

# TradeWatch



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## Further delays and controversy expected for implementation of EU Modernised Customs Code



Since the approval of the EU Modernised Customs Code (MCC) in 2008 (Regulation (EC) 450/2008), the trade community has been closely watching and awaiting the development of the MCC Implementing Provisions (MCCIP) currently being drafted by the European Commission (EC) in collaboration with the EU member states. The MCC provides for the creation of a pan-European electronic customs environment with harmonized and simplified customs procedures to promote trade with a balance between trade facilitation and customs controls.

Pursuant to the MCC, the MCCIP (a prerequisite to the implementation of the MCC) would take effect somewhere between one to five years (i.e., by 2013). Today, however, it is uncertain whether the EC can meet the MCC-established time frame considering that there continues to be a lack of consensus among the member states with respect to some key provisions. We highlight below some controversial provisions that are concerning for EU traders.

### Centralized clearance concept

A central pillar of the MCC is the concept of centralized clearance, which makes it possible for authorized EU traders to declare goods electronically and pay their customs duties and value-added tax (VAT) at the place where their business is established, irrespective of the member state where the goods are presented. Centralized clearance builds upon the current practice of Single Authorization for Simplified Procedures.

The current draft of the MCCIP, however, requires that traders send the required customs clearance information to multiple member states. Basically, where the customs office designated for the lodging of customs declarations (i.e., supervising customs office) is in a different member state than the customs office that receives the physical goods (i.e., customs office of presentation/importation), the importer must provide

the entry information to the customs offices in both member states as well as the member state where the VAT is due.

VAT, in particular, is a sticky point for the centralized clearance model. Under the present rules of the VAT directive 2006/112/EC, importers, even using centralized clearance, would still be subject to VAT obligations in each member state of physical arrival and destination of goods. Keeping the VAT rules unchanged seems to go against the simplification objective of the MCC and against the EU-wide objective of easing administrative burden on businesses.

Last year, the EC sought consultation from business on this issue. The response from business, recently released in the *EC Report on the Outcome of the Consultation on "Simplification of VAT Collection Procedures in Relation to Centralised Customs Clearance,"* (Brussels, KV/am taxud.c.1 (January 2011)) was overwhelmingly for a centralized model whereby the importer would submit VAT-related data to the member state of authorization, rather than to the member state of importation. Many respondents outlined that VAT amendments are vital for centralized clearance and VAT should be calculated together with customs duties. How the EC and member states will respond to these issues remains to be seen.

Overall, the draft MCCIP provisions regarding centralized clearance signal that many member states are seeking to retain control of their own customs and VAT processes and procedures, and are resisting the MCC's call for harmonization. For traders, these provisions incorporate additional requirements to the streamlined processes that the MCC envisioned.



## First sale for export customs valuation

Another area that is drawing significant interest and concern from the trade community is the draft MCCIP's "first sale for export" rules. These draft rules currently contain requirements for customs valuation that could increase the level of customs duties paid for multitiered transactions.

As background, many European companies that import merchandise subject to multiple sales prior to EU importation benefit from the first sale for export customs valuation strategy (where certain conditions are met). Under first sale for export, EU importers declare the price paid in the earlier sale (i.e., first sale) for customs purposes, resulting in a lower dutiable value and thus, lower customs duty liability.

On 9 September 2009, an MCCIP working document was published by the EC, which specifies that the last sale prior to the introduction of goods into the EU qualifies as the relevant transaction for the customs valuation basis. This language remains in the most recent published version of the working document, dated 25 January 2011.

This significant change would be a major setback for a lot of EU companies. In many cases, valuation based on the last sale for export will result in higher customs values, and thus higher customs duty liability, than under the present rules.

The last sale for export concept, however, is not yet a done deal. Within the EU Customs Code Committee (Valuation), there is not yet full agreement on this new concept. In fact, several member state customs authorities are opposed to the removal of the "first sale" interpretation.

For now, importers can plan to continue using the first sale for export strategy at least until 2013. There remains uncertainty as to the fate of "first sale" beyond that date, and we recommend that companies start looking into alternative supply chain and valuation strategies to lessen the impact of the potential loss of this interpretation on customs values.

## Customs valuation treatment of royalties

Another concerning development for EU importers is the future customs valuation treatment of royalties. Under the MCCIP proposals, royalties are much more easily included in the customs value.

Generally, royalty and license fees (which are treated the same for customs purposes) involve payments for rights to manufacture imported goods (e.g., patents, design, know-how); sale for export of imported goods (e.g., trademarks, registered designs); and use or resale of imported goods (e.g., copyright, distribution). Royalties are to be added to the transaction value (i.e., customs value) of imported goods only if they are (1) related to the goods being valued and (2) payable as a condition of sale of those goods for export to the EU.

Under the current Community Customs Code Implementation Regulation (Article 159), royalties can generally be excluded from customs value where:

- ▶ Payment of royalties is not a condition of sale because of the absence of a relation between buyer and royalty-recipient due to application of first sale for export
- ▶ Trademark royalties are not a condition of sale because the buyer of the imported goods is free to source them from suppliers related to the royalty-recipient, as well as suppliers who are not related to the royalty-recipient.

However, the MCCIP proposal (Article 230-11(3)) mentions that a royalty is a condition of sale if the seller or related entity requires the buyer to pay the royalty, or if the payment is made by the buyer to fulfill an obligation of the seller. The current "condition of sale" application has, therefore, been broadened to include an implied obligation of the seller.



Furthermore, Article 230-11 (3) of the proposed MCCIP introduces a new third possibility that a condition of sale exists if the goods may not be produced or sold without the royalty being paid directly or indirectly to the licensor. This new case of "condition of sale" is met quite easily because the production, sale or distribution of products that incorporate trademarks, technology or other intangibles falling under intellectual property rights such as trademarks, patents, copyrights, etc., without permission of the holder of this intellectual property right is against the law. This permission is granted by way of a license for which payment of the royalty is required.

In effect, the payment of royalties related to the imported goods, as a rule of thumb, is generally considered as a "condition of sale" for the goods imported into the EU and thus, must be included in the customs value. As it looks now, even profit-related royalties may have to be included in the customs value. Clearly, the EU is looking to take a much more aggressive position to include royalties in the customs value.

We note that there is no common agreement among customs authorities (worldwide) on factors that should be relevant to the condition of sale determination. The issue is currently being discussed by the World Customs Organization (WCO) Technical Committee on Customs Valuation. (See "World Customs Organization addresses customs treatment of transfer pricing studies and royalty controversy," TradeWatch, December 2010.\*) The upcoming WCO guidance could influence the proposed MCCIP language, although time may be running out if the 2013 deadline for application of the MCCIP is to be met.

