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'First Sale' Under Severe Pressure in the EU

By Madelein Perrick (Mayer Brown), Paulette Vander Schueren (Mayer Brown) and Mark Neville (International Trade Counsellors)

Introduction

For several decades now, when there is a series of sales, customs value in the EU can be based on a sale earlier than the "last sale" in the series, provided certain conditions are fulfilled. Thus, where sales are made from a supplier to a trading company that, in turn, resells to an EU importer, customs value could be based on the first sale, i.e., between the supplier and the trading company. This has the effect of excluding the margin of the trading company from customs value.

However, that may change. As part of a package of new customs implementing rules, the European Commission has proposed that this option be abolished by May 1, 2016. This will have an impact on many importers using this option as it will increase their customs debt, will necessitate changes

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Designing Effective Trade and Customs Internal Controls

By Florence Lam, Antonia Pereira and Andrew Siciliano (KPMG LLP)[1]

Overview

In May 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) updated the Internal Control–Integrated Framework (Framework) that companies use to assess their internal controls.[2] U.S. Customs and Border Protection (CBP or Customs) is expected to incorporate these changes into the Focused Assessment (FA)[3] program and Importer Self Assessment (ISA)[4] program early in the fiscal year of 2015.[5] As such, organizations interfacing with CBP should take advantage of this transition period to consider updates and enhancements to their internal controls. Taking the time to ensure alignment with the Framework before CBP's official implementation of the updates will put a company ahead of the curve in terms of ("the" should stay) better risk assessment practices that will be expected by CBP. Thus, any company looking to develop, assess or enhance

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to their supply chain and will increase prices to consumers in the EU.

The Current Situation

Article 29 of the Community Customs Code (CC)[1] provides that the customs value of imported good shall be the transaction value, that is, the price paid or payable for the goods when sold for export to the EU customs territory.

Article 147 of the implementing provisions to the CC (CCIR[2]) provides that, where there are successive sales, an earlier sale may determine the customs value in certain circumstances, i.e.:

1. For the purposes of Article 29 of the Code, the fact that the goods which are the subject of a sale are declared for free circulation shall be regarded as adequate indication that they were sold for export to the customs territory of the Community. In the case of successive sales before valuation, only the last sale, which led to the introduction of the goods into the customs territory of the Community, or a sale taking place in the customs territory of the Community before entry for free circulation of the goods shall constitute such indication.

Where a price is declared which relates to a sale taking place before the last sale on the basis of which the goods were introduced into the customs territory of the Community, it must be demonstrated to the satisfaction of the customs authorities that this sale of goods took place for export to the customs territory in question. (emphasis added)

In addition, the Commission issued guidance[3] on when an earlier (or first) sale could be used and what kind of conditions would need to be satisfied, such as the goods being shipped directly to the EU, being manufactured specifically for an EU buyer or to EU specifications etc.

In 2007, however, WCO Commentary 22.1[4] was adopted and this concluded that in a series of sales the export price is the price paid "*in the last sale prior to the introduction of the goods into the country of importation.*"

This Commentary certainly had an influence on the European Commission proposing the withdrawal of the first sale option as well as the U.S customs authorities' 2008-2009 effort to withdraw the first sale rule (which proposal was later withdrawn).

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Status and Adverse Consequences of U.S. Export Control Reform

By Matthew A. Goldstein (Matthew A. Goldstein PLLC)

Introduction

For decades, a wide range of industries complained that the United States export control system is overly complex, outdated, and inefficient. Responding to these and other calls for reform, President Obama first presented his plan for a comprehensive reform of the system in 2009. The reform, known as the "President's Export Control Reform Initiative," is overseen by the President's Export Reform Task Force, an interagency body that has coordinated the publication of over a thousand pages of proposed and final rules amending the Department of State's International Traffic in Arms Regulations ("ITAR"), 22 C.F.R. Parts 120-130, and the Department of Commerce's Export Administration Regulations ("EAR"), 15 C.F.R. Parts 730-774. As the changes take effect, a variety of adverse consequences have emerged, leading many industry members to question the Task Force's approach to reform.

Reform Goals and Initial Task Force Approach

The reform seeks to streamline agency resources, focus on threats that matter most, increase interoperability with allies, and reduce incentives for foreign manufacturers to design out U.S. origin technology. To achieve these goals, the Task Force initially planned to establish a single export licensing agency, a single export control list, transfer export jurisdiction over commercial communications satellites ("COMSAT") items from ITAR to EAR control, and facilitate the export of various parts, components, accessories, attachments, and other military items of lesser national security concern to U.S. allies through license exceptions. It further planned to harmonize agency definitions for common terms and positively describe items subject to control.

The Task Force's original plan centered on implementing a three-tiered structure that guided the list transfers, facilitated merger of the ITAR U.S. Munitions List ("USML") and EAR Commerce Control List ("CCL"), and clarified licensing policy. This required relevant agencies to divide controlled items between three tiers of control where: (1) The top tier included items involving weapons of mass destruction or are of a critical military or intelligence advantage that are not available abroad; (2) The middle tier included items providing substantial military or intelligence advantage that are only available from U.S. suppliers, and; (3) The bottom tier included such items that are available outside the U.S.

Preliminary Congressional Hurdles

The Task Force's initial plan required Congressional action because the Arms Export Control Act[1] and related legislation specifically vest certain licensing responsibilities in the Department of State. Therefore, Congressional action is required to establish a single licensing agency. The Task Force never introduced this legislation and a senior agency official recently advised that there are no plans to introduce it during the current administration.

Although the Task Force's focus was not on simplifying U.S. export controls, many industry members reasonably expected that export control reform would reduce the unnecessary complexity. Unfortunately, the export reform process and the resulting regulations have made matters increasingly complex.

Additionally, Congress established ITAR control over COMSAT items under the Strom Thurmond National Defense Authorization Act for Fiscal Year 1999,[2] so the transfer of these items to Department of Commerce jurisdiction required Congressional action. To address this requirement, the Task Force successfully lobbied Congress to add a rider to the National Defense Reauthorization Act for Fiscal Year 2013 to allow the President to transfer export jurisdiction over many COMSAT items to the Department of Commerce.[3]

Finally, because Section 38(j) of the Arms Export Control Act prohibits the implementation of country-based license exemptions without

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binding bilateral agreements in the ITAR, Congressional action was required to permit limited country-based exemptions in the ITAR for exports to allies without bilateral agreements. To address this requirement, Congress offered to amend the Arms Export Control Act to allow a limited country-based exemption without the need for bilateral agreements.[4]

Congressional authorization for an ITAR country-based exemption would have still allowed the Task Force to transfer COMSAT items to the EAR, harmonize agency definitions, and positively describe items subject to control. However, the Task Force did not support this option. Instead, it sought creation of the Strategic Trade Authorization ("STA"), a new country-based EAR license exception, and began the arduous process of transferring many USML defense articles to a new Commerce Munitions List (also known as the new "600 Series") established within the EAR CCL. These list transfers do not require Congressional approval but, pursuant to Section 38(f) of the Arms Export Control Act, the Administration must provide Congress with thirty-day advance notification prior to the transfer of each defense article.

The Control List Transfers

The Administration expressed concerns that the tiering process was taking too long and interfered with its plan for piecemeal list transfers on a rolling basis. It therefore abandoned the tiered approach in 2011. This change went largely unnoticed by industry and enabled the Task Force to submit its first round of control list transfers for Office of Management and Budget review on the eve of the 2012 Presidential election.

Following President Obama's re-election, the Task Force completed transfers for USML categories IV (Launch Vehicles, Guided Missiles, Ballistic Missiles, Rockets, Torpedoes, Bombs, and Mines), V (Explosives and Energetic Materials, Propellants, Incendiary Agents, and Their Constituents), VI (Surface Vessels of War and Special Naval Equipment), VII (Ground Vehicles), VIII (Aircraft and Related Articles), IX (Military Training Equipment), X (Personal Protective Equipment), XIII (Materials and Miscellaneous Articles), XV (Spacecraft Systems and Related Items), XVI (Nuclear Weapons Related Articles), XVII (Classified Articles, Technical Data, and Defense Services Not Otherwise Enumerated), and XX (Submersible Vessels and Related Articles).[5]

The contents of entire USML categories did not transition to the EAR, but the Task Force did populate Category XIX (Gas Turbine Engines and Associated Equipment), which was formerly reserved, to control a variety of items formerly under USML categories VI, VII, and VIII.

