Managing tariffs under the rapidly changing U.S. Trade Policy

Guidance for Japanese multinational enterprises

These days, tariffs play a key role in U.S. trade policy with the Trump administration actively implementing and enforcing new tariffs[1] and more aggressive trade policies in a relatively short period of time. The U.S. government imposed tariffs on steel and aluminum under Section 232 of the Trade Expansion Act of 1962 (Section 232) in March, 2018. Thereafter, the U.S. government enforced Section 201 of the Trade Act of 1974 (Section 201), renegotiated the North American Free Trade Agreement (NAFTA), enforced Section 301 of the Trade Act of 1974 (Section 301), which accelerated the U.S.-China trade war, and announced new potential tariffs on certain goods imported from the European Union (EU). Further, the U.S. Government investigated the application of Section 232 of the Trade Act of 1974 to automobiles and parts, postponing a decision until November 13, 2019. The tariff policies being implemented/contemplated by the U.S. administration are also closely related to international politics. Therefore, it is very difficult to predict the future. In Japan, the EU-Japan Economic Partnership Agreement (EPA) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership Agreement (TPP11 or CPTPP) have been enacted, and a Trade Agreement on goods between Japan and the U.S. (TAG) is expected to be extensively negotiated within the next few months. Each tariff policy/trade agreement would directly affect the business activities of Japanese multinational enterprises (MNEs) with complex value chains, as the treatment of customs and tariffs are rapidly changing. Given these circumstances, it is increasingly important to understand the entire value chain, evaluate the impact of individual tariffs, and initiate effective strategies to manage new tariffs. This article provides guidance regarding how to analyze and manage the impact of tariffs.

Understanding the entire value chain

Japanese MNEs need to first understand their entire value chain to assess the impact of specific trade policies and manage customs risks. While some MNEs may understand their supply chain at a high level, an in-depth understanding and analysis are necessary to manage tariffs effectively. Meanwhile, Japanese MNEs need to accurately understand the flow, nature, and type of each transaction in their value chain, including which country the goods and services are imported or exported from, transaction volume by article, and how much tariff is paid in each transaction. Having considered such facts, Japanese MNEs are better positioned to accurately understand the impact of a particular tariff and identify opportunities to mitigate the costs of the tariff. Fortunately, in the U.S., it is relatively easy for importers to obtain their own import data related to customs from U.S. Customs and Border Protection (CBP) to facilitate data and tariff impact analyses. For example, Japanese MNEs can analyze Importer Trade Activity (ITRAC) or Automated Commercial Environment (ACE)[2] data and trace back data, such as country of origin, tariff codes, customs duty paid, transaction amount, etc. related to U.S. imports.

Reviewing ITRAC and ACE data is also beneficial because it can lead importers to identify errors in their import declarations. These errors, if uncorrected, can potentially lead to penalties.[3] Importers can mitigate such risks and comply with the U.S. trade and customs regulations by identifying errors/issues during the review process.

Currently, the negotiation of TAG is underway, and is expected to bring intensive negotiations soon. Therefore, ITRAC/ACE data is extremely effective to evaluate the potential impact of TAG.

Optimizing tariffs

In general, customs duties are determined by customs value, country of origin, and the customs duty rate as set forth by a product's Harmonized Tariff Schedule (HTS) classification. In some cases, a company may overpay tariffs or may overlook viable reductions in tariffs because (i) the customs value of a product is overstated, (ii) possible duty drawback opportunities are not utilized, (iii) incorrect duty rates/HTS classifications are used, (iv) country of origin is improperly determined, or (v) free trade agreements (FTAs) are not properly employed.

Because many articles imported into the U.S. are subject to duties, it is beneficial to review whether a U.S. importer can apply a certain FTA, including the potential TAG (which is currently being negotiated), or utilize other methods to reduce tariffs.

