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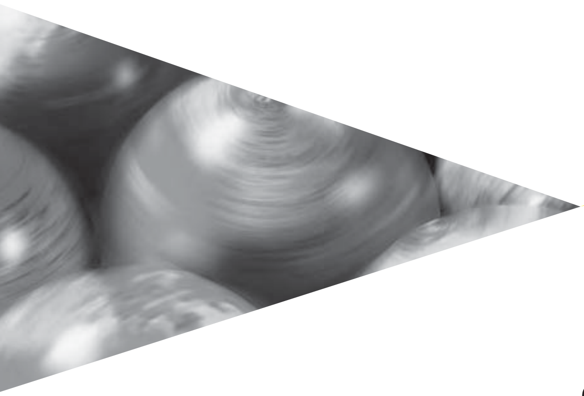
# TradeWatch



## In this issue



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# WCO approves advisory opinion on trademark royalties

The Technical Committee on Customs Valuation (TCCV) has approved a new advisory opinion on trademark royalties. Advisory Opinion 4.15 is the culmination of an eight-year review of the appropriate treatment of trademark royalties when imported product incorporating the trademark is purchased from an unrelated party, and the contract of sale contains no reference to the royalty.

The TCCV is a committee of customs authorities created by the World Trade Organization (WTO) Valuation Agreement and tasked with providing interpretation and guidance on the Valuation Agreement. It is administered by the World Customs Organization. While its guidance is not binding on any jurisdiction, its pronouncements are regularly cited by customs authorities worldwide.

## Background

The Valuation Agreement provides that royalties paid by the importer of product to someone other than the seller of the product must be added to the price paid for the product to determine transaction value when the royalty:

- Is related to the imported product
- Must be paid as a condition of the sale to the importer

Customs authorities have not expressed consistent views on how to determine if a royalty must be paid as a condition of sale. While all agree that a contractual provision in the product sales agreement which requires payment of the royalty in order for the seller to sell product to the buyer is a condition of sale, there is disagreement on whether, and how, a condition of sale may be implied when no legal condition exists.

## Advisory Opinion 4.15

Advisory Opinion 4.15 is premised on these facts:

- The trademark licensor and importer are related, but neither is related to the manufacturer/exporter of the products.
- The trademark license agreement imposes an obligation on the importer to pay a royalty to the licensor based on a fixed percentage of net income derived from the importer's resale of the products in the country of importation.
- The licensor also has a supply agreement with the manufacturer allowing the manufacturer to make the trademarked product subject to quality and design specifications. Notably, the supply agreement also states that the manufacturer may sell the product only to companies specified by the licensor.
- The sales contract between the manufacturer and the importer contains no clause requiring payment of the royalty.

In a short opinion, the TCCV states that pursuant to the supply agreement, the licensor "controls the production of goods bearing its trademark by authorizing the manufacture of licensed goods, determining which companies [manufacturer] may sell to, and directly providing the designs and technology for manufacturer M. Since [licensor] authorizes [importer] to use the trademark in connection with the manufacture and importation of the goods pursuant to the license agreement, [licensor] further influences and controls the transaction between [manufacturer] and [importer] by selecting which party may use the trademark and purchase the goods."

While the sales contract does not require payment of the royalty, the TCCV concludes that the result of non-payment of the royalty will be withdrawal of the manufacturer's authorization to sell goods to the importer. In effect, this amounts to a practical condition of sale, despite the fact that no legal condition exists. As a result, the royalty must be added to the value of the imported goods.

Previous versions of the case study upon which the advisory opinion is based did not expressly state that the licensor could designate authorized customers of the manufacturer. In the absence of an express provision, there appears to continue to be a difference among customs authorities as to when a condition of sale may be implied by the overall control of the licensor over the dealings of the parties. With the provision, the TCCV has issued clear guidance that the condition of sale is properly implied.

## Implications for importers

Much of the royalty discussion at the TCCV has centered on the concept of "control," with some customs authorities advocating that when the licensor exercises control of both the sales and license transactions, the condition of sale may be implied. Advisory Opinion 4.15 indicates a specific type of control which results in a dutiable royalty. We expect to see continuing development and use of the "control" analysis in a number of jurisdictions, and prudent importers will wish to evaluate their current royalties with consideration of factors which may indicate licensor control, and potentially adjust royalty structures.

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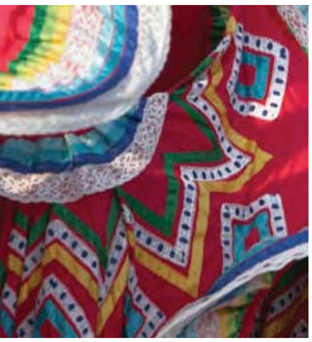
# Brazil

## Significant improvements to special customs regimes of temporary admission and temporary export



Recently, the Brazilian Federal Revenue published a new normative providing new and more simplified application and regulatory procedures for the special customs regimes of temporary admission and temporary exportation. Before the official publishing, Federal Revenue released the draft of the Normative Instruction for public consultation, allowing the market to review it and make adjustments before the final version. The Normative Instruction consolidates the legal provisions for these regimes – more than 35 existing acts – into a single act.

The following aspects in the published Normative Instruction are particularly relevant:

- Goods temporarily admitted for economic use will pay the import-related taxes (i.e., import duty, IPI, and social contributions on imports (e.g., PIS/PASEP Import and COFINS)), all at the rate of 1% per month, or month fraction, during the validity of this regime, considering the taxes originally due.
- During the validity of the temporary admission, it is authorized to replace the beneficiary and change the purpose of admission, in respect of all the goods admitted, according to Normative Instruction #121/2002.
- The grant of temporary admission and temporary export will be made on the customs clearance of the import or export declaration, respectively.

Additionally, the text of the Normative Instruction also refers to some rules based on the Convention on Temporary Admission, known as the Istanbul Convention. The Istanbul Convention was adopted by the World Customs Organization (WCO), in the 1990s, and it is the successor of the ATA Carnet Convention, from 1961.

However, in Brazil, the Congress only approved its text, by the Legislative Decree #563/2010 and the Brazilian adherence to the decree only occurred by means of the promulgation of Decree #7545/2011, almost 20 years after the signing of the Istanbul Convention.

The new legislation describes the goods to be temporarily admitted by means of the ATA Carnet, such as goods destined for specific events, related to professional equipment, for educational, scientific or cultural purposes, for personal use of travelers, and also for athletic purposes. The validity of the "passport" is up to six months, extendable once for the same period.

Effectively joining the Istanbul Convention represents a breakthrough in global standardization of customs procedures, and a breakthrough for the organizers and participants of international events, like the World Cup in 2014 and the Olympic Games in 2016, both to be held in Brazil.

However, for the effective use of the ATA Carnet System, some additional regulation, such as the appointment of the guarantor institution in Brazil, are still pending on definition and was not considered in the text subject to public consultation.

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# New automotive tax regime

Since 2012, the Brazilian government has been discussing and publishing measures to foster and protect the national automotive industry. The most significant of those measures is the new automotive tax regime called "Inovar-Auto," a Portuguese expression for "vehicle innovation."

The Inovar-Auto regime aims to improve technological development, innovation, safety, environmental protection, energy efficiency and quality of cars, trucks, buses and auto parts produced in Brazil. To this end, the regime grants special tax incentives for those established automakers, newcomers and importers of vehicles that are focused on producing and/or importing more efficient and sustainable technology, and investing in research and development, engineering and supplier's enablement for the development of the national automotive industry, up until 2017.

