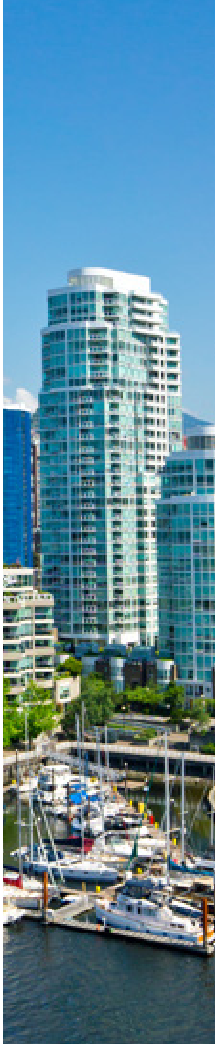
4 Schedule to the Customs *Tariff*, List of Tariff Provisions.

5 Agreement on Agriculture, signed in 1994 at the Uruguay Round.

6 Advidia, paragraphs 47-48.

7 Canada (Commissioner of Customs and Revenue) v. Produits laitiers Advidia Inc. (2006 FCA 41, Federal Court of Appeal Decisions, 31 January 2006).

8 Notice of Ways and Means, Canada Gazette, 12 June 2008.



Second, the Canadian government implemented a new TRQ for the imports of milk protein substances classified in Chapter 35 of the Customs Tariff Schedule. The resulting provision came into force in July 2008[9] – under subheading 3504.00 of the Customs Tariff Schedule, imports of milk protein substances including imports of diafiltered milk products are duty-free within access commitment (tariff item 3504.00.11), but subject to a 270% duty rate if imported over the access commitment (tariff item 3504.00.12).

However, obligations under various free trade agreements, such as those under the North American Free Trade Agreement (NAFTA), prevent Canada from implementing a TRQ rate of duty that is greater than the lesser of:

- The non-preferential rate of duty for heading 35.04 diafiltered milk at the time the agreement was signed, which was 12% in 1991
- The non-preferential duty rate at the time of implementing the new TRQ measure, which was 6.5% in 2008 just prior to the TRQ amendment[10]

Thus, US diafiltered milk, as long as it contains 85% protein concentration or more, can enter Canada duty-free. Other trade partners who enjoy the benefit of avoiding the 270% TRQ duty on heading 35.04 imports include Mexico, Colombia, Israel and Costa Rica, but there is no significant volume of diafiltered milk imports from these countries.

Dairy Product Regulations

Although US diafiltered milk imports enter Canada duty-free, domestic cheese processors still have to comply with the compositional cheese standards of the federal Dairy Products Regulations when using diafiltered milk and other milk products in the production of cheese.

According to the current compositional standards, the minimum required levels of casein content derived directly from milk (that may be ultrafiltered, partly skimmed, skim, but not subjected to any other processing) or cream, rather than from "other milk products," as stated in the regulations, ranges between 63% and 100% as set out below.[11]

Variety of cheese	**Minimum percentage of casein content that is derived from milk, partly skimmed milk, skim milk or cream** (as a percentage of the total protein content of cheese)	**Limit on the use of dairy ingredients** (as a percentage of the total protein content of cheese)
Pizza Mozzarella, Part Skim Pizza Mozzarella	63%	37%
Asiago, Baby Edam, Baby Gouda, Blue, Butterkase, Bra, BrieCaciovallo, Camembert, Danbo, Edam, Elbo, Emmental, Esrom, Feta, Fontina, Fynbo, Gouda, Gournay, Gruyère, Havarti, Kasseri, Limburger, Maribo, Montasio, Muenster, Neufchâtel, Parmesan, Provolone, Romano, St-Jorge, Saint-Paulin, Samsoë, Tilsiter, Tybo	95%	5%
Cheddar, Brick, Canadian Style Brick, Colby, Farmer's, Jack, Monterey (Monterey Jack), Mozzarella (Scamorza), Part Skim Mozzarella (Part Skim Scamorza), Part Skim Pizza and any other variety of cheese not specifically listed	83%	17%
Traditional Cheddar Cheese	100%	0%

9 CBSA, Tariff Notice 35 of 2008.

10 NAFTA, Article 703, Chapter 7, section 3(a).

11 *Dairy Products Regulations* (SOR/79-840), § 2.1(3) for cheddar, and § 28(a)(i.1)(A) through (C) for other cheeses.

The Dairy Products Regulations define a "milk product" to mean:

(a) Partly skimmed milk, skim milk, cream, buttermilk, whey and whey cream

(b) Milk in concentrated, dried, frozen or reconstituted form and any product referred to in (a) in concentrated, dried, frozen or reconstituted form

(c) Butter, butter oil and whey butter

(d) Milk solids

(e) Whey protein concentrate[12]

Fluid milk and cream of (a) and (b) above would be allowed under the minimum fluid milk and cream threshold, whereas the "other" products in the above list would be considered "other milk products" for the purpose of the cheese compositional standards. As a milk protein concentrate in dried form, diafiltered milk falls under the Dairy Products Regulations definition of a milk solid, which is "in respect of cheese, any constituent of milk – other than water – singly or in combination with other constituents of milk ...."[13] Hence, diafiltered milk is an "other milk product" and cannot be used to fulfill the minimum compositional requirements as listed in the cheese standards.

These standards were last revised in December 2008,[14] the same year the TRQ was applied to milk protein substances, as mentioned above. The Canadian Food Inspection Agency, responsible for enforcing cheese compositional standards, discussed the effect the new standards would have on curtailing the use of imports of non-TRQ milk substances.[15]

In other words, Canada opted to legislate into the Dairy Products Regulations the protection of dairy farmers that it was not able to implement in tariff policy for goods imported from a free trade agreement partner. Nonetheless, Canada's dairy producers associations claim that the standards outlines above are not being properly enforced.[16]

Implications

The Canadian federal government has acknowledged that the interplay of the classification under the Tariff Schedule and the cheese compositional standards of the Dairy Products Regulations influences supply management policy. In the case of the Tariff Schedule however, applying a TRQ to imports of 85% milk protein concentrate from the US seems unlikely, as it would contradict NAFTA provisions.

Moreover, under Canada's Comprehensive Economic and Trade Agreement (CETA)[17] with the European Union that is yet to be implemented, and the potential Trans-Pacific Partnership agreement (TPP),[18] which includes dairy exporter trade partners like New Zealand, diafiltered milk will be a duty-free import, increasing the materiality of the current disconnect between the interests of Canadian dairy farmers and Canadian cheese processors under the Dairy Products Regulations.

[12] *Dairy Products Regulations* (SOR/79-840), § 2 for milk product.

