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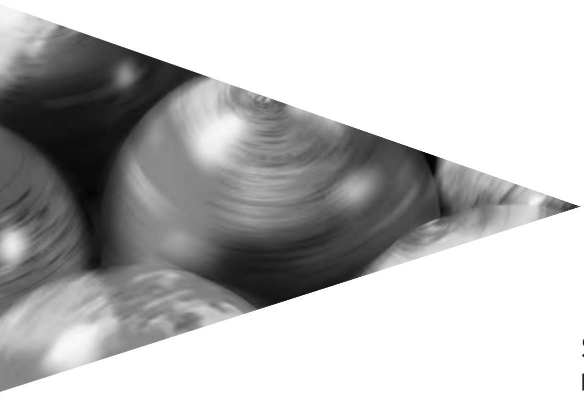


In this issue

Ernst & Young

Quality In Everything We Do

Spotlight on the European Union

Free trade agreement opportunities and challenges as EU accelerates new accords

The number of bilateral and multilateral free trade agreements (FTAs) is literally exploding as countries around the globe focus on expanding their individual FTA coverage to benefit their national interests and stimulate growth and local economic activity. The EU, which acts as a unit for its 27 member countries, is no exception, with a number of significant new and emerging FTAs.

New and emerging EU FTAs

Extending back to its inception, the EU has been active in establishing FTA relationships with key trading partners, but until recently, these have concentrated mainly on greater Europe and the nearby Mediterranean and North Africa region.

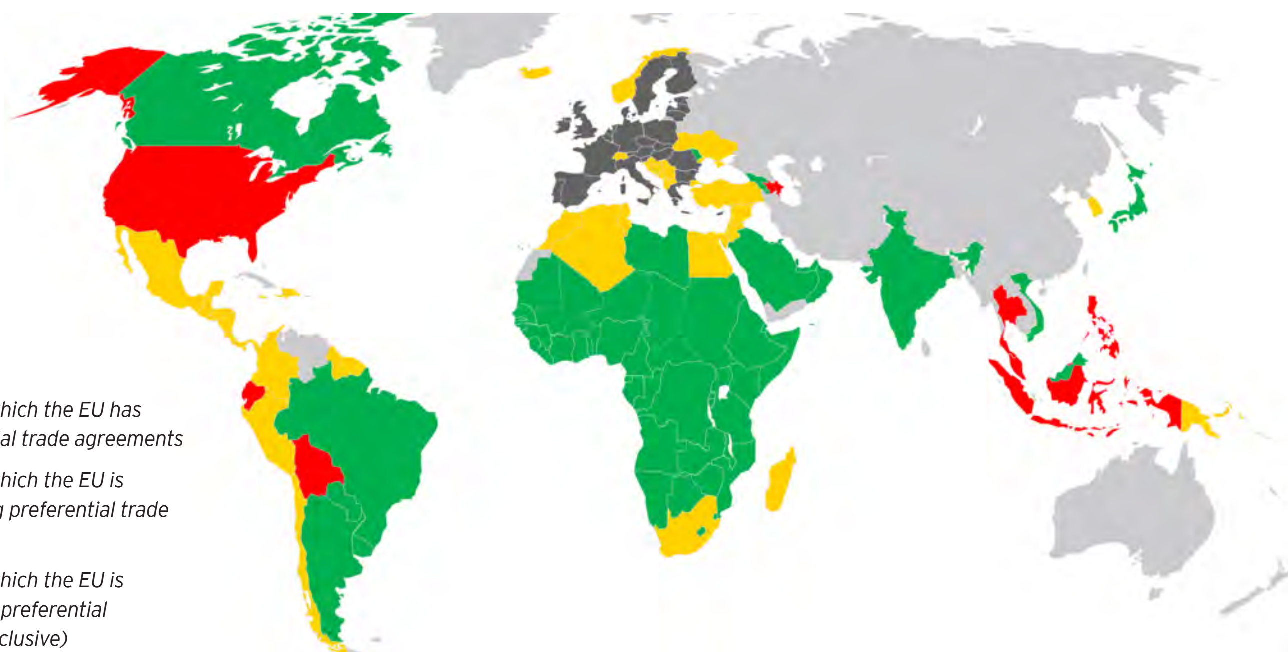
The EU does have some FTAs with countries in the Americas (Mexico and Chile) and, more recently, Asia (South Korea), but these are the exceptions rather than the rule. That may now be changing.

Examples of newly finalized FTAs that will take effect soon — some likely in 2013 — include:

- EU-Singapore FTA negotiations were completed in December 2012
- EU FTA with Andean Community (Peru and Colombia), completed in 2012, has already been approved by the European Parliament; the agreement will be preliminarily in force between the EU and Peru from 1 March 2013, and in Colombia once internal legal procedures are completed
- EU FTA with Central America (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama) was also completed in 2012 and has already been approved by the European Parliament

The EU is also moving forward with some key FTA relationships in Eastern Europe, Africa and with countries that formerly had relationships with EU member states, such as:

- The interestingly named Deep and Comprehensive Free Trade Area, which is part of the EU–Ukraine Association Agreement, is moving toward final completion



- *Countries with which the EU has concluded preferential trade agreements*
- *Countries with which the EU is currently negotiating preferential trade agreements*
- *Countries with which the EU is considering opening preferential negotiations (non-exclusive)*

Source: European Commission

- Economic Partnership Agreement with African, Caribbean and Pacific States (Cote d'Ivoire, Cameroon, Southern African Development Community, Ghana and Eastern African Community)

Even more interesting are a number of new FTA discussions that may move quite quickly. For example, the EU is moving forward its FTAs with the remaining countries of North America:

- EU-United States (EU-US) FTA talks were recently announced and will be the largest FTA combination when it takes effect. This may be a couple of years down the road, but still within the planning timeline of many companies
- EU-Canada FTA talks have been ongoing since 2009 and are now in the final phase of negotiation

With South America, the EU is due to exchange FTA offers (propose tariff reductions and timing) for an FTA with the countries of Mercosur (which includes Argentina, Brazil, Uruguay and Venezuela) by the end of the first quarter of 2013.

In Asia, we can also see the expanding FTA network that will emerge:

- EU-India talks were given a boost when both sides agreed on an intense work plan
- FTA negotiations with Singapore and Malaysia were launched in 2010 and with Vietnam in June 2012 (the third round of negotiation starts in April 2013)
- EU-Japan FTA negotiations are expected to be launched during spring 2013.

Opportunities for business

For EU businesses — or indeed for other companies seeking to access the EU's extended FTA network markets — developing FTA strategies can provide interesting opportunities to gain a competitive price advantage or better access to more global markets.

Keep in mind also that in addition to duty-free or reduced import tariffs for trade in goods, most FTAs also include provisions for:

- Improved access to government procurement opportunities
- Enhanced conditions for foreign direct investments as well as market access for services
- Removal (or relaxation) of non-tariff barriers, such as acceptance of partner country standards and certifications
- Agreements on transparency and enactment of legal requirements, including combating product piracy

The key challenge facing companies is to understand each agreement's scope (product coverage), effect (customs duty savings or other benefits) and then to see whether these benefits can be tapped into. The terms of the FTA are designed to limit the benefits to products that have been manufactured in one of the partner countries (this means the economic payback at national level is job creation and competitiveness as against the rest of the world) — see "rules of origin" discussion below. Once signed, each FTA typically has a written scope that defines the customs duty reductions and timing schedules on a product-by-product basis over the complete term of implementation.

Companies that import or export products (including materials, components, etc.) can obviously benefit directly under the terms of one or more FTAs. Factoring knowledge of FTAs and their benefits into sourcing and marketing decisions (as well as the terms of trade) can therefore have a direct effect on competitiveness (or conversely, a company can be adversely affected if a competitor gains an FTA advantage). As can be seen above, the EU FTA landscape will change dramatically in the coming years and companies that focus on maximizing the benefits will reap the greatest rewards.

Even companies that do not themselves import or export can gain from these FTAs if they have customers that require "local content" to satisfy the "rules of origin." Within the EU, an exporter often requests its local EU suppliers to provide a long-term declaration ((LTD), defined in EU Regulation 1207/2001) so that it can count these supplies as local content for product intended to be shipped to FTA destinations. An EU supplier's material or component thus becomes more attractive (compared to the same component from outside the EU, e.g., from low-cost countries in Asia) if an LTD supplier declaration can be provided certifying origin based on the terms of one or more FTA rules.

Another example of indirect benefits can be gained under a special arrangement called "cumulation" and we illustrate this by using an example of a company in an FTA country (say Korea, but in the future this could be Singapore, USA, Ukraine or any of the other new FTA countries). Imagine a situation where this supplier wants to get the benefit of the EU-Korea FTA, but cannot meet the local content requirement in Korea. Under "cumulation," the Korean company can count any EU materials as if they were Korean and this may bring the FTA qualification over the line, benefitting the Korean company, but also the EU sub-supplier. So EU suppliers can promote their "local content" advantage against suppliers in other countries of the same material.

There is a common misperception that making product "in the market, for the market" is the best option from a customs duty perspective. In many cases this is not true, as a product made elsewhere may have zero duty under the terms of an FTA whereas the product made in-market will bear a customs duty cost on any imported materials used in manufacture.

Qualification terms and conditions

FTA qualification has a number of conditions that will be defined by the FTA itself, but generally include:

- "Rules of origin" (often expressed as local value-added or regional value content rules) for product qualification
- "Direct transport" rules requiring that the product move directly from one FTA partner country to the other — these can also be tricky, particularly as they may challenge a company's distribution and/or hub logistics strategies and an understanding of the documentation necessary to support compliance is paramount

It goes without saying, compliance with the FTA's rules and requirements, such as rules of origin and direct transport rules, is crucial. If the respective conditions are not met, the FTA benefits cannot be claimed. Worse still, if an exporter certifies origin under the FTA and it turns out later that the product did not qualify, there are implications for both the exporter (who issues the origin certification) and for the importer (who relies on it).

Enforcement trends

In many countries, the importer will typically face retro-active assessment of customs duties and possibly serious fines and penalties even though it may have acted in good faith, relying on the origin certification from its supplier. Importers should protect themselves contractually and mitigate the adverse consequence by implementing due care processes. If a compliance failure occurs despite all these precautions, best practice is to initiate corrective action where this comes to light, e.g., penalties may be avoided or reduced where the company proactively self discloses prior to discovery by the customs authorities. (EU law does currently allow an importer to be excused of liability to the customs duty in certain circumstances, but this will often also examine whether due care was exercised in the first place.)

Exporters too can face serious consequences. Most FTAs place a responsibility on the authorities of the exporting country to impose significant penalties and carry out checks to ensure companies are observing the FTA rules and qualifying conditions. In some EU countries, the experience to date is often that customs actions to audit or validate FTA qualification were infrequent, e.g., only where the customs authority of the destination country specifically requested such action.

