TradeWatch



EY Global Trade

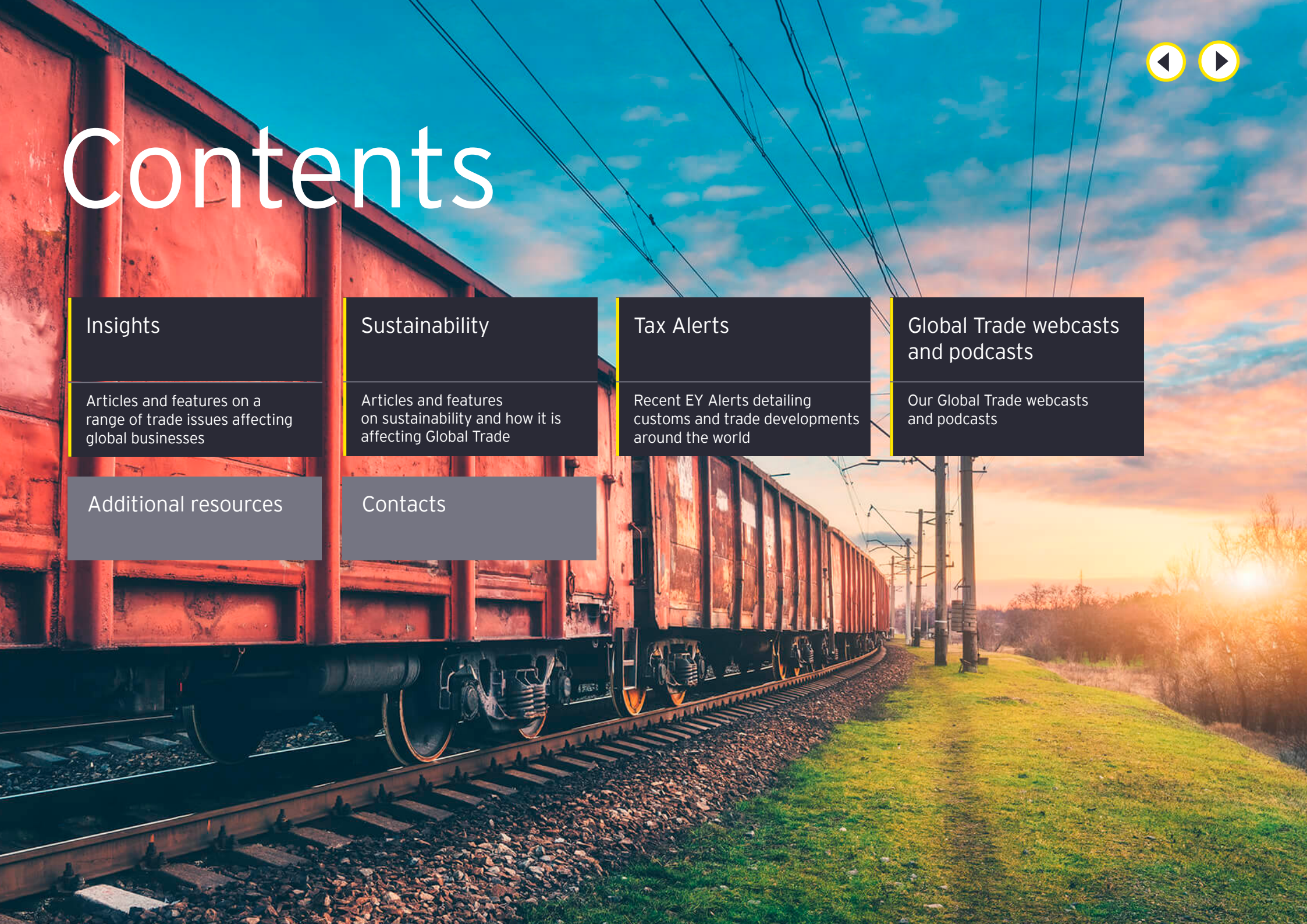
Issue 1 2022

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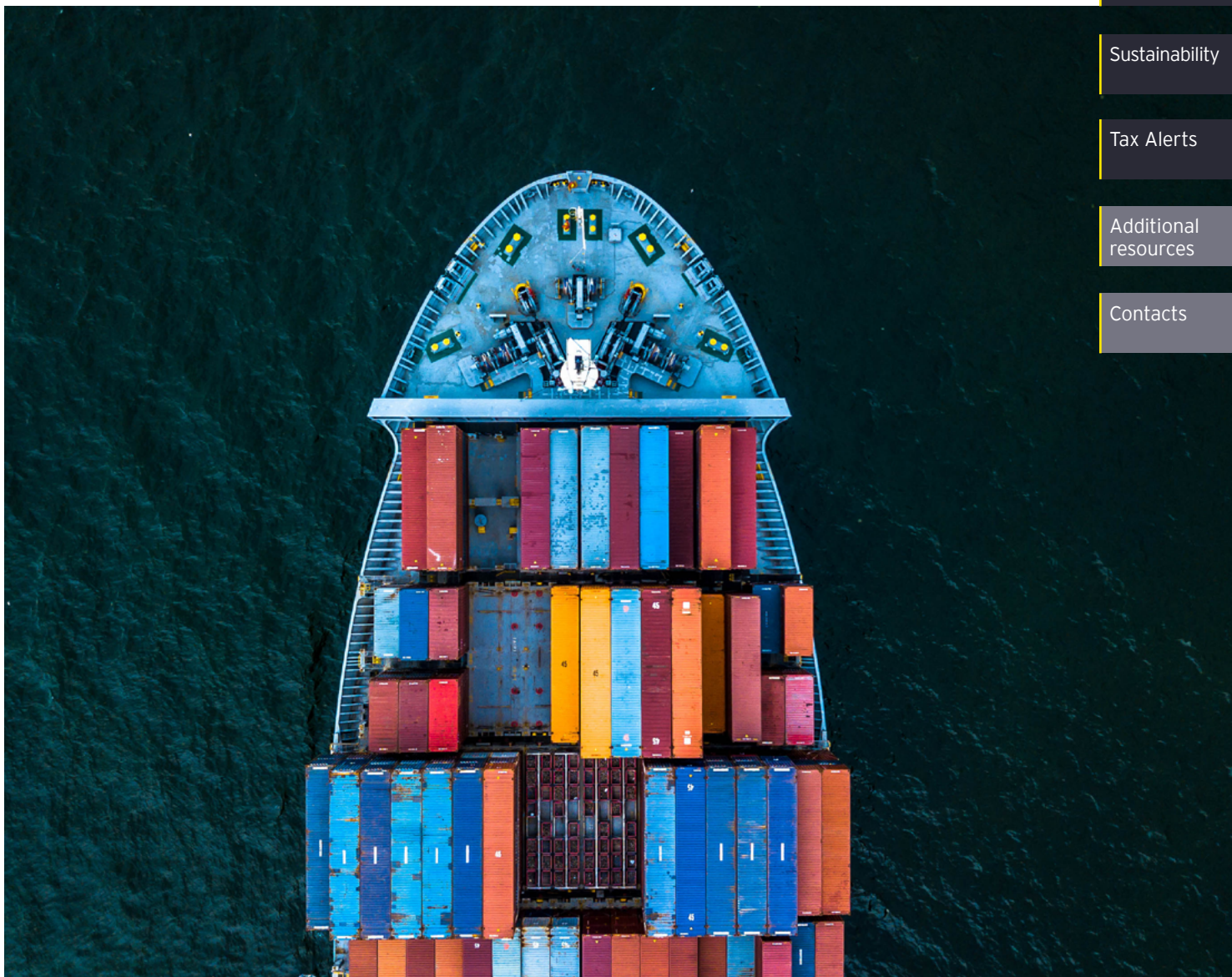
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Update on sanctions in response to war in Ukraine

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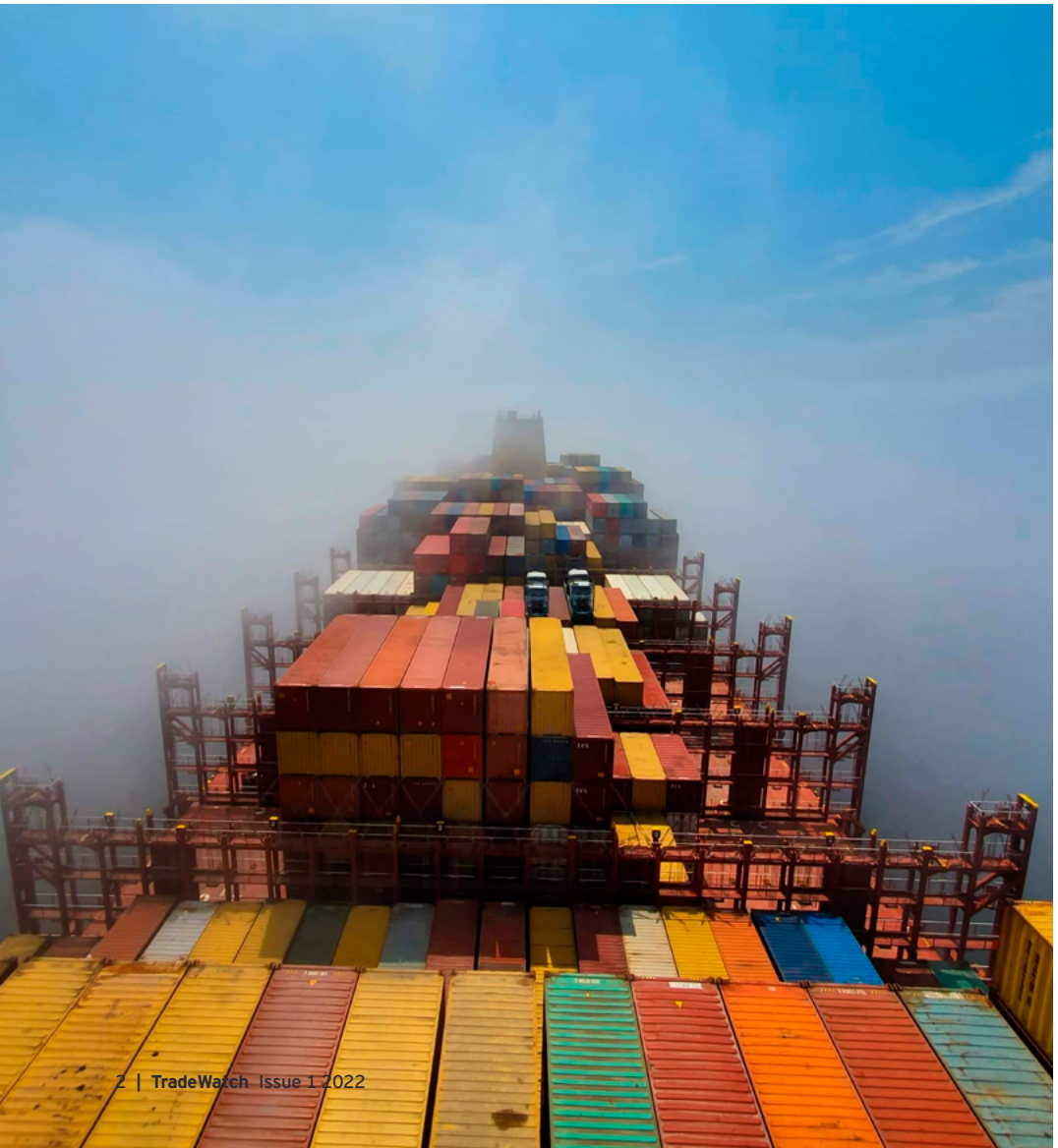
In response to the war in Ukraine, several countries and trade blocs have imposed prohibitions and sanctions on trade with Russia, Russian businesses and certain private individuals. These measures also apply to Belarus. Businesses may need to address asset freezes, prohibitions to trade goods with certain persons and businesses, and import or export bans. This places an additional layer of administrative obligations on the flow of goods both from and to Russia and Belarus.

To enable businesses to comply with sanctions imposed as a result of the war in Ukraine, we issue tax alerts on a regular basis. A list of the most recent alerts can be found in the **tax alert section** of this *TradeWatch* edition. An informative webcast on the sanctions is available on demand **here**.



Top seven trends in international trade in 2022

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As 2022 progresses, it's clear that this will be a busy year for international trade. As companies try to stay on top of trade developments, we set out the top seven trends we are watching.

1. Supply chain disruptions set to continue

More than anything, the COVID-19 pandemic has exposed the sheer scale of interdependencies in globally interconnected supply chains. While many hoped that this disruption would be a thing of the past by 2022, the ongoing war in Ukraine, recent and continuing closures of ports and factories in China and other countries demonstrate that the disruption is likely to continue in the near term.

Rising geopolitical tensions beyond Europe also continue to dominate supply chain disruption. In EY 2022 Geostrategic Outlook, we expect that geopolitical dynamics and the push by many governments to achieve self-sufficiency around strategic products will complicate traditional cross-border supply chains. Technology companies, manufacturers, automakers, life sciences companies and renewable energy companies are likely to be the most affected by these policy dynamics. Companies should now look to integrate more resilient practices into their supply chains to prepare themselves for future unanticipated developments.

2. More trade negotiations

The trade negotiations agenda continues at a considerable pace, with a host of free trade agreement (FTA) negotiations being launched, negotiated and concluded this year.

- **Expanding the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP)**. The UK, Taiwan, mainland China and South Korea all have applied to join the CPTPP, and negotiations are continuing with current signatories to the partnership (11 jurisdictions in total). The UK has reportedly provided the first stages of detailed information to those countries, and bilateral negotiations have started on specific trade issues.

- **India's trade negotiations**. India has concluded an interim trade agreement with Australia this year. It covers goods, services, rules of origin, sanitary and phytosanitary measures, and customs procedures. A more comprehensive trade agreement between the two nations would be negotiated by the end of 2022. Separately, in January 2022, the UK and Indian Governments jointly launched negotiations for a new comprehensive trade agreement.
- **European Union follows the UK**. Since the UK concluded FTA negotiations with Australia last year, the EU and Australia have renewed efforts (initially launched in 2018) to conclude an FTA. The EU also has launched a new effort to reach a comprehensive Digital Partnership with Singapore.[1] This news follows the joint announcement from the UK and Singapore, stating that they have now finalized a new Digital Economic Agreement.[2]
- **US pivots to the Indo-Pacific**. While unlikely to be a formal trade agreement, the new Indo-Pacific Strategy of the US promises a new economic framework for US engagement with the region and will bolster trade efforts through the Asia-Pacific Economic Cooperation (APEC).

3. Implementation at the forefront

For trade authorities in 2022, simply signing trade agreements won't be enough to benefit businesses. To that end, we are seeing a marked shift in focus for many governments, from negotiating trade agreements to engaging in their implementation. The entry into force of the Regional Comprehensive Economic Partnership (RCEP) in the Asia-Pacific region marks one of the largest trade deals ever agreed; enabling companies from member nations to use it will be an important consideration for the coming year.

In the UK, the Government is looking to provide new opportunities and resources focused on helping businesses to identify and utilize the network of new UK trade agreements to boost UK trade and investment. In the US, the Department of Commerce has teamed with a global financial services company to help small and midsize enterprises benefit from export-led growth.

4. Sustainable trade to continue to dominate

Sustainable trade is an integral part of using the world's resources responsibly and achieving net-zero targets. To develop a sustainable trade strategy, companies will need to be proactive in "greening" their international operations while also complying with new regulations around the world.

Trade policies are continuing to evolve rapidly in support of wider environmental goals across the globe. From the EU's proposed Carbon Border Adjustment Mechanism to new deforestation legislation in the UK and US, compliance will be a core consideration for many businesses. At the international level, countries are looking to new trade and environment initiatives at the United Nations, the Organisation for Economic Co-operation and Development, and the World Trade Organization (WTO).

5. Driving digitalization

Digital trade has ushered in a new world of compelling opportunities, allowing businesses with an internet connection to sell goods and services to customers anywhere on the planet. However, much of physical trade is still dominated by paper forms.

Work is ramping up, led by the International Chamber of Commerce (ICC) and through the Business 20 (B20) forum, to digitalize trade processes around the world. This work is being pursued through a variety of efforts, from digitalizing bills of lading to pioneering new digital trade agreements from Singapore with Australia, the UK and EU.

As these improvements continue, it's crucial for companies to permit the transfer of data through data flow partnerships and adequacy agreements. They also need to be aware of potential new data localization measures in the jurisdictions in which they operate, particularly in emerging markets.

1 Joint Statement: EU and Singapore agree to accelerate steps towards a comprehensive Digital Partnership, *EU Commission website*, Find it here.

2 UK Singapore joint statement on the launch of negotiations on a Digital Economy Agreement, *UK government website*, Find it here.

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6. Rescheduling the World Trade Organization's 12th Ministerial Conference

The WTO continues to face several challenges, including the lack of progress in its negotiating agenda, the need for more transparency, and the paralysis of its dispute settlement function, which has been mired in disagreements over the role of its highest adjudicating authority, the Appellate Body. In addition, the 2021 cancellation of the 12th ministerial conference (MC12) has caused some concern. The conference has now been rescheduled for June 2022, where countries are attempting to agree what possible outcomes could be agreed by WTO Trade Ministers. Although the ongoing discussion over Russia's participation in WTO negotiations risks agreement at the ministerial conference.



Other priorities this year include concluding talks among WTO members to find agreement around eliminating harmful fisheries subsidies (a task they originally intended to conclude by 2015 as part of the United Nations Sustainable Development Goals) and completing negotiations on e-commerce and investment facilitation.

7. Don't forget about Brexit

While Brexit may be done, its implementation is far from complete. As such, businesses need to be aware of various 2022 deadlines for several unilateral easements that were implemented by the UK Government and are set to end. The UK Government also has set out a phased plan of new controls that cover a range of regulatory standards (including requirements around the replacement of the EU's Conformité Européene (CE) mark with the UK Conformity Assessed (UKCA) mark) and checks for goods entering Great Britain from the EU.

Major differences remain on substantive issues in the Northern Ireland protocol, and it is likely that negotiations will continue well into 2022. Despite this uncertainty, an easement has been agreed for the continued supply of medicines entering into Northern Ireland from Great Britain without any impact for relabeling and testing.

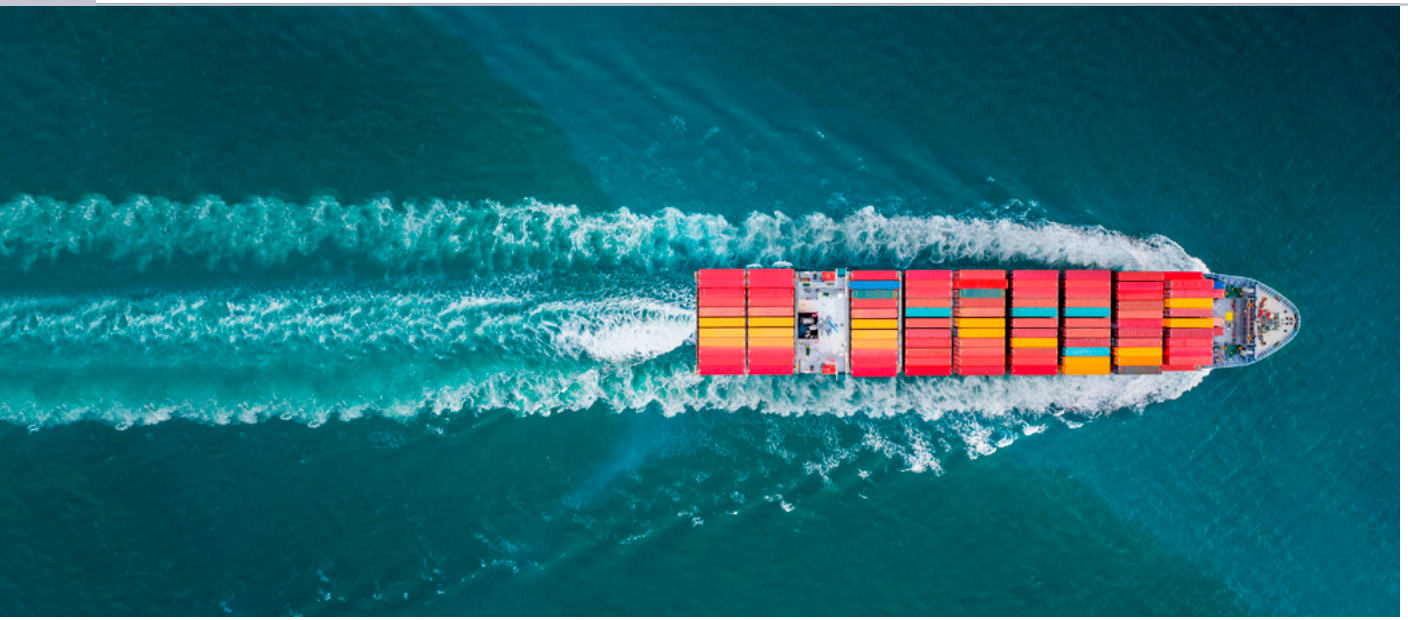
Designing a proactive trade strategy

The seven trends highlighted above are only some of the opportunities and challenges businesses are likely to face in their international operations over the coming months. Given the potential for change, now is the time for businesses to switch gears and re-assess their priorities, focusing on building strategic trade capabilities, understanding where value lies in supply chains, and boosting supply chain resilience. ■

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Taking trade from good to great

Over the past two years, almost every international business around the world has experienced challenges due to the COVID-19 pandemic. Many of these issues have impacted how companies trade. Recent examples include the rush to produce the coronavirus vaccines, the difficulties life sciences businesses have faced trying to secure their international supply chains and continue global distribution, and changes in product sourcing and assembly among manufacturing firms that have faced severe disruption.

Against this backdrop, **EY latest trade research** shows that C-suite executives view trade strategy as more important than ever. However, these findings also show that while most businesses have essential trade practices in place, taking additional action would help them fully realize the long-term value of a well-defined trade strategy.

In today's trade environment, many businesses are focused on the operational aspects of trade. This means that moving goods, data and people from point to point as efficiently as possible is top of mind for these enterprises, rather than some of the more strategic and longer-term aspects of trade. This issue is common, as many companies assign trade responsibilities to personnel who also serve the company in other capacities. For example, research shows that just 59% of international businesses surveyed in a recent EY report have a dedicated trade team, with many instead relying on expertise across multiple company functions such as legal, finance and tax.[1] This structure can be highly successful, provided it has high-level oversight and sponsorship from the C-suite team. However, this fragmented approach often does not deliver the value that an effective trade strategy can provide.

Fragmentation also can make it difficult for businesses to truly distinguish between the trade skills that they possess in-house and those that are needed. EY trade research shows that across many organizations, there are skills gaps in key areas relating to the more strategic aspects of trade.

While 75% of the organizations we surveyed are equipped to manage trade barriers relating to import/export licensing or regulatory requirements, just 41% have the skills needed to address measures restricting foreign direct investment.[2] For 69% of these businesses, rising protectionism was the single greatest concern cited about international trade, yet only 53% felt they had the trade skills and capabilities needed to manage geopolitical risk and threat identification.[3] These concerns highlight the challenges organizations face when their trade teams are set up to manage day-to-day operational needs but don't have the capacity to assess the opportunities and risks on the horizon with a strategic lens.

1 "International trade capability in 2021," *EY website* accessed 8 March 2022. Find it here.

2 *Ibid.*

3 *Ibid.*

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Despite these challenges, the EY survey also revealed that many trade teams are set to grow in the coming months, with 48% of businesses surveyed planning to increase their headcount.[4] It's worth noting, however, that the vast majority of these businesses plan to bring in junior team members rather than director-level personnel with more strategic expertise and a medium- to long-term view of trade.[5] As such, organizations may struggle to break out of their operational mindset until we see significant investment in training and/or hiring of more experienced team members.

Senior-level sponsorship can help drive the trade agenda, and it is important for the C-suite to work closely with the trade team so that the overall business strategy and trade strategy are aligned. In practice, when organizations have these capabilities in place, they are able to respond more quickly and effectively to trade challenges.

