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Customs Issues for Tax and Accounting Executives – Instalment #3

Managing Customs Duty Cost through “First Sale” or “Earlier Sale” Customs Valuation

I. Introduction

In the third instalment of “Customs Issues for Tax and Accounting Executives”, we would like to introduce “First-Sale” or “Earlier-Sale” Customs valuation planning, which have helped many Japan-based enterprises successfully manage their customs duty costs associated with the exports to the United States, the EU and certain other countries/territories.

II. Customs Valuation

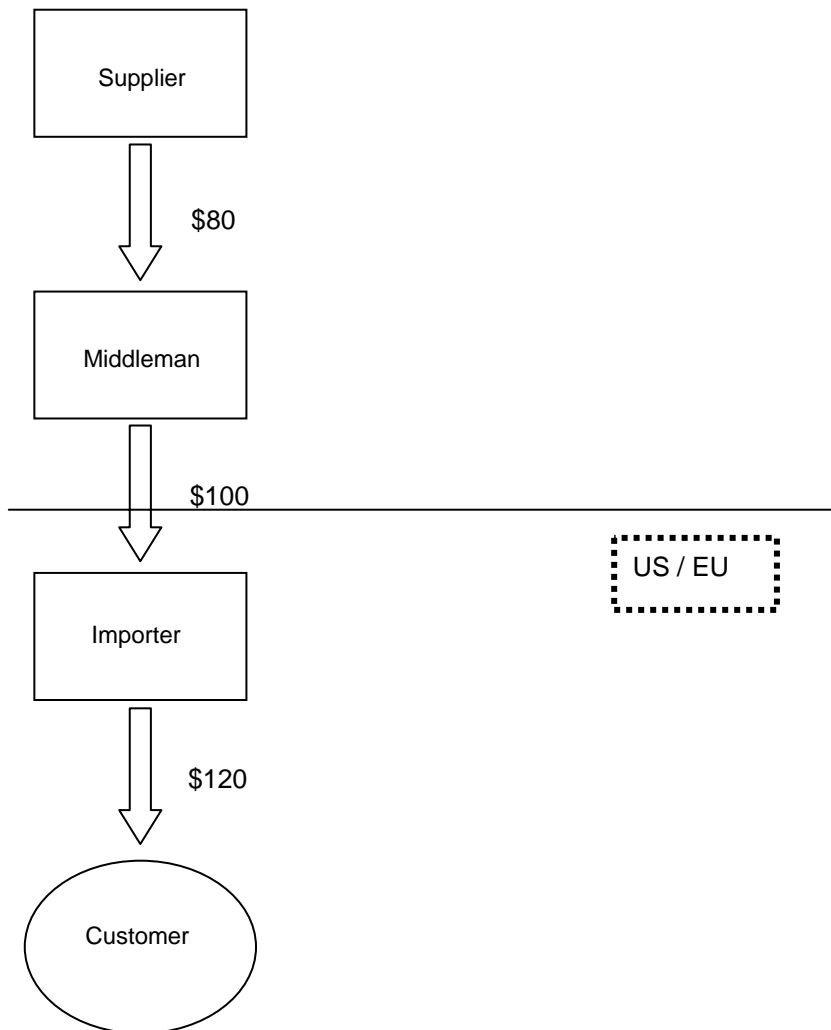
As discussed in the previous instalments, in most, if not, all industrialized trading nations (*i.e.* members of the World Trade Organization), foreign goods are subject to “appraisement,” or valuation, for customs purposes upon importation. Appraisement is important to importers as customs duties, in most countries, are principally based on the application of an *ad valorem* duty rates (*i.e.* rates of duty applied to the value of merchandise to determine the amount of duties owed).

As also discussed in the previous instalments, the customs value generally is based upon on the *Transaction Value* – the price paid by the importer/buyer to the seller of the imported merchandise in the sale transaction that caused the export to the country of importation - plus certain statutory additions.

III. Multi-Tiered Import Transactions

However, in multi-tiered import transactions (*e.g.* sales involving a “middleman”), where there is more than one sale that may qualify as the “sale for export”, a number of interesting questions are raised:

- Which sale may the importer use as the basis of appraisement for customs purposes?
- Should the basis for appraisement be the higher sale price paid by the importer to its seller, the middleman, or, the lower “first-sale” or “earlier sale” price paid by the middleman to its vendor?