According to our experience in Germany and elsewhere, the customs authorities are acknowledging that many companies have compliance issues with their FTA qualification, both inbound to EU and outbound. There have also been more instances of EU customs authorities initiating audits and imposing monetary fines and penalties.

Further, the EU customs authorities are becoming more proficient in auditing companies by looking at electronic data and even using data analytical software to test sourcing and origin criteria. The customs authorities are no longer looking for a needle in the haystack as with paper-based checks carried out in the past. Increasingly, with electronic data, companies are more transparent and systemic errors are more easily identified.

Furthermore, driven by the Authorised Economic Operator (AEO) initiative, customs auditors are moving to process (rather than transaction) auditing and using risk management techniques based on data within the customs authority's own systems (built up from import and export declarations) as well as the company's commercial system that they may have access to as part of AEO. Compliance issues detected in FTA preference determination and declaration can quickly lead to the discovery of other customs compliance issues by the customs authorities.

Importance of constant monitoring of FTA developments

Key points from the above are that there are very significant commercial benefits from strategic planning to gain advantage from FTAs and the need for a strong compliance program to secure these benefits and eliminate risk.

The most important aspect, however, is the fact that the FTA landscape for most countries is constantly changing. As we have seen, the EU FTA network will become much more global and in a relatively short time frame.

Some examples of where monitoring FTA developments is particularly important are as follows:

- 3- 5 year strategic sourcing and distribution and production allocation plans
- New and developing market access
- Decision on plant location
- Stock keeping unit (SKU) rationalization and product strategies, e.g., intermediate product formulations
- Tax-effective supply chain models (where both the direct tax and indirect tax implications of alternative business models can be considered)
- Low cost country (LCC) sourcing initiative — care is needed here, as sometimes LCC strategies can inadvertently compromise FTA benefits (e.g., if it undermines the local content requirement of an FTA "rule of origin")

As always, there is a need for care, both for existing and emerging FTAs bearing in mind:

- Each FTA has its own terms and conditions on scope, qualification, origin certification, etc. You cannot assume that a product qualifying under one FTA will automatically qualify under another.
- If a company has been approved for any simplifications (such as use of invoice statements as an alternative to certificates of origin), changes to the supply chain may require this approval to be updated.
- Various changes (currency exchange rates, changes in sourcing of parts or materials, etc.) can affect the added-value calculation under the "rules of origin."
- Long-term declarations for EU local content must be renewed annually (and any interim change in status flagged).
- Even existing FTAs can have changes that were either built into the FTA, but with a deferred implementation date or based on newly negotiated terms. A recent example is the current negotiations under way to update the EU-Korea FTA (see the article "EU-Korea FTA: splitting of consignment"). Typically, such changes aim to facilitate trade under the FTA, which could mean a new opportunity.

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EU — Singapore FTA

On 16 December 2012, Singapore and the EU successfully concluded negotiations for the EU-Singapore FTA (EUSFTA). EUSFTA will be the EU's second agreement with a key Asian trading partner (after the EU-Korea FTA) and will be the EU's first agreement with a member of the 10-member Association of Southeast Asian Nations. Although the draft text has not been made public while the parties conduct their legal reviews, the overall benefits of the agreement have been widely reported.

According to Singapore's Ministry of Trade and Industry, Singapore and EU companies will enjoy greater access to each others' markets under the EUSFTA. The EU will eliminate tariffs on all imports from Singapore over a period of five years. Eighty percent of the tariff lines will be covered upon entry into force of the agreement. Singapore exporters of electronics, chemicals and processed food products in particular will benefit from the removal of EU tariffs. On the other hand, Singapore will grant immediate duty-free access for all imports from the EU.

Additionally, through the EUSFTA, both Singapore and the EU will make commitments guaranteeing access to each others' services markets, which is expected to cover a wide range of sectors of interest to EU and Singapore, including environmental services, computer and related services, professional and business services, financial services and maritime transport services.

The EUSFTA is expected to be signed by both sides in spring 2013. The FTA will then have to be approved by both Singapore and the 27 member states of the EU. Ratification of the FTA is expected to take about a year, so the FTA should come into force next year.

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EU — FTA with Colombia and Peru

On 11 December 2012, the European Parliament approved the FTA with the Andean Community signatory countries of Colombia and Peru. The agreement is expected to be approved by the Colombian Congress in the coming months with entry into force in the third trimester of 2013, once internal legal procedures are completed. Peru has completed its ratification procedures and thus, the agreement is now provisionally applied (effective 1 March 2013) meaning that businesses can benefit from all agreed trade preferences; the agreement will fully enter into force once ratified by all 27 EU member states.

Colombian perspective

For Colombia, the agreement will allow the immediate duty-free entry for 99.9% of Colombian manufactured goods exported to the EU. The primary agricultural exports that will enjoy immediate tariff benefits include sugar and products with sugar content; beef; flowers; fruits and vegetables; coffee; and tobacco. Fuels and mining products (palm oil, ethanol and biodiesel) are also immediate beneficiaries.

Additionally, textile and apparel exports under Harmonized System Chapters 50-63 will enjoy duty-free entry into the EU. The rules of origin in this respect should be carefully assessed when any foreign materials are used in the processing.

According to the Colombian Ministry of Commerce, Industry and Tourism, many regions of Colombia will benefit under the agreement. For instance, Bogotá and Cundinamarca have more than 1,100 products capable of entering the European market duty-free. In the same way, Antioquia has more than 630 products; Atlántico has more than 570 products; Valle has 465 products; Norte de Santander has 188 products; and Santander has 133 products.

Colombian importers of manufactured goods, notably machinery and equipment, cars and car parts, originating in the EU will benefit under the agreement.

At the same time, the agreement includes more than 20 tariff reduction schedules that differ based on the sensitivity of the products. For example, dairy imports are subject to a tariff reduction period up to 15 years with safeguards for certain products, such as milk powder, cheese and infant formula.

Additionally, bilateral safeguards can be imposed during a transitory period, under which tariff preferences can be suspended if an unexpected increase in imports of a particular product causes or threatens to cause serious injury to the domestic industry.

Once fully implemented, the FTA will open up markets on both sides as well as increase the stability of the trading environment. Colombia is expecting a positive effect with growth in Gross Domestic Product considering the large EU market that will soon be more open to Colombian businesses.

Peruvian perspective

Given the fact that the EU is the second most relevant destination of Peruvian exports, the FTA will bring significant benefits to Peruvian companies, especially to those that belong to the fishing and mining industries. Other industries are also expected to benefit from preferential access to the European market, including agricultural and textile industries, which have not been a traditional export industry, but have growth potential under the agreement.

In this sense, fish and sea products, agricultural goods, such as coffee, fruits and vegetables, along with textiles and apparel that meet the FTA's rules of origin and are exported from Peru to the EU benefit from duty-free treatment.

Accumulation and procurement benefits

The FTA offers the possibility to accumulate origin between goods produced in Colombia and Peru. This allows companies located in these South American countries to work together, promoting further integration between both countries' markets.

Finally, it is important to mention that the FTA signed between Colombia, Peru and the EU will allow Colombian and Peruvian companies to participate in public procurement contracts with central government entities of the EU under equal conditions as EU resident companies for the procurement of goods and services to those entities.

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EU — Central America Association agreement

On 11 December 2012, the European Parliament approved the EU — Central America Association agreement. The agreement, which includes common rules and provisions that will apply to all parties, now needs to be ratified by the Central American member countries (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama).

The comprehensive agreement provides for immediate tariff elimination on most manufactured products. More sensitive products are subject to tariff elimination schedules, and certain agricultural products are subject to quotas. Similar to the EU-Colombia/Peru FTA, bilateral safeguard provisions apply for a transitory period. For the Central American member countries, the main objective of the tariff elimination is to increase trade in goods within the region as well as diversify the availability of goods for export to the EU.

The agreement is expected to be a key driver in promoting the regional economic integration of the Central American member countries, particularly with respect to common customs procedures, import/export administrative requirements and investment procedures, among others. Trade facilitation is also a major component of the agreement with the objective of eliminating unnecessary regulatory and administrative measures that hinder trade flows within the region.

Based on the agreement's commitments, it is expected that within two years after the FTA enters into force, the importer will only be subject to duty in the Central American destination country, rather than at each country's borders. Within three years, the parties agree to implement a single administrative document or electronic equivalent for customs declarations. The Central American countries commit to harmonize customs procedures within five years after the FTA enters into force. These commitments will significantly facilitate trade with the Central American region.

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EU — Korea FTA: splitting of consignment

On 1 July 2012, the EU-Korea FTA celebrated its first anniversary. Although statistics indicate that trade in general from the EU to Korea has increased, some improvements and amendments are still under consideration.

In particular, the limitations of the FTA's direct transportation rule present a significant obstacle for a common practice in today's global supply chains — the splitting of consignment in third countries. Recent meetings of the European Commission (Commission) and Customs Committee of the FTA provide some insight into possible approaches the negotiators could adopt to resolve the issue.

Direct transportation rule

As a general rule to bilateral FTAs, goods must be transported directly, and without being split up en route, from the exporting partner country to the importing partner country. However, a consignment may pass through another country, provided proof can be delivered that the goods were not entered into free circulation in the country of transit, and did not undergo any operation there other than unloading, reloading or any operation designed to keep them in good condition. Temporary storage in another country is allowed where it is necessary for transport reasons (e.g., reloading).

Proof of compliance can be given by a single transport document (e.g., bill of lading) covering the passage from the exporting country through the country of transit or a certificate issued by the customs authorities of the transit country (e.g., non-manipulation certificate meeting established criteria), which evidences that the transportation rule has been met.

Within the EU-Korea FTA, the provisions on direct transportation are included in article 13 to the agreement. This provision is similar in all FTAs the EU has concluded with its partner countries.

Splitting of consignment in third countries

Following the commonly used definition of 'direct transportation' under free trade agreements, the consignee (importer) is required to systematically submit evidence in case of transit; moreover, it will not be possible for the latter to claim preferential origin upon importation whenever the initial consignment is split up into sub-consignments. For example, consignment XYZ, which qualifies for preferential origin under the FTA, is shipped from Korea. The shipment is split up and repacked in India before being shipped to Belgium. Under this scenario, the consignment cannot claim the FTA preference because it does not comply with the direct transport rule.

Taking into consideration the aforementioned and the long-standing request from EU industry for free trade agreements to be more trade facilitating, particularly in the case of split consignments, the European Commission is currently reviewing the topic, by means of proposals in working documents (TAXUD/446280/12), which were sent by the Commission to the member states for discussion purposes.