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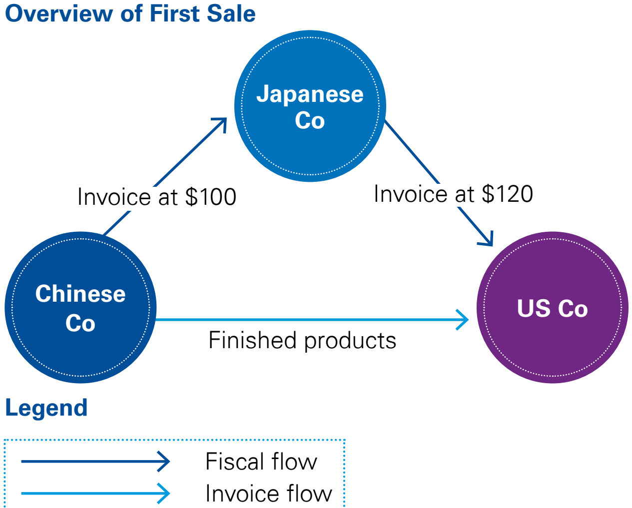
[1] This journal reflects the U.S. trade policy as of July, 2019.
[2] CBP has a web portal in ACE and the U.S. importers are able to obtain data related to custom clearance.
[3] For example, under 19 U.S.C. § 1592, in the case of loss of revenue by grossly negligent violations, the penalty is the lesser of (1) the domestic value of the goods, or (2) four times the loss of revenue.

Further, certain tariffs[4] enforced by the U.S. government are high (e.g., 25% tariffs on certain Chinese origin products under Section 301), and can have a significant impact on value chain operations and the financials of a company importing the articles subjects to these tariffs. It is important for companies to identify and execute approaches to mitigate tariffs[5]. The following describes several customs mitigating approaches that can be considered by Japanese MNEs to potentially realize tariff and import cost savings.

1 First Sale method

Generally, U.S. customs value is often based on the invoice price of the goods when sold from a foreign seller to a U.S. buyer. However, if there is an earlier sale in the supply chain (e.g., from an original factory to the foreign seller), and certain requirements are met, the "First Sale" method allows the goods to be appraised based on the invoice price in an earlier transaction in the supply chain (e.g., the factory invoice to the foreign seller). As such, there is often an opportunity to reduce tariffs if a company has adopted a principal structure model. A principal structure product flow, for example, may involve a Japanese parent company that has a manufacturing affiliate in China that manufactures a product and exports these finished products directly to a distributing company in the U.S. From an invoice flow perspective, the Chinese manufacturing affiliate issues an invoice to the Japanese principal, who in turn invoices the U.S. distribution affiliate. In the above scenario, from a transfer pricing perspective, the Japanese parent buys these finished products from the affiliate in China on a cost plus basis, and resells the finished products to the distribution affiliate in the U.S., such that the affiliate in the U.S. achieves a certain operating margin target. Under such an arrangement (i.e., principal structure), the Japanese parent company bears the major business risks.

Overview of First Sale



Under the transaction flow above, if the company satisfies the specific requirements for the First Sale method, customs value can be determined based on the Chinese Co's selling price to the Japanese Parent (i.e., $100), rather than Japanese Parent's selling price to US Co (i.e., $120). Consequently, the tariff paid by US Co can be reduced.

The First Sale method can be applied not only to products manufactured in a foreign country, but also to the products manufactured by domestic factories (i.e., in Japan). For example, if a Japanese Parent outsources production of certain products or parts to a manufacturer in Japan, the customs value can be appraised based on the manufacturer's selling price if the requirements for the First Sale method are satisfied.

The EU has discontinued its First Sale method program. However, the First Sale method is still valid in the U.S. As value chains become more complex and diverse, the First Sale method can be an effective approach to minimize tariff costs.

2 Duty drawback

By utilizing CBP's duty drawback program, U.S. importers can claim a refund of 99%[6] of paid duties upon successful and approved claims. Title 19 of the Code of Federal Regulations[7] specifies duty drawback under certain circumstances. The circumstances where duty drawback is applicable include, but are not limited to, when a company imports finished products into the United States and resells these product outside the United States, or when a company imports goods such as raw materials and parts into the United States and manufactures finished products, and then exports the finished products overseas. The following summarizes common examples in which duty drawback is applicable.

