Tax Function of the Future

Spotlight on

Aligning with customs and trade – A new Tax priority

Leading-in

The **Tax Function of the Future** series spotlights topics relevant to Tax with a *practical* focus on what Tax needs to do *now* to operate successfully in an increasingly complex tax and business environment.

The Tax Function of the Future series predicted challenges and offers solutions that Tax functions may face now or in the future. Our prior papers presented insights on topics ranging from new legislative and regulatory challenges to evolving tax operating sourcing models with emphasis on implications for technology, data, people, and process.

In this paper, we address Customs and Trade – a new area of focus for business and the general public as trade controversy and increasing global tension continue to dominate the headlines. What's causing this turmoil in customs and trade? And how do these sweeping developments affect Tax? This Spotlight sheds light on a function that may be only vaguely familiar to Corporate Tax professionals; however, its relevance to tax strategy is more evident now than ever before. It is important for Tax to pay close attention – Both functions need to be aligned to reap the benefits of opportunities and avoid unintended risks.

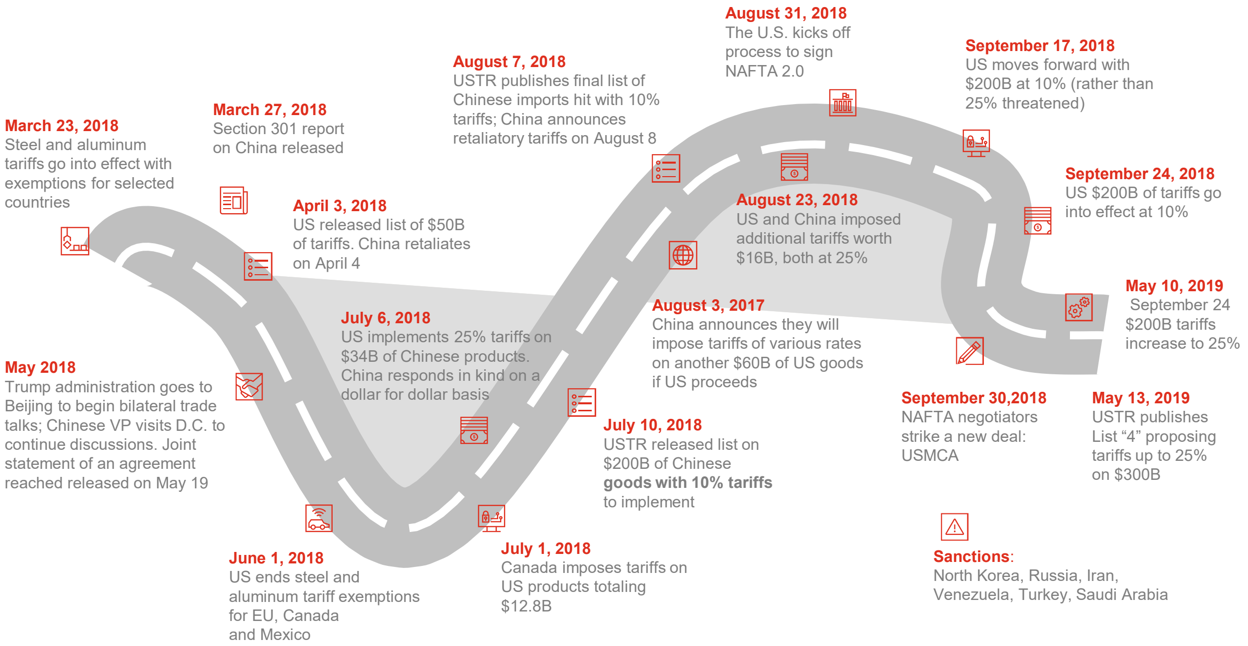
Managing Global Customs and Trade

Who has responsibility for the customs function? It varies by organization – duty and customs compliance may be managed by Supply Chain, Purchasing, Logistics, Legal, Finance, or even Tax. Operating models vary as well, ranging from an approach that is decentralized – managed at the business unit level – versus centralized, a top-down, Corporate led approach to optimizing duties and managing cost. In either case, the effectiveness of an organization's customs and trade function is dependent on its ability to align across functions to address constant change and increasing scrutiny from global authorities.

Why the need to act now?

Unprecedented volatility in global trade is causing US businesses to re-evaluate operations. Punitive tariffs imposed by the US on a broad range of products imported from China and our allies– including the European Union and, until recently, Canada and Mexico – can result in higher prices for US consumers unless changes are made to the supply chain to manage costs. Retaliatory tariffs imposed on US exports may also drive down US foreign sales and profitability – And developments continue to unfold.