## What to expect

The drafting of the MCCIP provisions has seen significant delays. With the looming 2013 deadline, there are concerns that there is currently a rush to conclude and adopt provisions that in many cases do not reflect the spirit and objectives of the MCC. This is particularly concerning with respect to the importance of developing an effective IT infrastructure to support

a truly pan-European electronic customs environment. A rushed deadline could mean that these electronic systems and procedures would not yet be in place at the time of MCCIP application, especially considering the current financial and budget pressures on member states. Furthermore, businesses need time to develop the necessary IT systems to support these new procedures and requirements.

There are indications that the implementation of the MCC will be delayed at least another year to mid-2014, and even longer for certain provisions, such as centralized clearance to ensure that IT-supported customs functions are operational in time. In a recent speech (19 May 2011) at the 78th meeting of the Directors General for Customs of the EU Member States and Turkey, the EU Commissioner for Taxation and Customs Union, Audit and Anti Fraud, Algirdas Šemeta indicated plans to propose amending the MCC in order to postpone implementation beyond the 2013 date. Interestingly, the MCC amendment opportunity would also be used to correct some provisions of the MCC that are "inconsistent" with EU legislation introduced since 2008 and elements that are "too difficult or workable to be implemented."

When the MCC is implemented – and it looks like we should expect this will occur sometime beyond 2013 – we may need to be prepared to deal with a less harmonized and simplified customs environment than the original MCC envisioned. The current direction of the MCCIP is concerning, and the trade community needs to take advantage of this window of opportunity to ensure that the voice of business is heard. The future of your customs operations and duty costs for decades to come depends on it.

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## Argentina

### Royalties paid abroad and their possible impact on the customs value



The customs valuation treatment of royalty payments is increasingly a customs audit issue for importers in most jurisdictions, and Argentina is no exception. In our experience, it is becoming more frequent for the Argentine customs authorities (Dirección General de Aduanas or DGA) to perform reviews aimed at determining whether, in those cases where royalties are paid abroad, such royalties should be included in the customs value and, if so, whether they were effectively included.

DGA's approach to royalty assessment has been updated, systematized, broadened and made more efficient over the years. This evolution did not happen by chance, considering the large number of companies that pay royalties to foreign-related parties, whether on account of trademarks, licenses or other similar items. The question is whether companies have also heightened their focus on the issues surrounding the customs valuation treatment of royalty payments and have implemented procedures and internal controls to effectively manage the risks.

#### Royalty payments as an addition to the value of imported goods

The customs valuation rules for Argentina are based on the World Trade Organization (WTO) Agreement on the Implementation of Article VII of the General Agreement on Tariffs and Trade (Valuation Agreement). Pursuant to the Valuation Agreement, transaction value is the preferred method for determining the customs value of imported goods, provided certain conditions are met. The transaction value is the price actually paid or payable for the goods when sold for export to the country of importation, subject to specified adjustments, which include certain royalty payments.

The Valuation Agreement provides that royalties paid by the importer must be added to the price paid for 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. Such additions to the price paid or payable must be made on the basis of objective and quantifiable data. As noted in prior editions of TradeWatch, there have been significant differences of opinion among customs authorities as to the proper interpretation of "condition of sale" (see "World Customs Organization addresses customs treatment of transfer pricing studies and royalty controversy," TradeWatch, December 2010\*). DGA's position is viewed by many importers as aggressive.

Where the DGA uncovers dutiable royalty payments that the company failed to include in the customs value, the consequences can be significant. The additional value amounts may result not only in assessments for additional duty and import taxes as well as interest, but the DGA could also impose a fine in the frame of Customs Code Section 954.

Such section provides that:

1. *Anyone who, in order to perform any of the transactions or report the purposes of the import or export makes a false statement before the customs service different from the one resulting from the inspection and that, should it have remained undetected, could cause or could have caused:*
  - a) *A detriment to fiscal revenue, shall be imposed a penalty equivalent to one to five times the amount of such detriment*
  - b) *A violation of a ban on imports or exports shall be subject to a fine of one to five times the customs value of the merchandise involved in the violation*

\*Available on the [www.ey.com/customs](http://www.ey.com/customs) website.



c) *The inflow or outflow of an amount paid or to be paid other than the one actually applicable shall be imposed a fine ranging from one to five times the amount of the difference.*

2. *If the act could be deemed to fall simultaneously under more than one of the cases provided for in point 1 above, the heaviest of the respective penalties shall be applied."*

Consequently, depending on the extent of the past importations involved and given that the DGA can go back five years, such assessments can be very costly.

Such proactive measures should help you better manage and safeguard your customs valuation position with respect to royalties. In turn, your company also needs to assess any compliance risk for past importations where royalty payments were involved, and consider the best remedy for any past risk identified.

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## Proactive customs approach for royalty payments

In order to properly manage the customs issues surrounding royalty payments, it is imperative that your company takes a proactive approach. Some basic measures include:

- ▶ Customs planning prior to the execution of the royalty agreement and related agreements, so that the company has an opportunity to assess the customs implications and consider alternatives to minimize any detrimental impact on the customs value, consistent with the law and regulations
- ▶ Proper communication channels among the foreign trade, tax and finance areas to promote information and data exchange to ensure that dutiable royalty payments are correctly included in the customs value declarations on a timely basis
- ▶ Periodic controls to verify that royalty payments are being afforded the correct customs treatment (as well as from a tax and foreign exchange standpoint)

# Brazil

## Supply chain strategies: capital goods manufacturing for FINAME credit line eligibility



Given the country's considerable recent and forecasted economic growth, there is currently a sense of urgency on the part of many foreign businesses to enter the Brazilian market. In many cases, businesses are considering significant capital investment projects, such as new manufacturing plants.

In Brazil, credit constraints are a primary factor that can hamper the feasibility of a new investment project. Through FINAME, a special agency for industrial financing, the Brazilian Development Bank (BNDES) supports the acquisition of new domestically produced machinery and equipment (M&E) and other capital goods by providing longer-term financing (up to 60 months) at interest rates lower than the prevailing market interest rates. Over time, FINAME has transformed from an advantageous option into an indispensable tool necessary to increase sales and commercial results.

The catch is that FINAME financing requires that the M&E meets certain local content requirements of 60% in both value and weight, which is consistent with FINAME's goal to support the purchase of domestic over imported M&E. In other words, M&E manufacturers that meet this local content requirement have a considerable competitive advantage over other domestically and foreign manufactured products.