## Incentives granted by Inovar-Auto

The special tax incentives focus on a reduction in the Imposto sobre Produtos Industrializades (IPI), i.e., federal value-added tax on manufactured goods, as follows:

- "Fictitious" or "deemed" IPI tax credits (based on the investment) to offset IPI debts on local sales and on the importation of vehicles, parts and pieces
- Up to 30% reduction of the IPI rate for a predefined quota of imported vehicles, limited to 4,800 vehicles per year
- Additional 1% to 2% reduction in IPI, from 2017 to 2020 for vehicles capable of achieving the energy efficiency levels defined in the legislation

The Federal Government estimates that the amount of taxes that will be relieved by the Inovar-Auto program will reach BRL12 billion by 2014.

## Implications of quota limits for importers

Inovar-Auto incentives for importers in Brazil are primarily focused on the reduction of IPI rates (30%) for a predefined quota of imported vehicles calculated upon the average of importations (both direct or indirect) of vehicles performed during the period of 2009 to 2011, limited to 4,800 units. Such average is defined as the quota for the whole year of 2013 importations.

However, we have been noticing that some companies are being temporarily authorized to participate in Inovar-Auto. In this case, the Government has determined fixed quotas per month, based on their analysis of the documentation provided by the company. Therefore, the quota limits mentioned above can suffer variations and even be established on a monthly basis.

Considering that the quotas can be used for any vehicle importation performed by a qualifying company, and that IPI is a very elevated cost on the price of the vehicles in Brazil, importers must evaluate how to best make use of the quotas. For instance, importers may elect to apply the reduced IPI rate for the more expensive vehicles to maximize the IPI savings on importation and resale of these vehicles, or to concentrate the quotas upon vehicles with a higher turnover of sales, thus making these vehicles more attractive in the Brazilian market.

## Recent additional rules

After long negotiations between the government and the automakers, new rules are being set to track local content that has been requested as part of the commitment of the Brazilian industry in order to make use of the full package of Inovar-Auto incentives. The idea of tracking local content is to foster local sourcing and the development of the auto-parts industry and related industries, such as steel and plastic suppliers.

Parts whose origin will be tracked by the local content calculation for Brazilian manufactured cars will be bodywork and chassis, seats, lighting system, brake system, shock absorbers and suspension, cooling system, tires, wheels, exhausts, engine, electronics, steering systems and panels. These items represent 85% of the components used in the construction of a vehicle. Though the parts are defined, the exact tracking system is still pending regulation.

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# More developments for state value-added tax (ICMS) reform

The Brazilian Senate is currently discussing the approval of a legislative bill, which aims to reduce the tax rate of the state value-added tax (ICMS) on all interstate transactions. This topic has been the subject of various articles in recent issues of *TradeWatch* (see March 2013 and December 2012) and continues to make headlines.

The project of the legislative bill is in the context of recent changes in the administration of the ICMS, and attempts to end the so-called fiscal war, characterized by the reduction of ICMS rate granted by the states as a way to create a competitive advantage over other states in attracting investments to their territories.

## Background

Many state incentive programs have been controversial and have created the 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 of all Brazilian states through the execution of an ICMS agreement from the National Council of Fiscal Policy (CONFAZ).

As the proper procedure to approve the ICMS tax benefits is not being followed by many states, the dispute for attracting investments has increased, making the Brazilian tax system even more complex. In addition, the Brazilian Supreme Court has already found several of those incentives unconstitutional, since they were granted without the approval of the representatives of CONFAZ.

As a result, in order to minimize the legal uncertainties generated by the fiscal war, new rules have been published by the Brazilian Congress and important measures are being discussed now.

The most significant measure taken was the publication of Resolution # 13/2012 which reduced the interstate rate of imported goods from the standard 7% or 12% to 4% in order to mitigate the effects of the tax benefits that were applicable for the importation transaction and subsequent resale to other Brazilian states.

Combined with the publication of the Resolution #13/2012, the government has been studying new measures to enhance the elimination of tax benefits granted without the correct procedure. The Senate Legislative Bill referred to above is another step to minimize the fiscal war.

## Legislative bill proposed by the Brazilian Senate

The Brazilian Senate is currently discussing a legislative bill that aims to unify the interstate ICMS tax rates at 4% for both imported and national goods. In this sense, the interstate rates of ICMS VAT currently set at 7% or 12%, depending on the state, would be gradually reduced to 4%, over a transition expected to occur between 2014 and 2025.

The legislative bill does not need to pass by vote on the House of Representatives. Therefore, once approved by the Senate, the reduction on interstate ICMS rate shall be in force in 2014.

In addition to the legislative bill referred above, the Brazilian National Congress is discussing other measures related to the systematic administration of ICMS, such as the validation of all state tax incentives already granted and not approved by CONFAZ, to assure some legal certainty to companies that brought investments to the Brazilian states due to such incentives.

It is clear that significant measures to mitigate the effects of the fiscal war will be changing the ICMS tax environment in Brazil, but much will be lost in terms of attractiveness to some states that are not logistically favored by suppliers and potential markets, which can result in more discrepancies on regional development in Brazil.

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# Canada

## The "iPod tariff" controversy in Canada and "end-use" certificates

Given Canada's recent proposal to eliminate the General Preferential Tariff (GPT) in 2015 for 72 "more developed" countries (Brazil, Russia, India and China, i.e., the BRIC countries, in particular), affected consumer electronics imports will face what is known as the "iPod tariff" unless an "end-use certificate" (to establish the items are "for use in" computers, etc.) can be provided to qualify for duty-free treatment.

The ostensibly "new" Canadian "iPod tariff" — meaning that import duties may apply to consumer electronics that have previously enjoyed duty-free preferential treatment upon importation — is beginning to attract as much attention from Canada's import community as it did in weeks past from the national media. When Mike Moffat, Economist and Assistant Professor at Western University, initially broke the story on Twitter,[1] the media first took interest in how this played into Canada's parliamentary theatrics. More than anything, Mr. Moffat's findings had the rare effect of turning normally relatively dull, other than to trade and customs specialists, tariff classification into an instant tabloid sensation.

For many affected Canadian importers, distributors and wholesalers of consumer electronics, the controversial alleged policy shift remains largely misunderstood. First, the label "iPod tariff" does not only cover MP3 players; rather, it applies to a broad spectrum of consumer electronics that can be used in computers and video game consoles, including television monitors and computer interfaces. Second, the precise indicators of the rumored policy shift remain rather elusive. With the exception of changes to the GPT regime in the 2013 Federal Budget (as discussed in our next article), the relevant legislation, regulations to the Customs Act, jurisprudence and written administrative guidance remain essentially unchanged since 2007.

Until the bedlam of recent media reaction, it was relatively clear that importers had two options to attempt to qualify consumer computer-related electronics for duty-free treatment: (i) tariff origin preferences such as the GPT or an FTA or (ii) alternatively, a special tariff provision.

First, when such consumer electronic products originate in countries that are beneficiaries of Canadian tariff preferences (e.g., China or India benefitting from GPT, or the US or Mexico benefitting from NAFTA) the goods can be imported duty-free by virtue of the origin preference.

