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Global Trade Law

Reducing Customs Duties: Strategies for Importers[1]

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Savvy businesses engaged in the importation of materials or finished goods base purchasing decisions on the "total landed cost" of merchandise. An important component of total landed cost is the applicable customs duties payable on the importation of the goods. To the extent that sourcing or supply chain decisions can reduce the amount of duties owed, importers stand to benefit through higher profitability. Conversely, an importer that incorrectly assumes duty-free status for its goods, may lose substantial profits if that assumption is wrong.

This paper will identify a number of the legal mechanisms for duty avoidance or reduction. For each mechanism, the article will review the basic legal framework and technical requirements for participation. Note that the details of these programs are complicated and very fact specific, thus this article cannot be considered legal advice.

Four duty reduction mechanisms will be considered. These mechanisms are:

- Free-trade agreements such as the NAFTA[3] and CAFTA-DR[4]
- Unilateral trade preferences such as the Generalized System of Preferences or the African Growth and Opportunities Act
- U.S. goods returned under tariff heading 9801 and 9802
- Duty drawback

In addition, brief reference will be made to the use of bonds for temporary importation, ATA carnets, bonded warehouses, and foreign trade zones.

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[3] North American Free-trade Agreement

[4] Central American-United States-Dominican Republic Free-trade Agreement

Free Trade Agreements

The United States has entered into a number of agreements with individual or groups of trading partners to create preferential trading relationships. For the most part, following a phase-in period, these agreements result in the duty-free movement of originating goods among the member countries.[5]

Currently, the United States has implemented free-trade agreements with the following countries or regions:

- Israel
- North America (Canada and Mexico)
- Jordan
- Singapore
- Chile
- Morocco
- Australia
- Central America (Costa Rica, Nicaragua, El Salvador, Honduras, Guatemala, and Dominican Republic)
- Bahrain

The United States is currently pursuing trade agreements with, among others, Oman, Malaysia, South Korea, Panama, Thailand, Columbia, and Peru. Thus, importers (as well as exporters) have numerous opportunities to select suppliers of originating goods in countries enjoying free-trade with the United States.

The issue for this paper is what constitutes "originating goods." Unfortunately, there is no truly uniform answer to that question. Each agreement has its own rules of origin. These rules, negotiated in the context of trade among the parties to the agreement, reflect unique and specific governmental and commercial concerns. Thus, the rules applicable under each agreement vary and companies producing merchandise considered originating under the NAFTA, for example, cannot assume that the same merchandise would qualify for duty preferences under the free-trade agreement with Singapore or Morocco.

Broadly speaking, the rules of origin follow two models. The NAFTA model focuses on the origin of specific materials used in the production of the finished good. In many cases, NAFTA-style rules also require that a set level of regional value added be present in the finished good. On the other hand, GSP-style rules more closely track the origin rules under the Generalized System of Preferences.

[5] These agreements, such as the NAFTA and the U.S.-Australia Free-trade Agreement, also cover broad trade interests such as services, non-trade barriers, the protection of direct foreign investment, labor, and the environment.

Almost all of the rules of origin discussed in this paper are set out as General Notes to the Harmonized Tariff Schedule of the United States.[6] Thus, the tariff schedule is the first and most important reference for this purpose.

NAFTA and Similar Agreements

The starting point for an analysis of the origin of goods under the NAFTA is the tariff classification of the finished article and the materials used in the production of it.[7] Without correct tariff classification, it is impossible to correctly determine the applicable rule of origin. The rules of origin applicable to NAFTA are set out at General Note 12 to the Harmonized Tariff Schedule of the United States. The Notes for the agreements are set out in the HTSUS as follows:

Israel	GN 8
NAFTA	GN 12
Jordan	GN 18
Singapore	GN 25
Chile	GN 26
Morocco	GN 27
Australia	GN 28
CAFTA-DR	GN 29
Bahrain	GN 30

Using NAFTA as a model, there are two possible ways most products will qualify as originating, and, therefore, be entitled to duty preferences. Those ways are: tariff shift and regional value content.