Major duty drawback cases

Items	Description
Direct identification manufacturing	Imported merchandise is used to manufacture articles in the United States that are subsequently exported or destroyed under Customs supervision.
Unused merchandise	Imported merchandise is unused and subsequently exported or destroyed under Customs supervision.
Rejected merchandise	Merchandise is exported or destroyed because it does not conform with samples or specifications, or has been shipped without the consent of the consignee, or has been determined to be defective as of the time of importation.

In the cases above, the U.S. importers can claim a drawback. The statute of limitations of duty drawback is five years back from the date of the claim.

3 Foreign trade zone

A Foreign Trade Zone (FTZ) is a geographical area within the territory of the U.S. that is considered to be out of U.S. commerce, and therefore not subject to CBP duties, taxes, and fees. FTZs provide several cost saving opportunities, including but not limited to reductions of CBP's processing fee,

[4] Generally, an FTA does not reduce the Section 201, 232, or 301 tariffs even if the underlying articles received preferential duty-free treatment under an FTA.

[5] Duty drawback can be applied on tariffs from Section 301 and 201, but not Section 232.

[6] The CBP collects 1.0 percent of duty drawback amount as a processing fee.

[7] Title 19—§1313 Drawback and refunds.

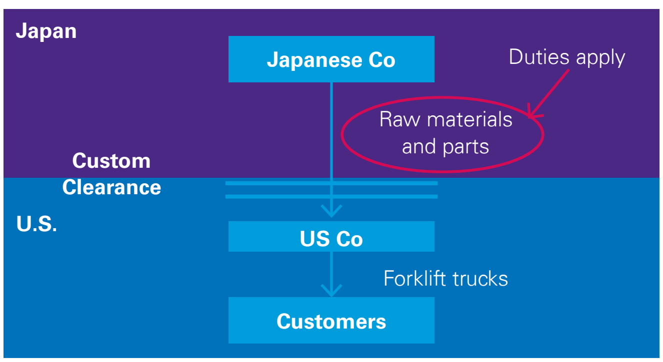
known as Merchandise Processing Fees (MFP) and custom broker fees, potential elimination of duties upon export, duty elimination for scrap and waste, and duty referral. CBP introduced FTZs to promote domestic business activities. Warehouses that are located in the U.S. and used by importers in their business may qualify as an FTZ after obtaining approval from CBP. Once a warehouse is approved as an FTZ, the warehouse is treated as if it is located outside the U.S.

In the specific scenario where a company imports raw materials and parts into an FTZ, manufactures a finished product within the FTZ, and then sells the finished products in the U.S., no duty is imposed when raw materials or parts are delivered to the FTZ warehouse. A customs duty will only be imposed when the manufactured products are entered into the United States (if at all) from the FTZ. As a result, importers can defer customs payments until shipment from their warehouse, which improves cash flow. Also, importers can reduce MFP, by clearing their product in aggregate. In addition, importers can reduce their Customs Broker fees by reducing the number of entries filed.

When an importer brings articles into the FTZ and subsequently manufactures finished products and then ships these products from the FTZ, the duty rate on finished products is applied on the products manufactured within the FTZ. If the tariff rates imposed on raw materials and parts and those imposed on finished products differ significantly, there is a possibility that importers can reduce the tariff owed by utilizing FTZs.

Example: Purchase of raw materials/parts for manufacture of forklift trucks in the U.S.

<Non FTZ>



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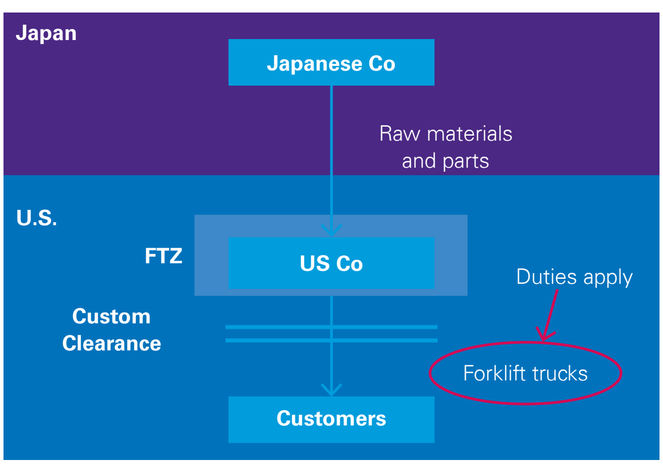

Non FTZ	FTZ
Tariff applies on the import of raw materials and parts based on U.S. trade and custom rules.	Under the FTZ, no duty is imposed when the raw materials and parts are delivered to the FTZ. Under the FTZ approach, forklift trucks are the article to be cleared and a zero duty is applicable to fiber cable (i.e., HTS 8427.10.4000).

