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Surviving the Sino-US Trade Dispute: Recommended Strategies

With the US ramping up trade tensions not just with mainland China, long seen as its prime adversary, but also with many of its closest allies, the export environment has seldom seemed so forbidding. For concerned Hong Kong businesses, however, there are a wide range of customs strategies, international regulations and export options that should allow them to ride out this particular storm and ensure they do not get caught in the crossfire between these two feuding giants.

After imposing Section 232 tariffs of 25% and 10% on imports of steel and aluminum products, on 15 June the Trump administration published two lists of goods produced in mainland China that would or could be hit with higher import duties. This followed a Section 301 investigation which ruled that mainland China's acts, policies and practices related to technology transfer, intellectual property and innovation were unreasonable and discriminatory.

Beijing reacted immediately to the steel/aluminium tariff increase by unveiling a list of 128 US products that now face higher duties of 15% or 25%. In retaliation for the 301 tariffs, it levied a 25 percent tariff on 545 US goods from 6 July and on another 114 products on an as-yet-undetermined date.

In an interview with Louis Chan, HKTDC Assistant Principal Economist (Global Research), Sally Peng, Member and Asia Pacific Practice Leader of Sandler, Travis & Rosenberg, Limited, shares some tips on how Hong Kong and mainland Chinese companies can make use of some lesser used customs tools to overcome these new hurdles.

Chan: How can Hong Kong and China companies avoid the Section 232 and Section 301 tariffs the US has imposed?


Sally Peng, Member and Asia Pacific Practice Leader of Sandler, Travis & Rosenberg, Limited.

Peng: There are several things that companies can do. First and foremost, they can try to get a company-specific exclusion from the tariffs, once the procedure for doing that has been set out and made clear. According to the US Department of Commerce, by 20 June 42 exclusions from the steel tariffs had been granted. That covers seven different companies importing steel products from mainland China, Japan, Sweden, Belgium and Germany. Also, it's not unusual for businesses that are going to suffer heavily from tariffs to work with their American counterparts and try to get the US Administration and Congress to exempt their products.

Secondly, manufacturers in Hong Kong and the mainland should see whether there is another potential classification for their product that might be more appropriate; or whether a slight modification to their product could move it into a classification that isn't subject to the tariffs. This is sometimes called "tariff engineering" – importers restructuring their products to try to get favourable duty treatment. For this to work, businesses need to allow enough time for their product development and design teams to reveal their new product specifications before they try exporting to the US market. Companies adopting this tactic should always use the services of a qualified customs expert, one who thoroughly understands the US tariff classification requirements.

Thirdly, companies can use the rules of origin to shift the official origin of a product from Hong Kong or mainland China to a country which isn't subject to the tariffs. But they have to take into account that US Customs determines a product's origin according to where the most substantial transformation takes place or where the components become a final product. Although textile and clothing shipments to the US made on or after 1 January 2009 are no longer subject to any quotas, many may remember that the quotas for apparel goods resulted in this kind of "operational engineering". This can be applied to many other products. There are certain manufacturing operations that make the good a product of the country in which that operation is performed. So companies can break down their manufacturing operations and move some of them elsewhere, legitimately using the rules of origin to save on tariffs. This process may lead to operations moving to other production bases, such as ASEAN countries, although companies would also have to consider the impact of some crucial supply chain factors like differences in logistic and labour costs.

Chan: What about if the goods are still subject to the quotas? Are there any ways to minimise the impact of the tariffs? How about the so-called "first sale rule"?

Peng: If the tariffs can't be partially or completely avoided by any of these means, then it's worth considering trying to lower the price on which the tariffs are assessed. You can do this by using a middleman to buy your product and sell it on. That middleman can legitimately be the same company as long as the arrangement is properly set up according to the "First Sale Rule", or FSR. This was first established by the US courts in 1988. It allows US buyers to lower duty-paid costs without cutting the profit margins of their offshore suppliers. It applies to multi-tiered transactions in which a US importer buys goods from a middleman who, in turn, has a contract with a factory for the production of the goods. The merchandise is appraised on the value of the sales price between the middleman and the factory.

