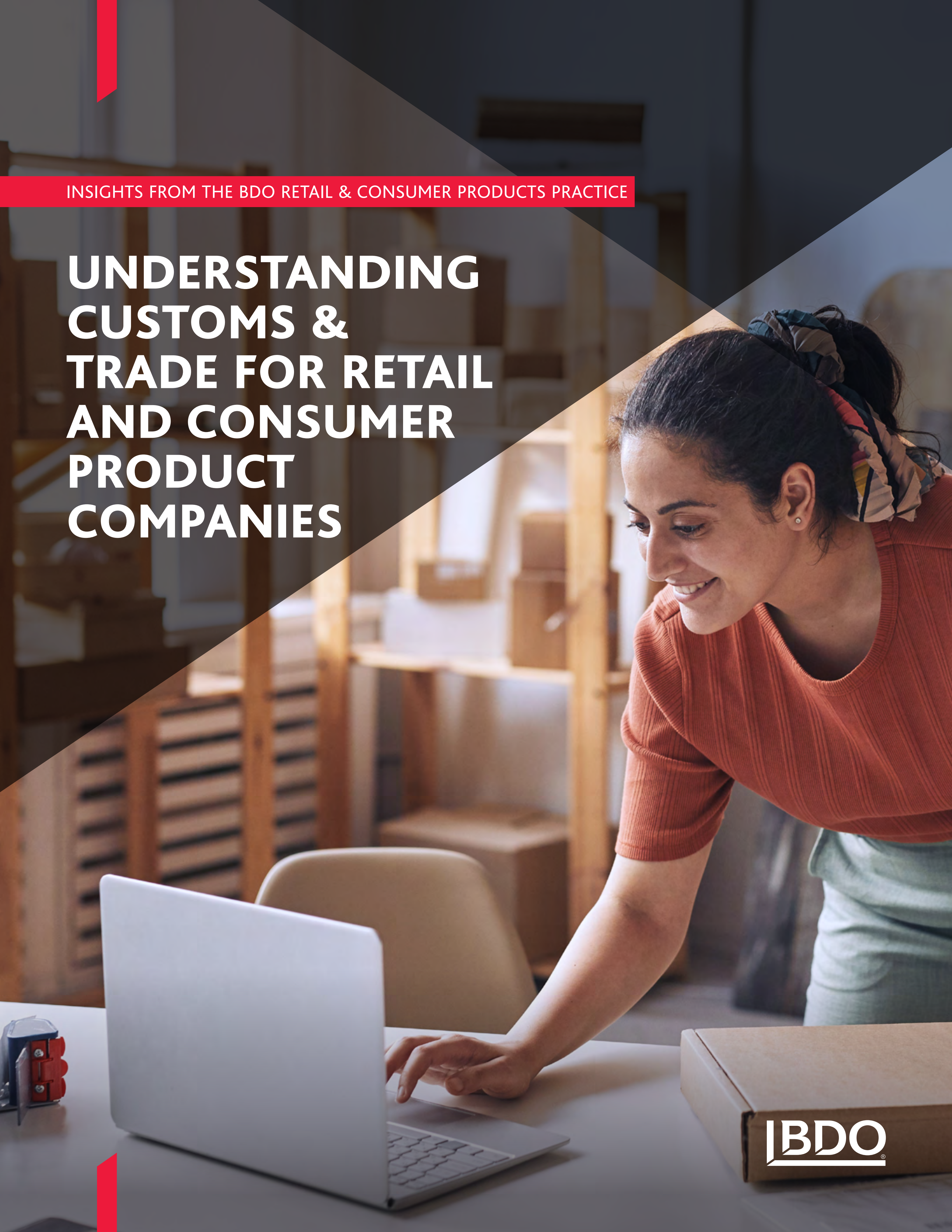
INSIGHTS FROM THE BDO RETAIL & CONSUMER PRODUCTS PRACTICE

UNDERSTANDING CUSTOMS & TRADE FOR RETAIL AND CONSUMER PRODUCT COMPANIES



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Many aspects of an import transaction impact the cost of goods and must be considered in calculating the landed cost. These factors can generally be categorized into what is referred to as the "Customs Triangle," tariff classification, valuation and country of origin. In particular, imports from China have taken on heightened significance due to the imposition of the Section 301 tariffs in 2018 and, more recently, the new statute concerning the use of forced labor. Both of these issues are discussed below.

