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Preparing for 2022: Year-End Cost Savings and Trade Compliance Considerations

December 8, 2021

by Luis A. Abad and Donald C. Hok, Washington National Tax*

As we approach the final days of 2021, year-end housekeeping for importers and exporters is expected to focus on strategies to lower customs duty spend, increase available cash flow, and enhance compliance with trade laws to avoid undue enforcement attention and negative publicity. This is particularly important in the current global trade environment, which is characterized by persistently high U.S. tariffs, global supply chain disruptions, heightened compliance scrutiny by governmental authorities, and increased emphasis on environmental, social and corporate ("ESG") governance.

Higher tariffs, such as the "Section 301 tariffs" imposed on imported goods of Chinese origin and "Section 232 tariffs" on global imports of steel and aluminum, continue to increase costs for many businesses, with the auto, manufacturing, agricultural, technology, solar, and retail industries bearing the brunt of the upsurge. As a result, planning discussions should consider ways to blunt the impact of Section 301 and Section 232 tariffs through potential duty/cost mitigation strategies, including how to potentially reduce, and compliantly report, the customs value (i.e., tariff basis) of imported goods. At the same time, authorities have noticeably ramped up enforcement on both imports and exports. Thus, companies should continue to evaluate whether internal processes sufficiently identify and mitigate associated compliance risks.

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* *Luis Abad is a principal and Donald Hok is a senior manager with the Trade and Customs Services group of KPMG's Washington National Tax ("WNT").*

Customs Arm’s Length Pricing

Customs duties are generally assessed on an ad valorem basis. For example, if a widget is valued at $100 and the associated duty rate is 10 percent, an importer is responsible for paying $10 in duty. Thus, figuring out the correct customs value of imported goods, and not more, plays a significant role in determining an importer’s duty spend, particularly in the current high-tariff environment. The related issues discussed below should be considered.

Customs Arm’s Length Pricing

In transactions between unrelated parties, the customs value of imported goods is presumed to be undertaken at arm’s length. However, between related parties, the seller’s price must generally meet the “circumstances of sales” test or closely approximate a “test value” to be considered arm’s length.

Under the circumstances of sales test, the transaction value between a related buyer and seller is acceptable if the circumstances surrounding the sale of the imported merchandise indicates that the relationship did not influence the “price actually paid or payable” for the imported goods. In this context, information provided to U.S. Customs and Border Protection (“CBP”) in a tax transfer pricing (“TP”) study (pursuant to Internal Revenue Code (“IRC”) section 482) may be relevant in examining the circumstances of the sale; however, it is generally insufficient to satisfy customs arm’s length requirements on its own. This is because the customs requirements and methods to establish that import transactions are conducted at arm’s length are different from those found in IRC section 482.

Given the complexities involved to accurately declare an acceptable customs value in related-party transactions, importers should document the appropriateness of their customs valuation method in a customs “reasonable care” study, and annually confirm that transactions are at arm’s length. This study and review can assist a U.S. importer to ward off potential penalties and help simplify responses in case of a CBP inquiry or audit.

Year-End Transfer Price Adjustments (Potential Duty Refunds)

Year-end compensating TP adjustments may trigger an importer’s obligation to retrospectively report such adjustments when they affect the previously declared customs value of the imported goods. Depending on the nature of the TP adjustment (upward or downward) and its impact on the “price actually paid or payable” by the importer for imported goods, the importer must either tender additional duties and related fees owed or may be eligible for a refund for any overpayment of duties.

For instance, in situations in which an upward TP adjustment is made resulting in an additional payment by the importer to the related foreign seller, thereby increasing the customs value, the importer generally must report the additional payment and allocate the payment on a pro rata basis over the affected customs entries. The importer must also pay any additional duties owed on the increased value.

Similarly, with regards to downward TP adjustments, which effectively results in a reduction in price or a rebate from the foreign seller to the related importer, the importer may potentially be eligible for a refund of duties paid on the decreased value, but only if the TP adjustment satisfies CBP’s five-factor “formulaic pricing” test. Thus, companies should proactively ensure that they have the necessary facts and documentation to align their transfer pricing policy with their declared customs value to increase the potential for a duty refund.