Tariff Shift

The NAFTA tariff shift rule requires that non-originating materials used in the production of the finished article undergo a qualifying change in tariff classification. The qualifying change is specified in the HTSUS General Note based on the classification of the finished article.

For example, assume a company in Chicago wants to import diesel-engine fuel pumps and can choose between a supplier in Mexico and another supplier in the United

[6] 19 U.S.C. § 1202, U.S. International Trade Commission Publication No. 3833.
[7] There are other ways a product may be deemed originating. For example, it may be "wholly obtained and produced" within the territory. This rule applies to a very few products including crops and minerals and goods produced from them without the addition of non-originating materials. This preference criterion is extremely uncommon for industrial goods and is often treated as prima facie incorrect.

Kingdom. All other things being equal,[8] the prospective importer will likely want to take advantage of the duty savings available under NAFTA.

Fuel pumps are classifiable in HTSUS subheading 8413.30.[9] The applicable NAFTA rule is as follows:

> (A) A change to subheadings 8413.11 through 8413.82 from any other heading; or
> (B) A change to subheadings 8413.11 through 8413.82 from subheadings 8413.91 through 8413.92, whether or not there is also a change from any other heading, provided there is a regional value content of not less than:
>> (1) 60 percent where the transaction value method is used, or
>> (2) 50 percent where the net cost method is used.

Part (A) is the tariff shift rule. Under this rule, the pumps might qualify for NAFTA if produced in North America and any non-originating materials used in the production of the pump shifts, as a result of production, from any other tariff heading.[10]

To determine whether the pump qualifies, the producer or exporter[11] must examine the classification of materials used in the production of the pump and identify those classifiable in tariff heading 8413. If there are none, or the parts classifiable in 8413 are originating (and can be verified as such through proper certification), the fuel pump will be certifiable as originating. Looking at heading 8413, it is clear that many parts such as nuts and bolts, screws, gaskets, and gears are classifiable in headings other than 8413. Consequently, those parts will undergo the required tariff shift from another heading to 8413. The origin of those parts, therefore, is immaterial to the NAFTA status of the finished pump.

However, subheading 8413.91 covers parts of pumps not more specifically provided for elsewhere. An example of a part classifiable in 8413.91 is a cast housing designed for and "dedicated to use" solely with a particular pump. If the Mexican fuel pump incorporates a housing (or other material of 8413.91) that is non-NAFTA originating, the entire pump will fail to qualify.

The tariff shift requirements are analyzed in substantially the same way for other trade agreements including the agreements with Australia, Chile, Singapore, and the CAFTA-DR agreement.

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[8] This, of course, is a big assumption. The importer will need to consider the piece price of the crankshaft, the cost of transportation and insurance, the quality of the merchandise, the financial stability of the supplier, and numerous other factors before making an informed purchase decision.

[9] Fuel pumps for diesel engines are classifiable in tariff item 8413.30.10 while other fuel pumps are classifiable in 8413.30.90.

[10] The "tariff heading" is the first four digits of the classification. In this case, the heading is 8413.

[11] Trade agreements subsequent to the NAFTA permit the importer to complete this analysis and self-certify. Under NAFTA, the importer must have a certificate of origin from the exporter in its possession at the time of making a claim for duty-free treatment. The exporter, in turn, might rely on a certificate of origin from one producer.

Regional Value Content

Should the pump fail the tariff shift test, the drafters have provided the fallback regional value content test quoted above as part (B) of the NAFTA rule. Under this test, the pump will be originating if the Regional Value Content ("RVC") exceeds 50% when calculated based upon the net cost methodology or 60% when calculated based upon the transaction value methodology.

The formula for the net cost method is:

$$RVC = (NC - VNM)/NC \times 100$$

In the formula, NC is Net Cost and VNM is the Value of Non-Originating Materials. The actual determination of these values can be complicated and is beyond the scope of this paper. The legal authority for the determination of Net Cost and the Value of Non-Originating Materials is in the Appendix to 19 C.F.R. § 181.