For the M&E to be eligible for FINAME financing, the good must be registered in the BNDES Computerized Supplier Registry (CSR). For registration, the local manufacturer must demonstrate to BNDES that the local production of a specific M&E complies with the local content requirements and other registration rules. In this case, it is essential that the manufacturer conducts a proper supply chain assessment and we recommend due diligence of your suppliers' origin claims to ensure compliance with the requirements.

On the other hand, for some M&E manufacturers, this issue can be a significant stumbling block. For instance, new technology requirements may mean that the necessary parts and components might not exist or be readily available in Brazil. Likewise, due to the strong Brazilian economy and a low number of suppliers or high demand for certain locally produced parts and components, the prices can be much higher than the same product imported.

A possible solution may exist. The BNDES legislation allows that manufacturers that have not yet reached the 60% level of local content requirement can establish a progressive nationalization plan (PNP). The PNP outlines how the company intends to increase the percentage of local content and meet the 60% level in up to three years. The PNP requires that the company explains the M&E manufacturing process and the steps the company will take over three years to increase the local content. The feasibility of the nationalization will be assessed by the BNDES, which means that the PNP should be supported by future local suppliers along with the industrial phases that will occur locally. If approved, the subject M&E could be registered in the CSR, providing customers with access to the FINAME credit line's vast benefits.

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# Mexico

## Importation of insurance services: considerations for maquiladora operations



Traditionally, the Mexican maquiladora program (which now operates pursuant to the IMMEX Decree) was a special customs program that allowed for the duty-free importation of raw materials, parts and components for export manufacturing operations. The program has evolved over time and now offers a wide range of value-added tax and direct tax benefits along with customs benefits.

A common scenario for a maquiladora operation is a foreign parent company that utilizes a Mexican subsidiary as the contract manufacturer. The non-Mexican parent company typically contracts for insurance services to cover these temporarily imported goods, which may also include machinery and equipment, against risks within Mexico.

Our experience has revealed that in the vast majority of cases, the non-Mexican parent company contracts with insurance companies residing in its own country of residence, rather than with a Mexican insurance provider. Moreover, the portion of the premiums attributable to risks within Mexican territory, paid by the foreign company to the foreign insurance entity, is subsequently charged by the parent company to its Mexican subsidiary. However, this importation of insurance services poses direct tax implications of which many companies are unaware.

Many foreign parent companies are surprised to learn that the Mexican income tax law expressly conditions the deductibility of insurance premiums paid by Mexican residents on the compliance with local federal insurance legislation. In this respect, Mexico's General Law of Insurance Institutions expressly prohibits contracting with foreign insurance companies for risks within its jurisdiction. Additionally, this law sanctions as legally non-binding or non-existent within the Mexican territory insurance contracts entered into with foreign insurance companies for risks within its jurisdiction.

As a result, premiums paid by Mexican subsidiaries to foreign parent companies for a non-Mexican insurance policy contracted by foreign residents against risks within Mexican territory normally represent a non-deductible expense for Mexican income tax purposes. This loss of a deduction can have a detrimental impact on production costs on a Mexican level. Additionally, from a business and legal standpoint, the goods may actually not be insured against risk if the insurance policy is considered invalid in the Mexican territory.

We highlight the above issue to also demonstrate the importance of reviewing transactions for cross-border manufacturing and supply chain operations with a bilateral perspective to avoid indirect and direct tax pitfalls that can easily be overlooked. Similarly, a comprehensive approach can identify hidden opportunities supported by both jurisdictions.

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# Latin America

## New Pacific Integration Agreement for Chile, Colombia, Mexico and Peru



On 29 April 2011, the presidents of Chile, Colombia, Mexico and Peru formalized their commitment to the new Pacific Integration Agreement upon signing of the “Lima Declaration” after summit discussions in Lima, Peru. The Lima Declaration provides a road map for the completion of negotiations and the eventual signing of the Pacific Integration Agreement, which intends to integrate the economies of the four Latin American countries of the Pacific coast to increase growth and development and improve the group’s attractiveness with more markets – Asia Pacific, in particular.

The main objectives of the Pacific Integration Agreement are to establish the eventual free circulation of goods, services, capital and people within the region. According to the Lima Declaration, the first phase involves drafting a framework agreement that will consolidate the existing bilateral free trade agreements entered between Chile, Colombia, Mexico and Peru, similar to the MERCOSUR approach, thereby creating a single, all encompassing agreement. The framework agreement will be developed by the Ministers of Economy or Foreign Trade of the four parties. The goal is to have the agreement ready to be presented for consideration in December 2011.

Additionally, this first phase will address certain high-profile priority integration areas, including facilitating the movement of businesses and people within the region, trade and customs cooperation and even the integration of the stock markets of the four parties. Technical groups will address each integration area. These technical groups also have the mandate of promoting the Pacific Integration Agreement and developing strategic external relations with other similar economic blocs or regions. The Asia Pacific market is a particular focus for growth and investment opportunities.

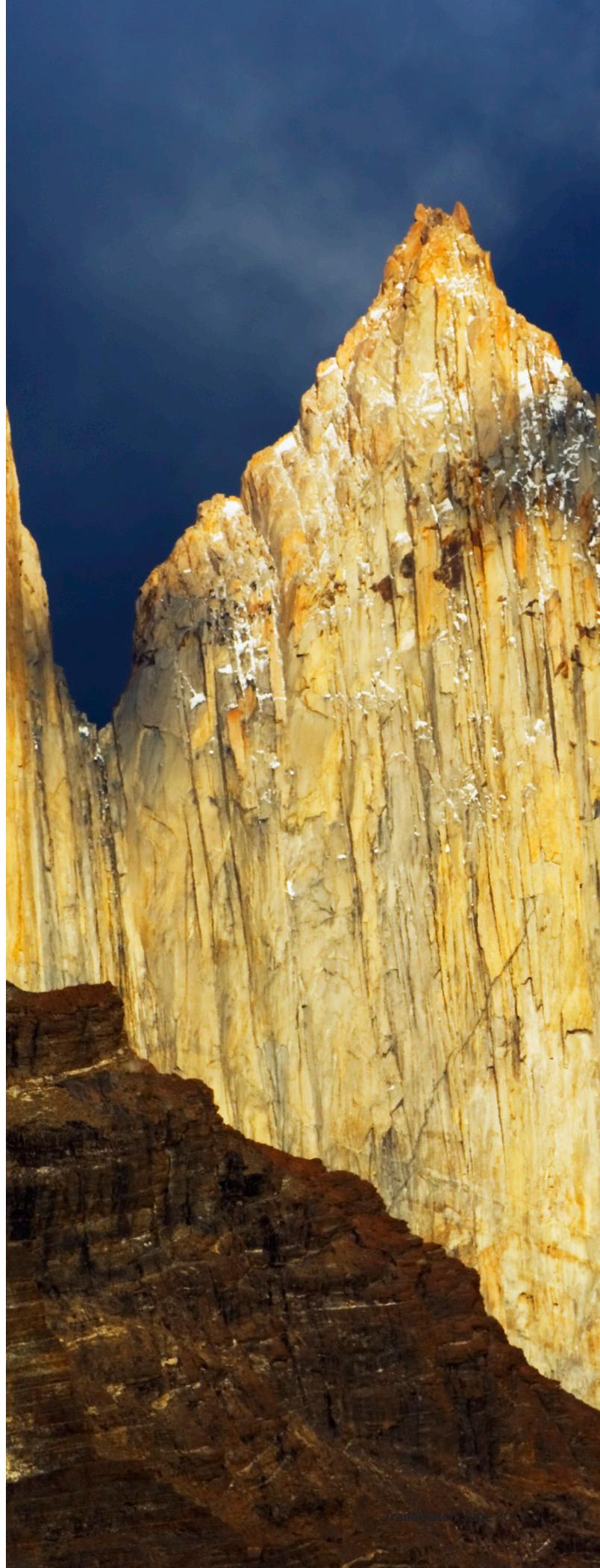
It is worth noting that Panama will participate in this integration process as an observer with the aim of also becoming a signatory to the Pacific Integration Agreement once the free trade agreements currently in negotiation between Panama and Chile, Colombia, Mexico and Peru are completed. The “Lima Declaration” also states that the Pacific Agreement integration process is open to any other country sharing the objectives stated by the parties.

