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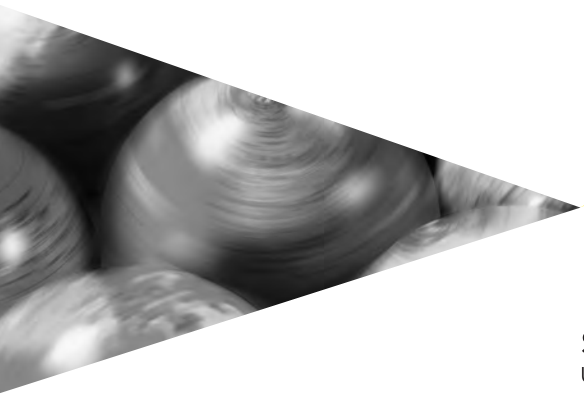
# TradeWatch



## In this issue



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Spotlight on

# US-EU mutual recognition agreement: action items for security-certified traders to benefit

As reported in the June 2012 *TradeWatch*, U.S. Customs and Border Protection (CBP) and the EU Taxation and Customs Union Directorate signed the US-EU Joint Customs Cooperation Committee (JCCC) decision regarding mutual recognition. This decision formally recognizes the compatibility of each other's security-certified trader programs, i.e., the U.S. Customs-Trade Partnership Against Terrorism (C-TPAT) program and the EU's Authorised Economic Operator (AEO) program. The favorable treatment from mutual recognition may result in lower costs, simplified procedures and greater predictability in conducting cross-border trade.

In a first wave, CBP will take into account the AEO status of EU companies importing into the US. In a second wave, a similar favorable treatment will apply to C-TPAT certified companies importing into the EU.

In terms of timeline, the JCCC has stated early 2013 as a go-live date; however, this will highly depend on the scope of the US C-TPAT program being broadened to include US exports, as well as on the readiness of IT systems that the EU is putting in place facilitating the exchange of information and data regarding C-TPAT certified companies.

## Action items for EU exporters to the US

For EU AEOs to take advantage of the security program, certain steps should be followed for the practical implementation of EU-US mutual recognition. The EU and the US have agreed to an automatic mechanism for the exchange of relevant data of the AEOs holding a certificate with the safety and security component (AEOS or AEOF). CBP can only grant benefits based on the information linked to a Manufacturer's Identification Number (MID). As a result, there is a need for a "matching process" to associate the EU EORI (Economic Operators Registration and Identification) numbers with MID numbers.

To this end, CBP has set up a web application within their C-TPAT web portal where EU AEOs should register their EORI number and associate this number with their MID number(s), https://mrctpat.cbp.dhs.gov. The application is activated once the exchange of relevant AEO data and testing is completed.

As mentioned, the mutual recognition benefits only apply to AEOS or AEOF. AEOs that do not hold the safety and security component now have an additional incentive to upgrade their AEO status.

## Action items for US exporters to the EU

US C-TPAT members will need to prepare for the upcoming changes to the program to also cover exports. While formal guidelines from CBP in this respect are still under development, US companies may consider looking to the EU AEO program with respect to safety and security requirements for outbound shipments for guidance to initiate preparations.

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# Iran Threat Reduction and Syria Human Rights Act of 2012 — implications for activities conducted by foreign affiliates with Iran

On 10 August 2012, President Barack Obama signed into law the Iran Threat Reduction and Syria Human Rights Act of 2012 (2012 Iran Act). Prior to this Act, many activities conducted by foreign affiliates of US companies in Iran were insulated from US jurisdiction provided that US persons did not facilitate the activities. Now, the Act extends the US Government's ability to impose penalties on all US companies for Iran-related dealings conducted by foreign affiliates. The Act also requires U.S. Securities and Exchange Commission (SEC) disclosures for SEC issuers or affiliates conducting certain Iran-related transactions.

## IEEPA law and penalties extend to foreign affiliates of US companies for Iran

Section 218 of the 2012 Iran Act extends civil penalties for violations of an order or regulation issued pursuant to the International Emergency Economic Powers Act (IEEPA) to US companies for the Iran-related dealings of its foreign affiliates by effectively expanding the definition of a US person to include a foreign affiliate of a US company. A foreign company is affiliated if it is owned (more than 50% by vote, value or board of director seats) or controlled (by way of actions, policies or personnel decisions) by the US company. This section is not self-enacting. President Obama is required to issue an Executive Order or regulations enforcing this provision no later than 9 October 2012. Forthcoming Presidential action will provide further clarity on the effective date of Section 218.

## SEC disclosure required for specified transactions of a SEC issuer or affiliate

Section 219 of the 2012 Iran Act requires the disclosure of specified Iran-related transactions knowingly entered into after 6 February 2013, by an SEC issuer or its affiliate. The term "affiliate" is not limited to a US company as the definition includes any "person that directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with such issuer." The types of transactions that trigger the disclosure requirement do not include all types of Iran-related transactions, but include transactions that could be categorized as more significant, egregious or preventable. While several other transaction types target the dealings of financial institutions, the following types of transactions relevant to commercial exporters include:

- Making an investment of US$20,000,000 or more within a 12-month period that directly and significantly contributes to the enhancement of Iran's ability to develop petroleum resources
- Exporting or transferring to Iran goods, services or technology knowing that the provision of such would contribute materially to Iran's ability to acquire or develop destabilizing numbers and types of advanced conventional weapons
- Entering into any transactions or dealings with persons or entities identified in Executive Orders No. 13224, No. 13382 or §560.304 of Title 31 of the Code of Federal Regulations which defines the scope of entities and persons who are part of the Government of Iran

Public disclosure of these transactions requires the President to initiate an investigation into the possible imposition of sanctions against the issuer or the affiliate of the issuer.

US companies with foreign affiliates engaging in previously lawful unlicensed Iran dealings will need to act to avoid penalties and in some cases avoid SEC disclosures. US export control and sanctions programs previously designed to detect and prevent only the actions of US persons with respect to Iran will need to be expanded to detect and prevent the actions of foreign affiliates.

This may include the implementation of transaction screening at foreign affiliate locations and training of foreign affiliate employees. Where foreign affiliate divestiture is an option of last resort, US companies may avoid penalties and disclosure requirements by divesting themselves of the foreign affiliate prior to 6 February 2013.

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# Americas

## Brazil

### REINTEGRA incentive for Brazilian exporting companies

Since August 2011, Brazil has implemented a variety of economic and tax measures under "Plano Brasil Maior" or "Plan Bigger Brazil." In the previous issue of *TradeWatch* (June 2012), we discussed the primary trade defense measures under this initiative. In this article, we discuss a tax incentive program under Plan Bigger Brazil that is designed to benefit Brazilian exporting companies.

REINTEGRA (Regime Especial de Reintegração de Valores Tributários para as Empresas Exportadoras) was introduced by Provisional Measure 540/2011 as a special tax refund regime for exporters of manufactured goods. Specifically, the program aims to reintegrate residual tax amounts that exist in supply chains (i.e., taxes paid throughout supply chains that have not been offset).

As background, exports are not subject to taxes normally due on merchandise sales transactions, such as federal and state value-added tax (IPI and ICMS, respectively), PIS and COFINS over gross revenue. Nevertheless, these taxes are due on the purchase of inputs used in the manufacturing of exported products. Although most of the taxes are recoverable, tax credit accumulation and cash flow costs resulting from such transactions generate residual cost that exporting companies are not able to offset by the credits system.

REINTEGRA establishes the possibility for exporters to be reimbursed, partially or fully, for the tributary residual cost existing in the supply chain. This amount is calculated as 3% of the exports' gross income. The refund may be:

- Used for the payment of tax debts or liabilities
- Paid in cash under conditions established by the tax administration

The residual cost calculation does not include goods whose cost of imported inputs exceed 40% (or up to 65% for some products) of the export price. Goods imported from the MERCOSUR trade bloc are considered as Brazilian origin in this context.

However, there are some restrictions. For instance, this regime applies only to goods listed in Decree No. 7633/2011. Additionally, the regime does not apply to imported goods that are re-exported by a Brazilian export company without undergoing any type of manufacturing process.

Exporting companies that have not yet taken advantage of the REINTEGRA regime should not delay. The regime is effective until 31 December 2012, unless the Brazilian Government extends the program.

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# Colombia

## US-Colombia free trade agreement: new restrictions and opportunities for textile suppliers

The Colombian textile and apparel industry is facing new and more stringent rules of origin for preferential access to the US under the US-Colombia Free Trade Agreement (US-CO FTA). The Andean Trade Promotion and Drug Eradication Act (ATPDEA), which has more flexible origin rules, no longer applies to Colombia. As a result, certain articles that previously enjoyed preferential access to the US may now be subject to high duty costs.