Reportedly, the Task Force also provided Congress with notification for transfers of Category XI (Military Electronics) in May 2014.[6] The requisite thirty-day waiting period for such notification expires in late June, clearing the way for publication of the final rule implementing the transfers in July 2014.

Transfers from categories I (Firearms, Close Assault Weapons and Combat Shotguns), II (Guns and Armament), and III (Ammunition/Ordnance) are reportedly stalled while agencies debate these transfer's effects on the government's ability to combat illegal gun trafficking.[7] Transfers from categories XII (Fire Control, Range Finder, Optical and Guidance and Control Equipment) and XIV (Toxicological Agents, Including Chemical Agents, Biological Agents, and Associated Equipment) are also still in interagency review and the Task Force has not estimated the timeframe for completion.

In addition to the list transfers, the Task Force revised USML Category XXI (formerly "Miscellaneous Defense Articles"), implemented a new 0Y521 ECCN series in the EAR to control emerging technologies not otherwise articulated, and applied new definitions for "specially designed," "part," "component," "accessories," "attachments," "equipment," and "end item." The Task Force has not yet harmonized other key regulatory terms, such as "technical data" and "technology," "public domain" and "publicly available," differences in scope of "fundamental research," or differing agency practices used in determining country of nationality.

Adverse Consequences Identified by the Task Force

The final rules implementing the reform required substantial modifications, and the Task Force already issued over fifty pages of correction rules. The Task Force also acknowledges various adverse consequences of the reform. These include the following, for which the Task Force coordinated a series of fixes outside the formal rulemaking process that have vastly increased the regulation's complexity:

Validity of Existing Authorizations for Transferred Items: Transfers of jurisdiction over items and activities subject to existing Department of State agreements and licenses created uncertainty over managing existing authorizations. To address this unintended consequence, the Department of

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State issued informal guidance on grandfathering and legacy issues and added a new section to its guidelines on preparing electronic agreements.[8] Although helpful, the guidance adds significant complexity to previous authorization management practices.

Restrictive Treatment of Deemed Reexports under the EAR: Because of the differences in the scope of EAR license exceptions and ITAR license exemptions for deemed re-exports of technology and source code to dual and third country nationals, the EAR can impose more restrictive deemed reexport controls on transferred items than the ITAR. To address this unintended consequence, the Department of Commerce issued informal guidance stating that it will permit the use of certain ITAR exemptions for deemed re-exports of EAR-controlled technology and source code.[9]

Dual-licensing Requirements for Mixed Jurisdiction Shipments: Exports of defense articles remaining on the ITAR with items transferred to the EAR implicate the need for separate licenses from the Departments of State and Commerce. To address the unintended consequence, the President amended a 1977 executive order to provide the Department of State with overlapping export-licensing jurisdiction for certain shipments containing both ITAR and EAR items.[10] The Department of State created a new "Paragraph x" in the USML to facilitate its management of these EAR exports, and has provided complex informal rules for industry's use in determining whether a shipment of EAR items qualifies for a Department of State license.

Adverse Consequences Identified by Industry

The Department of State's Defense Trade Advisory Group,[11] government contractors, the American Bar Association, export compliance professionals, and other industry members identified additional unintended consequences not yet fixed by the Task Force. These include the following:

Increased Compliance Burdens: In transferring items to the EAR, the Task Force split jurisdiction over many company product lines formerly only subject to the ITAR. As a result, companies with established ITAR compliance programs must reclassify items, establish new workflows and processes, reconfigure compliance tools, and train employees to address EAR practicalities. This has destabilized industry's ability to establish consistent compliance programs, and forces companies to devote significant resources to compliance with EAR requirements that were not an issue before reform.

Overly Burdensome STA Requirements: The STA license exception is now available for many exports of transferred items to government end users in countries considered STA eligible. However, the license exception requirements are so complicated and cumbersome that many companies are instead opting to obtain licenses. This calls the reform effort's success into question because industry use of STA is the cornerstone of the Task Force's plan to increase interoperability of allies.

Emerging Technology Controls Deter U.S.-Based Innovation: Revised USML Category XXI controls items that provide a "critical military or intelligence advantage," and new CCL ECCN 0Y521 controls items that provide a "significant military or intelligence advantage." These new standards are ambiguous, subjective, and hard to differentiate between in reality. Moreover, they provide nearly open-ended government discretion to control emerging technologies without meaningful advance notice. This uncertainty is expected to deter many companies from developing new technologies inside the U.S.

Implementing a limited ITAR country-based exemption through legislation instead of the complex, band aide-like list transfers would have better served industry interests and avoided disconnects with authorizing legislation.

Difficulty in Applying "Specially Designed": At nearly two thousand words in length, industry warned the Task Force that the new definition for "specially designed" was overly complex, confusing, and difficult to apply. But the Task Force imposed the definition throughout the USML and CCL, hoping to address industry concerns through explanatory notes, a custom glossary, online decision tools, advisory opinions, and industry outreach at seminars. While this guidance is helpful to some, the very need for so much guidance underscores the definition's lack of clarity.

"Specially Designed" Definition Conflicts with Multilateral Regimes: "Specially designed" is a term used in the Wassenaar Arrangement

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and Missile Technology Control Regime. Many members of these multilateral control regimes are former members of the Coordinating Committee for Multilateral Export Controls ("CoCom"), the multilateral regime used by NATO members during the Cold War. CoCom required the U.S. to comply with a Statement of Understanding defining "specially designed" as, "equipment used solely for a particular purpose."[12] The new Task Force definition for "specially designed" is significantly different than the CoCom understanding, opening the way for U.S. allies' disagreements on the scope of multilateral controls.

Perpetuation of ITAR See-Through Rule in the EAR: The ITAR See-Through Rule is a Department of State policy that subjects foreign manufactured items to U.S. re-export control restrictions when they contain any U.S. origin content subject to the ITAR. In response, many foreign manufacturers now design out ITAR-controlled content to avoid application of U.S. re-export controls. Similar to the ITAR See-Through Rule, USML defense articles transferred to the EAR are now subject to a zero percent *de minimis* level for exports to ITAR embargoed countries.[13] This treatment perpetuates the ITAR See-Through Rule in the EAR and, as a consequence, provides foreign manufacturers with a strong incentive to now design out all U.S. origin technology.

Disconnect with the "China Prohibition" in Defense Acquisitions: Section 1211 of the National Defense Authorization Act for Fiscal Year 2006 prohibits the Department of Defense from procuring USML defense articles from the People's Republic of China.[14] This prohibition cross-references USML defense articles as defined in the ITAR, which means the transfer of USML articles to the EAR creates a disconnect that circumvents Congressional intent underlying the prohibition.[15]

Disconnect with the Foreign Assistance Act of 1961: The Foreign Assistance Act of 1961 ("FAA") also cross-references USML defense articles as defined in the ITAR. The Task Force list transfers therefore create further disconnects with limitations on U.S. security assistance imposed by Congress under the FAA.[16] The transfers also create disconnects with FAA Foreign Military Sales ("FMS") program provisions because the Department of State is designated with regulatory responsibility for the FMS program and the EAR provides that FMS exports pursuant to a Letter of Offer and Acceptance are not subject to the Department of Commerce jurisdiction under the EAR.[17]

Conclusion

Although the Task Force's focus was not on simplifying U.S. export controls, many industry members reasonably expected that export control reform would reduce the unnecessary complexity. Unfortunately, the export reform process and the resulting regulations have made matters increasingly complex. Much of this results from Task Force reliance on regulatory rewrites instead of Congressional amendment, which has had the further effect of disconnecting export control lists from legislation that explicitly cross-references USML defense articles.