[13] *Dairy Products Regulations* (SOR/79-840), § 2 for milk solids.

[14] Canada Gazette Part I (Vol. 141, No. 24, 16 June 2007), Proposed Regulations, p. 1654.

[15] *Regulations Amending the Food and Drug Regulations and the Dairy Products Regulations* (SOR/2007-302).

[16] Dairy Farmers of Canada press release, PLD Website, 12 April 2016.

[17] Comprehensive Economic and Trade Agreement, Annex: Canada's Negative List Tariff Schedule.

[18] Trans-Pacific Partnership Agreement, Annex 2-D: Canada Tariff Elimination Schedule.

Increasing enforcement of the cheese compositional standards under the Dairy Products Regulations would seem to be the likely course of action should the government side with the farmers on this issue. The likelihood of such an outcome, however, remains unclear for the time being. If measures that enforce the cheese compositional standards more effectively were to be enacted, the market share of US exports to Canada of diafiltered milk would be reduced. That would be a troubling prospect for US exporters, considering that diafiltered milk production is generally geared for exports.

For Canadian processors using diafiltered milk, a restriction on its use in cheese recipes would effectively mean an increase in production costs and reduced competitiveness in the market. Combined with the prospect of CETA and TPP being implemented, both users and non-users of US diafiltered milk could face challenging competitive pressures in the near future.

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Colombia

Colombia adopts new customs code

Colombia has recently harmonized its customs legislation with international conventions such as the Andean Community of Nations (*Comunidad Andina,* CAN: Bolivia, Colombia, Ecuador and Peru) and the International Convention on the Simplification and Harmonization of Customs procedures (Kyoto Convention) of the World Customs Organization (WTO).

The Colombian Ministry of Finance and Public Credit (*Ministerio de Hacienda y Crédito Público*) issued Decree 390 on 7 March 2016 (the Decree) to introduce important amendments and modifications to existing Colombian customs legislation. The most important changes are as follows:

- The Decree revises in part the language, processes and procedures in line with those of international conventions, especially with the rules of CAN and the Kyoto Convention.
- The Decree adopts instruments to prevent, control and penalize smuggling, money laundering and tax evasion by increasing customs control in conjunction with trade facilitation. Efforts will focus on customs users that after a risk management assessment are designated medium or high risk. As a result, efforts on customs users deemed trustworthy based on risk assessment of their prior customs operations are likely to be minimal.
- Importers, exporters, operators of express shipments or express couriers, postal service operators or carriers, will be able to act as declarants for customs purposes. Accordingly, customs brokers or agents may be deemed as foreign trade operators and authorized by the National Tax and Customs Administration (*Dirección de Impuestos y Aduanas Nacionales,* DIAN) to provide representation services on behalf of importers and exporters for purposes of customs clearance of goods and other related formalities.
- Use of customs bond to guarantee payment of customs duties arising from foreign trade obligations will increase. A customs bond may be provided in the following forms: monetary deposit, guarantee obtained from an insurance company, guarantee obtained from a commercial bank, deposit of securities and others.
- The Decree introduces mechanisms aimed at improving foreign trade logistics, such as International Logistics Distribution Centers (*Centros de Distribución Logística Internacional*), non-intrusive inspection of goods, Specialized Logistics Infrastructures (*Infraestructuras Logísticas Especializadas*), and others.
- The Decree sets out provisions for electronic payment of customs duties and outlines rules intended to generate efficiencies in the customs clearance procedure.

On a final note, DIAN will promulgate specific regulations under Decree 390 of 2016 that are likely to be in force by September 2016.

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Changes to the Authorized Economic Operator request procedure

In the December 2015 issue of *TradeWatch* we discussed recent amendments to the Authorized Economic Operator (AEO) program that aligned Colombian regulations with international standards under the World Customs Organization (WCO).

Along with the implementation of these amendments, the National Tax and Customs Administration (*Dirección de Impuestos y Aduanas Nacionales,* DIAN), together with several other government agencies,[19] issued Resolution No. 15 of 17 February 2016, which simplifies the procedures for requesting AEO status by making certain requirements more flexible.

The Resolution does the following:

- Reduces the number of minimum requirements to request and maintain AEO status
- Specifies the Control Authorities who will validate each of the minimum requirements
- Maintains the benefits provided by Decree 3568 of 2011, as amended by Decree 1894 of 2015
- Reduces the legal period within which the Authorities must issue a decision on AEO status to approximately four months

Currently, only exporters may apply to DIAN for AEO authorization; however, the program is likely to expand in the near future to include ports and importers.

Another article in this issue discusses the recently adopted new Colombian customs code (Decree No. 390 dated 7 March 2016, Ministry of Treasury and Public Credit). Under this Decree, AEO becomes the most reliable customs operator program in Colombia.

Currently, 14 export companies have received AEO status. Companies will secure a competitive advantage if they determine whether they can benefit under the new rules and then proceed to structure their processes accordingly to qualify for the AEO program.

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[19] The Colombian National Police, the Colombian National Drug and Food Monitoring Institute (*Instituto Nacional de Vigilancia de Medicamentos y Alimentos,* INVIMA), and the Colombian Agricultural Institute (*Instituto Colombiano Agropecuario,* ICA).

Mexico

New benefits under the Strategic Bonded Warehouse customs regime

Mexico has recently amended its special customs regime legislation to grant additional benefits to companies electing to use the Strategic Bonded Warehouse (*Recinto Fiscalizado Estratégico,* RFE) customs regime.

The Mexican Customs Law establishes the RFE as a customs regime that is similar to the US Foreign Trade Zone. Accordingly, companies may enter goods into their facilities located within designated locations and managed by an authorized third party, for storage, distribution, manufacturing and other activities.

The RFE customs regime provides useful logistical benefits for companies operating in Mexico including:

- Entry of foreign goods for up to 60 months for warehousing, exhibition, sale, distribution, manufacturing, alterations or repair purposes
- Entry of domestic goods for warehousing, exhibition, sale, distribution, manufacturing, alterations or repair purposes
- Entry of fixed assets for the duration of the RFE regime authorization
- No payments for import duties or anti-dumping duties upon product entry
- Value-added tax (VAT) and excise tax certification for RFE operator that allows him or her to apply a tax credit against the VAT and excise tax due at the time of entry, thus eliminating the negative cash flow impact
- Compliance with non-tariff restrictions, including permits, and Mexican Official Standards (*Norma Oficial Mexicana,* NOM) at the time of entry, other than those related to sanitary measures, public health, environment and national security, not required
- Reduced clearance times by filing entry declarations (*pedimentos*) in the customs office assigned to the RFE
- RFE operator's choice to pay duties at the rate of either the raw materials used or of the finished product when foreign goods are permanently imported into Mexico

While the RFE customs regime provides benefits that are not available under other temporary import programs, such as the IMMEX (*Industria Manufacturera, Maquiladora y de Servicios de Exportación, Manufacturing, Maquiladora and Services Industry*) or Maquila program, multinational companies have typically preferred other types of customs regimes because of the additional operational requirements associated with the RFE customs regime.

