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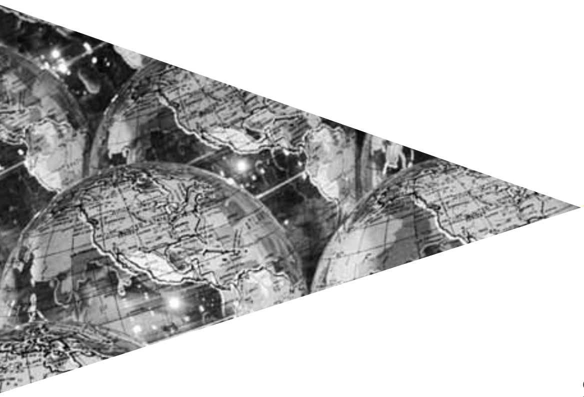

In this issue

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Spotlight on

Harmonized System changes may materially affect tariff classifications and duty rates; technology outpaces tariff amendments

Overview of Harmonized System changes

On 1 January 2012, World Customs Organization (WCO) Harmonized System Committee (HSC) amendments to the international Harmonized Commodity Description and Coding System (HS) of tariff nomenclature take effect on a nearly worldwide basis. The HS changes reflect "big picture" amendments to how certain types of goods are classified, and are intended to address changes to evolving technologies and industries. While the HS (and thus the proposed changes) are harmonized through the first six-digit "subheading" of a tariff number, there may be inconsistent interpretations of the new subheadings, and there (as always) will be very different terms across countries for details beyond the first six digits.

The modifications are the result of multiple sessions held by the HSC from September 2004 through March 2009. The amendments to the HS recommended by the WCO is the result of work conducted by the Review Sub-Committee (RSC). Established in 1990, the RSC is tasked with reviewing the HS nomenclature on a regular basis and to consider possible changes needed to keep it current with changes in technology and trade patterns.

The RSC's recommended amendments are then presented to the WCO participating countries for consideration. Participating countries have six months from date of notification to object. If no objections are received, the recommendations are deemed to be accepted and participating countries have a specified time period to translate the amendments into their national languages and obtain authorization from their governments to implement the amendments into their national tariff nomenclature (required to the six-digit international HS level).

A majority of the amendments under consideration comprise RSC proposals that resulted from its most recent review cycle of June 2009. Under Article 16 of the HS Convention, the date of implementation of recommended amendments is to be the first of January of the third year following the date of such notification. Therefore, the present amendments are scheduled for implementation on 1 January 2012.

Companies that have not addressed classification of their items under the new rules within the countries of their operation may have admissibility delays come January 1. More importantly, if companies have not considered the new HS taxonomy, and any ambiguities inherent in the new tariff schedules, they may find that their customs duty costs materially and suddenly change.

Key United States Harmonized Tariff Schedule changes for 2012

With respect to the United States, a significant number of amendments to subheadings will occur in chapters 1 through 21 for food products. The US proposed a new heading to cover sanitary goods such as diapers, sanitary towels, etc. to allow for additional subheadings of various types of advances in absorbent materials used in such products. The use of certain types of plastics as an alternative to or in addition to traditional materials of pulp, cotton or other fibers, is a recent advancement of technology for these goods that was not reflected in the HS.

Technological advances are also reflected through new amendments that provide separate identification in the HS for biodiesel fuels, nickel-metal hydride batteries used commercially in hybrid motor vehicles and lithium-ion batteries used commercially in powering consumer electronics products. Companies with business activities utlizing these commercial materials should pay particular attention to the amendments

becoming effective on January 1. Finally, a number of modifications have been made to the additional US Notes and to provisions of Chapters 98 and 99, although not part of the international HS, to reflect international amendments of the HS.

An examination of how the new tariff schedule affects imports of biodiesel into the US shows the different kinds of interpretive issues importers may face under the new rules and how evolving technological advances outpace adjustments to the tariff schedule.

Case study of 2012 changes — United States biodiesel imports

Background

As noted above, the Harmonized System is amended periodically to account for new technologies. Since the last major update in 2007, renewable energy and its urgency evolved considerably, including with respect to biodiesel. When biodiesel arose commercially, it was unclear where to place it within the Harmonized System. Traditional fuels, classified as "Petroleum oils and preparations thereof," fell under Chapter 27; certain miscellaneous chemical products fell under Chapter 38. Biodiesel production technology in the early 2000s utilized a chemical reaction caused by subjecting alcohol to plant and animal fats.

Because of this change in technology, the question at the time was whether or not biodiesel derived purely from chemical processing of plant and animal fats was a "petroleum oil [or] preparation thereof" or was that terminology reserved only for diesel derived from fossil oils? What about biodiesel blends featuring both renewable and fossil source materials? If biodiesel and "normal" diesel were functionally interchangeable, was it logical to have them in separate chapters? Questions arose across different jurisdictions as to how to best classify these products. U.S. Customs and Border Protection (Customs) classified biodiesel in Chapter 38 (miscellaneous chemical products) of the HTSUS under 3824.90.40, which provides for "fatty substances of animal or vegetable origin and mixtures thereof"[1] as a result of the chemical reaction required in its production. In 2010, the US added a specific provision for biodiesel under 3824.90.4030: "Biodiesel and mixtures thereof, not containing or containing less than 70% by weight of petroleum oils or oils obtained from bituminous materials." A US-specific Chapter 38 statistical note was also added: "For the purposes of heading 3824, the term 'biodiesel' means fatty acid esters of a kind used as fuel, derived from animal or vegetable fats and oils, whether or not used."

The WCO has attempted to address these questions as part of the 2012 HS. In turn, the US International Trade Commission (USITC) published its recommendations for corresponding 2012 amendments to the Harmonized System of the United States (HTSUS). Among the USITC's proposed amendments are new provisions that separate the identification of biodiesel. However, the proposed biodiesel changes leave key questions unresolved, and raise new ones.

Summary of 2012 HS changes related to biodiesel classification

The 2012 proposed amendments to the HS add new biodiesel provisions to both Chapter 27 (petroleum oils and preparations thereof) and Chapter 38 (miscellaneous chemical products). The 2012 amendments add a new Subheading, 2710.20, which is used to distinguish whether or not a particular petroleum product within heading 2710 contains biodiesel. The amendments also use the same biodiesel definition that was added in the 2010 US amendments, this time in a Chapter 27 subheading note and a Chapter 38 subheading note. Finally, the amendments add a new heading — 3826 — to separately allow for biodiesel.

[1] NY M85434 (13 September 2006), NY N021235 (28 January 2008), NY N025713 (16 April 2008), NY N062269 (5 June 2009).

The new HS classifications are behind the current technology used to produce biodiesel. Biodiesel is generally an animal or vegetable oil or fat-based diesel fuel. Traditional biodiesel production requires an esterification process involving alcohol. However, there are now other ways of manufacturing biodiesel that do not involve esterification. A recent technology advancement for producing biodiesel uses hydrogen, typically produced from petroleum oils through a separation process, instead of alcohol. As a result, biodiesel produced from hydrotreating processes do not contain fatty acid esters; they are made without esterification, and thus are not mono-alkyl esters of fatty acids as required in the pending amendments. The RSC effort that led to the 2009 recommendations, and thus the pending 2012 implementation of new subheadings, does not appear to take into consideration non-esterification production processes of biodiesel. As a result, there are unanswered questions about biodiesel produced with hydrogen, which may not fit within the new Chapter 38 classification.

Implications

While the 2012 HS changes were meant to clarify biodiesel classification, outstanding questions remain. Even though "normal" diesel and biodiesel may be functionally equivalent (in fact, in some cases, chemically similar), depending on how these questions are resolved, classification and duty rates could vary considerably based on the inputs used in biodiesel production, the process used in biodiesel production, the blend recipe and inventory controls where multisource mixing of tankage occurs. These differences can have significant duty impact.

For instance, in looking at the impact in the US, at the current price of biodiesel imported under new HTSUS classification 3826.00.10, as of 1 January 2012 biodiesel would be subject to an ad valorem duty of 4.6%, or approximately US$6.30 a barrel (42 gallons are in a barrel). The same barrel of biodiesel imported under HTSUS 2710.20 would be subject to a specific duty rate of US$0.105 a barrel — a 5,900% difference. As an additional consideration, Chapter 38 of the HTSUS distinguishes between pure biodiesel (B100) and biodiesel that contains other oils at the eight-digit level, with differential ad valorem duty rates of 4.6% and 6.5%, respectively.

The biodiesel example underscores the need for importers to consider the effect of the 2012 HS changes on their operations and cost structure for key materials and products, and key import locations. WCO amendments are to be adopted across all contracting states; accordingly, each country is undergoing changes to their tariff nomenclature (required to the six-digit international HS level). Each country's tariff nomenclature may have special distinctions that can lead to inconsistencies in application for different jurisdictions. Importers should recognize that these amendments may carry duty-rate implications, and could potentially affect qualification for preferential treatment under certain free trade agreements (FTAs) whose rules of origin are HS-based.

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Brazil

New horizons for the ICMS "fiscal war"

Given the high tax burden in Brazil, federal tax incentives designed to attract foreign investment, particularly for export manufacturing operations, provide important cost-saving strategies for companies looking to invest in Brazil. At the same time, Brazilian states have also been known to offer special benefits and incentives with respect to state value added tax (ICMS) to give themselves a competitive advantage over other states in attracting such investment to their territories.