Implementing a limited ITAR country-based exemption through legislation instead of the complex, band aide-like list transfers would have better served industry interests and avoided disconnects with authorizing legislation. As a result of the Task Force's approach, industry continues to experience the adverse consequences noted above. New challenges will invariably emerge as the reform enters its sixth year. To address these risks, trade compliance professionals must take the time necessary to translate continued Task Force changes into actual operational impacts. This is not an easy task and, in the end, the multitude of adverse consequences may overshadow any perceived long-term benefits of export control reform. ❑

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1 Arms Export Control Act of 1976 (Pub. L. No. 94-329).
2 Pub. L. 105–261.
3 National Defense Reauthorization Act for Fiscal Year 2013 (Pub. L. 112–239).
4 *See* Section 38(l) of the Foreign Relations Authorization Act for FY 2013, H.R. 6018 (112th).
5 For a comprehensive summary of Federal Register notices implementing the transfers, see the May 2014 ECR Control List Tracking Sheet, available at http://export.gov/ecr
6 *See* "ECR Status - Remaining USML Categories," ITAR Compliance Professionals Group Discussion, June 6, 2014, available at www.linkedin.com
7 *See e.g.*, Adam Entous and Evan Perez, "White House Efforts to Relax Gun Exports Face Resistance," Wall Street Journal, May 1, 2012.
8 *See* "Frequently Asked Questions (FAQs) / Grandfathering/Legacy Issues," available at http://www.pmddtc.state.gov/faqs/ecr.html; Guidelines for Preparing Electronic Agreements (Revision 4.1), Department of State, October 9, 2013, at Section 20, available at www.pmddtc.state.gov
9 *See* "Updated BIS Guidance Regarding the Treatment of Dual and Third Country Nationals with Respect to Deemed Reexports of Technology or Source Code

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Subject to the EAR," October 31, 2013, available at www.bis.doc.gov
10 Executive Order 11958 (January 18, 1977), as amended by Executive Order 13637 (March 8, 2013).
11 *See e.g.*, "Export Control Reform – Unintended Consequences – DTAG Working Group," January 16, 2014, available at http://pmddtc.state.gov/dtag; N.B. the DTAG is a federal advisory committee chartered to advise the Department of State on defense industry issues under the ITAR.
12 *See* COCOM Statement of Understanding attached to Supplemental Affidavit of Joseph F. Dytrt, Document 583-2 in United States v. Lachman, Case 1:93-cr-10193-DPW.
13 There is an exception to this restriction for exports of ".y" 600 series items, which are subject to embargoes on exports to Cuba, Iran, North Korea, Sudan, Syria, and China.
14 National Defense Authorization Act for Fiscal Year 2006 (Pub. L. 109-163) and National Defense Authorization Act for Fiscal Year 2012 (Pub. L. 112-81), codified at 48 C.F.R. Part 225, Subpart 225.7.
15 For further discussion, see Kenneth J. Nunnenkamp and Giovanna M. Cinelli, "The Consequences of Export Reform—Intended and Unintended," Jones Day Publications, September 2013, available at www.jonesday.com.
16 Foreign Assistance Act of 1961 (Pub. L. No. 87-195), relevant provisions codified at 22 U.S.C. §§ 2378(a), 2378d(a); *see also* "White Paper: Proposals to Relax Export Controls for Significant Military Equipment," American Bar Association Center for Human Rights, January 14, 2013.
17 *See* 15 C.F.R. § 734.3(1)(b)(vi).

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Free Trade Agreements

China, Australia Aim to Conclude Free Trade Talks by 2014

By Samuel Scoles (White & Case)

Overview

Chinese and Australian officials met in Canberra from May 5 to 8, 2014 for the 20th round of bilateral free trade agreement (FTA) negotiations. Leveraging the positive progress made during Australian Prime Minister Tony Abbott's visit to China in April, the two sides conducted comprehensive discussions and pledged to conclude negotiations by November 2014 during Chinese President Xi's attendance at the G20 Summit in Brisbane.

According to the Australian Department of Foreign Affairs and Trade (DFAT), the two sides held constructive discussions during this latest round in a number of areas, including trade in goods, technical barriers to trade, customs procedures and trade facilitation, rules of origin, dispute settlement, and investment. However, DFAT also indicated that substantial work remains to resolve certain sensitive areas, which suggests the possibility of holding another negotiating round to address the outstanding issues.

Key Issues

Market access in agricultural goods is one of Australia's core interests in the FTA negotiations. The Australian government expects to receive the same if not better agricultural concessions from China as what New Zealand achieved under the China-New Zealand FTA in force since October 2008. As a result, urging China to reduce import tariffs on Australian grain, sugar and meat is one of Australia's primary goals in the negotiations. Australia is also seeking the removal of China's technical barriers to trade on agriculture products. The exportation of beef to China, for example, is subject to advanced compulsory certification

Despite remaining sensitive issues, concluding the FTA negotiations by the end of 2014 is highly important to both countries.

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of suppliers by China's Administration of Quality Inspection, Supervision and Quarantine (AQSIQ).

In return, China is seeking improvement in sectors of interest such as investment by Chinese state-owned enterprises (SOEs) and the accompanying movement of natural persons (MNP).

Under Australia's current foreign investment policy, the Australian Foreign Investment Review Board (FIRB)[1] must review any investment regardless of value from an SOE, or an investment amount over AUD 248 million from private investors. As most investment from China comes from SOEs, compromise in the negotiations from Australia on the investment thresholds is of paramount importance to China. In previous negotiating rounds, Chinese negotiators have suggested revising the threshold that triggers the FIRB review process for SOE investments from zero to AUD 1.078 billion.

China is seeking improvement in sectors of interest such as investment by Chinese state-owned enterprises (SOEs) and the accompanying movement of natural persons (MNP).

However, despite Prime Minister Abbot's recent public comments recognizing the commercialization of Chinese SOEs, it remains uncertain whether Australia would agree that Chinese SOEs should be granted the same investment threshold (*i.e.*, AUD 1.078 billion) as private investments from current (New Zealand and United States) and future (Japan and Korea) FTA partners.

Some observers contend that the two sides are more likely to compromise at a lower threshold, such as AUD 300 million, which would keep most investment from Chinese SOEs outside of the FIRB review process.

Momentum to Conclude Talks in 2014

Despite remaining sensitive issues, concluding the FTA negotiations by the end of 2014 is highly important to both countries. In March 2014, Premier Li Keqiang pledged in his government work report delivered during the National People's Congress to "accelerate FTA negotiations with Korea, Australia and the Gulf Cooperation Council."

Australia is China's seventh largest trading partner with trade in goods and services valued at more than AUD 141 billion in 2013. Meanwhile, China is Australia's largest trading partner with bilateral trade in 2013 reaching AUD 122.5 billion – accounting for 25 percent of Australia's total trade value.

Other than the traditional export of goods such as wool, iron, copper ore, coal, and minerals, Australia's main exports to China have expanded to include mining equipment and relevant technologies. According to FIRB statistics, China has been the third largest source of foreign direct investment in Australia for the past four fiscal years with an accumulated amount of over AUD 60 billion.

After signing an FTA with Korea and concluding economic partnership agreement (EPA) negotiations with Japan in April, securing an FTA with China could be yet another policy achievement for the Abbott Administration in 2014. The Agreement may also add momentum to China's recent call at the Second APEC Senior Officials' Meeting (SOM2) held in Qingdao on May 14, 2014 for "concrete steps" towards the establishment of a Free Trade Area of the Asia-Pacific (FTAPP). ❑

1 Australia's legislative framework for screening foreign direct investment is set out under the *Foreign Acquisitions and Takeovers Act 1975* (FATA) and accompanying *Foreign Acquisitions and Takeovers Regulations 1989* (the "FATA Regulations"). This legislation empowers the Treasurer to block certain transactions (or require divesture in some cases) where the transaction is considered to be contrary to the 'national interest'. This legislation also requires all foreign investment in excess of certain thresholds to be submitted for consideration by the Treasurer prior to the transaction becoming binding.

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Trade & Customs Round Up

By Linda Zhang (Thomson Reuters)

U.S. Says Basic Outline in Place for International Services Trade Deal

U.S. Trade Representative Michael Froman announced that the basic outline of a Trade in Services Agreement (TISA) is in place, according to Reuters. Negotiators have made progress on market access and discussion on telecommunications and financial services.

The trade deal, if passed, would open trade in services among 50 countries, which makes up two-thirds of services trade in the world. Other issues that remain include cross-border data flows, state-owned enterprises, air pollution monitoring, and shipping services.

President Obama Says Hopes for Pacific Trade Pact in November

U.S. President Barack Obama said he aims to have a Trans-Pacific Partnership (TPP) agreement ready to show the public and stakeholders by November, when he will arrive in Australia to meet with G20 leaders, according to Reuters. In contrast, Australian Trade Minister Andrew Robb predicts that an agreement would be reached no earlier than the first half of 2015.