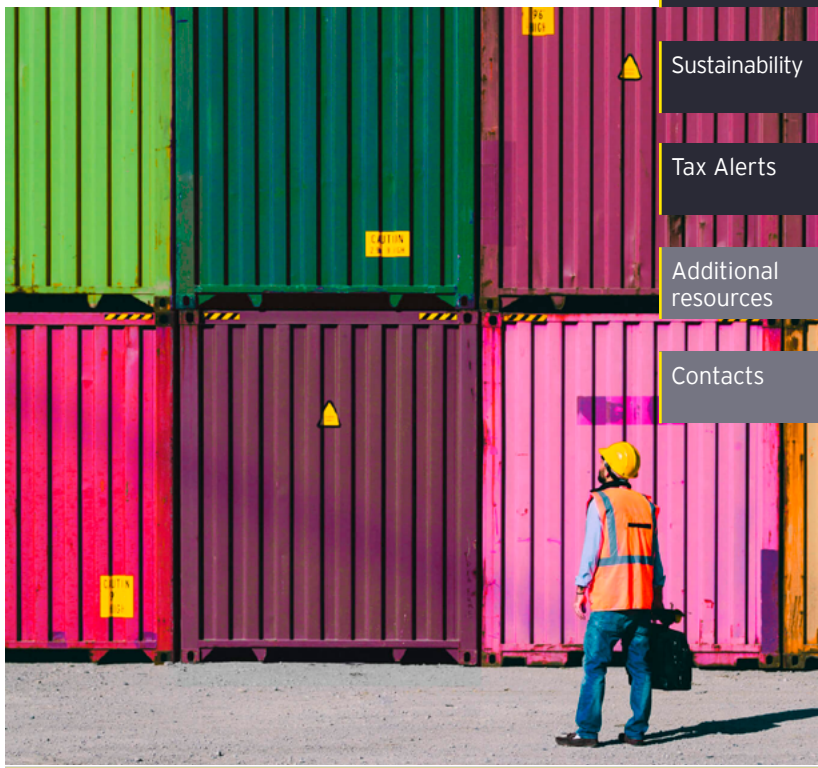
A knowledgeable and well-structured trade team with C-suite sponsorship can help leverage strong coordination and communication across the business; however, the business also must benchmark its progress to validate that the trade strategy continues to deliver value.

Several KPIs are crucial in helping businesses use every available lever within their trade toolbox, yet most companies tend to focus on a handful of operational KPIs. According to EY survey, 59% of businesses measure the KPI related to compliance and effective issues management (the most common KPI). Yet only 41% track the external insights and recommendations for the C-suite to shape company strategy. Again, there is an opportunity here for businesses to re-evaluate their trade strategy and the KPIs used to measure its success to confirm alignment with both the company's overall business strategy and the team's day-to-day role.

Businesses also may need to assess the trade skills they have in-house already to determine whether they need a boost, through either internal training or hiring. These enterprises also need to adopt a more long-range outlook to anticipate trade disruptions and opportunities on the horizon. Proactively incorporating these considerations into their strategy now, rather than in two years' time when it may be too late to react to a challenge or take advantage of an opportunity, is key.

There is no one-size-fits-all approach when it comes to trade strategy and the team responsible for delivering it, but several factors will increase a company's chances for success. Businesses need to gain senior-level sponsorship (ideally from the C-suite or a dedicated trade team leader) to both align their trade strategies with the wider business

While today's international businesses do a good job of developing and executing their trade strategies, the actions described above will go a long way toward elevating trade from good to great. ■



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4 *Ibid.*

5 *Ibid.*

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Articles and features on a range of trade issues published on EY.com

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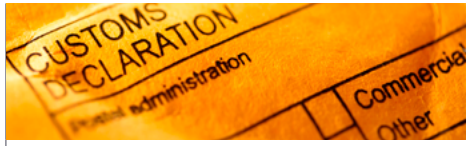


How a trade pact is positioning Africa for economic success

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Brazil and Mercosur: New edition of the Harmonized System from 1 April 2022



The Harmonized System (HS), developed by the World Customs Organization (WCO) is an essential tool for international trade, as it is used worldwide for the uniform classification of internationally traded goods and has been accepted by all contracting parties to the HS Convention. In addition, the HS serves as the basis for customs tariffs and for the compilation of international trade statistics in more than 200 economies.

The HS is updated every five years with the goal of staying up to date with the demands of international trade of goods of all kinds. In the previous edition of TradeWatch, an article was dedicated to the launch of the seventh edition of the HS that was supposed to be applied by all WCO members as of 1 January 2022. Brazil was late in adopting and the new version came into effect on 1 April 2022. This article elaborates on the consequences of the late adoption for businesses.

HS 2022: what's new?

As explained in the article which appeared in the previous edition of TradeWatch the HS Nomenclature 2022 (HS 2022), includes significant changes, with a total of 351 sets of revisions covering a wide range of goods moving across borders, many of which have been invented or developed significantly in recent years.

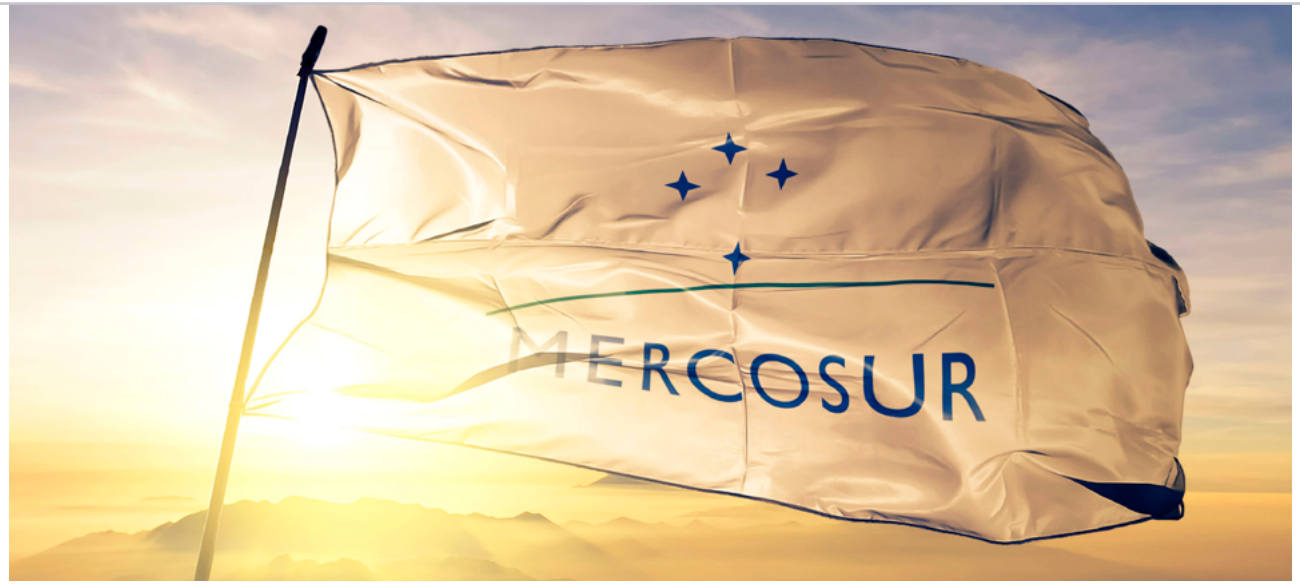
Below are a few impacted items highlighted by the WCO:

- Products for tackling global warming
- Unmanned vehicles
- Electronic waste
- Smartphones
- Cell cultures and cell therapy
- Tobacco and its derivatives
- Unmanned aerial vehicles (UAVs), commonly called drones, also have gained their own specific provisions

Impact of the changes in HS2022 on the NCM

For Brazil and the Mercosur trade bloc, it is important to evaluate the impact of HS 2022 on the common external tariff (TEC), which is based on the Mercosur Common Nomenclature (NCM), since there will be exclusions and deployments, as well as new NCM codes.

The NCM is a regional nomenclature represented in eight digits for the categorization of goods. It has been adopted by Brazil, Argentina, Paraguay and Uruguay since 1995, and it is used in all foreign



trade operations of the Mercosur countries. In Brazil, the NCM is responsible for the allocation of taxes involved in foreign trade, the outflow operations of industrialized products, trade defense rights and the identification of goods for purposes of special customs procedures, administrative treatments and import licensing, among other uses.

HS 2022 has deleted 323 NCM codes, changed the tax rates for 230 NCM codes and added 296 new NCM codes, with subsections replacing previously generic codes, such as "others."

As an example, NCM code 2106.90.90 (food preparations not elsewhere specified or included) remains in HS 2022. However, the new HS edition also includes several adjustments to classification interpretations for certain products in other NCM codes, such as 1601.00.00 (sausages and similar products, of meat, meat offal or blood: food preparations based on these products), 1602.10.00 (other prepared or preserved meat, meat offal or blood), and 3006.93.00 (pharmaceutical goods specified in note 4 to this chapter), among other items split out from code 2106.90.90.

Other NCM codes from HS 2017 have been deleted, including NCM code 3002.90.99 (human blood: animal blood prepared for therapeutic, prophylactic or diagnostic uses; antisera, other blood fractions and immunological products, whether or not modified or obtained by means of biotechnical processes; vaccines, toxins, cultures of micro-organisms (excluding yeast) and similar products), for which the classification interpretation now uses three possible frameworks (3002.49.99, 3002.59.00 and 3002.90.00) that are meant to clarify and provide more specificity for items classified elsewhere under the first general code.

Recommendations for businesses

Beginning on 1 April 2022, all trade operations must be aligned with the updated HS and NCM codes, including the new codes. In addition, the codes that have now been deleted may not be used after this date. Because these changes are not merely administrative, businesses also should examine their impact on tax and duty rates (especially import tax rates).

To comply with HS 2022, foreign trade operators should:

- Assess their tariff classification databases to identify impacted items.
- Conduct a detailed technical analysis of impacted items to adapt to the new guidelines and NCM classifications.
- Understand the state and federal rates for the impacted items and adapt their systems to enable compliance with HS 2022. ■

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Brazil: The return of the additional 1% COFINS on imports

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Starting on 1 April 2022, importers in Brazil will incur a 1% increase on import taxes. The reintroduction of an additional 1% COFINS[1] tax (Additional COFINS-Import) on the import of goods classified under certain tariff codes was approved in December 2021 by the government.

This additional percentage of COFINS-Import was originally introduced by the Brazilian Government in 2011 (at a rate of 1.5%), as a measure to compensate some payroll exemptions extended to businesses. Subsequently, the additional COFINS-Import underwent constant updates until 2018, when it was decided that this additional charge would be 1% and would be applied to imports only until 31 December 2020.

As there were no new regulations, the additional 1% COFINS-Import was not applied during 2021. However, the publication of Law 14.288, on 31 December 2021, renewed the measure until 31 December 2023. Respecting the 90-day holding period doctrine set out in the Brazilian Constitution, the additional charge of 1% COFINS-Import is reinstated with effect from 1 April 2022, and applies to a wide range of products,[2] including, for example, machinery and equipment under chapter 84 of the Harmonized System tariff classification.

1 Contribuiçao para o Financiamento da Seguridade Social (COFINS) is one of the value-added taxes imposed in Brazil. For more information, see the EY Worldwide VAT, GST and Sales Tax Guide.

2 The total list of impacted tariff codes is detailed in Law 10.865/2004, Art. 8.



Credits for import taxes

As federal taxes imposed on import operations, the COFINS-Import (gross receipt contribution) and the Programa de Integração Social and Programa de Formação do Patrimônio do Servidor Público (PIS/PASEP) are social contributions based on turnover that are levied on companies' gross revenues, representing 9.65% and 2.10% of the customs value, respectively. Other federal import taxes are import duty and the federal value-added tax (IPI), with rates for both determined based on the tariff classification of the goods and the operation type.

This set of import taxes currently represents, on average, 30%[3] of the customs value of finished goods imported into Brazil. Nevertheless, not all of these taxes represent direct costs to businesses, as Brazilian tax regulations include the noncumulative tax system. This system allows a credit entitlement (debit-credit method), enabling the recovery of the taxes paid as tax credits. IPI, PIS/PASEP-Import and COFINS-Import are subject to the noncumulative system, and credits for these taxes may be used by importing businesses. However, in the case of import duty, no credit is allowed, and this represents a direct cost to the importer.

Regarding the Additional 1% COFINS-Import, this 1% is not creditable and should also be treated as a direct cost to the importer. In practical terms, this represents an increase to the true cost of importing. The 30% example previously mentioned (as an average) would effectively rise to 31%, with the additional 1% being a cost to the importer.

3 Considering an import duty of 10%; Federal value-added tax (IPI) of 8%; PIS/PASEP of 2.10% and COFINS of 9.65%.

In conclusion, the reintroduction of the additional 1% of COFINS-Import represents a short-term increase in revenue collection but impacts the competitiveness of both importers and local industry.

What's next?

As the additional 1% COFINS-Import represents an increase to import costs, importers may look for alternatives in order to reduce or eliminate the impact of this additional value (for example, through the use of special customs regimes).

Drawback, the Special Customs Regime of Industrial Warehouse under Computerized Control (RECOF), ex-tariffs and other regimes may help businesses mitigate the impact of the renewed 1% increase to COFINS-Import, depending on the existing types of import and/or export operations undertaken by the business. ■

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Canada: Related-party customs valuation and use of OECD transfer pricing methodologies

On 6 December 2021, the Canada Border Services Agency (CBSA) updated Memorandum D13-4-5, *Transaction value method for related persons*. In this update, the agency has modified its administrative policy on the treatment of customs valuation for related parties under the transaction value method (TVM). In particular, a transfer price based on an Organisation for Economic Co-operation and Development (OECD) methodology will no longer be necessarily deemed adequate by CBSA in supporting the uninfluenced nature of a price paid or payable (PPP) for customs valuation purposes.

Going forward, the CBSA will consider its own influence tests, based on provisions of Canada's Customs Act and the Customs Valuation Agreement (CVA) of the World Trade Organization (WTO), as the primary basis for determining whether a relationship between a vendor and purchaser is uninfluenced for customs valuation under the TVM.

Background

In Canada, the primary method of customs valuation for imported goods is the TVM. For the TVM to be applicable, the imported goods must have been sold for export (SFE) to a purchaser in Canada "(PIC)", and the PPP can then be determined.

Per paragraph 48(1)(d) of the Customs Act, the TVM can only be used where the purchaser and the vendor of the goods are not related or, if they are related, where the importer clearly demonstrates one of the following:

- That the relationship did not influence the price paid or payable for the goods, by providing substantiating evidence related to the circumstances surrounding the sale[1]
- That the price closely approximates a test value[2]

In short, the importer must be able to demonstrate to the CBSA, if requested, that the relationship between the vendor and the purchaser had no effect on the selling price of the goods (i.e., the price was determined at arm's length for customs valuation purposes). If the importer fails to do so, they will be required to apply one of five alternate methods of customs valuation, as prescribed in section 47 of the Customs Act. Alternative methods must be considered sequentially, and the importer must apply the first method that applies to their situation.

1 Subpara. 48(1)(d)(i) of the Customs Act

2 Subpara. 48(1)(d)(ii) of the Customs Act

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In only one instance can the sequence in which the methods appear in the legislation be altered – the order of application of the deductive and computed methods can be reversed at the request of the importer.

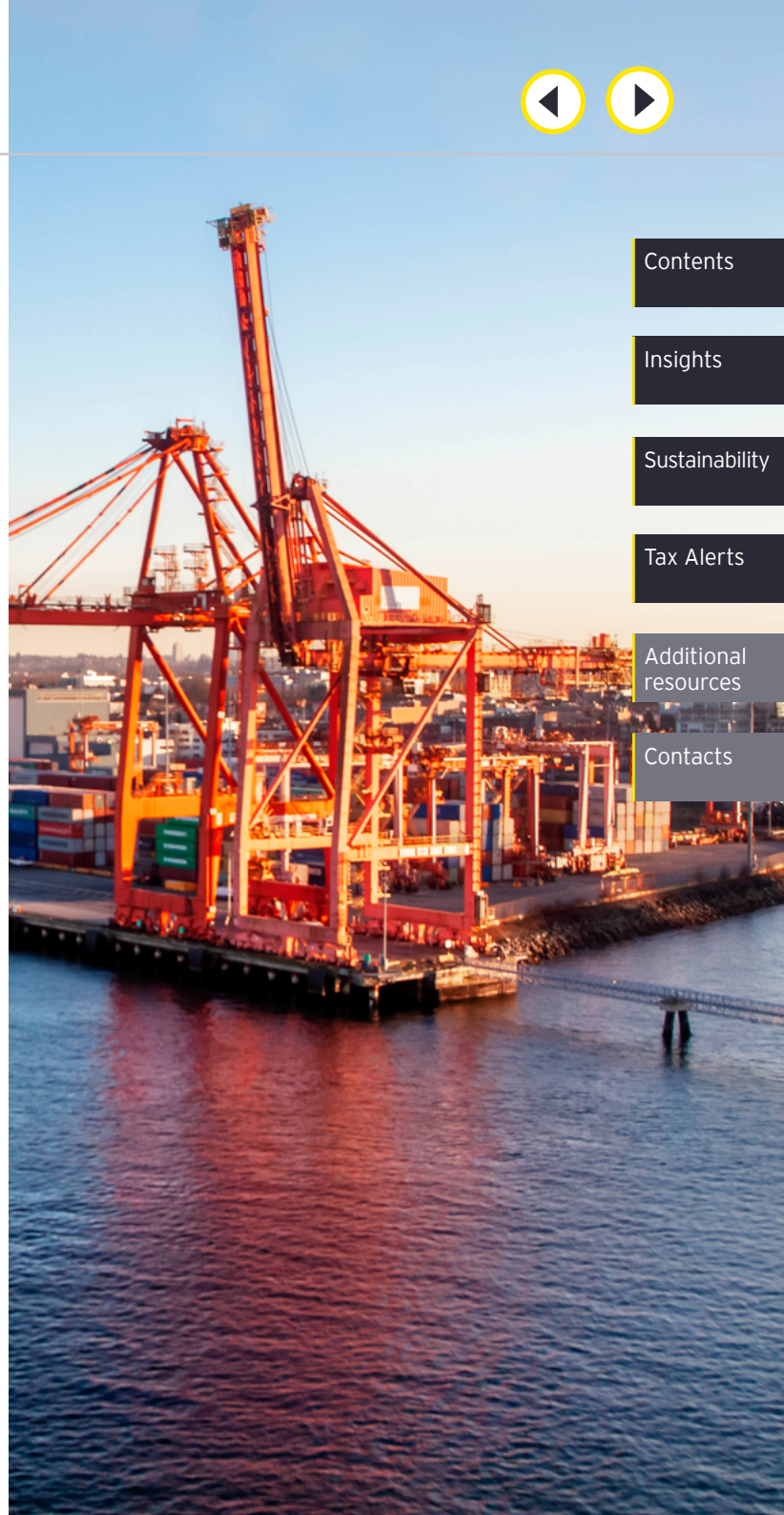
Main changes in CBSA administrative policy on related-party customs valuation

Prior to December 2021, CBSA generally accepted OECD-approved transfer pricing methodologies as a starting point for determining an acceptable value for duty (VFD) under the TVM for import transactions between related parties. However, in the past year, the CBSA has begun challenging importers on their use of the TVM for related-party transactions, specifically targeting the transactional net margin method (TNMM) and other profit-split transfer pricing methods that serve as the foundation for using the TVM for customs valuation.

With the December 2021 update of Memorandum D13-4-5, the CBSA has officially formalized its position on OECD transfer pricing methodologies, which results in the following significant changes as outlined in the memorandum:

- **Primacy of valuation requirements and provisions of the Customs Act and WTO CVA**. The CBSA's position is that OECD transfer pricing methodologies are ultimately international guidelines established for corporate income taxation purposes. These guidelines may include analyses and conclusions based on elements, factors, principles or industry comparators that are not necessarily reflective of or relevant to the customs valuation requirements and provisions established under domestic or international law, as provided for in the Customs Act or the CVA. Consequently, a transfer price based on an OECD methodology may not be adequate in supporting the uninfluenced nature of a PPP for customs valuation purposes.
- **Increased supporting information requirements when using OECD profit-split methodologies**. Importers should now expect that when an OECD transactional profit method is used to determine a transfer price that forms the basis of the customs value determined, the CBSA likely will require supporting information on the prices of the imported goods that is more directly related to the specific importations and transactional nature of the customs valuation requirements, such as the circumstances surrounding the sale of the specific goods or test values, as appropriate. This is a significant departure from prior CBSA practice, which generally did not require importers to provide this level of information.
- **Greater scrutiny of refund requests due to downward price adjustments**. For any refund requests due to downward transfer price adjustments, and in particular adjustments based on an OECD transactional profit method such as TNMM, the importer will first be required to demonstrate that applying the downward price adjustment achieves the arm's-length range for the profit indicator range identified in the related companies' transfer pricing documentation. The importer also will be required to demonstrate

3 CBSA Memorandum D13-4-5, *Transaction value method for related persons*, par. 18



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that the downward price adjustment involved an actual transfer of funds related to the transaction and was included in its business income tax filings with the Canada Revenue Agency (CRA). After the importer has demonstrated the above, the CBSA also will request additional information pertaining to the circumstances surrounding sales, or test values, to substantiate that the downward price adjustment also results in an uninfluenced price for customs valuation purposes.

Impacts and takeaways

The changes to the CBSA's treatment of related-party customs valuation will undoubtedly result in significant customs and tax planning challenges for businesses.

In the past, CBSA interpretations of OECD transfer pricing methodologies for customs purposes generally allowed importers to benefit from the understanding that their preferred transfer pricing methodology could serve as the basis for their customs valuation provided the TVM requirements were met. The previous state of affairs allowed importers to more easily benefit from tax planning efficiencies while also achieving desired results from an import duty mitigation perspective. The CBSA's latest stance on OECD transfer pricing methods signals that Canadian importers need to prepare for new, and apparently more restrictive, technical interpretations by the CBSA. The updated memorandum also makes clear there will be a greater documentary requirement on importers to support customs values based on a transfer price, and fewer opportunities for "crossover" transfer pricing (i.e., corporate income tax) and customs valuation planning.

Many of the issues discussed in this article were already observed by EY Global Trade professionals prior to December 2021, when the CBSA had already begun to challenge OECD-based transfer pricing methodologies as part of conducting valuation verifications, albeit not in a systematic manner. In general, valuation program verification audits seem to be taking much longer (i.e., 12 to 18 months and sometimes longer), and exchanges surrounding current transfer pricing practices have become more detailed and more central to the auditor's investigation. In many valuation audit files where the seller and the buyer are related, importers' valuations were challenged, and they were instructed to use an alternate method of valuation, or to use a sale at a higher level of trade under the TVM. The results of the CBSA's positions tend to be obligatory retroactive adjustments to historical customs entries, a transition to a new and typically much more complex method for determining the VFD, a higher VFD than previously calculated by the importer (resulting in additional customs duties and import goods and services tax owing to the CBSA), and lower profit margins for sales of the imported goods in Canada.

Now that the CBSA has updated its position on the acceptability of OECD-approved transfer pricing methods, importers who purchase and import goods from related parties should immediately review their transfer pricing methodology and customs values in light of the agency's new guidance. The agency is already robustly targeting related-party valuation, and valuation trade verifications traditionally have become lengthy and technically complex exercises.

Importers who are impacted by these developments need to proactively review their import transaction data and current practices, as well as their books and records and documentary support, before they are selected for an audit. A best practice is to have audit supporting documentation readily available, as well as a good understanding of how to properly respond to the questions the CBSA typically poses at the very beginning of the verification. ■

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Colombia: Court ruling on the cost of insurance in customs valuation



On 11 December 2020, the Court of Justice of the Andean Community issued a Preliminary Advisory Interpretation[1] of the internal file 24413-2018 of the Republic of Peru Supreme Court of Justice,[2] referring to the obligation to include the cost of insurance in the customs value of imported goods.

1. Laws to be interpreted

A. Paragraph 2 of Article 8 of the Agreement on Customs Valuation of the World Trade Organization (WTO) establishes that, to determine the customs value of imported goods using the transaction value method, certain price elements need to be included in the price actually paid or payable for the imported goods. In framing local legislation, the Agreement gives Members the option of including or excluding, in whole or in part:

   a. Transport costs of imported goods to the port or place of importation

   b. Loading, unloading and handling costs incurred in shipping imported goods to the port or place of importation

   c. The cost of insurance

Colombia opted to lay down in local legislation that transport costs to the port or place of importation need to be included in the customs value of imported goods (commonly referred to as the cost, insurance and freight (CIF) value).[3]

1 Process 617-IP-2019.

2 Case file of the Permanent Constitutional and Social Law Chamber of the Republic of Peru Supreme Court of Justice.

3 As defined by Incoterms® 2020 – ICC – International Chamber of Commerce (iccwbo.org)

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B. Article 32 of Andean Community Resolution 1684 of 2014 establishes the following:

   i. The cost of insurance includes the cost required to cover the risk of damage or loss of the goods during transport, loading, unloading or handling from the place of delivery abroad to the place of importation.

   ii. The amount to be taken into account for insurance is that of the insurance premium actually paid. Any statement of theoretical or estimated amounts not substantiated by documents shall under no circumstances be accepted.

   iii. The document proving the cost of insurance is the policy issued by the insurance company or the individual insurance certificate.

   iv. If the insurance costs are included in the commercial invoice and the amount agreed between the seller and buyer is not the same as that actually paid by the seller to a third party, the actual costs paid definitively for insurance up to the place of importation in accordance with the policy issued by the insurance company or the certificate showing a separate policy shall be taken into account.

   v. If the commercial invoice shows insurance costs higher than those appearing in the insurance policy, the difference shall form part of the cost of insurance for the purpose of calculating the customs value of the goods, unless the importer shows that the difference was repaid or will not be paid.

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vi. If there are trade negotiations in which the seller has insured the goods at origin and, in addition, the importer has taken other insurance or has a standing policy covering international transport of the same goods, with the same or different cover, the insurance agreed in the negotiations and the insurance taken out by the importer shall be declared.