Fiscal war between Brazilian states

Many state incentive programs have been controversial and have created a so-called fiscal war between the Brazilian states. Although the states are provided with constitutional autonomy to legislate over tax matters in their territory, the granting of incentives related to state ICMS requires prior approval through the execution of an ICMS agreement from the National Council of Fiscal Policy (CONFAZ).[2]

CONFAZ includes finance representatives from all states and approval must be unanimous. Hence, gaining CONFAZ approval is a monumental hurdle considering that proposed ICMS incentives, designed to promote the development of specific market sectors in the state, commonly result in a competitive advantage over the other states. Consequently, for the competing states, a vote in favor of another state's ICMS agreement can potentially harm their own chances of attracting new foreign investment.

As a result, in many cases, states have gone ahead without requesting CONFAZ approval and adopted their own tax policies with incentives consistent with CONFAZ requirements to promote economic development and comply with market demands. Such actions have created conflicts between states and lawsuits claiming harm from these unapproved state ICMS tax incentives that violate the federal legislation.

Resolution by the Brazilian Federal Supreme Court

Recently, the Brazilian Federal Supreme Court (Supremo Tribunal Federal or STF) reviewed 14 lawsuits against important Brazilian states (Rio de Janeiro, Paraná, Mato Grosso do Sul, Espírito Santo, Pará and São Paulo) that had granted ICMS benefits and incentives without approval from CONFAZ. In all cases, the STF declared the ICMS tax incentives as unconstitutional.

The STF held that:

- Any tax incentive related to state ICMS is valid and effective only with prior approval from CONFAZ.
- Amnesties and waiver of debts due to the use of such tax benefits are also considered as tax benefits and thus, are unconstitutional if not approved by CONFAZ.

What to expect

The STF has established a clear precedent for future similar cases, and going forward, companies will lose their "invalid" ICMS benefits. However, the question remains whether the STF's decision could have retroactive effect. In other words, it is uncertain whether or not businesses will be subject to ICMS assessments for amounts that should have been paid during the past five years (statute of limitations) but for the incentive programs. We note that in similar past decisions, the STF has generally leaned toward a retroactive application.

The issue is significant considering that a recent study by the Brazilian Tax Planning Institute (IBPT) has estimated that, should the decisions have retroactive effect, business would assume an estimated debt of almost US$160 billion. The most affected sectors are automotive, electronics, agricultural, machinery and equipment, paper and cellulose, metals or metallic minerals, aircraft, boats, pharmaceuticals, wholesalers, transport, and oil and gas.

[2] Article 155 of the Federal Constitution; Federal Complementary Law no. 24/1975.

Considering the consequences for affected businesses and the business environment in Brazil, many states are voicing their position in an effort to persuade STF that the decisions should have effect only going forward and not retroactively.

Even if STF decides in favor of a retroactive application, there are opportunities — despite the fiscal war — for the states to work together to alleviate the costly consequences for business. For instance, there is speculation that the states may negotiate with CONFAZ for authorization to grant tax amnesties or reductions for any past ICMS that was not paid due to the state incentive program.

Additionally, there have been news reports that the Brazilian Federal Government is considering reducing the ICMS tax rates for interstate operations from the current 12% and 7% to 4% and 2% to lessen the impact of the fiscal war. However, many states are unwilling to relinquish part of their tax collections and are opposed to the measure or planning to condition their approval of an ICMS rate reduction on CONFAZ approval of their ICMS tax incentive program.

Another potential response is that a state revokes the unconstitutional laws and substitutes them with new ones that basically grant the same benefits. As an example, the state of Santa Catarina has already created a new benefit program in place of the former "Pró-Emprego" program without CONFAZ approval. This measure may be effective, because once the law is cancelled, the lawsuit becomes moot and, in principle, a new lawsuit must be filed in order to confront the new benefit program. To prevent states from dodging the STF decision, the Brazilian National Confederation of Industry (CNI) has made a move to make the STF analyze the constitutionality of these new incentive programs, which were created to avoid the STF decision, in the same lawsuit of the previous, unconstitutional one. Such a response would speed up the judgment proceedings and promote compliance with the STF decision.

These are just a few of many possible scenarios currently under speculation. As you can see from the above, it is difficult to know exactly what to expect and what direction the fiscal war will take next.

Concluding thoughts

Despite the STF decision, the fiscal war has reached new horizons and the outcome is uncertain. Companies should assess the implications of the STF decision on their Brazilian operations and prepare for more changes to Brazil's tax landscape ahead. Bearing in mind that the STF decision involves several states and many incentive programs that affect a wide range of businesses and industries important to Brazil's economic development, we would not be surprised if CONFAZ comes up with a political solution with new tax planning opportunities for companies investing in Brazil.

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Brazil establishes new system for temporary imports

Brazil has agreed to join the Convention on Temporary Admission, also known as the Istanbul Convention. The Istanbul Convention, which has been widely adopted by most industrialized countries, is an international system of simplified and harmonized procedures aimed at facilitating the conditional duty-free and tax-free admission of temporary imports, such as commercial samples, professional equipment and goods for use at trade shows or exhibitions. Businesses thus benefit from cost savings, efficient procedures and predictability with temporary import operations between contracting parties to the Convention.

An important aspect of the Istanbul Convention is the ATA carnet system, which provides for a widely used international customs document for certain temporary imports of less than a year. With this system, businesses enjoy considerable simplification of customs formalities as the ATA carnet serves as a goods declaration at export, transit and import, and is secured by an international guarantee system that ensures duties and taxes will be paid in the event of non-compliance.

Pursuant to Presidential Decree 7.545/2011, effective 3 August 2011, Brazil has adopted the Istanbul Convention after approval by the National Congress last year. Brazil has agreed to most of the provisions of the Istanbul Convention, with the most significant exception being a reservation for the use of the ATA carnet for postal traffic, for which the ATA carnet will not be accepted. The ATA carnet will be allowed for other temporary import operations as set out in Annex B.1, B.2, B.5 and B.6 of the Istanbul Convention.

Brazil's establishment of a new system for temporary imports by joining of the Istanbul Convention is a significant development for trade. Although Brazil already has regulations that provide special procedures for temporary admissions with some import duty and tax relief, businesses often face difficulties and delays with the existing system.

For companies with international operations that involve temporary imports, such as trade shows and exhibitions, Brazil's acceptance of the Istanbul Convention is welcome news. The measure is also very important for the upcoming 2014 FIFA World Cup and 2016 Olympics, considering the amount of temporary import operations for the press, radio and television broadcasting, travelers' personal effects and goods imported for sports and event purposes.

Implementing regulations for the new temporary admission system based on the Istanbul Convention are forthcoming. Watch for further guidance in future issues of *TradeWatch*.

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Canada

Canada Border Services Agency's latest list of national trade compliance priorities

The Canada Border Services Agency (CBSA) actively conducts random and targeted post-importation verifications to assess trade compliance and revenue loss. The implications for importers can be significant with the potential for additional duty and tax assessments, monetary penalties and interest charges. Additionally, there are costs associated with the significant resources required to gather files, prepare information submissions, draft interim report responses and, when necessary, prepare and file adjustments to past customs entry declarations. The better prepared an importer is for an audit, the better the importer can manage and reduce these costs.

It is against this backdrop that the CBSA recently released its latest list of product categories designated as national trade compliance priorities (NPs). NPs are determined on a periodic basis through a risk-based approach, and constitute areas of specific interest above and beyond the more general areas of customs compliance CBSA generally monitors through random verifications.

CBSA has identified the following product categories and corresponding compliance area emphasis as NP audit targets:

NP product categories	Tariff classification	Customs valuation	Country of origin
Gloves	✓		
Cotton yarn	✓		
Furniture parts	✓		✓
Organic surfaces – active agents – soaps	✓		
Copper and articles thereof	✓		
Stone versus articles of stone	✓		
Tools, implements, cutlery, spoons and forks, of base metal; and parts	✓		
Juice products	✓		
Textile bags	✓		
Ski apparel		✓	
Parts of gas turbines		✓	
Light-duty automotive goods		✓	
Bulk shipments of ore		✓	
Plastic household goods		✓	
Motor car, bus and truck tires		✓	
Video recording apparatus		✓	
Pumps for liquids		✓	✓
Jewelry and parts thereof		✓	
Mattress upholstery			✓
Electronic generators			✓
Vegetable fats and oils			✓
Cocoa powder			✓

Companies that import NP products should be prepared for additional customs scrutiny, whether in the form of post-entry inquiries or notification of a pending audit. At the same time, importers that deal in goods or industries not listed as current NPs should not adopt a false sense of security. We commonly see CBSA verifications in sectors identified as NPs and sectors that are not listed as NPs.

It is important that importers take customs verifications seriously. Inadvertent mistakes or statements can prolong verifications and even cause the inquiry to be expanded into additional areas of investigation. For instance, mismanaging a response to a origin verification could jeopardize preferential tariff treatment enjoyed under an FTA. Similarly, responding to a valuation verification questionnaire without a technical understanding of the applicable rules may prompt CBSA to dive into an in-depth review of complex areas, such as related party pricing and royalty payments.

In this environment, it is important that companies take a proactive approach to customs compliance. There are a variety of compliance strategies that can be adapted to your company to assess risk areas and levels; identify compliance gaps; manage any identified areas of non-compliance; and improve trade processes and internal controls to promote trade compliance going-forward.

In brief, customs audits can be costly and cannot be avoided. Companies whose products are listed as a NP have been put on notice of an increased risk of customs verification; however, all importers should prepare accordingly.