Second, when these consumer electronics are made in countries like Japan or in Europe (developed countries with whom Canada has no current trade agreements and for whom Canada has no origin preference systems, which will include many newly developed countries in 2015), the goods can benefit from duty-free treatment under a concessionary provision that exists in the Schedule to the Canadian Customs Tariff. This provision is not conditional on the country of origin of the goods. Rather, an Annex Code under tariff heading 9948 has permitted,[2] and continues to permit, duty-free treatment of any goods qualifying as:

Articles for use in the following:

[...]

Automatic data processing machines [i.e., computers] and units thereof, magnetic or optical readers, machines for transcribing data onto data media in coded form and machines for processing such data

[...]

Video games used with a television receiver [i.e., video game consoles], and other electronic games

Parts and accessories of the foregoing

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1 Mike Moffat, "The mystery of the budget, the iPod and the tariff code," *The Globe and Mail*, 5 April 2013.

2 "9948.00.00" in the 'Schedule' to the Customs Tariff.

Tariff heading 9948 is an "end-use" provision. Administrative guidance published by Canada Border Services Agency (CBSA) in Departmental Memorandum D10-14-51 requires proof of the specified end-use.[3] For example, is the TV used as a computer monitor or is it also used as a TV to view cable TV? It is a fine line, and the use may change. This guidance specifies "importers are to maintain end-user certificates confirming that the goods were solely used for the purpose for which they were imported," that is, "for use in" computers, and so forth. This guidance is still current as of its date of publication (6 September 2007). These provisions were initially likely intended for and were used primarily for commercial purposes (that is, business use) for which it is relatively easy to obtain an "end-use" certificate; but how can these be obtained for consumer electronics (e.g., does one stand outside of Costco with forms and notary publics standing by?) However, it is not clear that the CBSA has rigidly audited or enforced this requirement for end-use certificates.

Annex Code 9948 had not created much interest, until recently when imports of large screen TVs started to be entered duty-free using 9948, despite not being able to satisfy specific NAFTA rules of origin for duty-free status. The loss of GPT preferences is expected to significantly increase the use of Annex Code 9948 for iPods and other similar consumer electronics if they can somehow satisfy the end-use requirement, and this is why the issue has become so prominent in the media.

## So, what exactly has changed?

Though the tariff treatments have not changed, the origin eligibility to the preferential duty-free treatment is slated to change as numerous countries will no longer be GPT beneficiaries in 2015. Among these is China, with a 77% share of video and audio electronics imported into Canada in 2012.[4] Consequently, as of 1 January 2015, iPods (currently manufactured in China) may very well be among those Chinese-origin consumer electronics imports that will indirectly experience a tariff hike to rates of 5% or 6%.

The CBSA has responded to such concerns through a press release where it was noted that MP3 players that would no longer benefit from GPT treatment could still benefit from Annex Code 9948.

However, what is contentious is the alleged shift in CBSA enforcement of the end-use certificate requirement under Annex Code 9948. Sony of Canada has stated that, subsequent to communications with the CBSA in November 2012, it is facing pressure to pay additional duties on past imports of televisions and other products it imported under 9948 if it cannot produce end-use certification from consumers.[5] Whether or not consumer electronics qualify under 9948 has previously been a question mostly dedicated to the legal interpretation of the terms "for use in." With the shift in CBSA enforcement policy towards scrutiny of end-use certificates, importers fear that the burden of proving that products qualify under 9948 will become unbearable.

3 Tariff Classification Policy: Tariff Item 9948.00.00, D10-14-51 (6 September 2007)
4 "Industry Canada", Trade Data Online, http://www.ic.gc.ca/eic/site/tdo-dcd.nsf/eng/Home accessed 5 June 2013.
5 "Sony says so-called iPod tax too hard to avoid," *The Canadian Press*, 9 April 2013.

If you are currently importing products under 9948, or plan to import products under 9948 following the reduction in the number of GPT beneficiary countries, you will need to keep up-to-date with the most recent developments. In particular, you must distinguish "for use in" with for "use with," which some have confused as being the same thing. If you hold a CBSA ruling referring to importation of goods under 9948, you must examine it closely (some rulings may simply refer to the requirements rather than stating that the goods qualify for duty-free entry). It would be surprising to find a ruling specifically providing that no end-use certificates will be required. In any event, be aware that the CBSA may attempt to challenge these rulings, or withdraw them (if they do indeed protect the past). While there are penalties for use of the 9948 tariff code without keeping records of valid "end-use" certificates pursuant to the Importers' Records Regulations that may be payable in any event, query whether importers can demonstrate other ways of proving the "for use in" requirement to establish justification for duty-free entry even without the certificates from consumers.

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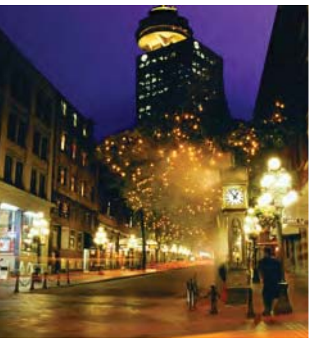
# Update: fewer beneficiary countries under proposed changes to Canada's General Preferential Tariff



Following our article in the March 2013 issue of *TradeWatch* (Vol. 12, No. 1), Canada's Department of Finance (Finance Canada) adjusted the forecast date for reducing the number of General Preferential Tariff (GPT) beneficiary countries.

Upon tabling the 2013 Federal Budget, Finance Canada pushed the date back to 1 January 2015, rather than the originally proposed date of 1 July 2014. In the Federal Budget, Finance Canada also confirmed its intentions to reduce the number of GPT beneficiaries following a round of public consultation.

Though the first of the Federal Budget implementation bills is currently in its second reading before Parliament, it makes no provision or mention of the planned reduction of GPT beneficiaries. It is expected that the changes to the list of beneficiaries will be effected through regulatory amendment of the Schedule to the Customs Tariff if it is not provided for in future legislation.

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# Mexico

## Mexican authorities initiate ambitious FTA audit program with broadened scope

Mexican free trade agreements (FTAs) grant the reduction or waiver of duties into Mexico for goods that "originate" in a partner country. FTA benefits are conditional, meaning that the goods must meet the agreement's specific rules and conditions to benefit. Since the entry into force of NAFTA in 1994, the Mexican tax authorities (SAT) have performed audits to verify origin qualification procedures applied by importers, exporters and producers. Today, the broad network of Mexican FTAs provides the SAT with an extensive source of audit material.

Under new leadership, the SAT has initiated an ambitious FTA audit program. In addition to traditional origin qualification reviews, the SAT is broadening the audit scope to include more focus on non-traditional areas, such as compliance with direct shipment requirements (i.e., transshipment provisions) and duty deferral restrictions (e.g., NAFTA article 303). Following is some insight into what companies can expect from the SAT's new audit program.

### More origin qualification reviews

During 2013, the SAT will increase their audit efforts related to FTA origin qualification. In this respect, companies can expect that the SAT will audit more companies through the introduction of sampling procedures. Sampling limits the review to a sample pool of transactions rather than the arduous undertaking of a comprehensive review. Reviews can thus be conducted in a more efficient and expeditious manner — for both the SAT and the company being audited. Accordingly, sampling frees up auditor resources, thus allowing the authorities to increase the number of audits.