Non-alteration rule

The non-alteration rule (also known as the non-manipulation rule) is one approach under consideration. This rule was introduced into the EU's Generalized System of Preferences (GSP) as a more flexible provision replacing the direct transportation rule (Article 74 of the implementing provisions to the Community Customs Code, CCCIP).

Contrary to the direct transportation rule, the non-alteration rule under GSP shall be considered as satisfied *a priori* unless the customs authorities have reason to believe the contrary; in such cases, the customs authorities may request the declarant to provide evidence of compliance (e.g., bill of lading). The European Commission has decided to promote, wherever possible, this type of provision in ongoing FTA negotiations.

Though the non-alteration rule makes it possible to split consignment into sub-consignments, one of the challenges will be the retrospective issuance of commercial documents indicating the originating status of the goods (i.e., splitting of origin declaration); especially for goods being split on high seas (e.g., oil products).

European Commission proposal to Korea

During the several meetings of the Origin Section of the Customs Code Committee held in Brussels last year, the working document (TAXUD/446280/12) has been commented on by the EU member states and a revised document was presented during their 198th meeting. In this respect, the European Commission stated that in order to remove "customs control" in a third country of storage in a workable way, there are two possible solutions:

- The requirement of "customs control" with a non-manipulation certificate is kept as a condition for allowing splitting of consignments in third countries, or
- The requirement of "customs control" is removed, but in case of doubts about a split consignment, a verification request should be made to the exporting party (i.e., the exporter should be able to trace the split consignment back to the one initially shipped).

Taking into consideration that it is almost impossible for the customs authorities of the importing party to control and/or verify "customs control" in third countries where the split takes place, EU member states agreed to include the "verification request" (i.e., option two) in their proposal to Korea.

State of play

Based on documents that have been made publicly available, it appears that Korea is not currently in favor of the Commission's second proposal, which placed "customs control" with verification requests to the exporting party. At the same time, Korea has not given any alternate solution to-date.

We note that further meetings of the Origin Section of the Customs Code Committee took place in December 2012 and February 2013 with this topic on the agenda; however, documents from these meetings have not yet been made public.

There is optimism that the EU and Korea will reach an agreement to address the FTA's limitations on consignments split in third countries. Both parties have indicated that a change to the direct transportation rule is necessary and important. Additionally, keep in mind that split consignments are allowed under the FTA between Korea and the European Free Trade Association, or EFTA (Iceland, Switzerland, Norway and Liechtenstein). In our opinion, a more business-friendly approach is imminent. Watch for further developments in future issues of *TradeWatch*.

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Mutual recognition arrangement signed between US and Taiwan; more to come

The US and Taiwan have signed a mutual recognition arrangement (MRA) that recognizes each other's respective supply chain security program, i.e., the U.S. Customs-Trade Partnership Against Terrorism (C-TPAT) and Taiwan's AEO program. Additionally, the arrangement allows for closer collaboration between both countries' customs agencies.

According to U.S. Customs and Border Protection (CBP), the arrangement recognizes the mutual cargo security standards and compatibility between the two programs. The arrangement acknowledges that each side will accept the security status of members of the other program, which will benefit more than 500 AEO members and more than 10,000 C-TPAT-certified companies upon implementation.

Favorable treatment from mutual recognition includes fewer customs inspections and streamlined processing procedures, which can translate into lower costs and greater predictability in conducting cross-border trade between the two countries. Details regarding implementation will be forthcoming.

Taiwan is the seventh country that the US has entered into a mutual recognition arrangement. The other countries include New Zealand, Canada, Jordan, Japan, Korea and the EU. Additionally, the US and Mexico recently announced a mutual recognition work plan involving C-TPAT and Mexico's security certified trader program, known as Nuevo Esquema de Empresas Certificadas or NEEC, which is expected to be implemented in two years. While mutual recognition would not mean automatic access to the benefits of both programs, it would allow simplified application procedures and recognition of previous security site visits for participants.

Taiwan is also currently in the process of implementing an agreement with China, known as the Cross-Strait Customs Cooperation Agreement (CSCCA), which includes mutual recognition of each country's AEO programs. Before the CSCCA will come into effect, both customs administrations must first implement their own internal rules and procedures to reflect the objectives of the CSCCA, and once finalized, notify each other that such rules and procedures are in place.

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Argentina — Mexico

New auto trade pact

Mexico's auto trade dispute with Argentina has been resolved as the countries have successfully negotiated a modified agreement under the Mercosur-Mexico Economic Complementation Agreement (ECA) No. 55. Pursuant to Decree No. 2425/2012, Argentina has cancelled the suspension of ECA No. 55 and reactivated the preferential duty treatment, although under a new quota system and stricter regional value content requirements. In turn, Mexico has committed to withdraw its World Trade Organization (WTO) trade dispute against Argentina's restrictive import practices.

As background, in June 2012, Argentina unilaterally suspended the preferential duty treatment granted to Mexican auto goods under ECA No. 55. Argentina cited the need to protect domestic manufacturers after Brazil and Mexico had entered into a modified agreement establishing a quota system and stricter regional value content requirements to limit Mexican auto imports into Brazil. Mexico responded by filing a dispute with the WTO and threatened additional measures to compensate the damage to Mexican auto exporters. (See the September 2012 issue of *TradeWatch*.)

New auto trade agreement

Similar to Mexico's modified agreement with Brazil, the new agreement between Argentina and Mexico establishes a quota system to limit the number of Mexican imports benefitting from 0% tariffs. The quota limits have been set in value as follows:

- US$ 575 million until 17 December 2013
- US$ 625 million until 17 December 2014
- US$ 187.5 million until 18 March 2015

The quota restrictions will end on 18 March 2015, meaning that from 19 March 2015 all Mexican vehicles (qualifying under the agreement's rules of origin) will benefit from a 0% duty rate.

The negotiated agreement also includes changes to the regional value content requirements under the ECA No. 55 rules of origin for vehicles originating in Mexico that enter Argentina. The minimum regional value content percentages will increase from 30% to 40% over the next three years as follows:

- 30% until 19 March 2013
- 35% until 19 March 2016
- 40% after 19 March 2016

Implications for business

The new auto trade agreement could have significant implications for Mexican auto manufacturers. The pact is designed to limit the number of Mexican imports that benefit under the preferential arrangement. In this respect, the higher regional value content limits could mean goods that previously benefitted from the agreement are no longer eligible unless some supply chain changes are made. Additionally, considering the attention on auto trade between the countries, Mexican exporters should anticipate increased scrutiny from Argentine Customs in verifying that the rules of origin are met. Accordingly, proper analysis and documentation are crucial.

Further, effective quota administration is now an essential part of the trade operation, as companies must ensure that quota permits are obtained and quota limits monitored. Overlooking this aspect can quickly become costly when otherwise eligible goods are subject to duty for not abiding by the new quota system.

Finally, although the auto trade dispute between Mexico and Argentina appears to have been resolved, under this climate it is important that businesses closely monitor further developments considering the sensitivity of auto trade for the region.

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Brazil

State of Espirito Santo reacts to new unified ICMS rate

Brazilian states have been known to offer special tax benefits and incentives with respect to state value-added tax (ICMS) to give themselves a competitive advantage over other states in attracting foreign investment to their territories. Many state incentive programs have been controversial and have created the so-called fiscal war between the Brazilian states. In an effort to level the playing field, Senate Resolution No. 13/2012 established a unified ICMS rate of 4% for interstate sales involving imported goods (see the December 2012 issue of *TradeWatch*.)

This reduction of the ICMS rate from 12% to 4% is expected to weaken the incentives currently offered to businesses by many Brazilian states, leaving them in a disadvantage. The state of Espirito Santo, however, is acting to minimize the impact of the ICMS unification and avoid the imminent decrease of regional foreign trade business.

FUNDAP (Funding for the Development of Harbor Activities) is an incentive regime offered by the state of Espirito Santo, which provides ICMS financing and deferral benefits for goods imported through the local ports and airports to promote regional development.

Prior to the ICMS rate unification, the ICMS basis rate was 12%. From this amount, 3% would go to municipalities and 1% to the state. The remaining 8% was funded under FUNDAP by BANDES (the Bank for Development for the State of Espirito Santo) so that businesses could benefit from low interest rates and ICMS deferral. The recent unification of ICMS rates means a reduction in rates from 12% to 4%, which significantly weakens the incentives offered under FUNDAP.

As a result, Espirito Santo made some amendments to the FUNDAP legislation. A FUNDAP committee was created to decide the entitlement and application of funding resources, such as establishing conditions to collect taxes on imported goods, set grace periods and amortization schedules, and define the interest rates applied by BANDES.

The new FUNDAP committee has already decided that with the new lower rate of 4%, the amount financed will be 3% and municipalities will get 1% of the revenue generated. This means an increase from 67% to 75% of the participation in the funding. Contract terms related to financing will have up to a five-year grace period and 20 years for repayment in annual installments of 1% per year.

Espirito Santo is not the only state with an ICMS incentive program impacted by the new ICMS rules. Although the state is the first to adjust the program to the new environment, other states are moving in the same direction to minimize the impact of ICMS rate unification and continue to offer incentives to importers and exporters conducting trade operations through the state. Accordingly, state incentive programs are likely to continue to compete with each other to attract foreign investment by finding ways to give businesses advantages when conducting trade operations in their state.

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Changes to rules for export financing

Recent changes to the rules for export financing offer some good news for Brazilian exporters.

Prior to March 2012, export financing opportunities in Brazil were attractive for foreign investors and benefitted Brazilian exporters. The Brazilian Central Bank (BACEN) Circular No. 3580/2012, however, dramatically changed the conditions related to funding for the advance payment for exportation (known as Advance Payment), which allows for the early liquidation of foreign exchange contracts prior to exportation of goods or provision of services. This measure dramatically reduced the advanced funding lines for exports and restricted the repayment to not more than 360 days from the date of shipment of the goods or rendering of services exported abroad. The aim was to help control the Brazilian currency (Real) against foreign currencies, the US dollar in particular, by limiting foreign investment in Brazil. For Brazilian exporters, the measure increased costs and limited financing options.

To the relief of many exporters, BACEN issued Circular No. 3617/2012 in December 2012, which eased many of the restrictions placed on Advance Payment by Circular No. 3580. Specifically, the maximum period for repayment was extended from 360 days to 1,800 days (five years) for transactions registered with BACEN. Additionally, the measure eased the restriction that the lender be the importer, thus allowing financial institutions or an entity abroad (including the exporter's principal company or subsidiaries) to participate.

These actions reveal that the Brazilian government is keeping a close eye on trade and its effects on currency exchange in order to protect the valuation of the Real and thus, limit the risk for investments. These latest changes to the rules for export financing ease some of the constraints established last year for Advance Payment and provide Brazilian exporters with greater access to export financing from abroad.