For instance, the US-CO FTA rules of origin limit the amount of third-party (i.e., non-US or non-Colombia) fabrics, yarn and fibers that can be used in a qualifying finished product. Compared to the ATPDEA, with origin rules that generally allow the use of materials from one or more of the ATPDEA countries, sourcing options are now drastically diminished under the US-CO FTA. Further, in some cases, the necessary materials are not available locally in the US or Colombia, or are in short supply.

To remedy this issue, the US–CO FTA provides for a "Short Supply List" (found in Annex 3-B), which entails certain fabrics, yarns or fibers designated by the US (in restricted or unrestricted quantities) as not available in commercial quantities in the US or Colombia. These designated goods may be sourced from third countries for use in textile and apparel products without counting against the originating material percentage required for US-CO FTA origin compliance.

The Short Supply List is maintained by the International Trade Administration of the U.S. Department of Commerce, Office of Textiles and Apparel (OTEXA). However, the formal procedures to request that OTEXA add a good to the Short Supply List have not yet been published. The implementing regulations, which are expected by the end of the year, will likely use the same model as other US FTAs with short supply provisions, such as the FTA with Central American countries and the Dominican Republic (CAFTA-DR). Currently, purchasers and suppliers can use existing short supply regulations under other US FTAs as guidance to begin compiling the necessary information and documentation.

Industry's participation in developing the Short Supply List can help lessen the detrimental effects of the more stringent rules of origin under the US-CO FTA. It is worth noting that the Colombian Ministry of Trade, Industry and Tourism is preparing a formal request to OTEXA to include at least six Harmonized Tariff Schedule subheadings (5208 43, 5510 11, 5107 10, 5107 20, 5108 20 and 5510 30) in the Short Supply List. Interested entities can also request that certain materials be removed from the list. Accordingly, textile and apparel purchasers and suppliers need to actively monitor developments.

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# Colombia FTA considerations: practical application of exceptions to the direct shipment requirement

Colombia's network of FTAs provides businesses with preferential access to a growing number of markets, conditioned on meeting the FTA rule of origin. Rules of origin are dependant not only on the manufacturing processes of the goods in the country of export, but also on the international transportation of the product.

Transit requirements are intended to lessen the risk that goods will be modified in a third country during the movement of the goods from one FTA member country to another. In this respect, FTAs generally require "direct consignment" or "direct shipment," meaning that the goods should be shipped directly between the parties to the FTA without transiting through a third country. Goods that are not shipped in accordance with these rules lose their status as originating goods under the FTA. At the same time, governments recognize that specific situations of transport and logistics necessitate temporary transits, transfers or storage in third countries. Accordingly, the FTA may provide for specific exceptions to the direct consignment requirement so that transit does not affect the origin of the goods under certain conditions.

## Transport documentation considerations

For goods that meet the FTA's origin requirements, but must transit a third country under an allowable exception, the transportation documentation can be vital to safeguard preferential access. In Colombia, there has been a debate regarding whether the transportation document (e.g., bill of lading) should be:

- Consigned to the destination country, even though the goods will pass through a third country

or

- Consigned to the third country where the transit will take place, whereby subsequently, an additional transportation document is issued to send the goods to the destination country

The Customs Administration of Colombia (DIAN) and the Ministry of Trade, Industry and Tourism have separately addressed this, and reached differing conclusions. DIAN considered the shipment of goods from Argentina (pursuant to MERCOSUR) and Mexico (pursuant to the Colombia-Mexico FTA) that are stored in Panamá due to geographical, transportation and/or logistic reasons. In applying a strict interpretation of the applicable direct consignment rules, the DIAN stated in Opinion 001 of February 15/2010:

> *"On the "direct consignment topic" it is appropriate to point out that the only document which accredits it is the Transportation Agreement (Bill of lading in the maritime transportation mode, Air-way bill in the air transportation mode and Consignment Note, in the land transportation mode), which covers the goods and where the information corresponding to the port of landing in the country of origin and the arrival place in the destination country must be included, independently, if for logistic reasons, the goods require making transit or transfer through a third country.*
>
> *If the transportation document has consigned a third country as destination country, (Panamá in the case under consultation), a country which is used in accordance with your communication only for storage purposes that facilitates the distribution of the goods, one of the conditions established in the Agreements is weakened, as is that the transit or transfer is justified due to geographical reasons or considerations relating with transportation requirements (and not for logistic – storage/ distribution of goods reasons)."*

On the other hand, earlier this year, the International Legal Matters Office of the Ministry of Trade, Industry and Tourism (Ministry) considered the application of the exception to the direct consignment rule in the FTA between Colombia and the United States (Article 4.13). The Ministry established:

> *"Making an interpretation of article 4.13 of the FTA between Colombia and the United States (hereinafter the "Agreement"), this Office finds that such origin rule does not demand that the transportation document should be expressly registered with the port or airport of the landing country and the port or airport of the goods final destination country."*[1]

The above finding was made in according to the literal interpretation of the rule and in accordance with Article 31 of the Vienna Convention on the Law of Treaties. The Ministry also supported its interpretation with the scope granted to the concept of "transit and transfer" in the context of other international agreements which regulate trade of goods, understanding that in this framework, there is no delimitation of when and where the travel of the goods in transit ends.

The conclusion that the goods sent from the US to Colombia do not lose origin for the single fact that the transport document is cut in the third country in transit, in our opinion, represents progress relative to the preliminary position of the customs authority. The statement of the Ministry does not imply that the customs authorities cannot require this document in the goods importation procedure, but "in the event it is requested and finding that it is cut, it cannot be concluded that because of this fact the rule of origin of transit and transfer is being infringed."

## Implications for business

In utilizing FTAs, businesses conduct careful planning and analysis to help ensure that the product meets the applicable agreement's rules of origin in order to benefit from the agreement. These recent opinions highlight the importance that such planning and analysis consider not only the documentation necessary to support that the manufacturing process confers origin, but also that the transportation documents support the direct consignment rule and exceptions thereof. As the two positions presented in Colombia point out, the documentation analysis should be FTA-specific as it cannot be assumed that what is allowed under one FTA will also be allowed under another FTA. The importance of due diligence cannot be understated.

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[1] OALI Opinion 141, in response to official letter 100210227-0315 of 4 May 2012.

# Customs tariff partially amended with new list of duty-free goods

Decree 1703, effective 15 August 2012, partially amended Decree 4927 (26 December 2011) to establish a zero rate of duty for 3,095 tariff subheadings for a one-year term. The decree is specifically aimed at providing benefits to the agricultural and industrial sectors. The new list of duty-free goods includes:

- Fuels and lubricants
- Raw materials and equipment for agricultural
- Inputs and machinery for industry
- Transport equipment
- Construction materials

Decree 1703 replaces the recently expired Decree 2916 and Decree 2917 of 12 August 2011, which had established a tariff of 0% for approximately 3,000 subheadings covering raw materials and capital goods not produced domestically. The new list contains some of the same goods that were duty-free under the previous decrees.

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# MERCOSUR-Mexico

## MERCOSUR-Mexico ECA No. 55: Argentina's suspension of preferential duty treatment affects Mexican automotive exporters

Since 2002, Mexican-originating automotive goods have benefited from preferential duty treatment in the MERCOSUR countries of Argentina, Brazil, Paraguay and Uruguay pursuant to the Economic Complementation Agreement No. 55 (ECA No. 55) under the framework of the Latin American Integration Association (ALADI).

During the early half of 2012, Brazil and Mexico entered into an agreement that modified ECA No. 55 as it pertained to the trade of automotive goods between the two countries due to Brazil's trade deficit in this respect. The agreement established an import quota for Mexican auto goods imported into Brazil and more stringent regional value content requirements. (See the article "Bigger Brazil's new trade defense measures" in the June 2012 *TradeWatch*).

In response, Argentina issued Decree No. 969/2012, which unilaterally suspended the application of ECA No. 55 as it pertains to trade in automotive goods between Argentina and Mexico for a three-year term. Argentina stated that the negotiation undertaken between Brazil and Mexico was not performed in accordance with the provisions of the ECA No. 55 since the inclusion of the quotas and increased regional value content requirements should have been approved by all the signatory parties (i.e., not only between Brazil and Mexico) even though the modifications only related to trade between those two nations. Moreover, Argentina stated that this violation had modified the trade flow of automotive goods and would increase Mexican auto imports into the other signatory parties to the ECA No. 55, thereby representing a grave and imminent threat to Argentinian manufacturers of automotive goods and affecting the development of current and future investments.

Mexico has refuted Argentina's claims and has filed a dispute with the World Trade Organization (WTO). Mexican authorities are also contemplating additional measures to compensate the damage caused by Argentina's unilateral suspension of preferential duty treatment to the import of Mexican automotive goods.

