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TradeWatch

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Spotlight on Canada

Canada Border Services Agency changes policy on allowing duty refunds from post-importation transfer pricing adjustments

The Canada Border Services Agency (CBSA) has removed a longstanding barrier to filing import duty refund claims pursuant to downward transfer pricing (TP) adjustments based on post-importation adjusted values. This is a welcome change in policy for importers of dutiable goods purchased in related-party transactions. Until now, the CBSA had generally refused to issue a refund of customs duties in circumstances where a downward TP adjustment results in a reduction in the "price paid or payable" (PPP) of dutiable goods. While the change in policy found in Customs Notice N-15-001[1] will allow refund claims to be made, it also means that downward TP adjustments must now be declared by way of voluntary amendments to self-correct the original declaration within a specified period. It is also likely that the CBSA will conduct more valuation audits (verifications) to ensure compliance and to offset revenue losses from duty refunds.

Background

The 180-degree turn in the policy treatment of TP adjustments was ostensibly prompted by the recent Canadian International Trade Tribunal (CITT) decision in Appeal No. AP-2012-067, *Hudson's Bay Company v President of the Canada Border Services Agency* (21 March 2014). The CITT ruled that the Customs Act (the Act) does not preclude an importer from recovering import duties if the PPP for the imported goods is reduced after importation by way of a discount or rebate that was "effected" (in existence) under a legally binding agreement, where the agreement was in place prior to the importation of the goods. The Act specifically provides that discounts or rebates to reduce the PPP that are effected after the importation of the goods are to be disregarded in determining the value.

However, Hudson's Bay did not involve related parties and TP adjustments. Post-import entry discounts or rebates by an importer unrelated to the vendor are different from TP adjustments, as the latter are by no means certain to occur. TP adjustments depend on the TP study and methodology. For example, if margins stay within a determined range, there will be no adjustments, and if there is an adjustment, it could be upward or downward.

The TP downward adjustment debate has been ongoing for some time well before the Hudson's Bay case. It is more likely the change came about due to pressure from the import community and the fact the US had adopted a similar policy. A review by the CBSA and Department of Finance has been underway for some time. Whatever the reason, it's a welcome change, although it will raise compliance burdens for related-party TP customs valuation purposes.

Requirements under the new policy

Legally binding agreements between related parties to adjust the TP based on TP studies or other acceptable documentation and methodologies under the OECD Guidelines entered into prior to importation will now be accepted as the basis for claiming refunds of import duties that were paid on the TP PPP at the time of importation and that were subsequently adjusted downward. Similarly, upward adjustments require additional duty to be paid. The Customs Notice specifies that in situations where an importer's TP documents and price agreement result in both upward and downward adjustments in a fiscal period, the net total of the adjustments, once determined, must be accounted for and reported to the CBSA. If the importer fails to report the net total of the adjustment, the CBSA will consider the PPP to be influenced by the relationship and unacceptable for customs valuation purposes.

1 The Customs Notice also applies to unrelated party transactions for post-importation discounts where rebate or price reduction mechanisms are in place pursuant to a legally binding agreement. This will trigger potential duty refunds for up to four years in appropriate circumstances (the CBSA had previously taken the position that the discounts must be reflected on the invoice or other documents used to account for the goods at the time of importation).

Self-corrections to the value for duty of imported goods are required within 90 days after a final TP adjustment has been made that results in an increase in the PPP to increase the duties payable (the existing obligation to report any upward TP adjustments remains the same). But the Customs Notice also states that importers may seek a refund of duties under Section 74 of the Act in circumstances where a downward TP adjustment is made to the PPP of dutiable goods, as follows:

- If the net total result is a downward price adjustment and the imported goods are subject to duties, a request for refund can be made for importations occurring within four years of the date of this notice.
- For TP adjustments that are revenue neutral (because the goods are not dutiable) self-correction amendments must be made under Section 32.2 of the Act, although downward adjustment corrections do not need to be reported for final adjustments made for periods closed prior to the date of the Customs Notice (19 January 2015).

Lessons learned

Importers must take into consideration a number of issues as a result of the policy change:

- Related party purchasers must not only have a supportable TP policy in place, but also a TP study or other documentation to justify the arm's-length nature of the transfer price chosen that is acceptable for customs purposes, as the focus is usually on income tax TP. The goals must align and consideration should be given to the impact of the TP on the customs value for duty.
- The TP policy and any adjustments made must be reflected in a written agreement, and the parties must act in accordance with that agreement.
- To avoid penalties, all adjustments, upward or downward, must be properly declared by way of self-corrections to the CBSA within 90 days of the time the adjustment is finalized, or of the time the net total of the adjustments in a fiscal period is determined.
- Importers must be ready for more customs valuation audits. Preparation includes ensuring that all required adjustments to the PPP or TP are declared and supported by documentation. Such adjustments may include amounts for design or other assistance provided to the manufacturer, royalties that are a condition of sale, service fees related to the goods and other payments that are part of the PPP, such as R&D payments made to the vendor.

Implications for importers

The change in policy may affect favorably importers that purchase goods from related parties outside Canada and pay import duties. It will now be possible to determine if refund claims are due, or if the "netting" (interim upward and downward adjustments in the same period) that is now permitted will help reduce the magnitude of upward adjustments the company may need to report.

Furthermore, importers should review adjustments made under any voluntary amendments in the last four years for dutiable goods to determine if refunds are possible. It is also advisable to ensure that the TP is documented and supported from a customs valuation perspective and finally, that a legally binding agreement that is consistently followed from a commercial practice point of view is in place.

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Americas

Argentina

Amendments to the requirement to transfer foreign currency proceeds from export transactions to Argentina

The Central Bank of Argentina (*Banco Central De La República Argentina*, BCRA) has recently amended the list of allowed deductions from foreign currency proceeds from exports of goods.

The foreign exchange regulatory system effective in Argentina since December 2001 requires exporters to transfer to Argentina, within a certain period of time, any foreign currency proceeds from exports of goods and to exchange such currency into Argentine pesos on the single and free-floating foreign currency exchange market.

BCRA's Communiqué A No. 5233, 24 October 2011, provides that financial institutions in charge of monitoring compliance with this requirement may report, without prior authorization from the BCRA, that this obligation has been met, even when the full amount was not transferred to the free-floating foreign exchange market because of certain deductions, in the following situations:

- Missing items, losses and/or deficiencies supported by the exporter's documentation
- Goods damaged prior to delivery as per prior agreement between the exporter and importer that is supported by documentation
- Where the amount of foreign currency collected for deficient shipments is applied to subsequent shipments for the purpose of correcting deficiencies
- Discounts and expenses for services payable abroad, provided that they are disclosed in the export document and that the documentation required for granting access to the local exchange market for this item is available, including prior authorization by the BCRA, when applicable
- Expenses not included in the export document directly related to the placing the goods on the foreign market that are not assessed as of the date of shipment, including, for example, expenses for business promotions and usual discounts debited by the importer related with to the placement of the product on the country of destination's market, provided that:
  - The amount involved does not exceed an amount equivalent to USD5,000 per export document, or the amount equivalent to USD100,000 per calendar year, per exporter
  - The entity in charge of the follow-up has at least:
    - documentation enabling access to the local exchange market to transfer the funds abroad to bear the expenses or discount, or to reimburse the expenses to the importer
    - the exporter's affidavit certifying the authenticity of the declaration

Recently, Communiqué A No. 5701 introduced point 1.6, which adds to the list of allowed deductions listed above "fines for delays generated by the exporter for failing to deliver the goods to the importer in the agreed-upon term," provided that the following conditions are met:

- Such deduction is specifically provided for in the international sale agreement between the parties
- The agreement was executed before the shipping date
- The delay caused by the exporter under the conditions stipulated by the agreement is expressly evidenced
- The exporter and importer are not directly or indirectly related as defined in Communiqué C 40209

Exporters who receive a lower than expected amount of foreign currency proceeds in Argentina should ensure they claim any applicable deductions and that sufficient documentation is available to support such claims.

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Brazil

Update on the implications of the Superior Court's decision to reduce the tax burden on resale of imported goods

Under a recent decision of the Brazilian Superior Court of Justice importers would not be required to pay Brazil's federal value-added tax called "tax on manufactured products" (*Imposto sobre Produtos Industrializades,* IPI) on the resale of imported goods that are not subject to a manufacturing process in Brazil. (Reported in the September 2014 *TradeWatch*.)

The narrow court decision, which resulted from five different lawsuits, was based on the argument that the IPI, when imposed on imported goods, violates the non-cumulative regime of this value-added tax. Additionally, the court determined that IPI should only be levied upon the importation and on the sale of goods that have been subject to local manufacturing processes. Thus, the sale of imported goods that have not undergone any manufacturing process in Brazil should not be subject to IPI.

Although very relevant to Brazilian taxpayers in general, at this time the decision is binding only on the importers that filed the lawsuits. The decision does not apply to all importers because it has not yet become final. The decision of the Superior Court was published on 18 December 2014, but due to the judicial recess, the appeal deadline has been postponed to the middle of March, 2015. Thus, the Brazilian Attorney General of the National Treasury can still appeal it and attempt to take the case to the Supreme Court. This means that every interested importer would have to file its own lawsuit to demand a refund of IPI payments made upon the resale of their imported goods.

Meanwhile, at the time of publication, the Superior Court of Justice is on the verge of hearing a new case on the same issues. To make matters worse from the importers' point of view, this time the court may conduct the process according to the "repetitive appeals" mechanism; Superior Court decisions using this mechanism are binding on all Brazilian courts. Another cause for concern is that the panel of judges has changed from the one that ruled on the first five cases. According to specialists, this fact may change the outcome as the decision issued last year was close: 5 to 3. With this new development and considering the political environment regarding this subject matter, the possibility looms that the court may rule against the importers now under a definitive mechanism.