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Mexico

Mexico's 2011 General Foreign Trade Rules

Mexico's Ministry of Finance issues, on an annual basis, general rules applicable to foreign trade operations. The additions and modifications to the General Foreign Trade Rules (GFTR) for 2011, published on 29 July 2011 in the Mexican Federal Register, include significant changes for foreign trade operations and IMMEX operations, in particular.

Annual post-entry adjustment to customs value

Before the latest GFTR were issued, Mexico's customs legislation established a limited and cumbersome process to make post-entry adjustments to the customs value declared on import "pedimentos." Through this process the importer was allowed to correct the customs value declared on import pedimentos up to two times (e.g., downwards price adjustments) or as many times as required when there were taxes due (e.g., upwards price adjustments). But, post-entry adjustments to customs value required amendment to each affected import pedimento filed by the importer. For an importer that made a single year-end adjustment for transfer pricing reasons that impacted every importation over the course of the year, each import pedimento required separate amendment.

The revised GTFR significantly simplifies the adjustment process for upward adjustments. Under the procedure established by new rule 6.2.1, importers may adjust the customs value declared in the pedimentos filed during the fiscal year by filing a single suplementary pedimento before the yearly tax return is due. The new rule requires importers to:

1. List all the original pedimentos which will be adjusted and the documentation which originates the adjustments.
2. Pay any taxes due from the customs value adjustments, updated or adjusted for inflation.
3. Pay the corresponding surcharges.
4. Pay a fine ranging between US$80 and US$120.

This procedure may only be used when upward price adjustments are made; the old rule continues to apply for downward adjustments.

New value added tax rules for IMMEX "virtual operations"

Through the virtual import/export mechanism, a foreign resident was able to sell goods temporarily imported by its IMMEX company[3] in Mexico to a final customer resident in Mexico. Even though the sale of goods in Mexican territory is subject to VAT, this transaction was treated as a "virtual" export and subject to a 0% VAT. The customer was treated as the permanent importer, and required to pay VAT on the import.

Under the amended GFTR, this transaction is now treated as a regular sale in Mexican territory and is subject to a 16% VAT.[4] Due to the fact that foreign residents cannot register exclusively for VAT purposes without also registering for income tax purposes, the Mexican resident who purchases the goods must withhold the corresponding VAT and pay it to the Mexican tax authorities. In addition, the merchandise continues to require permanent importation, which requires the purchaser to pay an additional VAT on import.

[3] This mechanism could only be applied by an IMMEX company which was registered before the customs authorities as an "Empresa Certificada."

[4] The VAT is 11% when the sale takes place within Mexico's border region.

This controversial change effectively imposes a double VAT payment upon the Mexican resident who purchases the goods, that is, the VAT due from the sale and the VAT due from the importation of the goods. Even though this double VAT may be recoverable either via credit or refund, it is to be expected that cash flow issues will arise due to the time required to process a refund request before the Mexican tax authorities.

This amendment to the GFTR has also created uncertainty among IMMEX companies which perform "maquila operations"[5] for income tax purposes and which may be eligible to apply certain tax credits proportional to their total exports, because it is not clear if the tax authorities may also stop considering virtual operations as exports, which could have a negative impact on the total exports of IMMEX companies and possibly on their tax credits.

Customs value declaration by IMMEX companies

Mexico's customs legislation generally requires that importers file a customs value declaration accompanied by a calculation sheet, signed by the importer's legal representative, which supports the methodology used to declare the customs value of imported products.

The GFTR have been modified to eliminate this requirement for IMMEX companies who perform temporary imports and declare a provisional customs value, as long as such value is based on the freight insurance contract or any other objective element which reflects the value of the temporarily imported products. Because of this, IMMEX companies are no longer required to file a value declaration nor the calculation sheet and they will not be required to complete Field 5 of the import declaration or "pedimento" which refers to the customs valuation method used.

It is worth noting that if IMMEX companies decide to permanently import the products that were temporarily imported under their IMMEX program, they should determine the customs value of such products in accordance with Mexico's customs legislation and include all required value documentation upon filing of the new permanent import pedimento.

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[5] "Maquila operations" for income tax purposes exist when an IMMEX company carries out, with inventories and other goods furnished, directly or indirectly, by a foreign resident with whom a maquila agreement is in place, the transformation, manufacture or repair of such goods.

NAFTA

Mexico reduces NAFTA retaliation measures against the United States

Businesses affected by Mexico's retaliatory measures against the US in the long-running NAFTA dispute involving cross-border trucking now have some relief. On 7 July 2011, the Mexican Ministry of Economy published the "Decree which modifies the import duty rate for goods originating in the United States," which reduced by half Mexico's retaliatory duties imposed on 99 US agricultural and industrial products. Meanwhile, the total elimination of the retaliatory duties is in sight.

The Mexico – US cross-border trucking dispute

As background, the dispute between Mexico and the US stems from the US failure to implement NAFTA provisions that would have provided Mexican cross-border trucking companies access to the US border states by 1995 and full access to the US territory by 2000. In February 2000, the Mexican Government initiated an arbitration procedure in accordance with Chapter XX of NAFTA. The NAFTA arbitral panel issued its final decision in February 2001, finding that the US had violated its obligations under NAFTA.

In response to the panel's decision, the US and Mexico implemented a pilot program in September 2007, which allowed up to 100 Mexico-domiciled motor carriers to operate beyond the US border commercial zones and up to 100 US carriers to operate in Mexico. This pilot program was extended in August 2008, and was expected to be in force until the year 2010. Nevertheless, the US Omnibus Appropriations Act of 2009 effectively terminated the pilot program due to the lack of US funding.

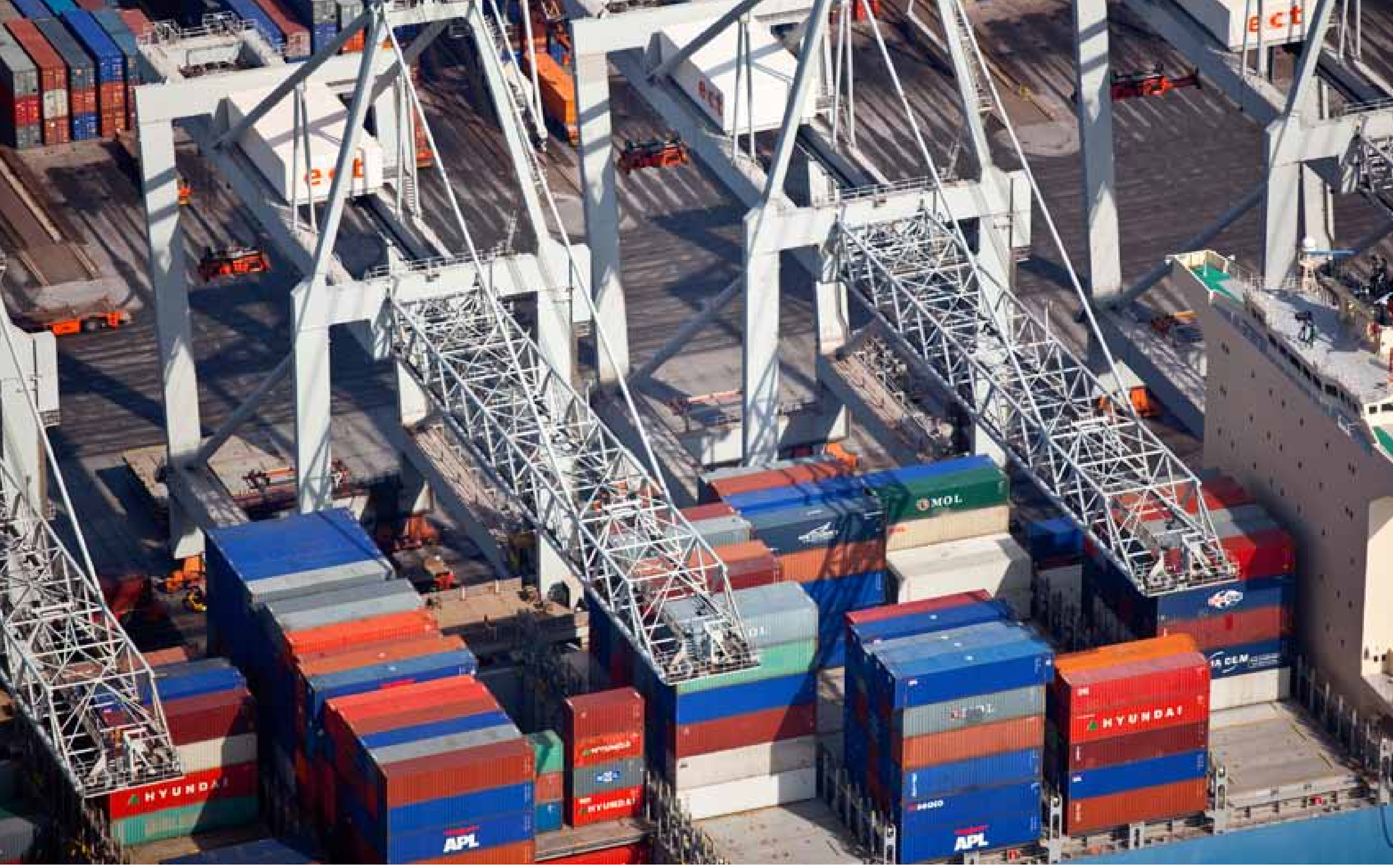
In March 2009, the Mexican Government implemented retaliatory measures pursuant to Article 2019 of NAFTA to pressure the US Government to comply with the arbitral panel's decision and implement the relevant NAFTA provisions. The initial retaliation list was comprised of 89 diverse US products, which were subject to tariffs ranging between 15% and 20% upon importation into Mexico.

