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A Few Pointers on Customs Law

Publication
November 30, 2000
ALI-ABA

Don't Let Your Client Import Trouble

With very few exceptions, all goods imported into the United States must be declared with the U.S. Customs Service and are subject to duties under the Harmonized Tariff Schedule of the United States (HTSUS). Duties vary with the type of merchandise, its value, its origin, and a number of other factors. Penalties for violating Customs laws or procedures can be quite substantial.

Despite the very high duties (which may be higher than the corporate tax rate), few importers - or their attorneys - give Customs law questions the same thought spent on tax planning or other issues. This is a mistake. The reality for any importer is that duties and fines imposed for Customs laws violations add an extra layer of cost to the item imported and correspondingly reduce the item's competitive worth in the domestic marketplace. If your client does any significant volume of importing business, you should acquaint yourself with the basics of Customs law.

Fundamentals

The duty payable at the time of entry is a function of four distinct factors:

The first factor is classification. Classification means how the imported goods are described in HTSUS (the Harmonized Tariff Schedule of the United States). The classification determines the duty rate and whether the product is eligible for a duty preference program;

The second factor is value. Most duties in the United States are based upon the Customs value of the imported merchandise;

The third factor is country of origin. Certain products, such as those from Canada, Mexico, Israel, some third world countries, and certain other countries may be eligible for reduced duties. Other products that are not from countries that are considered "most favored nations" are subject to increased duties; and

The final factor is entry status. Merchandise that is entered into a Customs bonded warehouse, a foreign trade zone, or for special purposes may be entered free of duty or with duty deferred.

Classification

Classification refers to the category the product fits into under the Harmonized Tariff Schedule. The Schedule is published by the U.S. International Trade Commission (USITC). See USITC Publication 3249 (2000).

System Structure

The merchandise classification system is like a pyramid, beginning at the Section level, such as vegetable, textiles, vehicles, and so forth, and then proceeding to the Chapter level, with articles such as tin items, aircraft, furniture, and so on. Within each Chapter, Headings are further organized by level of processing or by function or use. Subheadings further define products into various categories.

Reading the Headings

The first six digits of the tariff number, which are through the Heading, are standardized by the World Customs Organization, an international organization located in Brussels. Additional subheadings, from the seventh to the tenth digits, are available to individual countries to further make divisions for duty purposes or for purposes of quotas or statistical tracking.

Interpreting the Classifications

All of these breakdowns are subject to nationally and internationally promulgated rules of interpretation. Indeed, by far the vast majority of rulings issued by Customs deal with classification questions. Rulings are issued pursuant to regulation. See 19 C.F.R. pt. 177. More recent rulings are now available on Lexis or on the Web at http://www.customs.treas.gov/impoexpo/impoexpo.htm. They can also be purchased from commercial services such as Fuglei and Associates in Missoula, MT on CD-ROM.

General Rules

Section and Chapter notes are subject to General Rules of Interpretation. The notes are found at the start of the Harmonized Tariff Schedule. See USITC Publication 3249 (2000). These rules are designed to resolve classification issues when the same products are seemingly classified under more than one heading.

What's the "Essential Function"?

The rules provide that the heading to be used is the one providing the most specific description of the imported product or, for combinations of materials or multiple function products, the heading for the material, component, or function which provides the "essential character" of the product. If nothing else, the heading last in numerical order of the Harmonized System prevails.

Classification Change Affects the Duty Rate

The classification determined by Customs can have a significant effect on the rate of duty applied. For example, for years lavatory modules for use in commercial aircraft were imported by commercial aircraft manufacturers as HTSUS 8803.30.00104 (other parts of airplanes). Customs reclassified the modules as HTSUS 9406.00.8090 (prefabricated buildings). The result was an increase in duty from duty free to a duty of 5.7 per cent. Only after a protest was filed was Customs convinced that the original classification was correct.

Finished or Unassembled?

One area in which classification is particularly significant is the treatment of merchandise as finished or unassembled. Certain items may fall under different tariff rates, may be under a quota, or may be subject to dumping duties, depending on whether the item is a component or completed article.