Anger by U.S. Farmers Threatens Ambitious Pacific Trade Pact

U.S. farmers are dissatisfied with signs that Japan may maintain some barriers to its agricultural sector under the Trans-Pacific Partnership, according to Reuters. Four years into talks, U.S. negotiators have continued to face the challenge of balancing the elimination of all tariffs with the demand to adjust for sensitive industries.

New Zealand Urges U.S. to Hold Firm on Farm Exports in Pacific Trade Deal

New Zealand Prime Minister John Key has pushed the U.S. to stand its ground to not cut tariffs from sensitive farm exports under the proposed Pacific trade pact, according to Reuters. He added, if Japan could not make any adjustments, it should be removed from the trade deal.

EU Approves New Round of Japan Free-trade Talks from Early July

The European Union and Japan will resume a sixth round of free trade talks in Tokyo in July, according to Reuters, despite disagreements over a safety provision in railway production that prohibits foreign suppliers from entering the market.

USTR Welcomes Executive Actions to Preserve and Protect Oceans, TPP Implications

President Barack Obama announced a new Task Force to fight illegal fishing and encourage trade in legal, sustainable seafood, which impacts ongoing Pacific trade pact negotiations, said U.S. Trade Representative Michael Froman, according to the official press release. The Trans-Pacific Partnership has committed to advancing sustainable fisheries management, combat illegal fishing, and stop detrimental fisheries subsidies that contribute to overfishing.

Australia Says China Free Trade Deal Likely by End of Year

Australia's trade chief Andrew Robb said that he is determined to sign a free trade deal with China by the end of 2014, according to Reuters. However, there is little evidence of a breakthrough as Australia has refused to give more details. So far, Australia has completed trade deals with both Japan and South Korea.

Multinationals Will Not Get Too Much Power from EU-U.S. Trade Talks, EU Says

The European Union's trade chief said that multinational companies will not be given "too much power" by the proposed Transatlantic Trade and Investment Partnership, hoping to quell concerns from consumer and environment groups, according to Reuters.

The groups are concerned about a proposed dispute settlement mechanism that would allow companies to bring claims against a country if there is a treaty breach, which they claim would allow multinational companies to "bully" the EU's 28 governments without consideration of environmental, labor, and food laws.

Latest Round of U.S.-EU FTA Talks Deemed "Productive" but Much Work Remains

U.S. and EU officials said that negotiators have made progress in transatlantic trade talks on a majority of issues, including technical barriers to trade, state-to-state dispute settlement, and small

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and medium-sized businesses, according to the Sandler, Travis & Rosenberg Trade Report. They expect to progress to discussions on the remaining areas in the "near future."

Sixth Round of TTIP Talks to Be Held July 14-18

The sixth round of Transatlantic Trade and Investment Partnership (TTIP) talks will be held on July 14-18 in Brussels, according to a European Commission announcement. Negotiators will cover many topics including trade in goods and services, government procurement, and opportunities for small and medium-sized enterprises.

EU Threat on Banking in U.S. Trade Talks is Empty

A U.S. official said that the threat that the EU made to take financial services off the negotiating table in U.S.-EU trade talks is "empty", according to Reuters. Since the EU has already committed to international agreements that require participation of the sector, the exclusion is invalid. The EU has proposed financial services to be removed from a market access offer in services, in response to the refusal of the U.S. to harmonize rules on financial services.

Merkel Wants Hurdles Removed from EU-Mercosur Free Trade Pact

German Chancellor Angela Merkel has said she will do her best to conclude trade talks between the EU and South America's Mercosur trade bloc, despite difficulties over the past 15 years caused by sensitive agricultural sectors, among other issues, according to Reuters. Beyond contentions over farm subsidies, she discussed the need for expanded cooperation in scientific research, renewable energy, and methods to increase investment flows.

United States Wins Trade Enforcement Case Against China On Autos

The United States won a major case at the WTO concerning U.S. auto manufactures and autoworkers against China, according to the USTR website. The dispute settlement panel sided with the U.S. in determining that China's use of antidumping duties and countervailing duties on U.S.-made cars violated a number of international trade rules.

U.S. Sets New Import Duties on Chinese Solar Products

The U.S. has imposed new import duties on solar panels from China following a Commerce department ruling that the panels were subsided by the Chinese government, according to Reuters. The U.S. arm of Germany's SolarWorld claimed that the Chinese companies shifted production of solar cells used to make the panels to Taiwan to avoid duties, and have continued to export to U.S. markets at unfair prices.

USTR Hosts Public Hearing on the WTO Environmental Goods Agreement

The Office of United States Trade Representative (USTR) received comments on negotiating objectives regarding the WTO Environmental Goods Agreement in June, according to the USTR press release. Countries involved include the U.S., Australia, Canada, China, Costa Rica, the EU, Hong Kong, Japan, Korea, New Zealand, Norway, Singapore Switzerland, and Taiwan. The deal would eliminate tariffs on environmental goods such as solar water heaters and wind turbines.

First Meeting of United States—Panama Free Trade Commission of the United States-Panama Trade Promotion Agreement

The United States—Panama Free Trade Commission met for the first time to review the trade and economic impact of United States-Panama Trade Promotion Agreement, which has been in implementation for 19 months, according to the USTR website. Both sides agreed to continue to collaborate on effective implementation and compliance with agreements on trade in goods and services, intellectual property rights, labor, and environmental obligations of the agreement.

Latest Talks on U.S.-Central Asia Trade and Investment Framework Agreement

In June, the U.S. met with Central Asian officials for the 9th United States-Central Asia Trade and Investment Framework Agreement (TIFA) Council meeting, according the USTR website. The governments of Kazakhstan, Kyrgyzstan, Turkmenistan, Tajikistan, Uzbekistan, and Afghanistan participated in the discussion. The talks focused on WTO membership, customs, investment, standards and sanitary measures, and procurement. ❑

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CRS Releases NAFTA at 20 Report; Underscores Significance of TPP to North American Trade

By Daniel Wu (White & Case)

Summary

On April 28, 2014, the U.S. Congressional Research Service (CRS) released a report titled *NAFTA at 20: Overview and Trade Effects*. The report highlights recent trade trends and economic effects of the North American Free Trade Agreement (NAFTA) and the key issues the U.S. Congress should focus on concerning the Agreement, including further efforts to improve trilateral regulatory cooperation and border infrastructure. The CRS report expresses cautious optimism regarding the proposed Trans-Pacific Partnership (TPP) negotiations, which, if concluded, could prompt Mexico and Canada to accept stronger provisions on key negotiating areas, such as the intellectual property rights (IPR), labor, and environment.

Analysis:
Economic Trends with NAFTA Partners

The *NAFTA at 20: Overview and Trade Effects* report ("NAFTA Report")[1] highlights economic and trade trends with a focus on trilateral trade and the effect of NAFTA on the Canadian, Mexican, and U.S. economies since its entry into force of NAFTA on January 1, 1994.

Trilateral Trade

Trilateral trade has tripled since NAFTA entered into force. In 2011, trilateral trade among NAFTA partners reached $1 trillion. Specifically, trade between Mexico and the United States has contributed greatly to growth in North American trade, accounting for almost half of the increase in regional trade since 1994. Meanwhile, Canada and Mexico accounted for 33 percent of U.S. exports in 2013. Canada was the leading market for U.S. exports in 2013, whereas Mexico ranked second.

Conversely, Canada and Mexico ranked second and third respectively as sources of U.S. imports, giving way to China as the leading exporter to the U.S. market. In recent years, trade in petroleum products (16 percent of total trade) has become a central component of U.S. trade with Canada and Mexico.

Canada remains the leading supplier of crude petroleum oil to the United States, followed by Saudi Arabia and Mexico.

NAFTA's Effects on the Canadian Economy

From the Canadian perspective, an important consequence of NAFTA for Canada is what "did not happen" when the Agreement entered into force, such as becoming over dependent on the U.S. economy or losing control over its water or energy resources. Although Canada expected that NAFTA would become a catalyst for greater productivity in its industries, the NAFTA Reports states that those hopes vanished as Canada failed to make further investments in research and development and in information technology. The United States is both the leading purchaser of Canadian goods and source of imports to Canada. Traditionally, Canada was the largest purchaser of U.S. exports and supplier of U.S. imports. In 2007, China displaced Canada as the largest source of U.S. imports. Although Canada is not the largest investor in the United States, the United States is the largest destination for Canadian FDI.

