The Offshore Tax Planning Review

PLANNING ASPECTS OF IMPORT DUTIES AND VAT

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Introduction

The major impetus towards rationalising international trade is the General Agreement on Tariffs and Trade (GATT). Since 1948 when the originating 23 countries signed the Agreement, membership has built up to around 111 and it is claimed a further substantial number of other countries apply the rules of GATT. There is, therefore, a tried and tested structure in place for countries to discuss trade problems and negotiate to expand trade worldwide. And despite the headlines which focus on conflicts, there is an amazing degree of agreement providing the basis for common commodity coding, mutual assistance and aid to developing countries.

In this article, I am going to concentrate on exports to the EC which is a Customs Union. By that I mean a trading area where Member States do not normally charge import duty on goods crossing their borders with other member states. There are three main types of duty applied to imports into the EC, viz. import duty, excise duty, and VAT.

The newly created single market of the EC has not had a major impact on importers. For example, the Commission has controlled customs duty issues for many years and all duty collected at import is paid to it; the EC has negotiated as a single entity on trade agreements, including duty rates; and the EC Court of Justices is the final arbiter on any dispute on Customs matters within the EC. Therefore, this article is going to address established major planning points for companies and individuals importing into the EC.

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This article has been adapted from speaking notes used by Malcolm Grant for a presentation to members of the ITPA attending their Rome Conference.

Import Duty

Why should we spend time on customs and duty planning? The average rate of duty is claimed to be 6% but there are rates of 50% and with additional anti-dumping duties (ADD) it can be seen that for all products it is worth checking the impact duty has on costs, and for some products it is essential if profits and competitiveness are not going to be thrown away. Customs duty, unlike most taxes, impacts directly on the cost of a product. Therefore it is possible to have quite spectacular successes in improving profits. Equally important is helping clients avoid the appalling high cost of explaining to administrations why they broke the rules. This article is mainly about successes and failures of the author's clients in cutting costs painlessly and recovering from the disruption and high costs of breaking the rules.

Anti-Dumping Duty

The definition of ADD is a customs duty on imports providing a protection against the dumping of goods in the EC at prices substantially lower than the normal value. In most cases the price at which foreign producers sell goods at in their own country is taken as the normal value. The ADD is directed at specific goods from specific countries and is additional to, and independent of, any normal duty payable.

The planning points are to get involved with EC investigations when they are set up following a complaint; keep in touch with your industry's developments world-wide and be ready to switch to other suppliers and countries to avoid ADD on your imports; and complain to the EC if you are an indigenous company suffering from the effects of dumping.

VAT

Value Added Tax (VAT) is an internal tax and is currently applied at differing rates and to different goods and services in Member States. The Member States are committed to harmonisation and we will see progressively that the anomalies disappear. Import VAT is calculated in the same way as duty although the tax is applied against the general VAT rules.

In the UK we have two rates, zero and 17.5%. Imports can be duty-free but VAT will invariably apply at the full 17.5%. Of course, VAT is reclaimable and generally importers are able to claim the full amount back on their next quarterly return following importation. The main gain we achieve in this area is to reduce the impact on cash-flow of import VAT.

An important consideration for many exporters to the EC is whether they need to register for VAT. The general rule asks whether they are making a supply within the EC and does their business in any Member State exceed the threshold level of registration in that country. As with most tax planning there are choices before the event. Unfortunately, the advisor invariably finds that he is consulted too late and the decision has been taken by default.

Value on Which Duty is Calculated

A shoe company in the USA bought its UK distributor. The shoes, on average, sold in the UK for £75 a pair; the distributor had been buying them from the USA for £32 and paying duty and import VAT on that value. The US supplier is now able to have its subsidiary in the UK pay import duty based on £15, which is the price paid to the Far Eastern manufacturer. In the year of the purchase of the UK company the lower value for duty saved the company over £200,000 on imports and £12,000 on stock in warehouse at the time of purchase. Annual savings will continue each year. There is also a substantial cash-flow saving on import VAT. This tax is now charged on the lower value plus the lower duty now being paid.

These savings are possible because the EC interprets GATT rules on the value of goods sold for export to Member States to be any one of the series of sales of goods which are eventually imported into the EC. So, if we stay with our examples of shoes made in the Far East, there is a sale to the US company and a sale to the UK company. Either of these sales is the correct basis for calculating import duty and VAT. There are, of course, safeguards applied by Customs which require evidence of these earlier sales. Clearly, for many companies it is not possible to provide evidence of earlier sales but for those that can, mainly associated companies, dramatic savings are possible.

For tax reasons other than customs duty and VAT, offshore companies exist. You can see that the concept of earlier sales can become an important issue in looking at such schemes. A sale by a supplier to an offshore company and then on to a company in the EC provides two values to consider when importing the goods into the Member State. The value can be based on the price *paid* by the offshore company or the price *charged* by the offshore company to the EC company. Again, the reader will not be surprised to hear that the Customs administrations have safeguards to prevent abuse of these rules.

From these examples, I hope, it is clear that there is no single, correct value for a consignment on which to pay duty. It depends on the circumstances of each case. But once an acceptable value has been declared to Customs there are no routes which allow a lower value to be substituted. The value for duty is determined by applying six methods. They must be applied in strict order and the first method which applies must be the one which is used. Briefly, they fall into three categories:

(i) the price paid or payable;
(ii) the value calculated from the UK selling price;
(iii) the value based on the cost of production.

Well over 90% of importations fall into the first category, as do the examples I have been describing at this point. It is appropriate to provide an insight into the mysteries of valuation to help understand my next example.