In general terms, the Net Cost is the sum of all costs (not including certain specified excluded costs) incurred in the production of the good. These costs will include material costs, labor, and overhead. From Net Cost, the certifier subtracts the VNM, which is the materials costs of all non-originating materials. Applying the formula results in a percentage of value derived from North America. If it equals or exceeds 50%, the good is considered originating under NAFTA.

Rather, than start with the cost of production, the transaction value method starts with the sales price of the finished good.[12] Because the transaction value presumably includes a profit for the producer, the threshold is the higher 60%. In the case of related parties and for certain products (most notably automotive goods), the certifier must use the Net Cost Method to calculate the RVC. Further, where prices vary from sale to sale, it is often easier for the certifier to use the Net Cost Method.

Agreements subsequent to the NAFTA, including Singapore, Chile, Australia, and CAFTA-DR made significant changes to the RVC methodology. Rather than Net Cost and Transaction Value, these agreements employ the Build Down and Build Up methodology.

Both methods begin with the "Adjusted Value" of the finished product. In the Build Down Method, the formula is:

$$RVC = (AV - VNM)/AV \times 100.$$

This is termed "build down" because it starts with the full value of the goods and subtracts out non-originating value to determine the amount of regional value.

[12] Technically, the transaction value is the price paid or payable for the finished good by the buyer in America with certain adjustments such as for packing, international transportation, etc.

By contrast, the Build Up Method formula is:

$$RVC = VOM / AV \times 100.$$

This method starts by "building up" the value of originating materials to compare to the full value of the finished good and determine the regional value. The build up and build down methods tend to have lower qualifying percentages of 30% to 40% depending on the agreement and the product involved.

Other Free Trade Agreements

Free-trade agreements with fewer policy complications have a more simplified set of rules of origin. This category includes the agreements with Bahrain, Israel, Jordan, and Morocco. As a general principal, these agreements are very similar to the unilateral Generalized System of Preferences discussed in detail below.

To be originating, the Morocco FTA, for example requires that materials used in the production of the goods undergo a "substantial transformation" and that the finished goods have 35% regional value. A substantial transformation occurs when production results in a new or different article of commerce. The goods must also be shipped directly from Morocco to the United States.

The Morocco and Bahrain Agreements permit any amount of U.S. value added in the finished goods. The Jordan and Israel Agreements, in contrast, limit the amount of U.S. content to 15%.

All of the free-trade agreements have provisions dictating how an importer is to make the claim at the time of entry or thereafter. In addition, the agreements have specific recordkeeping requirements. Importantly, an importer claiming duty preferences under a free-trade agreement is also subject to civil penalties should Customs later determine that the claim was invalid and the importer failed to exercise "reasonable care" in asserting the claim.[13] Thus, importers seeking to benefit from free-trade agreements must establish internal corporate compliance policies including written procedures and post-claim audits.

Unilateral Preferences

The United States (as well as other major western trading countries) extends a number of trade preferences to lesser developed countries that satisfy certain requirements. Like free-trade agreements, the basic rules for these programs are set out in the General Notes to the tariff schedule. The relevant notes are as follows:

[13] See 19 U.S.C. §1592.

Generalized System of Preferences	GN 4
Caribbean Basin Economic Recovery Act (CBERA)	GN 7
Andean Trade Preferences Act & Andean Trade Promotion and Drug Eradication Act (ATPA/ATPDEA)	GN 11
African Growth and Opportunity Act	GN 16
Caribbean Basin Trade Partnership Act (CBTPA)	GN 17

In addition, the Customs Regulations[14] establish documentary and other requirements for each of these programs.

GSP is the most widely applicable of these programs. The statutory authority for GSP is 19 U.S.C. § 2461 et seq. In the statute, Congress delegated authority to the President to designate beneficiary developing countries. Goods originating in those countries are entitled to duty-free access to the U.S. market.

Like the Morocco and Jordan free-trade agreements discussed above, GSP has a detailed rule of origin.[15] The rule requires that the product be shipped directly from the beneficiary developing country ("BDC") to the United States. In addition, the total value of materials produced in the BDC plus the direct cost of processing in the BDC must be 35% of the appraised value of the merchandise as imported.