How To Tell the Difference

Harmonized Tariff Schedule General Rules of Interpretation 2(a) states generally that the tariff description of an article must refer to an article as incomplete or unfinished if the incomplete or unfinished article has the essential character of the complete or finished article.

Computer Industry Example

An example was in the news a few years ago. Certain flat panel electronic computer displays typically used in laptop computers were subject to an antidumping duty of approximately 63 per cent when imported into the United States from Japan. USITC Investigation No. 731-TA-469 (final), 56 Fed. Reg. 12,741 (1991). This level of duty made it almost prohibitive to import these panels. However, if the same panels were imported into Canada and assembled into laptop computers there, they could enter the United States as laptop computers under a different classification and tariff schedule. Under certain circumstances they could enter as Canadian goods and thus be subject to the Free Trade Agreement with Canada, greatly reducing the duty that would be paid. The result was a rush of computer companies setting up laptop assembly plants in Canada or various other countries.

Effect of NAFTA

The goal of NAFTA is to eliminate all customs duties on all goods originating in Canada, Mexico, or the United States over a transition period. NAFTA has had a tremendous impact on all aspects of Customs law and practice. To begin with, it has removed almost all tariffs between the three countries under various timetables, depending on the sensitivity of the particular import. About half of all Mexican tariffs were eliminated on the effective date of the agreement, with the rest to be eliminated over five or 10 years or, in a very few cases, 15 years. Since Mexican tariffs are about two-and-a-half times the U.S. tariff rates, this will have a major

impact on trade between the two countries. Canada's rates were already reduced by the U.S.-Canada Free Trade Agreement and have been essentially eliminated now by NAFTA.

As a result of the Customs Modernization Act, passed as part of NAFTA, there have been an increasing number of classification changes. For example, the 1996 Harmonized Tariff Schedule contains some 30,000 changes from the 1995 version. Most of these were not due to the ModAct, but a significant percentage were. Virtually every Customs Bulletin contains some proposed classification changes.

Valuation

Valuation under Customs laws is one area in which an attorney is very frequently involved. A statute that provides the methods used in determining the value for Customs purposes of imported goods is Section 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979. 19 U.S.C. § 1401a. This became effective on July 1, 1980. U.S. Customs law is derived from the valuation code of the General Agreement on Tariffs and Trade (GATT). Both the GATT code and the U.S. implementation focus on the use of "transaction value" as the basis for Customs valuation.

"Commercially Realistic" Transaction Value

United States law has developed a detailed definition of transaction value. 19 C.F.R. § 152.103. The basic premise is that imported merchandise is to be valued on the commercially realistic basis of the price paid or payable. When the importation is the result of sale between unrelated parties in the normal course of business, the dutiable value is established as the selling price or "transaction value." Transaction value is by far the most frequently used method of valuation.

The Meaning of "Transaction Value"

Transaction value is defined as "the price actually paid or payable for the merchandise when sold for exportation to the United States." This price must be increased to reflect packing costs, selling commissions, "assists" (something provided by the buyer, the value of which has to be added into the selling price), royalties or license fees, and the proceeds of any subsequent resale that accrue directly or indirectly to the seller if they are not already included. Additions to the price actually paid or payable create many of the disputes in Customs law. It is an area in which creative analysis can be very helpful to the client.

What Happens if Transaction Value Is Inapplicable?

In some cases, however, valuation cannot be determined by transaction value. This includes sales between related parties in which the price is not determined on an arm's-length basis, or the absence of a sale, such as a shift of inventory from one location to another.

Alternative Valuation Methods

When transaction value is not available, the dutiable value is determined by applying one of four alternative methods of valuation. 19 C.F.R. §§ 152.104-107 (1992). These are, in order of preference:

Transaction value of identical merchandise, that is, the value based upon the price for identical merchandise charged by the same manufacturer in a direct sale to an unrelated U.S. customer at about the same time;

Transaction value of similar merchandise based upon a price of nearly identical commercially interchangeable merchandise produced by the same manufacturer;

Deductive value derived from the price at which the article is ultimately sold in the United States less items such as included international freight, duties, charges, and certain commissions; and

Computed value, which is derived by building up the manufacturer's actual costs for labor and materials plus the general expenses and profit usually realized by the manufacturer.