Argentina's suspension of ECA No. 55 adds to the growing list of the country's recent trade-restrictive measures that include preregistration, review and approval of all import transactions and expanded import data requirements (as discussed in the March 2012 and June 2012 issues of *TradeWatch*). Compliance with these types of measures can be costly, as can an unexpected jump in duty, such as those experienced by Mexican auto exporters. These measures are affecting a large number of exporters globally and are concerning for supply chains that involve Argentina. Under this scenario, companies doing business with Argentina need to closely monitor further developments in order to keep abreast of new issues that could present a potential economic impact.

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# MERCOSUR

## Venezuela accepted as full member

Effective 31 July 2012, Venezuela has been accepted as a full member of the MERCOSUR trade bloc formed by Argentina, Brazil, Paraguay and Uruguay. Being a full member of MERCOSUR means to share the same goals of establishing a common market between member countries through the adoption of a common external tariff, a common trade policy and the free movement of goods, services and factors of production between the members through the elimination of customs duties and non-tariff restrictions.

Venezuela's full membership materialized when Paraguay's membership was suspended due to concerns over the country's recent democracy crisis with the ouster of President Fernando Lugo. Paraguay had been the primary resistance to Venezuela's acceptance as a full member.

Venezuela is an important market in Latin America, widely known for its oil operations and an economy that demands goods and infrastructure due to scarce industrial activities. Brazil, in particular, is expected to benefit from increased exports to the new member. However, politically, there are concerns that Venezuela may impair the bloc's trade negotiations with the US and EU.

Venezuela is currently under a transition period whereby the country has up to four years to adopt the tax regulations of MERCOSUR. This includes the adoption of the MERCOSUR common nomenclature and the common external tariff. The rules of origin expressed in the Economic Complementation Agreement No. 59 (MERCOSUR-Andean Community) apply until 1 January 2014.

Additional rules to allow for preferential trade between Venezuela and the other Member States are under development as are pending decisions with respect to the development of trade and services for the internal and external markets now that Venezuela is a new partner. Companies planning to take advantage of Venezuela's admission to MERCOSUR should monitor these developments closely.

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# Peru

## New assessments issued by customs authorities on the customs treatment of engineering fees under turnkey contracts

Customs valuation is a controversial issue for global traders in most jurisdictions and Peru is no exception. In the June 2012 issue of *TradeWatch*, we addressed the aggressive position the Peruvian customs authorities have taken with respect to the customs treatment of royalty payments. We now discuss recent guidance with respect to the customs treatment of engineering fees under turnkey contracts.

A turnkey contract is an agreement under which the contractor agrees to complete a facility (e.g., industrial plant) so that it is ready for use when delivered to the customer. These contracts generally involve the supply of engineering, procurement and the construction (e.g., design engineering of the entire plant, procurement, construction, installation, supervision, operation and training) required to complete the project.

Recent assessments issued by Peruvian customs authorities involve engineering increments to the customs value declared at the importation of different parts to be installed in Peru under turnkey agreements. These increments are based on the interpretation that the importation of different parts of a plant shall be treated as fragmented importations (i.e., split shipments) and as a consequence, design engineering related to the plant should be added to the declared customs value of such goods as part of the transaction value.

The Peruvian customs authorities based their decision on guidance from the World Customs Organization (WCO) Technical Committee on Customs Valuation. WCO Case Study 1.1 provides that the transaction value of plants (when sold to be exported to the importing country) must include the price of engineering design and development charged by their provider. WCO Commentary 6.1 (treatment of split shipments under Article 1 of the Agreement) provides that fragmented shipments for a plant or industrial equipment can be valued under the transaction value method for customs purposes. We note that this addition to the customs value is not an adjustment pursuant to Article 8.1 of the WTO Valuation Agreement, but rather a condition for the sale of the goods and part of the price paid or payable under the contract.

Peruvian customs authorities have applied such WCO guidance in cases in which the imported goods do not involve the importation of an entire plant in fragmented shipments, but rather the importation of different parts to be built in Peru together with locally produced parts of the plant.

In the case under analysis, the design engineering of the plant did not involve the engineering of imported goods (they were rack goods, bought from third parties), but engineering associated with the functioning and operation of the project, engineering related to activities to be performed within the importation country (such as plans relating to the installation, commissioning, monitoring and coordination of the installation work, etc.), as well as other engineering not required for the production of imported goods. Nevertheless, the Peruvian customs authorities determined that the customs value for the separately imported parts should include the total engineering costs developed abroad under the turnkey contract, despite the fact that some of these engineering costs are not related to the imported goods or even a condition of its sale.

The case is still in dispute as part of an administrative procedure with the Tax Authorities.

## Implications for business

Businesses that operate under turnkey contracts should consider the position taken by the customs authorities when determining the customs value for imports, particularly when engineering fees are involved. For any undeclared amounts, the importer may face an upward valuation increment that results in an additional import tax payment as well as penalties in the amount of double the additional tax payment. These unexpected charges can be significant.

We recommend that affected businesses review their turnkey contracts from a customs perspective to assess the implications that the terms of the agreement might have on the customs value and opportunities to reduce any areas of risk or exposure.

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# United States

## New ruling shows enhanced scrutiny in related party sales and first sale transactions

A recent ruling from U.S. Customs and Border Protection (CBP) provides important insight for importers in two key areas. First, it demonstrates the importance of critically examining the documentation used to support "first sale" transactions. Second, it provides a reminder of CBP's narrow view of the "all costs plus a profit" method to demonstrate that related party transactions are arm's length. While the context of the particular ruling is around first sale, these concepts are broadly applicable.

### Importance of examining the evidence

First issued as a response to an Internal Advice Request and second as a confirmation of the previous advice under a Reconsideration Request, the analysis provided by CBP in HQ H215658 (11 June 2012) demonstrates the importance of accurate supporting evidence to meet first sale requirements.

Under first sale valuation, a US importer that purchases a product subject to multiple sales before importation may use the value of an earlier, or "first sale," as transaction value provided three criteria are met:

- The first sale is a *bona fide* sale of the merchandise for exportation to the US.
- The merchandise is clearly destined for the US at the time of the first sale.
- The first sale is conducted at arm's length.

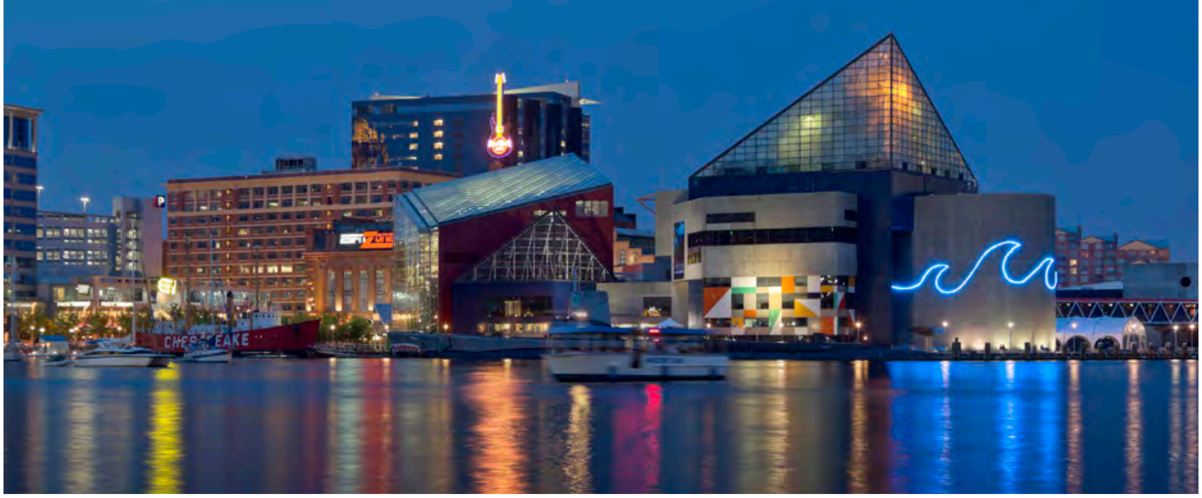
CBP first reviewed the bona fide sale requirement, focusing considerable analysis on the difference between the actions of the parties and commercial documentation with regards to Incoterms and the method of payment. Although the commercial documents clearly stated the transactions as being Ex-Factory, upon review of the freight payments and shipping documents it was determined that the factories were actually paying the inland transportation from the factory to the port of export, thus aligning more closely with FOB terms.

CBP went on to note that this difference has implications on product price. Where an invoice notes Ex-Factory terms, only the cost of the goods is reflected on the invoice. However, an FOB price would include the cost of the goods plus inland freight. This pricing discussion becomes increasingly relevant where the parties are related and the profits of each entity are reviewed in an effort to substantiate the "arm's-length" nature of the transaction.

While not actually determining whether or not there were bona fide sales between the parties, CBP's analysis in HQ H215658 highlights the importance of paying attention to transaction details and ensuring accuracy on entry documents so as to not invite scrutiny.