In the EU and US, the customs authorities permit importers in such multi-tiered import transactions to use a “first-sale” or “earlier sale” valuation method, which generally provides that, if certain conditions are met, the price paid by the middleman to its supplier/vendor (plus certain statutory additions) may be used for the purposes of appraising imported merchandise and declaring customs value.

In the example above, the Importer is able to reduce the customs duty cost as follows. Assuming that the applicable duty rate is 10%:

[Without First Sale] $\$100 \times 10\% = \10
 [With First Sale] $\$80 \times 10\% = \8

[Reduction in Duty] \$2

**Please note, in both cases, certain statutory additions as discussed in the previous instalments may need to be added to the respective transaction values.*

It is interesting to note that First Sale appraisement, in principle, is not accepted by Japan Customs authorities. However, duty cost reductions similar to First Sale valuation may be achieved through certain supply chain restructuring involving the use of commissionaire under the Commercial Code of Japan (Articles 551 through 558), and the customs affairs representative under the Customs Laws of Japan (Article 95).

IV. Application to Japan-based MNCs

Many Japanese businesses operate such multi-tiered transactions. A typical supply chain for Japan-based MNCs may include manufacturing subsidiaries located in China and the ASEAN nations as “Suppliers”, Japanese parent as “Middleman” and sales and distributions companies located in the US or EU as “Importer”.

VI. Requirements for Application of First-Sale Valuation

In order to use the first sale appraisal, the legal criteria required for applicability as well as the relevant documentary requirements must be met. The requirements are as follows:

- 1) A “bona fide” sale occurred in the first sale transaction;
- 2) The goods are clearly destined for the country of import;
- 3) The first sale transaction was conducted at an arm’s length price; and
- 4) A clear and complete documentary trail of the first sale transaction.

1) Bona Fide Sale Criteria

Several factors may indicate whether a bona fide sale has taken place between a buyer and seller, but no single factor is determinative. Some factors to consider in determining whether a bona fide sale exists are:

- Invoices and contracts between the buyer and seller indicate that the quality, quantity, prices, etc. are determined by the buyer and seller;
- Has the buyer assumed the risk of loss and acquired title to the imported merchandise;
- Did the buyer provide (or could provide) instructions to the seller;
- Was the buyer free to sell the items at any price;
- Could the buyer select its own customers without consulting the seller; and
- Could the buyer order the imported merchandise and have it delivered for its own inventory.

2) Clearly Destined Criteria

Customs will consider a sale to be clearly destined for export to the US or EU based on evidence such as invoices and purchase orders; shipping contracts or other documentation; manufacture, design, and other unique specifications or characteristics of the merchandise made in conformity with the buyer’s standards; labels, logos, stock numbers, bar codes and other unique marks; and marking, visas, warranties or other types of certification or characteristics required for entry or operation in the US or EU. To evidence that a sale was clearly destined for export, documentation should comprise a complete paper trail, showing the structure of the entire transaction.

3) Transactions/Prices at Arm’s Length Criteria

Customs will consider a sale between unrelated parties to have been conducted at “arm’s length.” However, if the parties are related, a sale will be considered arm’s length if an examination of the “circumstances of sale” of the imported merchandise indicates that the relationship between the

buyer and seller did not influence the price actually paid or payable or if the transaction value closely approximates a test value.

4) Record Keeping Requirements

Documentary evidence must be maintained so as to enable customs to properly assess duties on the imported merchandise. Accordingly, before an importer declares a value based on a transaction to which it is not a party, the importer should be satisfied that such a transaction meets the criteria discussed previously and be prepared to submit supporting evidence if requested to do so by customs. An importer who declares a value to customs without the necessary supporting documentation may be subject to penalty or other enforcement action.

VII. Summary

In order to determine whether the first-sale or earlier sale opportunity is supportable, whether retrospectively or prospectively, a company must first determine whether it is viable with minimal disruption to the company's established operations. Furthermore, the duty savings that would result from implementation of the strategy also must outweigh the costs. If so, implementation of the first-sale valuation methodology may provide significant savings and give a company a competitive advantage through increased cash flow, earning per share and above the line operating income. For many companies, implementation of first-sale is a lucrative and worthwhile investment, however, it is an investment that must be carefully managed.

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