2. Considerations

Article 8.2 of the Agreement establishes that, in the preparation of its legislation, each State will determine whether all or part of the cost of insurance should be included or excluded from the customs value. In the dispute raised in the internal judicial process 24413-2018, it must be clarified whether the cost of the Delay in Start-Up (DSU) insurance, which was intended to compensate the potential economic losses that would be generated (loss of profits) as a consequence of the delay in the disposition of the imported goods, should be incorporated into the customs value.

3. Interpretation

To clarify the scope of application of the word "insurance," Advisory Opinion 13.1 of the Technical Committee on Customs Valuation states that Article 8.2 of the Agreement refers to costs related to the shipment of imported goods (transport and transport-related costs). Hence, the word "insurance" in paragraph (c) should be interpreted as referring to insurance costs incurred for the goods during the operations specified in Article 8.2 (a) and (b) of the Agreement.

Additionally, the Andean Community Court of Justice stipulated that the cost of the premium or premiums that insure the goods is part of the customs value and refers to the insurance or insurances that cover the risks of damage or loss during shipping, loading, unloading, and handling of the goods up to the place of import.

The customs value must include all insurance covering the risks of damage or loss that the goods may suffer during shipping, loading, unloading, and handling, up to the place of import. Damages may include consequential damages, loss of profits and any other damages that may have been agreed upon.

Consequently, the scope of "cost of insurance" includes all insurances whose purpose is to insure the merchandise for damages or losses that could be suffered during shipping, loading, unloading, and handling, up to the place of import. In this regard, these additional insurance costs that were not included in the customs value, must be added to comply with the new provision. This means that the insurance that relates to international transport must be reflected in the import declaration as well as the insurance that covers those operations prior to transport, thus increasing the customs value and compelling the importer to retain documentary evidence to prove that it has been added. ■

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US: Chemical superfund excise taxes reinstated

In late 2021, the United States reinstated a significant excise tax on a variety of domestically produced and imported base chemicals and on imports of a wide range of chemical substances, which may impact many industries beyond just the core production of chemicals. Signed into law on 15 November 2021, by US President Joe Biden, the Infrastructure Investment and Jobs Act (IIJA) includes revenue provisions that renew chemical superfund excise taxes that were originally established in the 1980s. While these taxes were last in place from 1 January 1989, but expired in 1995,[1] the IIJA sets the effective date for reinstated taxes on both prior taxed chemicals and chemical substances, and newly identified chemical substances, as 1 July 2022, providing a short time frame for companies to assess the impact of the tax and its new provisions.

Found in Internal Revenue Code (IRC) Sections 4661, 4662, 4671, and 4672, the superfund excise taxes will be levied upon various imported and domestically produced chemicals throughout the supply chain of many end-item products, potentially including electronics, industrial equipment, and consumer products. IRC Sections 4661 and 4662 address taxes on certain chemicals (taxable chemicals), whereas IRC Sections 4671 and 4672 address certain additional substances (taxable substances), a distinction concerning products captured within the provisions and how the taxes are applied.[2] Further, IRC Section 4672(a)(4) states that the Internal Revenue Service (IRS) is to maintain a list of taxable substances that meet certain criteria, in addition to those listed in the IRC itself. The Internal Revenue Service published Notice 2021-66 on 14 December 2021, to that effect.

Affected taxpayers will be required to make semimonthly deposits as of the 1 July 2022, effective date and will report the taxes on Form 720, *Quarterly Federal Excise Tax Return, and Form 6627, Environmental Taxes*.[3]

As a result of the IIJA, chemical companies should undertake a detailed review of their domestic production if they manufacture the taxable chemicals defined in the IRC, their imports of those taxable chemicals, the chemical composition of their imports of chemical substances, and their products and supply chains to understand the implications of these new excise taxes. Moreover, as

1 *See* Infrastructure Investment and Jobs Act, Pub. L. No. 117-58 (2021)

2 *See* 26 U.S.C. §§ 4661, 4662, 4671, 4672.

3 *See* I.R.S. Notice 2021-66. *See also* 26 C.F.R. § 40.6302(c)-1.

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these taxes on certain imported and domestically produced chemicals may be passed on through sales throughout the supply chain, manufacturers of end items using these chemicals may be impacted as well, including makers of industrial equipment, electronics, and semiconductors, among others.

Taxable chemicals

Under IRC Sections 4661 and 4662, the excise tax is applied to the sale or use of one of 42 listed taxable chemicals by the manufacturer, producer or importer of the chemicals. No tax is imposed if the taxable chemical is exported, and the statute also provides various exemptions for certain qualifying activities. Notably, the tax is not necessarily paid by an importer upon the importation of the taxable chemical, but rather is incurred and thus paid when the importer sells or uses the taxable chemical.

The tax rate per ton for the 42 taxable chemicals is doubled from the rates that expired in 1995. The rates for the 42 chemicals are listed opposite:

Taxable chemicals	Tax rate per ton
Acetylene	$9.74
Ammonia	$5.28
Antimony	$8.90
Antimony trioxide	$7.50
Arsenic	$8.90
Arsenic trioxide	$7.50
Barium sulfide	$4.60
Benzene	$9.74
Bromine	$8.90
Butadiene	$9.74
Butane	$9.74
Butylene	$9.74
Cadmium	$8.90
Chlorine	$5.40
Chromite	$3.04
Chromium	$8.90
Cobalt	$8.90
Cupric oxide	$7.94
Cupric sulfate	$3.74
Cuprous oxide	$7.94
Ethylene	$9.74

Taxable chemicals	Tax rate per ton
Hydrochloric acid	$0.58
Hydrogen fluoride	$8.46
Lead oxide	$8.28
Mercury	$8.90
Methane	$6.88
Naphthalene	$9.74
Nickel	$8.90
Nitric acid	$0.48
Phosphorus	$8.90
Potassium dichromate	$3.38
Potassium hydroxide	$0.44
Propylene	$9.74
Sodium dichromate	$3.74
Sodium hydroxide	$0.56
Stannic chloride	$4.24
Stannous chloride	$5.70
Sulfuric acid	$0.52
Toluene	$9.74
Xylene	$9.74
Zinc chloride	$4.44
Zinc sulfate	$3.80

Taxable substances

The IIJA also reinstates, at two times the prior rate, an excise tax on taxable substances under IRC Sections 4671 and 4672. The tax rate for each taxable substance is based on the tax rate imposed on the taxable chemicals used in the manufacture or production of the taxable substance.

The IIJA directs the IRS to review and update the list of taxable substances for importers under IRC Sections 4671 and 4672. While the original list contained 50 taxable substances, the IRS has since identified an additional 101 taxable substances to be added to the list (see IRS Notice 2021-66), bringing the total taxable substances list to 151 unique types of chemical products. The IIJA also expands the threshold for the excise tax to apply, as previously the tax only applied to taxable substances where the base taxable chemical constituted more than 50% of the substance. The tax now applies where the base taxable chemical is more than 20% of the substance (by weight or value).

The responsibility is on the importer to provide the IRS with sufficient information to determine whether the imported taxable substance contains more than 20% of a taxable chemical, resulting in the applicable tax rate associated with that taxable chemical. If the importer does not provide the IRS with sufficient information about the chemicals used in the taxable substance to determine the applicable tax, the tax will automatically be 10% of the value of the taxable substance when it enters the US.

Impact to industries

An important point regarding the IIJA is that the impact of the tax is not limited to chemical companies, as the producers of end items that use chemicals, or chemical substances made from the base chemicals, will be impacted as well. This is particularly true for companies involved in the manufacture of industrial equipment, electronics, semiconductors, and other similar products. These effects may be felt as the taxes on imported and domestically produced chemicals are passed on in the sales process leading up to the end item.

To illustrate, a US producer of an end item — whether a complex product such as a semiconductor or a simpler product such as nickel-coated wire — may purchase several materials from domestic and foreign suppliers. At various points in the supply chain, these materials are subject to the excise tax due to the presence of taxable chemicals or taxable substances. Each time the tax is incurred by one of the suppliers, that supplier may pass on the tax to the next supplier or the final end-item manufacturer. The result is more costly production of an end item that is relatively far removed from the original importation or production of the taxable chemicals or taxable substances.

Exemptions

In some instances, an exception to the tax under IRC Section 4661 may apply with regard to the following substances:

- Methane or butane used as a fuel or in the manufacture or production of any motor, aviation, jet, or diesel fuel
- Chemicals used in the production of certain fertilizer, including nitric acid, sulfuric acid, ammonia, or methane
- Sulfuric acid produced as a by-product of air pollution control equipment
- Any substance derived from coal
- Certain substances used in the production of motor fuel, diesel fuel, aviation fuel, or jet fuel
- Certain substances having a transitory presence during the refining or smelting process
- Separated isomers of xylene, except in the case of any substance imported into the US or exported from the US
- Any chromium, cobalt, or nickel that is diverted or recovered in the US from any solid waste as part of a recycling process (and not as part of the original manufacturing or production process)
- Certain substances used in the production of animal feed
- Intermediate hydrocarbon streams containing mixtures of organic taxable chemicals

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Taxpayers should carefully review the full text of the exemptions, which contain additional detail, to determine if they may apply to a given product or circumstance.

Next steps for businesses

Given the IIJA's effective date, newly affected taxpayers should promptly take action, including the following steps, among others:

- Reviewing the chemical composition of products within the supply chain to determine which products and activities may be subject to the new excise tax
  - For example, some companies purchase or source feedstocks containing multiple chemicals that only become taxable when processed through a reactor or other conversion process that separates the base chemical from the feedstock, compound, gas, or other substance. Given that the tax can be incurred early in the supply chain, companies should look back to second- and third-tier suppliers for potential exposure.
- Identifying where sources for relevant data are housed (enterprise resource planning (ERP) systems, purchasing databases, etc.) to enable and support new and refreshed compliance processes
- Developing expertise and systems to determine taxable substances within the supply chain and calculate liabilities
- Determining whether exemption scenarios can reduce or create an exemption from the tax
- Evaluating the impact of the tax on pricing procedures
- Following IRS requirements in requesting guidance as to the taxability and tax rate for specific products
- Identifying and extracting data needed from various ERP systems to determine quantity, weight, and value information needed to compute transaction-level taxes
- Preparing and maintaining the data necessary to support tax calculations to be reported ■



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US: Court clarifies scope of duty-free imports of tools of trade

The Harmonized Tariff Schedule of the United States (HTSUS) 9801.00.85.00 allows duty-free entry for "professional books, implements, instruments, and tools of trade, occupation, or employment, when returned to the United States after having been exported for use temporarily abroad, if imported by or for the account of the person who exported such items." A 30 December 2021 decision by the United States Court of International Trade (CIT), provides clear guidance on the application of the duty-free provision.[1]

1 CIT Slip Op. No. 21-176 (30 December 2021)



Background

In the transactions at issue in this case, the US subsidiary of a global automotive company (the Company) repeatedly exported a trailer that provided trackside access to automotive repair parts and tools for teams at racing events in Canada, and then re-imported the trailer and its contents back to the US. The Court characterized the trailer as a "roving emporium" that was open for business solely with racing teams, which allowed competitors to repair their automobiles in the event of accidents. Parts sold to the racing teams were not returned to the Company. Upon return of the trailer to the US, the Company classified the parts and tools as duty-free under HTSUS 9801.00.85.00. US Customs and Border Protection, however, disagreed and instead classified the parts contained in the trailer under multiple dutiable tariff provisions of the HTSUS.

Analysis

The Court explained that for articles to be classified under subheading 9801.00.85.00, they must satisfy three requirements:

1. The articles must be professional books, implements, instruments, and tools of trade, occupation, or employment.
2. They must satisfy the above criterion when returned to the US after having been exported for use temporarily abroad.
3. They must be imported by or for the account of the person who exported such items.

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As such, the Court found that the automotive parts that were exported to Canada and re-entered into the US failed to meet at least one, if not two, of these three elements within subheading 9801.00.85.00. First, the Court states that the word "professional" in the statute is an adjective that applies to each of the nouns following. The Court went on to explain that the Company's inventory items do not satisfy this requirement because selling cars and their parts is not a professional pursuit within the meaning of subheading 9801.00.85.00 as it does not require "professed knowledge of some subject" or "prolonged training and a formal qualification." In addition, the Court noted that the goods did not relate to "learned" or "highly skilled" activities undertaken by the Company, such as repairing cars, but rather were brought merely for the purpose of sales among clients who raced cars.



Second, the Court also held that the Company's inventory items were not "tools of trade, occupation, or employment." The Court stated that tools of trade generally include "items necessary for the exercise of the trade or profession of the individual," and typically do not include "items for sale, either when they are inbound to or outbound from the United States."

Furthermore, the Court explained that the second requirement likely was not met, as the majority of the parts were consumables to be purchased in the event of wear and tear (e.g., oil, brake fluid, washers, hoses, grommets). "Parts that did find a specific use were permanently … used" and "remained in Canada with the racing teams," whereas the inventory that did return to the US "had never been put to a specific use" as it was not sold.

The Court contrasted the inventory items with non-inventory items that assisted the Company in making sales, such as the trailer itself, onboard computers, and hand tools loaned to the racing teams. These non-inventory items did qualify for duty-free entry on return to the US.

Noting that the proper analysis for subheading 9801.00.85.00 had not been previously performed, the Court went on to provide a detailed road map for future assessments:

1. First, "assess whether professed 'books, implements, instruments, and tools of trade, occupation, or employment' are for 'professional,' i.e., non-sales, purposes." The intended use for these items should relate to a form of skilled labor completed by trained members of a trade. Consumable products are not included, as selling does not fall within the scope of tradesmen's skilled labor.
2. Second, "determine whether the items were actually used temporarily by the claimant while abroad, not merely made available for purchase by others who might employ them in a professional capacity."
3. Third, "if the goods are also transported 'by or for the account of the person who exported such items,' they are nondutiable." The names and items listed on the paperwork must match for both exportation and re-entry.

HTSUS 9801.00.85.00 can be a valuable provision for professionals involved in cross-border trade. This case provides a clear explanation of the analysis that importers should conduct to take advantage of the duty-free provision. ■

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US: Possession requirement for substitution drawback



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Drawback is the ability to obtain a refund of customs duties, fees and taxes that were paid upon importation of articles into the US when those articles, or like-kind articles, are exported or destroyed. When a product is exported and recovery of duties is on a like-kind product, the type of drawback is referred to as unused merchandise substitution drawback.[1] The standard for determining like-kind status was liberalized in 2016 so that imports with the same eight-digit Harmonized Tariff classification are generally considered like-kind. As an example, automobiles are classified in accordance with engine size, so that an export of a six-cylinder vehicle made in the US would allow the exporter to claim a refund of duties paid on a different six-cylinder vehicle imported into the US.

One of the requirements of unused merchandise substitution drawback is that the drawback claimant must be in possession of the substituted merchandise that is exported. The statute defines "in possession" as "...including ownership while in bailment, in leased facilities, in transit, or in any other manner under the operational control of, the party claiming drawback...."[2] U.S. Customs and Border Protection (CBP) recently provided guidance on the possession requirement in a ruling, HQ H302869 (30 November 2021),[3] determining that acting as a foreign trade zone (FTZ) operator does not satisfy the possession requirement.

Ruling H302869

The ruling involves two subsidiaries of a global of an automotive company, one an importer and distributor of vehicles made outside the US (the Distributor) and the other a manufacturer of vehicles in the US (the Manufacturer). The Distributor imports vehicles into the US and is also the operator of an FTZ in South Carolina, where the Manufacturer assembles vehicles. Some of the vehicles assembled by the Manufacturer are exported. The Distributor sought to confirm that it has possession of the vehicles made in the South Carolina FTZ in its capacity as the FTZ operator, and therefore whether it is eligible to claim drawback on duties paid on an imported vehicle when a vehicle made in South Carolina (a substituted vehicle) is exported. CBP regulations specify that an FTZ operator is responsible for supervising FTZ activity and records, and for safekeeping and security merchandise in the FTZ.[4] While the operator may delegate supervision to the owner of the goods in the FTZ, the operator remains liable to CBP and posts a bond to guarantee payment of duties that are due to CBP when goods exit the FTZ for a domestic location.

1 19 U.S.C. § 1313(j)(2).

2 19 U.S.C. § 1313(j)(2)(C)(ii).

3 *CBP website*, accessed 10 March 2022. Find it here.

4 19 C.F.R. § 146.4

CBP determined that by acting in its capacity as FTZ operator, the Distributor would not meet the requirements for possession under 19 U.S.C. § 1313(j)(2). First, CBP reviewed the legislative history of the provision, finding that the US Congress never intended to create a market for drawback rights. Citing US House of Representatives Report No. 103-361(I), CBP states that Congress consistently intended the general rule to be "that the party claiming drawback must either have paid the duties on the imported merchandise or have received from the person who imported and paid the duties on the imported merchandise a certificate of delivery for the imported merchandise, commercially interchangeable merchandise, or any combination thereof." For cases where the claimant was not the importer, Congress intended that the claimant have proof of possession, e.g., a certificate of delivery of the substituted product, eliminating the possibility of drawback claimants merely trading paper ownership of goods.

Then, CBP reviewed its own prior interpretation of the possession requirement. Citing C.S.D. 85-52 (August 16, 1985), CBP interpreted the term "possession" to mean "complete control over the articles or merchandise on premises or locations where the possessor can put the articles or merchandise to any use chosen." CBP therefore found that there was no evidence showing that Congress intended to liberalize the definition of "possession," nor that it intended for mere custodial control, e.g., goods in a leased facility, to satisfy the possession requirement.

CBP also examined certain circumstances where drawback may be claimed when the substituted merchandise is in the physical custody of another, such as bailment, if the claimant maintains complete control and dominion over the merchandise. Under 19 U.S.C. § 1313(j)(2), possession includes ownership while in bailment. CBP further explained that the owner of the goods still has dominion and control over the goods while the goods are entrusted to another, the bailee. However, CBP stated, this does not mean that the bailee, such as an FTZ operator to whom the goods have been entrusted, possesses any rights beyond that of a mere custodian.

Finally, citing HQ 225166 (10 April 1996), CBP explained that physical custody of merchandise is at most an indication of guardianship over merchandise, whereas "the key element in establishing possession … is that the possessor has 'complete control' and dominion over the exported merchandise." CBP also stated that while the Distributor as an FTZ operator may have physical control of the vehicles that are stored at its FTZ, physical control is not equivalent to possession or complete dominion and control within the meaning of 19 U.S.C. § 1313(j)(2). CBP thus found that the Distributor did not provide any evidence showing that it will acquire title to the motor vehicles when they are stored in its custody. As such, for the proposed transaction, CBP found that the Distributor acting as an FTZ operator cannot satisfy the possession requirement of the substituted motor vehicles as required for substitution unused drawback merchandise claims. CBP concluded by stating that "two parties cannot possess the same object at the same time."

Implications

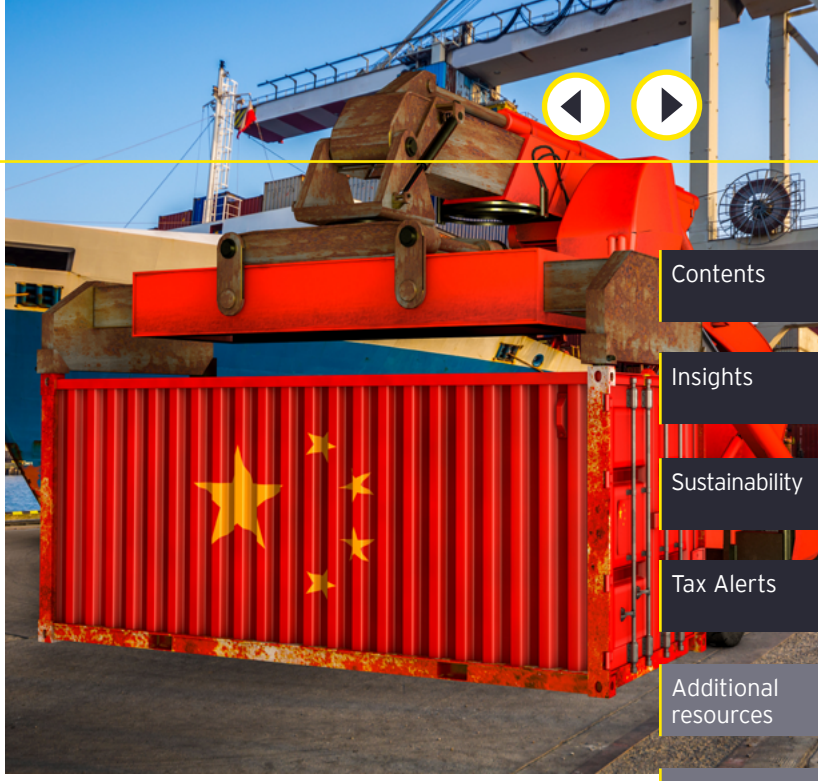
CBP articulates a strict standard for the possession requirement in stating that two parties cannot possess the same object at the same time. This effectively appears to require that a drawback claimant demonstrate that is both the legal owner and in physical possession of the substituted merchandise. In deciding whether a claimant satisfies possession under 19 U.S.C. § 1313(j)(2), CBP will analyze both commercial and transportation documents to determine whether the claimant has independent control over the merchandise, or if its control over merchandise is at the direction of another party. US companies with substitution drawback programs should carefully review the documentation in place supporting the possession requirement. ■

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China: Recent Global Trade developments in Mainland China



GAC promotes group customs supervision for enterprises involved in the processing industry

On 9 October 2021, the General Administration of Customs (GAC) released GAC Public Notice [2021] No. 80 (PN 80)[1] to fully promote the supervision of processing trade enterprises on a group basis. PN 80 took effect on 15 October 2021.

According to PN 80, processing trade enterprises that operate as part of the same corporate group may apply to be supervised by the customs authority on a group basis if they can meet certain criteria, including the following:

- The enterprise selected as the group representative for the application should be an advanced authorized enterprise under the customs law.
- The lead enterprise should have authorization from the other group members to act on their behalf.
- None of the group member enterprises falls under the category of enterprises acting in bad faith.
- There are complete and thorough internal control measures in place.
- The group members' activities do not involve goods that are subject to special monitoring or quotas.

Once the application is approved by the customs authority, the group members are granted the following facilitation measures:

- The group members may keep one customs handbook for all member enterprises or set up multiple customs handbooks for each member enterprise on a group basis.
- Bonded materials used for the purposes of processing can be circulated among the group members.
- The group members must store the bonded materials in venues that have been registered with the customs authority and keep the relevant records for future reference.
- Exchange and deployment of bonded and non-bonded materials under the same group are not subject to record-filing with the customs authority, but these activities must be recorded for future reference.
- Outward processing within the group is not subject to record-filing with the customs authority, and the guarantee is waived by customs where all the processing procedures are under outward processing within the same group. Finished goods, surplus materials and scraps/defects under outward processing are not required to be transported back to the original enterprise. However, the enterprises involved should still keep proper records for processed goods delivery receipt.

Group customs supervision for qualified groups should be welcomed by the processing industry. This facility should not only ease the administrative burden for processing trade enterprises but also help to save costs for certain processes, e.g., by waiving the guarantee for outward processing within the same group. Therefore, enterprises operating in this

1 "Announcement No. 80 [2021] of the General Administration of Customs (Announcement on Comprehensively Promoting the Supervision Model of Enterprise Group Processing Trade)," *GAC website*, accessed 15 March 2022. Find it here.

sector are encouraged to read PN 80 and evaluate whether they can qualify to enjoy the benefits of group supervision.

Public consultation on the supervision and administration of transit goods

On 18 November 2021, the GAC released the Measures of the Customs of the People's Republic of China (PRC) on the Supervision and Administration of Transit Goods (Discussion Draft) (the Discussion Draft)[2] for public consultation. The consultation period closed on 18 December 2021. The stated aims of the new measures are to safeguard national sovereignty and interests, and to strengthen the customs supervision and administration of transit goods.

Some key points mentioned in the Discussion Draft include the following:

- **Prohibited transit goods**
  The Discussion Draft clarifies the meaning of the term "prohibited transit goods," which includes weapons, poisons, drugs, dangerous chemicals, and microorganisms.
- **Transit supervision**
  Transit goods will be subject to customs supervision from entry to exit. Without the permission of the customs authority, no entity or individual may open, withdraw, deliver, ship, exchange, refit, mortgage, transfer or replace the goods.
- **Transit transport**
  The carrier should transport the transit goods along the route prescribed by the competent transportation authority from entry to exit of the transit goods. The carrier also should truthfully declare the goods to the customs authority at the place of entry and complete the customs formalities for transit transport. Transit goods can be transported only after being examined and released by customs at the point of entry and can be transported out of the country only after completing the domestic transport formalities with customs at the point of exit.