Volatility in US trade policy is causing a shift in focus to the issues of customs and trade



Note: Trade developments continued to unfold after May 13, 2019

Digging deeper

As the current trade environment continues to shift, businesses must remain diligent in keeping up with changes that can have substantial adverse impact on their business operations. Following is a listing, by category, of significant trade developments from March, 2018 to May 13, 2019.

Section 232 (steel & aluminum)

- Applies to products from nearly all trading nations with limited exceptions (e.g., Argentina, Brazil, Australia, Korea, South Africa)
- Imposed on a broad swath of raw materials and components made of aluminum and steel
- Rates are 10% for aluminum products and 25% for steel products
- Effective since 03/2018
- Administrative exclusion process to seek exemption at the product level is available, and has demonstrated some degree of success.
- Rescinded for products from Canada and Mexico effective 05/20/19

Section 232 (EU automobiles and auto parts)

- Applies to automobiles including SUVs and light trucks, and auto parts
- 25% tariff has been threatened
- Results of the Department of Commerce Investigation were submitted to the President on 2/17/19
- Presidential Proclamation issued 5/17/19 concluding that “automobiles and certain automobile parts are being imported in the U.S. in such quantities and under such circumstances as to threaten to impair the national security of the United States”
- President has instructed USTR and Commerce to monitor imports, engage in negotiations with trading partners (EU, Japan and others) and report back within 180 days

Retaliatory tariffs on US goods

- Imposed on various specific US-origin products in response to the US tariffs
- Imposed by Canada, Mexico, EU, Turkey, China, India, and Russia
- Each country has issued its own listing of targeted products
- Depending on the products, rates vary from 5%-140%
- Very limited opportunity to seek exemptions
- Some products and regions have been targeted due to political/geopolitical considerations

Section 301 (China origin) tariffs

- Applies to over 3,400 distinct tariff line items (i.e., products) imported from China
- **List 1**–imposed 25% tariffs to $34B in specific categories
- **List 2**–imposed 25% tariffs to an additional $16B in specific industrial sector products
- **List 3**–initially imposed 10% tariffs to targeted an additional $200B in diverse product categories from industrial products to retail & consumer and electronics; Rate increased to 25% on May 10, 2019. Exclusion process announced but not yet rolled out.
- Proposed List 4-Announced May 13, 2019 proposing tariffs up to 25% on an additional $267B in Chinese origin goods imported to the US.

Digging deeper

USMCA (United States-Mexico-Canada Agreement)

- Agreement to replace NAFTA signed on 09/30/2018
  1. Anticipated to go into effect in 2020 if ratified by all three countries
  2. Largely preserves the NAFTA framework
- Most significant changes were to automotive Rules of Origin
- Agreement introduces new "sunset" clause under which it expires naturally in 16 years
- Requires parties to notify of intent to engage in FTA with any non-market economy
- There remains considerable ratification timing risk in the US

Section 301 tariffs (retaliation to EU aircraft subsidies)

- Applies to two sections of products:
  - Aircraft and helicopters and parts thereof originating from France, Germany, Spain or the UK
  - Wider variety of items including seafood, cheese, citrus, olive oil, fruit products, wine, liqueurs, essential oils, yarn, carpets, sweaters, wool suits, ceramics, glassware, tools, cutlery, and clocks originating in any EU member state
- Proposed duties on EU imports are expected to be worth about $11.2B.
- The US has not communicated a timeline for the imposition of additional duties. A hearing on the matter is scheduled to be held on May 15, 2019.

EU retaliatory tariffs (response to US section 301)

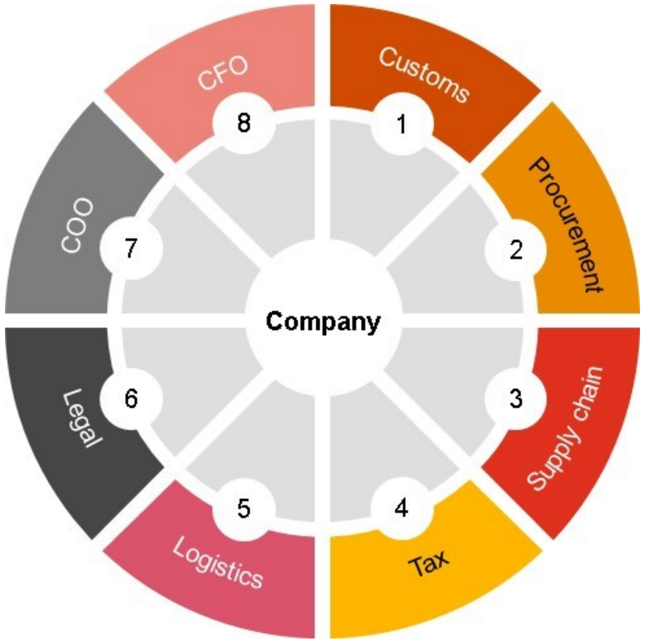
- EU proposed retaliatory tariffs following the US announcement of 301 tariffs undertaken to counter aircraft subsidies.
- Applies to $20B of US goods such as tractors, luggage, frozen fruit, fish, wine, ketchup and orange juice.
- The EU has not determined a timeline for the imposition of these tariffs. Public consultation on the matter will last until May 31, 2019.

