

## Mergers & Acquisitions: Provoking Thought and Action in Customs and Trade-focused Due Diligence

As we ring in a new year, you are probably looking forward to finalising a potential merger, acquisition or joint venture target. You go through your checklist one last time and all looks great, you did your due diligence and everything looks good to go.

However, if the target company has manufacturing plants in customs controlled zones, is trading goods across borders, has a large footprint in several countries in Asia where laws and processes are not so transparent, and is trading goods using free trade agreements, don't you want to ensure that any potential areas of exposure there are identified? Do you know the potential consequences that Customs could have on your new business if there is non-compliance?

In hindsight, including a Customs and Trade-focused due diligence in your checks of the target company is critical since a company cannot afford:

- a customs investigation that brings a key manufacturing or distribution entity to a halt or at least a crawl if non-compliance is found;
- disruption to supply chain through greater inspections at the border;
- severe penalties for non-compliance or imprisonment or both;
- possible seizure of goods;
- possible criminal offence.

In addition, Customs and other Government trade enforcement agencies across Asia don't care about the nature of the transaction, whether it is an asset purchase or a stock sale, or involving successor liability for all trade liabilities, including fines and penalties that will be attached to the buyer.

The purpose of international trade due diligence is, foremost, to identify existing or potential compliance problems with the laws that various customs authorities in each country enforce. This would

include customs laws and regulations, sanctions, export controls or equivalent local legislation, environmental regulations, anti-corruption laws, and other lesser-known ones such as labelling and country of origin regulations.

From a pure customs and trade perspective, the term "caveat emptor", "buyer beware", most certainly applies when considering merger and acquisition (M&A), joint ventures (JV), and consolidation.

### Intricate Web of Laws

An intricate web of laws, regulations and practices exists in many countries in Asia. There are regulations and laws that govern key aspects in the relationships between manufacturers, distributors, related suppliers, third-party suppliers, third-party service providers and the consumers. These regulations and laws also govern key aspects of the movement, manufacture, distribution, and use of products including raw materials and capital equipment.

In addition, in the last ten years customs authorities have progressively moved towards greater facilitation of the movement of goods and people across their borders. In doing so the onus for ensuring declarations to Customs are accurate, complete and authorised, and for full compliance with all Customs and related laws, moved totally to the importer-on-record.

Customs have also enhanced their investigative tools and one of those has been the sharing of information between revenue authorities within a country as well as Customs to Customs information sharing.

A key source of information for some Customs authorities comes from the implementation by direct tax revenue authorities of the Base Erosion and Profit Shifting (BEPS) Action items, which includes Action 13, documentation and reporting requirements.

These changes have been indirectly beneficial for some customs authorities. The information made available is quite substantive if the target company was required to submit full transfer pricing documentation. That would provide transparency to the total supply and value chains of any company and in a Merger or Acquisition, the target company.

We advocate that companies contemplating any M&A, JV, or consolidation seriously consider including a customs and trade due diligence as part of their normal due diligence.

The following are a selection of certain areas that would require some form of check:

- **Third-Party Service Providers:** Customs brokers, logistics services providers, suppliers, buying and selling agents, all pose potential areas of exposure if the target company has not put in place sound selection, appointing and managing procedures.
- **Valuation of Product:** Customs valuation where there are related party transactions is a key area of exposure. Ensuring all the relevant elements of value that need to be included in the declared value have been included. Ensuring that the correct method of value has been used as well. Items to consider are:
  - » Royalties
  - » Assists (items/materials provided by the buyer to the manufacturer free of charge or at reduced costs for use in the manufacture of the finished goods)
  - » Related party transactions
- **Preferential Origin:** Is the target company importing and/or exporting under any Free Trade Agreements? If yes, have they correctly applied the regional value rules or classification rules? If the products' main local/regional content is profit, that may not be sustainable in a future customs audit, and that preference could be lost causing the goods to become subject to normal tariff duty rates.
- **Classification of Goods:** Harmonised System (HS) classification of a good determines the import or export duty rate, whether it requires a license or permit, if there are other restrictions, or if it is prohibited. Hence, correct classification is essential.
- **Movement of raw materials within a country:** Often a target company may have more than one manufacturing plants in a country or they may have unrelated contract manufacturers in that country. This may require the movement of semi-finished components or product between plants. If these plants are within Free Trade Zones, then there are regulations in most countries governing that movement including the need to obtain prior approval.
- **Investment approvals and incentives:** the target companies may have investment incentives covering capital equipment and plant, duty and VAT/GST/S.Tax relief incentives. Is the equipment still subject to the conditions of the incentives, has anything been moved and have proper approvals been sought?
- **Anti-dumping duties:** Are any of the target company's goods or materials subject to anti-dumping duties? These duties can exceed 30 percent, and can and are often missed at the time of import.
- **Document retention:** The retention of documents for customs purposes is usually three to five years, and it is essential to ensure that the target company does in fact comply with its requirements. As a buyer, the lack of documentation can lead to potential penalties from customs. It also puts the buyer at a disadvantage should there be a customs audit covering that period. The buyer will not have records to use in their defence of any potential offence.
- **Practice vs. Law:** In some countries, authorities have allowed some businesses to use processes to be operated which may differ from the law. These are practices and while they have tentative approval from the direct local customs office, they pose a potential risk for the buyer if there is a clamp down on practices.

Above mentioned are just a few of the many areas that would need to be considered when undertaking a due diligence for customs and trade.

Not being aware of customs issues at the time of an acquisition may result in serious consequences: it can potentially close that business in any country. Customs retains a lot of power, and in most Asian countries they are not afraid to use that. The fact that they can impose full border checks on the movement

of your imports and exports, which will effectively bring your production to a crawl at best or a complete stop, should be further reason to consider this type of due diligence. Furthermore, Customs' ability to detain without arrest for periods up to 30 days in some countries is another reason to ensure that you are fully aware of any potential issues before the Customs has spotted it. While each country's Customs has different look-back periods, that right to review past records normally ranges between three to 10 years of past transactions.

Yet even with proper due diligence, buyers will want to ensure that seller indemnification covers all duties as well as fines and penalties, with a minimum five-year indemnification period.

For more information about the topics raised in this Trade Alert, please contact the Author or your Regional Contacts below:

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