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Canada

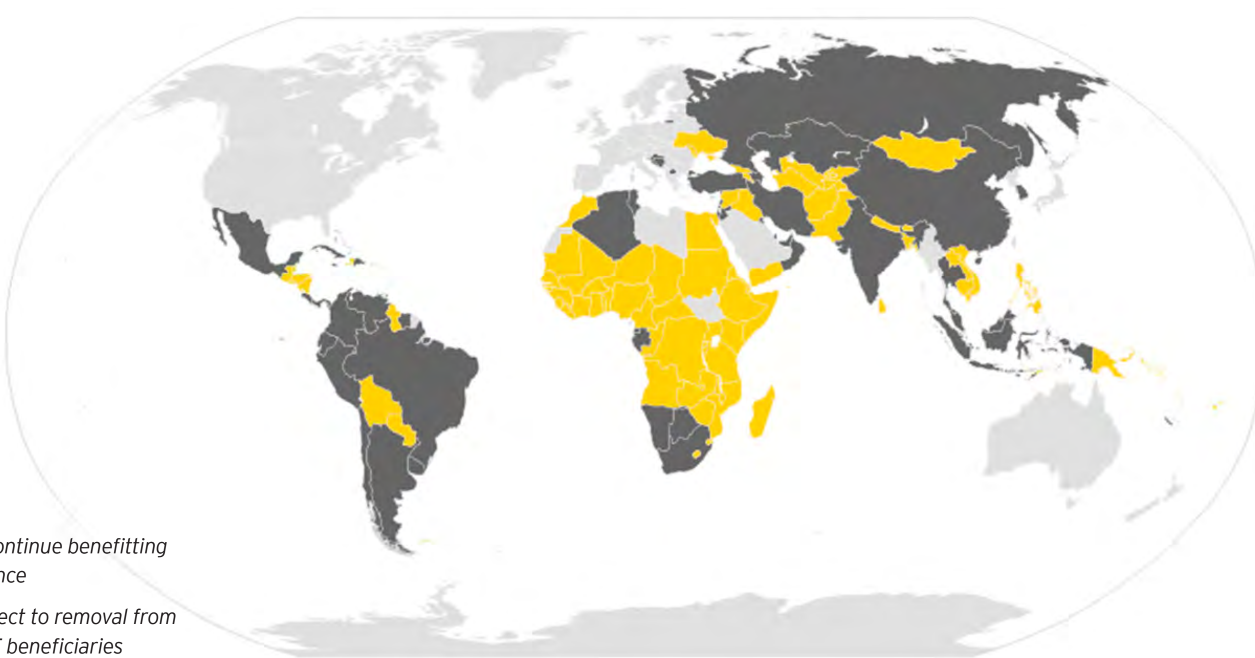
Fewer beneficiary countries under proposed changes to Canada's General Preferential Tariff

Canada's Department of Finance (Finance Canada) recently announced a proposed legislative amendment to the General Preferential Tariff (GPT). The proposed changes would significantly reduce the number of beneficiary countries by July 2014, affecting a large number of importers and businesses that currently benefit under the program.

The volume of trade benefitting from GPT in Canada is second only to trade benefitting from the North American Free Trade Agreement (NAFTA). Should the proposed changes pass, Canadian tariffs on numerous imports from China, Brazil and India, among others, are likely to increase to most favored nation (MFN) rates. Virtually the only categories of imports not covered by GPT preference are agricultural goods, textiles, apparel and footwear, as well as goods that are duty-free under the MFN tariff. It follows that other categories of goods originating in GPT beneficiary countries have often been able to qualify for GPT benefits.

The proposed amendment would remove 72 states and microstates from the list of beneficiary countries. This would effectively reduce the number of GPT beneficiaries to 103, almost half of the current 175 countries, as illustrated in the map below. (The full list of countries at issue is available on the Canada Gazette website.[1])

Some of the slated removals will have no practical impact, as Canada has implemented free trade agreements (e.g., with Mexico, Peru and Jordan) or provides other preferences (e.g. the Caribbean Commonwealth Countries) to those countries. Nevertheless, as illustrated in the map, the GPT currently provides very broad global coverage. Historically, few changes have ever been made to the list of beneficiary countries — Eastern European countries joining the European Union in the decades following the fall of the Berlin Wall constituted the most notable removals. Though the degree of economic development in other beneficiary countries has changed drastically over the last 40 or so years, GPT coverage remained rather stable.



■ *Countries to continue benefitting from GPT preference*

■ *Countries subject to removal from current list of GPT beneficiaries*

1 "Part I: Government Notices," in Canada Gazette (Vol. 146, No. 51 — December 22, 2012), http://www.gazette.gc.ca/rp-pr/p1/2012/2012-12-22/html/notice-avis-eng.html#d109.

In modern and practical terms, GPT facilitates trade with Canada's second most important trading partner in terms of imports, the People's Republic of China (second only to the US), as well as a good number of other top-25 countries of origin for Canadian imports, including South Korea, Brazil and India. Goods purchased from vendors and manufacturers located in these primary GPT-beneficiary countries and others are "at risk" of losing benefit from preferential tariff treatment, come July 2014. Should this proposal materialize, it raises the significance of the conclusion of the Canada-Korea FTA to Canadian importers of Korean products.

In addition to the list of beneficiary countries, Finance Canada is also reviewing the program's product coverage, rules of origin and safeguard measures. It can be expected that changes in favor of beneficiary imports are more likely to be implemented if the list of beneficiaries is indeed reduced.

Given the broad scope of reform, it is likely that the bottom line of virtually every importer engaging in some degree of non-NAFTA trade will be affected. Importers are advised to review their supply chain, assess the implications any increase in tariffs would have on their business, and consider supply chain planning opportunities to mitigate the effects of the upcoming changes.

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"At risk" GPT beneficiaries ranked in Top 25 countries that import into Canada[2]

Rank	Origin	2010 Imports (in CAD billions)	2011 Imports (in CAD billions)	2011 Share of Canadian Imports
2	China	$44.52B	$48.16B	10.8%
7	South Korea	$6.15B	$6.62B	1.5%
9	Algeria	$3.58B	$5.49B	1.2%
15	Brazil	$3.29B	$3.89B	0.9%
17	Kazakhstan	$2.28B	$2.85B	0.6%
19	Thailand	$2.41B	$2.67B	0.6%
21	India	$2.12B	$2.53B	0.6%
25	Argentina	$1.56B	$2.36B	0.5%

2 Industry Canada, 2011 Canadian Imports by Country of Origin, Trade Data Online, https://www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/home.

Colombia

New rules on imports for use in mining industry

Colombia's National Government issued Decree 2261, establishing new rules to regulate, register and control the importation of heavy machinery and chemicals that can be used in mining activities.

The decree adopts the previous license regime for the imports of machinery and parts classified under the following Harmonized System (HS) subheadings: 8429.11, 8429.19, 8429.51, 8429.52, 8429.59, 8431.42 and 8905.10.

In addition, according to the decree, previous license applicants must meet, among others, the following requirements:

- Be registered in the National Tax Registry (RUT by its Spanish acronym) for income tax, value-added tax and customs purposes
- Declare the controlled imported goods through the Tax and Customs Administration electronic system, including registered importer, the developing economic activity, the HS subheadings of the imported goods, and the destination and use of such goods
- Be domiciled or represented legally in Colombia
- Not have any pending debts with the Tax and Customs Administration (DIAN by its Spanish acronym), except those for which there are existing payment arrangements

The decree also requires imported machinery (classified in the subheadings mentioned above) to have a global positioning system security device and electronic monitor permanently installed in accordance with the technical requirements established by the National Police. Additionally, the decree provides for rules related to the transport and storage of the machinery and chemicals that can be used in mining activities.

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Pacific Alliance regional bloc

Further regional integration between Chile, Colombia, Mexico and Peru

The governments of Chile, Colombia, Mexico and Peru are making progress toward establishing the "Pacific Alliance" regional bloc. The Pacific Alliance aims for free trade and economic integration by facilitating the cross-border movement of originating goods, services, capital and people between member countries. While the member states are already partners in FTAs between each other, the Pacific Alliance intends to consolidate the existing FTAs into a single instrument that will contain a common tariff reduction schedule, a single set of rules of origin and the establishment of a common electronic certificate of origin, as well as expanded origin "cumulation" rules.

An important step forward was reached when, in January 2013 at the closing of the First Latin American and Caribbean Community — European Union Summit in Chile, the Pacific Alliance member countries agreed to finalize the common tariff reduction schedule by the end of March 2013. Under this agreement, 90% of all goods traded between the countries would enjoy duty-free treatment. A duty liberalization schedule would be implemented for the remaining 10% of goods.

The Pacific Alliance follows a trend of trade partners that consolidate existing FTAs into regional blocs with preferential duty treatment for goods originating in the member countries and other customs facilitation procedures. For businesses, these regional blocs offer significant flexibility and cost savings for trade and supply chain operations, particularly from provisions that allow more relaxed rules for origin "cumulation," transshipment and temporary warehousing. It will be interesting to see how the Pacific Alliance continues to develop, as the specific provisions of the final consolidated instrument take shape.

Finally, it will also be interesting to see how these developments will impact the negotiations for other regional initiatives, such as the Trans-Pacific Partnership Agreement, which includes Chile, Mexico and Peru along with the United States, Australia, Brunei Darussalam, Malaysia, New Zealand, Singapore and Vietnam.

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United States

CBP provides new guidance for determining country of origin of software

A recent ruling from US CBP provides significant guidance to US importers on how to determine the country of origin of software.

HQ H192146, issued on 8 June 2012, is quite notable in that it focuses on the country of origin of software as an intangible item, rather than on the "substantial transformation" of the carrier medium as a result of the software being burned onto it, or the concept of "software programming" of hardware to effectuate substantial transformation of the underlying hardware. In doing so, it provides insight into how CBP views and considers the various steps in the development of software when analyzing and determining its country of origin.

Background

The non-preferential rules of origin require that for items that are not entirely produced in one country, the parts, materials, components used in the production/ manufacturing process be "substantially transformed" into a new and different article with a different name, character or use that is different than that of the article or articles used to produce the finished product.

There is no one dispositive factor in determining whether substantial transformation has taken place. Rather, CBP has often noted that it considers the "totality of circumstances" and such determinations are made on a "case-by-case" basis. However, CBP has traditionally considered 1) country(ies) of origin of the components; 2) extent of processing taking place in a particular jurisdiction; and 3) whether such processing results in an item with a new name, character or use. Additionally, CBP has taken into account resources expended on product design and development; extent and nature of post-assembly inspection and testing; level of skills of workers, etc.