Controlling the Valuation

Many methods are available to reduce duty liability by controlling valuation. Many of these include "unbundling" or separately invoicing for various nondutiable costs. See generally Ruth F. Sturm, Customs Law and Administration § 47.2 (3d ed. 1993). These are discussed below.

Excluding Transportation Costs

The cost of transporting the imported merchandise within the country of exportation, if included in the price paid to the seller, can be excluded from dutiable value under certain circumstances. The general rule is that foreign inland freight is deemed nondutiable if it is separately invoiced and the charges occur after title to the merchandise has transferred. A direct means of avoiding duty on foreign inland freight is to make the purchase on an ex-factory basis with the freight arranged for by an agent acting for the buyer, as both the freight and the cost of the buyer's agent are not part of the Customs value.

Interest Payments

Some transactions provide for interest payments. If done carefully, these interest payments are not part of the Customs value. Thus, interest would not be dutiable when the interest charge is identified separately from the price paid or payable for the goods, the financing arrangement is written, and the buyer can demonstrate that the goods are actually sold at the price declared and the claimed rate of interest does not exceed the prevailing rate of interest in the country where the financing is provided.

Compensation for Inspection

Compensation paid by a buyer for delivery and inspection services may not be part of the dutiable charge for the goods. In some cases, when these services are performed by a buying agent, Customs has treated this as a buying commission that would not be dutiable.

Avoiding Duty on the Middleman's Markup

In many transactions the buyer deals with a middleman, rather than the original purchaser of the imported merchandise. By careful planning, the buyer can avoid paying duty on the middleman's markup. One way to do this is to argue that the sale from the manufacturer to the middleman was a sale "for exportation to the United States." This price paid would be the "price paid or payable for exportation to the United States" in the words of the statutory definition for transaction value. Thus, the buyer pays duty on this amount and not on the larger amount charged by the middleman to the importer.

Another possibility is to provide that the middleman act as the importer's purchasing agent or buying agent. The commission paid to the buying agent is not dutiable. This would require a written agency agreement which ensures that the agent is not vested with the responsibilities for the manufacturer's failure to perform or otherwise deliver. It must be clear that the buying agent is, in fact, a legitimate buying agent.

Country of Origin

A number of statutes administered by Customs depend upon the determination of the country of origin of the imported merchandise. These include:

Marking requirements by Customs and other federal agencies;

Qualification for free trade agreements such as NAFTA and the agreement with Israel;

Application of dumping or quota issues; or

The application of appropriate duty status such as Generalized System of Preferences, Most Favored Nation, or Caribbean Basin Initiative. See, e.g., Sturm, supra, at § 15.1.

Marking requirements administered by the FTC instead of Customs.

Multicountry Confusion

There is a certain amount of tension among the different country-of-origin determinations under different statutes. Indeed, it is possible that the same item may be considered the product of Country X for purposes of marking and of Country Y for purposes of determining duty. There is seldom a dispute about a product that is solely grown or manufactured in a single country. However, international trade now is so complex and multicountry processing so prevalent that it is frequently very difficult to tell what the country of origin of a particular product is. Cars, electronic goods, and textiles frequently have major portions of the work done

in a number of different countries.

There has recently been an increase in attempts to consolidate these various interpretations. During the spring of 1996 there were meetings by the International Trade Commission on markings (61 Fed. Reg. 5802), the FTC held a workshop and requested comments (61 Fed. Reg. 5340) and Customs requested comments (61 Fed. Reg. 3763).