The SAT will likely continue to focus on historically sensitive industries, such as steel, textile, electronics and footwear, while potentially including additional products from industries that may follow a similar pattern of high duties with complex rules of origin. Nevertheless, any companies that extensively benefit from Mexico's network of FTAs should be prepared in the event of an audit. This includes becoming familiar with the new sampling methodology and ensuring that procedures and internal controls are in place to timely respond to any inquiries by the authorities with carefully considered responses and documentary support to end the audit at the earliest stage possible.

### Direct shipment requirement

Under an FTA, originating goods that are not directly shipped to the destination markets may lose their duty preference if they are transshipped or temporarily warehoused in a third country, unless an exception applies and the goods meet the conditions for the exception. Such conditions typically require that the goods remain under the supervision of the customs authorities in the country of transshipment or temporary warehousing, and do not undergo operations other than unloading, reloading or any operation designed to preserve them in good condition.

For example, a common practice for EU goods originating under the Mexico-European Union FTA is to ship the goods through a US foreign trade zone prior to importation into Mexico. Such goods remain eligible for the FTA's tariff preferences despite the direct shipment rule assuming that proper documentation is maintained to support that the goods remained under the supervision of the US customs authorities and no further processing took place.

Compliance with the direct shipment requirement has not been an area regularly reviewed by the SAT. However, as part of the new audit efforts, auditors will begin to review importers' supporting documentation to confirm that goods that are being imported into Mexico have not lost their FTA tariff preference eligibility due to transshipment or temporary warehousing in a third country. Accordingly, this is an important area for companies to assess existing procedures and internal controls and address any compliance gaps prior to notice of a pending audit.

## NAFTA 303 audits

The SAT is initiating a vigorous audit program to review importer compliance with article 303 provisions of the North American Free Trade Agreement (NAFTA). This area has not received much attention from the SAT until now.

Article 303 of NAFTA was implemented in 2001 and establishes that duties are payable on non-NAFTA raw materials and components imported temporarily into Mexico under a Maquila or IMMEX program[6] when such goods are exported or incorporated into a product that is subsequently exported to Canada or the US.

The duty impact of NAFTA's article 303 can be alleviated where the raw materials and components temporarily imported under the IMMEX program qualify for and claim preferential duty treatment under any of Mexico's other applicable FTAs or via preferential PROSEC duty rates. The preferential duty rate may be claimed by the Mexican importer upon entry of the raw materials or when finished goods are exported to the US or Canada.

Where a Mexican FTA or PROSEC does not apply, importers may pay the applicable import duty on non-NAFTA originating goods at the general (i.e., most favored nation) duty rates upon their temporary importation into Mexico. Under this method, the temporary import entry or "pedimento" will reflect the payment of duties upon entry and compliance with NAFTA's article 303.

Alternatively, the importer may pay the applicable duties on non-NAFTA goods/inputs through a complementary entry or "pedimento" upon the exportation to Canada or the US. Under this mechanism, the complementary entry or "pedimento" must be filed no later than 60 days after the exportation took place. If the importer does not timely pay the applicable duties, penalties and fines may be assessed by the Mexican customs authorities.

Accordingly, IMMEX companies that benefit under NAFTA can expect increased scrutiny under an SAT audit for NAFTA article 303 compliance. Affected companies need to assess whether pedimentos were properly and timely filed to support that any applicable duties were paid or waived through an applicable FTA or the PROSEC program. Additionally, qualification for FTA or PROSEC preferences in this context may also be reviewed.

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6 Decree for the Promotion of the Manufacturing, Maquiladora, and Export Services Industry.

# Peru

## Customs auditors increasingly looking at transfer pricing report

The customs valuation treatment of related party sales is an increasing concern for importers in Peru.

Based on recent audits, the Peruvian customs authorities are becoming more interested in the transfer pricing report, particularly when the report concludes that the local margin on the distribution of imported goods is above the comparable range. The customs authorities are interpreting this finding as a "red flag" that the customs value could be undervalued, i.e., lower than it should have been – since the company made more profit on the local sales than others in the same industry.

Despite the shared ideal of an arm's-length price on transactions between related parties, the tax and customs rules are derived from a completely different set of rules and enforced by different authorities within the same institution. Even though the customs authorities are not allowed to use the information in the transfer pricing report to challenge the customs value, the customs authorities are heightening their scrutiny over the customs value in such cases.

Pursuant to the World Trade Organization (WTO) Valuation Agreement, transaction value, the preferred method for customs valuation, is the price paid or payable between a buyer and a seller. Transaction value is acceptable for related party sales if either (i) an examination of the circumstances of the sale indicates that the relationship between the parties does not influence the price actually paid or payable, or (ii) the transaction value of imported merchandise closely approximates a test value.

In Peru, however, there is little guidance as to how to meet these criteria, and the burden of proof is on the importer. As a result, importers must provide extensive documentation and analysis to demonstrate to the customs authorities that transaction value is acceptable despite the related party sale. Otherwise, the importer may be denied the use of transaction value and must resort to subsequent methods of customs valuation, as established under the WTO Valuation Agreement (e.g., transaction value of identical or similar goods sold to unrelated buyers in same country of importation, deductive value.)

Accordingly, this is a significant and complex issue for Peruvian companies involved in related party sales. It is important that affected businesses actively plan to meet both sets of rules, or risk liability either for income tax or for customs purposes.

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# United States

## US Customs provides guidance on refunds from post-importation transfer pricing adjustments

A recent ruling from US Customs and Border Protection (CBP) provides significant guidance for US importers in the complicated area of related party pricing and post importation transfer pricing adjustments.

Ruling HQ H018314, issued on 18 March 2013, is the first ruling which approves refunds from downward transfer pricing adjustment under the recently revised US policy. Notably, the ruling was issued to an importer whose related party pricing and sufficiency of documentation to support the use of transaction value was originally challenged by CBP in 2007, years before CBP formally adopted its policy to allow transfer pricing adjustments in May 2012. The ruling is quite involved as the importer was required to demonstrate retroactive adherence to the new policy in order to obtain refunds.

### Background

Most importers declare import values based on transaction value, i.e., the price paid or payable for imported merchandise. It is very common for US importers that purchase products from related parties to base their transfer pricing on the importer's targeted profit margins. If the financial results for a given period are within the targeted range, no additional action is taken. When profits are outside the targeted range, a retroactive adjustment (payment or refund) is made to bring the profits into the range. If certain conditions established by CBP are met, importers making net downward transfer pricing adjustments may receive customs duty refunds.

As reported in the June 2012 *TradeWatch*, CBP revised its policy to allow importers to use transaction value and make post-importation adjustments made pursuant to a transfer pricing policy provided that the transfer pricing policy meets five specific criteria, and the importer can demonstrate that the transfer pricing policy results in arm's-length pricing under customs-specific tests.

### Ruling illustrates complexity of meeting new policy for imports prior to May 2012

The importer in the ruling purchased finished goods from a related party and made quarterly transfer pricing adjustments based on the comparable profits method (CPM), supported by a transfer pricing study. The CPM compares the profits earned by the importer annually to the profits earned by other US distributors which purchase products from unrelated parties, but share a common function and risk profile with the importer. If the profits of the importer are within a statistically determined range of profit of the benchmarked companies, the prices are viewed as arm's length. If the profit is outside the established range, the prices must be adjusted to bring profit within the range.