Once the Pacific Agreement is drafted and signed by the presidents of Chile, Colombia, Mexico and Peru, it will need to be ratified locally by the legislative authorities of each country. In this regard, it is worth noting that on 6 April 2011, Mexico and Peru signed a Commercial Integration Agreement, which expanded the Economic Complementarity Agreement No. 8 previously enacted by both countries by granting preferential duty rates to a much larger universe of products and including trade in services clauses and dispute settlement mechanisms, among other relevant provisions. Unfortunately, and in spite of support from the Ministry of Economy, the Mexican Senate did not ratify the Commercial Integration Agreement, stating that it required a more thorough analysis of its potential consequences on Mexican manufacturing, which could not be performed in the Senate’s current legislative period. How this delay will affect the progress of the Pacific Integration Agreement remains to be seen.

While the drafting of the agreement is in its early stages and no formal timetable for full integration has been set, the formation of a Latin American Pacific integrated bloc has the potential to create a new free trade area in the Americas, providing global companies with significant new opportunities to integrate supply chains and reach new markets. In particular, the regional bloc would be an attractive alternative for export platform operations in Latin America with access to each signatory's market and potentially expanded markets by tapping into each signatory's existing bilateral trade agreements with other countries. Further, this group of Latin American countries would have more negotiating power as a whole in future trade agreement discussions with other trade and economic blocs. This may prove significant as the regional bloc actively pursues better access to Asia Pacific markets.

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# United States

## Uncertainty for US Generalized System of Preferences



For the first time in nearly a decade, the US Generalized System of Preferences (GSP) program expired on 31 December 2010. As a result, GSP-eligible products became subject to duty at most favored nation rates as of 1 January 2011, with immediate cost implications for affected importers.

The US GSP program, authorized under the Trade Act of 1974, allows importers to enter eligible products from beneficiary developing countries (BDC) duty-free. The trade program is intended to develop the competitiveness of BDC economies by removing tariffs that act as a barrier to exports entering the US market. As of the date of expiration, the program benefitted an estimated 4,800 products (i.e., tariff lines) from 129 BDCs.

### GSP program in limbo

The GSP program expired seven times between 1993 and 2001 (the most recent expiration), with lapses ranging from one to fifteen months while the US Congress weighed its decision to renew the program. In each circumstance, once reauthorized, the program was declared retroactive to the date of expiration, allowing businesses to claim refunds on any duties paid on GSP-eligible products during the lapse period. Although it is not definitive that Congress will do the same if it chooses to renew the program again, it is recommended that businesses continue to flag such products on the customs declaration with the applicable special program indicator in the event that the program is renewed and declared retroactive to its expiration date. During this period of limbo, businesses must deal with the cash flow and potential duty cost implications for an unknown time period.

### Outcome of 2010 annual review process unknown

Another area of uncertainty for GSP importers is the results of the 2010 annual review process. The annual review process assesses BDC country designation and product eligibility, subject to statutory criteria. GSP benefits are removed when exports are deemed to be competitive. Interested parties can proactively petition the US Trade Representative (USTR) to add or remove products from the list of eligible products. In mid-2010, the USTR initiated the annual review process and began accepting petitions; however, the expiration of the GSP program has led to the suspension of the annual review process.

The USTR had accepted three petitions seeking to remove products from the list. In this respect, on 2 March 2011, the USTR issued a public report analyzing the likely economic effect of removing duty-free treatment for products under Harmonized Tariff Schedule (HTS) subheading 9404.30.80 (certain sleeping bags) from all GSP-eligible countries and under HTS subheadings 3919.10.20 and 3919.90.50 (certain types of self-adhesive plates, sheets, film, foil, tape, strip and other flat shapes of plastics, in rolls) from Indonesia. However, there have been no formal announcements as to whether any country practices petitions have been accepted for review.

For importers exporting products named in the petitions or from BDC countries potentially at risk for removal from the list of BDCs, this uncertainty could prove costly as the duty paid during the interim until the program is reinstated (assuming retroactive effect) could become more than a cash flow issue, but a duty cost issue that could have a significant impact on product costs and prove detrimental to the importer's business.



## Current status

There has been some recent movement on the issue by Congress. On 2 March 2011, Senator Jeff Sessions introduced the "Free and Fair Trade Act" (S. Res. 433), a bill that would extend the GSP program and the Andean Trade Preference Act through 30 June 2012, retroactive to the date each program expired. The bill also seeks to prevent duty-free treatment of certain inexpensive sleeping bags imported under HTS subheading 9404.30.80. Then on 3 March 2011, House Representative Robert Aderholt introduced companion legislation (H.R. Res. 913). These bills are still in the initial stages of the legislative process.

The Obama administration has voiced its support of congressional action to extend the program. However, issues remain regarding the duty-free treatment of certain products, the status of certain BDC countries, the length of the proposed extension, as well as other financial and trade-related matters. These issues have been voiced by several members of Congress and will need to be addressed before the program is renewed.