On 18 August 2010, the Mexican Government announced a new list of US products, which removed certain products from the duty retaliation list while adding new ones. This new list encompassed a diverse range of US products, with the agricultural sector and various manufactured goods being the hardest hit, all of them subject to rates of duty between 5% and 25% (as discussed in the September 2010 issue of *TradeWatch*).

End to retaliatory duties in sight

Negotiations between the Mexican and US governments over the last two years have resulted in an agreement formalized in a Memorandum of Understanding (MOU) signed on 6 July 2011 by the U.S. Department of Transportation and the Mexican Ministry of Economy. The MOU establishes the terms for resolving the ongoing cross-border trucking dispute in stages.

The first stage involves a pilot program, which allows approved Mexican trucks to operate in the US interior beyond the 25 mile border region, thereby implementing the NAFTA provisions that had been stalled since 2009. In the second stage of the program, the US will grant full authority for Mexico-domiciled motor carriers to operate in the US interior.



Accordingly, the Mexican Government has reduced the retaliatory tariffs imposed on US-originating goods by 50% and has reciprocally allowed approved US trucks to operate in Mexico's interior. The retaliatory duties will be completely eliminated once the first Mexico-domiciled carrier is granted operating authority. Such authority requires that the Mexico-domiciled carrier pass a safety audit pursuant to guidelines established in the MOU.

What to expect

The pilot program is underway and businesses affected by the retaliatory duties are actively awaiting the first permit granting operating authority to a Mexico-domiciled carrier pursuant to the pilot program to end the suspension of NAFTA preferential tariff treatment on the 99 affected products. We note that while many retail industry groups have applauded the agreement, opposition from certain US industry groups, such as the truckers unions, remains high in the US.

The outcome of the pilot program will be closely followed, especially considering that Mexico has reserved the right under NAFTA to reinstate retaliatory measures should the US fail to withhold its end of the MOU. While the end to the dispute is in sight, until cross-border trucking becomes the status quo, the risk of future retaliatory measures remains.

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United States

US export control reform is taking shape

US export control reform is taking shape with significant progress on some important initiatives. With new rules already implemented in 2011, and more to come, companies need to understand the implications for their operations and compliance programs.

Overview — US export control reform

The Obama Administration believes that US export control reform is necessary to strengthen national and global security, enhance the competitiveness of key US manufacturing and technology sectors and adapt to the ever-changing technological and commercial landscape. Accordingly, in August 2009, President Barack Obama ordered a complete review of the US export control system. The original export control reform plan laid out by the Obama Administration was an ambitious plan to move from multiple agency control lists, jurisdiction, enforcement and information technology systems to the "singles":

- Single Control List — combining the United States Munitions List (USML) and the Commerce Control List (CCL) into a single tiered control list
- Single Licensing Agency — combining the jurisdiction and review of the Departments of State, Commerce, Defense and Treasury
- Single IT System — developing a single IT platform through which exporters would interact with the government during classification, licensing or related reviews
- Single Enforcement Agency — coordinating efforts of the seven agencies involved in the enforcement of US export control laws

Significant and steady progress has been made toward achieving the goals originally laid out in 2009; key changes implemented during 2011 are summarized as follows.

Dual and third-country nationals employed by licensed end-users

Addressing US export controls on intra-company transfers of controlled technology has always been complicated. On 16 May 2011, the U.S. Department of State, Directorate of Defense Trade Controls (DDTC) published a final rule creating a license exemption in 22 CFR 126.18 for internal transfers of unclassified defense articles and technical data to dual nationals or third-country nationals who are "regular employees" of approved foreign end-users, governmental entities, international organizations or consignees (including approved sub-licensees). 22 CFR 124.16 previously provided for a similar exemption, but limited the application of the exemption to nationals of NATO and EU member countries and nationals of Australia, Japan, New Zealand or Switzerland. The new exemption does not limit its application to nationals of particular countries.

To utilize the exemption, transactions must meet the following conditions:

- The foreign entity originally receiving the defense article or technical data must be a foreign licensee on an approved DDTC agreement.
- The transfer must be within the scope of the underlying export authorization.
- The defense article or technical data must be unclassified.
- The transfer must take place within the end-user's country, where the governmental entity or international organization conducts official business or where the consignee operates.
- The transferee must be a "regular employee," defined as "an individual permanently and directly employed by the company" and some long-term contractors under the direction and control of the company.
- The foreign entity must have "effective procedures" to prevent diversion for unauthorized purposes or to unauthorized users.

The "effective procedures" requirement may be satisfied by:

- Requiring a security clearance from the host country
- Requiring employees to sign non-disclosure agreements stating that they will not unlawfully transfer defense articles or technical data
- Screening employees for "substantive contacts" with 22 CFR 126.1 countries [6]

DDTC provided examples of "substantive contacts," which include:

- Regular travel to 19 CFR 126.1 countries
- Recent or continuing contact with agents, brokers and nationals of those countries
- Continued demonstrated allegiance to those countries
- Maintenance of business relationships with persons from those countries
- Maintenance of a residence in those countries
- Receiving salary or other continuing monetary compensation from those countries
- Acts otherwise indicating a risk of diversion

While the new expanded exemption for dual and third-country nationals brings the ITAR more in line with commercial and legal realities (i.e., privacy laws), companies must be cognizant of the strict controls on its use, including demands on companies to document processes and investigate their own employees for "substantive contacts." This new rule went into effect on 15 August 2011.

License exception strategic trade authorization

Another goal of US export control reform is to reduce controls on "lower risk" exports. On 16 June 2011, license exception strategic trade authorization (STA) was published by the Bureau of Industry and Security (BIS). STA was made immediately available for the export, re-export and transfer of many "dual use" goods, software and technologies on the CCL to a specific list of countries.

Whether STA applies is both item-specific and destination-specific. Both the item and the destination must be STA-eligible. Determining whether an item may make use of STA is based on the Export Control Classification of the item and the terms of STA itself (15 CFR § 740.20). Generally speaking, many types of items are eligible for STA. The receiving country must also be eligible for STA; currently 36 countries are eligible, including Argentina, Australia, Austria, Belgium, Bulgaria, Canada, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Latvia, Lithuania, Luxembourg, Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, South Korea, Spain, Sweden, Switzerland, Turkey and the United Kingdom. Additionally, items that are controlled only for National Security (NS) reasons may potentially be eligible for eight additional destinations under STA: Albania, Hong Kong, India, Israel, Malta, Singapore, South Africa and Taiwan.

Even where both the item and destination are eligible for STA, changes to internal controls are necessary prior to use. STA requires various mandatory notifications and acknowledgements, including:

- **Requirement to furnish ECCN:** Exporters must furnish the Export Control Classification Number at least once for each shipment under STA.

[6]Afghanistan, Belarus, Burma, China, Ivory Coast, Cuba, Cyprus, Democratic Republic of the Congo, Eritrea, Fiji, Republic of Guinea, Haiti, Iran, Iraq, Kyrgyzstan, Lebanon, Liberia, Libya, Republic of Niger, North Korea, Sierra Leone, Somalia, Sri Lanka, Sudan, Syria, Venezuela, Vietnam, Yemen and Zimbabwe.

- **Prior consignee statement:** Exporters must obtain an export control statement in the prescribed form from the foreign consignee at least once prior to shipping each item (the statements and a log of all shipments under STA must be maintained in the company records).
- **Notification to consignee of STA shipment:** Exporters must notify the consignee in writing (fax or email allowed) when a shipment is made under STA.
- **Requirement related to deemed exports:** A company which makes a deemed export must notify the recipient in writing of the restrictions related to further release of the software source code or technology (this may be accomplished through an employment agreement or non-disclosure agreement).

While STA was intended to help companies address the complicated US export control environment pending more substantive change, STA itself is fairly complex. Moreover, STA certainly does not address all situations. BIS estimates that 3,000 of the 22,000 licenses issued in 2010 would have been eligible for STA. Critics of STA claim that the compliance burden discussed above will limit the use of STA by exporters. BIS officials have indicated the greatest utility for STA will likely be to those companies who currently have products controlled on the USML, which will be moved to the CCL (discussed below) and become eligible for STA. STA can also be potentially used to address intra-company transfer and development of controlled dual use technologies, which has been a difficult area to address under existing US rules.

USML to CCL migration

On 15 July 2011, BIS issued a proposed rule explaining how BIS intends to classify and control items that no longer warrant control as "defense articles" on the USML. The proposed rule demonstrates how jurisdictional transfer from the USML to the "dual use" CCL will work. The Obama Administration plans to publish a series of rules that redefine items on the USML to a positive list with objective measurement criteria.

Strategic items previously controlled on the USML that no longer warrant control on the USML will be transferred to the CCL as part of a new "600" series of Export Control Classification Numbers (e.g., xY6xx). This will establish a de facto "Commerce Munitions List" within the CCL. The "600" series migration will result in varying levels of control. Some will be eligible for export to most destinations; others will enjoy the possibility of license exceptions; while others will remain highly controlled. Items that are not migrated to the new "600" series may conceivably fall under the existing CCL structure. If they are not described on the CCL, then they may be decontrolled to "EAR99" and in doing so be eligible for most destinations.