Origin of software as an intangible

HQ H192146 was issued as an advisory ruling to determine the country of origin of two different types of software — Database Management software and Application Integration software — for purposes of determining their eligibility for US government procurement[3]. The two software programs considered were both developed via seven distinctive steps, as characterized by the importer, which took place in various countries.

Step 1: Research for software/Development of road map (20% of workload)

Step 2: Development of Graphic User Interface (20% of workload)

Step 3: Development and writing of specification and architecture of software (10% of workload)

Step 4: Programming of the source code (15% of workload)

Step 5: Software build (20% of workload)

Step 6: Testing and validation (10% of workload)

Step 7: Burning of software onto server media from which customers will download (5% of workload)

CBP determined that the first software (Database Management) was substantially transformed in France as the "primary design and software build" occurred in France. As for the second (Application Integration) software, CBP determined its country of origin was France or Germany because the "software is substantially transformed into a new article with a new name, character and use in the country where the software build is performed (France or Germany)."

3 CBP issues such country of origin rulings to determine whether a product qualifies for granting waivers of certain "Buy American" restrictions for products offered to sale to the US government under the Trade Agreements Act of 1979)(TAA).

Location of "software build" particularly relevant

Although CBP did not provide a detailed analysis or discussion in its determinations of the respective countries of origin for the two types of software; from what CBP did say, all indication is that the location where the "software build" is of particular relevance. The ruling described software build as: "the process of methodically converting source code files into standalone lines, routines and subroutines of software object code files into standalone lines, routines and subroutines of software object code that can be run by a computer." It also included "software engineers reunite[ing] code that was developed by different teams and work[ing] out incompatibilities or bugs by re-writing or correcting programming and object code" as well as "creat[ing] every line of code, make all the executable software files in all their various versions, languages, and combinations, creat[ing] the installation package that the end-user will be able to easily install, and creat[ing] the final media such as a CD-Rom or files for a download website."

While the outcome of this ruling is specific to the importer's facts, it should spark the interest of those companies that produce software as well as those who may have previously utilized or plan to utilize "software programming" of hardware to effectuate substantial transformation of the underlying hardware – particularly if they sell such products to the US government and are subject to TAA requirements.

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The continuing extraterritorial expansion of US sanctions and export controls

Over the past year, the United States has increasingly used its sanctions and export controls to influence the conduct of non-US persons and non-US companies. This is particularly true with respect to Iran and items with military significance. Generally speaking, the US extends its jurisdiction (or jurisdiction-in-effect) to non-US persons and non-US companies by broadly defining controlled products and activities to include US items wherever located, US persons wherever located, items or data that transit through the US, and activities that substantially affect US interests. Some of the more recent, substantial enforcement actions have been taken against non-US companies and non-US persons for their role in violation of sanctions and export controls.

US items wherever located

Under the Export Administration Regulations (EAR) and the International Traffic in Arms Regulations (ITAR), US-origin items and even foreign-produced items may be controlled if the items incorporate US-origin components or technology. If controlled, then any person anywhere in the world who attempts to or engages in exporting, reexporting, transferring or retransferring the products, controlled technology, or technical data related to the products is subject to the ITAR or the EAR.

As an example, in June 2012, United Technologies Corporation settled charges of ITAR violations by its Canadian subsidiary Pratt-Whitney for US$75 million. The violations stemmed, in part, from Pratt-Whitney Canada's export of engines, which incorporated electronic engine control software that had been modified by its US parent for use in Chinese military helicopters. Incorporation of the US-modified software made the engines subject to the ITAR, and therefore, an ITAR violation resulted when the engines were exported to China by Pratt-Whitney Canada.

Additionally, in January 2013, British businessman Christopher Tappin, who was extradited from the United Kingdom in February 2012, was sentenced to 33 months in prison for violating ITAR. The charges against Mr. Tappin resulted from an attempted sale of US-origin zinc/silver oxide batteries for use in a Hawk surface-to-air missile to a customer in Iran. His extradition, and a series of extraditions occurring last year for US export control violations, demonstrates how non-US persons are prosecuted in the US when attempting to or engaging in transactions of controlled US items.

US persons wherever located

Where US products, as defined under the EAR or ITAR are not involved, jurisdiction may also be extended to the activities of non-US companies and non-US persons vicariously through the involvement of US persons, wherever located. Additionally, some laws extend jurisdiction to subsidiaries of US companies even if US persons are not directly involved. This creates obvious concerns for non-US companies and principals that employ US citizens, have US subsidiaries or are a subsidiary of a US company.

As an example, in the September 2012 issue of *TradeWatch*, we discussed the historic expansion of US sanctions regulations to encompass the activities of foreign affiliates of US companies with respect to Iran.

Items or data transiting through the US

Wholly foreign-made items or data that transit through the US may also be controlled. Depending on the particular circumstances, the physical arrival of controlled products may trigger the attachment of US export control jurisdiction over the product. Similarly, Office of Foreign Asset Controls (OFAC) penalties and sanctions on foreign entities in the financial sector frequently hinges on transactions that transit through the US banking system, thereby creating the authority for US enforcement.

For example, in December 2012, Standard Charter Bank (SBC) completed a US$132 million settlement with the OFAC regarding charges that it violated sanctions relating to Iran, Burma, Libya (since repealed) and Sudan. OFAC's allegations against SBC did not involve the conduct of US persons or persons acting within the US, but rather the conduct of foreign branches of SBC in London and Dubai. These branches allegedly "stripped" sanction-related messages from payment information and then funneled the payments through US banks in violation of the relevant sanctions.

Activities substantially affecting US interests

A final rationale for enforcement is based in part on the concept that Congress can choose to enforce sanctions against any person, anywhere in the world, when their conduct has the potential to substantially affect the United States. This authority extends whether or not US persons, US property or a territorial connection to the US exists. Much of the recent Iran sanctions legislation that applies to foreign persons, including the recent Iran Freedom and Counter-Proliferation Act of 2012, which was signed into law on 3 January 2013 relies on this concept. The new legislation continues the trend of identifying additional activities that companies, whether US or foreign, cannot engage in without risking imposition of US sanctions.

Examples of enforcement in this area are distinctive for their lack of a US connection. In January 2012, the State Department imposed sanctions on three companies for conducting business with Iran's energy sector in violation of the Comprehensive Iran Sanctions, Accountability and Divestment Act of 2010 (CISADA). The companies were legal and physical residents of China, Singapore and the United Arab Emirates, and the transactions involved the supply of non-US refined petroleum to Iran. Although the refined petroleum had no connection to the US and no US persons were involved in the transactions, the companies' sales to Iran exceeded the US$5 million annual threshold set out by CISADA for petroleum transactions involving Iran, thereby triggering the sanctions.

Ultimately the parties were all barred from receiving US export licenses, US Export-Import Bank financing, and loans over US$10 million from US financial institutions.

What to look for

The extraterritorial scope of US sanctions and export control regulations means that foreign companies, as well as US companies with foreign subsidiaries, need to consider how and when these rules can apply. The general rationales underpinning US extraterritorial enforcement provides a framework for asking important questions:

(1) Does the product contain US origin components or technology that would otherwise be controlled to the country of ultimate destination?

(2) Does the activity or transaction involve US persons, wherever located, US entities, or foreign subsidiaries of US companies?

  a. Are US persons directly involved?

  b. Are US persons on the Board of Directors or in management roles?

(3) Has an item physically been in the US or has data resided on US located servers?

Many of the recent Iranian sanctions are a unique exception to the scope of the above questions. The Iranian sanctions can apply whether or not a US product, person, system or payment is involved. Consequently, a foreign business that anticipates it may wish to conduct business in the US should consider whether any potential transaction with Iran involves a sanctioned activity.

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CBP expands the Centers of Excellence and Expertise program

US CBP recently announced that the agency will create six additional Centers of Excellence and Expertise (CEE or Centers) in 2013. The expansion of the program follows CBP's efforts in 2012 to establish four CEEs in key industries. With the four initial Centers now operational, CBP is expanding the program to cover additional industries.

Overview of CEE program

As reported in the June 2012 *TradeWatch*, the primary goal of the CEE program is to facilitate trade through expertise and efficiency, which includes lowering the trade community's cost of business by providing one-stop processing, increasing uniformity and transparency of practices, and enhancing CBP's enforcement efforts. The CEEs act as a resource to the broader trade community by acting as a ready source of information on CBP requirements and best practices related to a particular industry.

Each of the Centers operates virtually and is managed from a strategic location. CBP will leverage technology to bring the work to the Centers, regardless of where importation occurs or where CEE personnel are located. The Centers are manned by CBP personnel with expertise in certain specific industries and serve to link together personnel from across CBP with industry-specific knowledge. The expansion of the existing CEE centers demonstrates CBP's firm commitment to transforming current customs procedures to align with modern day business practices.

Expansion of CBP program

Building on the success of the current Centers, six new CEEs are to be established in fiscal year 2013:

- Agriculture & Prepared Products: *Miami, Florida*
- Apparel, Footwear and Textiles: *San Francisco, California*
- Base Metals: *Chicago, Illinois*
- Consumer Products and Mass Merchandising: *Atlanta, Georgia*
- Industrial & Manufacturing Materials: *Buffalo, New York*
- Machinery: *Laredo, Texas*

CBP has already established the following industry-based Centers:

- Electronics: *Long Beach, California*
- Pharmaceuticals, Health and Chemicals: *New York, New York*
- Automotive and Aerospace: *Detroit, Michigan*
- Petroleum, Natural Gas & Minerals: *Houston, Texas*

CBP collaboration with industry

CBP collaborates with the Advisory Committee on Commercial Operations of Customs and Border Protection and members of the trade industry in selecting and evaluating the Centers. For example, with the assistance of the American Association of Exporters and Importers, CBP established Industry Working Groups (IWG) to implement and prepare the new CEEs. IWGs are co-chaired by a representative from the trade industry and a CBP manager.

CBP's 12th annual trade symposium provided a collaborative environment for members of CBP and industry to discuss the operational accomplishments of the CEEs and discuss qualitative assessments made by members of the trade community. Evaluations of the CEE program were overall highly positive. Industry concerns expressed during the symposium focused primarily on improving communication and guidelines, increasing training opportunities, expanding the roles of the CEEs and the number of CEE members, improving inter-government coordination and improving processes and systems relating to the virtual environment of the Centers.

CEE participation and enrollment

Priority consideration for enrollment will be given to "trusted trader" importers enrolled in the C-TPAT and Importer Self Assessment programs. In return, "trusted trader" importers will ultimately benefit from the centralized processing and focused resources assigned by CBP to facilitate entry and compliance processes.