The longer the GSP program remains unauthorized, the greater the impact these additional costs will have on BDC and American businesses previously benefitting from the program's savings, particularly smaller businesses forced to pay additional duties for an extended period of time. A prolonged absence of GSP may also have a profound impact on the economic development of BDCs, especially those least developed BDCs the program seeks to assist.

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## New adjustments to the Importer Self-Assessment program Memorandum of Understanding



US Customs and Border Protection (CBP) recently notified members of the Importer Self-Assessment (ISA) program that updates have been made to the requirements for the Memorandum of Understanding (MOU). The MOU establishes the roles and responsibilities of the ISA member and CBP for participation in ISA. CBP maintains that the primary objective of the ISA program is to maintain a high level of trade compliance through the collaborative partnership efforts of the importer and CBP.

Benefits for participation in ISA include removal from the CBP Regulatory Audit Focused Assessment audit pool (including drawback and foreign-trade zones if included in the ISA application), assignment of a CBP national account manager, quarterly receipt of CBP Importer Trade Activity data, special prior disclosure privileges and potential mitigation of civil or liquidated damages due to participation in the program.

The updates, which are minor, are being made to conform the MOU with Department of Homeland Security requirements for such agreements. Among others, key changes include: a) the requirement to submit a revised MOU at the time of annual notification when the ISA member has added new Importer of Record numbers, b) clarification of the requirement to submit a comprehensive annual notification letter that provides a summary of the annual self-testing plan that the ISA member conducted and results of the same, c) a statement that the MOU is not intended to conflict with current laws or regulations and d) the change of CBP's point of contact for the MOU is now the Division Director of Trade Facilitation and Administration of the Office of International Trade.

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## Australia

### Australia facilitates inward processing



Australia's inward processing scheme, Tradex, has been relaxed to increase participation from companies with export processing operations. Supply chain partners, in particular, have more opportunities to benefit from the program.

#### Background

The Tradex Scheme, administered by AusIndustry, aims to provide up-front customs duty and goods and services tax (GST) relief for certain imported goods that are subsequently exported. Tradex is an alternative to the customs duty drawback program with added cash flow benefits given that drawback provides for refunds of duty and GST paid on goods subsequently exported. The scheme is similar to the European Union's suspension inward processing relief or China's processing trade programs.

The imported goods that are covered by Tradex include:

- ▶ Exported in the same condition as imported
- ▶ Mixed with other goods and subject to a process or treatment
- ▶ Incorporated into other goods after importation

Unlike some other inward processing regimes, only goods that are incorporated in the exported product may qualify, i.e., imports consumed in Australia during processing, but not incorporated in the exported goods are excluded from the scheme.

An existing facilitation is that the exporter can be the importer or a third party. However, to date, there have been strict administrative requirements for demonstrating the import and export of the relevant goods, which can make it a challenge for third parties to work together.

#### Recent developments

AusIndustry has indicated that the application of the rules is to be simplified to allow more importers to benefit from the scheme and thus support domestic processing in Australia.

As referenced, historically, importers have needed to demonstrate the amount of goods to be exported and this is generally achieved by assessing the amount of duty drawback obtained by the exporter on previous transactions. The new approach is for AusIndustry to work with the importer to determine a mutually agreed percentage of goods that are likely to be exported, not necessarily requiring drawback to be established first. This agreed percentage will then be used at the time of importation to calculate the size of the duty and GST relief. AusIndustry will then review the percentage periodically (e.g., annually) to determine whether changes are required.

This may seem a limited simplification, but, crucially, the new process allows importers to use their own books and records to demonstrate the amount of goods exported rather than to first use duty drawback. While the change is in itself helpful, the removal of the drawback requirement also better enables third parties to work together across a supply chain where the mechanics of drawback were previously an impediment.

The example used by AusIndustry as to the extent to which Tradex may apply relates to Australian wine manufacturers that purchase oak barrels from local suppliers, who have themselves imported the barrels from overseas. The barrels are used to age the wine as part of the manufacturing process, but the wine is actually bottled before export and so the post-aging barrels remain in Australia.



First point to note is that it was considered by AusIndustry that the oak barrels form part of the wine that is exported, as the barrels provide the wine with its flavor by containing the “essence” of the barrels. Hence, the Tradex scheme applies to the importation of the oak barrels as they are, in part, subsequently exported in the wine.

Having cleared the hurdle that the wine barrels can qualify for Tradex, AusIndustry worked with an industry body to agree on an overall percentage of barrel exports for the participating wine exporters, and the barrel importers can now apply that agreed percentage for the coming year for Tradex duty and GST relief with prices in the supply chain between the parties negotiated accordingly.

This example is interesting from two perspectives: (1) the interpretation of whether an item is a consumable that does not qualify for Tradex and when it is part of the exported product that does qualify; and (2) the multi-party supply chain agreements that can be sought, which can expand the application of the scheme.

If you export from Australia, now seems a good time to consider whether there are Tradex opportunities somewhere in your supply chain, even if you think you’re buying domestically.

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# Korea

## Korea – European Union free trade agreement: opportunities for Korean business



Free trade agreements (FTA) are increasingly linking diverse markets on different sides of the globe as demonstrated by the recently concluded FTA between the Republic of South Korea (Korea) and the European Union (EU). The Korea-EU FTA, expected to take effect from 1 July 2011, aims to eliminate or gradually reduce customs duty and other trade barriers on most products.

The EU has provided rare customs duty concessions to a developed and industrialized nation through this FTA. As a result, the agreement creates some unique opportunities and competitive advantages for Korean companies over other Asian economies exporting goods to the EU.

### Protective EU market opens for Korean business

The concessions from high EU customs tariffs for Korean products coupled with lack of similar comprehensive FTAs between the EU and any other Asian economy will provide an edge to Korean businesses interested in exporting goods to the EU. The primary Korean industries to benefit from the FTA will be electronic equipment, automobiles and machinery, which constitute major exports to the EU.

The technology and electronics sector attracts differential customs duty in the EU. The EU is a signatory to the World Trade Organization's (WTO) Information Technology Agreement (ITA) and thus has already implemented zero rate of customs duty on numerous information technology (IT) products. The EU will also implement a recent WTO ruling to exempt from duty certain additional IT products, namely flat panel displays, set top boxes and multi-functional devices. However, a large number of technology and consumer electronics products remain outside the preview of the ITA.

For these products, Korean exporters will gain a competitive cost advantage over other Asian and foreign suppliers due to the FTA's preferential tariff rates.

For the automotive sector, the EU's 10% tariff on motor vehicles and 22% tariff on trucks will be eliminated in three or five years (depending on product specifications). Again, the duty savings represent a significant cost advantage over Asia suppliers – assuming the FTA's rules of origin are met. We emphasize that the rules of origin for the automotive sector generally involve hefty local content requirements. For instance, motor vehicles must contain at least 55% of Korean or EU-originating materials in value to qualify for the preferential duty rates under the FTA.