At the recent BIS Update conference, BIS officials announced that the migration is expected to be completed by the end of 2012. It should be noted that the transfer of items from the USML requires the President to notify Congress at least 30 days prior to removing any items. It remains unclear how Congress will react to the proposed transition of items. Obviously, if Congress objects, it could significantly delay the process.

Conclusion

Export control reform is taking shape with steps in the right direction, but it also means that the rules companies have grown accustomed to are changing. Overall, these changes are intended to have a positive impact and reduce the overall export control burden for exporters. At the same time, some of the new exceptions and exemptions entail strict controls that could be areas of exposure if companies do not implement effective internal controls and documentation procedures to ensure and support that the various requirements and conditions are met. For the changes yet to come, companies will need to diligently monitor developments until the final rules are written, and update their compliance programs accordingly.

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CBP withdraws proposed amendments to CBP regulations on uniform rules of origin for imported merchandise; adopts amendments to specific rules of origin for five product areas

In a Final Rule document issued on 2 September 2011 in the Federal Register, U.S. Customs and Border Protection (CBP) did not adopt the uniform rules for country of origin determination that were proposed in 2008. The country of origin for goods imported into the US will continue to be determined either on a case-by-case basis according to the "substantial transformation" standard or, for goods imported under the North American Free Trade Agreement (NAFTA) and various subsequent FTAs, according to the shift in tariff classification. The proposed amendments to CBP regulations would have extended application of the NAFTA rules of origin, as codified in part in 19 CFR 102, to all imported merchandise origin determinations. However, the majority of comments CBP received (42 out of 70) during the twice-extended comment period opposed implementation of such uniform rules and for this reason CBP determined to withdraw the proposal.

The same notice of proposed rulemaking also contained proposed amendments to the specific rules of origin codified in 19 CFR 102 for five product categories:

1. Pipe fittings and flanges (headings 7301-7307): in addition to a change in heading 7301 through 7307 from any other heading including heading of that group, the amendments provide for a change within heading 7307 from fitting forgings or flange forgings to fittings or flanges made ready for commercial use by at least one of the following processes: bevelling, bore threading, center or step boring, face machining, heat treating, recoining or resizing, taper boring, machining ends or surfaces other than a gasket face, drilling bolt holes, and burring or shot blasting
2. Greeting cards (headings 4901-4811): the amendments provide for a specific rule for 4909: a change to 4909 from any other heading except heading 4911 when the change is a result of adding text
3. Glass optical fiber (subheading 9001.10): a change to subheading 9001.10 from any other subheading, except from subheading 8544.70 or glass performs of heading 7002
4. Rice preparations (subheading 1904.90): a change from any other heading except heading 1006 or wild rice of subheading 1008.90
5. Certain textile and apparel products (headings 6210-6212), the amendments create a separate rule for heading 6212 where if the good is knit to shape, a change to heading 6212 from any other heading, provided that the knit to shape components are knit in a single country, territory or insular possession

The proposed amendments serve to align these specific rules of origin with court decisions, customs rulings, CBP practice and underlying statutes. CBP adopted these amendments as proposed and the new rules go into effect as of 3 October 2011.

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The proposed customs fee increase could make US foreign-trade zones even more attractive

A proposed increase to the merchandise processing fee (MPF), a US customs user fee applied on a per shipment basis for imports, has the potential to significantly increase costs for some US importers. In turn, the US foreign-trade zone (FTZ) program, which provides an opportunity to significantly reduce these costs, could become even more attractive.

MPF is currently assessed at 0.21% of the merchandise value, with a US$25 minimum and US$485 maximum amount assessed per formal entry. The MPF cap is reached when a shipment exceeds approximately US$230,952 in value. With the proposed MPF increase, companies with shipments below the effective value threshold of US$230,952 may face significant additional MPF costs. For companies with import value shipments above the current threshold, there will be no difference felt from the proposed increase.

Current scenario

MPF cost implications

Depending on the frequency and value amount of shipments, annual MPF costs can be significant, as illustrated in Table 1.1 below. Companies are able to significantly reduce these MPF costs by using FTZs. A FTZ is an area physically located in the US, but considered outside the US customs territory. Companies operating under a FTZ designation can achieve a number of significant benefits, including reduction or elimination of import duties, increased cash flow, property tax savings and customs user fees (i.e., MPF) savings.

With respect to MPF, a key benefit is the ability to use weekly entry procedures exclusive to FTZs. Importers can file one entry per week covering all shipments from its FTZ, rather than one entry per shipment. The maximum MPF paid under FTZ procedures would be US$485 weekly and US$25,220 annually. As a result, the MPF liability is significant, as presented in Table 1.1.

Table 1.1 — Annual MPF costs (MPF at 0.21%) and FTZ savings

Value per shipment	Annual MPF costs at 10 shipments/week without FTZ	Annual MPF costs with FTZ	Annual MPF FTZ savings at 10 shipments/week	Annual MPF costs at 30 shipments/week without FTZ	Annual MPF costs with FTZ	Annual MPF FTZ savings at 30 shipments/week
US$140,000	US$152,880	US$25,220	US$127,660	US$458,640	US$25,220	US$433,420
US$200,000	US$218,400	US$25,220	US$193,180	US$655,200	US$25,220	US$629,980
US$230,000	US$251,160	US$25,220	US$225,940	US$753,480	US$25,220	US$728,260

Proposed increase to merchandise processing fees

MPF costs are expected to increase if a proposed MPF rate hike goes into effect. As a measure to offset the costs of the pending US — South Korea Free Trade Agreement (KORUS), both the U.S. Senate Finance Committee and the House Ways and Means Committee separately approved provisions in their respective draft KORUS implementing bills to increase the MPF rate from 0.21% to 0.329% (Senate version) and 0.3464% (House version). The current minimum and maximum MPF cap amounts (i.e., US$25 minimum and US$485 maximum) would remain.

MPF increase — cost implications

The proposed change to the MPF rate represents at least a 56% increase over the current rate; however, the actual impact to a company's MPF may be less for higher value shipments. This is because the US$485 MPF cap per entry will be more quickly reached at the higher proposed MPF rates, at approximately US$147,416 (using the proposed Senate rate of 0.329%). Table 1.2 below demonstrates the MPF costs under the proposed rate hike. Basically, shipments valued less than the new value threshold for the MPF cap (US$147,416) can expect an increase in MPF costs by a significant 56%. Shipments valued between US$147,416 and US$230,952 will also experience an increase in MPF costs, although perhaps a less significant increase because the lower value threshold to qualify for the MPF cap per entry helps soften the blow. On the other hand, MPF costs will remain consistent for shipments of values that exceed the MPF cap under the current rate (i.e., shipments that exceed US$230,952 in commercial value) and will obviously continue to benefit from the MPF cap going forward.

Despite the proposed MPF rate increase, the company with FTZ designation would still only pay US$25,220 annually under FTZ weekly entry procedures as the MPF cap amount (US$485 per entry) is not expected to change. Table 1.2 demonstrates the potential FTZ savings under the proposed MPF rate of 0.329%.

Table 1.2 — Annual MPF costs under proposed rate increase (MPF at 0.329%) and potential FTZ savings

Value per shipment	Annual MPF costs at 10 shipments/week without FTZ	Annual MPF costs with FTZ	Annual MPF FTZ savings at 10 shipments/week	Annual MPF costs at 30 shipments/week without FTZ	Annual MPF costs with FTZ	Annual MPF FTZ savings at 30 shipments/week
US$140,000	US$239,512	US$25,220	US$214,292	US$718,536	US$25,220	US$693,316
US$200,000	US$252,200	US$25,220	US$226,980	US$756,600	US$25,220	US$731,380
US$230,000	US$252,200	US$25,220	US$226,980	US$756,600	US$25,220	US$731,380

Conclusion

The proposed price increase will have a greater impact on companies whose current import values fall below the current US$230,952 threshold. For such companies concerned about the cost implications of the proposed MPF rate hike, consideration should be given to the FTZ program, which would provide relief from the increased costs. Companies that consistently import high-value shipments that exceed the threshold will not be impacted from the proposed increase. However, FTZ savings for these companies can still be sizeable when there is higher shipment frequency, regardless of the MPF rate (current or proposed).

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New changes to the origin rules for the United States-Chile FTA

In August 2011, the United States-Chile Free Trade Commission (FTC) held its seventh annual meeting to discuss the US-Chile FTA (UCFTA), which has been in effect since 2004. As an outcome of the meeting, the FTC agreed to a series of liberalizing amendments to several rules of origin for a variety of products to go into effect on 1 November 2011. These changes merit a close inspection by importers and exporters utilizing the UCFTA, as the criteria for qualification may have changed on a product-by-product basis.

Amendments were made to the rules of origin for certain products classified in Chapters 7, 9, 12, 18, 21, 40, 71, 84, 85 and 90 under Annex 4 of the UCFTA. Affected products include certain spices, coffee, machinery and equipment, and lamps.

Additionally, there are revisions to the notes for Annex 4, Section VI: Products of the Chemical or Allied Industries, which affect products classified in Chapters 28-38. The rules expand on the definitions of a chemical reaction to allow for more process-type tests for assessing origin.

Future modifications are expected in early 2012 as the FTC also agreed to modify the UCFTA rules of origin to comply with the countries' revised tariff schedules following the World Customs Organization amendments to the nomenclature of the Harmonized Commodity Description and Coding System 2012.