The decision is expected by the end of March 2015, unless, as noted above, the Government appeals the earlier decision to the Federal Supreme Court.

If the earlier decision, which is favorable to importers, becomes final, its impact can be massive not only to the Brazilian Treasury, which will have to issue refunds to importers for countless transactions over the past five years, but also to the local industry, because imported goods will have an additional advantage (equivalent to about 4.2% reduction in price, according to estimates) over locally manufactured goods, which will still be subject to IPI. In this respect, the local industry estimates that losses due to decreased competitiveness can reach USD7 billion per year in addition to the loss of thousands of jobs.

It is important to note that the Supreme Court adjudicates matters of constitutional law and does not have direct jurisdiction to rule on the merits of a tax law case. Notwithstanding, considering the economic impact and the political interests involved, it is likely that the Supreme Court will hear the case.

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

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Provisional measure increases social contribution rates levied upon importation of goods

Provisional Measure #668 of 30 January 2015, provides for a new increase of the standard rates of PIS and COFINS[2] to 2.1% and 9.65%, respectively for a 2.5% overall increase. The Measure is expected to become effective in May 2015.

The social contributions for PIS and COFINS levied upon the importation of goods were established back in 2004 and since then the applicable regular tax rate has been 1.65% for PIS and 7.6% for COFINS. An additional rate of 1% for COFINS was implemented in 2011 for certain goods according to their tariff classification.

The Ministry of Finance has justified the 2.5% increase to counteract the effects of the Federal Supreme Court's decision that excluded state VAT (ICMS) from the tax basis of these social contributions and adjusted the calculation basis to the customs value of the imported goods. (Reported in the December 2014 *TradeWatch*.)

According to the Minister of Finance, this decision has impacted significantly the cash flow of the Federal Government, which in turn has motivated the tax rate increase.

This increase can impact certain industry sectors that are subject to the PIS/COFINS monophasic treatment, such as cosmetics, perfumery, machinery, vehicles, tires and auto parts, among others, where different rate increases have been set, and which may result an increase of up to 60% of the original value.

That said, if the effective date is not postponed, Provisional Measure #668/2015 is expected to become law in the beginning of April 2015. Notwithstanding, it is not unusual for the National Congress to make adjustments to the original text, or even to disapprove certain rules that were created by similar provisional measures. This possibility is creating anxiety among importers who face an uncertain future.

It is difficult to predict the final outcome of the Provisional Measure. The Federal Government expects to collect around USD250 million this year and another USD350 million in 2016 because of it. Considering the current Brazilian political scenario and the difficulties of the current government to reduce expenditures, it seems that increases of the tax burden, such as this one, are key actions the Federal Government will start implementing to reduce public deficits.

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2 This is a kind of tax which provides federal contributions to two government programs: Social Integration Programs, *Programas de Integração Social,* or PIS, and Social Security Finance Contribution, *Contribuição para Financiamento da Seguridade Social*, or COFINS.

Colombia

Offshore free trade zones in Colombia

Colombia is experiencing an increase of new free trade zones (FTZ). Currently, there are nearly 38 permanent free trade zones (PFTZ) with more than 600 qualified industrial users, and 61 companies that have been authorized as special permanent free trade zones (SPFTZ).

FTZ have been recognized as one of the top new job creators in Colombia. According to statistics issued by the Ministry of Commerce, Industry and Tourism, and the National Administrative Department of Statistics (*Departamento Administrativo Nacional de Estadística*: DANE), FTZs have created nearly 112,000 new jobs. In addition, FTZs have encouraged foreign trade operations, with approximately USD858 million of imports, and USD444 million of exports (FOB value) during the third quarter of 2014.

To stimulate the hydrocarbons sector, promote economic development and create new jobs, the Colombian Government is offering customs and tax incentives to applicants for offshore FTZs. The conditions and requirements that must be met are set forth in Decree 2682 of 2014.

An offshore FTZ or PFTZ for oil and gas production may be granted for any maritime area in the country subject to a formal agreement with the National Hydrocarbons Agency. Land-based FTZs may be granted for other oil and gas-related services and activities.

The Colombian Government expects that these new incentives will increase the competitiveness of the Colombian hydrocarbon industry in general. Businesses that can effectively make the most of these incentives can often secure a competitive advantage.

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

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Peru

Tariff reduction and modification of the drawback regime refund rate

The Peruvian Government, in an effort to encourage economic efficiency and competitiveness, has recently approved regulatory provisions to reduce the tariff rates of a group of national subheadings and to reduce the applicable rate of the drawback regime for 2015 and 2016.

Tariff reduction

Through Supreme Decree No. 312-2014-EF (published on 6 November 2014), duty rates for 1,817 national tariff subheadings were reduced from 11% and 6% to 0%. The amended duty rates are related mostly to inputs and raw materials and include the list of environmental goods from the Bali round of the Asia-Pacific Economic Cooperation (APEC) negotiations. Additionally, the tariff reduction also lowers the value basis for other taxes, such as value added tax (VAT), thus lowering the tax amount as well.

The rate reduction was supposed to enter into force on 7 November 2014, but an *errata* was published and the enforcement date was postponed to 6 December2014.

By means of Supreme Decree No. 314-2014-EF (published on 18 November 2014) the Peruvian Government further reduced the number of national tariff subheadings affected by the tariff reduction from 1,817 to 1,085; excluding 732 subheadings from the original list. This modification was intended to take effect on 10 December 2014, which was later postponed until 18 December 2014 and is currently in effect.

Below are charts that show the composition of applicable Peruvian tariff rates before and after the tariff rate reduction.

Drawback reduction

The aforementioned tariff reduction also has a significant impact on the drawback regime and exporters will see reduced opportunity for refund.

Furthermore, Supreme Decree No. 314-2014-EF reduced the applicable refund rate from 5% of the FOB value of exported goods to 4% and 3% for the years 2015 and 2016 respectively.

Implications for importers

The aforementioned modifications have created an opportunity for importers and sellers who may be able to obtain a reduction of their operating costs; nevertheless, these modifications also represent a challenge to producers and exporters who will need to review the proper drawback claim procedure and to analyze possible reduction of benefits for the following years.

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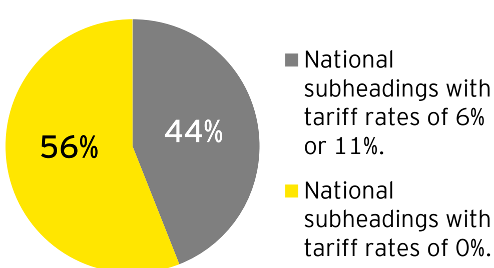
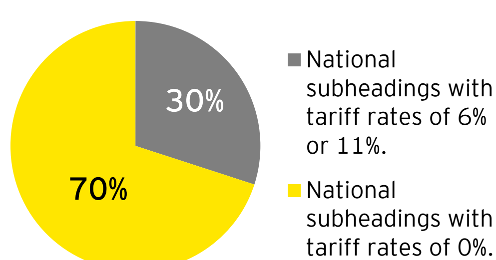
Before tariff rate reduction



After tariff rate reduction



United States

CBP tightens verification of duty preference programs claims process

As the number of free trade agreements (FTA) and other trade programs has increased, so has the interest of the U.S. Customs and Border Protection (CBP) in validating duty preference claims. The validation process has historically been the responsibility of import specialists located at the ports of entry in which the entry has been filed on the imported goods. Often the specialist located at a given port of entry may not have detailed specialized knowledge of a particular industry and HTSUS (Harmonized Tariff Schedule of the United States) code of an imported product, which has resulted in inconsistencies in requests for information, as well as requests for extraneous or inessential information from the importer.

To improve the efficiency of handling such requests, CBP has been reorganizing over the last three years their customs entry and import specialist duties under 10 Centers of Excellence and Expertise (CEE). Each Center is responsible for commodities common to its designated industries. Doing so allows the staff of a particular to CEE to focus on the HTSUS codes of their particular industries and the nuances around them. CBP's requests for information (on CBP Form 28) regarding duty preference claims have begun coming from CEE personnel rather than from an import specialist located at the port of entry. The significance is that these requests are more standardized and suited to the industry.

Given the variation of documentation among industries, CBP has been reluctant to issue a generic "checklist" of criteria needed to support a duty preference claim. Notwithstanding, a CBP official from the CEE for Petroleum, Natural Gas & Minerals[3], recently addressed a local trade group about general principles for supporting a duty preference claim and how to respond to a Form 28 Request for Information about such claim. The presentation also provided insight into the difficulties importers face in supporting a duty preference claim.

The official outlined that the CEE would now expect an importer responding to a request to include a packet of documents in the following format:

- CBP Form 28 Request for Information
- Executive summary
- Certificate or certification of origin
- Evidence of direct export
- Other evidence of origin determination
  - Narrative description of the process
  - Other documents in support of preference criteria
- Additional documents requested by CBP on CBP Form 28

The official emphasized the importance of the narrative description of how the importer determined that the goods were eligible for duty-free treatment. The narrative should reference attached documents, diagrams and calculations used in the determination.

In addition to the documentation supporting the eligibility criteria specified by the duty preference program, the official reiterated CBP's position that knowledge of the supply chain is of great importance. In a recent case, CBP denied a duty preference claim from an importer who purchased crude oil from a supplier in Colombia. The importer had a bill of lading showing that the crude oil had been loaded on the vessel in Colombia, but could not provide proof that the crude oil actually came from an oil field in Colombia.

3 "Organization for DPP Verifications" presented at the FTZ Oil Refinery Subzone Forum of the Upper Gulf Coast on 28 January 2015. Presenter: Laura L. Webb, Assistant Director of CBP's Petroleum, Natural Gas, and Minerals Center of Excellence and Expertise.