From 2005 to 2006, the importer made downward price adjustments for nearly all quarters and filed for refunds through the ACS Reconciliation Prototype (Reconciliation). In March 2007, the importer received a notice that CBP had liquidated the entries, denying the refunds and challenging the use of transaction value. In September 2007, the importer filed a protest, which was subsequently sent to CBP headquarters for internal advice. Subsequent reconciliation entries were similarly protested, and included in the review.

The internal advice was intentionally delayed by CBP in anticipation that a revised policy on adjustments would be adopted, which occurred in May 2012. In the meantime, CBP reviewed the importer's approach to demonstrating that the prices, as adjusted, met the circumstances of sale test necessary to demonstrate that transaction value is acceptable in a related party transaction. Using two of the examples provided in US regulations, the importer was able to satisfy CBP that related party prices were similar to sales made to an unrelated party in another country, and that the operating profits of the manufacturer exceeded the operating profits of the parent company.


Following the announcement of the revised CBP policy on adjustments, CBP requested the importer to demonstrate how it had satisfied the five criteria outlined in the policy, even though the goods had been imported long before the policy's implementation. The length of the ruling describing the documentation assembled illustrates how difficult this task can be, especially when the appropriate documents need to be reconstructed for importations that occurred long before. Nevertheless, the importer was able to satisfy each criterion, and CBP approved the refunds of duty.

## Implications for importers

This ruling clearly demonstrates that CBP will provide refunds when the criteria are met. Criterion includes demonstrating that the adjusted prices are appropriate to use as transaction value under the circumstances of sale test, as well as meeting each of the five criteria for using adjustments. The ruling also very clearly shows the importance of advance planning to do this correctly. While it is possible to satisfy all criteria retroactively, it is extremely burdensome.

In light of this ruling, importers who may make transfer pricing adjustments are well advised to take steps to ensure that business activities and supporting documentation align with the May 2012 policy:

1. Apply for Reconciliation if not already participating (importers must be approved to use Reconciliation in advance of the imports, whose value may be later adjusted)
2. Supplement transfer pricing policies with customs-specific addendum, including an explanation of how the transfer pricing adjustments apply to imported products
3. Clearly specify adjustments related to imported product in accounting records
4. Plan how to best demonstrate that adjustments shown in the accounting records are reported on the applicable federal income tax return
5. Document a circumstances of sale analysis demonstrating that the prices, as adjusted, are appropriate to use as transaction value

As noted in the ruling, Ernst & Young LLP assisted the importer with the circumstances of sale analysis and with establishing that the five criteria supporting the adjustment were met.

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# Asia-Pacific

# Australia

## Australia Customs outside the target range on transfer pricing

In April 2013, Australia Customs released a finalized revised practice statement regarding its administration of the customs valuation implications of transfer pricing policies.[7] It is considered that this is an indicator that Australia Customs will be more active in this area and, therefore, warrants the attention of companies with related party imports into Australia.

### A statement of intent

The issued practice statement is consistent with a draft issued for industry feedback in November 2012. The finalized version so closely follows the draft that it is apparent that Australia Customs has dismissed a variety of concerns raised in the consultation period. This is the interpretation it intends, no matter the practical consequences.

Most fundamental is the stated position that, "Customs and Border Protection's valuation methodologies are not analogous to the Berry Ratio or OECD methodologies." Rather than providing clarity, this creates uncertainty as it effectively means any Australian related party importer can no longer make the working assumption that its invoice price from a related party is valid for customs valuation purposes.

This is a shift from the position that a related party transaction is acceptable as a customs transaction value unless it is shown that the relationship has influenced the price, to one where from the outset the transfer pricing method applied is unacceptable. As a result, the importer is actively required to demonstrate that its related party value is at arm's length using customs valuation rules. To oversimplify: changing from innocent until proven guilty to guilty until proven innocent.

The inherent tension between evolving transfer pricing rules and static customs valuation rules is well documented. That the two are irreconcilable on strict readings is a long recognized point. Consequently, the guidance most needed is how, practically, a workable outcome can be achieved. While the practice statement has some pointers, Australian Customs does not address this fundamental issue. Rather, Australian Customs dabbles in the narrow margins of making adjustments, which even then it fails to achieve in its own terms as there are notable problems in this regard.

Given that part of the purpose of the guidance is for Australian Customs itself, all related party importers should carefully review the document in the context of their own transactions as this is how they will be viewed under audit. (http://www.customs.gov.au/webdata/resources/files/B_IND08Valuation-TransferPricingPolicy.pdf)

Where doubts exist as to how this interpretation may be applied, it is increasingly imperative to obtain advance rulings in order to get certainty now and avoid dispute later. At least the document is clear on this point.

### Missed opportunity

With global discussion on the interaction of the two disciplines having advanced considerably since Australia Customs originally issued a practice statement on the topic, the revised version was an opportunity to build off those discussions and offer greater clarity to importers. The limited ambition and impracticality of the guidance simply present it as a missed opportunity, unless, of course, its objective is to require the majority of related party importers to seek valuation rulings.

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7 Practice Statement B_IND08, "Valuation — Transfer Pricing Policy" (12 April 2013).

# Australian developments — new Anti-Dumping Commission, defense trade with the US and federal budget announcements

## Anti-Dumping Commission established from 1 July 2013

As a follow-up to our anti-dumping update in the December 2012 *TradeWatch*, legislation has recently passed to establish a national Anti-Dumping Commission, which will start operating from 1 July 2013. This Anti-Dumping Commission was one of the key recommendations from a national review recently carried out into Australia's anti-dumping arrangements. It is expected that the establishment of the Anti-Dumping Commission will provide greater transparency and rigor for dumping investigations by having a specialized body administer the system.

Previously, the International Trade Remedies Branch of the Australian Customs and Border Protection Service administered Australia's anti-dumping system. This power has now been transferred to the Anti-Dumping Commission, led by the Commissioner for Anti-Dumping. The Commissioner will have broad power to do all things necessary or convenient in connection with the performance of his or her functions. However, the final decision as to whether any anti-dumping or countervailing duty should be imposed will be made by the Minister for Home Affairs and Justice, Jason Clare. Mr. Clare has publicly communicated a strong intention to introduce further anti-dumping reforms, such as increased penalties and a simplified review process, and we expect to see more activity in this space in coming months.

The increased client support and focus on protecting Australian industry provided by the Anti-Dumping Commission, coupled with the Minister's intention to introduce further anti-dumping measures, could result in the number of anti-dumping investigations continuing to rise. Given this continued focus to strengthen Australia's anti-dumping measures, importers should consider whether current contractual arrangements include measures which sufficiently mitigate the potential effects of anti-dumping and countervailing duties, and manufacturers should consider their relative competitive position.

## Australia — US Defense Trade Cooperation Treaty enters into force

On 16 May 2013, the Australian Minister for Defence, Stephen Smith, and the US Ambassador to Australia, His Excellency Jeffrey Bleich, exchanged diplomatic notes to bring the Australia – US Defense Trade Cooperation Treaty (the Treaty) into force.

Signed in September 2007, the Treaty is aimed at providing greater access for Australian manufacturers to the US defense market. It does this by creating a framework for the transfer of eligible defense goods, services and technology between members of an "Approved Community" without the need for separate export licenses.

The Treaty is being implemented in Australia through the *Defence Trade Controls* Act 2012 (discussed in the December 2012 *TradeWatch*) which entered into force on 6 June 2013. From this date, entities can apply to become members of the "Approved Community" by making an application to the Australian Department of Defence.