According to statistics for 2010 provided by the Central Bank of Chile, bilateral trade has more than doubled since the FTA came into effect in 2004. The US was the primary source of foreign direct investment in Chile for the period 1974-2010, which totaled US$26.3 billion in 2010 alone. The UCFTA has encouraged US investment in Chile and should also continue to spur exports.

Considering the potentially significant savings from UCFTA preferential tariff treatment, now may be a good time to review present practices for confirming origin and eligibility of products under the agreement as your company assesses the implications of the upcoming amendments. Effective origin qualification processes and internal controls serve to ensure compliance with the rules and safeguard the duty savings from utilization of free FTAs.

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[7] Joint Statement of the VII Meeting of the US-Chile Free Trade Commission, 2 August 2011.

China

China Customs to more closely monitor the Processing Trade

Export manufacturers in China typically carry on their operations utilizing the Processing Trade, which allows them to import raw materials, parts, components, etc. on a bonded basis if used in export production. Processing Trade currently accounts for approximately 40% of China's total import and export trade volume and saves companies billions of dollars in upfront duty and VAT costs. This means the value and importance of the Processing Trade to a company's business strategy should not be underestimated.

Processing Trade has been widely utilized by multinational companies because they can avoid the upfront payment of duties/taxes on imported materials. These savings are particularly relevant in China as often payments of customs duty (China does not have a duty drawback program) or import VAT (there is an export VAT "leakage" cost) cannot be recovered or may only be partially recoverable. However, as a result of the huge cost savings and importance to the operations, one of an export manufacturer's largest business and tax risks in China revolves around the ability to continue using Processing Trade. Consequently, there have been many discussions in the government on how to strengthen the management of Processing Trade and more closely monitor companies' compliance with the regulations.

More focus on the "Customs Handbook"

The Processing Trade is managed by the Ministry of Commerce (MOFCOM) and the General Administration of Customs (China Customs). While MOFCOM provides the approvals for a company to operate as a Processing Trade entity, China Customs is the operational and execution agency to administer the program on a day-to-day basis. China Customs issues a *"Customs Handbook,"* either in a manual or electronic form, to track the bonded materials/components from the time of importation, through the manufacturing process and finally to the exportation of the finished goods. Entities using a *"Customs Handbook"* are held accountable by China Customs to "reconcile" the imported bonded and domestically sourced materials (i.e., the inputs) against their usage in exported finished goods (i.e., the outputs). However, variances in the usage, consumption and tracking of the bonded materials may occur for a variety of reasons and this can create a significant business and tax exposure for companies.

In order to strengthen the management of Processing Trade, China Customs has recently introduced an internal structural reform that may have a significant impact on the business operations of entities engaged in Processing Trade. The Processing Trade Supervision Department was previously responsible for overseeing and administering the Processing Trade. However, certain bonded inspection functions have been transferred from the Processing Trade Supervision Department to the Audit Department within China Customs.

Historically, the Processing Trade Supervision Department would normally allow a company to reconcile their *"Customs Handbook"* on their own and would largely rely on the bonded inventory quantities provided by the entities to conclude the *"Customs Handbook"* reconciliation. With the recent changes and based on experience, it is expected that the Audit Department is likely to apply a more thorough and aggressive approach in executing their inspection and reconciliation review responsibility. It is highly likely that companies will experience more frequent and robust *"Customs Handbook"* reconciliations and audits in the future. This will require a processing trade entity to ensure they have robust internal controls, comprehensive record-keeping practices and sufficient experienced resources to manage the operations and possibly facilitate an on-site inspection/audit by customs officials, should it arise.

Many large entities operating under Processing Trade rely heavily on the uninterrupted enjoyment of the program's costs savings to be competitive. Should these entities lose their ability to efficiently access the benefits, they would have to rethink their export manufacturing position in China.

What to expect

It is expected that the new initiatives will heighten China Customs' focus on identifying compliance gaps and exposures from violations of the relevant rules and regulations and making assessment against companies. For these reasons, public bonded warehouses and large processing trade companies may be identified and selected in the near future by the Audit Department for review and these entities could become the subject of a thorough inspection or full scale audit.

Such intensive audits usually have resulted in significant findings and additional costs to businesses that are not in a position to completely support their internal procedures.

The Audit Department will normally alert target entities by issuing a formal notice announcing their intention to either conduct a high-level review or propose a more intense audit. The time frame outlined in the notice is usually very short and may not provide sufficient time to adequately prepare before the Customs officials plan to conduct their on-site inspection and review the company's entire Processing Trade operations.

Are you ready for China Customs to audit your Processing Trade operations? Given the material impact negative findings could have to an entity (e.g., duty/VAT costs, penalties/interest and downgrading), we suggest that export manufacturers prepare now to better understand their operations, assess whether compliance gaps exist and seek to resolve these as soon as possible before China Customs comes knocking on your door.

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Japan

Japan-India CEPA enters into force

The Comprehensive Economic Partnership Agreement (CEPA) between Japan and the Republic of India (JICEPA) entered into force on 1 August 2011. This is the 12th effective Economic Partnership Agreement (EPA) for Japan and the 18th effective trade agreement for India.

The agreement seeks to liberalize and facilitate trade in goods and services, promote investment and promote cooperation between the countries in a wide range of activities including the improvement of the business environment. With respect to trade in goods, customs duties will be eliminated on approximately 94% of trade (based on value) between these countries within 10 years after the entry into force of the agreement.

Elimination or reduction of customs duties

Examples of some of the duty reduction or elimination schedules under this agreement are as below:

Japan duty reduction/elimination schedule for items from India

Sector	Item	Base rate	Duty reduction
Industrial products	Almost all items		Eliminated upon entry into force
Agricultural products	Durian	2.5%*	Eliminated upon entry into force
	Asparagus	3%	Eliminated upon entry into force
	Peppers	3%	Eliminated in 7 years
	Sweet corn	6%	Eliminated in 7 years
	Curry	3.6%*	Eliminated in 10 years
	Tea	2.5%	Eliminated in 10 years
Forestry products	Lumber	3.6%*	Eliminated upon entry into force
Fishery products	Shrimp	1%-2%	Eliminated upon entry into force
	Frozen octopus	5%*	Eliminated in 7 years
	Prepared shrimp	3.2%*-5.3%	Eliminated in 10 years
	Jelly fish	7%	Eliminated in 10 years

**GSP rate.*

India duty reduction/elimination schedule for items from Japan

Sector	Item	Base rate	Duty reduction
Automobile parts	Distributor, ignition coil	7.5%	Eliminated in 10 years
	Fender, muffler	10%	Eliminated in 10 years
	Diesel engine	12.5%	Reduced to 5% in 6 years
	Gear box	12.5%	Reduced to 6.25% in 8 years
Articles of iron and steel	Hot/cold rolled steel, alloys, galvanized sheet iron	5%	Eliminated in 5 years
Electric products	Lithium-ion batteries and lead-acid accumulators	10%	Eliminated in 10 years
	DVD players, video cameras, car radios	10%	Eliminated in 10 years
	MP3 players	5%	Eliminated in 5 years
	Microwaves	10%	Eliminated in 10 years
General machinery	Bulldozers	7.5%	Eliminated in 10 years
	Tractors	10%	Eliminated in 10 years
	Industrial robots	7.5%	Eliminated in 10 years
	Air conditioning machine parts	10%	Eliminated in 10 years
	Steam and vapor turbines, gas turbines	7.5%	Eliminated in 10 years
	Weaving machines (looms), industrial sewing machines	7.5%	Eliminated in 10 years
	Printing machines	7.5%	Eliminated in 10 years
Textile products	Woven fabrics of cotton	10%	Eliminated upon entry into force
	Clothing	10%	Eliminated upon entry into force
Chemical products	Printing ink	7.5%	Eliminated in 10 years
	Nylon	10%	Eliminated in 10 years
Agricultural products	Peaches, strawberries, persimmon	5%	Eliminated upon entry into force

(Compiled from materials published by the Japanese Ministry of Foreign Affairs and the Ministry of Economy, Trade and Industry.)

Rules of origin

In order for a good to benefit from preferential customs duty treatment provided by the FTA, it must meet the rules of origin. The rules of origin for JICEPA consist of the criteria below, which is consistent with other FTAs:

- Imported goods must qualify as an originating good
- Imported goods must meet the direct shipment criteria
- Valid certificate of origin must be submitted with the imported goods at the time of import

In order to qualify as an originating good under the JICEPA, the general rule is that the imported goods must have a qualifying value content of not less than 35%, and all non-originating materials used in the production of the good must undergo a change in tariff classification at the subheading (six-digit) level. This is designed to ensure that only products that have been significantly processed in India or Japan benefit from preferential treatment.

However, certain products are subject to product-specific rules, which may be more lenient or stricter than the general rule. For instance, certain chemicals and chemical products, and certain base metals and products of metal qualify as an originating good if all non-originating materials used in its production undergo a change in tariff classification at the heading (four-digit) level, regardless of value content. On the other hand, certain machinery, electronics and automobile products require a four-digit tariff classification change and 40% or 50% qualifying value content. Textiles and apparel are another area with strict product rules.

Increasing importance of compliance

As the volume of trade between countries with EPAs significantly increases, there are growing concerns that EPA preferential treatment may be inappropriately applied to ineligible products.