### Arm's-length pricing and "all costs plus a profit"

HQ H215658 also provides insight into how CBP is viewing the "all costs plus a profit" method of supporting related party pricing. Transaction value is acceptable for related party sales if either an examination of the circumstances of the sale indicates that the relationship between the parties does not influence the price actually paid or payable, or the transaction value of imported merchandise closely approximates a test value. Test values must have been previously accepted as a liquidated customs values. Frequently, no test values exist; consequently, an examination of the circumstances of sale is necessary to determine the acceptability of transaction value.



There is no prescribed approach to meet the circumstances of sale test. CBP regulations provide three illustrative examples of ways in which an importer may establish that the relationship of the parties did not influence the price:

1. If it can be shown that prices are settled in a manner consistent with the normal pricing practices of the industry
2. If it can be shown that prices are settled in the same way the seller settles prices for sales to unrelated buyers
3. If it can be shown that the prices are adequate to ensure recovery of all costs plus a profit which 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

In the ruling, the factory is a subsidiary of the "middleman," thus necessitating a circumstances of sale analysis. The importer submitted profit and loss statements of the factory and of the middleman as evidence that the "all costs plus a profit" method was satisfied. CBP disagreed. The factory profit and loss statement showed that the factory made a profit, and the primary disagreement was around how to assess if the profit was "equivalent to the firm's overall profit."

Two aspects of CBP's approach to the "all costs plus a profit" method illustrate the difficulty in using this method. First, CBP has continued its focus on comparing the seller's profit to that of the parent company of the seller; CBP states that it ordinarily views the parent company as the "firm" to make a comparison of "firm's overall profit." In this particular ruling, there is no indication that the importer suggested the comparison to the parent was inappropriate, but we would submit that it is in many cases. Businesses that organize into a variety of subsidiaries often have many different functions, only some of which are present in any single subsidiary. Moreover, many businesses have multiple tiers of subsidiaries, creating direct and ultimate parents.

The businesses do not intend, and there is no economic rationale, to assume that a parent and any particular direct or indirect subsidiary's profits are comparable in any respect. Without a more detailed look at the organization structure, a simple comparison of profits that are derived from unrelated activities will likely vary from period to period, and will not be reliable for long-term planning.

Secondly, CBP highlights the requirement that the seller must recover all of its costs plus earn a profit that is equivalent, defined as equal to or greater than, the firm's overall profit realized over a representative period of time in sales of merchandise of the same class or kind. While CBP states that this view is consistent with recent CBP authority, by defining "equivalent" as equal to or greater, with respect to comparing profits of the seller and the seller's parent, meeting the "all costs plus a profit" test becomes even less predictable. As the profit comparison is based on period of time, the time period reviewed may become determinative of ultimate success.

Based on CBP's narrow approach to the "all costs plus a profit" method, it may be difficult for importers to use this method predictably. Importantly, there are other ways to demonstrate the relationship of the parties did not influence the price. In fact, CBP cites rulings premised on other methods in its discussion in this ruling.

Although the context of this ruling is first sale, the guidance applies more broadly. Importers are well advised to critically examine audit trails in any situation in which the valuation approach may be dependent on it. Those purchasing from related parties should carefully assess the appropriate methodology for supporting the related party prices.

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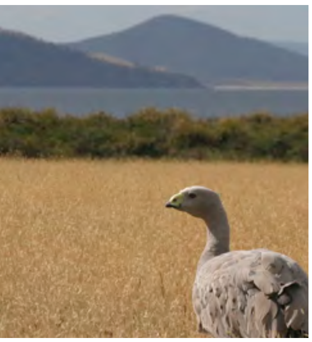
# Australia

## Customs compliance update



In line with our comments in the March 2012 issue of *TradeWatch*, the Australian Customs and Border Protection Service (Australian Customs) has continued to strengthen its focus on compliance (see the article, "Prepare for increased assessments and penalties issued by Australian Customs.")

Australian Customs has identified priority areas that will attract increased compliance attention within the revenue, cargo process and regulated trade categories. Priority areas identified include:

- Undervaluation, luxury car tax and misuse of self-assessed clearances
- Deliveries without authority, cargo control issues associated with major resource projects and cargo reporting timeliness and accuracy
- Importation and exportation of precursors, strategic goods and goods with consumer safety concerns

Australian Customs is currently reviewing its interim approach to cargo reporting compliance and will seek industry consultation on any proposed change to this approach following completion of its review.

It is also important to note that, following the six-month "administrative moratorium," which ended on 21 May 2012, Australian Customs has commenced serving infringement notices for the four additional strict liability offenses recently added under the Infringement Notice Scheme, related to breaches of license conditions and failures to follow written directions.

This year we have seen a rise in Australian Customs audit activity and would expect to see an increased number of infringement notices issued as a result.

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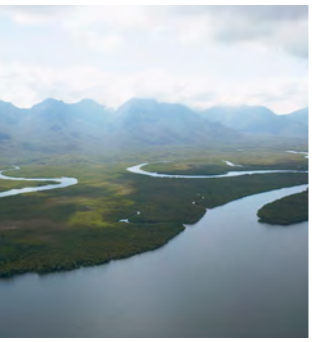
# Commercial approach to considering tariff concessions rejected by the Federal Court of Australia



The Federal Court of Australia has rejected the commercial approach to considering tariff concessions in a decision that holds significant implications for importers looking to take advantage of Tariff Concession Orders (TCOs), which act to reduce duty on eligible goods to zero.

Australia has a system of granting, on application, a zero rate of duty on goods where it can be shown that substitutable goods are not produced in Australia in the ordinary course of business. Notable exceptions are passenger motor vehicles and apparel.

A contentious issue is often whether a particular locally produced good is "substitutable" for the goods described in the TCO application. The Full Federal Court of Australia recently reviewed this issue in deciding whether a judgment by the Administrative Appeals Tribunal (AAT) relating to a TCO covering certain forklifts was correct.

The TCO under review specified that the forklift must be able to lift 1,200 kg to at least 5 meters. A local manufacturer argued its goods could meet that requirement, although the forklifts would be at the limit of their capacity in doing so.

As we reported in the December 2011 issue of *TradeWatch*, the AAT had found that the local and imported goods would rarely be put to similar uses and thus, the local goods were not substitutable for the goods described in the TCO. Accordingly, the AAT had reset the test of substitutability to the benefit of importers by introducing arguments of commerciality and practicality into what had previously been a very narrow legal test.

In reviewing the AAT decision, the Full Federal Court said that the AAT had adopted "a sensible commercial approach to the definition of substitutable goods." However, it nevertheless held that the AAT's approach was incorrect and that the local goods were substitutable for the goods described in the TCO.

In determining substitutability, the legislation requires a comparison of uses concerning how the goods are used, or could be used. The Full Federal Court held that the comparison of uses is not only between actual uses, but also between potential uses. However, not all conceivable uses will be considered. The use must be a reasonable use. The example given was that while a spoon could be used to dig a hole, this was not a reasonable use, meaning that a spoon would not be considered substitutable for an excavator.

In finding that the two forklifts were substitutable, the Full Federal Court held that the AAT was wrong to focus only on the actual uses of the goods. It said that in doing so, the AAT wrongly replaced the legislative test, which looks at potential uses, with one that looks at the relevant practical and commercial uses of the TCO goods.

The decision makes clear that issues of commercial reality should not be taken into account when considering TCO applications. While this will cause difficulties for importers seeking TCOs, the introduction of a "reasonable uses" test will prevent local manufacturers and Australian Customs from relying on unlikely theoretical uses of local goods. While a mere potential overlap in uses will be sufficient, the potential use must be a reasonable one.

These are important considerations in respect of future TCO applications and it will also be worth revisiting past TCO or revocation applications where the decision involved a focus on actual uses, or alternatively, uses which were not reasonable uses. Ultimately, the position adopted by the Full Federal Court provides more certainty to this area of law and should result in greater consistency in decision-making by Australian Customs when considering TCO applications.

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# Australian FTA update

As an update to previous editions of *TradeWatch* this year, we provide the following developments on current Australian FTA negotiations.

## Trans-Pacific Partnership

The latest round for the Trans-Pacific Partnership (TPP) negotiations, which involve Australia, Brunei Darussalam, Chile, Malaysia, New Zealand, Peru, Singapore, the US and Vietnam, was held in San Diego, California, US in July 2012. Important progress was made in the customs, cross-border services, telecommunications, government procurement, competition policy, and cooperation and capacity building working groups. In addition, the rules of origin, investment, financial services and temporary entry negotiating groups made significant progress. The next round of negotiations is scheduled to be held in Leesburg, Virginia, US during September 2012.

## China

No further negotiations for the Australia–People's Republic of China FTA have taken place since March 2012. However, there has been some media attention in regard to China's pressure on Australia to relax its regulations on foreign investment. The Australian opposition party is putting pressure on the Australian Government to complete the agreement; however, Australian Trade Minister Craig Emerson has indicated there is little desire to relax any foreign government investment measures currently in place. There are no concrete plans for any further negotiations in the future at this stage so this FTA remains outstanding with an unknown completion date.