When it is anticipated that companies will be making TP adjustments, importers should consider enrolling in CBP's *Reconciliation Program* to manage and facilitate the reporting of adjustments to CBP on an on-going basis. This may also enhance cash flow by expediting the refund of duties on eligible import transactions. Importers should ensure that their customs brokers are advised on how to flag entries and that reconciliation filings are timely submitted to CBP.

Shortfall/Maintenance and Related Payments

Another potential method to reduce duty spend relates to "shortfall" or "maintenance" payments made to manufacturers (related or unrelated), which may be excluded from an imported product's customs value. In situations involving a significant shortfall between anticipated production (or ordered quantities) and actual production (e.g., the importer's failure to ultimately purchase the contracted number of products due to economic COVID-19 disruptions), it is possible that the underlying supply-side losses or operating "shortfalls" can be more aptly addressed through an additional payment unrelated to the imported goods rather than through a dutiable adjustment to the transfer price of the imported goods. Generally, the "shortfall" payments made by the importer/buyer to the foreign manufacturer/seller would allow the manufacturer to recover certain fixed costs related to production underutilization, as well as potentially being treated as non-dutiable if certain conditions are met.

In addition, various other payments to the seller/manufacturer for goods not purchased are also generally not dutiable. Examples of potentially excludable payments are:

— Compensation for out-of-pocket expenses incurred due to the foreign seller's excess capacity, caused by a reduction in customer purchases

— Compensation for maintenance costs incurred by the seller for reserved but underutilized production capacity

— Payments for termination of supply contracts or cancellation of future purchase orders

Importers should thus evaluate whether their existing arrangements (i.e., written agreements, accounting records, and the actions of the parties), support the exclusion of these payments from the customs value of imported goods, or whether additional action should be undertaken to support the exclusion on a go-forward basis.

Statutory Additions and Deductions

Year-end is also a good time to review all off-invoice payments and costs that may be related to imported goods but are not already included in the "price actually paid or payable" because there are potential additions or deductions to customs value that must be considered in order to comply with the customs valuation rules. Examples of these additions under the transaction value method include:

— Royalties or license fees related to imported goods that the buyer is required to pay, directly or indirectly, as a condition of the sale of the imported goods for exportation to the United States

- "Assists" supplied directly or indirectly, and free of charge or at a reduced cost, by the buyer of the imported merchandise for use in connection with the production or the sale for export to the United States of goods (e.g., materials, components, tools, molds, production consumables, engineering, development, design, etc.)
- Proceeds of any subsequent resale, disposal, or use of the imported goods that accrue, directly or indirectly, to the seller
- Selling commissions incurred by the buyer with respect to imported goods
- Packing costs incurred by the buyer with respect to imported goods

It can often be difficult for a company's customs compliance team to identify these costs unless there is intracompany coordination and communication with other functions or departments (i.e., procurement, legal, accounting, tax, etc.). For example, a product design "assist" supplied free of charge by the importer to the foreign seller/manufacturer would not generally be itemized on the seller's commercial invoice for imported goods and may require coordination with the research and development group. Similarly, a license royalty for intellectual property that the importer pays to the foreign seller on an annual basis may appear on its general ledger of accounts but likely is not separately invoiced with the imported goods. In both cases, it is important that the importer identify the potential addition to customs value, evaluate whether additional duties are owed thereon, and report the additional value to CBP in order to avoid potential customs penalties and fines.

The customs rules also provide that certain charges or costs—such as maintenance or technical assistance provided with respect to imported goods after importation, international freight or insurance, and customs duties and other federal taxes (including excise taxes) payable on the imported merchandise for reason of its importation—are excludable from customs value. Thus, importers should understand how product prices are determined and which of these costs, if any, may already be "baked" into the product price. It may be possible to back-out such costs and reduce the cost basis of the product on which the *ad valorem* duties are assessed.