This is in part the result of the current system where the authority which issues the certificate of origin (CO) in the exporting country verifies the originating status of the product based on information provided by the manufacturer/exporter without being required to verify the accuracy of such information in detail. Reports published by the Ministry of Finance indicates that the Japanese customs authorities have found several cases of inappropriate use of EPA benefits, where the importer relied on a CO issued by the exporting authority for products which, upon closer inspection, were found not to satisfy the origin requirements.

As it is challenging for the importing country to verify the origin of goods, EPAs concluded by Japan include a verification procedure where the importing country can request the exporting country to verify the origin of certain products imported using the EPA. Under the verification procedure, the exporting country will request the manufacturer to submit documents to prove origin, and if insufficient, may conduct on-site visits. According to the Ministry of Economy, Trade and Industry, Japan has recently received several verification requests from its trade partners. It can be said that the use of EPAs is subject to greater scrutiny, and both the importer and exporter need to ensure that they are in compliance with all requirements.

The consequences of obtaining EPA benefits on ineligible goods for the importer is quite significant; in addition to repayment of the benefits received, the importer must usually pay penalties and interest. Additionally, there are also penalties to the exporter who had obtained a CO for ineligible goods. In order to ensure appropriate use of benefits under EPAs and avoid such penalties, it is important for importers to confirm that the exporter has a reliable compliance structure in place to accurately ascertain the origin of the products and ensure that relevant documents and records are properly maintained.

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Turkey

Turkey implements safeguard measures against certain textile imports

The Turkish Government has imposed provisional safeguard measures on certain textile imports while investigations by the Ministry of Finance are underway to determine any harm caused to textile producers in Turkey from cheap imports of textile products and raw materials. Pending the outcome of the investigations, the additional duty imposed can be significant.

Safeguard measures against woven materials and products made of such materials

The Decision on the Import Regime Decision no. 2011/1476 "regarding the application of additional customs tax in the import of textile products," was published in the *Official Gazette* on 24 March 2011. According to this decision, effective 22 July 2011, an additional ad valorem customs duty is provisionally applied on certain textile goods at specified rates varying between 11% to 30%, subject to minimum and maximum amounts. In cases where the additional customs duty is less than the minimum amounts or more than the maximum amount specified in the list, a fixed duty amount applies.

The Harmonized Schedule (HS) category of textile goods subject to the additional customs duty includes the following woven materials and products made of such materials:

- HS 51: Wool and fleece, thin or thick animal hair, thread made of horse hair and textiles woven with horse hair
- HS 52: Cotton
- HS 54: Synthetic and artificial filaments, borders and similar synthetic and artificial woven materials
- HS 55: Synthetic and artificial irregular fibers
- HS 61: Knitted clothes and accessories
- HS 62: Non-knitted clothes and accessories

Safeguard measures against imports of cotton threads

Similarly, Decision no. 2011/2041 on the "application of temporary protective measures in cotton thread imports" was promulgated in the *Official Gazette* dated 4 August 2011 and became effective as of 15 July 2011. According to this decision, an additional customs duty is assessed on imports of cotton thread (except sewing thread), primarily those containing 85% or more cotton and not ready for retail sale under HS section 5205. The additional duty rates vary between 12% to 17%, depending on the tariff classification of the goods, with established minimum and maximum amounts. In case the additional duties in question are less than the minimum amounts or more than maximum amounts specified in the table attached to the decision, specified fixed taxes apply.

Additional customs duties are provisional and serve as guarantees

Under both decisions, the additional duty assessed are provisional and serve as guarantees for the actual safeguard amounts to be determined at the conclusion of the Ministry of Economy's investigations. At that time, if it is decided that there is no need for safeguard measures, the additional duties collected will be refunded. In cases where the investigation indicates that more additional duties should have been applied, the difference will not be collected retrospectively. If it is determined that the additional customs duty amount was proper, then the guarantee amount will be recorded as income in the Treasury.

The assessment of additional duties applies to imports from all countries except for goods that originate from the European Union (EU) and countries that have an FTA with Turkey, which include the countries of the European Free Trade Association (Iceland, Liechtenstein, Norway and Switzerland), Israel, Macedonia, Croatia, Bosnia-Herzegovina, Morocco, West Bank and Gaza Strip, Tunisia, Syria, Egypt, Georgia, Albania, Serbia, Montenegro and Kosovo. We note that the additional customs duty does apply to EU exports under an Admission Temporaire Roulette (ATR) movement certificate that are not of EU or Turkish origin (i.e., goods in free circulation in the EU with relevant EU duties and taxes paid).[8]

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[8]The ATR Certificate entitles goods, which are in free circulation in the EU (including both EU-originating goods and goods imported into the EU with all the relevant duties and taxes paid) to receive preferential import duty treatment when shipped to Turkey.

Ukraine

More focus on customs valuation for pharmaceutical imports

Suspect pricing practices by some pharmaceutical importers has caught the attention of the Ukraine customs authorities. The focus is on overvalued imports of certain pharmaceutical products.

Pharmaceutical pricing controls and customs valuation

While pricing for pharmaceuticals is generally set by market supply and demand, certain vital products (e.g., medicines) listed in the National List of Essential Drugs and Medical Products are subject to pricing controls. Specifically, fixed markups apply to sales prices for medicines, based on the customs value for imported medicines or the first sale value of domestically produced medicines.

In the case of imported medicines, there have been recent instances where pharmaceutical companies have attempted to avoid the pricing controls and gain additional profit by declaring an artificially high customs value upon importation. Considering that registered medicines are exempt from VAT and duty-free, there are no customs or other import tax implications of declaring a higher customs value. However, the customs authorities are responsible for controlling the correctness of the information declared to customs, such as the customs value calculation (regardless of the revenue implications) and other legal requirements that apply to imports. In addition, the customs authorities are authorized to investigate potential violations of the customs rules and other rules that apply to imports and exports.

Accordingly, the customs authorities have initiated criminal cases against pharmaceutical importers accused of declaring artificially high customs prices and submitting inaccurate pricing documentation. It is worth noting that these cases did not involve disputes with respect to transfer pricing policies, but rather focus on fraudulent and fictitious over-invoicing of medicines to establish high customs import values, representing a higher base for the maximum allowed markup and because of this, higher profit margins.

These recent criminal cases may actually serve to increase the momentum of a government initiative to cancel the VAT exemption for imported vital remedies and medical purpose items currently granted by the Tax Code. The logic being that the introduction of import VAT would serve as a deterrent for companies from artificially increasing the customs value because VAT payable would increase accordingly.

The potential cancellation of the VAT exemption for imported medicines is concerning for importers, which would be at a cost disadvantage with local suppliers since local Ukrainian medicine manufacturers would continue to be exempted from VAT. A similar scenario occurred in June 2011 when the government cancelled the VAT exemption on certain medical products, only to reintroduce the VAT exemption on some of the affected products (e.g., diapers, pacifiers certain dental products, etc.) months later based on outrage and objections from the industry.

Implications for pharmaceutical importers

Considering these recent developments, pharmaceutical importers may face additional customs scrutiny at the border, particularly with respect to customs value declarations. Pharmaceutical companies importing medicines into Ukraine would be wise to review current customs valuation policies and practices and maintain a clear document trail, including sales and related agreements, to support declared values.

Such measures are also important to safeguard VAT exemption claims under the importation of remedies and medical purpose items. Although Ukrainian law currently provides for VAT exemption upon import of registered medicine and certain medical devices, it is very rigorous with regard to entities involved in tax evasion schemes. Hence, a comprehensive compliance review of past transactions to ensure supporting documentation is readily available, as well as establishing effective internal controls for future transactions (including proper control over your customs clearance service provider) is recommended to mitigate the risk of further tax reassessments and even criminal sanctions.

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Ukraine auto imports may face safeguard duties and quotas

There is increasing safeguard investigation activity underway in Ukraine that involves the automotive industry. Pursuant to two recent resolutions, auto imports may soon face safeguard duties and quotas. The implications could be significant and would impact the majority of passenger vehicles imported into Ukraine.

Safeguard duties for passenger vehicles, regardless of country of origin or export

The Ministry of Economy has announced that the Interdepartmental Commission for International Trade (the Commission) has initiated safeguard investigations for certain auto imports based on applications presented by the Association of Ukrainian Car Producers (UkrAutoprom). Resolution "On Initiation of Safeguard Investigation of the Import of Motor Cars to Ukraine Regardless of the Country of Origin and Export" No. SP-259/2011/4402-27, published on 2 July 2011, concerns all imports of motor vehicles into Ukraine with engine capacity from 1,000 to 2,200 cubic centimeters, classified under 8703.22.1000 and 8703.23.1910 of the Ukraine tariff nomenclature (UFEACC).

The Commission decided to initiate the investigation based on information presented by UkrAutoprom, which claims that the domestic industry is being injured by a surge in imports in recent years. UkrAutoprom has requested that the government introduce safeguard duties of 34% for a four-year period to protect domestic car manufacturers.

Pursuant to Ukraine's commitments as a member of the World Trade Organization (WTO), the imposition of safeguard measures would require that the Commission performs a comprehensive and independent analysis pursuant to the WTO Safeguards Agreement, which establishes specific criteria and factors to be considered based on available information and economic data. The Commission's investigation is currently ongoing.