There are, however, significant restrictions on the President's discretion. Most important, Congress has established two "competitive needs limitations" on the program. The first limit prohibits the extension of GSP treatment to merchandise from a BDC that exceeds, in value, 50% of the value of all such merchandise imported into the United States in a single year. The second limit prohibits GSP-treatment for goods that exceed an absolute dollar figure currently set at $130,000,000. Thus, importers relying on GSP for duty savings must carefully monitor the yearly status of the products to assure they do not lose GSP and become subject to duties.

Importers are responsible for exercising reasonable care in making GSP and other duty reduction claims. In United States v. Golden Ship Trading Company, 25 C.I.T. 40, Slip Op. 2001-7 (CIT 2001), the U.S. Court of International Trade held that an importer cannot rely solely on the representation of the producer or exporter that the goods are entitled to GSP treatment. Rather, the importer must affirmatively take reasonable steps to independently verify the claim. What those steps are will vary depending on the nature of the product and the relationship with the producer. Nevertheless, a simple certification by the supplier appears to be insufficient to insulate the importer from potential penalties. Consequently, importers need to establish and follow written compliance procedures including inquiry, recordkeeping, and post-claim audits.

[14] Title 19, Code of Federal Regulations.
[15] See 19 U.S.C. § 2463(c)(2).

U.S. Goods Returned

The tariff schedule contains a number of provisions giving importers of U.S.-origin products relief from customs duties. The first is tariff item 9801.00.10 which covers: "Products of the United States when returned after having been exported, without having been advanced in value or improved in condition by any process of manufacture or other means while abroad." This provision is useful for importers who accept returns from customers abroad or who may have inventory of U.S.-produced goods abroad. As with all these programs, there are specific documentary requirements to support the claim.[16] The principal compliance issue is having evidence to establish that the product was not subject to any process while abroad that would constitute advancement in value or improvement in condition.

Where an imported assembled good includes U.S.-origin parts, the importer may claim a duty credit based on the value of the U.S.-origin parts. This program is embodied in tariff item 9802.00.80. The complexity in this program is that the parts must be shipped from the U.S. ready to use in assembly, without further manufacture or fabrication. Also, the U.S.-origin parts must not be subjected to operations other than assembly and operations incidental to assembly.

With respect to incidental operations, the tariff lists cleaning, lubricating, and painting as incidental operations. There had been controversy over whether Customs could properly limit "painting" to preservative, non-decorative painting and eliminate the duty preference for U.S.-origin parts that are decoratively painted in addition to used in assembly. In DaimlerChrysler Corp. v. United States, 361 F.3d 1378 (Fed. Cir. 2004), the Federal Circuit reversed the Court of International Trade and found the statute to unambiguously permit all forms of painting. For operations not listed in the statute, Customs has the discretion to make reasonable interpretations to implement congressional intent. United States v. Haggar Apparel Co., 526 U.S. 380 (1999).[17]

Duty Drawback

Under certain circumstances, importers who pay duty on merchandise that is subsequently exported or destroyed can apply to Customs for a refund of 99% of the duty paid. This process, and the refund, is referred to as "duty drawback."

Drawback is generally provided for in 19 U.S.C. § 1313.[18] The relevant regulations are in Part 191 of C.F.R. Title 19. The three categories of drawback are manufacturing, unused merchandise, and rejected merchandise. In each case, the exported merchandise may be the same merchandise as was imported (so called "specific

[16] 19 C.F.R. § 10.1.
[17] Customs has used that discretion to identify numerous operations as either incidental or not incidental to assembly. See 19 C.F.R. § 10.16.
[18] The drawback of certain excise taxes is provided for in 26 U.S.C. § 5062.

identification") or another product that is of the same kind and quality (so called "substitution").