Tariffs, which are indirect "hidden" taxes, drive up the price of imported goods. For example, the Section 301 tariffs on goods from China (the largest source of high quality and affordable retail consumer products) significantly impacts retailers and consumers. Other trade-related factors that also affect retailers include: the increased U.S. government focus on forced labor, requirements for importers to undertake expansive audits of their supply chains, Section 232 "national security" tariffs on steel and aluminum (driving up the prices of metal-dependent products), free trade agreements such as the United States-Mexico-Canada Agreement, and the now lapsed Generalized System of Preferences (GSP) (providing for duty-free treatment of goods from developing countries). All of these factors impact the availability and cost of imported merchandise — the lifeblood of the retail industry.

For retailers, as with any other industry in today's globalized economy, supply chain planning has become more challenging and complex. The COVID-19 pandemic has severely disrupted the global supply chain, resulting in shortages of key materials and inputs, freight interruptions and skyrocketing shipping costs. New constraints have also been placed on the import and export of certain products. In addition to grappling with these externally driven pressures to keep businesses afloat and to meet intensifying demands for specific products, retail companies have to ensure they remain compliant with the myriad international trade rules and regulations governing this market.

Most companies in the retail sector operate globally and import a wide range of products including clothing, shoes, jewelry, cosmetics, home furnishings, lighting, luggage, toys and electronics. The list encompasses virtually everything people purchase and use on a routine basis. Many companies may overlook the impact of the customs and trade regulatory environment on cross-border movements of their materials and products. In fact, many retail companies do not include customs or export internal controls as part of their regulatory compliance planning and/or tax optimization planning, an oversight that can ultimately lead to civil penalties and overpaid duties.

Under **Section 484 of the Tariff Act**, the Importer of Record (i.e., the owner, purchaser or licensed customs broker) is responsible for using "reasonable care" when declaring its imports to U.S. Customs and Border Protection (CBP), such as classifying and determining the value and country of origin of imported merchandise. If the U.S. Importer of Record fails to exercise reasonable care (absent fraud), CBP may impose monetary penalties of up to four times the domestic value of the imported merchandise, depending on the level of culpability and whether any revenue loss is involved. Other countries have similar penalty regimes and strict rules regarding who can act as the Importer of Record. For example, the EU does not allow nonresident Importers of Record.

Aside from the potential exposure for misreporting, compliance with customs rules may provide many opportunities for legitimate duty savings on imports. As such, retail companies should make customs an integral part of their business strategy, from supply chain and tax planning to compliance.

The following outlines in more detail some considerations to keep in mind as your company assesses how to best approach customs planning and compliance.

TARIFF CLASSIFICATION

All imported goods must be classified under the appropriate full 10-digit Harmonized Tariff Schedule of the United States (HTSUS) code. Tariff classification is a critical component of customs compliance because it determines the applicable duty rate and special tariffs, as well as whether Partner Government Agency (PGA) rules also apply for imported merchandise. For example, both the Food and Drug Administration's regulations and CBP's regulations apply to imports of food items and cosmetics. Each time an item crosses from one country to another, a unique tariff code must be assigned to the product, which is reported to the local customs agency. All tariff codes are based on the global Harmonized Commodity Description & Coding System (HS) maintained by the World Customs Organization. An incorrect tariff code can lead to unnecessary inquiries/audits from CBP or from the relevant local customs authority, and monetary penalties may result from such an inquiry.

> A fully revised and updated HS went into effect globally on January 1, 2022, so the issue of tariff classification is especially ripe for review.

For imported merchandise, some companies use the tariff codes supplied by their vendors, manufacturers, middleman and customs broker. However, the Importer of Record has full responsibility for reporting the correct 10-digit HTSUS Code and should not blindly rely upon information provided by third parties. Detailed technical information about each item to be imported must be reviewed by a qualified/experienced customs team and the tariff classification reviewed must be based on the condition of the subject merchandise at the time of import. For instance, the classification of textile and apparel products under the HTSUS can be extremely complex (such as examining the decitex level of yarn and weight in grams per square meter of fabric) and these product categories are subject to very high rates of regular ("Normal Trade Relations") duty. Determining the correct classification can be challenging, requiring an analysis of the composition of the article and method of production, and it can be difficult to ascertain the proper tariff code without assistance from an experienced professional who knows and understands textile and apparel products, as well as the intricacies of the tariff code.