The official also described a situation in which a vessel carried goods from a non-FTA country, made a port of call in an FTA country, and obtained a fake bill of lading stating the goods were laden on the vessel in that port. The importer's attempt to defraud the government was later discovered because the importer also was required to provide proof of the bill of lading's legitimacy. Acceptable proof may consist of documentation of the vessel's loading history prior to lading in the FTA country.

For products that undergo a chemical reaction, such as petroleum-based fuels and intermediate oils, the guidance outlines that the documentation must:

- Describe the chemical reaction process
- Provide a schematic description of the refining or chemical process
- Highlight the portion that meets the definition for eligibility under the free trade agreement or program
- Provide a pictorial model of the chemical structure of the material before and after the reaction

Because many suppliers are unrelated to the importer and sales sometimes involve a middleman, the ability to gather such information may be difficult.

With the overwhelming amount of documentation needed to support a claim, at least for certain types of goods and certain industries, businesses throughout the supply chain must develop better methods of sharing information, or risk losing the benefits that the trade program was meant to provide. In the meantime, many importers into the US should affirm whether they can fully support a duty preference claim. If there is uncertainty in their process or support available for the claim, a better alternative may be to plan on initially paying duty on the merchandise that may be eligible for preferential treatment and then, once the claim can be supported, file a refund claim. In some instances, an importer may determine that it is better to forgo a duty preference claim altogether than risk a verification audit in the future.

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Recent CBP rulings focus on the accounting treatment and characterization of post-importation adjustments to determine inclusion in transaction value

Importers looking to claim post-importation adjustments to customs value should be cautious in characterizing and booking the subject payments. In two recent rulings issued to the same importer but covering transactions occurring in two different time periods, US Customs and Border Protection (CBP) considered whether post-importation payments from a parent-manufacturer to its subsidiary-distributor should be included as part of the customs value under the transaction value method of appraisement. These payments were both cash transfers made in accordance with an Advanced Pricing Agreement (APA). CBP's opposing treatment of these payments was primarily based on their characterization and effect on cost of goods sold (COGS). The factors cited by CBP in these rulings should influence future treatment of post-importation payments contemplated by an importer.

Claiming post-importation adjustments to transaction value

The primary method of appraisement for merchandise imported into the US is transaction value, i.e., the price actually paid or payable plus certain statutorily enumerated additions. Often, importers engaging in related party transactions make retroactive adjustments for tax purposes to meet the importer's targeted profit margins pursuant to a transfer pricing policy. These adjustments are properly included in transaction value where the transfer pricing policy meets the five criteria outlined by CBP in HQ W548314, issued on 16 May 2012, and the importer demonstrates arm's-length pricing under customs-specific tests.

Background of the rulings

In HQ H029658, issued on 8 December 2009, the importer in question received a ruling from CBP confirming that related party sales made pursuant to a bilateral APA were appropriately appraised under transaction value. While the transfer pricing approach used by the importer and approved in the APA was profits based, no post-entry adjustments were made for the period evaluated. For later periods, post-entry adjustments were made; in both cases the US profits were too low and to raise these profits into the range specified by the APA, the foreign seller made payments to the US importer. The US importer sought to treat these post-entry adjustments as part of the transaction value, and sought refunds of duties paid on the originally declared values.

"Marketing support" payments that do not affect COGS are not included in the transaction value

In the earlier ruling, HQ H125118, issued on 12 September 2014, CBP considered post-importation adjustments to the importer's profits for tax purposes during several years covered by the APA. The importer booked these payments as a reduction to the marketing expense account and characterized them as "marketing support" payments. The importer argued that these payments were in effect part of the transaction value formula detailed in the APA, as the payments offset unanticipated added costs incurred by the importer in providing consumer incentives. The payments reduced the importer's marketing expense, and correspondingly increased the importer's operating profit into the agreed APA range, producing the same income tax result as if the imported product prices were directly reduced. In addition, the importer claimed the characterization and treatment of the payments was a result of the parent company's inability during the years in question to obtain governmental permission to remit currency overseas if the payment was labeled as "APA support."

Despite these arguments, CBP concluded the payments were for post-importation services unrelated to customs value. Therefore, they could not be included in determining the transaction value of the merchandise. In its decision, CBP relied on the accounting treatment of the goods, noting that this is indicative of the intent of the parties that the price paid for the product was not altered.

APA support payments that do affect COGS are included in transaction value

In HQ H186055, issued on 15 January 2015, CBP considered payments between the same related parties during a later year. For this period, the parties characterized the payments as APA support payments. To support the inclusion of the payments in determining transaction value, the importer provided a complete paper trail illustrating the APA support payments received from its parent were booked as a reduction to COGS, and reflected as such in 2010 tax returns. In this case, CBP determined the five criteria outlined in HQ W548314 were met and allowed the post-importation adjustments to be taken into account in determining transaction value. In its analysis, CBP relied on the characterization of the APA support payments, the reduction in the COGS and the importer's ability to tie the payments to individual entries.

The importance of payment characterization and accounting treatment

Taken together, these two rulings illustrate the importance of the accounting treatment of post-entry adjustments made for transfer pricing purposes when determining the impact on transaction value. Compensating adjustments that directly impact the importer's COGS are viewed as adjustments to the price actually paid, and are considered in the determination of transaction value. Compensating adjustments that affect other accounts of the importer are not likely to be viewed as adjustments to the price actually paid for the product, and consequently will not be considered as part of transaction value.

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Foreign trade zone impacts on proposed value added taxes in Puerto Rico

Companies are presently evaluating the impact of proposed legislation to implement a value added tax (VAT) system in Puerto Rico. Under this proposal, put forth on February 11, 2015 in the Puerto Rico House of Representatives, the personal income tax will be reduced and the sales and use tax and gross receipts tax will be replaced by a VAT of 16% on goods and services. This VAT will be remitted on the importation of goods and levied at each stage in the chain of production and distribution based on the value added at each stage.

Puerto Rico is also within the customs territory of the United States; as such, many companies (in particular in the life sciences sector) avail themselves of the benefits of a foreign trade zone (FTZ). These companies primarily benefit by deferring duties on manufacturing inputs that are ultimately withdrawn from the FTZ and consumed in Puerto Rico, or eliminating duties on inputs that are ultimately exported from Puerto Rico to the United States or otherwise.

Under the proposal, admission of goods into a FTZ in Puerto Rico is not a taxable event; it is specifically excluded from the calculation and remittance of VAT. However, the VAT does apply to the goods upon withdrawal from the FTZ when entered for consumption into Puerto Rico. As a result, VAT payments are deferred on goods in inventory that ultimately remain in Puerto Rico. Additionally, goods that are exported from Puerto Rico (to the US or otherwise) are not subject to the VAT.

In addition to more traditional FTZ benefits, companies that manufacture in Puerto Rico for export (to the US or otherwise) may be able to reduce the compliance obligations and cash flow costs associated with the proposed VAT by establishing a FTZ.

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An evolving focus: Wind River BIS settlement and the effects on export controls enforcement for high-tech companies

Two major questions emerge after the Bureau of Industry and Security (BIS) announced in October of 2014 that the agency had leveled a USD750,000 penalty against Wind River Systems, Inc. (an acquired subsidiary of Intel Corporation) for unauthorized exports of encryption technology items:

- Are US export enforcement trends increasing for encryption technology and related items?
- What additional due diligence should be conducted on pending merger and/or acquisition activities (M&A) in the high-tech industry?

The case alleges that between 2008 and 2011, Wind River Systems sold operating software containing encryption to restricted parties on BIS Entity list (including foreign governments and foreign entities located in China, Hong Kong, Russia, Israel, South Africa, and South Korea) without a license in violation of the Export Administration Regulations (EAR). Wind River's settlement amount, when compared to other large-scale 2014 cases, might be viewed by some as less significant. The Wind River case, however, clearly signals a renewed enforcement focus by BIS to the intangible tech-world — past, present and future.

Companies should expect increased enforcement

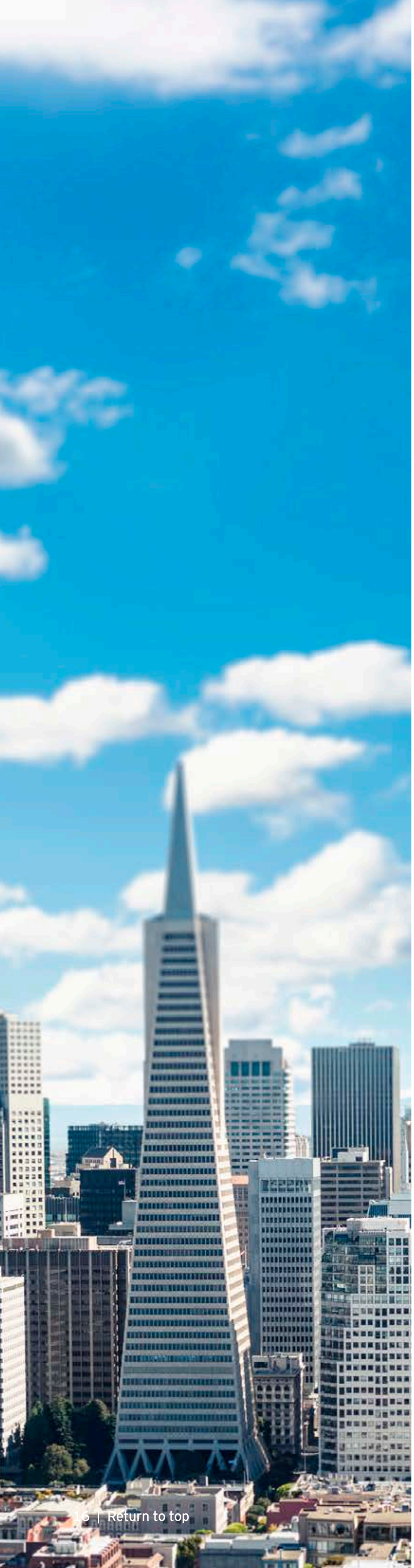
US companies have long been aware that engaging in transactions with parties on the BIS Entity list has built-in risks. Rather this case is unique because it is the first penalty that BIS has publically issued for an export of an item containing encryption to a country or entity not covered by an embargo or other country-based trade sanction.