### FTA requirements of emphasis

The Korea-EU FTA has some unique requirements that must be met to access preferential tariff treatment. We highlight a few of these requirements that may catch exporters off guard, as they are not commonly found in Korea's other FTAs.

#### *Mandatory participation in approved exporter program*

Exporters are obligated to participate in Korea's approved exporter program to be eligible for the FTA's preferential duty rates for shipments over EUR 6,000. To obtain approved exporter status, the Korean exporter must apply to the Korea Customs Service and demonstrate that certain requirements, including a good compliance record, are met. Essentially, the exporter must have a process of origin verification in place to support that the product has met the applicable rule of origin. It is important that Korean businesses apply for approved exporter status as soon as possible to ensure they do not miss out on preferential tariff benefits as of the 1 July implementation date.



### *Origin invoice declaration*

With approved exporter status comes the benefit of simplified procedures with respect to the origin declaration. Basically, the Korea-EU FTA will not use formal certificates of origin, but rather the approved exporter must insert the required preferential origin declaration on the invoice or a commercial document. This simplification is administratively beneficial and time saving considering that the invoice or other document can be transmitted and stored electronically and the exporter does not have to go through the process of obtaining a formal certificate of origin from the authorities.

### *Strict rules on direct shipments*

One area of emphasis for companies is the FTA's strict rules on direct shipments. Other Korea FTAs allow for goods to be shipped through a central distribution center as long as the goods do not undergo any further processing. However, the origin requirements of this FTA require that the goods must be directly shipped to the buyer. If the goods are shipped through a third country, the importer must be able to prove that at the time the goods were shipped from the exporter, they were bound for the importer and that the goods coming out of the third country are not just distribution center stock.

## **Additional opportunities**

There are some additional opportunities that may be of interest to Korean exporters when preparing to take advantage of the FTA.

### *Goods in transit at time of FTA implementation*

An area where we have seen companies take interest is in the protocols for handling goods in transit at the time of FTA implementation. As the Korea parliament has just recently passed the FTA legislation, the question is how preferential duty rates may apply to goods that were shipped before the implementation date of July 1 of this year.

The rules of origin stipulate that the importer has 12 months from the time of implementation to submit origin documentation to the customs officials proving the goods meet origin requirements. If this documentation is submitted within this 12-month timeline, any duty paid above the preferential duty rates can be refunded.

It is important to note that after implementation, an importer will have two years to submit origin documents in the case where goods are imported without the required origin declaration. However, this timeline has been reduced to one year for goods in transit at the time of implementation.

For companies that have goods stored in a bonded warehouse, free trade zone, or other type of duty suspension facility at the time of importation and wish to import these goods after 1 July 2011, special care should be taken to understand whether these goods will qualify under the "in transit" section of the origin requirements. Companies may wish to seek professional advice on these goods, as the origin requirements can be more complex in these situations.

### *Duty drawback*

Korean export manufacturers can claim duty drawback on goods exported to the EU under the FTA. Duty drawback provides for refunds of any customs duties paid on imports that were incorporated into the exported product. Accordingly, supply chain planning should consider the duty drawback program, as Korean manufacturers look for ways to lower production costs through foreign sourcing, but with a careful eye on the exported product's origin requirements under the FTA. We note that a special drawback clause is included in the FTA to address the fears of domestic manufacturers in the EU. It provides for a review of drawback schemes after five years from the entry into force of the FTA. If it is evident from the review that there is a significant increase in foreign sourcing, the amount of duty drawback can be limited with respect to a particular product.



### *Use of European distribution centers*

High EU customs duty on finished goods and lower duty rates on their parts and components have encouraged various companies to set up manufacturing/assembly units in the EU, which generally leads to higher investment and operating cost. As the FTA removes the customs duty cost from the imported finished product, Korean business has an opportunity to export finished products manufactured at a lower cost in Korea or other Asian countries (subject to fulfillment of the FTA's origin criteria) while also avoiding the additional capital investment to set up plants in the EU. Finished goods can thus be exported to a centralized center for distribution across the EU. We expect that Korean business will increasingly be establishing European distribution centers or supply chain hubs.

### **Concluding thoughts**

The Korea – EU FTA and its significant duty concessions offer Korean exporters significant competitive cost advantages over other Asian manufacturers. Access to preferential tariff treatment, however, is not automatic and we have highlighted a few of the requirements, such as approved exporter status, necessary for exporters to benefit from the FTA.

Similarly, safeguarding preferential tariff treatment requires that your origin verification process and internal controls support preferential duty claims. The EU will be conducting origin verifications to ensure that the goods qualify under the FTA's rules of origin. Korean companies have access to an EU binding origin information (BOI) to proactively seek guidance as to a product's origin eligibility from the EU authorities. Particularly for complex manufacturing supply chain operations, a BOI can provide business certainty and safeguard the significant cost savings.

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## European Union

### Proposed changes to EU rules on taxation of energy products



On 13 April 2011, the European Commission presented its proposal to update the European Union's indirect taxation framework for energy products so that it will become more compatible with current energy and climate change policies. Specifically, the changes aim to better support renewable energy sources and to encourage the consumption of energy sources emitting less CO<sub>2</sub>.

#### Background

Traditionally, energy taxes have been levied not only to raise revenue, but also to influence consumer behavior toward a more efficient use of energy and cleaner energy sources. The European Union currently regulates energy taxation within the internal EU market with common rules to establish what should be taxed; when and what exemptions are allowed. In this respect, the European Union sets minimum tax rates for energy products used in heating, electricity and motor fuels; however, these rates can vary within the EU market, as the individual member states can charge higher rates.

A primary issue with the current system is that because the tax rates are based on the volume of energy consumed, the current policy does not promote the use of renewable energy sources. In practice, renewable energy sources are taxed at the same rate as the energy source they are intending to replace, as is the case where biodiesel is taxed at the same rate as diesel. Additionally, the current system does not address the need to reduce CO<sub>2</sub> emissions. In this respect, a common EU framework for CO<sub>2</sub> taxation is necessary to avoid varying approaches being implemented by individual member states and ensure that industrial sectors already subject to the EU Emissions Trading System (ETS) do not face a form of double taxation for the same carbon emissions.

#### Proposed changes

The essence of the reform is to move the taxation of energy away from this traditional approach of taxing the quantity of fuel consumed, toward the taxation of energy content and CO<sub>2</sub> emissions. Accordingly, EU energy taxation would be based on two components:

1. *CO<sub>2</sub>* – A single minimum rate for CO<sub>2</sub> emissions would be introduced for all sectors not covered by the ETS, which are already subject to a carbon tax.
2. *Energy content* – Minimum tax rates would be based on the energy content of a fuel rather than its volume.