CBP will publish test notices in the Federal Register seeking new importers to participate in the new CEE centers. These notices will explain the process, procedures and eligibility requirements for participation, similar to the Federal Register notice issued on 28 August 2012 (77 Fed. Reg. 167), which involved testing in the four initial industry centers.

Upon completion of the implementation of the CEEs, eligible importers will have the opportunity to apply for the CEE that represents the industry that comprises the highest percentage of its customs entries, even if the full range of goods imported is covered under several industries.

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Australia

Increased penalties for customs offenses

From 28 December 2012, the penalty for making a false and misleading statement to the Australian Customs and Border Protection Service (Australian Customs) increased by 55%. This is in line with an increase in the Commonwealth value of a "penalty unit," which increases the penalty under the Infringement Notice Scheme from AU$1,100 to AU$1,700 per false and misleading statement.

As discussed in previous issues of *TradeWatch*, the penalty for a false and misleading statement can apply to situations where no underpayment of duty has occurred. In our experience, upon review clients often find that erroneous statements have been declared in the following areas:

- Incorrect tariff classification of goods that does not alter the duty rate
- Incorrect value or classification of goods covered by an FTA
- Incorrect valuation of goods (including duty-free goods)
- Incorrectly declaring whether the supplier and importer are related companies

Importantly, this increase also applies to other customs offenses where the penalty is expressed in "penalty units," such as:

- Prohibited imports and exports
- Deliberate false statements
- Movement of goods under customs control (i.e., excise equivalent and goods under bond)
- Penalties associated with document retention

This is the first change to the penalty unit value since 1997 and comes after moves by Australian Customs to strengthen its compliance regime. We recommend that importers review import declarations to ensure that appropriate processes are in place to minimize the risk of false or misleading statements being made on their behalf. A simple mistake repeated on multiple import declarations could result in thousands of false statements and as a result, significant penalties.

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Beware of broadly defined tariff concession orders

A recent Australian Tribunal case highlights the risk of entities relying on broadly defined tariff concession orders (TCOs) when importing goods with additional characteristics that fall outside the TCO description. The case is particularly important for goods imported in sets or with accessories, where the TCO was not drafted specifically to cover the goods imported.

Background

TCOs are tariff-based concessions that are granted on application by importers of goods. A TCO reduces the duty payable to zero. TCOs are made where there is no Australian manufacturer of substitutable goods and once granted, are available to be used by any future importer. To obtain the benefit of a TCO, the imported goods must be classified under the tariff heading for which the TCO is attached, and must fit within the description of the goods set out in the TCO.

The case, Cameron Australasia Pty Ltd and Chief Executive Officer of Customs [2012] AATA 865, (Cameron Australasia) concerned the application of a TCO to imported umbilicals (cables) on reels. The TCO was broadly defined, referring to hydraulic gas umbilicals generally, with no specific reference to reels. Australian Customs argued that because the umbilicals were imported on reels, they did not fit within the terms of the TCO. That is, what was imported was "more than" what was described in the TCO.

The importer unsuccessfully put forward numerous arguments in support of the goods falling within the TCO description, including that within the industry a reference to an umbilical included a reference to an umbilical on a reel and that an umbilical could only be transported on a reel.

Additional features vs additional goods

The Tribunal accepted the following in respect of TCOs that precisely describe a good:

1. If the goods exhibit an additional feature than the goods described in the TCO, that will not disqualify the goods from the benefit of the TCO; however,
2. If the goods include an additional good, as opposed to an additional feature or function, the TCO cannot be used.

This case is of particular relevance for goods imported in sets (where the set may include more than the primary good) or that come with accessories to the primary good.

Risks

Incorrect use of a TCO exposes the importer to:

1. Liability to pay short paid duty, and
2. Penalties of up to 100% of the short paid duty

Penalties apply even if there was no intention to incorrectly use the relevant TCO, and Customs can review imports going back four years.

What importers should do

TCOs can be a significant cost savings strategy for importers when effectively managed. As evidenced by Cameron Australasia and other recent cases, including ones that we have highlighted in recent issues of *TradeWatch* (see the September 2012 and December 2011 issues), the program's product-specific focus means that small nuances can easily take a product out of the TCO's coverage.

Importers are urged to be proactive in assessing and managing this risk. If Australian Customs determines that a TCO does not apply, there is little that can be done retrospectively. However, where there is a TCO that covers a primary good, it is likely a new TCO could be obtained to cover that primary good plus additional goods. The earlier that new TCO is obtained, the sooner the importer can enter goods duty-free with certainty.

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More Australian industry participation in major projects: implications for the Enhanced Project By-law Scheme

On 17 February 2013, the Australian Prime Minister announced "A Plan for Australian Industry," the government's initiative to promote job growth by backing Australian firms to win more work at home. The initiative holds implications for the Enhanced Project By-law Scheme (EPBS), a duty concession program for eligible imported goods procured for large investment projects in certain industry sectors.

The main purpose of EPBS is to encourage the use of Australian industry in investment projects and global supply chains. To this end, EPBS requires the development and implementation of an Australian Industry Participation (AIP) Plan. The AIP Plan must demonstrate how the project will provide full, fair and reasonable opportunity to the local Australian industry to supply goods and services to the project. Additionally, the duty concessions only apply to imported goods that cannot be locally sourced.

While the implementation of a AIP Plan has long been a pre-requisite to accessing the significant customs duty savings available under EPBS, some project proponents view the work involved in managing the AIP Plan as too onerous, choosing instead to pursue alternative customs planning strategies (such as Tariff Concession Orders). However, the AIP Plan may soon be a requirement placed on all large investment projects, regardless of whether the company is seeking EPBS.

Under the government's plan, independent of the EPBS, there will be an increased obligation to provide Australian industry with full, fair and reasonable opportunity to win work on major projects. Specifically, the government plans to require AIP Plans for all projects with capital expenditures of AU$500 million or more, regardless of the sector. Further, any projects in excess of AU$2 billion of expenditure seeking duty concessions under EPBS would be required to "embed" Australian Industry Opportunity officers within procurement teams.

Part of the government's rationale is that Australian industry is not currently being given the appropriate opportunities to participate in major projects because, among other reasons, such projects are increasingly being delivered through engineering, procurement, construction and management companies with established global supply chains. Further, equipment is often being modularized or fully integrated overseas prior to importation into Australia. The government's new initiative attempts to give local industries more visibility and opportunity to provide these manufacturing and related services. To that end, the plan includes establishing a new Australian Industry Participation authority, designed to be a one-stop-shop for Australian firms seeking to win work on large domestic projects.

For companies planning large investment projects in Australia, the AIP Plan is likely to become an integral part of the project planning. Some good news is that compliance with this requirement could also bring the company close to accessing duty concessions under EPBS without significant additional work. On the other hand, for larger projects (i.e., above AU$2 billion), the special requirement that a Australian Industry Opportunity officer participates with procurement teams may be viewed as a positive or a negative consideration for participation under EPBS.

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Japan

2013 Japan tax reform proposal brings key changes to the Customs Law

Japan's 2013 tax reform proposal, released on 24 January 2013, was approved in a Cabinet meeting on 29 January 2013. The tax reforms will be discussed by the Diet and are expected to be passed before the end of March 2013, with most of the changes effective from 1 April 2013. Please note that the Diet may modify or amend certain items.

The proposal includes changes in the following areas:

- Revision of the customs valuation provisions to provide clarity on how customs value should be determined
- Revision of the rate of overdue tax

Revision of the customs valuation provisions to provide clarity

The proposal prescribes that necessary measures will be taken to provide clarity on the customs valuation provisions to be conducive to the appropriate and fair collection of customs duties. Unfortunately, the tax reform proposal does not provide the text of the revised provisions or provide further details on the proposed measures. Some guidance is provided in a document prepared by the Customs and Tariff Bureau, which summarizes the key points of the tax reform that, in relevant part, refers to the recommendations of the Customs Valuation Working Group[4].

The Working Group has provided several recommendations. While it is not clear which (if any) of the Working Group's recommendations will actually be implemented, one of the key findings of the Working Group is that the absence of clear definitions of the terms used to describe the transaction value method, such as "import transaction," "buyer" and "seller" leaves room for misinterpretation on what constitutes an import transaction:

The value of imported goods which constitutes the basis for duty assessment shall… be the price actually paid or payable by a buyer, to or for the benefit of a seller…in an import transaction plus the cost of transport, etc…

Specifically, the Working Group expressed concern that some importers have misapplied this provision in multitiered transactions, incorrectly believing that an earlier sale construes an "import transaction" and that the purchaser in such earlier sale is the "buyer." The Working Group thus recommended that these terms be defined in the law, and further that the definition of "buyer" clarifies that "buyer" should be a resident who has a domicile or residence in the country of importation, i.e., Japan.

Implications for the importers

While Japan Customs has been reluctant to accept a non-resident entity's purchase price as a basis for customs value under the transaction value method, currently there is no clear justification for denial in the customs rules or guidance. If the Working Group's recommendation to revise the Customs Tariff Law to restrict the "buyer" in an import transaction to a resident entity is implemented, importers may find it increasingly challenging to have a non-resident entity's purchase price accepted as a customs value. Companies with less traditional import transactions (e.g., non-resident principal importing goods and holding inventory in Japan before resale to a local entity) may be required to calculate customs value by applying alternative valuation methods, which could be administratively burdensome and potentially result in a higher customs value and customs duty payment.

Companies that currently use a non-resident entity's purchase price or are contemplating the implementation of non-traditional import structures are advised to closely monitor whether and how the Working Group's recommendations are implemented.

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

4 The Customs Valuation Working Group, consisting largely of academia and professionals with practical experience, was set up by the Ministry of Finance in June 2012, to provide input on how the Customs Tariff Law and the Order for Enforcement of the Customs Tariff Law, which had not been revised since 1981, should be revised to better apply to today's trading environment.

Revision of the rate of overdue tax

Importers who do not pay customs duties by the statutory due date of tax payment incur an overdue tax. In light of the current economic environment of low interest rates, the proposal recognizes the necessity to reconsider the manner in which overdue tax is calculated, while also ensuring that taxes are paid in a timely manner. The reform proposal seeks to balance these needs by revising the formula as follows:

	Current formula	Proposed formula (Effective from 1 January 2014)
Rate applicable for the first two months from the day following the date the tax payment becomes due	The lower of: • 7.3% per annum. or • The official discount rate + 4%	The lower of: • 7.3% per annum, or • Special base ratio + 1%
Rate applicable after the period above up to maximum period of one year	• 14.6% per annum	The lower of: • 14.6% per annum, or • Special base ratio + 7.3%

In the charts above and below, the special base ratio is the sum of the average short-term prime lending rates for each month from the period beginning in October two years prior to September of the previous year, divided by 12 + 1%. We note that the period subject to calculation of overdue tax is capped at a maximum of one year, except in cases of willful or egregious wrongdoing where heavy additional tax is imposed.