If a company imports raw materials and parts into an FTZ and sells the finished products outside of the U.S., or imports finished products and sells outside of the U.S, the company would save MFE and improve cash flow[8] by utilizing FTZ.

4 Review of country of origin

In some cases, U.S. importers may have been incorrectly using the country where the exporter is located as the country of origin. This can result in the overpayment of duty and potential customs penalties. Thus, importers should ensure they are correctly applying the country of origin rules that are outlined in trade agreements or by the rules stipulated in the Tariff Act of 1930.

There are several types of U.S. rules of origin and each is applied differently depending on the purpose or application for determining origin. For example, one set of rules may apply for determining whether a product is eligible for preferential duty free treatment under an FTA; but another set of rules may apply for determining whether a product is subject to Section 301 duties; and yet a third set of rules may apply for determining country of origin for marking purposes (e.g., "Made in China").

For example, an article imported from Mexico may be considered as originating in Mexico and eligible for duty-free treatment upon import into the U.S. if the article satisfies the NAFTA rules of origin (e.g., Regional Value Content (RVC) of equal to or more than 62.5% based on the Net Cost Method). However, that same article may also be of Chinese origin for the purposes of determining the applicability of Section 301 if its Chinese components have not undergone a "substantial transformation" in Mexico and may still be subject to an additional 25% duty rate notwithstanding the preferential NAFTA treatment.

A "substantial transformation" generally occurs when an article emerges from a process with a new name, character, or use different from that possessed by the article prior to processing. Thus, if raw materials from China are shipped to and substantially transformed in Japan, the country of origin of the finished product for customs duty purposes would be Japan.

Thus, by examining the manufacturing processes and value chain of a specific product, the company can determine whether the origin used at custom clearance is accurate under the U.S. customs law and free trade agreements.

[8] Generally, if a company manufactures finished products with imported raw materials and parts within FTZ and sells the finished products outside of the U.S., or imports finished products and sells outside of the U.S., no duties apply on these imports.

Further, if TAG is implemented, the tariff rates applied to articles produced and satisfying the TAG preference requirements in Japan may be eligible for preferential duty free treatment. Therefore, Japanese companies should understand and review such origin rules in advance.

In general, because duty rates specified in FTAs are lower than the typical rates applied under the Most Favored Nation (MFN) rules, it is important to review the supply chain and production costs associated with all products to determine FTA eligibility. For example, the new United States-Mexico-Canada Agreement (USMCA), expected to become effective in January 2020, requires more stringent country of origin rules, specifically for automotive and auto parts. Thus, identifying the country of origin and accurately calculating the exact RVC would become more important for the Japanese company operating in North America.

5 Cost unbundling

Cost unbundling is also a potential approach to mitigate customs duty expenses. There may be certain costs elements that may be unnecessarily included in the declared customs value of an imported article that may be potentially excluded on a case-by-case basis. By doing so, a company can potentially reduce custom duty costs by declaring a lower import value.

Summary

Tariffs continue to be an important management issue given the current U.S.-China trade friction, U.S. customs policies, and TAG (which is currently being negotiated). Japanese companies conducting business in the United States may be directly affected. The Japanese corporate value chain is also closely linked to North America, Asia, and Europe. Understanding the entire value chain of the company, optimizing results, and mitigating the impact of customs duties will be critical for Japanese companies to maintain competitiveness in the global market.

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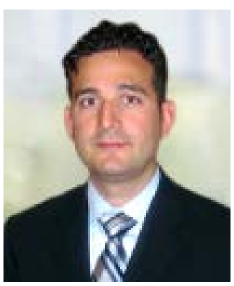

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