## Japan

Since the June 2012 *TradeWatch* publication, there were further negotiations held in Tokyo, Japan from 13 to 15 June. Good progress was reported for the FTA between Australia and Japan in relation to trade in goods, customs procedures, rules of origin, energy and mineral resources, food supply, trade in services, investment, dispute settlement, competition policy and intellectual property. Officials have made a commitment to commence with further negotiations later in 2012.

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# China

## Customs challenges for the pharmaceutical and medical device industry

In China, the pharmaceutical and medical device industry is heavily regulated, and trade compliance can be a challenge. There are various customs issues that biotech companies may encounter at different stages of their evolving business. A current hot topic in this respect is the customs considerations for clinic trials in China.

### Clinical trials

A challenging area is the import of clinical trial materials. Considering that these are non-commercialized shipments, the determination of an acceptable customs value can be a complex exercise when transaction value cannot be used. This is a common area also observed elsewhere in the world, but China Customs tends to be aggressive in attempts to apply a high commercial value to the trial medicines for valuation purposes.

As background, in recent years, there has been an ever-increasing spread of clinical trials to emerging markets, such as China. The reasons for this expansion range from significantly lower per-patient costs to wider patient pools and more patients who have never previously taken drugs for treatment. Unlike Europe and the US, dosage-form clinical trial materials are subject to import duty in China. The duty rates range from 4% to 6.5% in addition to 17% value-added tax (VAT), which is mostly unrecoverable because the materials are not sold as part of normal commercial business.

While different companies adopt different valuation methodologies for their trial materials, ranging from variations of cost-plus to resale-minus, import values often run into millions of dollars and must be capable of being justified to the local customs authorities. Given the applicable duty rates, this can result in significant clinical trial costs that may not have been factored into the budget.

As a result, pharmaceutical companies are seeking to adopt proactive strategies to deal with these issues, such as:

- Assessing in a strategic manner the sourcing of dosage materials at the outset
- Determining in advance the technical basis on which to assess the customs value, working in conjunction with tax and transfer pricing colleagues
- Planning trial timescales which allow the company to take advantage of existing customs relief programs that can alleviate these costs
- Working collaboratively with authorities to reduce risk

The complications of conducting clinical trials in China generated much discussion during a recent industry forum hosted by Ernst & Young (China) Advisory Limited. The program, which included a member of China Customs and Ernst & Young (China) Advisory Limited representatives from the Indirect Tax and Transfer Pricing practices, discussed a variety of customs duty and VAT issues specific to the pharmaceutical and medical device industry. We anticipate more facilitation of China Customs dialogue with industry through these types of events. Look for developments in future issues of *TradeWatch*.

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# India

## India's growing network of FTAs — challenges and opportunities

India has granted significant duty concessions to imports from a vast number of countries in Asia through FTAs with ASEAN, Malaysia, Thailand, South Korea and Japan. Additionally, India's FTA network includes preferential arrangements with Chile and MERCOSUR and negotiations underway with the EU and African countries, among others.

For importers, India's FTAs bring opportunities to significantly lower duty costs while at the same time represent significant compliance challenges that can also prove costly if not effectively managed. The key challenge with respect to India's FTAs is compliance with the rule of origin requirements, an area that is attracting increased scrutiny by the India Customs authorities.

Rules of origin help determine the country of origin of the goods. To be eligible for the lower preferential tariff, the exporter needs to obtain a certificate of origin from the government agency of the exporting FTA member country. The importer must present the certificate of origin to the India Customs authorities at the time of importation. This seemingly simple procedure can actually be onerous due to the complex and overlapping rules of India's FTAs.

Most of India's FTAs employ the twin criteria of "value-added content" and "change in tariff classification" to determine the origin of goods that are not wholly produced or obtained in the territory of the FTA Member States. This is a high standard for importers given that both of these criteria must be met for each product (some exceptions apply).

The value-added content rule requires that a certain specified minimum percentage of local content be added to a product in the country where the origin is being claimed. Keep in mind, however, that the required value-added content percentage varies across FTAs.

The change in tariff classification rule, on the other hand, is based on a tariff shift, meaning that the product at issue must be classified under a different tariff heading than the tariff heading of the components used in the production of that good. While some FTAs require a change of tariff classification at the four-digit level, others do so at the six-digit level.

For business, it is vital to understand that the rules of origin vary from FTA to FTA for the same product. Additionally, India may have granted different levels of duty concessions to a particular good from the same country under multiple FTAs. In this respect, the product may qualify under one FTA's rules of origin, but not the other's. For instance, India offers duty concessions to imports from Malaysia under the India-Malaysia FTA as well as the India-ASEAN FTA. As the rules of origin differ under these FTAs, a product may qualify as originating under one FTA, but may not satisfy the rules of origin under the other FTA. In this scenario, the importer needs to assess which FTA provides the lower duty concession and ensure that the applicable FTA's rules of origin are met.

The number of overlapping FTAs and the distinct set of rules specific to them poses problems for business. Structuring production processes specifically for each FTA adds to production costs. Furthermore, the calculations involved to satisfy the product's value-added content requirement of an FTA can be cumbersome and requires sophisticated accounting systems.

Most of the FTAs with Asian countries require the exporter to obtain the certificate of origin from the designated government authority of the exporting country, which may involve meetings with the officials and extensive document support. On the other hand, the Customs authorities in India may question the validity of the certificate of origin or the calculations applied, even though approved by the exporting country. Although the exporter may be responsible for obtaining the certificate of origin, the importer claiming a duty benefit under an FTA is ultimately liable. In other words, should the India Customs authorities determine that the product does not qualify under the FTA, the importer will not be eligible for preferential duties on the import of that product. Accordingly, importers need to ensure that the rules of origin and the direct consignment rules are satisfied and that the certificate of origin is genuine.

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# Japan

## New 24-hour advance filing rules on cargo information


As part of the 2012 tax reforms, Japan's legislature approved the Advance Filing Rules on Maritime Container Cargo Information (Advance Filing Rules). The rules require a vessel operator or non-vessel operating common carrier (NVOCC) to electronically submit information on maritime container cargo to enter into a Japanese port, no later than 24-hours before departure of the vessel from the port of loading. The new rules require electronic submissions (i.e., paper submissions will no longer be allowed) of an expanded set of data elements. The Advance Filing Rules will be implemented in March 2014.

While the current customs laws also require the submission of information on maritime container cargo before entry into a Japanese port, the new requirements change the timing and form of submission, bringing the Japanese requirements in line with the World Customs Organization's recommendations under the Framework of Standards to Secure and Facilitate Global Trade (SAFE). See below a comparison of the current and new rules.

| | *Current rules* | *New rules* | *SAFE rules* |
|---|---|---|---|
| Timing of filing | 24-hours before arrival at Japanese port | 24-hours before departure of the vessel from the port of loading | Before departure of the vessel from the port of loading |
| Party responsible for filing | Captain of vessel | Vessel operator or NVOCC | Vessel operator or their representative |
| Required data elements | Equivalent to master bill of lading | Equivalent to house bill of lading | Equivalent to house bill of lading |
| Electronic submission | Optional | Required | Required |

Japan Customs recently released further details regarding the new requirement, including the proposed data elements, which are as follows:

### Proposed data elements of advanced filing rules on maritime container cargo information

1. Consignor name
2. Consignor address
3. Consignor telephone number
4. Consignor country code
5. Consignee name
6. Consignee address
7. Consignee telephone number
8. Consignee country code
9. Notify party name
10. Notify party address
11. Notify party telephone number
12. Notify party country code
13. Description of goods
14. Harmonized system code (6-digit)
15. Number of packages
16. Total gross weight
17. Volume
18. Mark and number of cargo
19. Carrier code
20. Vessel code (call sign)
21. Voyage number
22. Port of loading
23. Estimated date and time of departure
24. Port of origin code
25. Port of discharge code
26. Estimated date of arrival
27. Place of delivery
28. Bill of lading number
29. Container number
30. Seal number
31. Container size code
32. Container type code
33. Container ownership code
34. Dangerous goods code (IMDG code)
35. Whether each container is empty or full
36. Processing category code


In addition, a relaxed application of the rules is currently being considered with respect to certain short-distance shipping routes. These routes include shipments from Russia (Korsakov and Vladivostok), Korea (Pusan, Pohang and Inchon), China (Tianjin Xingang, Dalian, Qingdao, Shanghai and Hong Kong) and Taiwan (Kaohsiung and Keelung) to certain designated Japanese ports. Under the proposed relaxed application, the vessel operators or NVOCC will be required to electronically submit the relevant data elements before departure from the port of loading, instead of 24-hours before departure. It should be noted, however, that no relaxation is currently being considered for shipments to ports in Tokyo, Kanagawa, Chiba, Shizuoka, Aichi and Mie prefectures. Additionally, the relaxed application is intended to be temporary, until the implementation of the Advance Filing Rules is well established.