Both of these components would be combined to produce an overall tax rate at which the energy product is taxed. As before, member states can set their own rates higher than the established minimum rates. However, the same rates must then be applied to all fuels used for the same purpose.

#### Implications for trade

The European Union continues to use energy taxation as an important instrument to promote energy and climate control policies and the proposed changes place additional focus on renewable energy sources and low carbon emissions. The changes also intend to provide more business certainty with a consistent CO<sub>2</sub> taxation policy for all member states. At the same time, overall tax rates and thus price differences will likely continue to vary between member states, which have flexibility to set rates above the minimum established rates. In this respect, competitiveness concerns between member states remain as energy products, which have a significant impact on production costs, may be more costly in one member state over another due to the tax differentials.



Similarly, there are competitiveness concerns with respect to cheaper imports from countries not subject to carbon taxes and related requirements that increase production costs. Nevertheless, there are currently no formal plans to implement a carbon border tariff on imported products. The proposed changes to the EU Energy Taxation Directive primarily affect sectors not currently subject to the ETS, such as transport, households, agriculture and smaller businesses that are generally considered less susceptible to international competition. Again, the new CO<sub>2</sub> tax does not apply to the primary high energy consuming industry sectors at risk of carbon leakage, as they are already subject to carbon prices under the ETS and thus avoid the concerns of double taxation in this respect. We note that the proposal does provide tax credit provisions for affected non-ETS sectors with a high energy intensity that could be significantly affected by unfair trade competition, based on their historical energy consumption.

## Next steps

The new Energy Taxation Directive is now being discussed by the European Parliament and the Council, which are likely to result in modifications to the proposal. We expect that the general principles of the current proposal will be maintained and a fundamental change to the current energy taxation mechanism is almost certain. Even if the changes enter into force as of 2013, a long transitional period will be necessary for member states to restructure their taxes and allow national administrations as well as businesses time to adjust.

Nevertheless, businesses should prepare for a significant change to the current energy taxation calculation method and anticipate that some products (such as diesel) will be taxed more heavily than presently. In addition, some renewable energy products will be taxed less and some of the existing energy tax exemptions will be abolished. Therefore, we recommend companies dealing with energy products to closely monitor the legislative changes regarding energy taxation and to consider the impact of the current proposal on their operations. Watch for further developments in future issues of TradeWatch.

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# Turkey

## Turkey implements encryption import controls



Turkey now restricts the import, manufacture and use of encryption technology. The *“Regulation on the Principles and Procedures for Coded or Encrypted Communication by Public Organizations and Institutions and Real and Legal Persons in Electronic Communication Service”* became effective after promulgation in the Official Gazette no. 27738, dated 23 October 2010. Accordingly, authorization from the Board of Information Technologies and Communication (the Board) is required to import, manufacture and use coded or encrypted communication equipment or systems.

Coded or encrypted communications that are detected to be carried out without the Board's authorization shall be shut down and a criminal complaint will be filed against the parties involved. The purpose here is to ensure that such equipment is used only with authorization.

Under this regulation, the Turkish Armed Forces, Turkish Gendarmerie, Undersecretariat of National Intelligence Organization, Turkish National Police and Ministry of Foreign Affairs are authorized to conduct coded or encrypted communication through electronic or wireless communication services. Apart from these authorities, the production or importation of encrypted communication systems in electronic communication services in Turkey is subject to authorization under these regulations.

Article 5 of the Regulation states that the arrangement concerns manufacturers that produce or import coded or encrypted communication devices or keys. Manufacturers are obliged to provide data on the coded or encrypted devices that they have produced or imported to the Board. Individuals that use these products do not have to obtain authorization after the manufacturers have delivered such data to the Board. For example, a company manufacturing smartphones with encryption technologies must apply to the Board, while the smartphone user does not have to make an application. These arrangements are introduced for manufacturers or importers.

However, there is also an arrangement introduced for encrypted or coded communication devices brought by travelers. In case these individuals have privately developed an encrypted or coded communication device similar to a manufacturer, they must provide their encryption data to the Board in order to use these devices in Turkey. Private development of a code or encryption is considered a “manufacture,” subject to Article 5 of the regulation.

We emphasize that the regulation is targeting importers and manufacturers of products with encryption technologies – even if they are established in another country. Business travelers are generally excluded from the scope of this application.

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## Turkey limits distance selling of sports nutrition products and cosmetics

On 19 April 2011, the Customs General Directorate published Circular no. 2011/23 that establishes import restrictions for sports nutrition products and cosmetics. These restrictions effectively limit or restrict distance selling of the affected products.

Sports nutrition products, including supplements, can no longer be imported via mail shipment or through fast cargo without a prescription. This practice aims to prevent procurement and use of vitamin supplements (e.g., proteins, carbohydrates, minerals) from abroad without any doctor supervision. Local athletes that hold the "National Sportsman Certificate" can present the certificate, in place of a doctor's prescription, to the Customs authorities in order to import affected products by mail or through fast cargo. The circular thus places controls on the distance selling of sports nutrition products by foreign sellers, particularly those that utilize the internet to access consumers in Turkey.

For cosmetics, the circular no longer allows importation by mail or fast cargo. Recently, consumers have been ordering cosmetics from websites of foreign sellers, taking advantage of cost savings due to the exemption from Customs taxes for "gifts" not exceeding EUR 150. The circular effectively restricts distance selling of cosmetics from sellers abroad.

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## Restricted party screening software: Inside the black box



A challenging trade management and export control compliance area for global business today is managing compliance with unilateral and multilateral regulations that restrict transactions with certain individuals and entities, commonly referred to as restricted parties. As the consequences of trading with restricted parties can be severe, many companies screen their purchasing, sales and financial transactions to ensure that all parties to the transaction (e.g., customers, suppliers, banks, freight forwarders, etc.) are not covered by an applicable restricted party list.

For global business, restricted party screening can be a monumental task considering the large number of restricted party lists. Many countries, such as European Union members, the United States, Australia, Canada, Japan, New Zealand and others each have their own restricted party lists. Moreover, certain multilateral organizations, such as the United Nations and the World Bank, may be the source of restricted parties. Complying with restricted parties as designated by US regulations is particularly complicated because multiple US government agencies publish their own individual lists (each with different regulatory requirements) and because of the broad extraterritorial reach of the US regulations, which may impact both foreign and domestic transactions based on the involvement of US goods or US persons.