For instance, designated RFEs may only be established in locations adjoining a customs office, and companies operating under the RFE customs regime need to maintain an automated inventory control system that provides the customs authorities a permanent and uninterrupted access.

In an effort to increase use of the RFE customs regime, the government has enacted amendments to the legislation to allow companies to establish designated RFE locations anywhere in the country. In addition, a decree published on 4 February 2016 creates additional benefits under the RFE regime including, among others, the following:

- A tax incentive to cover the fees that must be paid to the authorities for operating under the RFE customs regime
- Reduced customs processing fee (*Derecho de Trámite Aduanero*) paid upon entry for goods, machinery and equipment (M&E)
- Administrative benefits, including immediate registration in the Importer's Registry for Specific Sectors as well as immediate authorization of the company's VAT and excise tax certification, upon request
- Additional logistical benefits including:
    - Option to perform the entry or withdrawal from the RFE before any customs office on any day, including during non-business hours
    - Possibility to amend the origin of goods entered into the RFE within three months of entry without prior authorization from the tax authorities
    - Withdraw domestic or permanently imported goods that were entered into the RFE without considering the withdrawal as an importation
    - Option to apply free trade agreement or PROSEC (*Programa de Promoción Sectorial,* Sector Promotion Program) preferential duty rates upon entry
    - Option to enter domestic or permanently imported goods for storage, exhibition, sale and distribution into the RFE facility without considering such entry as an exportation

Mexico currently has 10 designated RFE locations where companies can establish facilities and operate under the RFE customs regime. Considering the changes that the Mexican government is implementing, this is a good opportunity for companies with operations in Mexico to assess whether the RFE customs regime may provide useful advantages compared to other temporary import programs.

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China

China Customs makes major amendments to the *Declaration Requirements for Import/Export Entry*

On 24 March 2016, the General Administration of Customs (GAC or Customs) released GAC Notice 2016 No. 20, *The Notice Regarding the Amendments to the Declaration Requirements for Import/Export Entry* (the Notice).

Background

The Notice, in effect as of 30 March 2016, updates the original *Declaration Requirements for Import/Export Entry* announced in GAC Notice 2008 No. 52. The amendments in the Notice include, among others, the following:

- The descriptions of several data fields to be completed have been adjusted, as for example:
  - "Operating Entity" and "Operating Entity inside the Zone" are now "Shipper/Consignee."
  - "Recipient Entity" and "Recipient Entity inside the Zone" are now "Consumption/Usage Entity."
  - The previous statement, "The undersigned hereby states that the above declarations are true and takes legal responsibility," is now "The undersigned is legally responsible for the truth of the declarations and the settlement of taxes under the law."
- Data fields that are no longer relevant have been deleted, including, among others:
  - "Foreign Exchange Approval Certificate No."
  - "Customs Review and Release Date"
- New data fields have been included, such as "Trading Country (Region)," "Special Relationship," "Price Impact," "Royalty Payment," and others along with guidance on how to complete these new fields.
- Guidance for completing the fields with description adjustments has been provided, for example for "Shipper/Consignee," "Consumption/Usage Entity," "Manufacturing/Selling Entity," "Country (Region) of Origin" for export declaration, "Destination Country (Region)" for import declaration, and others.
- The line items allowed in each declaration have been increased from 20 to 50.

All of the above amendments also apply to inbound/outbound registration with Customs for goods imported or exported through bonded areas.

Observations

The amendments described above will help Customs to achieve various objectives, including:

- Accommodate the evolving state supervision requirements for import and export
- Standardize importer/exporter's declaration activities
- Improve the quality of data declared to Customs in import/export entries
- Consolidate the requirements and other separate rules in effect since 2008

In general, these amendments are updates and supplements to previous requirements intended to enable Customs to supervise more effectively the declaration process.

Implications for importers and exporters

Among the various amendments, the following three new fields, which require importers and exporters to provide a Yes or No confirmation, deserve special consideration. While the requirement of the Import and Export Price Supplementary Declaration remain unchanged, the answer provided in these fields may give rise to additional implications from a customs perspective:

1. **Whether there is a "special relationship" between the seller and the buyer**

Article 16 of GAC Decree 2013 No. 213, *PRC Customs Valuation Rules for Determining the Dutiable Value of Import and Export Goods* (Valuation Rules) defines special relationships for customs purposes. The definition of special relationships according to the Valuation Rules, however, is broader than the definition under the tax rules. Under the Valuation Rules, a larger percentage of cross-border transactions between multinationals are likely to be considered as having special relationships from a customs perspective as compared from a tax perspective.

2. **Whether the special relationship between the seller and the buyer has influenced the transaction value**

The influence of the special relationship on the import price is assessed according to Articles 17 and 18 of the Customs Valuation Rules. However, there is still lack of clarity when providing a Yes or No answer to the following questions:

- If Customs has previously determined that the import price was influenced by the relationship (for example, during a periodic review and assessment, which is conducted only when necessary), then how should the question of whether the relationship between the buyer and seller has influenced the price be answered (i.e., Yes or No)?
- If the same importer described above shifts the entry port from one to another, would such a shift change the answer to the same question?

- Will there be any administrative or legal consequence if there is a No answer, but later Customs makes a different assessment?
- In the above situation, would the result be different if the importer is able to produce an assessment made by a third party to support the No answer?

Importers and exporters need to consider all of these possibilities before answering Yes or No on their custom declaration.

3. **Whether there is a royalty payment paid or payable**

According to the Valuation Rules, royalty and licensing fee payments are conditionally dutiable only if certain relevant criteria have been met. Therefore, a Yes answer to this question should not automatically result in a dutiable treatment of the disclosed royalty/licensing fee arrangement. However, Customs has subjected royalty payments to increased scrutiny over the years. Accordingly, importers and exporters are advised to conduct a dutiable treatment analysis when providing a Yes answer to confirm the royalty arrangement.

Effect of additional data fields

The additional information from the new data fields will likely provide Customs with better statistics and enhanced supervision over goods imported/exported under Free Trade Agreements (FTAs). Making accurate import/export customs declarations becomes critical considering that origin declaration is likely to attract increasing attention from Customs as more and more goods are traded under FTAs.