New administrative regulations on record-filing by customs declarations entities

On 19 November 2021, the GAC released the Administrative Regulations of the Customs of the PRC on the Record-filing of Customs Declaration Entities via GAC Order [2021] No. 253 (Order 253).[3] Order 253 took effect on 1 January 2022. At the same time, the Administrative Regulations of the Customs of the PRC on the Registration of Customs Declaration Entities (Annex 37 to GAC Order [2018] No. 240) and the Administrative Measures on Entry-exit Inspection and Quarantine Declaration Enterprises (Annex 74 to GAC Order [2018] No. 240) were abolished.

Key points of Order 253 are as follows:

- **Qualification for record-filing**
  The consignee or consignor of imported and exported goods or the customs declaration entity must obtain the qualification of market entity before applying for record-filing. In addition, a consignee or consignor of imported and exported goods is also required to conduct record-filing for foreign trade operators.
- **Record-filing materials**
  To apply for record-filing, the customs declaration entity must submit the Statement of Record-filing of Customs Declaration Entity to the customs authority (see the Annex to Order 253).
- **Validity period of record-filing**
  The record-filing of a customs declaration entity is permanently valid. The validity period for temporary record-filing is one year; after the expiration date, the entity can apply for a renewal.
- **Changes to declarant's information**
  If any of the information specified in the Statement of Record-filing of Customs Declaration Entity changes, such as the name of the customs declaration entity, the type of market entity, its domicile (main premises), legal representative (person in charge), and customs declaration personnel, the customs declaration entity must notify the local customs authority within 30 days from the date of the change.

2 "Notice of the General Administration of Customs on Public Comments on the Measures for the Supervision of Transit Goods by the Customs of the People's Republic of China (Draft for Comment)," *GAC website*, accessed 15 March 2022. Find it here.

3 "Provisions of the People's Republic of China on the Administration of Filing of Customs Declaration Entities (Order No. 253 of the General Administration of Customs)," *GAC website*, accessed 15 March 2022. Find it here.

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- **Record-filing cancellation**
  In any of the following circumstances, a customs declaration entity must complete the formalities of canceling record-filing with local customs:
  - Termination due to dissolution, bankruptcy, or other legal reasons
  - The business registration is canceled or revoked by the market supervision and administration authority.
  - The record-filing of the consignee or consignor of imported and exported goods as a foreign trade operator is invalid.
  - A temporary record-filing entity is disqualified for market entity status.
  - Other circumstances under which the record-filing should be canceled according to law.

Administrative measures related to the origin goods under the RCEP and approved exporters

The Regional Comprehensive Economic Partnership Agreement (RCEP) is a free trade agreement entered into by 15 signatory countries, including China.[4] It came into effect on 1 January 2022, for 10 countries (Australia, Brunei, Cambodia, China, Japan, Laos, New Zealand, Singapore, Thailand and Vietnam) and on 1 February 2022 for South Korea.

In anticipation of RCEP, on 23 November 2021, the GAC released the Administrative Measures of the Customs of the PRC on the Origin of Imported and Exported Goods under the RCEP (the Administrative Measures) via GAC Order [2021] No. 255 (Order 254). The Administrative Measures apply to the importation or exportation of originating goods among the members of RCEP that have approved the ratification of the RCEP agreement. A list of members in this category is published by the GAC and will be updated as changes occur.[5]

The Administrative Measures contain 44 articles in six chapters that provide details regarding the criteria of originating status, efficient administration of customs procedures, and procedures for the issuance of certificates of origin.

Under RCEP, certification of origin documentation also includes the declaration of origin issued by approved exporters. The detailed rules in this regard, including the criteria for approved exporters, application procedures, and issuance of the declaration of origin, are further stipulated in the Administrative Measures of the Customs of the PRC on Approved Exporters released via GAC Order [2021] No. 254 (Order 254) that were issued by the GAC on the same day. The rules stipulated for approved exporters in Order 254 also apply to approved exporters under other bilateral free trade agreements concluded by the PRC, e.g., the free trade agreement between China and Iceland.

Both the Administrative Measures and Order 254 came into effect on 1 January 2022.

Reform of customs guarantees

To promote trade facilitation, on 24 November 2021, the GAC released GAC Public Notice [2021] No. 100 (PN 100) to launch a reform of customs guarantee procedures (the Reform) on a nationwide basis, effective beginning on 1 December 2021.[6]

Key features of the Reform are as follows:

Before the Reform	Under the Reform
An enterprise was required to submit different types of guarantee letters to the supervising customs office for the customs guarantee for the following situations: ▸ Combined tax declaration ▸ Early discharge of goods where the relevant taxes have not yet been settled within the tax filing deadline ▸ Early discharge of goods before the determination of classification, dutiable price and origin of the import goods ▸ Early discharge of goods where the valid customs declaration forms and other documentation for the customs declaration are not available ▸ Early discharge of goods where other required customs-related procedures are not completed	Except for enterprises acting in bad faith (as classified by customs), all consignors and consignees of import/export goods can complete the record filing for customs guarantees for the abovementioned situations with one guarantee letter (i.e., the attachment of PN 100) and insurance letter for customs guarantee issued by the commercial bank or finance institution by sharing the total amount of guarantee limit.

4 RCEP signatories are Australia, Brunei, Cambodia, China, Indonesia, Japan, Laos, Malaysia, Myanmar, New Zealand, Philippines, Singapore, South Korea, Thailand and Vietnam.

5 "An overview of the chapters of the Regional Comprehensive Economic Partnership (RCEP)," *PRC Government website*, accessed 15 March 2022. Find it here. "Measures for the Administration of Origin of Imported and Exported Goods under the "Regional Comprehensive Economic Partnership Agreement" of the Customs of the People's Republic of China (Order No. 255 of the General Administration of Customs)," *GAC website*, accessed 15 March 2022. Find it here. "Measures for the Administration of Approved Exporters of the Customs of the People's Republic of China (Order No. 254 of the General Administration of Customs)," *GAC website*, accessed 15 March 2022. Find it here.

6 "Announcement No. 100 [2021] of the General Administration of Customs (Announcement on Deepening the Reform of Customs Tax Guarantee)," *GAC website*, accessed 15 March 2022. Find it here.

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With the launch of this reform, the total amount of guarantee limit in one guarantee letter can be used for all the above-mentioned matters. These measures are likely to be welcomed by enterprises as they should bring relief in both cash flow and administrative burden. Also, according to PN 100, the procedures for record-filing and the use of the guarantee limit all may be completed online, which is anticipated to further speed up the customs clearance process.



GAC issues further guidance on implementing RCEP and the Administrative Measures for approved exporters

As noted above, the RCEP free trade agreement, came into effect on 1 January 2022 for China and nine other signatories. The Administrative Measures of the Customs of the PRC on the Origin of Imported and Exported Goods under the RCEP were issued by GAC Order [2021] No. 25 (Order 25), and the GAC released GAC Public Notice [2021] No. 106 (PN 106) on 14 December 2021, to give further guidance on certain matters related to implementing the RCEP.[7]

The term "members of the RCEP" as prescribed in Order 25 and in PN 106 refers to the 10 countries that had already approved the ratification of the RCEP as of 1 January 2022, i.e., Australia, Brunei, Cambodia, China, Japan, Laos, New Zealand, Singapore, Thailand and Vietnam. Any changes to the list will be announced by the GAC under a separate public notice.

PN 106 also provides detailed procedures regarding the application of conventional tariff rates under the RCEP and other relevant processes regarding the application of certificates of origin, etc.

On 12 November 2021, the GAC released GAC Public Notice [2021] No. 105 (PN 105) to further elaborate on the Administrative Measures of the Customs of the PRC on Approved Exporters released via GAC Order [2021] No. 254 (Order 254) to cover areas related to the application, de-registration, and withdrawal of the status of approved exporters, etc.

7 "An overview of the chapters of the Regional Comprehensive Economic Partnership (RCEP)," *PRC Government website*, accessed 15 March 2022. Find it here. "Announcement No. 106 [2021] of the General Administration of Customs (Announcement on Matters Related to the Implementation of the Regional Comprehensive Economic Partnership Agreement)," *GAC website*, accessed 15 March 2022. Find it here. "Announcement No. 105 [2021] of the General Administration of Customs (Announcement on the Implementation of the "Administrative Measures for Approved Exporters of the Customs of the People's Republic of China")," *GAC website*, accessed 15 March 2022. Find it here. "Measures for the Administration of Origin of Imported and Exported Goods under the "Regional Comprehensive Economic Partnership Agreement" of the Customs of the People's Republic of China (Order No. 255 of the General Administration of Customs)," *GAC website*, accessed 15 March 2022. Find it here. "Measures for the Administration of Approved Exporters of the Customs of the People's Republic of China (Order No. 254 of the General Administration of Customs)," *GAC website*, accessed 15 March 2022. Find it here.

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Approved exporters should follow GAC regulations to issue declarations of country of origin to enjoy the benefits under various trade agreements, including the RCEP. Exporters who were approved before 31 December 2021, can still issue declarations of country of origin according to the original regulations issued before 31 March 2022.

PNs 106 and 105 both became effective on 1 January 2022.[8]

Guidance on the 2022 tariff adjustment

On 13 December 2021, the Customs Tariff Commission of the State Council released Shuiweihui [2021] No. 18 (Circular 18) regarding the 2022 tariff adjustment, which came into effect on 1 January 2022.

According to Circular 18, as of 1 January 2022, 954 import commodities are subject to temporary tariff rates, i.e., rates that are lower than the most-favored-nation tariff rates applied to these commodities before 1 January 2022. The temporary tariff rates that apply to seven information technology products will be canceled as of 1 July 2022. Eight categories of commodities, including wheat, will still be under the administration of the tariff quota. Importation of cotton outside the tariff quota is subject to sliding scale duty. Upon adjustment, the number of tariff items of the 2022 Customs Tariff of Import and Export Commodities will be increased to 8,930.

In this context, it is also worth noting that China reduced tariff rates beginning 1 January 2022 on certain commodities imported from the other nine countries that have already ratified the implementation of the RCEP. Details are specified in Appendix 5 of Circular 18.

Changes regarding key technological equipment entitled to import VAT and duty reliefs

According to Caiguanshui [2020] No. 2 (Circular 2)[9] regarding the Administrative Measures for Import-level Tax Policies on Key Technological Equipment (KTE) issued by the Ministry of Industry and Information Technology (MIIT), imported key components and raw materials for the production of encouraged KTE or products by qualified enterprises and nuclear power project owners are exempt from custom duty and import-level value-added tax (VAT).

On 10 December 2021, the MIIT and several other departments jointly released Gongxinbulianzhongzhuang [2021] No. 198 (Circular 198), adjusting the catalogs listing the KTE entitled to benefit from certain import-level tax policies.

Three catalogs were annexed to Circular 198, which took effect on 1 January 2022: the Catalog of State Encouraged KTE and Products (2021) (2021 KTE Catalog), the Commodity Catalog of Key Components and Raw Materials of KTE and Products (2021) (2021 Commodity Catalog) and the Catalog of Non-tax-exempt Imported KTE and Products (2021) (2021 Non-tax-exempt Catalog). Caiguanshui [2019] No. 38 (Circular 38), Notice regarding the adjustments to the catalogs of KTE that are entitled to certain import-level tax policies, was abolished at the same time.

Circular 198 also introduced transitional arrangements for enterprises and projects that were granted the right to preferential import-level tax policies on or before 31 December 2021, and that will import the KTE no later than 30 June 2022.

On the same day, the MIIT issued another notice, Gongcaihan [2021] No. 203 (Circular 203), to clarify certain matters related to applications by enterprises eligible for import-level tax policies related to KTE. The key points are discussed below.

Application conditions

An enterprise that applies for import-level tax policies for KTE must be an enterprise producing encouraged KTE or products, and must also meet all the following conditions:

- The enterprise is an independent legal entity.
- The enterprise did not commit any illegal or serious dishonest acts.
- The enterprise has its own core technology and intellectual property rights.

8 "Notice of the Customs Tariff Commission of the State Council on the tariff adjustment plan for 2022," *Ministry of Finance website*, accessed 15 March 2022. Find it here.

9 "Circular of the five departments on adjusting the relevant catalogs of the tax policy for the import of major technical equipment," *MIIT website*, accessed 15 March 2022. Find it here.

"Circular 203," *PRC Government website*, accessed 15 March 2022. Find it here.

"Circular on printing and distributing the measures for the administration of import tax policies for major technical equipment," *State Taxation Administration website*, accessed 15 March 2022. Find it here. "Circular on adjusting the relevant catalog of import tax policies for major technical equipment," *State Taxation Administration website*, accessed 15 March 2022. Find it here.



- The KTE and products associated with the application for the tax benefits should meet the relevant requirements of the Catalog of State Encouraged KTE and Products.

Application procedures

Applicant enterprises, including owners of nuclear power projects, must submit their applications to the local competent industry and information technology authorities. Applicant enterprises, including owners of nuclear power projects under a central enterprise group, must submit the applications to the MIIT through the group. The application deadline was 17 December 2021.

Tax-free importation by scientific research institutes

According to Caiguanshui [2021] No. 23,[10] the importation of production materials for scientific research, technological development and education purpose by qualifying entities is exempt from import-level customs duty, VAT and consumption tax. Qualifying entities include science and research institutions, technological development institutions, schools, party schools (schools of administration) and libraries. The importation of books and materials for scientific research and education purposes by publication import entities for science and research institutes, schools, party schools (schools of administration) and libraries is also exempt from import-level VAT.

To implement these policies,[11] the Ministry of Science and Technology (MOST), Ministry of Finance (MOF), GAC and State Taxation Administration (STA) jointly formulated the Administrative Rules on Tax-free Importation of Supplies for Scientific Research, Technology Development and Education by Scientific Research Institutes (hereinafter referred to as the Administrative Rules).

Under the Administrative Rules, various scientific research institutes (as defined below) may lodge an application to the relevant authorities. Once approved, they may apply to the competent customs authority for a tax reduction or exemption for imported supplies for scientific research, technology development and education. The authorized scientific research institutes are categorized as follows:

- **Scientific research institute**
  Central-level scientific research institutes are public institutes approved and established by the departments, commissions and people's organizations of central and state authorities, which are mainly engaged in basic research, public welfare research, and applied technology research and development.
- **Scientific research base**
  Scientific research bases are national laboratories, national key laboratories, national key enterprises laboratories, national technology innovation centers, national clinical medicine research centers and national engineering technology research centers that are approved by the MOST.

10 Caiguanshui [2021] No. 23 (Circular 23) Notice regarding the import-level tax policies for supporting technology innovation during the 14th Five-Year Plan period.

11 Released via Guokefazheng [2021] No. 270 on 30 September 2021.

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- **Transformed scientific research institute**
  Transformed scientific research institutes are engaged in scientific research and technology development, and they are transformed into enterprises.
- **Social research and development (R&D) institutes**
  Social technology R&D institutes may submit relevant materials to the competent authority to apply for tax exemption status.

Change and supervision

In the case of the division, merger, cancellation, or change of name or business scope of a scientific research institute, it can continue to enjoy the import tax policies supporting technology innovation from the date of registration of the change if it meets the criteria for tax exemption after the change, upon verification. Otherwise, it may no longer enjoy the policies from the date of registration of the change.

Any institute that undertakes fraudulent acts for the verification of its tax exemption status will no longer enjoy the import tax policies supporting technology innovation and must pay back the corresponding taxes that were reduced or exempted.

The Administrative Rules are effective from 1 January 2021 through 31 December 2025. Relevant scientific research institutes are advised to read the Administrative Rules carefully to fully utilize the benefits offered.

Public consultation and guidance on tax violations

In October 2021, the STA released a discussion draft to revise the prevailing Administrative Measures for the Information Disclosure of Significant Tax Violations and Taxpayers Acting in Bad Faith[12] (the Prevailing Measures). The consultation period ended on 30 October 2021.

The Discussion Draft includes 27 articles in five chapters and an appendix covering general principles, determination of taxpayers acting in bad faith, information disclosure and disciplinary measures, and remedy measures. Key proposed changes include the following:

- Revised standards for significant tax violations
  - Withholding or collecting tax but failing to pay the tax or paying less than the withheld/collected amount, where the outstanding tax payments exceeding RMB1 million, is a significant tax violation (newly added).

12 Released via STA Public Notice [2018] No. 54.

- Obstructing the collection of underpaid tax by the tax authorities by transferring or concealing assets, with the outstanding tax payments exceeding RMB1 million, also constitutes a significant tax violation (the threshold is RMB100,000 as prescribed in the Prevailing Measures).
- Another significant tax violation is issuing false tax invoices (other than special VAT invoices or other invoices falsely issued for export tax refund fraud or tax deductions) at 100 or more copies or an amount that exceeds RMB4 million (the threshold is RMB400,000 as prescribed in the Prevailing Measures).
- Stealing, intercepting, falsifying or selling data of tax invoices is a significant tax violation (newly added).
- Administrative sanctions are imposed by the tax authorities for illegal provision of bank accounts, invoices, certificates or other documents to taxpayers or withholding agents that result in underpayment or outstanding payment of tax exceeding RMB1 million or export tax refund fraud.
- Administrative sanctions are imposed by the tax authorities as authorized tax agents for violations of tax laws or administrative rules that result in underpayments or outstanding payment of tax that exceed RMB1 million (newly added).
- Determination of a party acting in bad faith

  A person shall be determined to be a party acting in bad faith if they have committed one of the prescribed significant tax violations and fall under any of the following circumstances:
  - The tax authority releases a notification of tax administration sanction, but the person fails to apply for administrative reconsideration within the prescribed time frame.
  - The person applies for tax administrative reconsideration but fails to file for administrative litigation within the prescribed time frame.
  - The people's court makes a valid ruling on one of the significant tax violations.
- According to Article 22 of the Discussion Draft, the remedy measures shall not apply to the following situations, unless one of the following prescribed exceptions applies:
  - The person received tax adjustments or administrative sanctions by the tax authorities for tax evasion, dodging tax payments demanded by the tax authorities, export tax refund fraud, anti-taxation, issuance of false tax invoices, etc., after having been found to be acting in bad faith.
  - The person was regarded as acting in bad faith twice or more in a five-year period.

In addition, the Discussion Draft proposed that if persons regarded as acting in bad faith settle their unpaid taxes, surcharges and penalties before their information is disclosed to the public, the tax authorities shall not make public disclosure of such information.

The changes proposed in the Discussion Draft[13] show the intent to not only tighten the standards for significant tax violations but also to provide remedy measures and opportunities for persons acting in bad faith to avoid having their information made public.

Sixth set of exclusions for US goods imposed with additional tariffs

According to Customs Tariff Commission Public Notice [2020] No. 10 (PN 10) (regarding extending the second set of exclusions to the goods originating from the United States that are imposed with the first round of additional tariffs) and Customs Tariff Commission Public Notice [2021] No. 5 (PN 5) (regarding extending the fourth set of exclusions to the goods originating from the United States that are imposed with additional tariffs), additional tariffs against the United States' Section 301 tariffs would not be imposed on these goods until 25 December 2021. On 24 December 2021, the Customs Tariff Commission released Customs Tariff Commission Public Notice [2021] No. 9 (PN 9) to extend the exclusion.[14]

13 "Measures for the administration of the publication of information on untrustworthy entities in major tax violations (draft amendments for solicitation of comments)," *STA website*, accessed 15 March 2022. Find it here. "Announcement on the promulgation of the measures for the publication of information on cases of major tax violations and untrustworthiness," *STA website*, accessed 15 March 2022. Find it here.

14 "Announcement of the Customs Tariff Commission of the State Council on the Sixth Exclusion Extension List of Tariffs on US and Canada Commodities," *PRC Government website*, accessed 15 March 2022. Find it here.

"Announcement of the Customs Tariff Commission of the State Council on the Second Exclusion Extension List of Tariffs on US and Canada Commodities," *MOF website*, accessed 15 March 2022. "Announcement of the Customs Tariff Commission of the State Council on the Fourth. Find it here.

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As a result, six types of goods listed in the attachment to PN 10 and 79 types of goods listed in the attachment of PN 5 continued to be excluded from additional tariffs against the United States' Section 301 measures from 26 December 2021 to 31 December 2021, while 124 types of goods listed in the attachment to PN 9 continue to be excluded from additional tariffs against Section 301 measures from 1 January 2022 to 30 June 2022.

Comprehensive bonded zones

To regulate the administration of comprehensive bonded zones (CBZs) by the customs and promote the opening up and development of CBZs, the GAC released the Administrative Measures of the Customs of the People's Republic of China (PRC) on CBZsvia GAC Order [2021] No. 256 (Order 256) on 1 January 2022. Key features of the Administrative Measures are as follows:

Scope of business activities

Enterprises in CBZs can carry out various business activities according to law such as research and development, processing, manufacturing, maintenance, goods storage, financial leasing, cross-border ecommerce, entrepot trade, etc.

Entry and exit of goods

- The entry and exit of goods between CBZs and overseas are not subject to tariff quotas and license administration. Consignees, consignors or agents should truthfully declare the goods to the customs, fill in the record-filing list of entry and exit of goods, and complete the relevant formalities in accordance with the customs regulations.
- The customs levy import-level duties and taxes on the means of transport and consumer goods entering CBZs for the self-use of enterprises and administrative institutions in the zones. Unless otherwise prescribed by laws and regulations, goods transported abroad from CBZs are exempt from export duties.
- For goods entering and exiting CBZs within the territory of the PRC, enterprises in CBZs or consignees and consignors outside CBZs should pay duties and import-level taxes according to the actual status of the goods when entering and exiting CBZs. Goods circulating between CBZs and other special customs supervision areas or bonded supervision sites are exempt from duties and import-level taxes.

Administration of goods in the CBZs

- Where enterprises transfer or circulate goods in a CBZ, both parties should submit electronic information such as the name, quantity and amount of the goods to the customs in a timely manner.
- Where enterprises in CBZs transport their own machines, equipment and parts outside the CBZ for testing and maintenance in accordance with the customs regulations, the machines, equipment and parts must not be used for processing, production and use outside CBZs during the prescribed period and must be returned to the CBZ within 60 days from the date of exit. Where the machines, equipment and their parts cannot be returned on time, enterprises can apply for an extension. The extension period shall not exceed 30 days.



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- Where enterprises in CBZs transport molds, raw materials and semi-finished products out of the CBZ for outward processing in accordance with customs regulations, the outward processing period must not exceed the validity period of the contract, and the processed goods must be returned to the CBZ as scheduled.

Administration of enterprises in CBZs

Enterprises and their branches in CBZs should obtain the market entity qualification, complete the registration or record-filing formalities with customs according to law, cooperate with customs in inspection, and truthfully provide relevant books, documents and other materials and electronic data.

Order 256 become effective on 1 April 2022. Relevant enterprises in CBZs are advised to read Order 256 carefully and observe the regulations.[15]

Supplementary items to the RCEP agreement

On 9 January 2022, the Customs Tariff Commission released Customs Tariff Commission PN [2022] No. 1 (PN 1), announcing the application of the preferential tariff rates under the RCEP to certain imported goods (as indicated in the attachment of PN 1) originated from South Korea, effective from 1 February 2022.

Subsequent to issuing PN 1, the GAC released GAC PN [2022] No. 8 (PN 8) on 20 January 2022, to supplement the prevailing Administrative Measures of the General Customs of the PRC on the Origin of Imported and Exported Goods under the RCEP released via GAC Order [2021] No. 255 (Order 255) as follows:

- Include South Korea on the list of member countries as prescribed in Article 2 of Order 255
- Include the List of Special Goods Exported to South Korea on the List of Special Goods as prescribed in Article 14 of Order 255

Both PN 1 and PN 8 became effective on 1 February 2022.[16]

Regulations for Hainan FTP

On 24 December 2021, the MOF, STA and GAC jointly released Caiguanshui [2021] No. 49 (Circular 49) to adjust the zero-tariff policy for raw and auxiliary materials for the Hainan Free Trade Port (FTP).[17]

Key features of Circular 49 include:

- In total, 187 commodities have been added to the list of raw and auxiliary materials subject to the zero-tariff policy for the Hainan FTP.
- Other rules of the zero-tariff policies for raw and auxiliary materials as stipulated in Caiguanshui [2020] No. 42 (Circular 42), Notice regarding the zero-tariff policy for raw and auxiliary materials for the Hainan FTP, shall be continuously implemented.

Relevant authorities of Hainan Province will evaluate the needs of industries in view of the development of Hainan FTP and the requirements for ecological and environmental protections, and they will guide enterprises to make rational use of zero-tariff raw and auxiliary materials.

Expanding the application of policies for the Yangpu Bonded Port Area

To further promote the construction of Hainan FTP, on 30 December 2021, the GAC released PN [2021] No. 120 (PN 120) to expand the policies applied to Yangpu Bonded Port Area (under PN [2020] No. 73 regarding the Regulatory Measures of Customs of the PRC for the Yangpu Bonded Port Area) and PN [2020] No. 109, Notice regarding the statistical

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15 "Measures for the Administration of Customs Comprehensive Bonded Areas of the People's Republic of China (Order No. 256 of the General Administration of Customs)," *GAC website*, accessed 15 March 2022. Find it here.