Manufacturing drawback is permitted where an imported material is used in manufacturing in the United States and the manufactured product containing that imported material or a properly substituted material is exported or destroyed. The exportation or destruction must take place within five years of the relevant importation. For substituted merchandise, the manufacturing must take place within three years of the importation.

Drawback is also available when imported merchandise is exported or destroyed without being used in the United States. The exportation or destruction must take place within three years of the importation. Similar to manufacturing drawback, unused merchandise drawback may be claimed where a substituted commercially interchangeable product is exported or destroyed.

The last category of drawback is for rejected merchandise. This type of drawback is available for imported merchandise that was either shipped without consent of did not confirm to specifications. The merchandise must be exported or destroyed within three years of importation.

There is a complicated relationship between drawback and the NAFTA. The NAFTA limits drawback where the merchandise is exported to another NAFTA country. The reason for this is the concern that non-NAFTA material could be imported into North America, used to produce a NAFTA-originating product, and then be the subject of drawback. In that scenario, the importer of the non-NAFTA material would have almost no duty liability (due to the 99% drawback) and the importer of the NAFTA-originating good would also have no duty liability (due to the NAFTA). As a result, non-NAFTA goods, which might otherwise have been subject to duty, escape duty entirely.

To correct this perceived problem, the NAFTA requires that the three NAFTA countries limit the availability of drawback in these circumstances. Rather than refunding 99% of the duties paid upon export, the country may only refund an amount equal to the lesser of the duties owed the country into which the material was imported or the country into which the finished good was imported. Because NAFTA goods will almost always be duty-free, the refund is limited to zero; thereby, effectively eliminating drawback in these circumstances.[19]

[19] The regulations implementing this rule are found at 19 C.F.R. Subpart E. These limitations also apply to duty deferral and waiver programs such as Foreign Trade Zones and Temporary Importation Bonds.

Other Possibilities

As long at the U.S. government has been collecting customs duties,[20] enterprising importers have looked for ways to reduce their duty liability. This article has touched upon the major ones. Additional duty reduction opportunities are highlighted below.

Temporary Importation Bonds

Certain merchandise can be imported into the United States without the payment of duty where it will be exported within a year or an approved extension period not to exceed three years. The importer seeking to take advantage of these opportunities must have an appropriate bond securing Customs in the event the merchandise is not properly exported or destroyed. Most of the TIB provisions are found in heading 9813 of the Harmonized Tariff Schedule of the United States.

ATA Carnet

A carnet is similar to a passport for merchandise. Importers holding a properly executed carnet are entitled to temporarily import merchandise without paying duty. Carnets are issued by the U.S. Council for International Business and require either a security deposit or bond. Presently, a carnet will be recognized in 65 countries and 27 territories.

Foreign Trade Zones and Bonded Warehouses

A foreign trade zone is a specially designated area near a U.S. port of entry that is technically considered to be outside the customs territory of the United States. As a result, when properly documented and controlled, foreign merchandise can be admitted into an FTZ and not subjected to duty until it is withdrawn from the zone into the commerce of the United States. In circumstances where parts are subject to higher duty rates than the finished goods, a so called tariff inversion, manufacturers can benefit. Other benefits include the avoidance of local property taxes.

A bonded warehouse is similar to a foreign trade zone but much more limited in terms of activities permitted within the warehouse. A bonded warehouse is essentially a private warehouse in which the warehouse operator agrees to assume responsibility for

[20] Prior to the imposition of the income tax, customs duties were the primary source of federal revenues. The second piece of legislation passed by the first congress was for the raising of revenues by the collection of customs duties. Impost Act, 1 Stat. 24 (July 4, 1789) (repealed 1790).

the control of the merchandise until it is properly released and, when required, an entry made.

Conclusion

Customs law is a complicated regulatory area in which companies are exposed to significant risks of liability. Importers can often benefit from one or more legal opportunities to reduce their overall duty liability. Each of these opportunities, however, brings with it technical legal obligations involving reporting, recordkeeping, and due diligence in verifying asserted claims. Importers are, therefore, well advised to work closely with internal and external compliance professionals to establish comprehensive and accurate compliance procedures.