Final thoughts

The updated declaration requirements are likely to affect a company's day-to-day import/export clearance process. This is especially true for multinationals engaged in cross-border transactions with related parties.

Meanwhile, it is apparent that China Customs invests significant time and effort to enforce compliance through post-importation audit. Customs is likely to utilize the new data requirements during such audit. The Yes or No answers and the accuracy of data submitted to Customs in the relevant fields can directly affect the audit outcome.

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China amends import tax policy for cross-border B2C business

The business to consumer (B2C) model refers to a situation where sellers conduct transactions directly with end consumers, usually over the internet. The increasing cross-border B2C trade has prompted the Chinese authorities to introduce an import tax policy that applies specifically to B2C transactions.

On 24 March 2016, China's Ministry of Finance, General Administration of Customs (Customs) and State Taxation Administration jointly released *Notice Regarding Import Tax Policy for Cross-border B2C Business,* Cai Guan Shui [2016] No. 18 (the Notice), which came into effect on 8 April 2016.

In relation to the Notice, Customs, the Ministry of Finance and numerous central government authorities (11-13 different authorities in all) jointly issued the following two Positive Lists of Cross-border B2C Goods (the Positive Lists):

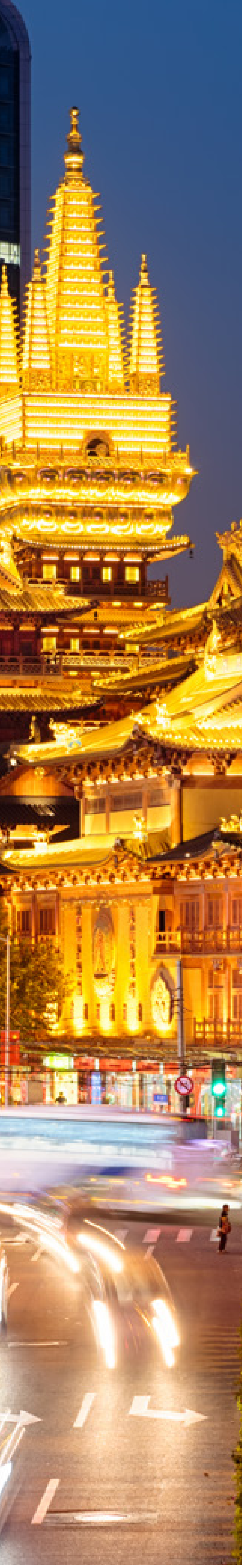
- *Notice Regarding the Issuance of the List of Cross-border E-commerce Retail Import Commodities,* Announcement [2016] No. 40 on 6 April 2016
- *Notice Regarding the Issuance of the List of Cross-border E-commerce Retail Import Commodities,* Announcement [2016] No. 47 on 15 April 2016

In addition to the Notice and Positive Lists, the Customs also released Notice Regarding Matters Related to the Supervision on Cross-border E-commerce Retail Import/ Export Commodities, Announcement [2016] No. 26) on 7 April 2016.

The import tax policy changes according to the various notices described above are significant for the booming cross-border B2C business in China. As clarified by the Ministry of Finance on its official website, the changes are mainly devised to achieve a number of objectives as discussed below.

Background

- China imposes a postal tax, which is a blended import tax rate consisting of customs duty, consumption tax and import VAT on "articles" (i.e., documents, passenger belongings or gifts for family and friends) imported for noncommercial purposes. The applicable postal tax rate has generally been lower than the composite import tax rates for similar goods imported for commercial/trading purposes.
- B2C goods enter China through postal channels, but because of their nature, they are considered commercial goods that are different from the articles mentioned above (i.e., documents, passenger belongings or gifts for family and friends).



- If B2C goods are only subjected to postal tax, the overall tax burden would be lower than that of similar domestic goods, or goods imported under a general trade mode, which may result in unfair competition.

Major changes

The import tax policy changes for cross-border B2C trade are summarized in the following table:

Main points	Before adjustment	After adjustment
Applicable tax	▸ Postal tax	▸ Duty, import VAT and consumption tax (i.e., standard import tax treatment for goods imported under general trade)
Value threshold	▸ "Reasonable quantity" of imported goods for personal/self-usage ▸ RMB1000 (approximately USD153) per transaction except for goods imported from Hong Kong, Macau and Taiwan, where the postal tax is RMB800 (approximately USD122); no annual value cap ▸ Treated as normal importation of goods if beyond the above value threshold ▸ Single and non-separable articles can still be treated as personal items even if beyond the above value threshold	▸ RMB2000 (approximately USD305) per transaction with an annual value cap of 20,000 RMB (approximately USD3,052) per individual ▸ Treated as normal importation of commercial goods if beyond the above value threshold
Dutiable value	▸ Actual sales price as per purchase order	▸ Actual transaction value (including retail price, freight and insurance)
Applicable tax rate	▸ Items are categorized into four separate categories subject to the respective postal tax rates at 10%/20%/30%/50%.	▸ Below the value threshold mentioned above, 0% duty rate and 70% of consumption tax and import VAT ▸ Beyond the value threshold mentioned above, treated as normal importation of commercial goods
Exemption	▸ Exemption applies if the tax payable is no more than RMB50 (approximately USD7.6).	▸ No exemption
Scope	▸ Consumer products are not subject to the catalog of products prohibited for importation.	▸ If the goods are specified on the Positive Lists, the transaction payment data must match the logistics record.
Sales return	▸ Not specified in the rules ▸ Subject to local practice	▸ Import tax paid refundable upon return within 30 days of release by customs ▸ Annual accumulated transaction value should be correspondingly adjusted for the relevant individual
Nature of transaction	▸ Cross-border B2C goods are treated as items for personal use.	▸ Cross-border B2C goods are treated as commercial goods.

Implications

The recent import tax policy changes are significant and will likely impact cross-border B2C business in the following ways:

- The tax burden for cross-border B2C and postal channel transactions has increased. The new rule has removed the previous exemption that applied to small value transactions (if the tax payable is no more than RMB50). Though the new policy allows a 0% duty rate for transactions under the value threshold, the 70% of consumption tax and import VAT payable on imported goods would still increase the average tax burden as compared to that under the previous postal tax mechanism.

  Under the new rules, the postal tax still applies to cross-border passenger belongings and personal items imported through postal channels. Upon the introduction of the new B2C rules, the postal tax has also been changed from the previous four rate categories (10%/20%/30%/50%) to three categories with increased rates (15%/30%/60%), which has balanced the tax burden differences between the two parallel channels (i.e., cross-border B2C vs. postal channel).
- Value thresholds and Positive Lists for the B2C scope have been introduced. The new rules introduce a value threshold of RMB2,000 per transaction with an annual value cap of RMB20,000 per individual. Only the goods below the threshold qualify for the B2C treatment; otherwise, the transaction would be treated as normal importation of commercial goods.