"Substantial Transformation" Test

The traditional rule used in Customs has been to determine whether the processes in the particular country involved constitute a "substantial transformation," changing an existing product into a "new and different product." However, because of the unworkability of this standard in the modern trade environment, the international move has recently been to look also to the valuation of the work done in the particular country to determine whether that country becomes a country of origin. Thus, NAFTA applies a far more complex analysis for country of origin than the old "substantial transformation" test. NAFTA, Chapter 4, Annex 401.

Differing Approaches

Some products to be sold in both the United States and the European Union must have different markings, depending upon the country in which the product is to be sold. For example, U.S. Customs has long held that the assembly of an integrated circuit chip into a package which includes electrical leads and protective material, as well as the chip, constitutes a substantial transformation which changes the raw semiconductor chip produced in Country X into a new and different product which has to be marked with the country of assembly as the country of origin. The EU holds that the country where the electronic circuitry is laid down on the semiconductor substrate is the country of origin. Subsequent integration operations do not change the semiconductor chip's nature.

Lack of Uniformity Is Expensive

This lack of international uniformity adds additional costs and expense to the manufacturing process. Similar problems are created when products from a number of countries are blended to make a generic product. This has recently been a problem, for example, with orange juice concentrate manufacturers who may use concentrate purchased from five to 10 different countries. The problems of how to do the marking are obvious. The lack of international uniformity for country-of-origin criteria is a problem that is of increasing magnitude for manufacturers who conduct multinational business operations.

"Regional" Goods Under NAFTA

NAFTA will have a tremendous impact on country-of-origin issues. Because entry from Canada and Mexico is now largely duty free, it becomes very important that the goods imported actually be from Canada or Mexico. Consequently, the Rules of Origin section is one of the

most detailed and complex parts of NAFTA. It follows the Canada-U.S. Free Trade Agreement in providing that goods that are wholly from North America (that is, from the United States, Canada, and Mexico) qualify for treatment under NAFTA.

Nonregional Becomes Regional

Goods containing nonregional materials are also considered to be North American if the nonregional materials are sufficiently transformed in North America so as to undergo a specified change in tariff classification. NAFTA has a lengthy appendix that details all of these specified changes.

Content Requirements

In some cases, the goods have to have a specified percentage of regional content as well as meet the substantial transformation rules. For example, passenger automobiles and light trucks will need to contain 62.5 per cent North American content to qualify for preferential tariff treatment when the NAFTA rules of origin are fully phased in. In other cases the specified percentage of regional content is sufficient in itself to meet the country-of-origin rules.

In some cases there are specific cost accounting rules required to meet the percentage test. For example, automotive products must use the net cost method (total cost minus royalty, sales promotion, packing, shipping, and some interest costs) with tracing of component parts through the production chain.

NAFTA Prompts New Marking Rules

As mandated by NAFTA and to promote uniformity, Customs proposed new marking rules for determining whether a good is a product of a NAFTA country for marking purposes. New textile and apparel assembly rules of origin become effective as of July 1, 1996. Other proposed rules were published in the Federal Register, January 3, 1994 (59 Fed. Reg. 110). Although these rules by their terms applied only to NAFTA determinations, Customs also was in the process of establishing identical rules for determining country of origin for all imported goods. Federal Register, January 3, 1994 (59 Fed. Reg. 141) and Federal Register, May 5, 1995 (60 Fed. Reg 22312). Because of the controversy over these proposed rules, the administration recently instructed the Customs Service to drop this proposal. Rules of origin remains the current thorniest problem for Customs, with additional changes anticipated on both the national and international level in the next few years. The problem extends across diverse agencies including Customs, the FTC, and the Commerce Department.

Harmonization of Origin Rules

The Agreement on Rules of Origin reached in the Uruguay Round of Multilateral Trade Negotiations represent a major move toward an internationalization of the rules of origin. They were intended to end the use of preferential rules of origin as trade barriers. The Origin

Agreement will harmonize the nonpreferential rules of origin in two steps. First there will be a transitional period, envisioned as three years, during which harmonized rules will be drafted by a Technical Committee. Once the rules are drafted, a GATT ministerial conference will adopt the rules and set a time for implementation. In addition there are some limitations on use of rules of origin as trade barriers during the transition period. There are also some limitations on the continued use of certain preferential rules of origin and procedural safeguards on the formulation and implementation of rules of origin in the hope to have more transparency even if preferential rules of origin are utilized.