As technology trade shifts beyond the physical to the intangible, US export enforcement agencies such as BIS and the Directorate of Defense Trade Controls (DDTC) — as well as the accompanying regulations — have lagged behind the light-speed development of new technologies and lacked the resources necessary to enforce export control requirements in the intangible world. However, recent developments in the international intelligence community, including the very public conflict between technology companies (e.g., Apple iOS) and US and foreign governmental intelligence agencies over the implementation of so-called "strong encryption" in personal computers and mobile devices, have pointed to strong possibility of an action against an encryption software exporter for some time; especially transactions with nations and/or entities with perceived risk to US national security interests.

Companies must now pay much closer attention to properly identifying, classifying and managing access to technical data and types of encryption software; or risk getting caught up in this new wave of enforcement.

Parallels in the cloud

If the Wind River penalty action demonstrates BIS's new interest in controlling exports of encryption software, it also signals that the trade community should expect to soon see increased enforcement activity in encryption's companion technology — cloud computing. Avoiding risk in this area is especially complex where neither BIS nor the State Department's enforcement arm — the Directorate of Defense Trade Control (DDTC) — have provided the public with clear guidance regarding the prevention of export violations specifically addressing technical data or software and services in the cloud. The Wind River subject matter should prompt attention from companies rapidly expanding in the cloud space to evaluate encryption technology export risks that may apply to both users and service providers and to manage such risks accordingly.



Reminder for comprehensive due diligence: successor liability

Additionally, the Wind River settlement serves as a reminder that companies should assign or understand export or trade control risk prior to an acquisition or merger (or begin assigning risk where, after the fact of a merger or acquisition, looming issues begin to emerge). The legal theory of "successor liability" has been used by government enforcement agencies to target companies who themselves have not committed export compliance violations for several years. Cases preceding Wind River — such as a USD1.76 million penalty action by BIS against Sigma-Aldrich in 2002 for illegal exports of biological toxins committed by an acquired company, and a USD25 million penalty action by DDTC in 2009 against Luxembourg-based Qioptiq S.A.R.L. in connection with illegal re-exports of ITAR-controlled technology similarly made by an acquired company before the acquisition — each demonstrates a steady and growing appetite by government to pursue enforcement of a company's "past life" in export or trade-controlled activities.

For these reasons, buyers are well advised to include export control due diligence in the evaluation process.

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China

China and South Korea reach free trade agreement

South Korean President Park Geun-hye and Chinese President Xi Jinping announced the successful conclusion of the China and South Korea free trade agreement (FTA) during the annual Asia-Pacific Economic Cooperation summit held in Beijing in November 2014.

After years of negotiations and with all the bilateral trade issues now cleared, the agreement is expected to be formally signed and ratified by both parties as early as mid-2015.

According to reports, the trade pact aims to eliminate around 90% of import tariffs across more than 15 areas over the next two decades, sharply reducing barriers to commerce between the two trading giants.

While limited official information has been released to date as to which industries the agreement will cover, unofficial reports have emerged that the finance, telecom, electronics and online commerce industries are some of those that will be covered. It has also been reported that the agricultural and automobile industries presented the biggest challenge to reaching an agreement.

Economically, this agreement is a win-win for both China, the world's largest exporter, and South Korea, which ranks seventh. Last year, bilateral trade between China and South Korea topped USD220 billion. While China is South Korea's largest trading partner, with bilateral trade accounting for 21% of South Korea's total trade volume in 2013, South Korea is China's third-largest.

Politically, this deal is a success for China and presents another challenge to US influence in Asia, as American negotiators are attempting to get their own regional FTAs in place. The US has been working to conclude negotiation of the 12-nation Trans-Pacific Partnership (TPP). It is unclear at this point whether South Korea (which has a FTA in place with the US) and China, both of whom have expressed interest, will now join in the TPP negotiations.

Businesses need to consider what systems, compliance and documentary requirements need to be implemented in order for them to take full advantage of the free trade opportunities offered by this FTA. Businesses that have undertaken the necessary research and implemented the requisite compliance and documentary processes are able fully exploit and maximizes the particular FTA preferential benefits.

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Japan

Japan customs annual post-entry audit still shows high non-compliance rate in customs valuation

In an effort to ensure compliance with customs laws, particularly with regard to making correct import declarations and paying the correct taxes and duties, Japan Customs, under the Ministry of Finance (MOF), conducts post-entry audits every year. On 7 November 2014, MOF published the results of post-entry audits conducted from July 2013 to June 2014. The results show that the total non-declared and under-declared value of all audited companies was approximately JPY88.8 billion. The total amount of additional customs duty and tax (including penalties) was JPY8.4 billion.

Rate of non-compliance among importers still high

The post-entry audit team audited a total of 3,614 importers. Of these, 2,427 or 71.3% of importers audited were found to have failed to make correct import declarations. The rate of failure to make correct declarations has hovered around 70% in recent years. The top five product categories for this year's post-entry audit and the amount of their duty/tax shortfall are as follows:

Items and HS code	The amount of duty/tax shortfall
1. Meat and edible meat offal (Chapter 02)	JPY1,430 million
2. Electrical equipment (Chapter 85)	JPY957 million
3. Footwear (Chapter 64)	JPY753 million
4. Machinery (Chapter 84)	JPY655 million
5. Apparel and clothing (Chapter 62)	JPY567 million

These top five categories make up about 60% of the total duty/tax shortfall. Typical examples of incorrect declaration cases identified by customs are as follows:

- **Price adjustment amount paid by importer (other than invoicing amount)** – An importer in Japan had a contract with a foreign exporter which stated that the import price should be adjusted based on the domestic sales results of the imported goods. The importer paid an additional amount as adjusted fees to the foreign exporter, which should have been included in the taxable value, but the importer failed to revise the import declaration accordingly.
- **Intentionally adjusted price declaration of frozen pork under variable levy** – An importer of frozen pork from Australia declared a value different from its actual transaction value. The declared value was close to JPY524 per kilogram, a value which makes import duty at the lowest level under the Gate Price system.[4] In Japan, customs duty of pork is subject to the Gate Price system, which sets the lowest possible customs duty at a declared value of JPY524 per kilogram.
- **Value of materials provided by importer free of charge not included in declared value** – An importer of apparel from China had provided cloth and auxiliary materials to the exporter free of charge. The cost of material that should have been included in taxable value was not included in the importer's declared value.
- **Non-declaration of royalty fee pertaining to imported goods** – An importer of food additives from the US had made payment of a royalty fee pertaining to the imported goods to its parent company. This fee should have been included in the declared import value, but the fee was not included when the goods were imported.

4 Gate Price system: If imported pork, priced at entry into Japan, is valued at or above the gate price, then the importer pays only the simple tariff rate (4.3 %). If the import value is lower than the gate price, the importer must pay the difference between the import value and the gate price as a duty, in addition to the tariff applied at the gate price value.

- Fraudulently undervalued invoice declaration subject to heavy additional penalty — An importer of electrical equipment from China had received an original quote document from an exporter, which showed the actual transaction value. However, the importer intentionally made another invoice for customs declaration purposes which showed a lower price in order to claim lower duty. A heavy additional penalty was imposed on this importer in addition to the normal penalty tax.

While the non-compliance rate of audited importers has been stable at around 70% in recent years, the number of audits has been decreasing over the same period. Some commentators consider the primary reason for this decrease to be that more auditor resources have been allocated to targeting key importers of pork under the Gate Price system. Consequently, the total number of audited importers was reduced from about 6,000 importers a year to 3,614 last year and the HS Chapter 02 industry (Meat and edible meat offal) was raised to the top of the duty/tax shortfall category. Nevertheless, this reduction in the number of audited importers is likely to be temporary and we should expect to see more audits in 2015. Furthermore, targeting Chapter 02 industries does not necessarily mean that industries with mainly non-dutiable items are no longer targeted. Industries such as electronics and machinery are likely to continue to attract customs' attention. Given such circumstances and the potential for increased exposure due to the expected consumption tax increase from 8% to 10% in 2017, importers are encouraged to conduct customs health checks to detect hidden customs issues and manage penalty risks in a timely manner.

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East African Community

Trade protectionism in the East African Community

As the East African Community (EAC: Burundi, Kenya, Rwanda, Tanzania and Uganda) continues its transition to a single-customs territory, traders are enjoying reduced customs costs from the free circulation of goods within the region, a common external tariff (CET) and reduced non-tariff barriers. Certain "sensitive" goods, however, continue to be affected by trade measures aimed at protecting the local "infant industries" that need more time to grow and prepare for foreign competition.

Increased duty for list of sensitive items imported into the EAC

When the EAC partner states signed the Customs Union Protocol, they agreed to eliminate all internal tariffs and apply a CET to imports from outside the EAC. The EAC adopted a three band tariff as follows:

- Raw materials — 0% import duty rate
- Intermediate goods — 10% duty rate
- Finished goods — 25% duty rate

The partner states also agreed to approve a list of "sensitive items" subject to import duty rates of more than 25% (between 35% and 100%). These sensitive items are those imports into the EAC that can be imported, but which are also produced by upcoming local industries within the region. Some of these items are necessities and include milk, wheat, maize/corn, wheat flour, maize flour, rice, sugar, cigars, matches, khangas/kikoyi/kitenge[5] and used clothing.

The sensitive list has been implemented since 2005 with only a few adjustments to date. For instance, last year cement was removed from the sensitive list.