  At the same time, the government has introduced two Positive Lists for the scope of B2C goods, which cover about 1,300 HS codes, including most consumer products. But taking the aforesaid value threshold into consideration, this would exclude most luxury products from the B2C scope, while the remark note in the Positive Lists would make the importation less "flexible" when compared with the previous mechanism for certain consumer products that are subject to licensing or registration requirements (discussed below).
- Additional compliance requirements for selected products have been added. As mentioned above, the government has announced exceptions for certain products on the Positive Lists. These products are mostly food, health care and cosmetics products that are subject to pre-market licensing or registration requirements as part of the usual importation procedure.

  Under the previous B2C mechanism, these licensing or registration requirements were usually waived for these products. The Positive Lists under the new rules subject these products to the applicable licensing and registration requirements when imported for the first time (or when traded through the bonded areas).
- The new rules streamline the importation process to facilitate the B2C transactions by specifying the applicable declaration requirements along with clearance procedures and customs supervision controls. In addition, this is the first time Customs explicitly permits an import tax refund for returned goods.

Concluding thoughts

Cross-border B2C business boomed in China over the recent years because of the rapid economic growth. It is expected that the new policy changes, however, will likely present significant challenges in the form of increased tax burden, value thresholds, qualifying Positive Lists, additional compliance requirements, and others, for traders that have already been in, or prepare to enter, the cross-border B2C business.

Look for further insight into the changing B2C trend for the retail and consumer products industry in future issues of *TradeWatch*.

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Japan

2016 Reform of Customs Law and other relevant laws

After Japan's government approved the 2016 tax reform bill on 24 December 2015, the Ministry of Finance promulgated a number of notable amendments to certain provisions of the Customs Law and other relevant laws on 31 March 2016. The majority of the revisions became effective on 1 April 2016. This article focuses on major points that may have significant implications for companies that engage in global trade in Japan.

Revision of customs penalty provisions

Penalty imposed even in the case of voluntary disclosure

Under Japan's Customs law, a penalty of 10% of the duty shortfall is imposed on importers who fail to properly declare the customs value of the goods upon importation and are later found by Customs to have underreported the customs value. However, in a Customs audit situation, where importers make voluntary disclosures of underreported goods before the actual day of the audit — even after Customs issues an advance audit notice to the importer — the penalty would be waived.

This practice has resulted in an increasing number of importers who neglect making proper customs declarations on an entry-by-entry basis, but instead make last-minute disclosures prior to the audit to avoid paying penalties.

In order to remedy this situation, the provision was amended to impose a 5% penalty on importers who make voluntary disclosures after the advance audit notice is issued. The amendment aims to make importers more compliant on the entry-by-entry level, while still providing an incentive for importers to make voluntary disclosures even after the issuance of the audit notice by imposing a lower penalty (5%) compared with the normal penalty of 10% for under-reported declaration.

For importers who fail to declare customs value at all upon importation (non-declaration), a heavier penalty of 10% of duty shortfall will be imposed if voluntary disclosure is made after the advance notice, but before the actual audit date, which is still less than the 15% of duty shortfall applicable to findings of non-declaration in Customs audits.

Additional penalty for repeated offense

If an importer receives a penalty for non-declaration (or a heavier penalty for fraud or gross negligence upon customs declaration) within five years from previous penalties for the same offense, an additional 10% will be imposed as penalty for repeated noncompliance with proper customs declaration requirements.

Therefore, under the amended Customs Law, in cases of repeated noncompliance within five years, the relevant penalties would be a total of 25% for non-declaration, 45% for underreported declaration with fraud or gross negligence and 50% for non-declaration with fraud or gross negligence. Since these additional penalty provisions are not applicable to underreported declarations, the penalty on underreported declaration remains at 10% in general.

Both of the above provisions will apply to goods imported on or after 1 January 2017. Given the stricter application, importers need to ensure that they are making accurate declarations and voluntary corrections as necessary to avoid additional duty or penalty, especially in the case of recurring noncompliance with customs declaration requirements.

Liberalized customs declaration policy

A liberalized customs declaration option that allows Authorized Economic Operators (AEOs) a more flexible choice of customs office for filing customs declarations was also introduced as one of the amendments to Customs Law (discussed in the September 2015 issue of *TradeWatch*). Currently, customs declarations must be submitted at the customs office where the goods are physically located, forcing many companies to employ multiple brokers and manage customs entries on a port-by-port basis.

Given that the Director General of Customs designates AEOs as persons/entities capable of appropriately managing import/export operations and presumed to be reliable on their customs declarations, the new measure will provide AEOs the flexibility to declare goods at a customs office other than the customs office where the goods are physically located. Non-AEOs will continue to file customs declarations at the customs office where the goods are located.

This measure could provide AEOs in Japan opportunities to further reduce administrative costs, streamline their import operations and even improve their customs compliance. This is a significant development, which may persuade companies that are not entirely convinced of the merits of the AEO programs in Japan to obtain AEO certification.

The measure is expected to become effective within two years from the promulgation date of the amended Customs Law, the specific date to be stipulated by a Cabinet Order. While the details of the regulations are still under discussion and are expected to be publicized in the near future, companies without AEO qualification may wish to consider acquiring AEO certification to benefit from the additional advantages of this measure before the final regulations are published.

Extension of period for temporary tariff rates

Temporary tariff rates of 431 products currently in place will continue to apply until 31 March 2017, along with special tariffs imposed on beef and pork.

Goods that infringe trade secrets are included in prohibited goods list for exportation/importation

The import/export of goods known to use unlawfully a trade secret are treated as an act of unfair competition under the revised Unfair Completion Prevention Act, in force as of 1 January 2016. Accordingly, as a border enforcement provision, they are included on the list of "goods, the exportation/importation of which is prohibited" under the Customs Law. This revised provision came into force on 1 June 2016.

Revision of the period subject to overdue tax

Importers will not have to pay interest on overdue tax in cases where, after the filing of a customs declaration, the amount of duty owed is corrected downward and then later corrected upward. According to the revised provision, which will come into force on 1 January 2017, interest will not be imposed for the period from the original customs declaration to the correction upwards.