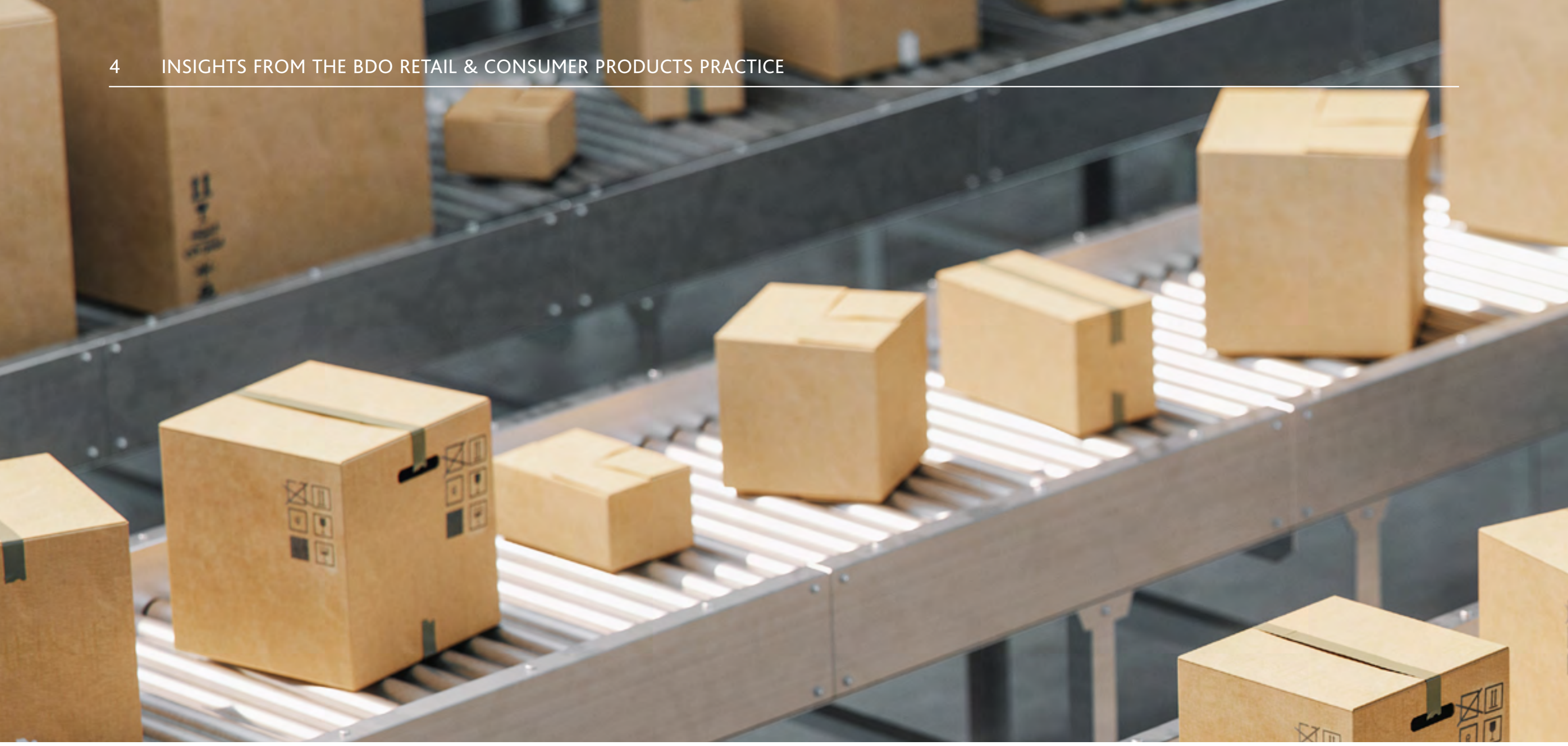
CUSTOMS VALUATION

In addition to reporting the correct tariff code, importers must report the correct value of the imported merchandise. Under CBP rules, value is normally the price reflected on the commercial invoice. However, when value includes additions to the price paid or payable (such as royalties, license fees or selling commissions), these must be added to the declared value. Customs valuation is thus another critical area for the retail industry. For instance, many transactions involve the use of a contract manufacturer selling to a middleman, which re-sells the merchandise to the U.S. importer. Such a scenario implicates the "First Sale Rule" (FSR), whereby the lower factory to middleman price and not the middleman price to the U.S. importer can be used as the value reported to CBP.