16 "Overview of the Chapters of the Regional Comprehensive Economic Partnership (RCEP)," *PRC website*, accessed 15 March 2022. Find it here. "The Customs Tariff Commission of the State Council on the implementation of some imported goods originating in South Korea; Announcement on the Agreement Rates of the Regional Comprehensive Economic Partnership (RCEP)," *MOF website*, accessed 15 March 2022. Find it here. "Announcement No. 8 [2022] of the General Administration of Customs (Announcement on Announcement of New Matters for the Implementation of the Regional Comprehensive Economic Partnership Agreement), *GAC website*, accessed 15 March 2022. Find it here. "Measures for the Administration of Origin of Imported and Exported Goods under the "Regional Comprehensive Economic Partnership Agreement" of the Customs of the People's Republic of China (Order No. 255 of the General Administration of Customs)," *GAC website*, accessed 15 March 2022. Find it here.

17 "Notice of the Ministry of Finance, the General Administration of Customs, and the State Administration of Taxation on Adjusting the "Zero Tariff" Policy for Raw and Auxiliary Materials in Hainan Free Trade Port," *MOF website*, accessed 15 March 2022. Find it here. "Notice on the "Zero Tariff" Policy for Raw and Auxiliary Materials of Hainan Free Trade Port," *MOF website*, accessed 15 March 2022. Find it here.

method for Yangpu Bonded Port Area) to the Haikou Comprehensive Free Trade Zone and the Haikou Airport Comprehensive Free Trade Zone.[18]

The main features of the policies that have been extended to the Haikou Comprehensive Free Trade Zone and Haikou Airport Comprehensive Free Trade Zone include the following:

- Sales of goods produced by enterprises engaging in encouraged industries to domestic areas shall be subject to import level VAT/consumption tax but exempt from import-level custom duty if one of the following is true:
  - The products were not made from any imported materials/parts.
  - The products were made from imported materials/parts, but an increase of 30% of the goods' value from processing took part in Yangpu Bonded Port Area.

According to the Overall Plan for the Construction of the Hainan Free Trade Port (the Plan), it is expected that the above policies will be applicable to the whole island of Hainan by 2025. ■



18 "Announcement No. 120 [2021] of the General Administration of Customs (Announcement on Expanding the Application Scope of the Policy System of Yangpu Free Trade Port Area)," *GAC website*, accessed 15 March 2022. Find it here. "Announcement No. 73 [2020] of the General Administration of Customs (Announcement on Issuing the Measures for the Supervision of Yangpu Bonded Port Area by the Customs of the People's Republic of China)," *GAC website*, accessed 15 March 2022. Find it here. "Announcement No. 109 [2020] of the General Administration of Customs (Announcement on the Statistical Measures for Yangpu Free Trade Port Area)," *GAC website*, accessed 15 March 2022. Find it here. "The Central Committee of the Communist Party of China and the State Council issued the overall plan for the construction of Hainan Free Trade Port," *PRC Government website*, accessed 15 March 2022. Find it here.

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Japan: Annual report on post-entry customs



The Japan Ministry of Finance has released a report[1] in respect of post-entry customs audits that were conducted between July 2020 and June 2021. These annual reports are useful sources of information for importers as they highlight the focus areas of Japan Customs' audits and where compliance errors often occur. In particular, the cases highlighted in the report provide useful information on areas where companies may overlook their compliance obligations and, where appropriate, they may wish to address these issues proactively.

In this latest report, Japan Customs found that the customs value of imports into Japan was underdeclared by more than JPY63 billion, which is approximately a 50% decrease in value compared to the previous year. However, this decrease may be partly explained by the decline in the number of audited importers (approximately 21.3% of the previous fiscal year). In total, Japan Customs assessed a total of JPY6.7 billion in underpaid duties/taxes and administrative penalties, which includes JPY130 million in penalties for fraud or gross negligence.

The top five categories

The top five imports with the largest underpayment of customs duty and import consumption tax are listed, by Harmonized System (HS) Chapters, in the table below:

Imports (HS Chapter)	Duty/tax shortfall (JPY billions)
Optical instruments and apparatus (Chapter 90)	1.7
Electrical equipment (Chapter 85)	1.3
Machinery and mechanical appliances (Chapter 84)	0.4
Sugars and sugar confectionery (Chapter 17)	0.4
Articles of apparel and clothing accessories not knitted or crocheted (Chapter 62)	0.4

1 "The result of post-entry customs audits regarding declarations of customs duties, etc., that were conducted between July 2020 and June 2021," *Japan Ministry of Finance website*, accessed 16 March 2022. Find it here.

Together, these five chapters account for about 65% of the total underpaid duties and taxes. Three of the top five imports have been on the list for the last three years, these being optical instruments and apparatus (Chapter 90), electrical equipment (Chapter 85), and machinery and mechanical appliances (Chapter 84), and the underpaid duties/taxes for these items were JPY1.7 billion, JPY1.3 billion and JPY0.4 billion, respectively. In particular, electrical equipment (Chapter 85) and optical instruments and apparatus (Chapter 90) have been repeatedly listed in the top five. However, two of this year's categories, sugar and sugar confectionery (Chapter 17) and articles of apparel and clothing accessories (not knitted or crocheted) (Chapter 62), have not been in the top five for the past several years.

Major examples of customs violations

The report published by the Ministry of Finance also highlighted some specific cases where importers were subjected to additional duties. These cases concern two types of violation: cases not involving fraud or gross negligence and cases that do involve fraud or gross negligence.

Cases not involving fraud or gross negligence

In cases not involving fraud or gross negligence, importers are required to pay the underpaid duties/taxes, as well as administrative penalties, which are generally imposed at a rate of 5% to 15% of the underpaid duties/taxes[2] and overdue taxes (interest for late payment).

- **Case 1: Failure to report dutiable costs of molds**
  An importer of automobile parts from Vietnam supplied parts and materials as well as molds. However, as the importer provided the molds for free, they failed to include the value of molds as a part of the customs value. Due to this oversight, the importer was found to have underdeclared by a total of JPY 542.1 million and was assessed a total of JPY 58.2 million in underpaid taxes and administrative penalties.

- **Case 2: Error in declaration of goods imported on consignment from nonresidents**
  An importer of furniture products from China was responsible for customs clearance procedures and domestic transportation of furniture products and other items to be sold by a nonresident on an e-commerce site in Japan. However, the customs value was determined using an inappropriate calculation method and was declared based on the invoice prepared by the exporter. As a result, the importer was found to have underdeclared by a total of JPY241 million and was assessed a total of JPY22 million in underpaid taxes and administrative penalties.

Cases involving fraud or gross negligence

In cases involving fraud or gross negligence, importers are required to pay penalties for fraud or gross negligence that are generally imposed at a rate of 35% to 40% of the underpaid duties/taxes.

- **Case 3: Declaration of falsified invoice created by importer**
  An importer of pet products from China created invoices with lower prices for declaration purposes and declared these as the customs value, despite being aware of the appropriate prices of the imported goods prior to filing declarations. This resulted in a total of JPY89.8 million in underdeclared customs value and a total of JPY16.5 million assessed underpaid taxes and administrative penalties, of which JPY4.1 million.

- **Case 4: Declaration of lower value of imported goods**
  An importer of clothing from China declared the lower prices written in the invoices as the customs value, despite being aware of the appropriate prices of the imported goods prior to filing declarations. The importer did not take any corrective action and intentionally declared these lower prices as the customs value to evade tax. As a result, the importer was found to have underdeclared by a total of JPY35.9 million and was assessed a total of JPY7.9 million in underpaid taxes and administrative penalties, of which JPY1 million was a penalty for fraud or gross negligence.

2 In addition, in the case of a deficient declaration, if an incremental tax after the correction of customs declaration exceeds the amount of the principal tax or JPY0.5 million (whichever is greater), an additional tax for deficient declaration shall be collected at the rate of % of the excessive amount. If, in the case of no declaration, the tax amount payable under the decision exceeds JPY0.5 million, an additional tax for no declaration shall be collected at the rate of 5% of the excessive amount.

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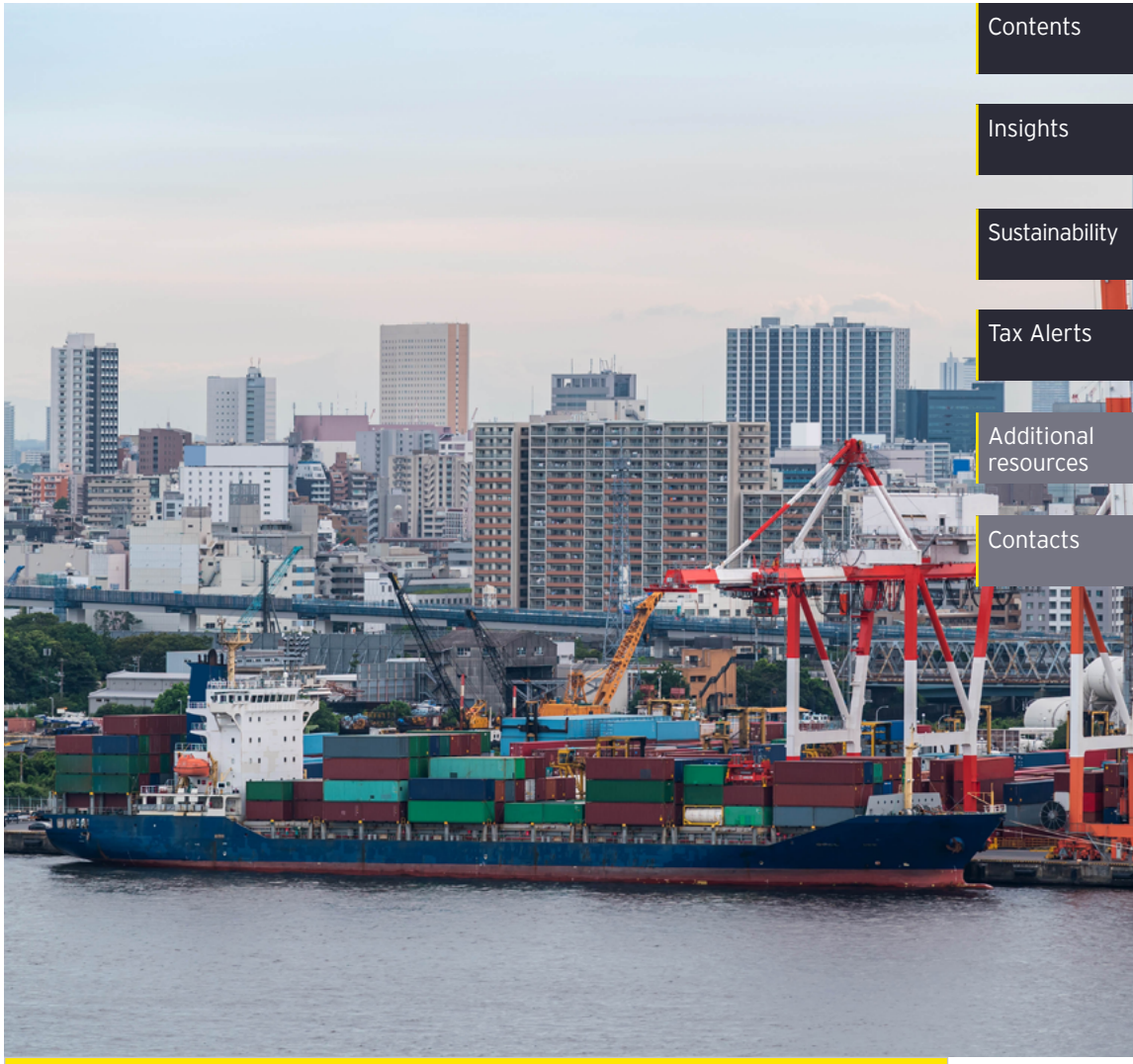
Implications for importers

The cases highlighted above reinforce the continued focus by Japan Customs on the declared import value and the importance of correctly declaring the customs value in accordance with Japanese Customs Tariff Law.

It is important to mention that the failure to declare payments that have been made separately from invoice price as part of the customs value has been reported as an issue continuously in past reports. This error can be seen in the examples cited in this year's report. In Case 1, the importer should have included the costs of molds in the declared customs value. In Case 2, the importer should have accurately reported the customs value instead of determining the value based on the invoice prepared by the exporter. In addition to these cases, the Ministry of Finance has also reported that cases in which importers fail to report the costs of materials provided by them to the exporters are quite prevalent when such materials were provided free of charge.

As illustrated in the cases above, it is crucial that importers understand the Japanese Customs Tariff Law, and declare appropriate customs values or file amended declarations in accordance with that law.

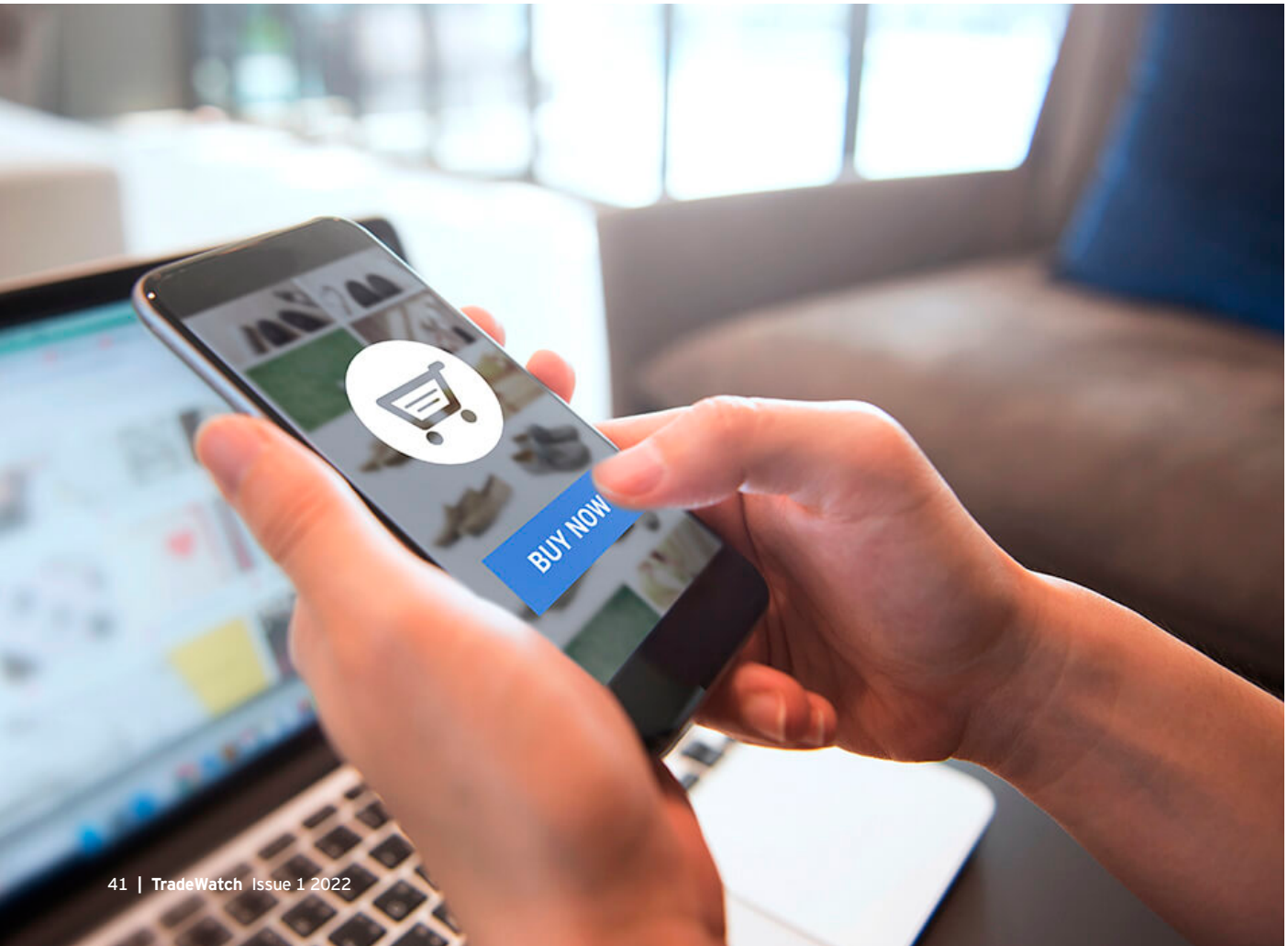
Importers into Japan should be aware that Japan Customs continues to rigorously and regularly check and enforce compliance, and any instances of noncompliance identified are penalized. As such, maintaining appropriate internal compliance mechanisms and processes to enable compliance with import and export legislation should be a top priority for companies that import goods into Japan. ■



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Belgium and Germany: Issues for e-commerce sellers to consider for imported goods



On 1 July 2021, the European Union (EU) introduced a new set of value-added tax (VAT) rules for dealing with cross-border sales of goods to private consumers. The new rules apply to sales made within the EU (intra-Community distance sales) and imports of goods from outside the EU (distance sales of imported goods).

Broadly, as a result of the reform, VAT applies to all business-to-consumer (B2C) sales of goods in the EU, with the tax payable in the country where the customer is a resident. The package also introduced obligations for online marketplaces and options for simplified reporting for low-value consignments, including a special scheme for distance sales of goods imported from third countries into the EU (the Import One-Stop Shop (IOSS)) and a simplified procedure for goods imported via postal carriers and couriers. Details about the new rules were outlined in TradeWatch Issue 2 2021.

However, not all aspects of the new rules have proven simple for e-commerce businesses to understand or follow. In this article, we consider some practical issues for e-commerce sellers to consider related to distance sales of goods imported from outside the EU, with specific references to Belgium and Germany.

1. Challenges in Belgium

Importer of record

Due to the implementation of the e-commerce VAT package, Belgium and other EU Member States also updated their respective legal provision that describes who can act as an importer of record.

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With effect from 1 July 2021, the provision sets out a new rule to determine the importer of record for the distance sale of imported goods into Belgium – either for sale to a customer located there or for sale to a customer located in another Member State.

Under the main customs rule, when goods are imported into Belgium, the consignee is liable to settle any import VAT that is due. In principle, this can be the recipient of the goods, the supplier of the goods, or a previous supplier of the goods (if specific conditions are met). However, when the import relates to a distance sale of goods, as a result of the updated legal provision, additional aspects now need to be considered, including the value of the consignment of the goods, as well as how the import VAT will be settled.

The intrinsic value of the goods

In assessing the intrinsic value of the consignment of goods, a distinction is made between the following:

- An importation of goods (other than excise goods), qualifying as an import distance sale, where the consignment of the goods has an intrinsic value higher than EUR150.
- An importation of goods (other than excise goods), qualifying as an import distance sale, where the consignment of the goods has an intrinsic value equal to or less than EUR150.

Importation of goods with an intrinsic value higher than EUR150

For the importation of consignments with an intrinsic value higher than EUR150, it is necessary to determine whether the distance sale of imported goods takes place in Belgium or in another EU Member State.

If Belgium is the Member State of importation and arrival of the goods, the general rule applies for determining the importer of record (that is, either the supplier or the recipient of the goods can be appointed as importer of record). However, if the goods imported through Belgium are destined for another EU Member State, the Belgian VAT legislation sets out that only the supplier can be appointed as importer of record.

Importation of goods with an intrinsic value of EUR150 or less

If the consignment of the goods has an intrinsic value equal to or lower than EUR150, the importer of record will depend on the settlement regime that has been chosen to settle the import VAT. In this respect, there are three possible options:

1. The supplier has opted to register for the IOSS, which requires the supplier to act as importer of record.
2. The simplified import procedure requires the final customer to act as importer of record, with the import VAT collected from the customer and reported by the courier or postal service.
3. The normal regime (i.e., neither the IOSS nor the simplified import procedure issued) requires that the supplier be deemed to act as the importer of record.

VAT obligations and pricing

Determining who is the importer of record is one aspect for e-commerce sellers to consider, but it is not the only one. Depending on who is acting as importer of record and other relevant aspects (such as the intrinsic value of the consignment and the import VAT settlement regime), other VAT chargeability and liability rules are likely to be triggered. This, in turn, has an impact on VAT registration and VAT reporting obligations. One crucial consideration is setting the prices of the products in the web shop, based on whether the supplier must charge VAT.

Import declarations

Furthermore, if the supplier wishes to use the IOSS regime, it should be aware that it can only be applied when the imported goods are declared by means of an H7 super-reduced dataset customs declaration.

Conclusions

E-commerce businesses that sell imported goods to EU customers need to be fully aware of the legislative and practical issues they may encounter following the VAT e-commerce reform. The updated Belgian legal provisions regarding who can act as importer of record after 1 July 2021, is one important example of the complexity that e-commerce traders face in this area. Sellers that supply distance sales of goods to final consumers in the EU should carefully assess all the relevant logistics and customs aspects of their sales to understand their impact and the options they may have for accounting for VAT.

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2. Challenges in Germany

Along with the challenges in Belgium, there is an additional risk regarding the correct VAT treatment of B2C e-commerce supply chains for which no IOSS clearance is used from a non-EU seller to German customers where goods are sold under Incoterm Delivered Duty Paid (DDP). In such supply chains, typically the seller collects the all-in price (including anticipated import duties) when the customer is ordering goods. Customers also have to accept the general terms and conditions before ordering goods. These general terms and conditions of the seller typically contain a clause according to which the customer authorized the seller to import the goods in the name of and on behalf of the customer.

Thus, the seller assigns a logistic provider with shipping and customs clearance. Although engaged by the seller, logistic service providers often lodge the customs declaration as a direct representative of the customer.



Customs declarant

From a customs perspective, any person who fulfills the legal requirements established in Article 170 of the Union Customs Code (UCC) can act as customs declarant. With respect to the release of goods into free circulation (imports), the customs declarant shall be a person who satisfies [one/both] of the following:

1. Is able to provide all of the information that is required for the application of the provisions governing the customs procedure in respect of which the goods are declared (Article 170 para. 2 of the UCC)
2. Is established in the customs territory of the Union (Article 170 para. 2 of the UCC)

In a B2C DDP transaction, this person is typically the non-EU seller of the goods. However, from a customs law perspective, it could also be any other person who is established in the EU and who has the information needed for the declaration process (e.g., the customer). In addition, the customs declarant can appoint a customs representative (Article 18 para. 1 of the UCC) to lodge the customs declaration. But, if the customs representative acts without authorization (i.e., the customs power of attorney), the customs representative shall be deemed to be acting in its own name and on its own behalf.

VAT regulations

From a German VAT perspective, the customs declarant becomes debtor of the import VAT. In addition, if the goods supplied are transported or dispatched to Germany from a non-EU territory, the

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place of supply of such goods shall be deemed to be in Germany, if the supplier or his agent is liable for import VAT (Section 3 para 8 of the German VAT Act). This means that, in addition to the import itself for which import VAT arises, there would be a local taxable supply from the seller of the goods to the customer of the goods, if the seller or his agent is debtor of the import VAT.

This regulation is decisive with regard to B2C distance selling imports, but it does not sufficiently clarify who should be regarded as the person designated or recognized as liable for payment of the import VAT within the meaning of Section 3 para 8 of the German VAT Act. But, in three decisions, the German Federal Fiscal Court has taken the view that the person designated or recognized as liable for payment of the import VAT is the seller and not the receiver (customer) of the goods, although the customer was named as customs declarant in the customs declaration. In all three cases, the seller's general terms and conditions contained a clause according to which the customer authorized the seller to import the goods in the name of and on behalf of the customer. The German Federal Fiscal Court concluded that the clauses in the terms and conditions are not a valid authorization but rather an invalid surprise clause within the meaning of Section 305c of the German Civil Code.

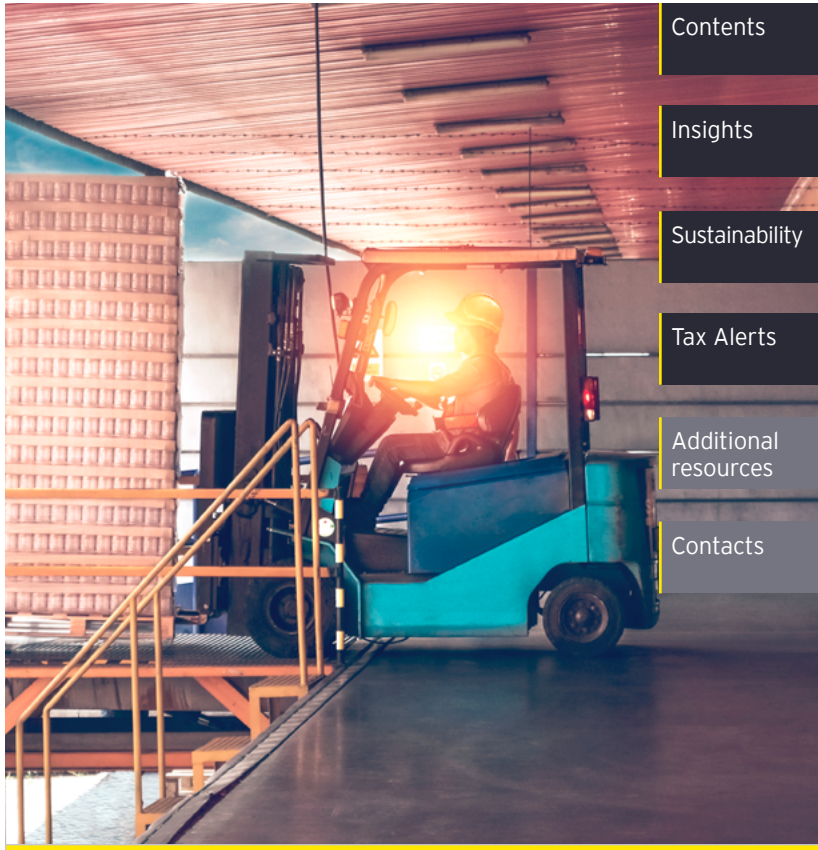
Risks

With that in mind, for B2C distance selling imports, we recommend that businesses implement processes to validate that the involved customs service provider is only acting as a representative of the receiver if a sufficient legal authorization is in place (which must be granted actively from the receiver). In this regard, general clauses on customs representation within the general terms and conditions are not sufficient.