Implications of the Customs Law reform for business in Japan

The 2016 Customs Law reform provides flexibility and efficiency to import operations that will mean enhanced opportunities for businesses. At the same time, the reform introduces additional stringent measures. Customs will look for a functional compliance system within the organization, AEO certification or use of the self-certification system under certain free trade agreements. Therefore, it is paramount for businesses engaged in import operations to implement and improve customs compliance practices within their organizational structure to achieve efficient management of import operations as well as minimize potential risks.

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East Africa Community

South Sudan confirmed as member of the East Africa Community

At the East Africa Community (EAC) 17th Summit held in Arusha on 2 March 2016, the EAC member states of Kenya, Uganda, Tanzania, Rwanda and Burundi, through their heads of state, agreed by resolution to admit South Sudan into the EAC.

South Sudan now agrees to comply with all applicable laws and regulations of the EAC within three years of transition. As a result, South Sudan will (among others):

- Adopt the East African Community Customs Act, 2004 for customs administration
- Adopt the EAC Common External Tariff for determination of import duty chargeable on imports
- Adopt the EAC duty remissions regulations
- Participate in the Single Customs Territory System for both intra-regional imports and those from outside the Community

Currently, the EAC is at the common market stage after having fully implemented the customs union stage as outlined below.

EAC customs union

The heads of state of Kenya, Uganda and Tanzania signed a protocol on 2 March 2004 that which established the EAC customs union. The Republics of Rwanda and Burundi joined in 2008 and started applying its instruments in July 2009.

The objectives of the customs union are to:

- Liberalize intra-regional trade in goods on the basis of mutually beneficial trade arrangements among the member states
- Promote production efficiency within the EAC
- Enhance domestic, cross-border and foreign investment in the EAC
- Promote economic development and diversified industrialization in the EAC

EAC common market

The EAC common market is the merger of the market territories represented by the different EAC member states.

The Protocol on the Establishment of the EAC Common Market entered into force on 1 July 2010, following ratification by the member states. Currently, South Sudan's imports of most goods and services from the EAC.

By joining the EAC common market, South Sudan will benefit from:

- Accelerated economic growth and development through the attainment of free movement of goods, persons and labor; the rights of establishment and residence; and the free movement of services and capital
- Elimination of internal tariffs on goods imported from other member states

- Strong, coordinated and regulated economic and trade relations with other member states
- Sustained and expanded economic activities within the EAC, a benefit to be equitably distributed among the member states
- Common understanding and cooperation promotion among the nationals of the member states for their economic and social development
- Enhanced research and technological expansion to accelerate economic and social development

Under the EAC common market protocol that South Sudan is expected to implement, member states will enjoy free trade (or zero duty imposed) on goods and services among themselves and a common external tariff (CET), where imports from countries outside the EAC are subjected to the same tariff when sold to any EAC member state.

South Sudan's admission into the EAC is a positive development because it will result in:

- Removal of trade barriers with the other member states
- Harmonization of common external tariffs will that lead to certainty and fairness during payment of taxes
- Improved movement of goods and people to and from the other member states
- Enhanced regional cooperation with other member states
- Increased trade and larger market

Final thoughts

Customs duty in South Sudan has remained a significant challenge in the past as no comprehensive laws existed to regulate imports. Membership in the EAC will be a positive step toward establishing new laws, harmonizing duty rates and helping South Sudan to develop its own customs department. Companies and individuals with interests in the region should monitor the enactment of these laws in South Sudan as well as its system harmonization with the rest of EAC.

Look for updates and further insight into new developments and implementation advancements in the EAC in future Tax Alerts and forthcoming editions of *TradeWatch*.

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Uganda's NTB reporting system to help eliminate non-tariff barriers to trade

In order to reduce or eliminate non-tariff barriers (NTBs) and facilitate the smooth flow of trade in the region, Uganda's Ministry of Trade recently commissioned and rolled out the NTB electronic reporting system (NTB reporting system). Traders already use the NTB reporting system to report NTBs they may encounter in their course of trading.

NTB elimination remains a challenge to the East Africa Community (EAC) regional bloc. However, with the East Africa Legislative Assembly's enactment of the EAC Elimination of Non-Tariff Barriers Act in 2015, efforts like the NTB reporting system are continuously made to curb NTBs and to improve intra-regional trade.

What are NTBs?

NTBs are laws, regulations, administrative and technical requirements, infrastructural challenges, bureaucratic and protectionist procedures, and other barriers to trade other than taxes (tariffs) imposed by member states that result in slowdown of trade, increase costs of doing business, and block the free movement of goods and services. By so doing, NTBs work against the spirit of the East Africa Community Customs Union that guarantees free movement of goods and services within the East Africa Community regional bloc. Examples of such barriers abound in the transport and logistics sector and include weighbridges, police roadblocks and poor transport infrastructure.

These have presented a challenge to the free movement of goods across borders within the region.

What is the NTB reporting system?

The NTB reporting system is an electronic tool developed for reporting, monitoring and eliminating NTBs encountered by traders within the region. The authorities are currently publicizing the NTB reporting system to the public through different media.

Using this system, traders report any NTB encountered along the different regional trade corridors through a mobile phone message service (SMS) and via e-mail so that the responsible government bodies or other EAC countries may take action.

The web- and phone-based NTB reporting system is designed to be used by anyone with a mobile phone connected to the four telecommunications companies' networks (UTL, Airtel, MTN and Africel) or one with internet access.

For the mobile telephone platform, the user dials *201#, follows the instructions and submits the complaints at a cost of UGX140 (approximately USD0.04) per SMS. Alternately, traders can log on to the web portal at http://ntbtool.mtic.go.ug and register their complaint.

The NTBs most commonly reported are in the categories of weighbridges, standard inspections, customs, immigration, police roadblocks, EAC Affairs, business registration and licenses, plant and animal inspections, among others.

Regarding NTBs encountered within the territory of Uganda, reports are shared simultaneously between the Ministry of Trade and the appropriate government agency for action or elimination.

Where the NTBs relate to other countries within the region, the report is shared with the respective country during the regional forums usually held on a quarterly basis. The reported NTBs would then be inserted into the Time-Bound Matrix on the Elimination of NTBs for timely action by the respective countries.

How successful is the system in eliminating NTBs?

In January 2016, the Ministry of Trade reported in its inaugural online quarterly newsletter that "the web and phone based NTB reporting system is operational and more than 65 NTB reported through the system have been resolved."

However, it is noteworthy that the timely resolution of the reported cross-border NTBs may be dependent on the political will of the concerned countries to eliminate reported NTBs, as there is no penalty if a country delays or fails to take action.

Also, while it is true that many people and traders in Uganda have mobile phones and should be able to use the reporting tool, low internet access as well as poor telephone and internet connections still exist in many areas in and outside Uganda. The success of this system, therefore, is likely to be hampered by this challenge, especially given that many NTBs, such as impassable roads, are found in hard-to-reach areas that are also out of reach of the telephone and internet services.