Customs administers laws requiring labeling for goods of foreign origin. However, because goods do not require marking with foreign origin, does not mean that the goods can be marked "Made in the U.S.A." The FTC regulates use of the "Made in the U.S.A." label. Under the FTC rules, goods must be all or virtually all made in the U.S.A. Thus goods which are substantially transformed in the U.S.A. from foreign components or material, may not be required to be labeled as "Product of __________ Country". However it could not be labeled "Made in the U.S.A." because of the significant foreign components. See www.ftc.gov/bcp/conline/pubs/buspubs/madeusa.htm for a discussion of the FTC rules in this difficult area.

Status of Entry

Merchandise imported into the United States is not subject for duty until it is officially "entered" for consumption. There are a number of methods to delay or avoid the entry for consumption and thus either avoid or substantially reduce duty. These include the use of Customs bonded warehouses and foreign trade zones.

Foreign Trade Zones

A foreign trade zone (FTZ) is a "restricted-access site, in or adjacent to a Customs port of entry, operated pursuant to public utility principles ..." 15 C.F.R. § 400.2(g). FTZ's are administered by the Foreign Trade Zones Board and may be either general purpose (public) or specialized (private). Customs duty is not due upon entry of the goods into a foreign trade zone but only upon removal from the zone into the commerce of the United States. The duty rate is the lower of the rate for the finished goods after assembling or manufacturing in the zone or for the imported parts and components. Thus if the rate for the finished product is lower than for the imported components, there can be a substantial savings. In addition, there is no duty for scrap or for exported goods, and no duty is due until the goods in question are ready to be sold. In some cases using a zone can avoid problems with quotas.

Bonded Warehouse

The bonded warehouse has a much more limited use, in that manufacturing is not permitted except for export use. The major advantage of a bonded warehouse is for duty deferment. However, if the rate is expected to go down, as, for example, under NAFTA, it may be advantageous to import the goods to a bonded warehouse and then hold them for entry until

the lower rate goes into effect.

Penalties

Compliance failures, including merely negligent ones, can result in penalties, including:

- Liquidated damages;
- Seizures; or
- Civil penalties.

Liquidated Damages

Liquidated damages typically result when merchandise is recalled by Customs (under a Notice of Redelivery) and the merchandise is not redelivered. They are assessed against the bond filed at the time of importation.

The Notice of Redelivery is most frequently issued for:

- An improper country of origin marking;
- Pirated copyright merchandise;
- Counterfeit or other trademark violation merchandise;
- Requests for samples or additional examination that is not complied with; or
- Quota or visa requirements or enforcement by Customs or the statute of another agency such as FDA, Consumer Products Safety Commission, or the FTC.

Typically, there is a 30-day redelivery period. If your client does not redeliver the goods, there is a claim for liquidated damages generally in the amount of the value of the merchandise. This usually gets the client's attention.

Make Compliance Efforts Known

To avoid substantial damages, if there is going to be a problem with redelivery (and frequently there is, as the goods may be sold or used by the time of the notice), let Customs know and show your efforts to comply. File a timely Application for Relief with Customs setting forth the facts to justify cancellation or reduction of the claim. 19 C.F.R. pt. 172. Customs has guidelines that can lead to reductions to as little as one per cent of the claim, $100, or in some cases, even no damages assessed at all.

Mod Act Changes

The Customs Modernization Act has implemented a number of changes. It introduced the concept of "reasonable care" into the making of customs declarations and thus shifted the burden of compliance onto the importer. Legal responsibility for correctly classifying and

valuing the product is now entirely upon the importer instead of Customs as it was before. The importer must do more than simply rely on a Customs broker to enter products. The importer must be able to demonstrate the establishment of in-house training, formal compliance review on a regular basis and written procedures of how the importer complies with its legal duty of reasonable care.