Otherwise, the following scenarios could lead to a local VAT taxable supply after the goods have been released into free circulation (imported):

1. The seller of the goods is acting as customs declarant.
2. The customs representative is entering the buyer of the goods as customs declarant in the import declaration, but there is no sufficient authorization for customs representation in place.

In both scenarios, the seller would have to register for VAT purposes in Germany and report the local sale to the receiver in its monthly VAT returns. The invoices to the recipients should accordingly show local VAT. If the seller does not report the applicable VAT, tax authorities might regard the seller as evading VAT. It's worth noting that there are tax offices in Germany that specifically focus on sales foreign of e-commerce sellers supplying to German customers. ■



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EU Commission proposes instrument against economic coercion

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In December 2021, the European Union (EU) Commission (the Commission) published a proposal to counter the use of economic coercion by third countries.[1] The Commission has said that this legal instrument is in response to the fact that the EU and its Member States have become the target of deliberate economic pressure by countries outside the EU in the recent past. The Commission states that the EU does not currently have an instrument that specifically targets coercion. It also states that the EU needs an appropriate instrument to deter and counteract economic coercion by non-EU countries and that this is necessary to protect the rights and interests of both the EU and its individual Member States.

According to the Commission, the proposed legislation provides predictability and transparency. It shows the EU's adherence to a rules-based approach, while having a deterrent effect on possible coercion by non-EU countries. The legislative

1 Proposal for a Regulation of the European Parliament and of the Council on the protection of the Union and its Member States from economic coercion by third countries, 8 December 2021, COM (2021) 775 final.

framework is under the common commercial policy of the EU and offers the EU the possibility for swift and efficient action.

Economic coercion

The Commission defines economic coercion as a situation in which a non-EU country tries to influence either the EU or one of the individual Member States to take a specific policy choice by applying, or threatening to apply, measures affecting trade or investment. One recent example of this is the imposition of additional import duties by the United States on French wine in response to the digital services tax imposed by France. Under the proposal, this type of situation could be regarded as economic coercion and could trigger the prescribed countermeasures, which are described below.

Possible measures

When a non-EU country conducts economic coercion, the EU will first directly engage with the relevant country in an effort to end it. If the economic coercion does not stop immediately, the proposed legislation allows the EU to react swiftly and effectively. It also provides for a proportional response for each situation. Measures described in Annex I to the proposal include the following, among others:

- The suspension of any tariff concessions and the imposition of new or increased customs duties, including the re-establishment of customs duties at the most-favored-nation level or the imposition of customs duties beyond the most-favored-nation level, or the introduction of any additional charge on the importation or exportation of goods.
- The suspension of applicable international obligations, as necessary, and the introduction or increase of restrictions on the importation or exportation of goods, whether made effective through quotas, import or export licenses or other measures, or on the payment for goods.
- The suspension of applicable international obligations and the introduction of restrictions on trade in goods made effective through measures applying to transiting goods or internal measures applying to goods.

Restrictions on services and investments are also mentioned in the Annex as possible measures against non-EU countries that apply economic coercion.

According to Annex II to the proposal, the origin rules as included in the Union Customs Code will apply in determining whether tariff measures apply to stop economic coercion.



Next steps

The next step in the legislative process is a discussion within the European Parliament and in the Council of the European Union. After that, the proposal can be adopted, taking into account any amendments made by these institutions. ■

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EU: Special focus on valuation aspects under the transitional PEM rules of origin



In TradeWatch, Issue 3 2021, we discussed the revised Pan-Euro-Mediterranean (PEM) preferential rules of origin, commonly referred to as transitional rules that entered into force on 1 September 2021.

These transitional rules contain a number of improvements and simplifications to the Regional Convention on Pan-Euro-Mediterranean preferential rules of origin (PEM Convention).

At the time of writing, the new rules are applicable, in an initial stage, for trade between the EU and Albania, Faroe Islands, Georgia, Iceland, Jordan, Palestine, Norway, Switzerland, North Macedonia, Republic of Moldova, and Serbia.

The adoption of the amendments to the bilateral protocols on rules of origin with Bosnia and Herzegovina, Egypt, Israel, Kosovo, Lebanon, Montenegro, Turkey and Ukraine is ongoing, but they are each at different stages of progress.

The transitional rules apply alternative rules of origin to those of the PEM Convention, which continues to fully apply among all PEM contracting parties. The rules apply on an optional basis, pending the adoption of the revision of the PEM Convention.

Calculation option based on average values

Although the goal of the new rules is simplification, they bring additional challenges in practice. These challenges are demonstrated in the calculation of the value of non-originating materials and ex-works prices of products.

Similar materials may be sourced at different purchase prices over time, and similar products may be sold to different customers at different sales prices. For the calculation of value limitation under the current PEM Convention, the specific ex-works price as well as the actual value of the non-originating materials for each consignment must be considered.

Likewise, under the transitional PEM rules, the preferential status determination must also be carried out for each individual product. However, when assessing if a product complies with a value limitation for non-originating materials, the transitional PEM rules offer the exporter the option of calculating the ex-works price and the value of non-originating materials on an average basis, taking account of fluctuations in costs and currency rates, and this may provide exporters with more predictability.

Pre-authorization requirement

Using a calculation based on an average basis requires pre-authorization by the customs authorities.

The wording of the provision is explicitly aimed solely at exporters. However, the European Commission's guidance clarifies the applicability of this method to the issuance of suppliers' declarations for supplies within the EU.

If an exporter opts for the calculation based on average values, it must consistently apply this method during the year following the fiscal year of reference or, where applicable, for a shorter period used as a reference.

If an exporter opts for the calculation based on average values, both the average ex-works price of the same product and the average value of the non-originating materials used to produce those products must be calculated. Determining only the average ex-works price or only the average value of the non-originating materials used is not permitted.

Moreover, the simplification must be consistently applied for all products and non-originating materials the company is handling. Using this simplification only for specific goods is prohibited.

Exporters may opt out of applying the average method under specific conditions if they record that the fluctuations in costs or currency rates that justified the use of such a method have ceased.

Averaging provisions

The average ex-works price of the product and average value of non-originating materials used must be calculated on the basis of the sum of the ex-works prices charged for all sales of the same products carried out during the preceding fiscal year and the sum of the value of all the non-originating materials used in the manufacture of the same products over the preceding fiscal year.

If figures for a complete fiscal year are not available, a shorter period may be applied, which must not be less than three months.

Averaging periods

For those calculating the average ex-works price, the date of invoicing is decisive. If the invoice is issued in the reference period, the ex-works price must be included in the sum of the ex-works prices charged for all sales of the same products.

However, as far as materials are concerned, if they have a longer storage period, the average value of non-originating materials must also include materials sourced in earlier years to determine the average value if the materials are used in the manufacture of the products sold in the preceding fiscal year.

Consequently, economic operators need to trace the original value of the materials that were actually used in production in the fiscal year of reference. If this is not possible, reasonable worst-case assumptions must be made to determine an average value of non-originating materials for the year following the fiscal year of reference.

Valuation basis for materials used

Under the transitional rules, no changes were made to the definition of the value of materials.

The primary valuation basis forms the customs value at the time of importation of the non-originating materials used. The first ascertainable price paid for the materials may only be used if the customs value is not known and cannot be ascertained.

Challenges are common in practice in determining the customs value for the purpose of calculating the average value of non-originating materials or directly determining the non-originating value of an individual component.

If elements that constitute part of the customs value (such as materials supplied free of charge for use in connection with production or low-quantity surcharges) are not broken down at an item level and are therefore not included in the material price in the master data, reasonable worst-case assumptions need to be made and accounted for in determining the origin determination.

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Implications for the proof of origin

There is no interchange between the current PEM Convention and the transitional rules. Therefore, if an exporter calculates the ex-works price and the value of non-originating materials on an average basis, the origin has to be determined exclusively in accordance with the revised rules.

This principle also applies with respect to originating materials used as components in production, for which the origin has to be acquired and proven in accordance with the transitional rules of origin.

Supplier's declarations therefore must specify the applicable rules according to which the product is originating, and, in particular, must state whether the rules of origin complied with are those of the PEM Convention, the transitional rules, or both.

Context of trade agreements outside the PEM area

Apart from the transitional PEM rules, only a few preferential regulations permit calculation based on average prices.

One of these is the Generalized Scheme of Preferences (GSP) for certain developing countries and another is the Trade and Cooperation Agreement (TCA) between the EU and the UK.

Under the TCA, the value of non-originating materials used in production may be calculated on the basis of the weighted average value formula or other inventory valuation method under accounting principles that are generally accepted by the exporting party.

Application of average ex-works prices under the TCA is not possible. In contrast, if a business opts for averaging under the transitional PEM rules, average values must be determined both for the ex-works price and for the value of non-originating materials.

Consequently, when assessing whether a product qualifies with originating status under the TCA agreement on the one hand and under the PEM transitional rules on the other, it is not sufficient to simply determine whether the value of non-originating materials does not exceed a given percentage of the ex-works price of the final product under the applicable rule. In addition, businesses must determine whether the valuation method applied is accepted under the agreement in question. Therefore, careful consideration and thoughtful configuration of the origin calculation method used is essential to meet the particular rules of the different agreements in terms of valuation.

Outlook and need for action

Although the revised, more flexible PEM rules were created to simplify their application for economic operators, the effort and possible limitations must be evaluated before they decide whether to apply the new transitional rules.

It is prudent to evaluate the implications of the revised rules on the originating status under the transitional PEM agreement and potential adverse effects considering the full set of trade agreements to which the EU is a party.

For economic operators applying numerous preferential agreements, the benefit of the simpler rules may be limited until all the agreements used allow the application of comparable rules.

For businesses trading with different countries within the PEM area or whose trade is covered by another trade agreement, it is important to validate that appropriate procedures are adopted to differentiate between the two sets of rules while maintaining the requirements under the trade agreements outside the PEM area.

Further developments on the applicability of the revised PEM rules with the different agreement partners should be continuously monitored, and the implementation of those rules within the organization should be planned with consideration. ■

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EU Trade Policy: from policymaking to effective enforcement

In February 2021, the European Union (EU) announced **a review** of its trade policy. The reviewed trade policy aims to create an open strategic autonomy for the EU and focuses on sustainability, the transformation of the EU economy in line with its green and digital objectives and increasing the EU's ability to pursue its interests and enforce its rights autonomously.

Over the last few months (and even before the adoption of the Trade Policy review), EU institutions have been working on several pieces of EU legislation that reflect the EU's desire to defend its values and interests more forcefully. This reflects a shift in priority from negotiating preferential trade agreements to enforcing and implementing trade commitments. Moreover, the European Commission (the Commission) has also published several reports[1] to illustrate and quantify how it is putting its trade policy into practice by identifying and combating unfair trade practices.



This article discusses the Commission's findings as conveyed in its Report on the Implementation and Enforcement of EU Trade Agreements, published in 2021.[2] We will also comment on the creation of the Chief Trade Enforcement Officer role, the proposed anti-coercion instrument and the proposed regulation to address distortions caused by foreign subsidies.

1 "First Annual Report on the screening of foreign direct investments into the Union," *EU Commission website*, accessed 16 March 2022. Find it here.

"Report on the implementation of Regulation (EU) 2021/821 setting up a Union regime for the control of exports, brokering, technical assistance, transit and transfer of dual-use items," *EU Commission website,* accessed 16 March 2022. Find it here.

"39th Annual Report from the Commission to the European Parliament and the Council on the EU's Anti-Dumping, Anti-Subsidy and Safeguard activities and the Use of Trade Defence Instruments by Third Countries targeting the EU in 2020," *EU Commission website*, accessed 16 March 2022. Find it here.

"Report on Implementation and Enforcement of EU Trade Agreements," *EU Commission website*, accessed 16 March 2022. Find it here.

2 "Report on Implementation and Enforcement of EU Trade Agreements," *EU Commission website*, accessed 16 March 2021. Find it here.

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Report on the implementation and enforcement of EU trade agreements

Free trade agreements (FTAs) usually get most attention when they are being negotiated or concluded. However, this report focuses on the implementation of FTAs.

Despite the fact that free trade negotiations are lengthy and, in many instances, may span a number of years, the Commission has successfully concluded many FTAs that have been ratified. The most important FTAs in recent years are the agreements with the United Kingdom (UK), Vietnam, Canada and Singapore.

However, not all negotiations are successful. Free trade talks between the EU and the US about the Trans-Atlantic Trade and Investment Partnership (TTIP) did not result in the conclusion of an agreement amid strong opposition from the very beginning among politicians and nongovernmental organizations (NGOs). One barrier was the concern that that EU regulatory standards would be lowered to allow easier access for US food products to the EU market. In addition, the difficult ratification process of the Comprehensive Economic and Trade Agreement between the EU and Canada and the final approval steps of the political agreement between the EU and the Mercosur countries demonstrate that the conclusion of an FTA is no longer an event that passes by unnoticed by the general public.

This explains why representatives of the negotiating parties (and those who are in favor of the agreement) must increasingly promote and advertise all potential benefits of the trade agreement and why the conclusion and the signature of FTAs are often regarded as occasions for celebration by the concluding parties.

Given the profile of FTAs, it is interesting to measure to what extent their potential benefits are actually being exploited — because negotiating an FTA is one thing but providing for its proper implementation is another. Two main aspects of implementation are important. First, the fulfillment by each of the negotiating parties of its obligations under the FTA is crucial. Second, the extent to which economic operators of one party effectively benefit from the FTA by, for example, increased access to the market of the other party is also important.

The Report on the Implementation and Enforcement of EU Trade Agreements is the EU's first report that seeks to explain the Commission's efforts in validating that the EU's trading partners are bound to the commitments stipulated in their trade agreements with the EU. The report specifically focuses on four core areas:

1. Making full use of the opportunities provided by EU trade agreements

Measuring the success of the implementation of FTAs in terms of trade figures and trade balances is not easy for the year 2020. The COVID-19 pandemic has led to a significant decrease in demand and supply chain disruption, which in turn led to a decrease in export and import volumes. Consequently, trade with the EU's preferential partners (which accounts for almost a third of EU trade in 2020), decreased by 9.1%.[3] However, it is possible to compare trade with preferential partners and trade with other partners, which dropped by 10.5%. The same trend applies to both imports and exports.[4] Although the pandemic has significantly disrupted global supply chains and has negatively impacted trade figures with preferential partners, FTAs remained an important element to facilitate trade with those partners.

However, this does not mean that there are no issues with the implementation or further improvement of those FTAs, even with longstanding partners such as Switzerland (in connection with the Institutional Framework Agreement), Turkey (in connection with the modernized customs union and trade barriers) and Norway (in connection with the processed agricultural products).

A first step in improving the implementation of FTAs is to monitor related activities in the FTA partner countries. This monitoring happens, in the first instance, with the support of the EU delegations (such as EU embassies and diplomatic representations of the EU) in those countries. For new FTAs, the EU also seeks to promote the agreement in the partner country through the launch of awareness-raising campaigns and technical cooperation.

3 Report on Implementation and Enforcement of EU Trade Agreements," *EU Commission website*, accessed 16 March 2021. These figures do not include Vietnam (as the FTA only entered into force mid-2020) and the UK (for which the FTA was not applicable yet). Find it here

4 Report on Implementation and Enforcement of EU Trade Agreements," *EU Commission website*, accessed 16 March 2021. Find it here

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Proper monitoring of local developments allows the Commission to proactively use the institutional frameworks provided for by the FTA. Those frameworks consist of numerous committees and working groups that address specific technical issues. However, the FTA also provides for regular ministerial meetings to discuss issues of a more political nature.

Those discussions allow the Commission to discuss measures that may impact the implementation of the FTA, even if those measures are still in a draft phase.

It is important for economic operators to be aware of these permanent monitoring and dialogue mechanisms. For example, economic operators that encounter the improper implementation of an EU FTA should consider reaching out to their national or EU authorities so that they can take this into consideration in their outreach efforts.

Aside from these permanent monitoring exercises, FTAs are, in principle, also evaluated every five years after their application.

- **EU trade policy and sustainability**
  Within this specific section of the report, a large emphasis was also placed on the implementation and enforcement of trade and sustainable development (TSD) commitments that are embedded in the recent FTAs concluded by the EU. Following the European Green Deal announced in 2019, great emphasis has been placed on the EU meeting its environmental goals. This also encompasses the implementation and enforcement of the TSD chapter enshrined in the EU FTAs, which usually concern the obligation for the trading partners to ratify numerous labor and human rights conventions. The EU is currently conducting a review of the implementation of all TSD chapters in its various FTAs. Findings in this context can also lead to the launch of dispute settlement procedures, which the EU has done with respect to South Korea.

The review of the TSD chapters in conjunction with the EU's first legal proceeding concerning the implementation of TSD commitments clearly illustrates the EU's priority to leverage the benefits that arise from preferential trade with its desire to encourage third countries to take sustainable developments more into consideration. Therefore, environmental and sustainable considerations are now important areas that the EU's trading partners must take into consideration and commit to when conducting free trade negotiations with the EU.

2. Supporting the uptake of trade agreement by small businesses

In addition to the Commission's intention to focus more on the actual implementation and enforcement of its FTAs, its secondary goal is to ensure that the benefits that FTAs offer to businesses also extend to the EU's small and medium enterprises (SMEs). To accomplish this goal, the EU has developed several online tools that help to guide SMEs in unlocking the benefits conferred by FTAs. They include:

- **Access2Markets portal.** Updated in 2020, this portal providers visitors with a one-stop shop source of all information concerning (preferential) trade, import/export requirements, rules of origin requirements and tariffs.



- **Rules of Origin Self-Assessment (ROSA) tool.** A function within the Access2Market portal, ROSA provides users with instructions concerning the documents required when claiming preferential preference under certain FTAs.
- **Access2Procurement.** This tool that supports EU suppliers in determining their eligibility for applying for government procurement contracts in third countries.
- **Single Entry Point.** A tool found on the Access2Markets portal, Single Entry Point enables users to file complaints concerning market access barriers, infringements of GSP and TSD commitments conducted by the EU's trade partners.

3. Addressing trade barriers and finding solutions

Trade barriers can take the form of sanitary and phyto-sanitary measures; technical barriers to trade; tariffs and equivalents and quantitative restrictions; and export taxes and restrictions.

The Commission also invests in tackling trade barriers using channels other than the institutional frameworks for the EU FTAs. This is necessary as EU economic operators may be confronted with trade barriers in countries that have not concluded an FTA with the EU or in areas that are not covered by an FTA.

The Trade Barriers Regulation (TBR) provides stakeholders located in the EU with the right to lodge complaints concerning the implementation of trade barriers in third countries. Through the TBR and diplomatic channels, the EU seeks to remove as many trade barriers as possible via bilateral or multilateral (World Trade Organization (WTO)) channels. In 2020, the European Commission was successful in fully or partially removing 33 trade barriers implemented by 22 countries.

4. Enforcing trade commitments through dispute settlement

Diplomatic and political efforts do not always lead to the required results. This is why it remains important for the EU to also defend its interests by resolving disputes using other forums. Examples include the WTO forum (specifically, through the panel procedure) or the multi-party interim appeal arbitration arrangement (MPIA) while adjudication at the Appellate Body of the WTO is blocked, and through bilateral dispute settlement mechanisms.

The report also reiterates that the entry into force of the amended Enforcement Regulation has provided additional remedies for the EU to enforce its interests; namely, the ability to impose countermeasures against non-EU countries, specifically counter measures in trade in services and intellectual property rights.



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Chief Trade Enforcement Officer (CTEO)

While the report summarizes the Commission's activities in the designated four focus areas, other developments that the EU has initiated to increase its enforcement and implementation should also be considered. They include the recently established Chief Trade Enforcement Officer (CTEO) role.

The CTEO position was recently established by the Commission within its Directorate General for Trade section to strengthen the implementation and enforcement of the EU's trade policy. The role encompasses the application of rules that affect EU economic operators both within the EU and in export markets (e.g., by validating that preferential partners are correctly applying the FTAs concluded with the EU). The specific activities of the CTEO include but are not limited to the following:

- Monitoring trade defense investigations (such as anti-dumping, anti-subsidies and safeguards)
- Managing Single Entry Point
- Conducting investigations and consultation over alleged violations by the EU's trading partners concerning their commitments under the applicable FTAs and WTO rules
- Confirming that the EU's trading partners comply with their agreed TSD commitments

The first consolidated report on the enforcement and implementation of EU trade agreements discussed above is a concrete result of the work of the EU's CTEO.

Other legal developments

- **Anti-Coercion Instrument**
  On 8 December 2021, the Commission published its proposal for a new instrument that would significantly enhance its trade defense instruments. The proposed Anti-Coercion Instrument, as the name suggests, aims to "deter countries from restricting or threatening to restrict trade or investment to bring about a change of policy in the EU in areas such as climate change, taxation or food safety."[5] This proposal is discussed in more detail in a separate article in this publication.

- **EU proposal to address distortions caused by foreign subsidies**

  In May 2021, the Commission submitted its proposal for a legal instrument that addresses distortions in the EU's internal market caused by foreign subsidies. The proposal, which borrows many features from the EU's state aid regime and the EU's merger control regime under competition law, stipulates that subsidies granted by the public authorities of non-EU countries to companies operating in the EU market must first be examined by the Commission. The instrument should be considered as complementing EU rules on competition, public procurement and trade defense instruments. Under the proposal, recipients will be able to receive financial contributions only after the Commission has given its approval.

  Currently, this proposal is going through the EU legislative procedure.

5 "EU strengthens protection against economic coercion," *European Commission website*, accessed 16 March 2022. Find it here.

Conclusion

These measures make clear the Commission's announced focus on implementation and enforcement of FTAs. With the adoption of a set of new legislative proposals and the creation of the CTEO to make better use of the instruments that already exist, the Commission is clearly aiming to take concrete steps to achieve its desired open strategic autonomy in trade matters. ■

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UK: Trade negotiations in 2022



Following the UK's exit from the European Union (EU), many of the UK's negotiations with the rest of the world were focused on "rolling over" the free trade agreements (FTAs) that existed between the EU and third countries. Those continuity agreements have been covered in some detail in a previous article. This article examines the UK's forward-looking trade negotiations agenda and what it means for businesses.

UK-New Zealand FTA

On 28 February 2022, the UK and New Zealand signed a new trade agreement.[1] As with the UK-Australia FTA, the UK-New Zealand FTA is a modern and comprehensive agreement that includes provisions relating to the trade of goods, services, digital, investment and mobility provisions. Under the agreement, the UK will eliminate tariffs on 96.7% of tariff lines on the day the FTA enters into force; New Zealand will liberalize 100% of tariff lines on the same day. The UK's remaining tariff lines relate primarily to agricultural products, namely butter, beef and sheep meat.

UK-India FTA

On 17 January 2022, the UK and Indian Governments jointly launched negotiations to conclude a trade agreement between the two countries, with the second round of negotiations held in March. The aim of the negotiations is to conclude a comprehensive trading arrangement that covers goods, services, investment and digital trade.

While India has historically not been an advocate of FTAs, recent developments include a new India-United Arab Emirates FTA, concluded in February 2022, and positive movement toward an India-Australia agreement. The UK and India have said that they are considering whether an interim or "early harvest" agreement could be concluded quickly, perhaps to include binding commitments to continue negotiating the full FTA.

Acceding to the CPTPP

The UK's applied to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) in 2021, and negotiations are continuing with the current 11 member jurisdictions. The UK has provided the first stage of detailed information to those CPTPP jurisdictions, and bilateral negotiations have begun on specific trade issues. To oversee this second stage in the negotiations, Japan will chair the UK's Accession Working Group.

1 UK-New Zealand Free Trade Agreement – GOV.UK (www.gov.uk)

UK-Singapore DEA

The UK has announced that an agreement has been reached with Singapore on a Digital Economy Agreement (DEA). The agreement will cover open digital markets, digital trading systems, data provision, consumer protection, emerging technologies, and specific provisions relating to financial and legal services.

UK-GCC FTA

The UK has been gathering evidence from businesses and other stakeholders to identify its negotiating priorities with the Gulf Cooperation Council (GCC) countries, with negotiations expected to be launched in early 2022.