Deliberate and effective awareness and education campaigns to publicize the reporting tool and to educate traders on how to use it are needed to ensure success. For example, as most NTB are encountered by "nontechnical" people like long-distance truck drivers, the system needs to be sufficiently user-friendly for them to be able to use it. Continuous education on how the system works will also be helpful.

Closing thoughts

In spite of the challenges, the NTB reporting system is a step in the right direction of combating NTBs that continue to affect the free movement of goods within Uganda, East Africa and beyond. With similar initiatives and other trade facilitation measures currently in the process of implementation, doing business in Uganda is bound to become more attractive to investors.

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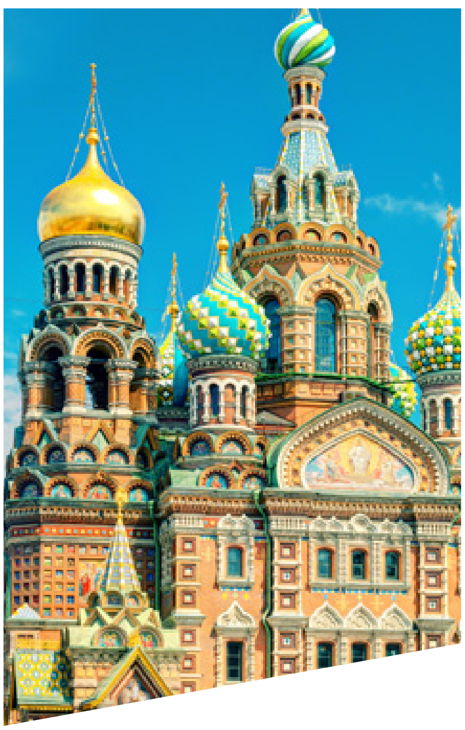
Russia

Russian Supreme Court rules on customs valuation



The Russian Supreme Court has recently issued two determinations related to customs valuation practice, which may have adverse consequences for companies that are importing goods into Russia.

Customs value adjustments

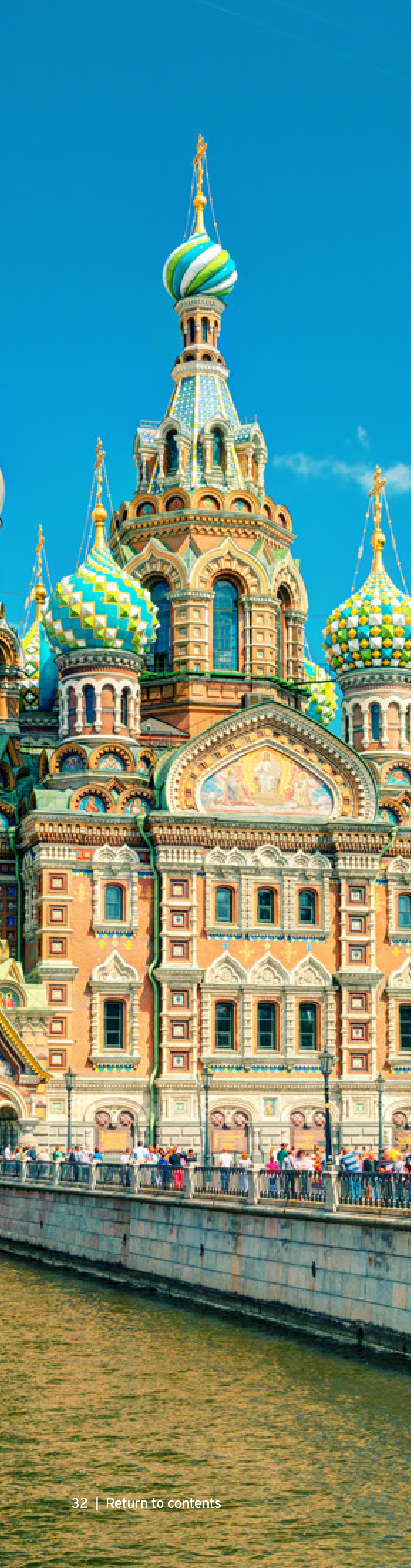
The first case, Determination A51-30666/2014 on Case No. 303-КГ15-10774, deals with customs value adjustments.

During a customs value inspection, Russian Customs (Customs) asked a company to provide additional documents to substantiate the declared customs value. The company responded that it was unable to provide part of the documents (namely, the price list and the export declaration), but presented the remaining requested documents. Customs decided that the documents submitted by the company were insufficient to confirm the declared customs value and made an adjustment.

The company appealed to an arbitration court, which declared the Customs' decision unlawful. The court of appeals and the cassation court also ruled against the Customs' decision to adjust the customs value, noting that the company had presented all the documents available in course of common business practice and that Customs had provided no evidence that these documents were insufficient.

However, the Supreme Court reversed the rulings of the lower courts based on the following rationale:

- The company failed to present all the requested documents in support of the customs value. For this reason, Customs had the right to adjust the customs value based on the documents and information that were available.
- The company could have presented the price list and the export declaration to support the customs value. However, the company failed to provide these documents, or in the alternative, failed to offer other documents to provide a satisfactory explanation for the difference between the declared customs value and the price information available to Customs.
- When goods are imported at a price that differs significantly from the transaction price of identical or similar goods, a company should gather evidence to justify the lower customs value before importing the goods.



The Supreme Court's judgment requires courts to make a more detailed analysis of the circumstances of each situation. Where the declared customs value significantly differs from the price information available to Customs, a company must be able to justify the declared value. If the company fails to provide sufficient justification, i.e., cannot submit all requested documents, or is unable to explain by other means why there is a significant difference between the declared customs value and the information on respective prices available to Customs, Customs' decision to adjust the customs value is justifiable.

This position is contrary to the previously published position of the Supreme Arbitration Court (Ruling No. 96 of the Supreme Arbitration Court of 25 December 2013) and respective case law, which places the burden on Customs to prove that the declared customs value is inaccurate.

Although the Supreme Court's ruling relates to a specific case, many courts are already citing it in other similar cases and consider Customs' decisions to adjust the declared customs value lawful when companies fail to provide all requested supporting documents.[20]

Treatment of royalty payments

The second case, Determination No. 307-КГ15-14266 of 21 March 2016 (on Case No. A56-53020/2014) deals with royalties payable for the right to use intellectual property.

The case concerned a company that imported into Russia stickers that were essentially certificates of authenticity of Microsoft software. The stickers were intended to be affixed to the outside surface of the computer to indicate the existence of a license to use Microsoft software.