The NAFTA Report expresses cautious optimism regarding the TPP negotiations if its provisions go beyond what the three partners negotiated under NAFTA or what the United States has agreed to in its other bilateral free trade agreements.

NAFTA's Effects on the Mexican Economy

NAFTA has resulted in economic and social benefits for the Mexican economy, but these have been uneven according to the NAFTA Report. Most post-NAFTA studies on economic effects have found that the net effects on the Mexican economy are positive, albeit modest. According to studies released by the World Bank in recent years, thanks to NAFTA, Mexico has increased its productivity, reduced macroeconomic volatility, and adapted to U.S. technological innovations more rapidly. Other studies offer contrasting views and argue that NAFTA has failed to improve

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the performance of the Mexican economy as a whole and reduce income disparities between Mexico and its NAFTA trading partners. These studies argue that Mexico needs to invest more in education, innovation and infrastructure to narrow the income disparities with its northern neighbors. The NAFTA Report notes that one of the most controversial aspects of NAFTA's effects on the Mexican economy relates to job displacement in Mexico's agricultural sector, in particular the corn industry.

NAFTA's Effects on the U.S. Economy

As total trade with Canada and Mexico was equal to less than 5 percent of U.S. global trade, the NAFTA Report notes that the overall effect of NAFTA on the U.S. economy has been small. Recent studies from leading U.S. government agencies, such as the U.S. International Trade Commission (USITC) and the Congressional Budget Office observe that NAFTA has had a small, but positive, effect on the overall U.S. economy.

Moreover, U.S. trade with Canada and Mexico was already growing prior to NAFTA, and it would have continued to do so without the Agreement. The NAFTA Report also notes that the United States has benefited from production sharing arrangements along the U.S.-Mexico border. Inputs produced in the United States exported to Mexico and the return flow of finished goods to the United States has increased the importance of the U.S.-Mexico border region as a linked "production site." NAFTA has been a key driving force to integrate certain industries, such as the North American auto industry. For example, in 2013, Mexico was the leading supplier of automotive goods to the United States, accounting for 28 percent of motor vehicle and auto part in the United States.

Analysis: TPP Implications and Future Trilateral Cooperation

The NAFTA Report points out that the TPP negotiations could have implications for Canada and Mexico, particularly in the areas of investment, services, government procurement, IPR, labor, and environment.

If agreement is reached on TPP, Canada and Mexico will likely have to meet NAFTA-Plus provisions on labor, environment and IPR, as well as some issues that were not addressed in detail in NAFTA, such as disciplines on state-owned enterprises (SOEs). So far, NAFTA parties have sought to improve cooperation in the areas of transportation, competitiveness, energy, and security. However, they may need to shift their attention to other more immediate challenges, such as border infrastructure and domestic supply chains.

The NAFTA Report also notes that the United States could deepen relations with Canada and Mexico through a common trade agenda with shared values. The latter, as suggested by trade policy experts, would have positive implications for corporate governance, labor rights, environmental protection, and democratic governance. Some experts propose expanding the current trilateral relationship through a Customs Union with a common external tariff to facilitate trade and deepen integration. Security concerns, however, represents the main obstacle to this initiative. Other experts support the proposal of establishing a North American Investment Fund to help Mexico "catch up" with its northern neighbors and narrow income disparities.

Outlook

The most noteworthy element of the NAFTA Report is its discussion of the TPP's implications for market access and rules under NAFTA. The NAFTA Report expresses cautious optimism regarding the TPP negotiations if its provisions go beyond what the three partners negotiated under NAFTA or what the United States has agreed to in its other bilateral free trade agreements (FTA). If the TPP presents NAFTA-Plus obligations, it may provide a basis and catalyst for higher quality NAFTA trade.

One legacy of NAFTA is that it has served as a model for other FTAs that the United States later negotiated and also for multilateral negotiations of the WTO Uruguay Round; however, the TPP may serve as a necessary refresh of the 20-year old Agreement. This refresh could help modernize NAFTA to be more in line with the current and envisioned state of trade among TPP Parties, while setting a precedent for establishing so-called "21st century" rules of trade. ❑

1 The report is available at https://www.fas.org/sgp/crs/row/R42965.pdf.

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The European Commission's Proposal to Abolish 'First Sale' Goes Beyond International Provisions

The text that the European Commission now proposes reads as follows:

"For the purposes of Article 70(1)[5] of the Code, the value of the goods shall be determined at the time of acceptance of the customs declaration on the basis of the transaction occurring immediately before the goods are declared for free circulation." (emphasis added)

Not only does this text remove the option to use an earlier sale, it could even result in domestic EU sales being used as the basis for transaction value, for example, a sale from an EU warehouse or a sale deep in the EU where the goods are sold and resold but only customs cleared by the final customer.

Clearly a sale within the EU just before customs clearance would no longer be a sale for export to the country of importation within the meaning of Article 1 CVA. It would even be inconsistent with Article 70.1 Union Customs Code[6] (i.e., the successor to the CC which it is supposed to implement) which explicitly refers to the price of the goods "when sold for export". It would go even beyond the *"last sale prior to the introduction of the goods into the importing country"* of WCO Commentary 22.1 and such EU sales would no longer constitute an *"international transfer of goods"* within the meaning of WCO Advisory Opinion 14.1 which provides that *"only transactions involving an actual international transfer of goods may be used in valuing merchandise under the transaction value method."* It would, in fact, be in violation of the CVA and the international valuation rules.

It would also abolish the EU's longstanding practice to allow the use of an earlier sale. As long as an earlier sale is a sale for export, it is perfectly in line with the CVA and there is no legal need to abolish it. Many EU businesses have come to rely on the earlier sale option and have based their import strategies on it, in line with international valuation principles.

The European Commission's Reasoning for Abolishing First Sale

The Commission has put forward several reasons for its intention to abolish the option to use an earlier sale.

The Need for Uniformity and Simplification

The Commission considers that the current Article 147 CCIR is badly drafted, contradictory and ambiguous and should be replaced by a clear and simple rule. However, the U.S. experience shows that it is possible to formulate a rule allowing the use of an earlier sale that is clear and unambiguous and, at the same time, imposes a high standard of proof on the importers. This last feature, marked by the burden being shifted to the importer, eases the task of the customs authorities considerably. In the U.S., the conditions under which customs valuation might be based upon an earlier sale in successive sales were formulated in two court cases, Nissho Iwai American Corp. v. United States[7], and Synergy Sport International, Ltd. v. United States[8]. Administrative guidance took the form of a Treasury Decision issued by the U.S. Customs Service[9] on December 13, 1996 ("TD 96-87").[10] U.S. Customs starts from the presumption that the price paid by the importer is the basis for the transaction value. However, this presumption can be rebutted by any importer who would furnish an earlier sale as the qualifying "sale for export" on which to base transaction value. Such an importer has the burden of proving that, at the time of this earlier sale transaction, the goods were "clearly destined for the USA" and that the value of that transaction must also be an arm's length price. Thus, amongst the information that the importer must provide is the following:

The first sale rule is currently being discussed between the Commission and the Member States in the Customs Code Committee. Discussions will continue in the coming months, but so far, the Commission appears to be inflexible and resolved to abolish first sale.

(i) The roles of all parties in the successive transactions must be described in detail and documents provided for each transaction that was involved in the exportation of the goods to the US. Such documentation would include purchase orders, invoices, contracts, proof of payment and additional documents (e.g. correspondence) that demonstrate how the parties dealt with each other. These documents must support the claim that the goods were clearly destined for the U.S. (direct shipment, U.S. specifications or labeling, etc.).

(ii) Any information on additions to transaction value should be provided (packing costs, selling

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commission, assists, royalties/license fees and proceeds of subsequent resale) for the requested transaction.

In short, the likelihood of success of the importer seeking first sale treatment will turn on whether the importer has met its considerable burden of satisfying the rigors of TD 96-87.

The U.S. first sale program as administered by U.S. Customs and Border Protection is used widely across many different industry sectors as is attested in the comprehensive study conducted by the U.S. International Trade Commission that contributed to the maintenance of the first sale in the USA.[11] Over the course of more than twenty years, many dozens of rulings have been issued by U.S. Customs and Border Protection to amplify this pervasive use of first sale and elaborate the conditions under which first sale treatment may be granted or denied.