Upgrading the UK's continuity FTAs with Mexico, Canada, Israel and South Korea

As part of the UK's efforts to maintain its trading relationship following the UK's departure from the EU, many so-called continuity FTAs were agreed with countries that had existing trading arrangements with the EU.

For two of these countries (Mexico and Canada), the FTA included commitments to revisit the agreements in 2022 to increase the scope and ambition of those agreements with the UK. Services, digital and regulatory cooperation are expected to be high on the agenda in these trade negotiations. More recently, the UK announced that upgrades to the existing continuity FTAs with South Korea and Israel are being considered as well.

Focus to shift to implementation

For trade authorities in 2022, simply signing trade agreements won't be enough to benefit businesses. To that end, we are seeing a marked shift in the UK Government's focus, from negotiating trade agreements to engaging in their implementation. The entry into force of the UK-Australia FTA in the latter half of 2022 will be an important moment as the agreement is ratified by the respective parliaments.

Accordingly, the UK Department for International Trade's new export strategy will look to provide new opportunities and resources focused on helping businesses identify and utilize these agreements to boost UK trade.

Next steps

The new trading environment will continue to have an impact on strategic decisions for many businesses, be they new markets, new product lines or new location decisions. Businesses should:

- Closely monitor future UK trade negotiations and determine whether they could have an impact on their international trading operations.
- Engage with industry bodies and the UK Government to confirm that the issues and priorities are understood going into future trade negotiations. ■



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At the frontiers of sustainable trade – three priorities for customs authorities to accelerate the ESG revolution



Last November's United Nations Climate Change Conference (COP26) may be out of the headlines, but the commitment to sustainable economic growth remains high on the agenda for government and business leaders. And, once again, customs authorities find themselves at the forefront of this complex global challenge.

Companies involved in international trade are under pressure to demonstrate that they, and their suppliers, are meeting environmental, social and governance (ESG) expectations. More and more companies are signing up to national or international ESG standards frameworks and reporting their ESG performance, but there is no single set of globally agreed baseline standards for sustainability disclosure.

These requirements also place a significant additional burden on customs authorities, which are responsible for validating that goods crossing the border are compliant with ESG standards and enforcing the growing number of restrictions, duties and taxes on products that are carbon-intensive or polluting.

Increasingly, the importer of record must verify that the products are not tainted by forced labor, modern slavery or child labor, and that the sale is not used to fund armed conflict or other illegal practices. Businesses, and indeed entire global supply chains, have a moral and, increasingly, legal obligation to audit their supply chain providers and show customs authorities a "clean bill of health."

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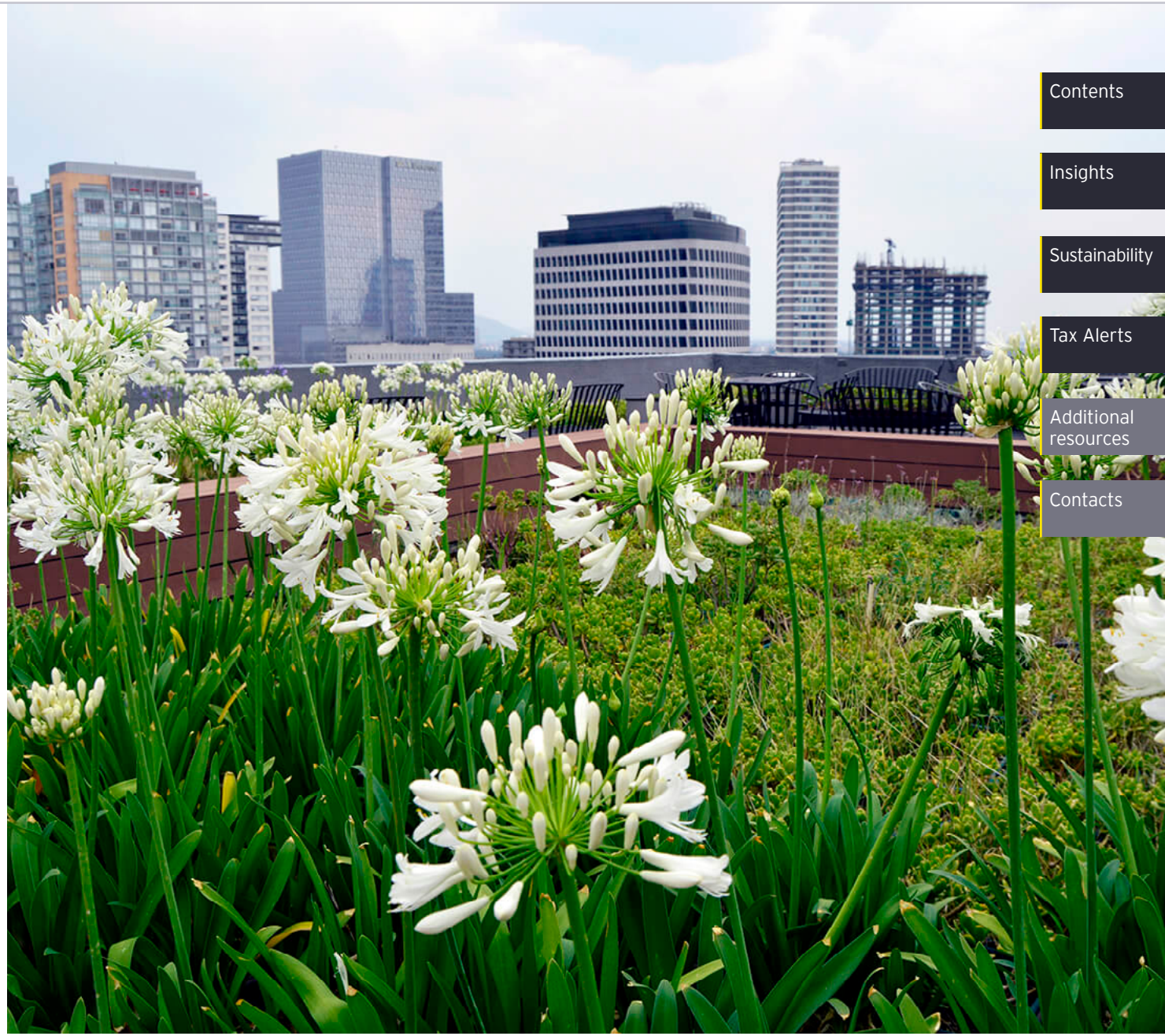
Under the "S" and "G" of ESG standards, companies and their suppliers also must demonstrate diversity and equity, act respectfully toward indigenous peoples, protect consumer data, and have robust governance structures and policies to counter corruption and bribery.

Customs authorities may currently lack the capabilities and resources to tackle all of these mounting ESG-related compliance demands, resulting in complicated and onerous data collection and reporting requirements. But, by prioritizing the following actions, they can accelerate efforts to make international trade more ESG-compliant.

Priority 1: Transform the agency

Customs authorities are typically large organizations with significant infrastructure and workforces. There is plenty that can be done to "green" their fleets by converting to hybrid and electric vehicles, using sustainable power for facilities and operations, and reducing airplane and vessel emissions through improved route and load planning. Bigger agencies, with vast real estate footprints, can switch to renewables, reduce water consumption and waste, and adopt rooftop solar panels, LED lighting, improved insulation and smart building technologies such as sensors, metering and "digital twins" that simulate real facilities to deliver efficiencies. They could even consider living green walls and rooftops.

At a workforce level, agencies should lead by example on the "S" aspect of ESG standards, treating employees with respect, encouraging diversity, fair pay and career progression; and providing safe working conditions for all.





Priority 2: Fix border congestion

Lines of idling trucks at border crossings and container ships queued up at ports, all emitting harmful pollutants, have an environmental impact. Local communities may suffer directly from higher health care costs, damage to infrastructure and homes, and the societal impact of streets full of trucks.

The pandemic created unforeseen, dramatic shifts in demand and strained infrastructure, capacity and manpower. Undoubtedly, these factors have increased border congestion issues. Despite these limitations, there are ways for authorities to speed up checking and decrease the carbon footprint at ports and borders. Increased collaboration between countries along the trade route could help customs authorities anticipate and modulate flow, as could smarter and more responsive queue management systems.

Customs authorities should consider or revisit trade accelerators such as "green lanes" for lower-risk, higher-priority cargo. To do this, they will need a more digitized platform, less physical paperwork, and better cargo screening and selectivity. By working with the commercial sector, they can develop more efficient scanning technologies, and adopt automation and AI to improve operational capabilities.

Port operators are implementing **port optimization solutions**, using data and analytics to better manage the flow of vessels and cargo to minimize delays and journey times, enabling customs authorities to increase the effectiveness and efficiency of their own resources. Governments also must determine the cost and benefit (economical and environmental) of investing in additional deep-water ports, roads and bridges.

Priority 3: Enforce sustainable trade

The complexity of global supply chains, along with the lack of global standards to measure and report ESG-related information, makes enforcement increasingly challenging. Customs authorities have to work and communicate with manufacturers, shippers, agents, brokers and logistics providers, as well as coordinating with numerous government agencies involved in ESG compliance, including areas such as food and drugs, agriculture, environmental protection, trade and industry, health, transport and infrastructure.

To make things more complex, companies are still coming to terms with ESG compliance. Where once their main concern was self-certification, they now have to facilitate inspection and verification. Customs authorities must strike a delicate balance between enforcing evolving laws and regulations and enabling trade to flow.

One approach that's growing in popularity is single, digital trade windows that streamline sharing of shipment data, including ESG compliance and reporting between government agencies, speeding up the approval process of multiple agencies.

Sophisticated data analytics can bring greater visibility across the supply chain, identifying poor environmental behavior, evidence of corruption or forced labor, and other ESG risks.

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Customs authorities must strike a delicate balance between enforcing evolving laws and regulations and enabling trade to flow.

Blockchain solutions also could help customs authorities verify the origins of goods, their components, ESG compliance and other mandates.

All these issues result in a heavier workload for customs staff striving to keep up with evolving ESG legislation and national, multilateral and bilateral ESG agreements, including labeling, marking and numbering duties. They need ongoing training, not just in procedures and detection techniques but also in acquiring an "ESG mindset." To achieve this, customs authorities likely will need more funding to recruit officers with the appropriate skills, adopt better technology and constantly re-educate their teams.

Staying one step ahead

Customs authorities face many challenges in implementing and enforcing government policy. They are tasked with implementing fast-evolving regulations and standards, while keeping trade flowing to drive economic growth, and ensuring the safety and security of their country's citizens.

ESG issues are undoubtedly playing an increasing role in customs work, and authorities have to keep abreast of changing legislation and technology, developing new skills, capabilities and knowledge.

However, by considering the priorities outlined in this article, customs authorities will be better prepared to take a leading role in helping nations achieve their ESG goals, as both enforcers and implementers of policy.

Actions for businesses

As treaties and associated rules and regulations around ESG standards continue to evolve, and as global consumer preferences drive the need for companies to evolve their ESG strategies, planning and commitments, there are three considerations businesses should keep in mind.

First, staying ahead of evolving rules and regulations, especially on a global scale, can be a challenge. With trillions of US dollars pledged by public and private entities in commitments to address global climate change, for example, it is likely that requirements for companies to disclose information on their carbon footprint to their investors will precede other norms, standards and markings. These requirements may come from departments other than customs but may be subject to customs enforcement. As with any law or regulation, validating compliance with country-specific requirements will be an important aspect of the competitive agenda, and reporting compliance will be critical, if not a differentiator.

Second, ESG and supply chain transparency are increasingly becoming topics to be considered jointly. For example, for companies doing business with the UK, Australia and the US (countries with anti-slavery or forced labor legislation), companies of all sizes are looking for and adopting new strategies for understanding whether forced labor exists in their ecosystems. As forced labor is not merely a factor of manufacturing or the country of origin, ESG-conscious companies will likely also look to identifying and eliminating forced labor throughout their supply chains — developing mechanisms to help spot forced labor, as well as reporting it to relevant authorities.

The third area is closely related to the first two. The disruptions to supply chains caused by the pandemic, are now further complicated by the needs of companies to understand the implications of sanctions at all levels in their supply chains. That need for transparency and understanding has significant implications for a vast percentage, if not a majority, of commercial and public sector supply chains, and may drive unprecedented demand for supply chain visibility. Alternatives to sanctioned entities will be a challenge for supply chains, especially where ESG adherence and compliance are concerned, and this may perpetuate disruptions and delays. ■

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CBAM and its impact on EU cross-border imports

On 14 July 2021, the European Union (EU) Commission adopted a set of proposals referred to as the 'Fit for 55' package. This package aims to align EU climate, energy, land use, transport and taxation policies with the goal of reducing net greenhouse gas emissions by at least 55% by 2030 and achieving climate neutrality by 2050.

Key highlights of the proposed carbon legislation for business are:

- The Carbon Border Adjustment Mechanism (CBAM) will impose a carbon price on imports of a targeted selection of products so that ambitious climate action in Europe does not lead to "carbon leakage."
- There might be a more rapid phaseout of free emission allowances for goods subject to the CBAM measure as well as emissions occurring in the sector of aviation. Furthermore, shipping shall be included in the EU Emissions Trading System (EU ETS).
- The Alternative Fuels Infrastructure Regulation requires that aircraft and ships have access to clean electricity supply in major ports and airports.
- There will be a maximum limit on the greenhouse gas content of energy used by ships calling at EU ports.
- A revision of the Energy Taxation Directive proposes to align the taxation of energy products with EU energy and climate policies.

This is a rapidly evolving area of government policy and since this article was written, there have been a number of important developments related to this topic. For more recent information, please refer to EY tax alert **European Parliament approves five elements of "Fit for 55" climate package, including a more ambitious EU Carbon Border Adjustment Mechanism**.

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CBAM progress

The CBAM proposal now needs to be enacted by the European Parliament (EP) and the European Council. Under the ordinary legislative procedure, the EP's Committee on the Environment, Public Health and Food Safety (ENVI) is responsible for the CBAM. ENVI has undertaken the first reading of the proposal and submitted its recommendation to the European Parliament in December 2021.

In January 2022, other committees involved in the CBAM, including the Committee on International Trade (INTA), the Committee on Economic and Monetary Affairs (ECON), and the Committee on Agriculture and Rural Development (AGRI), have also provided their recommendations to ENVI to be considered for the amendment of the CBAM proposal.

The recommendation, led by EP member and CBAM proposal rapporteur Mohammed Chahim for ENVI, is seen as a substantial transformation of the initial draft, aimed at rapid deployment with wider coverage. The recommendations from other committees also echo the same sentiments.

Furthermore, the EU Member States representatives have commented on a compromise legislative proposal which was provided by the European Commission.

The summary of the latest CBAM proposal and recommendations from ENVI and other committees is as follows:

- **Accelerated phaseout of free allocations.** ENVI has suggested the phasing out of free allocation of emission allowances in sectors to which the CBAM applies, granted to the EU manufacturers subject to the EU ETS starting from 1 Jan 2024, and completely phased out by 31 December 2028. The phaseout would ensure that imported goods covered by the CBAM are not treated unfairly as compared to EU-produced goods of the same class. The plan effectively means that EU producers of goods covered by the EU ETS would be required to reduce carbon emissions more quickly to stay competitive. Likewise, the import of goods covered under the CBAM would be subject to higher landed costs into the EU as the price of CBAM certificates (necessary for placing CBAM covered goods onto the EU market) would be linked to the price under the EU ETS. To enable competitiveness, both the manufacture of the goods covered under the ETS in the EU, as well as the import of CBAM covered goods into the EU, would be more attractive commercially for goods that are less emission-intensive. The interaction of CBAM and the EU ETS, specifically the phase-out of free allocated emissions, continues to be the most intensively debated issue between the European Commission, the EP and the EU Member States.
- **New products to be included.** A large scope of goods in the categories of polymers, organic basic chemicals and hydrogen may be added to the initial list of goods covered by the CBAM. The initial list contains selected products in the cement, electricity, fertilizers, iron and steel as well as aluminum sectors. In continued discussions in the EP, the inclusion of petroleum products was also discussed. It needs to be noted, however, that the EU Member States currently seem to in favor of postponing the inclusion of these products.
- **Ultimate product coverage.** Ultimately, the CBAM should cover all the products covered by the EU ETS, including a wide range of goods such as crude petroleum, refined petroleum products, iron and ferrous ores, oils and fats, starch, sugar, malt, textile fibers, pulp paper and paperboards, dyes and pigments, basic pharma, ceramics and many more.
- **Transition period.** It is clarified that the transitional phase will span 24 months, i.e., from 1 January 2023 to 31 December 2024. This means that businesses now have only a few months to prepare for reporting obligations that may take effect on 1 January 2023.
- **Emissions covered.** The CBAM will cover direct emissions related to the production processes of goods over which the producer has direct control, including emissions from the production of heating and cooling consumed during the production processes. There is still debate about the point of time when indirect emissions related to greenhouse gas emissions from the generation of electricity that is consumed during goods production processes will need to be included in the CBAM assessment base. However, with regard to the indirect emissions, the recommendation also suggests the inclusion of



downstream products to be covered by the scope of the CBAM. Therefore, the scope of the CBAM may be extended in the future. Notably, if the EU adjusts the intra-EU Emission Trading Framework in the future, this could be reflected in the CBAM rules.

- **Single, central CBAM authority.** The most recent information shows consensus that instead of a decentralized system with 27 CBAM authorities in each EU Member State, there should be a single CBAM authority at the EU level to enable swift, coherent and cost-effective implementation. This also would make "forum shopping" between Member States impossible.
- **Role of customs authorities.** Customs authorities will be responsible for the CBAM (for example, validating that each importer (customs declarant) is registered with the central CBAM authority).
- **Recognition of explicit carbon pricing policies only.** Only the introduction of explicit carbon pricing policies (i.e., those that put a price on carbon directly through carbon taxes or emissions trading schemes) shall qualify to provide reductions from the EU CBAM payments for third-country imports.
- **Low value imports.** The latest CBAM proposal draft envisages a low value threshold for exclusion of low value imports from the CBAM measure.
- **Support for LDCs.** Directly exempting the least developed countries (LDCs) from the CBAM was ruled out as it could send the wrong signal. However, one of the recommendations provides for financial support for decarbonization projects LDCs may undertake.
- **Origin of the goods.** The non-preferential origin of goods is a key factor in determining the carbon emissions subject to CBAM charges when applying country-based average emissions, based on benchmarked values. The recommendation clarifies that non-preferential rules of origin under the Union Customs Code will apply in these circumstances. In the context of the proposed scope, this means that if the production of goods involves more than one country or territory, the goods shall be deemed to originate in the country or territory where they underwent their last substantial, economically justified processing or working in an undertaking equipped for that purpose resulting in the manufacture of a new product or representing an important stage of manufacture. For some types of goods, specific rules apply.
- **Carbon export facilities.** Some EU Member States would like the EU to consider facilities for businesses that export goods subject to carbon pricing outside the EU. Such measures could be implemented by way of export credits or refunds. However, having a beneficiary scheme of this type is currently under debate and the result of further negotiations are awaited.

The impact of the proposals

Overall, the recommendations emphasize the political intention that the CBAM will be implemented when planned or its implementation may even be accelerated, and that it will be expanded to meet the goals of the European Green Deal. This means that businesses are likely to have less than 12 months to assess the impact of the new measures and implement them to meet their compliance obligations from 1 January 2023.

The rapid phaseout of free allocation of EU ETS allowances would mean that potentially starting from 1 January 2024, the carbon cost for manufacturers subject to EU ETS who are also offered a protection under the CBAM could increase the price of manufacturing much faster than expected given the need to acquire additional EU ETS allowances. On the other hand, the importation of CBAM covered goods will also in most instances become more expensive. Overall, the market price of any goods subject to EU ETS or the CBAM as well as any derivative products will increase unless businesses reduce their greenhouse gas emissions.

Time to assess the impact

The future legislation on carbon pricing, energy tax and related regulations is still in process. Tough political discussions around these issues are expected, and the final details of some regulations likely will look different from the July 2021 and the current compromise legislative proposal and the recommendations of ENVI and other committees.

Nevertheless, the direction of the regulations is quite clear, and key EU representatives have repeatedly emphasized the political will for its implementation. Therefore, despite the fact that some details may still be unclear or the details of the proposed legislation may change in the final versions, businesses should prepare now for their impact. This includes EU manufacturers, traders, importers, foreign exporters and all other parties that are potentially impacted by carbon pricing measures. They should quickly initiate a comprehensive analysis of the expected impact of the CBAM, changes to the EU ETS, energy taxation and other relevant fields of law. Specifically, EU manufacturers of goods covered by the EU ETS need to evaluate their market position, since according to the current plan, there may be no export refund or rebate scheme to reduce the need for the EU ETS allowances.

A variety of factors should be examined to evaluate the impact of the CBAM and identify required actions, priorities and the interdependencies between measures.

Key considerations include the following:

1. **Evaluate whether the CBAM impacts operations.** Examine customs data, purchase data, bills of materials, transactional models and logistic flows to ascertain the applicability of CBAM.
2. **Quantify the exposure.** Calculate the impact of CBAM cost and expected cost for administrative governance as a base for subsequent strategic analysis of future supply chain planning, procurement, contracts, and infrastructure, as well as merger and acquisition strategy.
3. **Analyze data availability and quality.** Determine which data elements will be needed to fulfill the expected CBAM compliance obligations, ascertain which data is available and assess data quality. Identify how any gaps can be closed in time to prepare for the expected administrative obligations
4. **Review the global value chain and footprint.** This should include as they relate to the EU region and the expected CBAM as well as EU-ETS implications to determine options to optimize cost to serve the market, and to consequently determine the strategy, such as where to invest in manufacturing installations to reduce emissions, transform to alternative products and other appropriate measures.
5. **Review implication on business models.** Analyze the impact of CBAM on business models, the competitive landscape and corporate values.

Summary

The European Green Deal and similar initiatives in a number of jurisdictions around the globe are gradually taking shape, which will have a tangible impact on efforts to reduce carbon emissions – and this impact is not limited to the EU. Rather, it spans the global sourcing and distribution footprint of businesses covered by the EU's proposals for the CBAM and emissions trading internally within the EU.

The new measures offer opportunities and represent challenges. They provide an opportunity for businesses to review their environmental, social, and governance (ESG) responsibility preparedness. Businesses should proactively embrace these changes and prepare to align their business models to the expected carbon emissions framework. But pursuing the new measures is not just about doing the right thing. It also can help disrupt emission- and energy-intensive industries and businesses. In addition, timing can be critical to identify the impact of these measures and plan responses before the expected increases of direct and indirect carbon costs become a reality. ■

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EU: Proposal to introduce a deforestation regulation

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On 17 November 2021, the European Commission proposed a regulation, driven by the European Union (EU), to minimize deforestation and forest degradation.[1] Businesses placing certain commodities on the EU market that are associated with deforestation and forest degradation will become subject to mandatory due diligence rules upon import of these commodities into the EU.

The European Commission's proposal aims to only allow deforestation-free products on the EU market. It places mandatory due diligence rules on imports of six commodities. The commodities in scope are beef, wood, palm oil, soya, coffee and cocoa as well as some of their derived products (for example, leather, chocolate or furniture). Based on an impact assessment performed by the European Commission, these commodities are the biggest contributors to global deforestation and forest degradation. This list will be reviewed periodically and may be expanded or adapted over time to address changing deforestation patterns.

Upon importation of the above-mentioned products, businesses will need to comply with several mandatory due diligence rules. These rules are intended to validate that the commodities and products in scope of the regulation have not



1 Proposal for a Regulation of the European Parliament and of the Council on the making available on the Union market as well as export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010, COM (2021) 706 final.



been produced on land deforested or degraded after 31 December 2020 and have been produced in accordance with the laws of the country of production. The due diligence rules consist of three steps. First, the businesses placing the commodities on the EU market for the first time need to confirm that they have access to information on the commodity and its quantity, supplier and country of production. They also should have information available about the geographic coordinates of the plots of land where the commodities in scope were produced. This allows the competent authorities to determine whether products and commodities are deforestation-free. Second, businesses will need to leverage the information on the plots of land used for producing the commodities to analyze and evaluate the risk in the supply chain. Last, businesses will need to take adequate and proportionate mitigation measures. If the mandatory due diligence rules are violated by the businesses placing the commodities on the EU market, this may lead to fines and confiscation of the relevant commodities and products, as well as confiscation of revenues, suspension or prohibition of relevant economic activities, and exclusion from public procurement processes for the operators and traders that violate the regulation.

The checks performed by the competent authorities depend on where the goods originated. As such, producer countries or subnational regions will be assigned a risk level according to a three-tiered risk rating system (i.e., low, medium and high). The authorities will perform these checks more frequently if products are coming from high-risk countries and when related businesses have a bad track record. In high-risk cases, at least 15% of all imported commodities in scope of this regulation need to be checked by the competent authorities according to the proposed rules.