While the Advance Filing Rules apply to the vessel operator or NVOCC, in order to comply with these requirements, the vessel operator/NVOCC must obtain the necessary data elements from the shippers. Accordingly, exporters to Japan will likely receive requests for data elements from their vessel operators/NVOCC as further details regarding the new requirements become available. Exporters will need to review their information systems and internal controls to ensure that such data can be provided in a timely and accurate fashion.

Watch for further developments in future issues of *TradeWatch*.

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# Relaxation of document submission requirements for customs clearance

As part of the 2012 tax reforms, the Japanese legislature passed a bill to relax certain requirements regarding the submission of certain import/export related documentation at the time of customs clearance. The amendment became effective 1 July 2012.

Prior to the entry into force of the amendment, importers and exporters were required to submit an invoice with their import/export declarations (some exceptions apply). Now, importers and exporters are only required to submit contracts, invoices or other documents to support their import/export declarations where Japan Customs (Customs) determines that such supporting documentation is required to issue an import/export permit.

Shortly before the entry into force of this amendment, Customs issued guidance clarifying that in general, submission of invoices/packing lists and individual customs valuation declarations (an additional form for imports where customs value is not based on the transaction value method) will no longer be required for low-risk Category 1 imports (simple check only), but will continue to be required for Category 2 and 3 imports (documents review and/or physical inspection).

This is a welcome development for companies that have previously generated pro forma invoices manually to support their customs value, such as in cases where the goods are imported under a sales contract, but the transfer of title and generation of invoice do not occur until after import. While the guidance suggests that importers will nevertheless be required to submit invoices for Category 2 and 3 imports, the language is more relaxed, and Customs appears to be more flexible in accepting documents other than manually generated pro forma invoices for Category 2 and 3 imports, for instance, price lists. However, this should be confirmed on an individual basis with Customs in advance of import.

Overall, the relaxed documentation requirements work to facilitate trade, but with the understanding that Customs conducts post-importation reviews to confirm compliance. In this respect, we emphasize that while the submission of invoices may no longer be required for Category 1 shipments, importers and exporters are required to maintain evidence — which generally includes invoices — to support their declarations for five years. The customs audit provides Customs with more time to verify the accuracy of declarations post-importation, so that low-risk imports can benefit from faster customs clearance. At the same time, importers should be prepared to face increased scrutiny of customs values and supporting documents during post-entry customs audits.

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# Extension of retaliatory tariffs to certain bearings from the US

The Japanese Ministry of Finance recently announced a one-year extension of the retaliatory tariffs applicable to certain bearings originating in the United States, which were set to expire on 30 August. The scope and duty rates were also reviewed. As of 1 September 2012, ball bearings classified in Harmonized System (HS) 8482.10 are no longer subject to retaliatory tariffs. However, the retaliatory tariffs on tapered roller bearings (including cone and tapered roller assemblies) classified in HS 8482.20 will increase from the current 1.7% to 4%.

As background, Japan has imposed retaliatory tariffs on certain bearings from the United States since September 2005, because the United States did not amend the Continued Dumping and Subsidy Offset Act of 2000 (commonly referred to as "Byrd Amendment") and specifically, its provision to distribute anti-dumping duties collected in the United States to affected companies) despite a 2003 WTO ruling finding that the Amendment was not compliant with WTO rules.

While the Byrd Amendment was terminated on 8 February 2006, transitional provisions continued to allow the distribution of anti-dumping duties for goods cleared through customs before 1 October 2007. Due to extended legal and court procedures, the duties collected before this cut-off date are still being distributed today. Accordingly, Japan has extended the retaliatory tariffs annually after reviewing the retaliatory tariff rates and scope so that retaliatory tariffs will be aligned with the distributed anti-dumping duties.

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# New Zealand

## Customs targets importers with royalties and other required uplifts to the value of imported goods

The New Zealand Customs Service (Customs) is currently targeting importers that are required to uplift the value of the imported goods. The most common form of uplift is an adjustment for royalties payable in respect of imported goods. Importers that are flagged in Custom's system as requiring an uplift are being sent a letter requesting specific information. For example, some of the questions concern the nature of the uplift and the time at which the uplift is reviewed. Customs is also communicating a strong reminder regarding the consequences of noncompliance in this area.

This article briefly highlights the negative consequences for importers as a result of this current activity (the bad news) and the opportunities that are available (the good news).

### *The bad news:*

- In our discussions with Customs on this issue, the increased activity is clearly a result of pressure for Customs to collect additional revenue, even if the revenue is only in the form of Goods and Services Tax (GST) applicable to the imported goods and the importer is able to recover the GST from Inland Revenue.
- Customs is changing their internal processes to closely monitor compliance in this area. Affected importers should now expect to receive frequent requests for information from Customs.
- Customs has the power to impose significant penalties for noncompliance (refer to our previous coverage of the new penalty regime for importers in our June 2012 issue of *TradeWatch*), even in cases where there is only GST at stake.

### *The good news:*

- Customs views the existing approach to uplifts (i.e., where a set percentage is applied throughout the year and reviewed on an annual basis) as an administrative practice to address the technical requirements of the Customs & Excise Act 1996 in a pragmatic manner. Fortunately, Customs is not seeking to change this administrative practice.
- Royalties and other payments (such as management fees) made to non-residents are not necessarily required to be included in the value of the goods for customs purposes. The payments need to meet the prescribed criteria set out in the Customs & Excise Act. It is prudent to establish whether there is in fact an exposure for customs purposes before accepting any course of action proposed by Customs.
- It may still be possible to make a voluntary disclosure to eliminate any penalty exposure.

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# European Union

## Challenges for the technology sector as the ECJ addresses tariff classification for components

Information technology goods have generally enjoyed duty-free access since the 1996 implementation of the WTO's Information Technology Agreement (ITA). In the EU, the ITA tariff exemption has been partially implemented in heading 8486 of the customs tariff, which covers machines used for the manufacture of *inter alia* semiconductor devices and integrated circuits. As a result, products classified under certain subheadings of 8486, which include parts and accessories, can be imported duty-free into the EU. However, a recent European Court of Justice (ECJ) judgment serves as a reminder that not all components qualify as parts and accessories and thus, may be subject to duty.

### Components of semiconductor manufacturing machines excluded from duty-free treatment in the EU

On 19 July 2012, the ECJ delivered its judgment in a customs case concerning the tariff classification of polishing pads intended for semiconductor wafer-polishing machines. The pads, in the form of discs that measure approximately 40 cm in diameter and 3 mm thick, are adhesive and made up of different plastic layers and are intended for polishing machines for working semiconductor materials.

At issue was whether these polishing pads should be classified under:

- Tariff code 8466 91 15, as parts or accessories suitable for use solely or principally with the machines classified under headings 8456 to 8465

or

- Tariff code 3939 90 10 as a self-adhesive flat shape made of plastic, on the basis of its constituent material

We note that the case also involved imports prior to 2007, when the customs tariff was modified. For purposes of this article, we focus on the current tariff classification codes.

According to the ECJ, the polishing pads should be classified under tariff code 3939 90 10 for the following reasons:

- In principle, there are arguments to classify the polishing pads at issue under Chapter 39, considering their physical characteristics.
- The notion of "parts" implies a whole for the operation of which the part is essential and the notion of "accessories" implies an interchangeable part designed to adapt a machine for a particular operation, or to increase its range of operations, or to perform a particular service relative to the main function of the machine.
- The polishing pads cannot be considered to be "parts" or "accessories" suitable for use with semiconductor wafer-polishing machines and cannot therefore be classified under heading 8486 of the customs tariff.

The definition of "parts" and "accessories" was given in earlier ECJ judgments with respect to network cards and ink cartridges, which considered classification under the duty-free heading 8473 (i.e., parts and accessories of heading 8471). However, this is the first judgment in which the ECJ practically applies the criteria to parts and accessories of heading 8486. In this case, polishing pads are excluded as "parts" of wafer-polishing machines by the ECJ because they are not essential for the operation of wafer-polishing machines. Hence, the argument that the polishing pads are exclusively intended to be fitted on certain types of wafer-polishing machines is not decisive to conclude that the concerned product is a part or accessory. Accordingly, these components of semiconductor manufacturing machines have been excluded from duty-free treatment in the EU.

## Practical consequences

Based on this ECJ judgment, importers should not rely on the component's "sole or principal use" with a product classified under 8486 to classify the product as a duty-free part or accessory of this heading. Rather, the definition of "parts" and "accessories" as provided in this case should be referenced in the classification determination. In a broader sense, the judgment may trigger examination not only on components classified as parts and accessories of heading 8486, but also on components classified as parts and accessories under other headings in Chapter 84.