All imports into the US are subject to what's called appraisement. The preferred way of doing this is to calculate the transaction value – that is, "the price actually paid or payable for the merchandise when sold for export to the US," plus certain additions. When it's agreed that the transaction value is unacceptable, the importer can enter its merchandise under one of the other statutory appraisement methods: the transaction value of identical or similar merchandise; the deductive value; the computed value; or, if none of these applies, a method of valuation similar to one of these.

Most goods imported into the US from Asia are appraised according to transaction value, which is the invoice price between the seller (either a middleman or trading company, or the factory) and the importer. Import duties are then assessed on the appraised value of the goods. For example, in a traditional three-tiered transaction, a US customer will issue a purchase order to a vendor for a certain quantity of goods at an established price, say US$10,000. The middleman or trading company will buy these goods from a manufacturer for a lower price, say US$7,000. The vendor's profit is US$3,000 on the transaction. An invoice for US$10,000 will be issued by the vendor to the US customer. This invoice is presented to the US Customs and Border Protection, or CBP, when the goods are imported and the customer pays duty based on the value of the goods as reflected in this invoice. If the tariff level is 25%, as in the case of the section 301 tariffs, that's US$2,500.

Now consider this transaction using the FSR. The invoicing and payment stay the same, but now it's the invoice between the middleman or trading company and the factory that is presented to CBP for appraisement and calculating the duty to be paid. The US buyer in this case pays just US$1,750, rather than US$2,500. The middleman's price and profit margin haven't changed, but the US buyer gets a substantial reduction in its duty-paid costs.

The practical considerations involved in using the FSR can make it seem daunting and even prohibitive at first. But with careful planning and the proper documents, it is possible to set it up in a way that satisfies the US government. You have to be prepared to substantiate that the goods were subject to two bona fide sales, that both sales were at arm's length, and that the goods were destined for export to the US at the time of the first sale. To show that the price of the first sale price is accurate, the middleman, the factory, and the US buyer must be prepared to present documents including:

- purchase orders with copies of terms between all parties;
- confirmations;
- invoices;
- written contracts or sales agreements;
- bills of lading for the final products and materials;
- proof of payment, such as letters of credit;
- production orders and/or manufacturing instructions and other unique specifications of the merchandise to conform to the buyer's standards;
- examples of labels, logos, stock numbers, bar codes, and other unique merchandise or carton marks; and
- examples of country of origin marking on finished goods, hang tags, and so on.

In cases in which the middleman and the factory are linked, the books and records of both businesses might need to be reviewed, to make sure that the transaction is at "arm's length" – that is, that the relationship didn't affect the purchase price of the goods.

While it might seem that a relationship between the middleman and the factory would make it difficult to prove to the US government that an FSV was legitimate, it can actually provide an opportunity for the US buyer to make additional savings. CBP allows certain expenses unrelated to the production of the goods to be shifted from the books of the manufacturer to those of a related middleman. This means the First Sale price can be cut even further without affecting the purchase price between the US buyer and the middleman. And that means more savings on duty.

Sometimes a manufacturer can be reluctant to reveal what the "First Sale" price is, and that can be a very real obstacle when trying to implement an FSR. It might be possible to use a law firm to ensure that sensitive information can be shielded, but many manufacturers have great reservations about revealing their cost information to third parties.

Meanwhile, CBP has always had an uneasy relationship with the FSR, and it's often turned its attention to ratcheting up its efforts to verify that companies using this methodology are doing so properly.

So it's important, when setting up proper First Sale programmes, to take proactive steps to make sure that multi-tiered transactions meet the FSR requirements. It's also important that there are internal controls and procedures in place to have the documents to show that you are in compliance with the rules, if and when CBP comes knocking. Because the information is often kept by different partners in the supply chain, it is particularly important for importers to tell their partners what their responsibilities are for keeping and producing records. If you fail to meet the FSR requirements, that may be considered a lack of reasonable care, and could lead to you facing penalties. It's essential you get experts in the field to make a careful review of documentation flow if you're going to ensure that the information presented to CBP is accurate and substantiated.

Other than using the FSR, if you're importing goods into the US and using it as a distribution base before re-exporting them, you could consider using a foreign-trade zone or bonded warehouse. This will allow you to avoid duty on the goods destined for re-exportation, or to defer paying duties for goods that enter the US at a later date. The goods will still be subject to the tariffs when and/or if they enter the US economy, but deferring or delaying paying those duties until you have to, can help manage cash flows better.

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