## 2013 Federal Budget Announcements

On 14 May 2013, Australian Treasurer Wayne Swan handed down his latest Federal Budget. The following changes to customs and international trade were set out in the budget:

- A restructure of Import Processing Charges (IPC) with IPC increasing for consignments valued at over AU$10,000 while IPCs relating to consignments below AU$10,000 remain unchanged
- Import tax revenue is expected to increase by AU$850 million to a total of AU$13.5 billion, with concession benefits expected to remain flat.
- A reduction in Australian Customs and Border Protection Service staff numbers
- Proportion of revenue targeted import audits where revenue was adjusted by AU$1,000 or more is a flat 55%
- Establishment of a new agency to carry out the proposed *A Plan for Australian Jobs* (as discussed in the March 2013 *TradeWatch*)

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# Korea

## Customs audits to increase along with financial exposure from import VAT

Due to shortfalls in customs revenue collections over the past year compared to previous years, Korea Customs has announced its intention to increase the number of customs audits in 2013. It is expected that company-level audits will increase by over 50% this year, affecting up to 130 companies. Overall, it is expected that the total number of companies audited this year could more than double the amount that was audited last year.

### More focus on multinationals and related party pricing

Korea Customs has also announced that it will be focusing on multinational corporations that have large volumes of related party sales with their local Korean entities. Korea Customs claims that roughly 70% of total customs assessments arise from multinational companies and that this percentage shows that multinationals represent a higher risk of underpaying import duties and related taxes.

Related party pricing is a common issue for multinationals and a common focus in their audits. Korea Customs' highly developed customs system allows the authorities to track inflows and outflows of goods and capital on a transaction level basis down to the line item on the invoice. In turn, Korea Customs can quickly spot "outliers" and anomalies, such as fluctuations in import prices and transfer pricing adjustments, which may indicate an area where the importer is not compliant. Korea Customs has also announced they will increase their scrutiny of import/export process compliance through these audits as well.

Also on the radar for audit are companies that have not been audited in the past four years and/or that have import levels of greater than US$50 million. Companies with high duty rates or high value luxury goods are also likely to be selected for audit.

### Increased financial exposure due to changes to VAT Enforcement Decree

Additionally, proposed changes to Korea's VAT Enforcement Decree mean that import VAT payable under an audit assessment will no longer be recoverable. This change would increase the financial exposure of companies importing goods into Korea when under audit.

Specifically, article 56 of the decree would specify that VAT paid as a result of the following three reasons will no longer be credible to the importer:

1. VAT paid as the result of an audit assessment from Korea Customs
2. VAT paid as a result of an error found by Korea Customs
3. VAT knowingly underpaid by the importer and assessed by Korea Customs in a manner similar to points 1 and 2 above

With an average duty rate of 8% in Korea, the VAT portion of many audit assessments generally account for 45% to 55% of the total assessment value. These changes would prevent an importer assessed as the result of an audit from recovering this amount, thereby significantly increasing the potential financial exposure.

As the VAT regulatory changes are scheduled to be implemented on 1 July 2013, it is recommended that companies move quickly to mitigate the risk of customs assessments going forward.

## What should importers do?

Given the current aggressive audit environment and potential for increased financial exposure due to the VAT changes, importers need to be proactive in mitigating their potential customs risks in Korea.

For multinationals, in particular, customs valuation needs to be reviewed and any compliance gaps addressed. This entails reviewing all aspects of business operations that impact the dutiable amount. Royalty payments, buying commissions, cost sharing agreements or other similar payments should be carefully reviewed from a customs perspective. Additionally, it is also important to understand how the company's import prices compare with industry pricing, and to ensure that the company has solid support for their related party pricing from a customs perspective.

Also, keep in mind that along with corporate-level audits, Korea Customs will continue to conduct ad hoc audits (i.e., audits with little notice), free trade agreement (FTA) origin audits, foreign exchange investigations and other aspects of its compliance review programs. Accordingly, an internal customs compliance review should address all potential risk areas to mitigate any financial exposure.

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# Korea-Turkey FTA

The FTA between South Korea and Turkey that was signed in August of 2012 was implemented on 1 May 2013. This free trade agreement will reduce the duty rates on the majority of goods traded between the countries over the next 10 years, with the majority of products being reduced to zero in a much quicker time frame.

As the 17th largest economy in the world, Turkey has become an emerging production location for global corporations due in part to the large domestic market, cheaper labor cost, and its customs union with the EU. This FTA is expected to increase the ability of companies that produce in both Korea and Turkey to have greater access to each other's important global economies.

While the FTA is similar to that of the FTA between Korea and the EU, one area of difference is the relaxed requirement for obtaining a certificate of origin. While the Korea — EU FTA requires that the exporter become an "approved exporter" in order to issue the origin statement on shipments of over €6,000, the Korea-Turkey FTA does not have an approved exporter requirement. This can help streamline the process of creating and submitting the documents required for the importer to receive the FTA's preferential duty treatment. However, the lack of this requirement will require companies that utilize this FTA to be proactive in managing their FTA and origin compliance.

See also the Turkey article "Free trade agenda."

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# European Union

## Union Customs Code: implications for customs valuation planning

It has become increasingly difficult during the last few years to get a clear understanding of when and what changes to the current EU customs legal framework will take place, which in turn makes planning challenging. This is particularly the case with customs valuation planning as the future of topics, such as "first sale for export" and dutiability of royalties remain unclear, with discussions between the European Parliament (Parliament), European Council (Council) and European Commission (Commission) continuing. What we are seeing now is less of a push to complete the implementing provisions of the Modernised Customs Code (MCC); rather, the Union Customs Code (UCC) is taking center stage. We provide below some insight into this transition and also explain what this could mean for economic operators in view of customs valuation planning.

### Where we stand today

Currently, economic operators apply the Community Customs Code (CCC) and corresponding implementing provisions (CCCIP). This legal framework has been updated through the years, but in essence the text and spirit of the law date back to the early 1990s. To streamline customs procedures, introduce an EU-wide electronic customs environment and better facilitate trade, the MCC was drafted and entered into force in 2008; however, due to the lack of implementing provisions, the MCC is not yet applied. The latest draft of MCC implementing provisions was published by the Commission in late 2011 and included new (although expected) clauses on the abolishment of the first sale for export customs valuation planning strategy and the introduction of a very broad definition of the "condition of sale" in view of dutiability of royalties and license fees. This ignited a cat and mouse play between the Commission and the Parliament; the latter being assigned with increased powers in view of altered EU law making processes further to the Lisbon Treaty.

In 2011, the Parliament voted on a resolution for customs modernization, simultaneously requesting the status quo for valuation areas, such as the first sale for export and dutiability of royalties. In February 2012, the Commission reacted with an opposing position on first sale for export and aggressive position on the dutiability of royalty payments, being in favor of making such payments an unambiguous part of the customs value whether directly or indirectly linked to the sales transaction. This would mean that many trademark royalties, currently excluded from the EU customs dutiable value based upon "freedom of source" criterion would become very difficult or almost impossible to keep out of the customs value under the proposed legal framework.

At the same time, over this period between late 2011 and early 2012, the efforts to finalize the implementing provisions of the MCC decreased as the Commission, Council and Parliament shifted their efforts to recast the MCC and turn it into the UCC as we know today.