This is an area that may attract additional customs scrutiny, particularly in the event of a customs audit where the company can face significant exposure for underpaid duty. Component suppliers and importers should review their tariff classifications, particularly where such products have been classified as parts and accessories of products in Chapter 84. Importers should also consider applying for a Binding Tariff Information from the Customs authorities to obtain certainty with respect to the tariff classification of a product.

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# Pharmaceutical sector benefits from recent ECJ tariff classification judgment

In the EU, pharmaceutical products are classified under Chapter 30 of the customs tariff and are duty-free. However, the raw materials used in the manufacturing of pharmaceutical products are not always considered as pharmaceutical products for tariff classification purposes and may be subject to high duty rates.

On 12 July 2012, the ECJ delivered its judgment in a case concerning the tariff classification of blood albumin, an important raw material for the pharmaceutical sector that is used as a growth medium for cells. The result is a positive development for the pharmaceutical sector that could have far reaching implications.

## Blood albumin not prepared for therapeutic or prophylactic use is considered a pharmaceutical product

The case involved blood albumin derived from bovine animal blood, which is not suitable for human or animal consumption. It is used as a growth medium for cells and constitutes one of 14 components in the preparation of certain antibodies used in the treatment of certain illnesses and health issues. The market price of the product is approximately US$600 per kg, where as blood albumin used in the food industry costs around US$6 per kg.

The importer classified the product in Chapter 30 as a pharmaceutical product under tariff code 3002 10 10 (Antisera), duty-free. However, the Dutch Customs authorities argued that the product should be classified under Chapter 35 (Albuminoidal substances; modified starches; glues; enzymes) under tariff code 3502 90 70 (Albumins, other than egg albumin and milk albumin (lactalbumin)), subject to a duty rate of 6.4 %. The Dutch Customs authorities referred to note 1 of Chapter 30 of the customs tariff, which excludes blood albumin not prepared for therapeutic or prophylactic use from being classified under Chapter 30. Prophylactic means "preventive" or "contraceptive."

At issue was whether the product was prepared for therapeutic or prophylactic use, in spite of the fact that the product itself has no therapeutic or prophylactic effect, but was produced for the preparation of products with such effect. The product at issue is essential to the preparation of products with a therapeutic or prophylactic effect and, by its nature, can only be used for such purpose.

According to the ECJ, the blood albumin is prepared for therapeutic or prophylactic use for the following reasons:

- The intended use of the product is decisive.
- Neither the notes in Chapter 30 and Chapter 35 of the customs tariff nor the explanatory notes relating to the tariff headings 3002 and 3502 state that blood albumin must have an inherent therapeutic or prophylactic value.
- The expression "prepared for" must be understood as having a two-fold meaning: a product may, either by nature be used directly for therapeutic or prophylactic purposes, or be prepared for such use.

Accordingly, blood albumin which does not have an inherent therapeutic or prophylactic effect cannot be excluded from the classification under Chapter 30 (pharmaceutical products) of the customs tariff.

## Practical consequences

The ECJ judgment allows for blood albumin, which was produced for the preparation of products having a prophylactic of therapeutic effect (i.e., antibodies), and which, by its nature, may only be used for that purpose, to be classified as a pharmaceutical product under Chapter 30, duty-free. Considering the market price of this type of blood albumin, the ECJ decision is welcome news for the pharmaceutical industry. We emphasize that the judgment does not apply to all types of blood albumins.

At the same time, the judgment may have far reaching implications. There may be other imported raw materials that meet the criteria established by the ECJ in support of a duty-free classification as a pharmaceutical product. Accordingly, pharmaceutical manufacturers should review their tariff classifications for imported raw materials to assess whether the judgment could support a duty-free classification for their products. Importers should also consider applying for a Binding Tariff Information from the customs authorities to obtain certainty with respect to the tariff classification of a product.

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# Norway

## Liability for NOx emissions excise duty — implications for petroleum companies

Norway's excise duty on emissions of nitrogen oxides (NOx) is an important environmental tax levied on petroleum activities on the Norwegian continental shelf (NCS). For oil and gas installations, NOx duty liability can be significant. For 2012, the rate is set at NOK16.69 (US$2.75) per kg NOx, which suggests a daily excise rate exceeding NOK25,000 (approximately US$4,120) for a medium-sized vessel. For an oil and gas rig, the annual excise rate can easily amount to over NOK10 million (US$1.6 million), except for companies that pay lower rates as members of the NOx fund (which we discuss later).

The NOx duty applies to both domestic and foreign entities. The determination as to the entity (e.g., owner, licensee or operator) that is liable for NOx registration and payment is not always clear. Given that the NOx duty can represent substantial costs for petroleum companies, it is important that the players know whether or not they are liable for paying the duty, particularly when entering into contract negotiations.

### Liability for NOx duty

Pursuant to the wording of the regulations, it is the company that owns or operates the source of emission that is liable to register and pay the excise duty. We note that the Norwegian word used is "driver," which means anyone who operates the emission source, but not necessarily the field operator. It is established practice that the field operator is liable for the payment of NOx duty for emissions from permanent oil and gas installations on the NCS. It is also agreed that the liable party for NOx emissions from a vessel is the vessel owner. At issue is which party is liable with respect to NOx emissions from movable oil and gas rigs (e.g., jack-up rig) both in transit and when the rigs are "on location."

A Municipal Court ruling dated 29 March 2011 addressed the issue of whether or not the legal framework provides legal authority to hold field operators liable for the payment of excise duty on movable oil and gas rigs "on location." While the wording of the statutory provision provides little or no guidance, the court found other legal arguments to support the conclusion that the field operator can be held liable.

The court reasoned that making the field operator liable would be best aligned with the legal framework governing pollution control in general. In this respect, the Norwegian Pollution Control Act from 1981 provides that an approval must be granted by the Norwegian Pollution Control Authority before any polluting activities are undertaken. On the NCS, this approval is given to the field operators and all "polluters" operate under these approvals. In that sense, placing the liability on the field operators to pay the duty corresponds with the governing principle, "the polluter pays," (EEA agreement art. 73). It should be noted that this governing principle does not apply to all fields (e.g., direct taxation).

An element that obscures the picture above is the NOx Fund, which is the primary policy instrument to reduce NOx emissions in Norway. The State of Norway has entered into an environmental agreement with industry organizations regarding the reduction of NOx emissions. To that effect, the industry organizations have established a separate NOx fund that will be used to fulfill their commitments under the agreement.

The head of the NOx Fund, under his testimony in court, stated that it was crucial for the effectiveness of the Fund that the liability for the excise duty was put on the rig owners or the rig entrepreneurs, and not the field operators. His argument was that if the rig owners were not liable for the NOx duty assessed on movable rigs, the gain from becoming a member of the NOx Fund would not be significant enough to be an incentive for the rig owners to participate. In other words, the rig owners, who can actually effect physical changes to the oil and gas rigs to reduce emissions (e.g., installing accurate NOx measurement gauges), would not become members of the Fund and hence, would not be compelled to comply with the measures set forth in the Fund agreements.

The court agreed that making the rig owner or rig entrepreneur liable for the excise duty would be a more efficient way of fulfilling the goals of the NOx Fund; nevertheless, the court reasoned that the field operators could join the fund for emissions from the movable rigs and demand that NOx reducing measures be covered under their contract with the rig owner. Moreover, the court found that the established practice of the NOx Fund, i.e., aiming the incentives toward the rig owner and not the field operators, did not carry sufficient weight as the Fund is a private foundation. The court considered that contracts between the field operators and rig owners/entrepreneurs could cover all the information and measurements necessary to fulfill the NOx legal requirements.

Considering that this issue has not been tried before the Norwegian Supreme Court, the decision of the Municipal Court has limited precedent. Further, this decision has been appealed to the Court of Appeals and main proceedings are expected to commence in October 2012. Accordingly, it is likely that we have not yet seen the definitive solution to the issue of NOx liability for moving oil and gas installations.

## Implications for petroleum companies

For now, the liability rests with the field operators to pay the NOx duty assessed on movable oil and gas rigs "on location" on the NCS, pending the upcoming decision by the Court of Appeals or ultimately the Supreme Court. Field operators that have not paid NOx duties on such movable rigs because the duty has been paid by the rig owner are at risk that the customs authority will issue a post-clearance assessment if the error is not disclosed and dealt with.

Additionally, the case highlights the importance of the contractual arrangement between the rig owner and the field operator. A contractual relationship is necessary in order for the field operator to become a member of the NOx Fund, which is vital in terms of reducing costs and fulfilling industry's obligations under the agreement. The contract also becomes important in terms of allocating the costs of the NOx obligation. Furthermore, it is clear that the rig owners/entrepreneurs are the players that have the means necessary to perform accurate NOx measurements by installing NOx measurement gauges, etc.