Brexit

- The EU has granted the UK an extension through October 31st to establish an exit plan.
- However, as an EU member state the UK is obligated to participate in European Parliament elections (on May 23-26), and if the UK refuses to participate, EU withdrawal will take place on June 1, 2019.
- This would create a "no deal" scenario with full customs and border controls implemented.
- In both scenarios, implications for businesses would include increased duty and tax costs, compliance responsibilities and would necessitate changes in supply chain and organizational structures.

What's the impact?

The effects of these developments can be felt across an enterprise – well beyond customs and trade – as C-Suite and business leaders start to assess likely impact and develop solutions to address sales, operations, supply chain strategy, as well as finance, tax, treasury and technology solutions to enable change. Below are examples of areas that leaders must quickly assess for impact.



The impact of trade and tariffs can be felt across the enterprise.

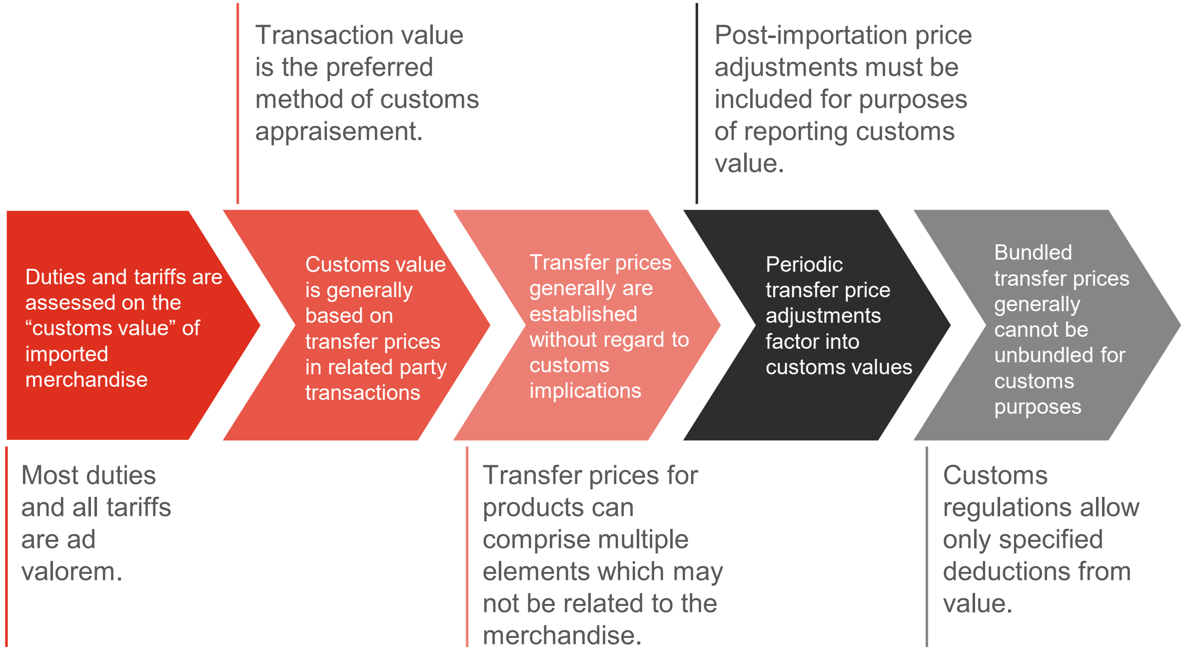
- **CEO – Chief Executive Officer**
  - Strategy and business operations
  - Acquisitions and dispositions
- **COO – Chief Operating Officer**
  - Crisis management
  - Data analysis and investigation
  - Product design/ redesign
  - Customer relations
- **Supply chain management**
  - Product sourcing and vendor selection
  - Supply chain and logistics
- **CFO – Chief Finance Officer**
  - Treasury/ financial hedging
  - Pricing
  - **Tax planning and structuring**
- **CTO – Chief Technology Officer**
  - ERP (Enterprise Resource Planning) systems
  - Digital and emerging technologies
- **General Counsel/ Trade Compliance**
  - Risk and regulatory compliance

Digging deeper

The Tax angle

As businesses organize to assess mitigating strategies, Tax needs to consider how to work with other enterprise functions to efficiently to enhance supply chain operations and reduce operating costs without increasing tax risk or decreasing operational benefits. What are the main areas that are likely to have tax impact?