While FSR applies only to imports into the U.S., all major trading nations use the same valuation rules (with some minor exceptions) as set forth in the 1979 GATT (now WTO) Valuation Agreement. The most predominant method of determining the value of imported goods is the "transaction value" method, which refers to the price actually paid or payable for the merchandise when sold for export.

In sales between related parties, the transaction value stems from the transfer price based on a transfer pricing study prepared under the local income tax rules. Relying on transfer prices to establish the transaction value, standing alone, is insufficient to satisfy the customs valuation rules. CBP has clearly stated that relying on the intercompany price determined by a transfer pricing study is not enough to support the use of transaction value for customs purposes because an inherent conflict exists between income tax and customs duty for purposes of the value of imports: lower customs values result in higher income tax and vice versa. Where transactions are concluded between unrelated parties, companies must review how the invoice price was calculated and determine whether it meets CBP's transaction valuation requirements. For example, items may be imported as samples without a "bona fide sale for exportation." If transaction value does not apply, all of the other valuation methods must be examined in sequential order (unlike transfer pricing, which simply uses the "best method" among other methods).

In addition, various payments for services or intangibles made to foreign parties outside of the import transaction must be examined for potential dutiability. CBP generally applies a "totality of the circumstances" standard to determine the dutiability of any payment made by the importer to a foreign company. If CBP determines that a sufficient link between the payment and the imported products exists, the payment would likely be dutiable.