Milk imports are taxed at 50% to 60%. Used clothing and sugar are subject to higher rates to give the textile and sugar manufacturers a chance to grow and compete in the local market. This would then imply that the past nine or so years have given the nascent industry some time to grow and be able to compete with imports of other foreign brands.

Increased duty for steel and iron imports into Kenya

The June 2013/14 *EAC Gazette* introduced increased rates of duty on imports of certain steel and iron products from an initial 0% to 10% or from 10% to 25% in Kenya. The increase was introduced to protect local industries that were operating at a loss and were being displaced by cheaper imports. With plans to build the standard gauge railway in East Africa, as well as plans for other infrastructure projects, demand for steel and iron products is expected to rise significantly.

Increased duty for paper imports into the EAC

In October 2014, Kenya reintroduced a 25% duty on imported paper and paperboard not made in EAC. This was after the EAC had studied and agreed that paper is an intermediate product and should therefore attract the intermediate goods duty rate of 10% under the CET. Again, for Kenya it was a move to protect local producers from competition from foreign suppliers. Other EAC member states continue to impose a 10% duty rate on the same products.

5 Types of traditional fabrics and garments from the East Africa region.

Import quota limits on sugar imported from COMESA into Kenya

Sugar has continued to be a sensitive item in the EAC region with an import duty rate of 100% or US$200 per metric ton. On the other hand, under the EAC's trade agreement with the Common Market for Eastern and Southern Africa[6] (COMESA), the duty rate for sugar is 0%. However, even though some countries, such as Egypt, Zambia and Zimbabwe are members of COMESA, some of them, for example, Egypt, subsidize their industries, thus making their goods cheaper and more competitive than their EAC counterparts. The Kenyan Government has been requesting the COMESA secretariat, in a bid to protect local industries, to limit sugar imports from COMESA into Kenya, so that the local suppliers may benefit from an increased demand for their sugar.

Closing thoughts

Protection of local industries is a key step toward current growth and future economic development; however, governments need to be cautious of how, to whom and when the protection should start and stop to boost and maintain growth.

The following highlights some key areas to watch:

- The list of sensitive items has been in effect since 2005 when the EAC was formed. Governments will decide when the affected industries have received enough protection and are, therefore, ready to compete with foreign suppliers of similar products. For example, effective 1 July 2014, the EAC Council of Ministers released a list of sensitive goods whose higher duty rates will be progressively reduced over the next three years until they reach the CET finished goods rate of 25%. Some of these goods include crown corks, sacks and bags of jute and matches.
- Provided that all EAC countries have concurrent memberships with COMESA or SADC (South African Development Community), the EAC may face continued pressure from COMESA and SADC to stop applying these tariff barriers on their affected products under the treaties signed by the EAC member states. This implies that the protection measures in some cases may be short-lived and may not achieve the planned results.
- With the signing of several agreements like the EAC — EU Economic Partnership Agreement (EPA) and the membership to multiple regional economic communities, countries like Kenya that are members of EAC, COMESA and the planned EAC-COMESA — SADC Free Trade Area (FTA) may expect additional incentives beyond trade protectionism to enable local industries to achieve growth and remain competitive.

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6 COMESA Member States: Burundi, Comoros, D.R. Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia and Zimbabwe

European Union

Union Customs Code: customs valuation update

In December 2014, the European Commission issued consolidated preliminary drafts of the delegated and implementing acts under the Union Customs Code (UCC). Although adopted in 2013, most provisions of the UCC will apply starting 1 May 2016. In the meantime, the Commission continues the work on the delegated and implementing acts to ensure EU member states implement them before the UCC's effective date.

The latest consolidated preliminary drafts of the delegated and implementing acts reflect the "state of play of discussions with Member States and other stakeholders" and served as the basis for discussions in January 2015. The Commission is expected to adopt the delegated and implementing acts — subject to minor changes — and to publish them in May 2015.

In the December 2014 edition of *TradeWatch*, we discussed the second preliminary draft of the delegated and implementing acts. We highlighted important topics, like customs valuation and Authorized Economic Operator (AEO) as defined in the first draft of delegated and implementing acts.

In this article we will focus on customs valuation items, more specifically, the possible changes to the existing "first sale for export" rule and the inclusion of royalty and license fees in the transaction value. In doing so, we will provide an update of the results of the latest discussions.

The "last sale" for export

The consolidated preliminary draft Implementing acts include a provision that explicitly refers to the transaction, on the basis of which customs value is determined:

"The transaction value of the goods shall be determined at the time of acceptance of the customs declaration on the basis of the sale occurring immediately before the goods are brought into the customs territory of the Union."

This above provision has not been substantially amended since the second preliminary drafts were issued: the European Commission has not changed its viewpoint and finds that the transaction value should be determined on the basis of the last sale rather than an earlier sale. Moreover, it is apparent that the discussions with Member States and stakeholders in mid-January did not persuade the European Commission into making any concessions. If adopted, the above provision would in effect abolish the existing "first sale for export" rules, which allow EU importers that meet certain requirements to declare the price paid in the earlier sale (i.e., the first sale) for customs purposes, resulting in a lower dutiable value and, thus, lower customs duty obligation. The wording of subsequent preliminary drafts is a source of concern to business stakeholders who have expressed their views on numerous occasions.

Noteworthy of this concern is that the rule, as amended, seems to exclude sales made within the EU. While the second draft refers to: *"the transaction occurring immediately before the goods are declared for free circulation,"* the subsequent consolidated draft refers to: *"the sale occurring immediately before the goods are brought into the customs territory of the Union."* In addition, a second paragraph has been added as follows:

"Where goods have not been sold for export to the customs territory of the Union before having been brought into that customs territory, the transaction value shall be determined on the basis of their sale at the moment the goods are in temporary storage or placed under a special procedure other than internal transit, end-use or outward processing."

The above statement is inconsistent with the WTO's Customs Valuation Agreement, which defines the transaction value as "the price actually paid or payable for the goods when sold for export." According to the Commission's current draft, a transaction within the EU could also be the basis for the "transaction value." In contrast, where goods have not been sold for export, the WTO Customs Valuation Agreement requires use of one of the alternative methods of valuation.

Transitional period for first sale

As it is highly unlikely for the Commission to change its approach to valuation under the Union Customs Code, one concession currently under consideration, prompted by a proposal made by one of the member states, is to allow first sale valuation for a transitional period until 31 December 2017 for situations where a contract was in place before the new regulations were adopted.

Royalties and licence fees: an attempt to increase the taxable scope

The implementing acts will include one consolidated article on the definition of royalties and license fees, which elaborate on the applicable test criteria, i.e., that the payments are "related to the goods being valued" and that these are "a condition of sale."

The text of the consolidated preliminary draft remains unchanged from that of the second draft regarding royalties and licence fees, apart from the addition of the following paragraph:

"If royalties or licence fees relate partly to the imported goods and partly to other ingredients or component parts added to the goods after their importation, or to post-importation activities or services, an appropriate apportionment may be made only on the basis of objective and quantifiable data."

The above corresponds *mutatis mutandis* to the paragraph 3 of the current Article 158 of the Community Customs Code Implementing Provisions.

This being said, we focus on the "condition of sale" rules. These rules have been the subject of heated debate between business stakeholders and the European Commission. Given the current information, the implementing acts will provide three situations where the "condition of sale" is assumed when any of these is met:

- The seller or person related to the seller requires the buyer to make this payment
- The payment by the buyer is made to satisfy an obligation of the seller, in accordance with contractual obligations
- The goods cannot be sold to, or purchased by the buyer without payment of the royalties or license fees to a licensor

The third item seems to include a variety of situations and leaves ample room for interpretation. For instance, in a scenario whereby the buyer, the seller and the licensor are all unrelated, a royalty or a licence fee could still become dutiable. Moreover, the rule seems to shift power to the licensor since it focuses on the obligations of the buyer, rather than the requirements of the seller. Put differently, a licensor can generally block the sale if the royalty is not paid by the buyer.

Consequently, the royalty would become dutiable in almost all situations. Furthermore, the rule does not mention that for a royalty or a licence fee to become dutiable, it should be the buyer making this payment. This is inconsistent with the WTO's Customs Valuation Agreement and the Union Customs Code, both of which refer to the buyer making a payment either directly or indirectly.

The above rule appears to be an attempt to increase the taxable scope, making royalties and licence fees much more easily included in the customs value.

Closing comments

Market operators are anxiously awaiting the final disposition of the above items as it can have a major impact on imports into the EU. In view that favorable changes are unlikely, companies should already consider taking preliminary steps to optimise future situations, e.g., by carefully reviewing existing structures and intellectual property contracts to exclude a "condition of sale."

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Goods imported separately can be considered as 'goods put up in sets'

Importers who unpack or dismantle sets of goods before importing separately to avoid attracting a higher duty rate of the same goods when classified together as "goods put up in sets" may have to reconsider this practice. The Supreme Court in Belgium has lodged a request for a preliminary ruling to the European Court of Justice (ECJ) to determine whether individual goods can be classified separately, even if such goods belong together and are intended to be offered packed together as a set on the retail market. If the ECJ's judgment answers this question negatively, the impact on this practice by companies that import consumer goods into the European Union (EU) can be significant.

Rules of interpretation for goods put up in sets

The General Rules of Interpretation (GRI) are used to classify goods according to the Harmonized Tariff Schedule, which determines the import duty rate of the goods. One of these rules relates to the importation of goods put up in sets. According to the World Customs Organization, Explanatory Notes, goods put up in sets are goods that:

- Consist of at least two different articles which are classifiable in different headings
- Consist of products or articles put up together to meet a particular need or carry out a specific activity
- Are put up in a manner suitable for sale directly to users without repacking (e.g., in boxes or cases or on boards)

By way of example, a disposable/non-reusable plastic cup of negligible value with a sachet containing coffee, and one sachet containing sugar put up together for the preparation of one cup of coffee, will be classified as a set and classified as if they consisted of the component which gives them their essential character.