Many EU businesses have based their import compliance strategies on existing customs valuation principles that are consistent with international norms, ensure predictability and generally work well in practice.

As an example of a losing importer effort, one might refer to ruling no. 547155 (March 22, 2001) where the claim for first sale was rejected for insufficient information. In a 2013 ruling,[12] an importer's claim for first sale was also rejected. The conclusion points to the process employed by U.S. Customs:

The totality of the circumstances leads CBP to conclude the "sale" between these parties is not an arm's length sale. In addition, although numerous documents were submitted in support of Ecko's claim, the documentation fell short of the "complete paper trail" referenced in T.D. 96-87. Therefore, such sale cannot be used under transaction value as the sale for exportation to the United States under "first sale" transaction value.

For a recent example of a successful first sale claim, see ruling no. H246654 (March 6, 2014).

The wide use of first sale in the U.S. has more recently been confirmed by a study carried out by KPMG[13] which conducted interviews with over 25 of the leading U.S. retail companies that are utilizing first sale. It shows that 65 percent of survey participants have used first sale for 2-6 years and 25 percent for 7 years and more and that yearly savings are substantial.

Taken together, the U.S. provisions, guidance and practice demonstrate that a first sale rule can be clearly and uniformly applied in practice without any undue problems for the customs authorities. This is the case even when the first sale is between related parties, with importers then having to justify that such a sale was not influenced by the relationship, as is the case with any related party sale. In other words, even though the "first sale" will be a transaction between foreign parties, the same rules that are normally applied to validate any other sale for export continue to apply in the case of the first sale rule.[14]

You should recognize that the U.S. rules and the current EU rules as expressed in Article 147 of the CCIR are congruent, with the only difference being that the U.S. rules and administrative practices have been more widely elaborated.

Discrimination against Small and Medium Enterprises (SMEs)

The Commission has also indicated that the first sale rule would discriminate against SMEs that have no related intermediate companies.

There is, in fact, no discrimination vis-à-vis SMEs because these SMEs purchase at the same price as the intermediate trading company. Whether the manufacturer in the Far East sells to an intermediate trading company or to an SME importing into the EU, all things being equal, the price to the trading company and the SME, and thus the customs value, will be equal. The only effect of allowing customs value to be determined on the first sale is to avoid customs duties being imposed on the gross margin of the trading company. In any case, no complaints about the first sale rule appear to have been made by any association representing EU SME interests.

The Commission further believes that SMEs are prevented from using first sale because they would buy from unrelated intermediate trading companies who would refuse to disclose the first sale prices charged by their suppliers which would reveal their margins to their customers. First, the KPMG study mentioned above confirms that mechanisms are found and work in practice to address the issue of the disclosure of the margin by the unrelated trading company.[15] Alternatively, if SMEs wanted to benefit from the assistance of experts overseas in purchasing products, rather than a buy-and-sale with a trading company, they could use the help of an economic operator in the

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role of a buying agent whereby the agency fee earned by the middleman would also be treated as non-dutiable.

SMEs are also known to make less use of other customs planning mechanisms. For example, FTAs are eschewed by SMEs, due to complicated rules of origin, and other duty saving regimes (e.g., inward processing or processing under customs control) are also not pursued. Yet, the EU has not seen the degree to which SMEs may not use these programs as a reason to abolish them.

In the above-mentioned U.S. ITC report on first sale, it is stated that approximately 8.5 percent of U.S. importers (23,500 companies) took advantage of first sale; although this number cannot be dissected, such a large group must necessarily include a large number of SMEs.

Differences between Customs Value and Amount Entered into Importer's Accounts

The Commission has stated that the use of first sale may lead to differences between, on the one hand, the declared customs value, and on the other hand, the value entered into the importer's account. That may still be the case if first sale were abolished as there are a number of pricing elements that are not dutiable (e.g., buying commissions, interest charges). These elements would not be part of customs value whilst they would show in the importer's accounts as an element in the cost of goods sold. In other words, this is not a valid reason to abolish first sale.[16]

Negative Consequences of Abolishing First Sale

Many EU businesses have based their import compliance strategies on existing customs valuation principles that are consistent with international norms, ensure predictability and generally work well in practice. If this option were removed, EU businesses would incur significant costs due to the combined effect of unnecessary costly alterations to their supply chain structures and higher import duties both on finished and semi-finished goods. They would also lose flexibility as to how to set up their supply chains, including the use of warehousing.

EU user industries will have to pay more for the inputs they rely on for their production. Customs duties are a highly regressive form of taxation. Higher import duties would in turn lead to price increases on a broad range of goods that would not be in the interest of EU users and consumers. EU businesses' competitiveness would be reduced as a result.

Status of the EU Proposal

The first sale rule is currently being discussed between the Commission and the Member States in the Customs Code Committee. Discussions will continue in the coming months, but so far, the Commission appears to be inflexible and resolved to abolish first sale.

The EU Member States can block the EU Commission's proposal based on a qualified majority vote (i.e., larger EU Member States having a larger vote). If there were a simple majority against the EU Commission's proposal (i.e., 15 Member States), the proposal would likely be considered in an appeal committee. The vote is likely to be taken in early 2015. ❑

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1 Regulation 2913/92.
2 Regulation 2454/93.
3 Commentary 7 in the EU Compendium on Customs Valuation Texts.
4 Commentary 22.1 on "the meaning of 'sold for export to the country of importation" in a series of sale.'
5 Article 70 UCC provides that the primary basis for valuation is the transaction value, i.e. the price paid or payable for the goods when sold for export to the customs territory of the Union.
6 Regulation 952/2013.
7 982 F.2d 505 (Fed. Cir. 1992)
8 17 CIT 18 (1993).
9 The U.S. Customs Service was subsequently renamed U.S. Customs and Border Protection.
10 Which has been reproduced in the Informed Compliance Publication of August 2005 entitled "Bona Fide Sales & Sales for Exportation to the United States," at pages 11 – 13.
11 U.S. International Trade Commission, "Use of the "First Sale Rule" for Customs Valuation of U.S. Imports," Investigation No. 332-505, USITC Publication 4121, December 2009, http://www.usitc.gov/publications/332/pub4121.pdf.
12 Ruling no. 240423 (July 31, 2013).
13 This Study is reported on by a recent article in the April issue of Thomson Reuters' "Practical Trade & Customs Strategies."
14 For examples of rulings in which the importer met this burden, see ruling nos. H208055 (Oct. 3, 2012) and W563542 (July 24, 2009). For an example of an unsuccessful importer claim, see ruling no. H097035 (Nov. 15, 2011)
15 Thus, KPMG found the following: "In addition, a key challenge for many importers during implementation of First Sale appraisement is conducting the arm's length analysis for related vendor/factory scenarios. Many vendors do not want to disclose profits to their customers and fear that by disclosing their cost structure, the retailer's sourcing teams may try to decrease the price or negotiate directly with the factory. Notwithstanding, many of the retailers in the study indicated they were able to alleviate these concerns through non-disclosure agreements, by

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segregating the First Sale team from the purchasing department(s), and through other internal controls. Although receiving financial information from the vendors and factories to satisfy U.S. Customs and Border Protection's (CBP) arms length requirement can be a challenge for retailers and trade professionals, it is a challenge that many retailers have been able to overcome."

16 In this connection, we note that in the U.S. there is an income tax provision, Internal Revenue Code Section 1059A, which applies to related party transactions. This section connects customs value with the price at which the imported goods might be carried at inventory. There has been no problem in bridging the gap between the two tax disciplines or in reconciling the differences in treatment due to first sale.

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Internal Controls

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their import or export controls would benefit from reviewing their internal controls in tandem with the Framework.

Background

Since the presentation of the updated framework, COSO has published a new thought leadership paper demonstrating how the Framework improves organizational performance and governance.[6] According to COSO, the original framework was updated to align with the increasingly complex, technologically driven, and global business environment.[7] As a result, the updates made to the framework include enhancements intended to address changes in the business environment by specifying criteria to use in the development and assessment of internal controls, and by increasing the focus on operations, compliance, and nonfinancial reporting objectives. The chart below is a side-by-side comparison of what has been maintained and what has changed from the original framework.