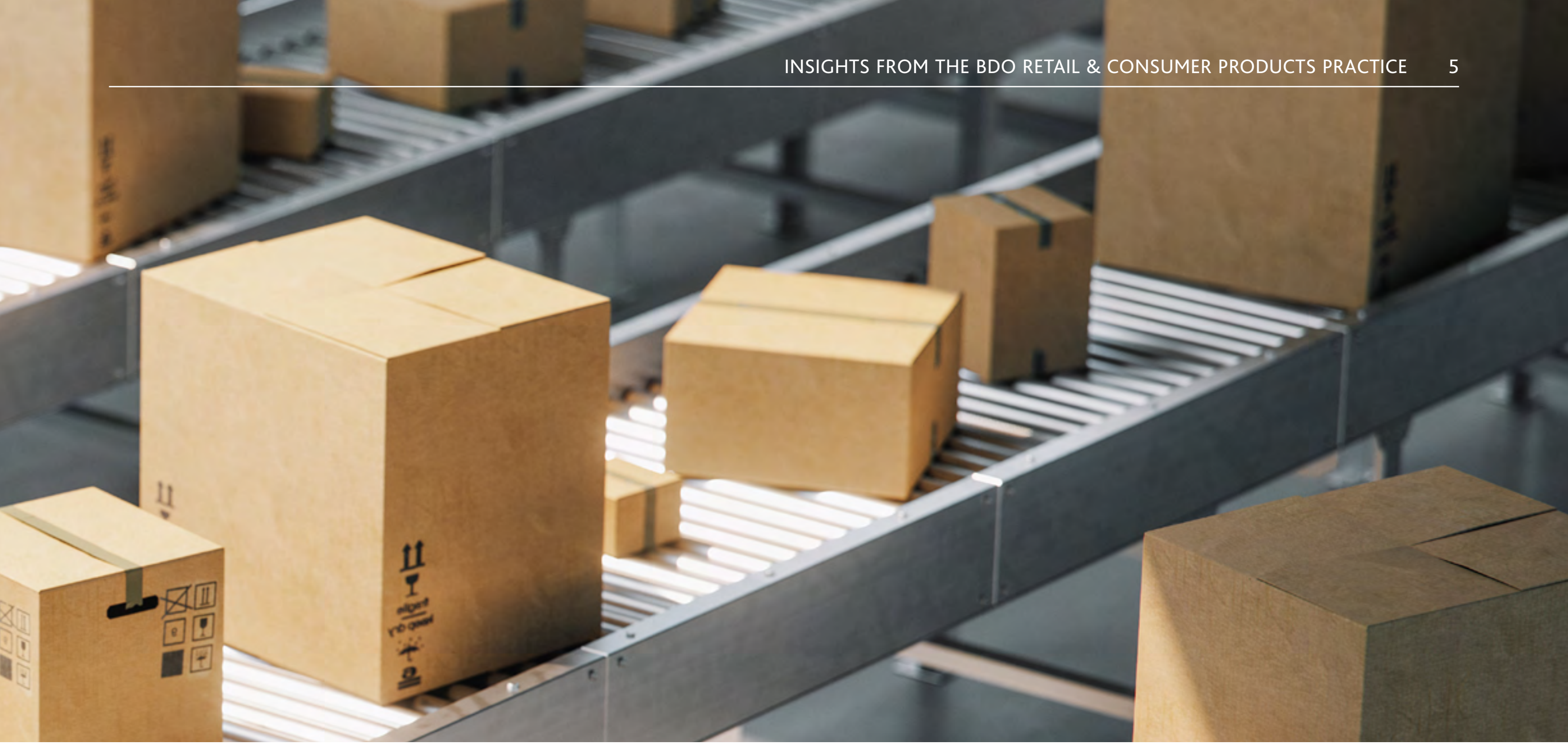


COUNTRY OF ORIGIN

Country of origin is always an issue for imported products and must be properly declared to CBP or other local customs authority in the country of import. For goods entering the U.S., CBP employs the “wholly obtained” criterion for goods that are wholly the growth, product or manufacture of a particular country. Simply stated, if the imported product is completely produced in one country, that country is the country of origin for that product. On the other hand, CBP employs the “substantial transformation” criterion for goods that consist in whole or in part of materials from more than one country. The substantial transformation criterion is based on a change in name/character/use in the last country of processing. For example, an article that consists in whole or in part of materials from more than one country is a product of the last country in which it was substantially transformed into a different article of commerce with a name, character and use distinct from that of the original materials. Substantial transformation is primarily a customs law concept and the evaluation of whether components have undergone sufficient processing to lose their individual identity when incorporated into a finished product is a complex analysis subject to many variables — and compounded by confusing court rulings on this issue. For example, in a recent court case, it was determined that a substantial transformation did not occur if the components have a pre-determined use when imported into the country of final production.

For textiles and apparel, the origin rules are even more complex. Generally, the country of origin of a textile or apparel product is the country in which it is wholly obtained or produced. The country of origin of textile and apparel products produced in more than one country, however, is the country in which the components of the product are wholly assembled, except for minor finishing operations such as attaching buttons and subassemblies like pockets. If assembly operations take place in more than one country, the country of origin is the country in which the most important assembly or most important manufacturing process occurs. If this cannot be determined, the country of origin is the last country in which an important assembly or manufacturing operation occurred. A determination of which assembly or manufacturing operation is the most important is determined on a case-by-case basis. The importer must perform a factual analysis drawing on a vast body of prior customs rulings and case law.

Given the complexity of this area, retailers should obtain the advice of experienced professionals if such technical expertise does not exist in-house.



FORCED LABOR

U.S. law has prohibited the importation of merchandise produced or manufactured by forced labor for more than 90 years. The issue has been under closer scrutiny over the past several years, particularly with regard to products made in the Xinjiang Uyghur Autonomous Region (XUAR) of China where allegations of abuse against the Uyghur ethnic minority by the Chinese government are prevalent.

As a result, CBP has issued a number of Withhold Release Orders (WROs) for shipments of goods from this region covering:

- COTTON
- TOMATOES AND DOWNSTREAM PRODUCTS
- SILICA-BASED PRODUCTS
- COMPUTER PARTS

CBP issues a WRO after a petitioner files an allegation that goods made with forced labor are likely to be imported into the U.S. CBP initiates an investigation if the petition indicates that a reasonable suspicion of forced labor exists. If the investigation reveals that forced labor is involved, CBP issues the WRO.

As noted above, U.S. importers have an obligation to exercise "reasonable care" and take appropriate action to, e.g., establish that their imported goods have not been produced with forced labor. Thus, retailers should establish procedures to assess their suppliers (including upstream processes for purchased goods) to understand the risks associated with the use of forced labor. This is critical because the law prohibits the importation of goods made "**wholly or in part**" by forced labor.