Finally, liability for emissions from movable rigs under transit has not been specifically addressed by the courts. The consensus is that as long as the movable rig has its own propulsion system, the rig is viewed as a vessel and hence, the rig owner is liable for the excise duty. On the other hand, if the rig is towed on behalf of the field operator, the legal situation is more uncertain and requires an in-depth legal analysis.

Watch for further developments in future issues of *TradeWatch*.

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# Turkey

## Customs modernization — advantages of the single-window practice in Turkey

The provisions regarding the "single-window" system, which is included under the Modernized Customs Code accepted with EU Council Regulation no. 450/2008, will be implemented in all EU Member State in 2013. It is expected that this system will also come into effect in Turkey in 2013.

The single-window system aims to coordinate border control procedures, such as port transactions, customs transactions, technical controls and licensing through an integrated management system. This system shares the information and documentation electronically with the relevant government institutions/administrations in Turkey to expedite the collection of necessary approvals for more efficient customs clearance.

In Turkey, the implications of the single-window system are significant. Border controls not only involve revenue collection, but also involve other controls designed to protect intellectual property rights and public health and safety as well as prevent unfair competition. Approvals and permissions from different government agencies are commonplace for import transactions and oftentimes delay customs clearance. This is because the permission and approval process is currently conducted between the customs administration and each relevant government organization in paper form. This practice is time consuming and administratively burdensome. For instance, the importation of electronics requires an approval letter from the Turkish Standards Institution that must be attached to the appendix of the declarations submitted to the customs administration before the shipment will be cleared by customs.

A study conducted by the Ministry of Trade and Customs found that 330 different documents are used in customs transactions and 309 of these documents are collected from institutions/administrations other than the customs administration. In other words, only 21 of these documents are provided by the customs administration. Solely by considering these figures, it is clear that other institutions/administrations have an impact on the customs clearance process.

Under the single-window system, all required documentation and information required for the import/export operation is submitted by the trader to a single application point, using an internationally accepted standard form. The information is then shared with the relevant government agencies, which will submit their approvals as required to the same application point in electronic form. Accordingly, the necessary controls to effect the trade transaction are conducted in the same time and place through coordination and cooperation.

Under this advantageous system, the trader benefits from faster customs clearance, which also means reduced customs costs, such as warehousing, demurrage and loading/unloading expenses that can be significant when there are extensive border delays. The improved supply chain speed and certainly also presents new opportunities for business with respect to inventory management and production planning. Additionally, the electronic environment improves the tracking of trade transaction data. Accordingly, it is important that traders review their information systems and internal controls to ensure the accuracy and availability of the required data for compliance purposes.

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# Ukraine

## Ukraine ratifies FTA with CIS countries

On 30 July 2012, the Verkhovna Rada of Ukraine ratified the Commonwealth of Independent States (CIS) FTA. The agreement had been signed last October by eight CIS countries, namely, the Russian Federation, Armenia, Belorussia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan and Ukraine. Ukraine is the third Member State that has ratified the CIS FTA after the Russian Federation and Belorussia.

### Overview

The CIS FTA has replaced existing bilateral and multilateral free trade agreements that were in force between CIS Member States. The agreement calls for the gradual cancelation of customs duties and tariff quotas for goods originating in the member countries, although a broad range of products are excluded (which we discuss later).

The CIS FTA also:

- Limits the possibility of increasing duties on goods that are removed from the free trade regime
- Obligates participating countries not to apply new restrictions in mutual trade
- Determines the terms for repealing import exemptions
- Initiates the process of abolishing export duties
- Reduces the number of existing agreements that guide trade and economic relations with CIS countries
- Fosters resolution of trade disputes in accordance with WTO mechanisms and procedures

### Economic outlook

The Ukrainian Government is optimistic that the implementation of the CIS FTA will have a positive impact on the Ukrainian economy and trade. Based on an economic feasibility report prepared for the ratification, Ukraine's gross domestic product is estimated to increase by 2.5% upon implementation of the agreement with certain industries expected to benefit significantly.

For instance, the Ukrainian metal manufacturing industry will benefit from the upcoming export duties cancellation under the free trade regime. The resulting growth in this industry could increase by more than 4%, especially within the tubes and rolled metal manufacturing sector. It is worth noting that the Ukrainian budget may substantially suffer from the cancellation of export duties for scrap of ferrous and non-ferrous metals.

The Ukrainian agriculture and food manufacturing industry could benefit from the end of "trade wars" between Member States, removal of sanitary barriers and abolishment of anti-dumping measures (such as those applied to Ukrainian confectionery products) under the agreement. This industry growth is expected to exceed 3.5%.

The CIS FTA could have the most significant impact on the Ukrainian machinery industry (the contemplated increase is about 7%). The CIS territory has historically been a vast trade market for Ukrainian machines, tools and spare parts, valves and fittings and electric transformers. Removal of tariff barriers, such as import duties and quotas makes these Ukrainian goods more market and price accessible in the CIS area.

At the same time, the Ukrainian Government sees some potential threats of the agreement that may impair the positive effect of CIS free trade. Specifically, the agreement contains a great number of commodity exclusions and restrictions for mutual trade between Member States, including crude oil and natural gas that are vitally important for Ukraine. A positive development, however, is that the list is exhaustive and should not be extended.

To some extent, the prospects of the CIS FTA depend on whether the Russian Federation will continue discussions on reducing the commodity exclusions mentioned. Also under negotiation is access to the pipeline transit networks of Member States, which would benefit the distribution of Middle East natural gas imports to Ukraine.

Notably, the Verkhovna Rada's authorized committee did not support the ratification of the CIS FTA. The committee representatives stressed that ratification of the proposed agreement could create a double standard legal system in mutual trade with the Customs Union countries (Russia, Belarus and Kazakhstan). Specifically, the legal provisions of the Customs Union will have priority over the agreement. From a practical perspective, this may permit the Customs Union Member States to impose additional trade sanctions and restrictions on the Member States that are parties to the agreement, but are not participants of the Customs Union.

The CIS FTA enters into force on 23 September 2012.

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# East African Community

## Authorized Economic Operator making progress in East African Community

The revenue authorities within the East African Community (EAC) have established customs modernization departments with several projects to improve customs administration and revenue collection. One of the modernization projects is the Authorized Economic Operator (AEO). An AEO is an institution (e.g., importer, clearing agent or transport company) that is authorized to import and move cargo within the EAC region without undergoing cargo inspections and other customs interventions that can cause delays at customs check points. Instead, the AEO only faces customs review sometime after importation in the form of post-clearance audits (which, we note, non-AEOs are also subject to) to confirm compliance with the customs rules and regulations.

### AEO progress in the EAC

The EAC partner states launched the AEO program in 2008 to be implemented through a pilot program. However, there was a lack of consistency with respect to the application of each member's pilot programs. One of the primary challenges was that not all partner states were accepting a registered AEO evaluated by another state's revenue authority, despite the intent for mutual recognition.

In March 2012 at the 5th steering committee meeting for the World Customs Organization- EAC facilitation project, all five EAC partner states (Rwanda, Uganda, Kenya, Tanzania and Burundi) officially signed a new common customs policy for AEO.

Under this common policy, AEO authorization is granted to institutions that:

- Meet key requirements with respect to customs compliance
- Have fully functional and technologically strong information systems
- Have an internal program of self-assessment to promote customs compliance
- Once the AEO program becomes fully implemented, registered importers will have the following benefits:
- Reduced transport costs due to faster deliveries of cargo across the region
- Reduced storage costs/demurrage considering that the goods are not subject to customs border inspections
- Reduced customs intervention for goods in transit since the goods are not subject to customs border inspections

All EAC partner states are still in the pilot phase, and Kenya and Uganda have been actively promoting the AEO project by requesting interested parties to apply and be evaluated for possible consideration. In Kenya, as of August 2012, over 60 companies have been registered for the program.

## Implications for business

AEO in the EAC is designed to reward companies that establish themselves as "low-risk" importers with faster cargo clearance so that the revenue authorities can focus their resources on higher risk importers. AEO status can provide companies with significant competitive advantages in terms of supply chain certainty and reduced import costs.

Only companies that meet the EAC AEO requirements will be granted AEO status. Accordingly, it is important that interested companies prepare by conducting an effective self-assessment prior to AEO application.

As part of the self-assessment, the following actions should be considered:

- Undertake a customs health check (i.e., customs review/internal audit) of your import and export operations. Any identified exposure can be voluntarily disclosed to the customs authorities with the payment of any tax deficiencies.
- Implement procedures and internal controls that promote continued compliance with all customs laws and regulations.
- Undertake a review of the company's information systems to ensure that necessary data is accurate and can be timely provided to the revenue authorities upon request.

Overall, during these turbulent times of economic downturn, businesses need to consider all opportunities to reduce product costs in order to be competitive. With the AEO program's progress in the EAC, the cost and supply chain advantages of this preferred status are starting to materialize. More than ever, AEO is poised to become a significant customs modernization program that benefits compliance-minded traders in the region.

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