Quotas on passenger vehicles imported from Uzbekistan

Draft Resolution "On Application of Quotas and Licensing Regime to Motor Vehicles Originating from the Republic of Uzbekistan for 2011-2014" was published by the Ministry of Economic Development and Trade on 7 July 2011. The resolution is the result of an antidiscriminatory investigation conducted by the Commission, initiated by UkrAutoprom.

The Commission's investigation revealed that actions of the Government of the Republic of Uzbekistan (Uzbekistan) against lawful rights and interests of Ukrainian companies engaged in foreign economic activities were discriminatory. In particular, Uzbekistan applied favorable excise tax rates to motor vehicles manufactured in Uzbekistan and the Russian Federation, in violation of the provisions of the FTA between Ukraine and Uzbekistan. Ukraine cars imported into Uzbekistan were subject to excise duties of 70% compared to 5% for Russian imports. In other words, the amount of excise tax paid for Ukraine-originating vehicles was 14 times the tax paid by Russia-originating passenger vehicles. Additionally, Ukrainian cars were subject to excise taxes at 2.4 times the rate applied to Uzbek cars. Consequently, the Commission determined that Ukrainian companies were in an inferior position compared to Uzbek and Russian manufacturers selling cars in Uzbekistan.

As a result of the investigation, the Draft Resolution proposes to establish the following quotas for a three-year period on the import of cars originating from Uzbekistan with an engine capacity not exceeding 2,200 cubic centimeters:

- Vehicles classified under 8703 21 10 00 UFEACC – one vehicle per year
- Vehicles classified under 8703 22 10 00 UFEACC – one vehicle per year
- Vehicles classified under 8703 23 19 10 UFEACC – one vehicle per year

Meanwhile, the Interdepartmental International Trade Commission has requested that the Ministry of Economy of Ukraine jointly with the Ministry of Foreign Affairs of Ukraine address this issue to the authorities of the Republic of Uzbekistan to negotiate and settle the dispute.

Implications for auto importers

The current safeguard investigation activity in Ukraine is concerning for auto importers. The proposed quotas on passenger vehicles imported from Uzbekistan are significant. If implemented, the quotas could signal momentum towards the protection of the domestic auto industry, at a time when auto importers are anxiously anticipating the outcome of the Commission's safeguard investigation currently underway, which would impact all passenger vehicles, regardless of the country of origin or export.

A primary concern is that the Commission and any safeguard remedy imposed would stray from the framework of the WTO Safeguard Agreement. 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. For now, auto importers must wait with uncertainty.

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

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South Africa

South Africa aligns customs accreditation with the European Union

Accredited client status is taking on a new role in South Africa. Significant initiatives are underway to align South Africa's customs accreditation program with that of the EU and to offer more tangible benefits for approved traders. With a robust approach and positive changes already taking shape, there are more reasons for South African companies to take another look at accreditation for customs procedures.

History and background — customs accreditation

Following Section 64E of the South African Customs and Excise Act 91 of 1964 (the Act), the Commissioner may grant accredited client status to any applicant who is registered or licensed under any provision of the Act. The Commissioner may further determine levels of accredited client status and specific criteria applicable to each level.

Years before the World Customs Organization (WCO) finalized the SAFE Framework of Standards to Secure and Facilitate Global Trade (WCO SAFE Framework), South Africa had already introduced a trader accreditation program. The program failed as the South Africa Revenue Service (SARS) was not appropriately vetting the applications so that effectively anyone who applied obtained accreditation status. On the other hand, the envisaged benefits of accreditation were never introduced, making this initial accreditation wave a "no measure."

With the implementation of the SARS Customs Modernization Program, accreditation has been revisited and SARS has taken a more robust approach. South Africa is currently focusing on accreditation for customs procedures only. The Self-assessment Systems Questionnaire was reworked and sent to a number of large importers, inviting them to participate in the "Preferred Trader Pilot Program." Now more customs accreditation initiatives are underway.

The European Union-South Africa Authorized Economic Operator Program

The EU is South Africa's main trading partner and has supported development in South Africa since 1986 through various cooperation agreements. The Trade, Development and Cooperation Agreement (TDCA) is the main legal basis for relations between the EU and South Africa and provides the framework for cooperation in the social, economic, political and cultural field. The parties recently agreed to launch a customs project, financed under the TDCA facility, covering the implementation of the WCO SAFE Framework in South Africa. South Africa intends to align its Authorized Economic Operator (AEO) strategy with that of the EU to ensure that standards for both compliance and security match those of the EU.

The main objective of the project is to support South Africa's efforts to develop AEO schemes in line with the EU AEO program. The program will focus on the creation of legislative, policy and procedural aspects regarding implementation, monitoring and evaluating AEO. The EU Commission experts will share best practices in risk management, account management and audit methodology. The program will further address benefits, facilitations and simplifications granted under AEO and relations with business.

The indicative starting date for this four-phased EU-SA AEO program is October 2011. The first phase will consist of an initial analysis by the Director General, Taxation and Customs Union (DG TAXUD) representatives of South Africa's AEO legislation from the point of view of its compliance with the WCO SAFE Framework and the EU AEO legislation. In a second phase, the South African dedicated study team will visit selected EU Member States to investigate and understand the EU requirements, standards and procedures in sufficient detail to be able to replicate the EU quality standards in South Africa. The selected EU countries are Belgium and the United Kingdom because of the ongoing long-term cooperation between SARS and the customs administrations of those two member states.

Based on the initial analysis undertaken in phases one and two, the EU expert team will visit South Africa in the third phase, to assess the progress; address gaps and needs in terms of legislation, procedures and implementation; and to identify solutions. Besides meetings with SARS, the EU expert team will visit customs offices and selected potential AEOs in South Africa. Seminars and workshops for customs officials and the trade community may also take place.

The project will be concluded within 12 months with the compilation of a report, outlining concrete recommendations regarding the future development of supply chain security management, including the AEO legislation and implementation in South Africa.

Introduction of 'Level 2' accreditation

Meanwhile, the Rules to Section 64E of the Act have been amended and published, taking effect from 1 August 2011. The rules indicate that any application for accredited client status to date is to be considered as Level 1 accreditation, whereas all new applications — following the new rules — are Level 2.

The rules limit the persons who may apply for Level 2 accreditation to registered importers and exporters only. This means that other operators in the supply chain, e.g., warehouse keepers or clearing agents, even though they are registered or licensed under a provision of the Act, are currently excluded from accreditation status. The rules further describe the criteria businesses need to comply with when applying for accreditation status.

Actual benefits

Comparing the EU AEO legislation from an AEO accredited trader's benefits perspective, the newly published rules are positively surprising as a list of applicable benefits to accredited clients is included:

- Appointment of a Customs Relationship Manager
- Reduction of the amount of any security required for compliance with a customs procedure
- Fewer routine documentary and physical inspections
- Prioritizing a request for tariff and valuation determinations
- Prioritizing access to non-intrusive inspection techniques when goods are stopped or detained for inspection

Impact on business

With the amendment of the rules, SARS has taken an important step, indicating that incentives will be offered to economic operators making the effort to move towards self-compliance and applying for Level 2 accredited client status. Further, the alignment of South Africa's AEO program to that of the EU is a big step toward more harmonization and standardization between the accreditation programs rolled out in various jurisdictions around the world and may speed up and enhance mutual recognition. Multinationals operating in both the EU and South Africa can only benefit from this alignment when setting up standard operating procedures as part of a global customs compliance framework.

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Uganda

The customs implications of Uganda's new transfer pricing regulations

Uganda is poised to face the complex issue that continues to challenge customs authorities and businesses worldwide — how to align transfer pricing and customs valuation rules for cross-border transaction between related parties.

Effective 1 July 2011, transfer pricing regulations based on the Organisation for Economic Co-operation and Development (OECD) guidelines were introduced to Uganda's Income Tax Law. The regulations establish the acceptable intercompany price for income tax purposes. The OECD guidelines for transfer pricing set out a series of methodologies, which are designed to provide a range of profits that may be considered "arm's length" between related parties. The OECD methodologies are based on comparisons with external organizations, giving great focus on the functional analysis of economically significant functions and who performs them.

The transfer pricing rules are not applicable for customs valuation, which defines value for both customs duty and VAT assessments. Uganda's customs valuation rules are established in the Customs Law, and are based on the World Trade Organization's General Agreement on Tariffs and Trade (WTO Valuation Agreement). Under the WTO Valuation Agreement, the preferred method of valuation is transaction value, the price paid or payable for the merchandise. Transaction value is allowed for related party transactions, provided that it can be demonstrated that the price was not influenced by the relationship between the parties.

As reported in previous issues of *TradeWatch* (most recently, see the December 2010 issue of *TradeWatch*), customs authorities around the world are struggling with the appropriate interaction of the customs and income tax transfer pricing rules. With Uganda's adoption of the OECD standards for income tax transfer pricing, these issues will also be present in Uganda.

As the transfer pricing rules have only recently been introduced, it is unknown how the Uganda tax and customs authorities will respond to this complex issue. However, one should not assume that prices that satisfy the income tax authorities will also be satisfactory from a customs perspective, or vice versa. The inconsistent approaches could create uncertainty for import prices declared by taxpayers and lead to increased scrutiny and risk during audits — separately from both the customs and tax authorities.

It is therefore important for companies to prepare full documentation and keep records to support the intercompany prices used for cross-border transactions. While the transfer pricing rules require that the company implements a formal, documented transfer pricing policy pursuant to the Income Tax Law, we recommend a similar approach for customs purposes with documentation that supports your company's preferred valuation method pursuant to the Customs Law.

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