The overdue tax rate is also used to calculate interest on refunds of overpaid customs duties. The reform proposal seeks to revise the formula as follows:

	Current formula	Proposed formula (Effective from 1 January 2014)
Interest on refunds of overpaid customs duties	The lower of: • 7.3% per annum, or • The official discount rate + 4%	The lower of: • 7.3% per annum, or • Special base ratio

It is notable that under the current regulations, the overdue tax and interest that accrue on refunds of overpaid customs duties are the same rate, whereas under the reform proposal, the overdue tax rate will be one percentage point higher than the interest on refunds.

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Amendments to Japan's Generalized System of Preferences program

Generalized System of Preferences (GSP) is a trade program that aims to assist the economic development of developing countries by providing preferential access to Japanese markets through the application of reduced duty rates on certain products from such developing countries.

In applying the criteria for graduation and product exclusion, the following changes to the GSP program are planned:

Graduation of certain beneficiary countries from the GSP program

Croatia was classified as high income economy in World Bank statistics for three consecutive years, and shall no longer be a GSP beneficiary from 1 April 2013. The higher MFN rate (import customs duty rate applicable to WTO countries) will apply thereafter.

Exclusion of certain products originating in China

The following products originating from China will be excluded from the GSP program as of 1 April 2013, because they have been deemed as highly competitive in the Japanese market. Importers currently utilizing the GSP program to import the goods below from China will see an increase in landed cost due to the higher duty rate.

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HS Code	Description	Preferential Rate *(until 31 March 2012)*	MFN Rate *(from 1 April 2013)*
54.03	Artificial filament yarn (other than sewing thread), not put for retail sale, including artificial monofilament of less than 67 decitex	3.2 - 5.28%	4 - 6.6%
96.16	Scent sprays and similar toilet sprays, and mounts and heads thereof; powder-puffs and pads for the application of cosmetics or toilet preparations	0%	3.9%

Singapore

New Advance Export Declaration requirement from April 2013

Effective 1 April 2013, Singapore will implement the Advance Export Declaration (AED) for all exports. This means that exports of non-controlled and non-dutiable items by sea and air will also require declarations before the goods leave Singapore.

Currently, Singapore Customs requires AED only for exports of controlled and dutiable items by sea and air or exports by land. Declarations for exports of non-controlled and non-dutiable items by sea and air are allowed to be made within three days of the goods leaving Singapore under an existing administrative exemption. This exemption will be rescinded with effect from 1 April 2013.

Singapore Customs is yet to finalize the cutoff time for making export declarations for non-controlled and non-dutiable goods. However, based on current industry practices and considerations, the recommendation is that the export declaration be made before lodgment of the cargo with the ground handling agent or cargo arrival at the port gates. There will be no change to the current AED requirement for export of controlled or dutiable goods by sea and air, and for all goods by road and rail.

There will be an 18-month transition from 1 April 2013 to 30 September 2014, to provide companies with additional time to further fine-tune their processes, systems and information flow, in order to fully comply with the new AED requirements for non-controlled and non-dutiable items. During this period, traders will generally not be penalized by Singapore Customs for non-compliance with the new requirements; however, all other customs penalties will continue to be applicable during the transition period.

The AED initiative aims to strengthen Singapore's supply chain security and align its export declaration practices with international norms. This move by Singapore is in accordance with the World Customs Organization's Framework of Standards to Secure and Facilitate Global Trade (SAFE Framework). With advance cargo information, Singapore Customs will be able to identify high-risk consignments for checks before export. Additionally, advance information will enable Singapore Customs to facilitate legitimate and secured trade through measures, such as timely export risk assessment and collaboration with overseas Customs administrations through MRAs. The implementation of the AED will help Singapore in sustaining its status as a trusted and secure key player in the international supply chain.

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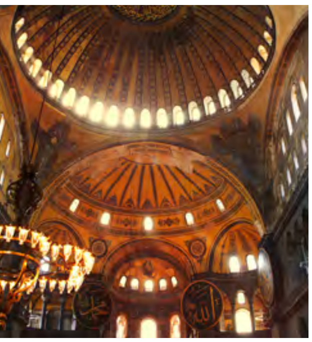
Turkey

Authorized Economic Operator: will customs procedures be simpler and faster?



Turkey now offers an extensive range of customs simplifications for approved companies that are granted the Authorized Economic Operator (AEO) certification. These simplifications are designed to provide significant advantages for AEOs with reduced costs and faster customs clearance.

Turkey's AEO regime is established under article 5/A of Customs Law no. 4458 (as amended by Law no. 5911) with principles and procedures provided under regulation. The regulation establishing the new customs simplifications for AEOs was published in the Official Gazette no. 28524 on 10 January 2013 ("Regulation on the Simplification of Customs Procedures"). The benefits from these simplifications stem from the AEO's privileges to perform many customs procedures on-site and priority status with respect to customs control (i.e., examination procedures). We highlight a selection of the primary simplified procedures introduced with AEO status below.

Simplified customs procedures (automatic)

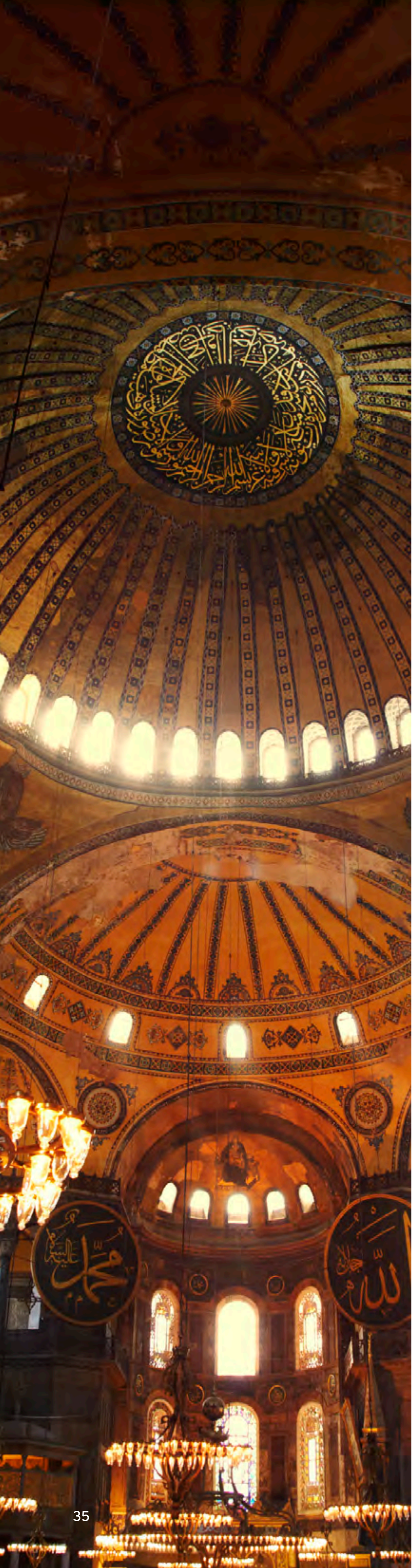
The following simplified procedures are provided to AEOs automatically, without further request:

- **Deficient declaration procedure:** AEO certificate owners are allowed to submit the customs declaration without attaching one or more of the following documents (some exceptions apply): A.TR circulation certificate; proof of origin documents; freight receipt, which must be submitted according to the type of delivery; insurance policy; and the processed agricultural products analysis result report, which must be submitted in case of releasing processed agricultural products for free circulation.
- **Partial guarantee practice:** For guarantee applications related to inward processing and outward processing regimes, the AEOs benefit from a partial guarantee of 10% of import duties, when required.

Simplified customs procedures upon request

Furthermore, AEOs shall also be allowed to carry out the following simplified practices upon their request under certain conditions:

- **Lump-sum guarantee practice:** AEOs may request to pay a lump-sum guarantee instead of providing individual guarantees for each transaction separately. This practice applies to cases where the goods are subject to a procedure or usage that requires the payment of a guarantee for customs duties and other taxes.
- **Approved exporter authority:** This authority provides the following simplified procedures for exports:
  - On-site customs clearance permission for exports (facility approval required)
  - All necessary controls are conducted on-site at the company's facility
  - Authority to issue A.TR circulation certificates (certain conditions apply)
  - Permission to issue invoice declaration or EUR.MED invoice declaration as approved exporters (applies to trade under Turkey's preferential trade arrangements: free trade agreements, the generalized system of preferences and agricultural trade between Turkey and the European Union)
  - Authorized sender permission, which applies to transit procedures that can be carried out at the AEO's facility (certain conditions and restrictions apply)



Simplified security and safety control procedures (automatic)

The AEO privileges also involve simplified security and safety control procedures, such as:

- Submission of summarized declaration containing reduced obligatory data
- Blue line application (i.e., controls for declarations deferred post-importation)
- Fewer document and physical controls
- Priority when document and physical controls are carried out

Closing thoughts

Given the extensive list of customs simplifications established under the new regulation, there is no question that Turkey's AEO program offers significant opportunities for trusted traders to reduce time and costs in their supply chain. For instance, the ability to have customs controls of exported products performed at the company's site without having to go to the customs authority is an advantage estimated to save 90% of export costs. Companies with extensive import and export operations that obtain AEO status will clearly gain a competitive advantage over non-AEOs.

To apply for the AEO certificate, companies established in Turkey must demonstrate that they meet specified requirements, such as adequate and traceable documentation; implemented safety and security measures; and financial solvency. The customs authorities will validate that the AEO criteria are met by the company and will make periodic checks to ensure that the AEO maintains the required level of customs compliance, safety and security.

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Customs Union of Russia, Belarus and Kazakhstan

Further customs simplifications and opportunities for AEOs

One of the Customs Union's legislative innovations is the establishment of the AEO, which was activated in 2012. A primary benefit of AEO status is the use of special simplified procedures. These procedures help to accelerate the customs clearance of goods, improve its efficiency and reduce the related costs.

Entities engaged in foreign economic activity are clearly very interested in receiving the status of AEO. More than 70 entities have become AEOs to-date.

Russia has recently proposed a package of amendments to the customs law and regulations to further boost the attractiveness of AEO status. In this respect, the amendments address some of the limitations of the special simplified procedures with modifications that expand the customs simplifications offered and make AEO status available to a wider range of entities. These amendments were developed in accordance with the road map prepared by the Agency for Strategic Initiatives and approved by Government Regulation No. 1125-r of 29 June 2012.