It is possible to classify different goods as a set under a heading subject to a higher import duty rate than the import duty rate of the goods if classified individually. Some companies deal with such potential financial loss by unpacking or dismantling of the goods before importation. This way the goods are classified separately and subjected to a lower duty rate. After import, the various products are then packed together and sold to the consumer. This was the practice used by a Belgian company that has resulted in a question from the Belgian Supreme Court to the ECJ.

The case

In 2008, a Belgian company imported combined video and audio systems into the EU. The devices were classified under separate tariff codes, namely the DVD player itself (tariff code 8518 1095 subject to an import duty rate of 2.5%) and detachable speakers (tariff code 8518 2200 subject to an import duty rate of 4.5%). The Belgian customs authorities did not agree with the way the goods were classified. The Belgian customs authorities held the position that the classification should be based on the combination of the devices and that, the goods should be viewed as goods "put up in sets." The authorities classified the goods under subheading 8521 9000, as video recording or reproducing apparatus, which attracts an import duty rate of 13.9%.

The Supreme Court in Belgium has referred this case to the ECJ. If the position of the Belgian customs authorities is upheld, it can have considerable consequences for the many companies who import goods separately to avoid classification as goods put up in sets. Furthermore, the judgment can also lead to the question of whether parts of goods that are imported separately can be considered as a complete product for determining the import duty rate without the declarant's request.

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

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GSP eligibility for commingled goods: what Germany's restrictive approach could mean for EU importers

In the December 2014 issue of *TradeWatch*, we highlighted an important issue currently being considered by the European Court of Justice (ECJ) regarding eligibility under the EU Generalized System of Preferences (GSP) for products commingled or blended with other part consignments en route. Specifically, the issue is whether the commingled or blended goods can, in certain circumstances, be deemed to comply with the "same products" requirement under the GSP and Article 74(1) of Commission Regulation (EEC) No 2454/93 (Customs Code Implementing Provisions, CCIP).

The ECJ decision is expected to result in a more uniform interpretation of the "same products" requirement throughout the EU. It remains to be seen whether the ECJ will adopt a more flexible approach, such as that applied in the Netherlands, or a more restrictive approach, such as in Germany.

In this article, we focus on the more restrictive interpretation currently applied in Germany and the difficulties faced by importers from such an approach.

Current restrictive approach in Germany

German customs authorities currently use a relatively restrictive interpretation of the "same products" requirement. What prompted the request for an ECJ ruling by the Fiscal Court of Hamburg (*Finanzgericht Hamburg*), however, was not just the level of restriction, but rather the non-uniform legal treatment of the same situation by the customs authorities in the various Member States in the EU. In fact, until recently the legal treatment was also non-uniform within Germany, i.e., the various superior customs offices took different approaches in determining GSP eligibility.

The case currently under consideration by the ECJ involves the intentional mixing of different batches of product. In Germany, however, the customs authorities have determined that even the unintentional mixing of different batches can disqualify the goods from preferential treatment. A number of recent cases illustrate the difficulties importers currently face. These cases concern importers of various goods, such as biodiesel, wheat and other fungible goods that are usually transported in storage tanks. In these cases, the German customs authorities claimed that the storage tanks of the transport vehicle could not have possibly been completely clean prior to loading with qualifying goods but still had residue in the tank walls and pipes from previous shipments. The "contamination" of the qualifying goods with the residual non-qualifying goods, rendered the entire shipment ineligible for preferential treatment.

Difficulties with current requirements

While a thorough and complete cleaning of every storage tank is technically possible, the cost of transportation to a cleaning site, actual cleaning and downtime would be prohibitive, especially where such cleaning is not necessary for any other health or business reason. These cleaning costs are likely to exceed any benefit from the GSP preferential treatment. Hence, the requirement for clean tanks, as argued in the ECJ preliminary ruling request, is an "ivory tower" requirement that in practice prevents certain industries from obtaining the GSP preferential treatment, to which they are entitled.

To make matters worse, in response to the Fiscal Court's criticism regarding the nonuniform treatment, the German customs authorities have issued an internal decision to the customs administration in Germany, which directs customs offices to waive any proof for preferential treatment and assess retroactively the most-favored nation duty rate for any goods imported in storage tanks as described above. Although this strict interpretation ignores the economic impossibility of using clean storage tanks, it is in line with the position of "worst case principle" that German customs has always held, specifically, that the eligibility for preferential treatment is lost as soon as a company commingles qualifying and non-qualifying goods regardless of the quantities involved.

Implications for German and EU importers

In view of German customs current actions, companies doing business in Germany should evaluate their supply chain for situations where goods qualified for preferential origin are either transported, stored or manufactured in a manner that may result in any commingling with non-qualifying goods. Situations that might be critical should be analyzed in detail to evaluate risk potential and formulate arguments in support of the company's position. There is still hope that German customs may accept a more pragmatic approach, although this is less likely to happen before the ECJ's forthcoming ruling. In the meantime, importers in relevant industries should expect greater scrutiny during importation or preference audits. Similarly, all EU importers of affected products should take into account the current German position and prepare for a potential "worst case scenario" in anticipation of the ECJ decision.

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Gabon

Update: easing measures on special restrictions for the import of certain secondhand vehicles

Gabon's government has recently introduced a new draft decree, which promises to ease the restrictions on the import of certain secondhand vehicles in the Republic of Gabon.

As reported in the December 2014 issue of *TradeWatch*, Gabon's government had introduced some restrictive measures (Order No. 002707) in 2013 to address the increasing influx of secondhand vehicles and to deal with certain fraudulent practices associated such importation. Because of the difficulties with the implementation of these measures and the increasing backlog of noncompliant vehicles parked in the customs clearance areas, the government has decided to reconsider the import restrictions of certain secondhand vehicles.

Existing regulations

Order No. 002707 of 2013, which regulates the import and the reception of secondhand vehicles applies to vehicles of categories B, C, D, E and F.

The order considers vehicles used for six months or longer as secondhand vehicles and prohibits the importation of such vehicles that have been used for more than three years.

Easing measures introduced by the draft decree

The easing measures pertain to

- Certain special status vehicles (vehicles of diplomats accredited in Gabon and Gabonese vehicles returning from abroad)
- Category C and E vehicles defined by the Highway Code (vehicles transporting goods weighing more than 3.5 metric tons, and vehicles coupled to a tow truck weighing more than 750 kg)

The draft decree will allow the importation of the aforementioned types of vehicles that have been in use of up to six years.

The draft decree, however, maintains the three year maximum for the import of category A, B and C vehicles.

Transitional measures

The draft decree, which is yet to be finalized, provides a transitional period of three months for eligible vehicles imported prior to the date the draft decree becomes effective. Watch for further developments to be reported in future issues of *TradeWatch*.

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Kenya

Impact of the Excisable Goods Management System legislation on businesses in Kenya

The Government of Kenya has always required excise stamps to be affixed on certain high-value goods subject to excise tax, like wines, spirits and cigarettes, to ensure full compliance by the producers and importers of these products. The manual affixing of excise stamps has led to a number of administrative and monitoring challenges for the Kenyan Government.

EGMS in Kenya

In an attempt to curb the above challenges, the Government has implemented the Excisable Goods Management System (EGMS), which is an electronic system that manages excise stamps and the production and sale of excisable goods. This move is aimed at expanding the tax base as well as ensuring that only quality goods are in circulation.

The goods that are currently affected by the EGMS include wines, spirits and cigarettes. The Kenya Revenue Authority (KRA) plans to roll out the EGMS to all excisable goods other than motor vehicles by April 2015. The current list of excisable goods in Kenya includes wines; juices; cosmetics; bottled water; sodas; ice blocks; petroleum fuel; tobacco; and other products. Under the EGMS legislation, excise stamps would have to be affixed to each individual product on the aforementioned list.

Both manufacturers and distributors will be supplied with the system to be installed at their production or import facilities. The system includes excise stamps validation and authentication system; devices for identification and association of each package with the corresponding individual excise stamp; and production accounting equipment and devices for control, registration, recording and transmission of data on the quantities of excisable goods to the Commissioner of the KRA. This effectively means that businesses will have to provide a secure location within their premises for the installation of the EGMS in addition to providing stable internet connectivity.

Importer registration requirements

Under KRA's guidelines, an importer that is physically located in Kenya is required to register before any goods may be imported into Kenya. All importers of excisable goods other than motor vehicles were required to register with the Commissioner by 31 January 2013.[7] In addition, foreign manufacturers are required to register as importers of excisable goods or, alternatively, their appointed distributors or branches must register.

According to an ongoing procedure, a committee has been appointed by the Commissioner to vet all applicants. The list of importers who meet the set criteria will be published, and forwarded to Kenya's Customs Services Department. Going forward, only approved importers will be allowed to clear excisable goods at the ports of entry. Any goods attempted to be imported by a person who has not been approved by the Commissioner will not be cleared and will be subjected to forfeiture. Although the timelines are not clearly outlined, KRA indicates that the complete roll out is anticipated to be effective by end of April 2015.

Expected benefits:

- This measure by the KRA is aimed at ensuring that all excisable goods manufactured or imported are recorded and properly taxed. It is expected that the move will increase the revenue collected from excise tax.
- The measure will provide provide a consistent application among among players in various sectors as all excisable goods will be subjected to taxes. It will also help ensure that all manufacturing companies are held responsible for their product's safety since the excise stamps can help trace goods back to the manufacturers.

7 Although the deadline of registration has already passed, it is possible to submit special requests to the KRA to register future importers.