The first draft of the UCC was published by the Commission in February 2012. The articles on royalties were not directly addressed in the UCC, but transferred to the delegated and implementing acts that are yet to be drafted. However, upon first reading in early 2013, Parliament had over 100 proposed amendments, and expressed the need to explicitly embed the GATT customs valuation article on royalties and dutiability in the UCC (as part of the elements of the transaction value) and not to transfer this topic to the delegated and implementing acts.

Accordingly, one can only hope that a status quo with the current treatment of royalties and license fees is implied and that merely some non-essential elements of the law will be addressed in the delegated and implementing acts to the UCC. It will be interesting to find out which definition of "condition of sale" will be put forward.

In view of the first sale for export planning, Parliament proposed to address the topic in the UCC (again, rather than in the delegated and implementing acts) and explicitly allow for the acceptance of a sale taking place before the last sale on the basis of which the goods were introduced into the customs territory of the EU, as long as it can be demonstrated that it concerns a sale for export to the customs territory in question.

In May 2013, the last version of the draft UCC text published by Parliament's Committee on Internal Market and Consumer Protection shows that Parliament is betting on a status quo for dutiability of royalty and license fees with the current legislative articles (CCC). However, for first sale for export, the article explicitly referencing a series of successive sales has not been withheld and therefore, it is difficult to predict the outcome for this area of customs valuation planning due to the lack of delegated and implementing acts to date.

## Looking ahead

Looking ahead, the MCC is due to become effective on 24 June 2013; however, due to the lack of implementing provisions, a regulation has been proposed to push back that date to 1 November 2013. In the end, the MCC may be a moot point as on the same date, the UCC is expected to enter into force and the specific article repealing the MCC shall apply. To summarize, as of November 2013, the MCC will have disappeared and we will be facing a UCC that entered into force, but lacks delegated and implementing acts. It is expected that the UCC will become applicable in May 2016 because by that date the delegated and implementing acts should have been finalized. In the meantime, regardless of the outcome of discussions between Parliament, the Commission and Council on topics such as customs valuation, it seems very likely that economic operators can rely on the current EU customs regulations for another few years.

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# Germany

## New directions for customs valuation of related-party transactions

A revised internal instruction on customs valuation was issued by the German Federal Ministry of Finance in September 2012. Although the document is designed to assist customs officials in their day-to-day work and is not binding for the courts, it is deemed to influence the customs treatment of intercompany transactions and how far these transactions are subject to audit.

The implications of the revised instruction are rather contradictory. On the one hand, it reinforces the willingness of the customs authorities to accept the transaction value for related-party transactions and to recognize transfer pricing documentation as valid proof of arm's-length transactions. On the other hand, it introduces a range of indicators that signal a possible influence over the price, which implies that a wide acceptance of the transaction value might be difficult to achieve.

### Customs value vs. transfer pricing

Despite the notorious tensions, both the customs and tax authorities agree that the value of intercompany transactions should be based on the arm's-length principle, i.e., that it should be comparable to the market price paid between related parties. However, the acceptable ways of arriving at the arm's-length price are rather different: tax authorities assess the transactions on the year-end basis, while customs authorities scrutinize each transaction separately. Moreover, the methods used to determine the correct value do not always coincide. Although among the various transfer pricing methods approved by tax authorities, the cost-plus method is generally preferred by the customs authorities, but it is not a rule.

The customs valuation is primarily done on the basis of transaction value — the price paid or payable for the goods when sold for export to the customs territory of the European Community. One of the conditions for using the transaction value is that the buyer and seller are not related and, if they are, then transaction value is still acceptable if the relationship did not influence the price. This subjects intercompany transactions to greater scrutiny.

In its revised internal instruction on customs valuation, the German Federal Ministry of Finance has introduced a range of so-called "indicators, signaling a possible influence over the price." By doing this, the German authority is effectively seeking to limit the possibilities for reducing the customs duty burden by means of price manipulation.

It is important to note that the list of the indicators was included in the instruction as a part of the body text and not by means of examples, which are used in the instruction in some places. This means that customs officials will almost certainly consider these indicators during any customs clearance procedure or customs audit.

Among the factors that appear on the list are some rather routine transfer pricing exercises undertaken by multinational groups to adjust prices between companies, including retroactive year-end and periodic adjustments, compensatory payments, and adjustments within a target margin scheme. Although these mechanisms are considered legitimate from an income tax perspective, they will not prompt a customs official to scrutinize every detail of the transactions involved. In the end, customs might conclude that the relationship between the parties influenced the price and that the transaction value is no longer applicable. Thus, another method of customs valuation will come into question and consequently, the calculation might become more complicated and, in the end, lead to higher customs duties.

In this context, it is clear that customs issues should be considered in planning any transfer pricing strategy. A higher customs duty burden often counterbalances income tax reductions achieved through redistribution of the company's resources. Involving customs professionals in this process can help companies reconcile these contradictory requirements and find a suitable solution. Moreover, due consideration of the customs issues in designing a transfer pricing program — reflected, for example, in the transfer pricing documentation — can anticipate and exceed the expectations of the customs auditors and smooth the audit process.

## Practical implications

There is some good news in all of this. Despite the conflicting regulations, it is still possible — with a bit of planning — to make it all work. The instruction now regulates price decreases and price increases. Companies can avoid unpleasant surprises by submitting all of the documents regarding price adjustments to the customs authorities in advance. It is important to note that price adjustment arrangements should clearly appear in the written contract and should be presented to the customs authority at the time of importation.

Arguably, it should be possible to get a refund of duties overpaid in Germany arising from price adjustments that reduce the customs value of imported goods, provided written contracts include a respective clause. Unfortunately, so far there is no formal program for reporting retroactive transfer pricing adjustments in Germany similar to the US Customs and Border Protection Reconciliation Program (as highlighted in the US article, "US Customs provides guidance on refunds from post-importation transfer pricing adjustments"). In the EU, there is a special regime for incomplete customs declarations, which allows provisional values to be submitted at the time of the importation. Alternatively, importers can make use of a post-clearance examination of the customs declaration and revise their import entries for the preceding three years.

The German customs instruction also offers another opportunity: an advance non-binding ruling, which assesses prospective price adjustment arrangements by a special valuation division of the German customs authority.

## Documents talk

Tax provisions require companies to have transfer pricing studies on hand for relevant related-party transactions. Although such studies might contain information that is useful for customs purposes, the reference points for tax and customs purposes do not fully coincide, so customs will consider these studies merely as an indication of a possible arm's-length transaction.

While tax authorities compare the economic operator under review with other companies with a similar business function and delve into the books of the local taxpayer, the customs authorities make their comparisons on a product level. They may review comparable imports in their customs clearance databases to determine a reasonable price.

The good thing is that control over the transfer pricing documentation lies entirely in the hands of the company concerned. That means it is possible to reflect both transfer pricing and customs issues in one set of documents. This is especially true, taking into account the next novelty in the customs internal instruction.

One of the most important provisions of the revised instruction is that a company's transfer pricing documentation will be recognized among the proofs of an arm's-length transaction. By implementing this provision, the German Federal Ministry of Finance reinforces the proposals of the International Chamber of Commerce (ICC) and the ICC Committee on Customs and Trade Regulations, as well as Commentary 23.1 of the Technical Committee on Customs Valuation at the World Customs Organization to accept the transfer pricing documentation and decrease the pressure on multinational corporations. Understandably, advance pricing agreements or transfer pricing studies alone will not suffice. But it is companies themselves that can highlight the information relevant for customs purposes and can make the transfer pricing documentation talk in their favor before the customs authorities.