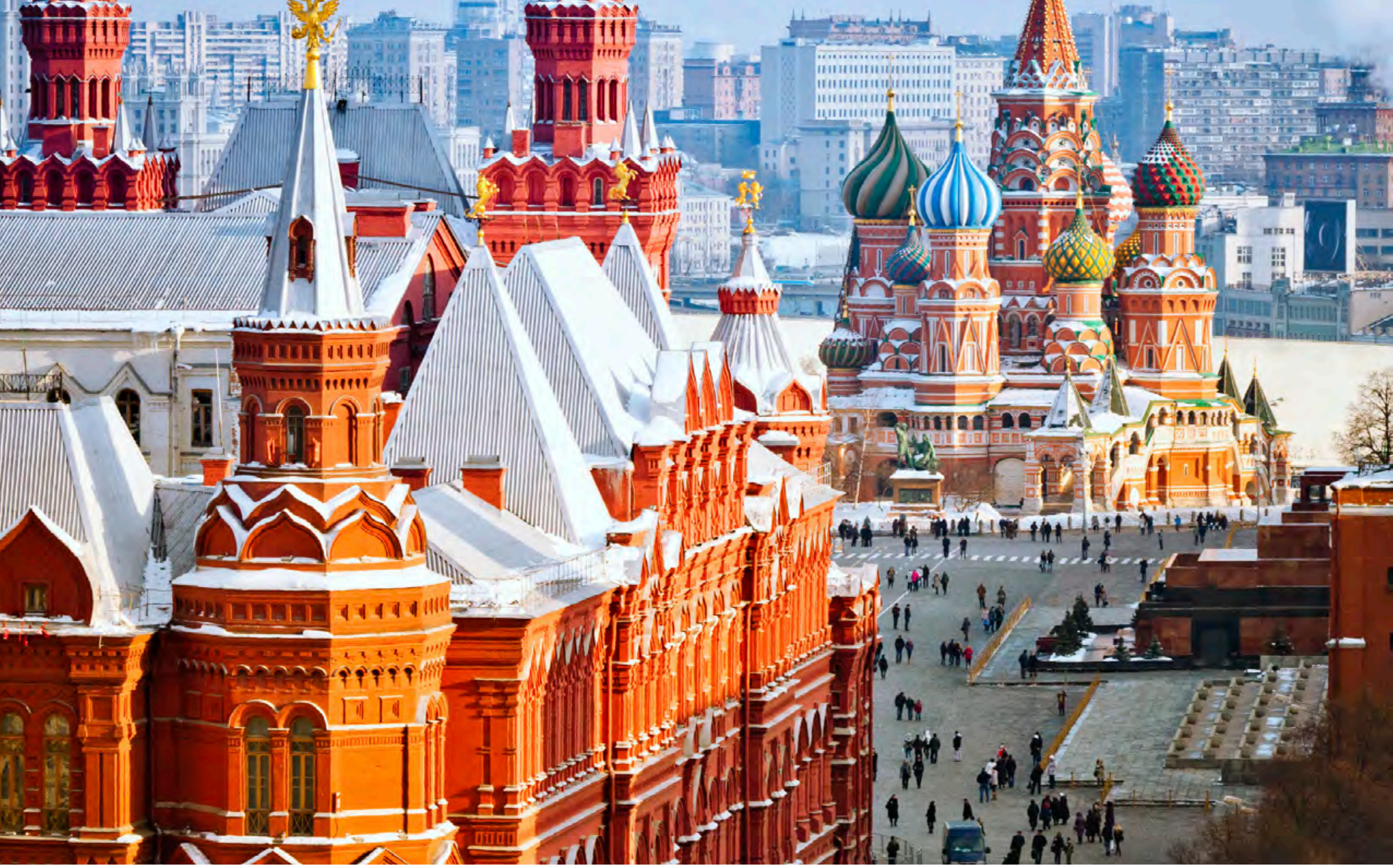
Securing the release of goods prior to filing a customs declaration

Under current rules, AEO status allows goods to be released prior to the filing of a customs declaration, but only when the amount of customs duties and taxes payable does not exceed the amount of the security deposit. AEO status requires standard security deposit levels of EUR 150,000 for entities engaged in the production and/or export of goods, and EUR 1 million in all other cases. However, to benefit from this customs simplification, AEOs must secure security deposits in amounts that can far exceed the established standard. This requirement is costly and administratively burdensome for AEOs to continually track whether the amount of security deposit is sufficient to cover the amount of customs payments on imports.

The proposed amendments include the withdrawal of this requirement for increased security deposit levels. As a result, the expenses of many AEOs in this respect would be reduced, as would the administrative burden on both the AEO and the customs authorities with respect to complying with the required security deposit levels.

More flexible customs duty payment system

A new customs simplification proposed in the amendments would provide a more flexible customs duty payment system for certain AEOs. Specifically, AEOs engaged in production activities would be able to defer the payment of customs duties and taxes or pay them in installments. The AEO thus benefits from cash flow advantages.



Expanded use of flexible customs transit procedure

It is also proposed that those entities that are not engaged in production and that have received AEO status should have the opportunity to deliver goods transported under the customs transit procedure to their sites and territories. Currently, this option is available only to production entities.

The draft amendments include the exclusion of the provision that the possibility to complete the customs transit of goods at an AEO's sites and territories does not apply to goods transferred under international agreements directly envisaging that only the customs authorities can be considered the place of delivery. The Federal Customs Service of Russia's Letter No. 04-30\50061 of 8 October 2012, states that based on this provision the customs transit procedure of goods transferred with the application of Carnet TIR cannot be completed (closed) at the AEO's sites and territories. We believe that after the exclusion of this legislative provision, the possibility to close the customs transit procedure at an AEO's sites and territories will likely be available for goods transferred with the application of Carnet TIR.

Closing thoughts

The amendment package is an important step as part of Russia's initiative to improve customs administration pursuant to the road map established by the Agency for Strategic Initiatives. By offering AEOs more tangible benefits in terms of customs simplifications, Russian entities have more incentive to consider becoming a trusted trader under the AEO program.

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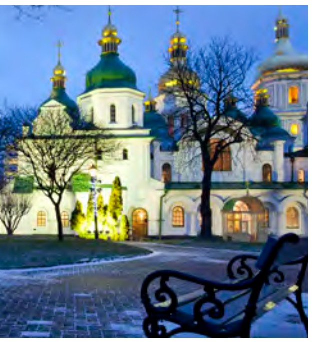
Ukraine

New safeguard duties on certain auto imports



In 2011, Ukraine's Interdepartmental Commission on International Trade (the Commission) initiated a safeguard investigation on the import of passenger cars into Ukraine, independent of their country of origin. (See the September 2011 issue of *TradeWatch*). According to the Commission, the investigation has determined that the increase in the volume of imports poses a threat to the local auto industry. This finding was based in part on a remarkable fall in the volume of cars produced by local manufacturers (78.9% reduction in 2010) and in sales of Ukrainian cars on the domestic market (86.3% reduction in 2010). The Commission's analysis of global auto industry trends indicates that countries that produce automobiles will use their manufacturing potential to export cards into Ukraine.

Based on the above, the Commission has concluded that there is a need to introduce safeguard duties on imported passenger cars, depending on engine capacity, at the following rates:

- 6.46% for motor cars with cylinder capacity exceeding 1,000 cm3, but not exceeding 1,500 cm3
- 12.95% for motor cars with cylinder capacity exceeding 1,500 cm3, but not exceeding 2,200 cm3.

The notification on the introduction of special measures for passenger car import into Ukraine was officially published on 14 March 2013, and will take force 30 days after the date of official publication.

The safeguard duties on cars will impact all passenger vehicles, regardless of the country of origin or export. Keep in mind that this is not the first attempt by Ukrainian car manufacturers to protect the domestic auto industry. In 2009, Ukraine introduced the controversial 13% temporary surcharge to import duties that applied to motor vehicles, among other products, in response to the economic crisis at that time. The surcharge was later cancelled in response to a WTO ruling against the measure.

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

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East Africa Community

Customs modernization in East Africa — single electronic window

Customs clearance of goods in the East Africa Community (EAC) involves self declaration to the customs authorities of the items being imported, their value and country of origin among other data requirements. Increasingly across the globe, this declaration is made using automated systems for the efficient importation or exportation of goods as well as compilation of accurate trade statistics.

The EAC is working to improve the level of automation and electronic systems used for customs clearance, which currently vary among member countries. This customs modernization initiative promotes the implementation of an electronic single window operation. Under the electronic single window, both the revenue authorities and other regulatory bodies involved in customs clearance approve importations using one platform.

The Common Market for Eastern and Southern Africa adopted the Automated System for Customs Data (ASYCUDA) as the official customs system. This system has been updated with different versions over time.

Within the EAC region, Uganda, Tanzania, Rwanda and Burundi currently use the version, ASYCUDA++ whereas Kenya uses the SIMBA System. ASYCUDA++ is not fully automated and involves extensive paperwork and use of manual systems. At times, the system does not generate all required reports. Such inefficiencies necessitate an upgrade of the system to ASYCUDA World, which is web-based and offers full-time online access to customs services. It is basically based on an electronic single window operation.

Once taxpayers file customs entries using the ASYCUDA World or SIMBA system, they are no longer required to physically get approval from the regulatory authorities on these entries. These regulatory authority officials now have a module in the ASYCUDA World or SIMBA system through which both approvals are made, and entries released after all necessary approvals, which shortens the approval process.

In Uganda, ASYCUDA World was rolled out in November 2012, with a pilot study being done in Jinja District Customs office. It is expected that the system will be rolled out throughout the country by March 2013. By this time, the customs clearing process will be fully automated as opposed to the current use of paperwork.

In Rwanda, Rwanda Revenue Authority (RRA) rolled out ASYCUDA World in July 2012. The RRA electronic Single Window links traders with government clearing bodies such as RRA, Rwanda Development Board, Ministry of Health and Rwanda Bureau of Standards. The electronic single window complements various reforms aimed at easing the flow of goods in and out of the country, such as introduction of 24-hour border operations at Gatuna and Gisenyi.

In 2011, Kenya established a state corporation, Kenya Trade Network Agency (KENTRADE), to implement the Electronic Single Window System as a possible solution to lengthy, corrupt, manual and uncoordinated trade processes and procedures.

Tanzania continues to operate using ASYCUDA ++; however, negotiations are in progress to enhance and upgrade to ASYCUDA World in April 2013.

The EAC's push toward modernized customs systems and the electronic single window offers significant benefits for importers. Some of the primary benefits include:

- Reduced clearing time with revenue authorities by half
- Submission of declarations by traders from anywhere in the world
- Online monitoring of the declaration status of goods
- Trade facilitation through standardized information and documents at a single entry point

It is envisaged that increased efficiencies in the trade process will be created with this system upgrade. The cost of doing business in East Africa should therefore be reduced, thus attracting more investment and trade.

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