The software itself was supplied to the company in electronic form only, without any physical media (i.e., disks or flash drives). The company paid royalties for the right to use the software, and the total amount payable depended on the number of copies of the software the company downloaded. The company did not include the amount of royalties in the customs value of the imported stickers.

After inspection, Customs concluded that the amount of royalties for each software download should be added to the customs value of each sticker. The court of appeals and the cassation courts ruled that Customs had acted improperly in adjusting the customs value. However, the Supreme Court ruled that Customs had acted lawfully, asserting that the imported stickers were directly related to the software, formed part of it and essentially were a medium of the intellectual property, for the use of which the company paid royalties. Furthermore, in accordance with the position of the Supreme Court, the number of imported stickers confirmed the quantity of software downloads (deliveries into Russia) and, therefore, confirmed the amount of royalties payable as a condition of sale of the software.

It is important to note, however, that other similar case law exists, which is favorable for importers. For example, there is a case where the court ruled against Customs' attempts to include royalties paid for the use of imported software activation keys in the customs value.

[20] According to the Russian legal system, a Supreme Court decision is binding on the parties and the lower courts dealing with the specific case, but not with regard to other similar cases. Nevertheless, there is evidence, as in the situation described in this article, that in practice, Russian courts are increasingly using precedent as a source of law.

The above-mentioned decision of the Supreme Court possibly represents to Customs a new opportunity for additional budget revenues. However, the existence of court rulings that are in favor of importers suggests that companies still have a chance to succeed if they appeal in a timely manner Customs' decisions to adjust the customs value.

Implications for importers

In practical terms, companies may encounter difficulties in finding information on the value of identical and similar imported goods or in obtaining some of the documents requested by Customs from suppliers. In particular, companies may find it difficult to find information on the calculation of the price of goods, such as cost and/or price breakdowns. As a result, companies will need to look for possible alternate ways of substantiating the declared customs value and to make appropriate substitutions for any requested documents that are not available.

With regard to the Supreme Court's second determination, companies may find it difficult to formulate satisfactory arguments against including in the customs value the royalties paid for use of downloaded software.

Taking the above into consideration, companies importing goods into Russia should do the following:

- Have the required set of documents and arguments in support of the declared customs value ready at the time of importing goods
- Consider the respective Supreme Court's decision while responding to Customs' requests regarding the customs value of imported goods: present all the required documents or find alternative ways of substantiating the customs value that the Customs authorities are most likely to consider satisfactory
- Pay close attention to situations where suppliers change their prices and review those changes from the point of view of supporting customs value
- Analyze existing supply contracts and software licensing agreements from the point of view of potential customs risks
- Prepare arguments to justify the declared customs value of imported goods in case of royalties payable for use of downloaded software.

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Turkey

Resource Utilization Support Fund issue in "cash pooling" applications

According to current practice, companies with multinational operations usually develop a global strategy for their organizational structures, human resources management, marketing, accounting and production systems, financial decisions and investment preferences, and others. Decisions that may appear as opportunities from a global perspective may also bring new risks and problems when considered at a single country level.

The Resource Utilization Support Fund (RUSF)[21] in Turkey creates such a problem for multinational companies that implement the "cash pooling" system to create financial advantages as part of their global strategy. RUSF, a tax assessed on loans provided by banks and consumer financing companies, is also collected on certain imports that are financed by credit.

What is cash pooling?

Cash pooling is, in brief, a cash equalization process among the companies of a corporate group. The purpose of this method is to gather the financing of multinational companies in a single place and transfer the cash surplus to companies with cash deficit. To do this, while transferring group companies' funds to a central account, the deficiency of affiliated companies is eliminated, (i.e., equalized) automatically from this account.

For multinational companies that carry out their import and export operations through intragroup companies, the collection of all funds in a single central account results in the transfer of import costs to an account determined by the group company. Thus, the increase in funds held by the central account and the increased volume of activities significantly reduce companies' financing costs.

What is the source of the RUSF problem?

RUSF was established in 1988 by Decree on RUSF 88/12944. Pursuant to this decree, unless an exemption applies, a contribution to RUSF is collected on the CIF (Cost-Insurance-Freight) value of imported goods according to one of the following payment methods:

- Cash against goods
- Letter of acceptance
- Deferred letter of credit

The applicable RUSF rate for imports where the aforementioned payment methods are used is 6%. Whether an RUSF withholding will apply depends on whether there is a loan disbursement in the financing of the import.

[21] See discussions of RUSF in the March 2014 and June 2015 issues of *TradeWatch*.

If the seller does not provide a loan to the buyer for the import transaction or does not create a late payment advantage for the import price, RUSF is unlikely to apply.

However, on 4 December 2014, the Revenue Administration published Letter No. 70903105-165.01.03, which provides that prior to importation, importers need to show customs authorities that the amount paid for the goods has been transferred to the importer's account abroad to be able to avoid RUSF withholding. Additionally, payment of the import price to the account of another company or individuals specified by the exporter is not necessarily deemed transfer to the exporter. Thus, payments of import costs to a company other than the exporter are likely to trigger RUSF liability.

There are no clear indications as to whether the aforementioned Revenue Administration approach applies to group companies as well. Since companies that prefer the cash pool method gather import costs in a central account, payments are not directly made to the seller. Consequently, such transactions are likely to subject the imported goods to RUSF withholding solely on the grounds that the payment is not sent to the seller. RUSF is also likely to apply in situations where the importer does not benefit from a payment term advantage, where the payment is made under the advance payment method, or even where the payment is made to a joint account of the same group company and the payment is indirectly transferred to the actual seller. This approach appears to be more prevalent than the approach focused on payment terms and loan, on which RUSF application is based.

The Revenue Administration approach not only adversely affects multinational companies' cash pool systems, but also conflicts with current customs procedure. In particular, under current customs legislation, the import cost can be partially or wholly paid to third parties on behalf of the seller. Payments made on behalf of the seller are deemed transfer of the cost and are included in the customs value for customs purposes, while the Revenue Administration rejects such payments as transfer of the cost and applies RUSF.

Final thoughts

The Revenue Administration's formal approach affects many multinational companies that use the cash pooling method. Although they may be able to show that these payments are made in advance and are in line with general RUSF rules, the imported goods could still be subject to RUSF withholding as long as no direct payments are made to the seller.

Current legislation does not address this situation, thereby making it impossible to pinpoint the taxable event exactly. As a result, the Revenue Administration's formal approach prevails. It would be beneficial to revisit this approach so that multinational companies operating in Turkey can continue to participate in their corporate group's global financial strategies.

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