Consequences for transacting with a restricted party vary based on which country's laws are involved and which restricted party lists apply. The failure to comply with applicable regulations can result in civil or criminal fines or penalties and possibly imprisonment. Violations of certain US restricted party lists may result in the revocation of export privileges.

While screening can be performed manually, due to the practical realities of screening many business partners against numerous restricted party lists, many companies are utilizing restricted party screening software or web-based solutions. Companies choosing electronic screening need to recognize that not all

software solutions perform equally well. Depending on the logic employed by the software, its interface with your information technology environment and choices made when configuring the software, electronic screening may be under-inclusive (and fail to identify restricted parties) or over-inclusive (leading to significant operational and compliance demands on the business as false positives are resolved). To effectively choose, implement and monitor (i.e., test) a restricted party screening solution, it is critical that you understand the solution's logic, along with its strengths and limitations – in other words, know what is and is not in the “black box.”

### Understand the logic of restricted party screening solutions

First, consider how data will migrate from your information technology environment to the screening software. Some software vendors cannot accept data that is not in specific formats, and it is not always easy to reformat your data to meet their needs. This issue is best identified before a vendor is selected.

Second, consider how the restricted party screening solutions screen your records. Each provider has their own unique algorithms for screening your records against the published lists. While the variations or combinations of algorithms are many, the main concepts behind them are fairly limited. Some search algorithms look only for exact matches, while others can find records that “sound alike” or are similar. Some only look at names, while others look at names or addresses. Some have search scripts that return different results even when similar concepts are applied, much like two internet search engines may return different results.



If you perform scenario testing (as discussed in the next section), you will see notable differences in over-inclusiveness and under-inclusiveness based on software design and configuration. For example, many vendors screen names, but not addresses. This produces fewer false positives, but obviously makes it easy for a restricted party to bypass screening merely by changing its name.

*Establish compliance cost versus risk metrics to measure performance and then use scenario testing to measure each potential vendor against those metrics*

Third, consider the compliance costs versus the risks of the restricted party screening solution. Ideally, you want to develop a solution that is not over-inclusive (i.e., returning too many false positives), which wastes your employees' valuable time, and not under-inclusive (i.e., missing direct hits), which subjects the company to risk of non-compliance. This balancing act can be addressed by establishing metrics and then performing front-end and ongoing testing of your restricted party screening solution.

This is best performed as part of software selection using "scenario testing." Scenario testing involves creating dummy vendor, customer and master data with known issues and then running the data through different configurations of each software vendor's solution. For example, one effective approach we utilize is:

- ▶ Create a sample set of customer records based on actual customer data (this should be sanitized to protect the privacy and identity of your customers, but should preserve the character and flaws inherent in actual data) that has the same look and feel as the data you would actually provide once the solutions is "live."
- ▶ Embed testable scenarios that look like your customer data, but actually include names and/or addresses of restricted parties. Be creative and include not only exact matches but also similar or phonetically identical names and specific risk areas. Properly structured testable scenarios test both over-

inclusiveness and under-inclusiveness. Do not provide the answer key to the potential vendor!

- ▶ Before you have the data set screened by the various service providers, have the vendor explain how their algorithms work and the configurations they normally recommend or see their clients use. Do your best to understand whether the algorithms proposed to be used are designed to catch only exact matches or whether they cast a wider net. You will also need to understand whether the various service providers screen names and addresses or only names.
- ▶ Have the various service providers screen your data set and provide you with a list of all the "hits" that are produced in their system.
- ▶ Compare the "hits" to the testable scenarios that were imbedded in the data set.
- ▶ Once you have the results, you can make a more informed decision as to the balance.

Following is an example of the results experienced by one company using scenario testing as part of restricted party screening software selection. Note that results for each vendor varied based on configuration, and for purposes of the chart below we selected only one configuration for each vendor.

Vendor	Cost	Direct hits missed	Total scenarios missed	False positive rate
A	Low	38%	60%	3.4%
B	Med	91%	91%	5.9%
C	High	4.7%	14.3%	16.9%

As you can see in the table above, as configured, the lowest cost vendor missed 38% of direct "hit" testable scenarios while the highest cost vendor only missed 4.7% of direct "hit" testable scenarios. Vendor B demonstrates why testing is vitally important because in the tested configuration it missed 91% of direct "hit" testable scenarios! A company that did not perform scenario testing during vendor selection may be buying an expensive solution that does little.



Scenario testing results have to be compared with the desired metrics and the company's export profile. For example, the cost to resolve false positives can be quantified and used as a cost factor in vendor selection. This latter balancing exercise is inherently company-specific.

If your company is already using a restricted party screening solution, you may wish to use a test environment to periodically examine the software or its configuration by creating dummy orders or fake customer records using restricted party names and/or addresses to see if the system catches them. If the system does not catch it, find out why and close the gap by working with your service provider.

## Look toward leading practices for restricted party screening

While no system is perfect, there are a number of leading practices that can be implemented to reduce risk and hopefully minimize costs to your company at the same time.

- ▶ Screen against all the restricted party lists that are applicable to your company and transactions (do not forget about foreign lists).
- ▶ Make sure that the lists you are using (or your service provider is using) are updated regularly.
- ▶ Automate the process as much as possible to avoid the potential for human error during data input.
- ▶ Use a solution that has the ability to screen names and addresses (make sure you ask).
- ▶ Use a solution that has advanced algorithms, which identify names similar to restricted parties without having to be exact.
- ▶ Use a solution that can also identify countries of concern, which may be subject to embargoes or economic sanctions and can distinguish between country codes (for example, whether "IR" stands for Ireland or Iran).
- ▶ Manage the solution to reduce false positives and streamline the resolution process for your personnel.

- ▶ Find a solution that has the ability to make notes or override a false positive so it does not come up as a hit in the future, but which screens overrides against new entries on the lists.
- ▶ Use a solution that allows you to provide your own list of individuals or entities that you have chosen not to do business with. These individuals or entities may not have paid previous invoices or are known to on-sell in violation of your distributor agreements.
- ▶ Test the solution and its configuration before implementation.
- ▶ Test the solution regularly to ensure the accuracy of the screening. This should include scheduled periodic testing (e.g., every 12 months) and spot testing (shortly after a list is updated).
- ▶ Maintain an audit trail of all screenings, including those that resulted in no "hits." You should be able to access these records easily and quickly in case you need to provide them due to a government inquiry.
- ▶ Screen all records including customers, vendors, visitors, employees and contractors upon first engagement with your company and regularly thereafter (e.g., annually).

## Conclusion

Restricted party software and web-based screening solutions can serve as an essential tool to reduce the risk that your company transacts with restricted parties. Just be sure that you know what is in that "black box."

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