This article will consider the Framework's five components--control environment, risk assessment, control activities, information and communication, and risk monitoring--along with the 17 principles associated with the components.[8] These 17 principles represent the fundamental concepts associated with the five components of internal control. This article will provide considerations for how companies can integrate each of the five components and 17 principles of the Framework into their internal trade control processes.

Designing an Internal Control Program

Designing an effective internal control program is an ongoing process, which requires alignment with dynamic business models, advancing technology, and changing regulatory requirements.

The Framework's components assist in adapting internal control systems to these changes by providing an understanding of the

What is not changing	*What is changing*
• Core definition of internal control	• Updates in business and operating environments
• Each of the five components of internal control are required for effective internal control	• Expanded operations and reporting objectives
• The important role of judgment in designing, implementing and conducting internal control, and in assessing its effectiveness	• The inclusion of implicit fundamental concepts underlying the five components in the form of 17 principles
• Three categories of objectives and five components of internal control	• Increased relevance and dependence on information technology
	• Heightened attention to fraud risk assessment and response

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control environment, tools for assessing risks, and managing such risks through control activities.

Control Environment

A company's environment is the set of standards, processes, and structures that provide the background for the operation of a company's internal controls. Establishing a robust control environment is essential to instituting and safeguarding a company's internal control program.

Of the 17 principles (contained within the Framework's five components), five principles are enumerated to help companies ensure that they are operating in an environment that is conducive to effective internal controls.

The first principle requires that the company demonstrate a commitment to integrity and ethical values. The second requires that the company exercises oversight of the development and performance of internal controls. The third has the company establish structures, reporting lines, and appropriate authority. The fourth requires that the company demonstrate a commitment to attract, develop, and retain competent individuals aligned with the company's objectives, and finally, the fifth principle ensures that companies enforce accountability.[9]

These principles are illustrated by the control environment best practices that organizations involved in international trade may consider in designing or upgrading its internal control program. For instance, executive management should be engaged in risk management, seeking trade opportunities, working towards compliance operational efficiencies, and ensuring that the company is operating in a control environment. In addition, the company should assess the structure of the organization and aim to have clearly defined roles for each of its departments.

Leading industry practices indicate that these best practices can be met by taking a cross-functional approach to managing an international trade environment by instituting a layered trade infrastructure into the company's business structure. These layers of support start with recognizing and retaining the appropriate personnel along with acquiring training resources to continuously support and maintain effective personnel. This cohesive and layered approach to designing and supporting a robust control environment requires an effective support structure which includes compliance policies, practices, and tools; efficient and updated systems and technology; and tailored knowledge management and sharing.

In terms of leading control environment practices, international trade (i.e., trade and customs) environment best practices should be comprised of an effective support structure. Within an established trade organization, this support structure should consist of subject matter experts to provide guidance and oversight to trade operations; tax professionals to coordinate valuation matters related to the cross-border movement of goods; engineering to provide classification support; logistics for supply chain support; legal professionals to support the business by validating compliance risks and responding to request by government authorities; and proper government relations to support the business by proactively seeking opportunities in legislative developments and advocating the company's trade priorities.

Risk Assessment

Risk is defined as the possibility that an event will occur and adversely affect the achievement of the company's objectives. The assessment of risk is fundamental to the internal control of a company because it forms the basis for determining how risks will be managed.

The Framework provides four specific principles to help companies assess risk. They include: calling for companies to specify suitable objectives to enable identification and assessment of risks; requiring companies to identify risks to achieve objectives across the entity and to analyze risks to determine how they should be managed; requiring that a company consider the potential for fraud in assessing risks; and asking that a company identify and assess changes that could significantly impact internal controls.[10]

These four principles allow for a heightened focus on areas that were not explicitly stressed in the original framework such as, company structure and operations, technology, and service providers.

In order to achieve these four principles and ensure effective risk assessment, best practices have incorporated the application and review of risk assessment tools including parameters such as the application of data analytics; questionnaires; interviews; and reviews of past transactions.

Data Analytics. Data analytics can be leveraged to review, foresee and prepare for trade risks. For example, a company's Importer Trade Activity (ITRAC) data, Automated Commercial

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Environment (ACE) data, Automated Export System (AES) data, sales data or other forms of aggregate data can be evaluated to assess trends and identify risks. For example, ITRAC and ACE data would collate import CBP Form 7501 parameters while AES data would collate Census export filing elements.

Recently, in addition to standardized data parameters (such as ITRAC and AES), there has been a growing interest for creative and flexible data analytics including standard parameters that can be compared to other forms of aggregate data and data sets that can be combined to form a larger database. This increased regard for data analytics may be especially revealing in considering recent trends and the ensuing risk assessment capabilities that result.

The manifestation of synergies between different data sources ranging from correlating "like" parameters of domestic data (i.e., ACE and internal sales data) to the implementation of global trade management (GTM) platforms (i.e., companies running a global SAP or Oracle platform) demonstrate just how valuable and significant data technology has become. To accommodate the growing global business landscape, global trade management solution providers have companies not only questioning the capabilities of existing systems and their reporting metrics, but also the sufficiency of existing and future trade systems to process revealing data analytics. This heightened interest in data analytics and the systems that support the data highlights the adaptability and sophistication of current systems. In addition, the increase in existing analytical systems with predefined trade queries has captured the interest of not only the novice but also the experienced trade professional who now can leverage a baseline analytical tool in generating sophisticated queries.

Questionnaires. As an information gathering tool, questionnaires have traditionally served as a mechanism for evaluating risk. Some of the benefits of using questionnaires include standardized and efficient collection of information. However, questionnaires also have limitations, which include heightened probability of ineffective results for vetting more complex matters and possible low quality data in instances where the questionnaires are returned incomplete.

Thus, for risk assessment purposes, companies have developed, customized, and automated questionnaires to facilitate specific scopes, address select audiences, and provide a standard platform for scoring risk.

As a risk assessment tool, questionnaires facilitate a range of simple-to-sophisticated data collection. At its best, automated questionnaires can provide a panorama of data to help a company hone in on which internal controls and processes to focus upon and dedicate time. This allows for efficient risk assessment and greater focus on areas with higher risk or need.

Internal Interviews. Interviews with relevant departments and business units can assist in determining if reasonable care standards are being met in the import and export of goods, as well as whether there are gaps in the company's structure and operations process.

Traditionally, and similar to questionnaires, interviews can be used for survey purposes and to discuss import considerations, such as the valuation of goods,[11] classification of goods, and the determination of country of origin.[12] Similarly, interviews can be used to discuss export considerations such as whether the product requires compliance with defense-related controls (i.e., International Traffic in Arms Regulations (ITAR) and the U.S. Munitions List (USML)), U.S. Department of Commerce controls (i.e., Export Administration Regulations (EAR) or Commerce Control List (CCL)) controls, and whether the product warrants an export license or additional controls.

Interviews, especially those that consist of frank dialogue, can function as a unique tool for reading between the lines of what is happening within an environment, and whether personnel are confident and feel supported regarding internal current practices.

Reviews of Past Transactions. A company can review and leverage historic transactions in order to assess risks. The review can include revisiting past audit reports, previously identified problematic areas, and higher-risk areas.

A review of past transactions will entail examining standard parameters (such as classification and valuation) as reviewed by CBP. These include assists declared to form part of the price paid or payable, related-party transactions, and whether the good has been assessed per the correct method of appraisement – an aspect fundamental to the concept of valuation.

In addition, the review will also require an analysis of parameters that are specific to the company's business processes. For instance, there may be the need to review for special program indicators, harmonized-tariff schedule provisions such as American goods returned, or existence of Free Trade Zone (FTZ) transactions.

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Considering both standard and specific parameters ensures that reviews capture all aspects of a company's transactions.

Control Activities

Control activities are established through policies and procedures that help ensure mitigation of risk. The Framework's three principles for establishing control activities include: the development of control activities that contribute to the mitigation of risks to achieve objectives, the development of general control activities over technology to support achieving objectives, and the deployment of control activities through policies that establish expectations and procedure that put policies into actions.[13]

These three principles can be met through existing best practices which include CBP's ISA guidance for developing internal controls, FA internal control questionnaire, tailored policies and procedures manual, the right processes defined, and keeping up with business transformations.