On December 23, 2021, President Biden signed into law, the Uyghur Forced Labor Prevention Act (UFLPA). The bill was the culmination of bipartisan attempts to restrict imports from the XUAR and the new law creates a rebuttable presumption that all products mined, produced or manufactured wholly or in part in the XUAR are made with forced labor. The UFLPA will enter effect on June 21, 2022 and represents a tectonic shift in U.S. enforcement policy. Whereas previously U.S. restrictions on XUAR-origin imports into the U.S. were limited to bans on specific categories of items such as cotton, tomatoes and downstream products and items produced by specific state-owned factories, the new law will effectively ban imports of all items produced in whole or in part in the XUAR. Further, the rebuttable presumption now extends to any product from China (or any other country) made with inputs from the XUAR. The UFLPA will require companies to take considerable proactive steps to rebut the presumption.

Under the UFLPA, retailers will need to develop processes and procedures that will demonstrate:

1. Due diligence and supply chain management measures in relation to items produced using forced labor;
2. The type, nature and extent of evidence that demonstrates items imported from China were not produced in the XUAR; and
3. The type, nature and extent of evidence that demonstrates items originating in China were not produced using forced labor.

Retailers should realize that if an allegation of forced labor is made against goods they are importing into the U.S., it will likely be too late to investigate whether the goods were in fact made in whole or in part by forced labor considering the breadth of suppliers and vendors that an investigation would need to cover. Such an investigation is time-consuming, especially given the need to track and confirm the country of origin of each raw material used in making the finished goods and cannot likely be completed before CBP may issue a WRO.

Each WRO is accompanied by a press release that could negatively impact a company and may result in potential seizures or exclusion of goods, loss of sales and/or revenue and — most importantly — reputational risk. Such an impact can be most acute in the retail sector which produces, imports and sells goods in many instances on a seasonal basis, using different suppliers. Therefore, retailers can suffer significant losses if, e.g., shipments of apparel suspected of being made with cotton from the XUAR were detained pending a rebuttal of the presumption of forced labor. Even if the rebuttal were successful, the season for selling the garments would have passed and by the next season, the apparel could be out of style and result in substantial monetary losses for the retailer. In addition, the stigma of importing goods manufactured with forced labor could result in brand erosion and lost sales.

WHERE DO YOU GO FROM HERE?

Many retail importers place too much reliance on external customs brokers and freight forwarders or they lack adequate internal resources. Global duty spend should be part of any multinational's tax planning agenda; tariffs (customs duties) are an indirect tax and are squarely part of understanding total tax liability on a worldwide basis. Given the complex tariff classification, customs valuation and origin issues often encountered in the retail industry, budgets should include seeking expert advice in this complicated and highly technical area. In addition to the various customs issues, companies will need to undertake enhanced due diligence measures with respect to their global operations and supply chains and exercise heightened vigilance to facilitate compliance with increased enforcement measures such as the UFLPA. We suggest the following preliminary steps to remain current with customs compliance obligations and make the most of any opportunities to save on import duties:

1 REVIEW and update the company's import/export compliance policies and procedures and documentation, including the internal tariff code database.

2 ASSESS the company's transfer pricing policy covering import transactions with related parties to evaluate the intercompany price under the customs valuation rules.

3 EXAMINE whether any payments related to imported or exported items are dutiable.

4 UNDERTAKE a comprehensive review of the company's supply chain to identify vulnerabilities, i.e., goods made with forced labor, how and by whom products are made, and how materials, etc. are sourced to develop a flexible and resilient model that can adapt to a quickly changing sourcing world.

5 EVALUATE supply chain models to gauge whether the products effectively meet the global customs requirements, including CBP's "substantial transformation" rules to confirm the U.S. origin and any eligibility for preferential tariffs.

SEE FULL LIST ▶

BDO is experienced in working with retailers and importers of consumer products to facilitate global duty spend optimization and minimize risk and exposure. Understanding your global customs obligations is important for avoiding costly fees and regulatory challenges while maximizing the potential cost savings wherever you do business.

People who know Retail and Consumer Products, know BDO.

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