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# Turkey

## Free trade agenda

Turkey's free trade agenda is moving forward with some interesting developments.

### Turkey — South Korea

As mentioned in the Korea article "Korea-Turkey free trade agreement," Turkey's newest FTA took effect on 1 May 2013. While Korean goods already enjoy duty-free or reduced duty in Turkey pursuant to the FTA signed between South Korea and the European Union, that agreement did not provide tariff preferences for Turkish goods imported into South Korea. Now Turkish exporters can also benefit from preferential tariffs in the Korean market.

For Turkish importers and exporters it is important to understand the implications of the origin declaration requirements. Origin declarations can be made by the exporter on an invoice, delivery note or any other commercial document. In other words, the trader is not required to seek a formal certificate of origin for a certifying body. Instead, the trader is charged with the additional responsibility of making the origin determination, which requires an understanding of the sometimes complex origin rules. The customs authorities can then verify the trader's origin claims post-importation. Accordingly, it is important that traders planning to benefit under the agreement carefully analyze the origin rules in the agreement in detail for different sectors and products and to ensure that these rules are followed.

### What's next

Next up on the free trade agenda is Turkey's free trade agreement with Mauritius, which entered into force on 1 June 2013, and the agreement with Lebanon, which will take effect upon the completion of internal ratification procedures.

Also of interest is the free trade agreement being developed by the European Union and the United States, known as the Transatlantic Trade and Investment Partnership. Whether Turkey will be included in the agreement is unclear. Turkey's participation would obviously yield favorable outcomes, but the real issue is what Turkey would lose if not involved. We anticipate much more on this topic in the near future.

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# Israel

## Israeli Supreme Court ruling opens door for certain post-importation amendments

### Executive summary

The Israeli Supreme Court rejected an appeal by the Israeli Tax Authorities (ITA) and allowed Holis Industries Ltd (Holis) to make post-importation classification amendments to a customs declaration, and receive refunds of overpaid customs duties. The Supreme Court ruling, State of Israel — Israel Tax Authority — Department of Customs v. Holis Industries Ltd. (CA 992/11) marks a significant policy shift with respect to allowable post-importation adjustments and widens the opportunities for Israeli importers to retroactively correct certain misclassification errors on the declaration and recover any overpaid customs duties.

### Background

Holis had erroneously classified natural wood used as a raw material for the manufacturing of its Venetian blinds products, as an item subject to customs at a rate of 12%. Once Holis identified its mistake, it classified the natural wood as an exempt item and requested that the ITA amend the relevant past declarations and refund the overpaid customs duties pursuant to Section 6 of the Indirect Tax Law (overpaid or underpaid customs) 1968. The ITA rejected Holis' request. The case was referred to the Israeli Supreme Court after a successful appeal by Holis in the first district court.

### Supreme Court ruling

The ITA argued for a limited scope for post-importation amendments pursuant to Section 6. Specifically, the ITA argued that Section 6 itself stipulates that post-importation adjustments are not allowed when the imported goods are on-sold by the importer to its customers (so that the overpaid duty is effectively absorbed by them).

The Supreme Court ruled that Holis did not on-sell the imported goods; therefore, it could request the ITA to make post-importation amendments. Holis sold a completely different product — Venetian blinds — and not the natural wood itself. Further, the Supreme Court stated that when manufacturers import raw materials used for the manufacturing of a substantially different product, the conditions of Section 6 are met; thus, the sale of the final substantially different product should not be viewed as a sale of the imported raw materials themselves.

### Impact on Israeli importers

The Holis ruling opens the door for importers to make certain retroactive amendments to customs declarations and receive a refund of overpaid duties. Upon identifying an imported item that was misclassified, importers should consider utilizing Section 6 to correct the declaration and collect a refund of any overpaid duties.

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# East African Community

## Implications of a single customs territory on export incentives

In the East African Community (EAC), there is a growing policy debate against the use of tax incentives and exemptions to attract both foreign direct investment and local investment due to the heavy revenue losses for the governments without equitable gains in the economy. As the five partner states (Rwanda, Uganda, Kenya, Tanzania and Burundi) work to harmonize tax incentives and consider reducing them, exporters are already facing new hurdles to many of the export promotion schemes that they have been enjoying in their own countries for years.

In 2004, the EAC formed a customs union, i.e., a duty-free trade area with a common external tariff and a common market, which is not yet fully implemented. The next step towards full implementation of the customs union — the single customs territory — will merge the partner states into one customs territory with a common legal framework. The single customs territory will boost trade facilitation and investment through the free circulation of goods within the region, an interconnected payment system with the collection of duties at the first point of entry into the EAC and, importantly, minimal non-tariff barriers and internal border controls.

The customs union presents some obstacles for manufacturing companies benefitting from export-related tax incentives. These tax incentives include the following:

- Export promotion schemes (e.g., export processing zones)
- Duty drawback schemes
- Duty and VAT remission schemes
- Manufacturing under bond schemes

Basically, the transition to a customs union has limited the opportunity for manufacturers to benefit from export-related incentives because intra-EAC trade no longer qualifies as an "export." Further, in the case of export promotion schemes, the Protocol for the Establishment of the East African Community Customs Union (2004) established that such incentives were accessible only to operations that export 80% of production to countries outside of the EAC. In other words, only 20% of production can be sold within the EAC and such goods are subject to duty at the common external tariff rates (i.e., 25% for finished goods). This 80% export requirement was to take effect in January 2010 when the definition of an "export" changed as EAC originating goods became duty-free when traded in the region. However, the rule only came into effect recently and without much notice or guidance to the EAC trade community. Nevertheless, the authorities are now enforcing the 80% export requirement, with costly consequences for many manufacturing operations.

Additionally, complying with the 80% export requirement presents obstacles for export manufacturing operations considering that the single customs territory is not yet implemented. For instance, non-tariff barriers and border controls remain between the EAC partner states, which can make it more difficult and costly for some businesses to get their goods to an export market. The single customs territory should minimize these challenges by facilitating the process of exporting goods outside the EAC.

Further, there has been a general lack of guidance to assist companies in complying with the new export promotion schemes. Issues such as how to apply value-added tax and excise taxes for intra-EAC sales need to be addressed since these are not harmonized within the EAC. Penalties for approved companies that do not meet the 80% export production threshold need to be clearly put in place. These are potential costs that need to be considered when companies assess whether to operate under the export promotion schemes especially if they are dealing in intra-EAC trade.

In the meantime, there are signs that the single customs territory is moving forward. To promote the circulation of goods with minimal or no border controls, the EAC has launched the Authorized Economic Operator status for approved businesses and "One Stop Border Stops" are being implemented at several borders. Progress has been made to harmonize quality standards for goods with over 1,200 EAC standards already harmonized and a new law, the EAC Standards, Quality Assurance, Metrology and Testing Act which was recently enacted. Additionally, several studies have been completed or are underway to provide recommendations for the common legal framework, including studies aimed at harmonizing domestic tax regimes on cross-border trade within the EAC.

Exporters currently benefitting from EAC export incentives need to assess their compliance and be prepared for more changes as the single customs territory takes shape. At the same time, the EAC governments need to address many outstanding issues that could dilute the benefits of the export promotion schemes and thus, hinder the trade region's ability to achieve export-led growth.

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