Imported goods flow much quicker now. Rather than waiting at the border for Customs to clear the shipment and make the classification and valuation, the goods are entered typically without Customs inspection. Customs, under the concept of "informed compliance", examines documents on a post-entry basis to ensure compliance with Customs requirements. Thus Customs is now relying on extensive audits after entry and requiring the importer to check with experts before entry rather than holding up entry. This shifting of the burden to the importer also means a greater role for attorneys as importers seek pre entry advice or help once an audit is underway.

The Mod Act thus uses a carrot and stick approach. In return for allowing automation to speed up entry and processing of goods, Customs requires post-entry verification of the validity of the customs declaration. The Mod Act contains an extensive revision of the law requiring recordkeeping, including substantial penalties for inadequate records to substantiate the information in the declaration. Customs has put out a list of records and required recordkeeping (the so-called (a)(1)(A) list) which is published as part of the "informed compliance publications" entitled "What Every Member of the Trade Community Should Know About Records and Recordkeeping Requirements" which is available on the Web at www.customs.treas.gov/impoexpo/informtx.htm. Generally these informed compliance publications are very helpful and an easy way to get up to speed on Customs policy in a particular area. There are about fifty publications, which cover the gamut from very general publications on valuation to very specific publications on mushrooms or granite.

Seizures

Customs can seize merchandise that is introduced into the United States contrary to law. Seizures are normally handled administratively with the filing of a petition for remission. Typically, remission requires removal of the problem that caused the seizure, if possible, or exportation of the merchandise if the problem cannot be corrected. Typically, storage and related costs must also be paid. Again, Customs has published guidelines for remission of seizures that are essential to practice in this area.

Civil Penalties

Most civil penalties are assessed under Section 592 of the Tariff Act of 1930, as amended. 19 U.S.C. § 1592. This section was amended and additional penalty provisions added by the Customs Modernization Act, passed as part of the NAFTA authorization. These provisions allow Customs to assess penalties for the fraudulent, grossly negligent, or negligent entry or

introduction of merchandise into the United States by means of any document, written or oral statement, or act that is material and false or any omission that is material. The maximum penalties that can be imposed depend upon the degree of culpability. In addition, the penalties can be reduced markedly by making a prior disclosure. If your client discovers a problem with a Customs entry, it is far better to disclose it than to wait for Customs to possibly find out about it.

Procedure

When Customs believes that a Section 592 violation has occurred, they will issue a pre-penalty notice at the District level. This may be the first time the importer knows of the problem. The problem may also be discovered as a result of an investigation or audit of the company's books and records. The importer should respond to the pre-penalty notice and try to explain why there is no violation. Customs may then either determine that there is no violation or issue a penalty notice. The importer can then seek mitigation of the penalty or file an offer in compromise. The methods for seeking mitigation are found at 19 C.F.R. pt. 171. Appendix B to that section contains the guidelines for mitigation. The focus should be on the various levels of culpability and the factors that are included in the regulations that affect the level of culpability. There is, however, the possibility for a very substantial mitigation of the initial penalty.

Conclusion

The combination of GATT, NAFTA and the Customs Modernization Act has made some of the most substantial changes in Customs law in years. New regulations with substantial changes in Customs procedures are coming out almost daily. The Customs Modification Act provides the statutory framework for substantial automation of Customs entries, thus authorizing what has been happening already in reality.

This article just scratches the surface of the intricacies of Customs practice. The whole areas of vessel repair duty, with its rate of 50 per cent duty for "repairs" and "equipment" purchased abroad by U.S. flag ships, duty drawbacks, liquidation and protest, American goods returned, trademarked goods and "grey market" goods will have to wait for another time. In addition, other provisions of NAFTA, such as elimination of non-tariff barriers, coordination of customs forms and procedures, transparency of technical standards so they will not be trade barriers, higher protection of intellectual property rights, commitments in specific service sectors (including attorneys), and protection of investments have not been discussed in detail.