The European Parliament and the European Council will discuss the proposal sometime in 2022. Based on the current proposal, the regulation should enter into force in 2023. Businesses should begin preparing by making an impact assessment, monitoring the geographical locations of the plots where their commodities are produced, and taking adequate and proportionate mitigation measures where possible. ■

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EU: Is decarbonization a major threat for European ports?

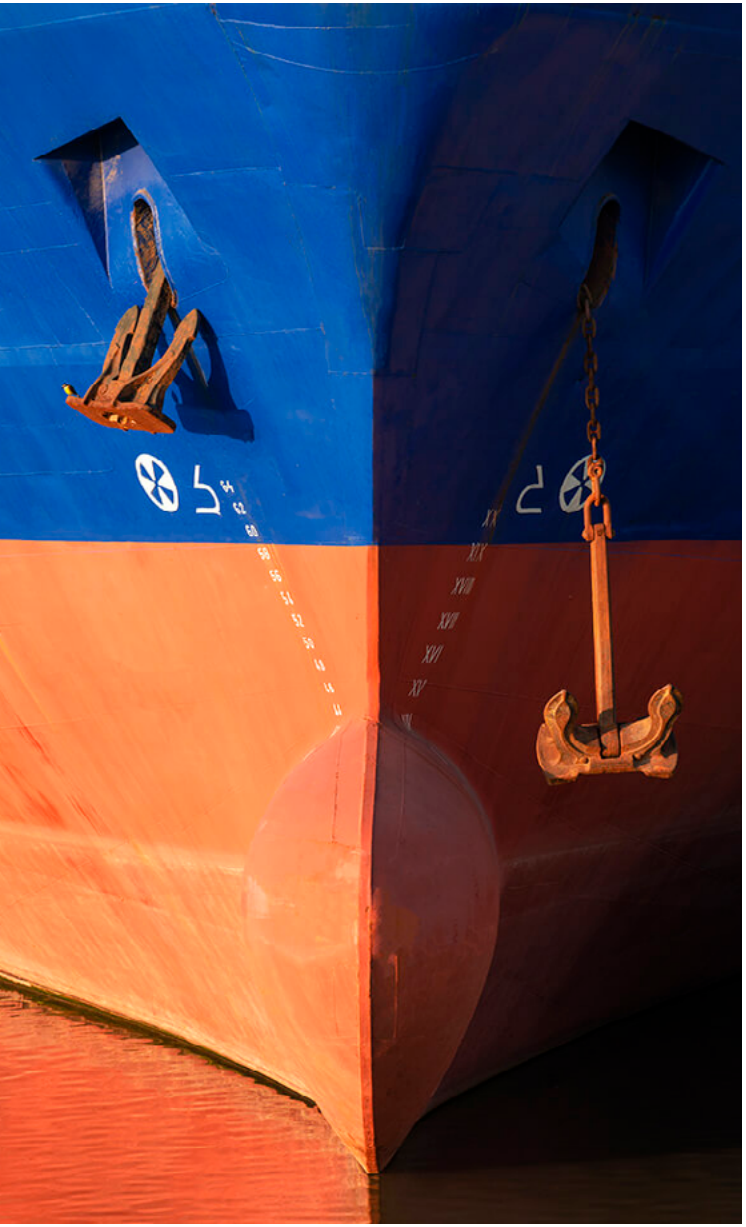


The European Union (EU) claims a leading role in the fight against climate change, having committed not only to be the first carbon-neutral continent by 2050 but also to accelerate the CO2 emissions reduction pace up to a target of 55% by 2030 in comparison with the level registered in 1990. The recent adoption of this latter commitment obliges the EU to amend a wide group of sectorial regulations that were consistent with the previous target of reduction of 40% but that are not sufficient to meet the updated target. This has led the EU to announce the Fit for 55 program, one of the largest legal packages in the EU's history to date.

In July 2021, the EU Commission presented several legal proposals that aimed to increase the climate-related ambition of the EU. These proposals are being discussed now, with the goal of having their core content in force by 2023. The main areas of interest in this legal package are the reform of the EU Emissions Trading System (EU ETS) and the introduction of a Carbon Border Adjustment Mechanism (CBAM), a new framework of taxation for energy and energy products and regulations aimed at promoting renewable energies, electric mobility or decarbonized fuels.

Many of these initiatives could lead to problems around competitiveness for affected EU companies, which could be obliged to compete in global markets with products coming from jurisdictions with no equivalent taxes or regulations. One important example of this is the significant difference between the carbon prices payable in the EU currently (around EUR90 per ton), in contrast to the nonexistent or very reduced carbon prices that

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apply in many other jurisdictions. These differences may result in a loss of business activity from the EU to non-EU countries with lower or no carbon pricing. In addition, the proposed measures also may undermine the effectiveness of European policy on the environmental impact of climate change.

The maritime sector

Until now, the different levels of carbon prices within and outside the EU had not impacted the maritime sector. Maritime transport has some special characteristics (such as the extraterritoriality of most of the emissions, mobility of the emitting source, and the difficulty of switching to alternative fuels) that have led to the common understanding that emission reductions in this sector should be targeted more properly by means of international agreement in a multilateral forum such as the International Maritime Organization (IMO).

Without abandoning its efforts to promote these multilateral negotiations within the IMO, the EU has now decided that now is the time to move forward unilaterally.

The main measure proposed by the European Commission to decarbonize maritime transport has been the inclusion of the sector within the scope of the EU ETS. The measure's purpose is not only to tax CO2 emissions produced at berth in EU ports or during intra-EU journeys, but also to tax 50% of the emissions of journeys with a sole origin or destination in an EU port.

This measure is likely to result in significant additional carbon costs for maritime sector businesses operating in the EU. It could also lead to a lack of competitiveness for the ports most exposed to competition from non-EU ports that will not incur equivalent carbon costs. The risk is likely to be higher for ports nearest to competing non-EU ports, especially for those with a bigger share of transshipment activity. The European Sea Ports Organization (ESPO) has recognized the risk of displacement of maritime transport activity to other ports in the Mediterranean, the Baltic or the North Sea. In particular, in the Strait of Gibraltar, there would be a potential risk of relocation of transshipment activity from Algeciras (in Spain) to Tanger-Med (in Morocco). The same could happen in the North Sea with transshipment activity being moved to competitive UK ports.

In the example provided, a maritime service from Asia to Central Europe sailing across the Strait of Gibraltar could become considerably more cost-efficient if the transshipment activity were to move from Algeciras to Tanger-Med, because:

- It would not pay carbon costs for the emissions produced during the first journey, in contrast to the 50% payable if the transshipment were made in Algeciras.
- It would just pay carbon costs for the 50% of the emissions produced during the second journey, as opposed to the 100% payable if the transshipment were made in Algeciras.
- It would not pay carbon costs for the emissions produced at berth in Tanger-Med.

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The risk of displacement of activity cannot be analyzed just from an EU ETS perspective. Other Fit for 55 measures (FuelEU Maritime, reform of the energy directive, etc.) could have a cumulative effect leading to the risk of transport businesses switching activity to non-EU transshipment hubs.

Some European ports have asked the EU for protective measures to minimize the risk of carbon leakage in this sector. The European Parliament, particularly the Committee on Transport and Tourism (TRAN), has acknowledged that "port evasion and shift of transshipment hubs cannot be ruled out entirely … and especially the latter may have a major impact on specific ports and regional communities."[1]

The EU Commission has therefore requested a more balanced playing field for EU and competitive non-EU ports. The need to implement anti-carbon leakage measures is not unknown territory for EU lawmakers, as some measures of this kind traditionally have been arbitrated to protect the European carbon-intensive industrial sector. In the case of the maritime industry, the EU may work through two potential approaches.

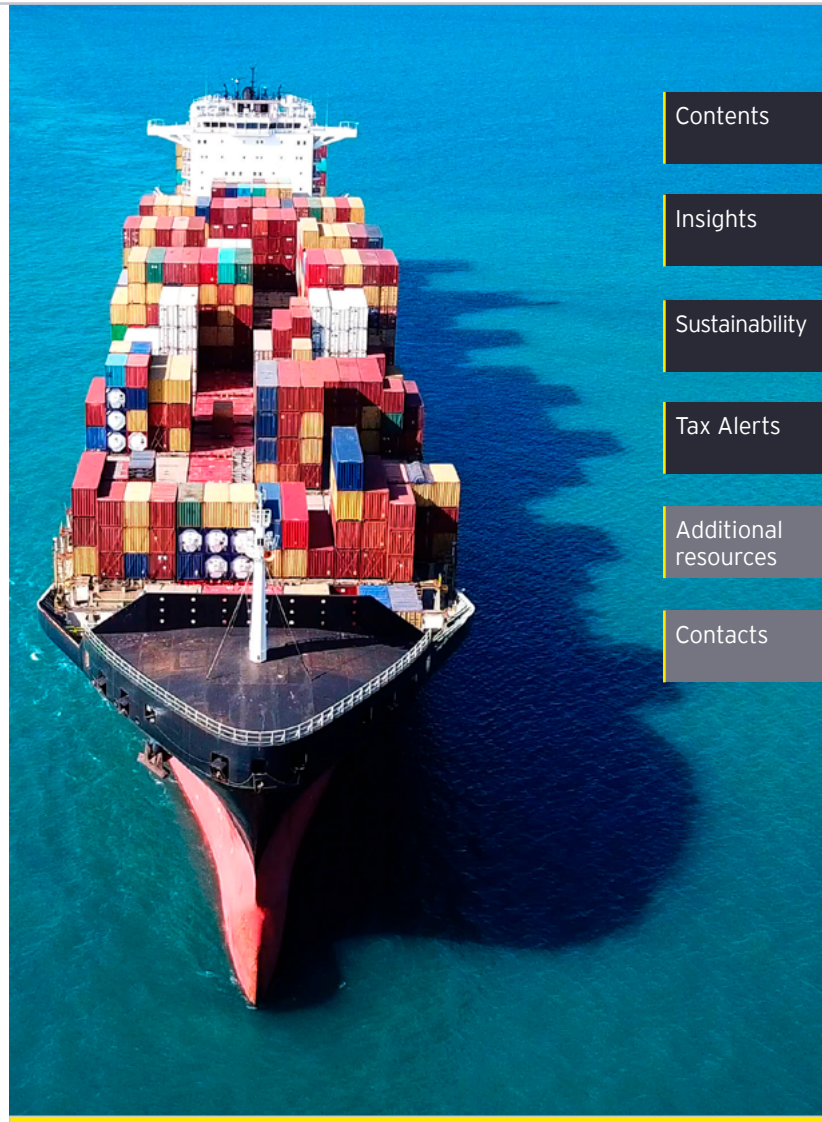
On the one hand, the EU could exclude the EU ports most exposed to a risk of carbon leakage from the application of the new system (through exemption of the port itself or of certain journeys, assignment of free allowances to the operators, etc.). This approach would be similar to the one traditionally followed by means of the mechanism of granting free allowances to the industry in the EU ETS. In its report of October 2021, the European Parliament's TRAN Committee declared that the granting of free allowances would be an acceptable option to minimize the risk of carbon leakage in this sector.[2]

On the other hand, the EU could oblige vessels making an intermediate stop in a non-EU competitive port to pay carbon costs. That could be executed by including the non-EU port with the EU ETS (ideally following negotiations with the non-EU authority) or by means of a posteriori assessment of the carbon costs that were initially saved as a result of the non-EU intermediate stage.

The second approach may be incomplete and would present significant technical challenges. However, this may be the route that the EU adopts. When both EU and non-EU competitors effectively pay for their respective carbon emissions, this rebalancing of market positions could enhance the effectiveness of EU climate policy. This approach would also be consistent with the new policy the EU Commission has designed to protect EU industries at risk of carbon leakage, where the recently proposed CBAM is intended to replace the traditional use of the free allowances mechanism. ■

1 "The aviation and maritime sectors and the EU ETS: challenges and impacts," *European Parliament website*, accessed 14 March 2022. Find it here.

2 *Ibid.*



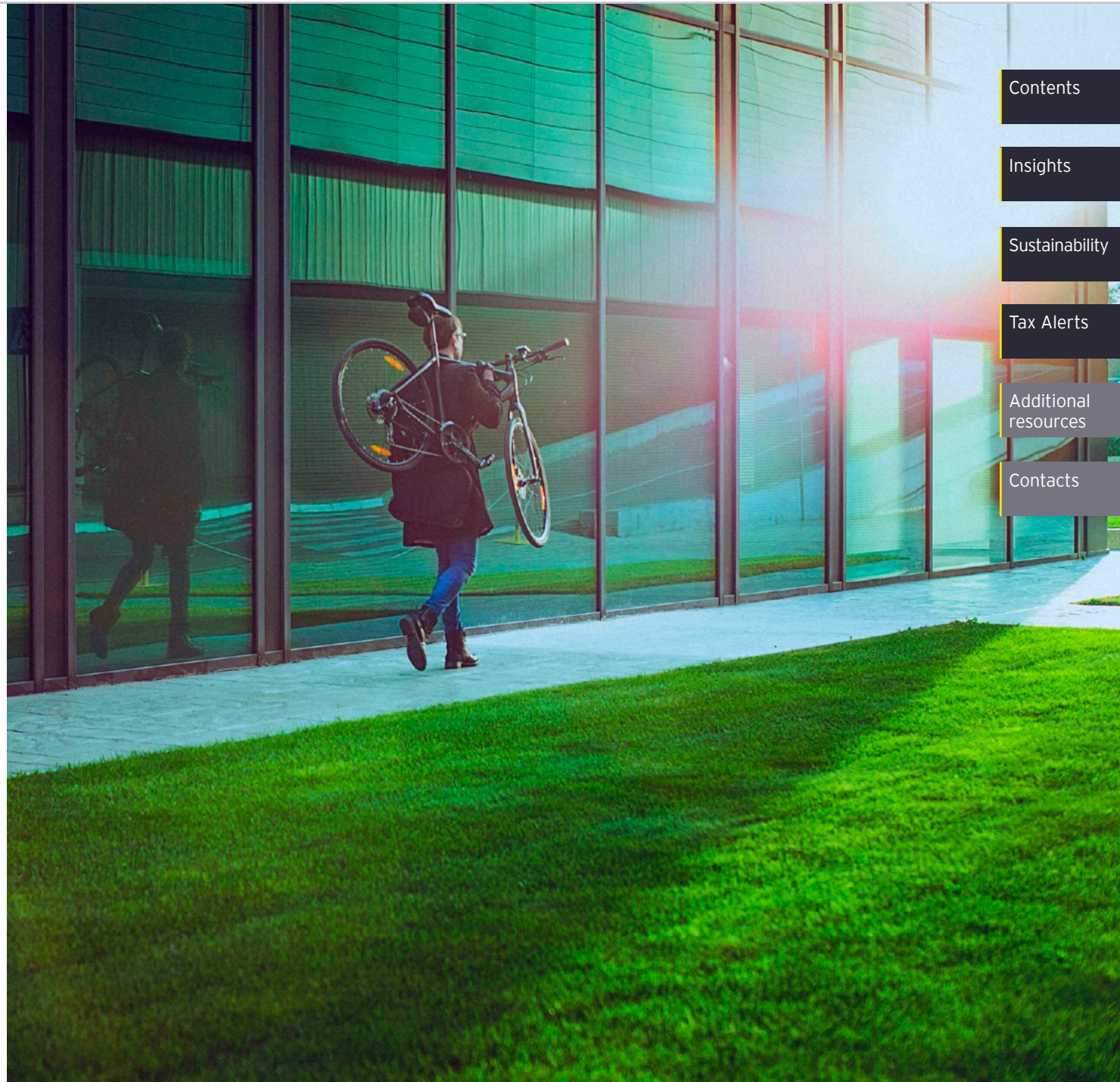
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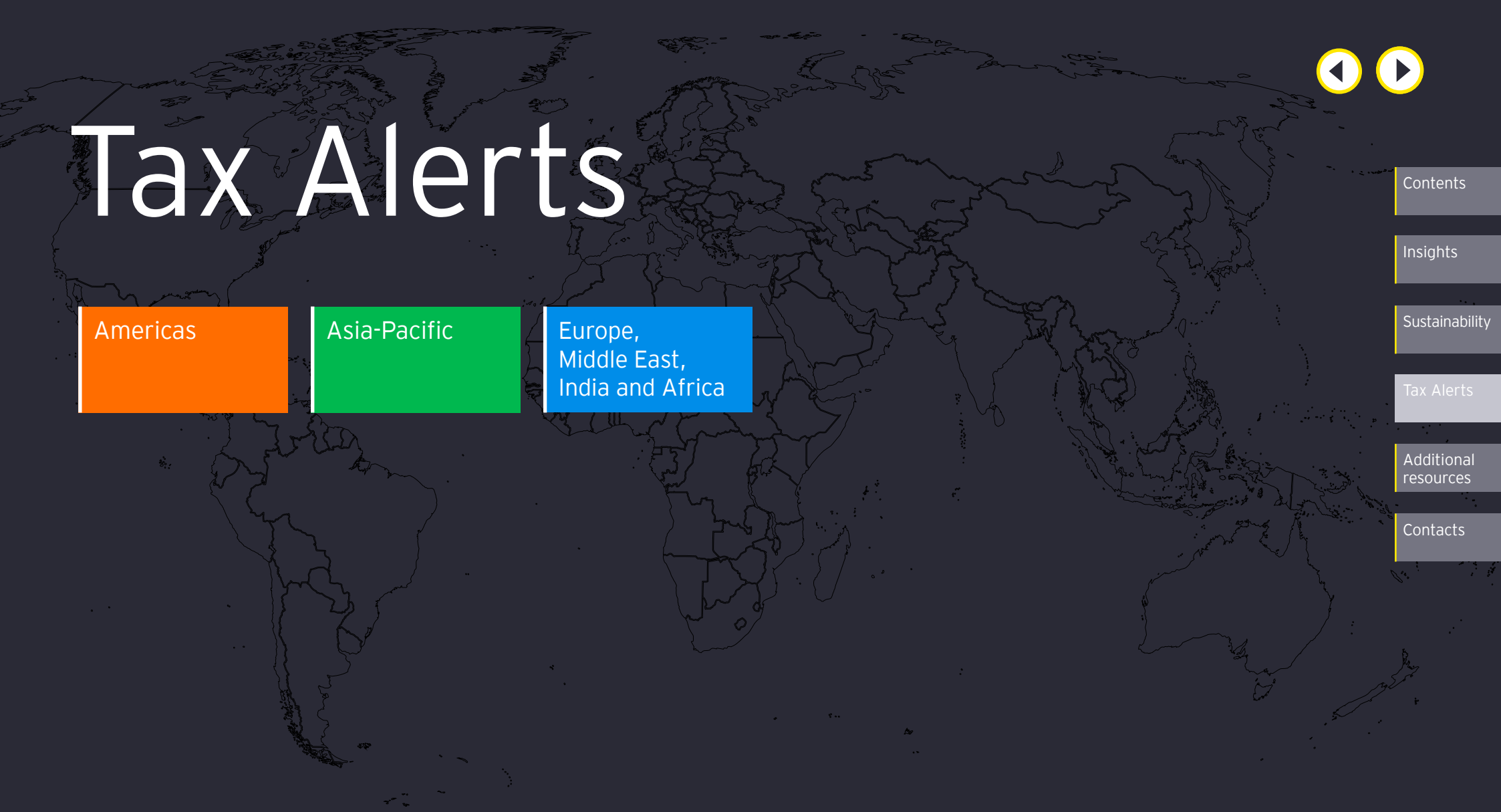
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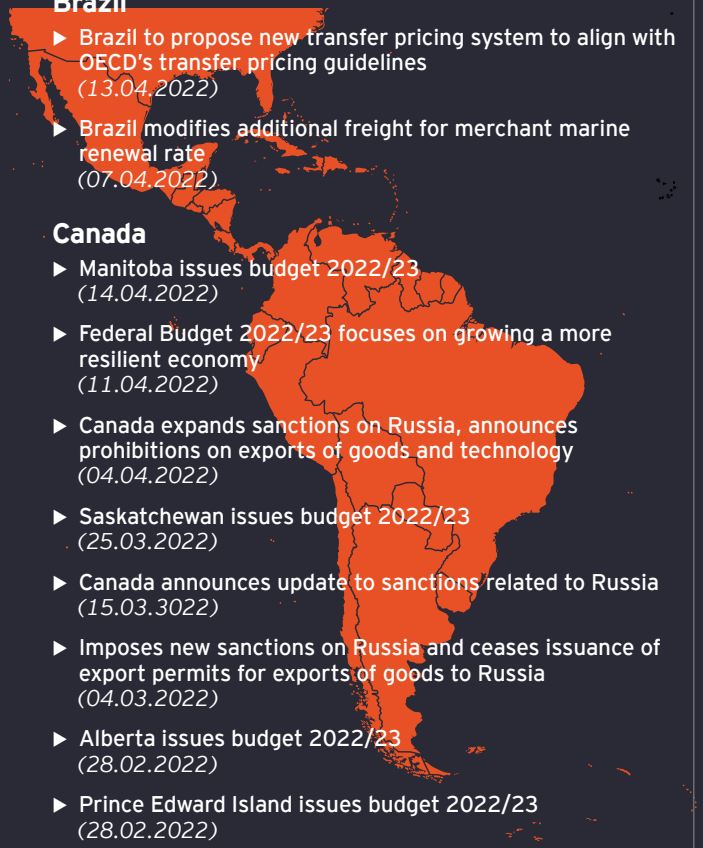
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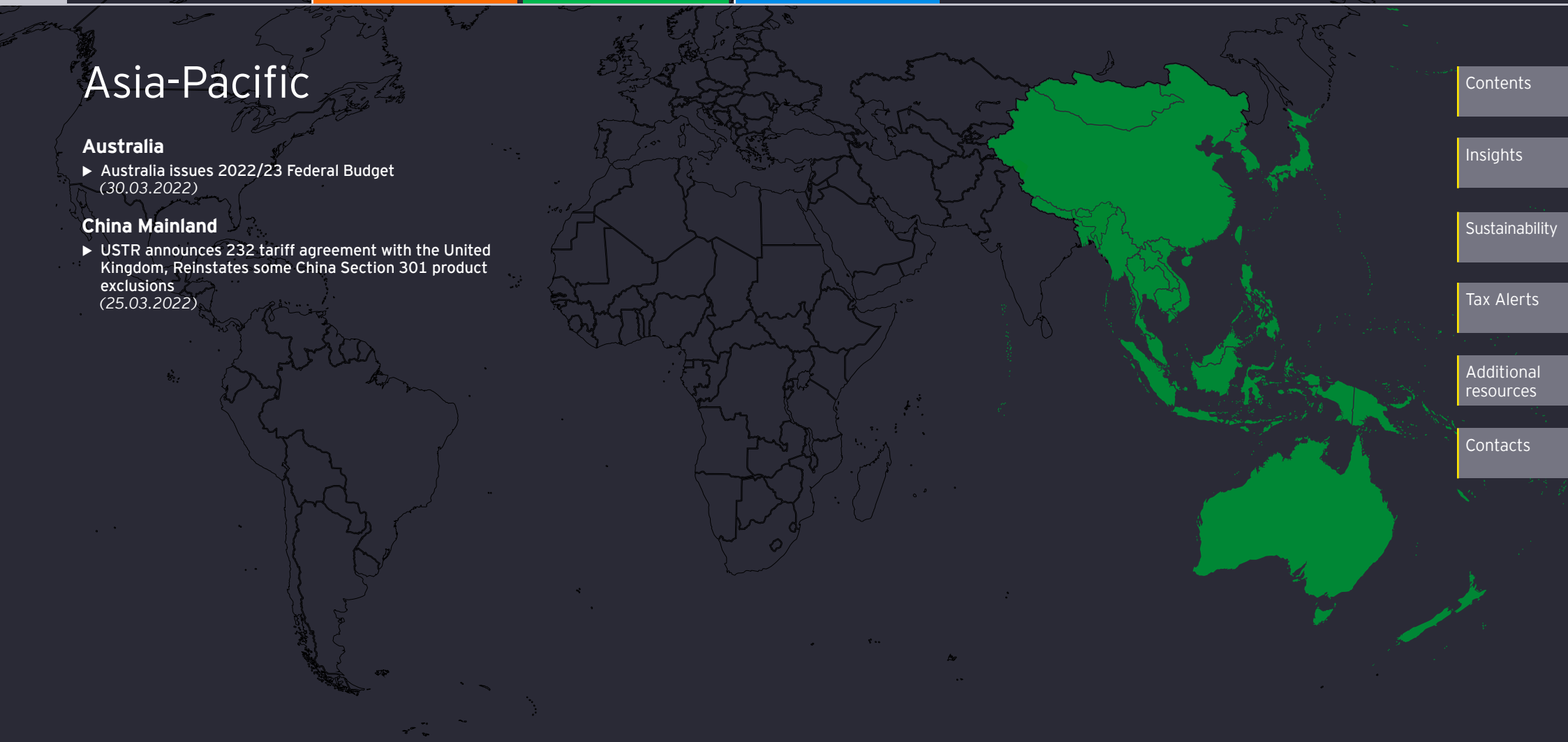
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