- The move will equally help in the battle against influx of substandard and potentially dangerous goods into the market, especially in the area of alcoholic beverages. The measure thus comes as a relief to manufacturers who have in the past suffered massive losses due to counterfeiting of their products. In this respect, the new system is also expected to bolster the efforts of the Anti-Counterfeit Agency, the body that was set up in 2010 by the Government through the Anti-Counterfeit Act No. 13 of 2008 to coordinate national efforts against counterfeit products.
- The implementation of the EGMS is also expected to improve compliance with respect to other quality standards and to help safeguard public health. Before a license can be issued to either manufacture or import excisable goods into Kenya, KRA requires companies to produce Quality Certificates showing that the goods have been tested by the Kenya Bureau of Standards, or by appointed agents and that they are safe for consumption. Manufacturers and importers of noncompliant goods will be denied manufacture/import licenses in addition to being subject to severe penalties for non-compliance.

Expected challenges

Although the anticipated benefits with the implementation of this system are many, certain problems, at least initially, are expected as follows:

- Increased cost of doing business — the system comes with increased costs to businesses in the form of bearing the costs of excise stamps and complying with the other requirements of the EGMS
- Initial implementation problems with issues that haven't been addressed, such as how to affix excise stamps on petroleum products, or to each and every bottle of low-cost beer produced
- Administrative burdens involved with reconciliations of the excise stamps

Implications for importers

Affected businesses are advised to consider engaging the revenue authority to reduce the cost of excise stamps to a level that will not affect adversely their margins, and to agree on the best ways to address the grey areas of EGMS implementation.

In addition, they should allocate dedicated resources to undertake reconciliations on a regular basis to mitigate the risks associated with variances in the stamps issued versus stamps used.

The continued efforts in implementation of the EGMS are expected to result in increased revenues for the Government. More benefits are likely to be realized if the anticipated challenges are proactively addressed, especially in view of the likely increase of similar initiatives to be implemented at the regional level in the spirit of harmonization of internal taxes within the East African Community Customs Union.

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Norway

Increased customs scrutiny and reassessments on cross-border payments for intercompany services

The Directorate of Customs and Excise (*Toll-og avgiftsdirektoratet,* TAD) in Norway has recently confirmed a number of decisions where Norwegian subsidiary companies were reassessed for value added tax (VAT) and customs duties on payments for intercompany services (e.g., management fees) purchased from the parent company abroad. These cases serve as an important reminder that, under certain circumstances, intercompany service payments must be included in the customs value of imported goods, and signal an aggressive approach by the customs authorities to include the full amount of such payments unless the importer can sufficiently demonstrate otherwise.

Customs valuation treatment of intercompany services — overview

Customs valuation is a complex issue for Norwegian importers, particularly with respect to transactions between related parties, which attracts scrutiny from the customs authorities due to the subsequent payments for services that may be required to be included in the declared customs value.

As an overview, the customs value is the basis for the assessment of import VAT and customs duties (exceptions apply, particularly for the petroleum industry). The primary method for determining the customs value is transaction value, that is, the price actually paid or payable for the goods from the sale for export to Norway, with certain adjustments that are specifically enumerated in the legislation. The transaction value constitutes the complete payment, which the buyer makes to the seller for the goods.

If the parties are related, transaction value can be used as long as the agreed price is not influenced by the relationship. If the terms and conditions for use of transaction value are not met, for example because the price is influenced by the relationship, or sufficient information about the price of the goods is not available, then the customs value is determined on the basis of alternative methods outlined in the customs legislation.

Certain intercompany service payments made by the buyer (importer) to the seller (parent company abroad) may be a required addition to the purchase price of the goods under transaction value. Some examples include payments for the transportation of the goods to the place of entry, royalties, and design and development fees. Management and administrative fees may also be a required addition to the customs value unless it can be established that such services were provided specifically for the benefit of the Norwegian subsidiaries operations. For instance, if the management fee invoice includes work that the information technology (IT) department of the parent company has performed for itself that is related to its own procurement system for item purchases from suppliers, this cost should have been included in the pricing of the goods. Accordingly, to the extent that the management fee invoice includes such services, they must form part of the customs value of the imported goods; other services may be excluded under certain circumstances.

In practice, however, these services may be provided by the parent to all group companies and commonly, allocation keys determine the amount of the fees that is invoiced to each subsidiary. The most common allocation key is revenue-based, that is, the subsidiary is charged for the costs based on the same fraction as the company's share of the group's total turnover. This type of allocation key is accepted under the Organisation for Economic Co-operation and Development (OECD) transfer pricing guidelines and usually accepted by the Norwegian tax authorities with regard to corporate taxation. However, as the recent cases demonstrate below, certain allocation keys may not be acceptable for customs purposes and prove costly in terms of reassessments.

Reassessment cases

The customs authorities have in recent years audited a number of companies with a focus on the above issues. Recently, TAD affirmed several decisions made by local customs regions to reassess VAT and customs duties on Norwegian subsidiaries' management fee payments.

These cases are significant as some of the companies were reassessed for all of their intercompany service purchases. The reassessment and the corresponding administrative charges imposed accounted for significant amounts, as the companies had few employees in Norway and purchased the vast majority of services from their parent company.

In these cases, the intercompany services were billed on the basis of the revenue-based allocation keys. The customs value was reassessed to include the full amount of management fee payments partly because the invoices were not itemized to identify the price paid for each type of service provided. In other words, the amounts for specific services that should not be included in the customs value could not be determined.

For example, the invoices did not provide a separate value for "IT services," but only specified a total value for all purchases of intercompany services during the period. In addition, some of the invoiced items were apparently for the benefit of the parent company itself. For instance, the marketing activity that the parent company had performed for the Norwegian market was also considered to benefit the parent company's own business with the sale of goods to Norway. In one case, the customs authorities discovered that the management fee agreement included the parent company's costs for packaging material for the exported goods, i.e., costs that should have been included as part of the price for the imported goods.

Cause for concern

Based on these cases, TAD is taking an aggressive position to include intercompany service fees in the customs value. This position is concerning in many respects.

The cases imply that the use of revenue-based allocation keys to determine the amount of management fees may deny the importer the opportunity to challenge a portion of that fee that should be excluded from the customs value. At the same time, the emphasis on itemized management fee invoices neglects that the company likely could have provided more specific information for each service provided (dutiable and non-dutiable) even though billed on a turnover-allocation key, if the customs authorities had made the request during audit.

Furthermore, there are no special documentation requirements in the legislation, nor any formal guidelines from the customs authorities as to when the intercompany service payments should be kept outside of the customs value of the goods. In these cases, the customs authorities took a broad interpretation in determining the dutiable nature of the services based on whether the services provided by the parent also indirectly benefitted the parent.

Arguably, if the customs authorities were in doubt as to the real consideration for the purchase of the imported goods, then an alternative customs valuation method may apply that does not require an assessment of the management fee payment. While the customs authorities did not take this position, a change in valuation methods could prove administratively burdensome for companies.

Finally, TAD appears to have based their reassessment decisions on a judgment delivered by an appellate court in 2008 (LB-2008-11968); the so-called "Peppercorn judgment." This pertained to the reassessment of a Norwegian company that, in addition to buying goods from its parent company in Denmark, also paid an annual fee for the purchase of intercompany services billed as "administrative support" to the same company. The case concerned the dispute about two of the items in the administration support, i.e. the amounts billed respectively as "IT management" and "sales assistance." The parties had an agreement that these two items in part consisted of costs related to the parent company's business and, therefore, these two items in part should have been included in the customs value of the goods. Since the company had not provided the details of how these two items were to be distributed between the parent and subsidiary, the court concluded that the two items in their entirety were to be included in the customs value of the goods. The court held that the company had to bear the risk for the increased customs value because it had not provided sufficient details to define the distribution of the payments.

The facts of the Peppercorn judgment, however, are significantly different from the facts of the aforementioned reassessment cases. In the Peppercorn case, the parties agreed that each of the two items in part contained the costs that relate to the parent company's business. The question was only how the allocation should be carried out. Additionally, the company was only reassessed for the two items and not the entire administration support fee. In the reassessment cases discussed above, there was no such agreement. In these cases it was the customs authorities who suspected that some of the costs were related to the parent company's business. The TAD reassessments, therefore, are not supported by the Peppercorn judgment.

Implications for importers

In light of TAD's recent reassessment decisions, many importers run the risk of having to pay VAT and customs duties (and corresponding fees) on all of their services purchases. Companies should expect further scrutiny by the customs authorities of management fee agreements where the buyer of the services is also buying goods from the same company. Additionally, the new, more stringent transfer pricing documentation requirements for tax purposes currently being implemented in Norway will contribute to the increased focus in this area, because the new documentation requirements make much more information about intercompany transactions available to the authorities.

Industries that are assessed customs duties based on value will continue to be especially at risk. In Norway, this is an issue for the textile industry in particular, but other industries are also vulnerable. Even if a reassessment of other industries only relates to import VAT (deductible in Norwegian VAT returns), the imposition of additional tax that is not deductible should be expected. Recently, an importer was fined in over NOK1.7 million in additional (penalty) VAT in a reassessment of the VAT for total management fee payments over a period of three years.

In view of the TAD decisions, it is difficult to find a way to keep management fees that have not been clearly itemized out of the customs value of the goods. This alone implies that the question may be addressed by the courts in the near future. In addition, many companies now find themselves in the unfortunate situation where the management fee that they paid according to a turnover-based distribution key may be accepted for tax purposes, but not necessarily for customs purposes.

For this reason it is important that all businesses that may be affected should ensure that there is a written agreement between the parent company and the subsidiary for intercompany service sales that clearly itemizes the respective services. Additionally, individual services should be invoiced separately. It is particularly important to make sure that none of the elements of the deal are in reality costs that relate to the parent company's business. As the TAD decisions discussed above demonstrate, only one misplaced item could cause the entire management fee to be reassessed as part of the customs value of the goods.