Transfer pricing – the constant connection



Transfer pricing is a key aspect of tax planning strategy; however, there is a constant link between transfer pricing and tariffs and duties that many Corporate Tax professionals may be unaware of. Customs values for multinational corporations –the basis for duties and tariffs–is generally based on related party transfer prices; however, such prices are often set and adjusted without regard to the implications of customs and duties. As a result, duties and tariffs may be incorrectly imposed, potentially resulting in unnecessarily increased duty and tariff exposure at best and creating compliance exposures at worst.

The interaction between customs compliance and transfer pricing is increasingly evident in the enforcement of new trade policies as trade wars and rising tariffs put additional pressure on pricing. Transfer pricing implications can also be seen in:

- **Trade compliance assessments:**

Increased focus on related party transactions result in assessments by customs authorities. These assessments include analysis of the value declared on importation and review of how transfer pricing adjustments have been treated for customs purposes.

- **US tax reform planning:**

Companies reacting to US tax reform, seeking opportunities for efficient transfer pricing structures may overlook the implications created to corresponding customs values.

- **County by Country Reporting (CbCR):**

Enables focus on high margin territories, creating a red flag for customs authorities, as high margins indicate low import prices.

Supply chain – Operations strategy

Changes to manufacturing sourcing, location, and process can impact US and foreign jurisdiction taxability. Will products still meet the ‘substantial transformation’ test in order to avoid US Subpart F income? Would a change in manufacturing or distribution geographic footprint create nexus or increase taxability in certain jurisdictions? These are only a few examples of tax considerations resulting from supply chain modifications to address rising tariffs.

Digging deeper

Mergers and acquisitions (M&A)

New tariffs, sanctions, and regulatory change cascade into the M&A deal space making the assessment of trade impacts critical for decision making. M&A may also be an organization's means to strategic sourcing. Has Tax been consulted? Tax due diligence may uncover opportunities and risks when acquiring or integrating a business.

When acquiring a business

- Evaluating value chain integration could create opportunities or avoid tariff costs.
- **Buy side**–Look for sourcing synergies or supply chain tariff mitigation strategies for target.
- **Sell side**–Understand restructuring opportunities that may allow for ease of integration post-acquisition.

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When integrating a business

- US tax reform changes provide opportunities to mitigate/eliminate tariffs.
- **Buy side**–Customs and trade deal integration strategy may increase post-deal value.
- **Sell side**–Understanding integration opportunities enhances negotiating position.

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The trade, tax reform, and technology interplay

There are many factors to consider when addressing trade; however, none should be handled in isolation. Since December, 2017, Tax has been struggling to understand and comply with new, complex US tax reform rules and calculations. Business decisions made to address US tax reform may now affect trade and pricing at a time when tariffs are increasing. With the need for analysis of overlapping areas with volumes of transactional data, technology solutions are in demand. Automation of source system data and the use of digital and emerging technology solutions can enable efficient and effective customs and tax analysis, planning, and compliance.

Landed cost including tariffs
- Direct labor, freight
- Indirect labor
- Changes to BOM (cost, etc.)
- Impact to inventory position, AVL
- Impact to lead time

GILTI, BEAT, FDII
- Direct tax
- Earnings liquidity
- Transfer price
- Regulatory compliance

Pricing, revenue shifting
- Market share and margin trade-offs
- Incentives to grow outside US
- Accelerate CoS (Cost of Sales)savings programs

Automation & agility
- Cloud conversion
- ML, analytics, automation
- Deduction for capital asset investments

Iterative analysis is needed in all areas

Digging deeper

The path forward

It takes an enterprise to effectively manage the customs and trade function, particularly during these changing times. Significant integration and coordination with Tax and other core business functions is needed to fully address all impacted areas. Considering the significance of trade to the business, Tax should be proactive in establishing an approach for incorporating trade and customs into tax strategy.

	Tax checklist for trade
✓	Meet with the team responsible for trade and know the plan for tariff mitigation
✓	Model tariff mitigation strategies with Transfer Pricing and International Tax impacts (both US and non-US)
✓	Have an independent review of trade modeling with Transfer Pricing and Tax
✓	Have bridge memo for differences between trade and transfer pricing
✓	Team with the business to understand transaction flows and business direction

Connect with us

To have a deeper conversation about how these customs and trade issues may affect you and your business, please contact:

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