A tool that can be used in safeguarding these best practices is a process map of the company's business structure. Process mapping involves defining what a company does, who is responsible, the standard to which a business process should be held, and how to determine the success of a business process. The purpose of this tool is to assist organizations in becoming more efficient. A clear and detailed process map allows insight into whether improvements can be made to the company's processes. In the context of the Framework, a process map would ensure that a company's internal controls are aligned with the Framework's principles and components.

Altogether, risk assessment consisting of a totality of resources (such as the combination of data analytics, questionnaires, internal interviews and control activity metrics) serves as foundation in the design of an internal control program. This foundation is strengthened by the diversity of resources (such as data analytics, questionnaires, interviews, review of past transactions) as opposed to any single element.

Developing an Internal Control Program: Information and Communication

Veracity of information and effective communication are necessary for an entity to carry out internal control responsibilities to support control objectives. For example, companies involved in the import and export of goods, should strive to remain at the forefront of Customs' new rules and regulations, or changes to existing regulations. In order to do so, proper internal control programs should be developed. The Framework provides the following three principles that a company should work towards in supporting these internal controls: using relevant information, communicating objectives and responsibilities internally, and communicating with external parties regarding matters affecting internal controls.[14]

Some best practices that companies have applied to develop the internal framework for facilitating information and communication include establishing a training plan with appropriate topics and ensuring sufficient training for each department within the company. Effective training is not only appropriate to a department, but is also effectively communicated to the audience within a department. Training may take on the form of webinars, in-person training, training modules, or whatever means are effective to the company in developing internal controls.

Successful alignment of a company's internal controls with the Framework's principles and components will require effort in the short term and the long term, because success is predicated on proper upkeep with business transformation and automation.

Finally, documenting internal communication protocols (and as applicable, leveraging external service providers) helps facilitate matters affecting internal controls. These development considerations surrounding information and communication encapsulate a solid internal control program.

Re-Designing Internal Controls: Risk Monitoring Activities

To determine whether each of the five components is present and functioning, ongoing and separate evaluations (or a combination of the two) may be applied. The process of risk monitoring activities not only reassesses the original design and development of the internal controls, but also allows for the opportunity to re-design and reassess those same internal controls. The two principles provided to achieve

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this component are: the selection, development and performance of ongoing and/or separate evaluations to determine the presence and functioning of controls and timely evaluation and communication of control deficiencies to responsible parties to take corrective action.[15]

These two principles add explicit testing requirements to the original framework, including instituting test controls from a process and transactional perspective and developing testing within the context of the 17 principles in the Framework.

Best practices that have been leveraged by organizations may include developing and applying audit testing and sampling plans, customizing and instituting testing checklists, and incorporating automated processes where possible. These best practices have been instituted by organizations with the goal of clearly defining risks and risk consequences through audit findings to be able to quantify errors and assess resulting error rates.

Control activities are established through policies and procedures that help ensure mitigation of risk.

In the end, the performances of such evaluations, along with the investigation of deficiencies, are communicated internally, all the while involving management in Customs-related auditing.

The output from these tools should provide a company insight into necessary revisions to current processes and testing plans, and if there is a need to re-design internal controls.

Bridging the Gaps within Your Organization

Utilizing the Framework to ensure compliance with CBP regulations requires designing, developing, and re-designing internal controls. These processes will allow visibility into not only what opportunities and weaknesses exist within an organization, but will also highlight the opportunities that should be prioritized. Although these processes require additional efforts by an organization, these efforts quickly translate into streamlined processes and potential savings.

Addressing weaknesses, however, may prove to be a more complex and challenging task than taking advantage of opportunities. This is because addressing weaknesses requires not only changing the *status quo*, but also recognizing that a company's current processes are insufficient -- which invariably carries the unsavory aura of the unknown. In this space, many considerations may arise as to the cause and remediation of these "darker opportunities" and with them the lingering and ominous considerations that the risk outcome and ensuing next steps are unfamiliar.

Thus, with raised flags warning of caution ahead, how does an organization proceed when next steps are open-ended and have the potential to shake up the status quo? For example, who wants to deal with and clarify an organization's accrual process; process for disclosure of risk; and determine whether a reconciliation program is appropriate for the company, whether unliquidated entries should be adjusted, or whether more transactional testing is required?

One way to facilitate this daunting task of transitioning into the Framework is to take the time to consider key trade and customs areas, such as:

- Technology Controls: develop internal audit plans for reviews of Global Trade Management (GMT), and other systems and solutions related to Foreign Trade Zones, customs entry self-filing solutions, restricted party screening, etc.;
- Customs Compliance Management Structure: include reviews of customs compliance organization and match activities to the current operating model;
- Customs Broker and other Service Provider Controls: develop controls to assess third parties providing services necessary to trade operations (i.e., build customs broker and forwarder controls into current compliance manuals;
- Coordinate Global Trade and Fraud Detection Activities: develop controls that allow management to consider the potential for fraud when assessing trade risks (i.e., global imports/Foreign Corrupt Practices Act (FCPA), U.S. export controls/Office of Foreign Assets Controls (OFAC), etc.;
- Documented Trade Processes: enhance trade and customs control documentation, particularly with respect to controls that involve judgment.

In developing that transition plan, a company can further consider points such as:

- The education on and evaluation of the 2013 Framework changes as they impact the trade function;

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- Mapping of the existing trade system of internal controls to the 17 principles of the 2013 Framework;
- Assessing the efficiency and effectiveness of the existing trade system of internal controls;
- Reviewing both transactions *and* processes to not only resolve issues but fix processes and prevent future like errors;
- Identifying and discussing control design gaps with senior management and develop plans to remediate any such gaps;
- Implementing new or updated controls, if needed;
- Maintaining mechanisms to report identified risk areas that may result in violations of Customs regulations;
- Interacting with audit committee, board of directors, internal auditors and/or service providers;
- Evaluating impact on reporting to CBP via updated manuals, ISA Annual Notification Letters, communication with CBP Centers of Excellence and Expertise, CBP Account Managers, etc.

As a result, the organization looking to align its processes with the Framework has to take the time to consider the *status quo*, changes of process, remediation, or any other activity. However, the hardest part in aligning an organization with the Framework may be the decision of how to address the process gaps to avoid future errors. These hard but necessary decisions and the action upon those deficiencies, will dictate the effectiveness in bridging the gaps within an organization.

Conclusion

As previously discussed, significant updates to the Framework address enhanced governance concepts involving the board of directors and its committees, increased relevance of technology, enhanced considerations of anti-fraud expectations, consideration for variability of different business models and organizational structures, and greater

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specificity for documentation related to trade controls.

Successful alignment of a company's internal controls with the Framework's principles and components will require effort in the short term and the long term, because success is predicated on proper upkeep with business transformation and automation. However, this effort will be undoubtedly worthwhile as alignment with the Framework will help sustain and improve business performances as well as ensure compliance with CBP laws and regulations. ❑

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1 This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

2 COSO's original Framework was published in 1992 and is recognized as the leading guidance for designing, implementing, and conducting internal control.

3 The FA Program is a component of CBP's trade compliance program. It is a risk-based audit program, which CBP has aligned with the Framework. The purpose of FA is to evaluate a company's internal controls and determine the company's level of compliance with CBP laws and regulations, as well as whether there are appropriate internal controls in place to ensure future compliance.

4 ISA is a voluntary trade facilitation program that provides companies the opportunity to monitor their own compliance in exchange for trade benefits. CBP has adopted the Framework's components into the participation requirements for ISA.

5 *CBP to Update Focused Assessment Program*, CBP Trade News Letter (Jan. 31, 2014), *available at* http://www.cbp.gov/sites/default/files/documents/CBP%20Trade%20January%202014%20(publish).pdf.

6 February 2014, Governance and Operational Performance: Improving Organizational Performance and Governance.

7 Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control-Integrated Framework Executive Summary* (May 2013) (hereinafter "Executive Summary").

8 Executive Summary at 4-5.

9 *Id.* at 6.

10 *Id.* at 7.

11 Inquiries into the valuation of goods include whether prices from related parties meet CBP requirements; whether the company is declaring the correct values at time of entry; and whether royalty payments, assists, or additions to the price are being properly accounted for.

12 For example, a question as to these issues may include who oversees and reviews your classifications and country of origin for accuracy?

13 Executive Summary at 7.

14 *Id.*

15 *Id.*

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