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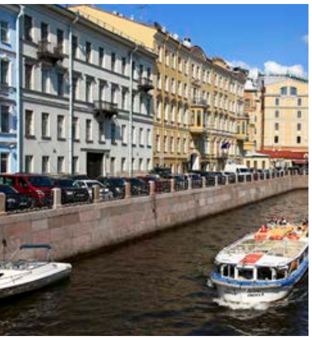
Russia

Russia introduces new environmental duties



The Russian Government has introduced a new draft Resolution, which imposes an environmental duty on certain goods imported into Russia as well as on certain locally produced goods that are subject to recycling after loss of their reuse value.

The potential environmental duty rates vary depending on the type of goods. Thus, the duty rate for hardware products, electronics, optical and electrical equipment is 4.5% of the cost value of one ton of goods, or one commodity unit (net of VAT). A duty rate of 1.5% may be potentially introduced for the following types of goods:

- Paper and paper products
- Rubber and plastic products
- Mineral nonmetallic products
- Lubricating oil
- Base metals
- Finished metallic goods except machines and equipment
- Timber, woodwork and cork products except furniture; straw products and weaving materials

It is expected that imposition of the environmental duty will lead to development of the waste management industry in Russia. However, at the same time, it will also lead to an increased tax burden on importers and local manufacturers.

The procedure for collecting the environmental duty remains unclear. In particular, the draft Resolution does not define an executive authority responsible for environmental duty collection. It is possible that customs authorities will collect these duties in a manner similar to the way waste disposal fees[8] are currently collected on importation of wheeled vehicles (chassis) into Russia.

The only way for importers and manufacturers to be exempted from payment of the environmental duty is to perform their own the management of wastes derived from imported or locally produced goods. The draft Resolution, however, does not set any requirements for the kind of waste management system that must be used by importers or local manufacturers.

It is unclear at this time when the Resolution will go into effect.

Watch for updates in future issues of *TradeWatch*.

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8 Waste disposal fees are imposed for the purpose of ensuring ecological safety, protecting human health and the environment.

Turkey

Fundamental changes in the customs warehouse regime.

As part of Turkey's Medium-Term Economic Program (MTEP), which aims to reduce the country's current account deficit, the Turkish Government has introduced, among others, several changes in the customs warehouse regime. These changes are expected to increase costs and make compliance with customs warehouse regime more complicated.

What are the latest developments in the customs warehouse regime?

Changes in the current customs warehouse regime were introduced on 2 December 2014. An outline of the most prominent features follows:

- The customs warehouse bond has been changed to a fixed amount of EUR100,000.
- In addition to the fixed bond, an additional guarantee of 10% of products subject to high import duties such as meat and meat products; tea; bananas, tobacco and tobacco products; alcoholic beverages; corn; and other goods will be imposed.
- Starting on 15 February 2015, camera systems must be installed in warehouses to provide continuous visual and audio recording.
- The customs warehouse regime may not be used to import bulk petroleum and fuel oil and (except for raw petroleum and transit to abroad) the authority will not accept applications for investment permits related to the opening and operating of fuel oil warehouses.
- Starting on 15 February 2015, counter systems must be installed and used to detect the quantity of bulk petroleum and fuel oil (including liquefied petroleum gas) which will serve as a basis for completing import procedures.

What are customs warehouse regime and customs warehouse?

Under a customs warehouse regime, imported goods may be placed into a customs warehouse and remain there indefinitely without being subjected to import duties (customs duty, value added tax, special consumption tax, etc.) and trade policy measures until they are withdrawn for free circulation.

Turkey's foreign trade legislation provides for two types of customs warehouse: public and private. There are warehouse users and warehouse operators in public warehouses, which anyone can use in return for a warehousing fee. In private warehouses, on the other hand, the operator and user of the warehouse is the same entity, which can only store its own goods in the warehouse. According to the Ministry of Customs and Trade's 2013 activity report, there are 1,312 public and private warehouses in Turkey.

Does the customs warehouse regime offer any advantage?

The customs warehouse regime primarily offers a financial advantage to importers. In this regard, many manufacturing companies operate with inventory and manufacture products upon the orders they receive. They store the inventories required for production in customs warehouses instead of their private warehouses and procure the goods from such warehouses as needed by completing the customs procedure for entry into free circulation and by paying import duties. Thus, they avoid paying the import duties until the moment the goods are needed for production. Until then, the goods can be stored in customs warehouses without any import duty payment.

The customs warehouse regime can also be used as a sort of "rest stop" in order to conduct import transactions more properly. The customs warehouse regime offers a significant operational advantage to importers, particularly for goods subject to time-consuming permit procedures or where goods must undergo alteration procedures (such as packaging or labeling) before they are released into free circulation.

This regime is also the only alternative for nonresidents to sell goods in Turkey. As per Turkey's foreign trade legislation, nonresident companies may not conduct import transactions except for transit and temporary importation regimes. Foreign nonresident companies may store goods in public warehouses in Turkey upon receiving a tax number. The sale transaction can be conducted when a resident buyer is present, and the buyer will then complete the import transaction accordingly.

This practice (called "consignment import") is very significant for Turkey's development into a supply chain hub. Due to its geographical location, many companies use Turkey as a bridge to expand their business to the Middle East and the Far East. Companies store their goods in Turkey and procure them as needed more rapidly and reliably depending on the orders they receive. Thus, the customs warehouse regime plays an important role in enabling companies to benefit from Turkey's favorable geographical location.

Final thoughts

The recently introduced changes are likely to both increase costs and complicate the procedures for using customs warehouses in foreign trade transactions. Nevertheless, customs warehouses continue to offer operational efficiency and inventory security in addition to financial advantages in foreign trade transactions. Therefore, this practice will continue to be used until a better foreign trade instrument is found. Considering the number of warehouses and quantity of goods currently stored in them, it is unrealistic to abandon this regime because of the recently introduced changes.

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Ukraine

Ukraine's parliament adopts import surcharge law

On 28 December 2014, Ukraine's parliament (*Верхóвна Рада України* or *Verkhovna Rada* of Ukraine) passed a law that introduces additional surcharge for goods imported into Ukraine. Under the Law *On Measures for Stabilizing the Balance of Payments of Ukraine in Accordance with Article XII of GATT 1994*, a surcharge in addition to regular customs duties will be levied on the customs value of goods brought into Ukraine under the import customs procedure (release into free circulation) during the 12-month period from the date the Law goes into effect. The surcharge will apply regardless of the goods' origin and any applicable free trade agreements, but will not apply to goods imported into Ukraine and placed under other customs procedures (e.g., inward processing, temporary import or customs bonded warehouse).

Expected surcharge rates are as follows:

- 10% for goods classified under Chapters 1-24 of Ukraine's Customs Tariff Schedule (agricultural goods)
- 5% for goods classified under Chapters 25-97 of Ukraine's Customs Tariff Schedule (industrial goods)
- 10% for goods subject to customs duty under article 374 of Ukraine's Customs Code that are imported by individuals

The following main categories of goods are exempt from the import surcharge: oil; natural gas; new fuel elements, electricity; coal; gasoline; diesel fuel; humanitarian and technical aid; and certain medical goods.

According to amendments introduced in Ukraine's Customs Code, the surcharge represents the kind of customs duty which, inter alia, is to be included in the Value Added Tax (VAT) base for goods imported into Ukraine.

The Ukrainian Government held technical consultations with the relevant international financial organizations regarding the implementation of this surcharge before the law became effective on 26 February 2015.

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

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United Arab Emirates

Dubai free zone businesses may be subject to significant customs compliance risks

The number of transactional and inventory audits by Dubai's customs authority appears to be on the rise. Recent reviews conducted by EY have shown that a significant number of businesses established in Dubai free zones do not have sufficient understanding of duty compliance requirements and potential customs audit exposure. This constitutes a significant risk for entities established in all Dubai free zones.

Dubai free zones are customs-controlled areas where any goods entering or leaving a free zone must be declared to the Dubai Customs Authority (Dubai Customs). The whereabouts of any goods brought into a Dubai free zone should be traceable throughout and the removal, consumption or scrapping of stock must be properly declared to customs. In addition, goods entering the mainland United Arab Emirates (UAE) from a Dubai free zone are subject to customs procedures, including a likely liability to duty.

If a Dubai free zone entity is subject to a customs audit, it will be requested to demonstrate the whereabouts of any goods it has imported into its free zone establishment. If it is unable to locate or trace the goods, Dubai Customs may assume that the "missing goods" have entered the mainland UAE without proper customs declaration and may apply customs duty and penalties to the value of the goods. This will generally mean customs duty of 5% plus a 10% penalty. There may be more serious consequences if Dubai Customs deem the non-declaration to constitute smuggling.

The chronological scope for a customs duty audit of a Dubai free zone entity is a contentious issue. The statute of limitation under Gulf Cooperation Council (GCC) customs law is five years. However, Dubai Customs hold the position that this begins when goods are declared out of the free zone. Therefore, if Dubai Customs take the view that goods have been taken into the mainland UAE without declaration, the statute of limitation will not apply and the customs audit period may go back to the date the entity under audit was established within the free zone.

These requirements are generally understood by businesses operating in fenced free zones, such as the Jebel Ali Free Zone. However, businesses often fail to realize that these requirements also apply in unfenced free zones such as the Dubai International Financial Centre (DIFC), the Dubai Multi Commodities Centre (DMCC) and the Dubai Technology and Media Free Zone (known as TECOM).

Businesses established in unfenced free zones in Dubai do not generally trade in goods, but instead engage in the provision of services. However, these businesses may import a considerable amount of goods into their free zone of establishment for non-trading purposes. Such imports may include, for example, furniture and fittings, notebook or mobile computers, mobile phones and corporate merchandise.

Based on Dubai Customs' recent free zone audit activity, it is important that businesses seek appropriate advice to understand the risks and to minimize potential exposure to additional duty costs.

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ED None

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