Value for Duty Based on UK Selling Price

A foreign manufacturer of golf bags opened a branch outlet in the UK. Because it is a branch and therefore part of the same legal entity as the foreign manufacturing company, Customs rules make it clear that there can be no sale between them. In layman's terms, you cannot sell to yourself. When applying the six methods for valuing this company's goods for duty we are forced out of the first category and into the second category above - a calculation based on the UK selling price. It is possible to deduct from the selling price in the UK all of the costs associated with the sales. The result is that the value used to calculate duty is almost 50% of the UK selling price. You will appreciate that the foreign manufacturer is delighted with the arrangement.

Value for Duty Based on Cost of Production

The third category above is a value for duty based on the cost of production of the imported goods. Customs throughout the EC are unhappy with this method because of the difficulties of obtaining acceptable evidence. However, in the last few months we have had a case where a US company exporting to Canada uses this cost based method for calculating duty. UK Customs have accepted in principle this approach, although for technical reasons (which I feel weaken our case) have ruled that such imports into the UK are sales at a clear price for export. But we may in future find the cost-based method becoming more common.

In order for a company to benefit from duty calculations based on these last two categories it usually needs to be a branch or sole agent, or the transaction needs to be a one-off supply.

All of the examples I have described free the actual price paid by the importing company from scrutiny by Customs. Changes to transfer pricing arrangements are irrelevant to the duty calculation and pricing policies become of little interest to Customs.

Classification for Duty

That is enough on the value on which duty is charged. Let us now look at some issues surrounding the actual rate of duty. All goods imported into the EC are described in the Tariff which incorporates the Harmonised Commodity Description and Coding System (the Harmonised System, or HS). The Tariff uses over 14,000 codes to classify goods. The average rate is claimed to be 6% but the range is 0% to 50% plus ADD where appropriate.

An example is a company which imports small pumps for incorporation in toiletry dispensers. Customs decided after years of imports by this company that the pumps were actually parts of scent spray. The duty increased from around 4% to 12%. The company was able to demonstrate that imports had been properly entered at the lower rate and obtained a Binding Tariff Information certificate. The BTI is valid for six years and gives importers certainty that the classification, and therefore the duty rate, is agreed and any change of interpretation is always advised to certificate holders. Had the company obtained one of these earlier, it is unlikely that Customs would have challenged their imports and tried to classify them as parts of scent sprays.

Import Licences

The Tariff classification is an important indicator of whether or not a specific import licence is required. All goods imported into the UK need a licence but most are covered by an Open General Licence (OGL). A specific licence can be a major hurdle to importers.

An importer of sports goods entered a consignment of track-suits worth £40,000. When Customs officials examined the consignment they discovered that the goods were shell suits. A subtle difference when we see them in shops but a major difference in the context of international trade. The consignment was detained by Customs and held for four months until the correct licence was obtained. The importer had to pay his suppliers £4,000 for the necessary documentation and was fined £2,000 by Customs for making a false import declaration. A BTI would have prevented the importer falling into this trap.

Origin of Goods

The origin of goods is not always straightforward. But it is important because it can affect the requirement for a specific licence, entitlement to lower rates of duty, and whether goods are chargeable with ADD. The key document is the certificate of origin issued by the exporting country.

Designer knitwear assembled by a manufacturer sewing panels together in one Far Eastern country obtained the knitted panels from another country and the wool was a product of yet another country. The manufacturer wanted labels in each garment showing the country of origin but wasn't sure which country this was. We were able to confirm that the country of assembly was the country of origin for EC purposes, which also entitled these goods to a lower rate of duty when they were imported.

Deferment and Avoidance of Duty and VAT Payment

Customs allow delays in paying duty or VAT in certain circumstances. The most common is their Duty Deferment scheme whereby approved importers and freight forwarders have an average credit period of four weeks before duty and import VAT is deducted from their bank accounts by direct debit. Duty-free warehousing is probably the next most common.

There are a number of customs regimes which allow duty to be repaid when goods are re-exported and a few which permit goods to remain in the EC without payment of duty.

Customs Investigations

No article on Customs is complete without a graphic description of what happens to importers (and their advisors and agents) when things go wrong. Customs administrations world-wide tend to have Draconian powers; many are armed. The EC is no exception, although in the UK they are no longer armed.

A company which had no presence in the EC had an estimated 20 drugs investigators diverted to scrutinise their UK business in a number of synchronised raids. Their selling agents were arrested and spent at least one night in gaol. Consignments and all business records in the UK, including administrative computers, were seized. There were no imports allowed for a month and business was badly disrupted. Customs were eventually persuaded that the £2,000,000 commercial fraud which they suspected was not fraud at all, but the company still had to make a six figure settlement covering underpaid duty and VAT plus a penalty.

A clothing importer failed to properly control invoices from its supplier and declared some consignments on the basis of cut, make and trim costs without the cost of the material being included. The MD became heavily involved in helping investigators compile a schedule separating out those undervalued consignments and establishing a total of duty and VAT underpaid. Customs originally estimated £200,000 duty plus VAT and wanted a penalty of £50,000. The importer was comparatively lucky and settled for £120,000 underpaid duty and VAT with a penalty of £5,000.

My third example is of a consignment of T-shirts from the Far East. When Customs officials examined this consignment they found that some T-shirts needed a licence and others didn't. The importer was arrested and released on bail although his records showed that he had ordered only those T-shirts which were not licensable. Each of the sample packages officials had chosen to open had a mixture of licensable and unlicensable T-shirts. The consignment was seized and became the property of the Crown. Customs examined each package over three months to ascertain exactly how many T-shirts needed a licence. They then offered to sell the goods back to the importer (who had to buy documentation from his supplier in order to obtain an import licence) and fined him.

Careful planning is the only sure way of enjoying the benefits and avoiding the pitfalls I've described.