Duty Mitigation Strategies

Given the potentially significant effect of the high tariffs in the current international trade environment, it is also important to understand what other duty mitigation opportunities are available to importers. Among the most significant opportunities are Section 301 exclusions, duty drawback, and use of the *de minimis* value exception.

Section 301 Exclusion

In imposing the Section 301 tariffs, the United States Trade Representative ("USTR") created a process by which importers could petition for the exclusion of their specific products from those duties. While the time period under the initial exclusion process expired, the USTR invited public comments with respect to whether a more limited number (549) of previously approved exclusions should be reinstated. Thus, companies should review the USTR's proposed exclusions and monitor whether approvals will affect their own imported products.

Duty Drawback

The customs drawback rules permit the recovery, or refund, of 99 percent of the duties, including Section 301 tariffs, originally paid on imported merchandise when the goods are subsequently exported from the United States. The most common forms of drawback are manufacturing drawback (i.e., duty-paid imported goods are incorporated into products manufactured in the United States and subsequently exported) and unused merchandise drawback (i.e., merchandise imported into the United States are exported without further processing) . In 2016, the United States passed the Trade Facilitation and Trade Enforcement Act of 2015 ("TFTEA") that streamlined and modernized the drawback process, thereby increasing drawback claimants' potential refunds. Among other things, TFTEA expanded importers' claim drawback on exported goods that match imported goods to the eight-digit HTSUS level (i.e., substitution drawback), with some limitations. In addition, the timeline for filing claims was revised to five years from the date of importation. These changes allow for a more generous application of the drawback rules that may present new or broader duty refund opportunities than before.

De Minimis Value

Customs rules also provide for a duty and import tax exemption for any shipment of goods imported by one person on one day having a fair retail value of $800 or less. Coupled with the fact that more consumers are shopping on-line from home due to COVID-19, the use of this exemption has increased direct business-to-consumer, e-commerce import transactions, particularly given that importing, traditional transportation costs, and holding inventory in the United States has become more costly from a customs tariff perspective. Thus, the use of the *de minimis* value for direct retail shipments to U.S. consumers from abroad should be at top of mind when planning e-commerce and inventory strategies to reduce duty costs.

First Sale for Export

The First Sale for Export ("FSFE") transaction valuation principle allows importers in the United States who import qualifying goods through multi-tiered supply chains to potentially reduce the amount of duties owed to CBP. For example, when a U.S. importer purchases and imports goods from a foreign middleman (for $100) who, in turn, purchased the goods from a foreign manufacturer (for $60), the customs declared value for the goods may be based on the lower "first sale" price between the foreign middleman and foreign manufacturer ($60 in the example) rather than on the higher price in the sale between the U.S. importer and foreign middleman ($100 in the example). This reduces the customs transaction valuation basis on which ad valorem duties are assessed, thereby reducing the importer's duty liability. To qualify the FSFE price as the declared import value, the U.S. importer must establish that the claimed FSFE transaction is a bona fide sale, the goods are clearly destined for export to the United States, and the price paid to the foreign manufacturer by the middleman is at arm's length.

Year-End Trade Compliance Review

Customs Arm's Length Review

As discussed above, the declared customs value of goods sold between related parties must be transacted at arm's length. It is generally recommended that an importer review its related-party purchases annually to ensure that what the importer is declaring to CBP is accurate and meets this requirement.

Recently, however, the U.S. Court of International Trade ("CIT") issued a decision in *Meyer Corp. v. United States*, Court No. 13-00154, Slip Op. 21-26 (Ct. Int'l Trade 2021), questioning the applicability of the longstanding FSFE duties savings principle by a U.S. importer for goods and inputs produced in non-market economy ("NME") countries such as China and Vietnam. While CBP's interpretative application of the *Meyer Corp.* decision is still to be determined and the CIT's decision is currently pending appeal, the case offers a unique perspective on the customs valuation risks of transacting business with entities in a NME country even outside the FSFE context. As a result, importers are advised to undertake a customs arm's length review, particularly in light of the *Meyer Corp.* decision.

Tariff Code Changes

The Harmonized System of the United States ("HTSUS") establishes the general structure of product categories for imported goods. The categories are separated into sections, chapters, four-digit headings, more disaggregated six-digit subheadings, and national subdivisions (eight-digit subheadings and ten-digit statistical reporting numbers). It also includes general rules of interpretation, and section and chapter legal notes that define the scope of sections, chapters, headings and subheadings. The HTSUS also includes additional U.S. chapter notes and other national provisions that facilitate the administration of U.S. customs, tariff, and statistical programs.

The World Customs Organization ("WCO") recently published a new Harmonized System ("HS") Nomenclature list for 2022 that is expected to be followed by the approximately 200 customs authorities worldwide, including the United States. The published changes affect over 1,500 HS codes with a significant impact to Chapters 84 and 85, which relate to different types of machinery and machine parts, as well as companies dealing with agricultural, chemical, wood, textile, and metal goods. In addition, new technologies such as smartphones and drones received specific subheadings in the revised HS Nomenclature. The new list and revisions to the HTSUS will go into effect on January 1, 2022. Companies are advised to assess the implications for their businesses and to update their internal product databases to ensure accurate classifications and corresponding duty payments, because they will be required to use the new codes starting on the effective date. This may be particularly challenging if a previous code has been revised to include new codes.

FTA Solicitation

Importers seeking to claim preferential tariff treatment under the U.S. 14 Free Trade Agreements ("FTAs") must ensure they have sufficient documentary evidence in their possession to qualify the preferential claim. In most situations, this means maintaining a facially valid certificate of origin ("COO").

COOs are generally issued for a one-year period from January 1 – December 31, and the process of requesting these COOs is generally referred to as FTA solicitation, whereby importers will solicit COOs from their suppliers. Importers are reminded to initiate their FTA solicitation process to ensure compliance in the new year.

Sufficiency of Customs Bonds

CBP requires that importers maintain customs bonds to protect the government in the event the importer fails to adequately pay its obligations. These bonds are calculated based on the total duties, taxes, and fees paid by the importer on a yearly rolling basis, with a minimum bond of $50,000. However, as a result of the Section 301 and 232 tariffs that increased importers' duty liability, importers may find that their existing customs bonds are insufficient to cover the increased duty liability, in which cases the importer will be prohibited from entering goods into the U.S. until a new bond is obtained and filed with CBP. Importers are advised to review the sufficiency of their customs bonds to ensure compliance with applicable law and regulations.

Developments in Export Compliance

U.S. export controls consist of laws and regulations that regulate and restrict the release of certain technologies, information, and services to foreign nationals (within and outside the United States) and foreign countries for reasons for foreign policy and national security. There have been several developments regarding increased export requirements for “emerging” and “foundational” technologies. The U.S. Department of Commerce, Bureau of Industry and Security (“BIS”) recently issued rules designating various items as “emerging” or “foundational” technologies under section 1758 of the Export Control Reform Act. For example, on October 5, 2021, BIS designated certain software capable of designing and building functional genetic elements from digital sequence data to be evaluated in this category of technologies. As developments in this area continues to advance, exporters are cautioned to preemptively consider whether their products (current and future) may fall into an export-controlled category, and/or whether their transactions violate U.S. sanctions.

Conclusion

It is important for each importer to consider these compliance and cost-savings opportunities as part of their FY21 year-end discussions and in their FY22 planning. When multinational corporations are contemplating TP adjustments, modifications to or termination of existing supply or e-commerce arrangements, or reviewing the accuracy of their import values, there may be opportunities to obtain duty refunds or put in place a customs valuation strategy to mitigate import costs and enhance cash flow. The potential benefit can be significant, particularly for importers operating in industries hardest hit by the current high tariff levels. At the same time, companies should continue to evaluate whether internal processes sufficiently identify and mitigate associated compliance risks in both imports and exports.

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