REVISITING THE FIRST SALE FOR EXPORT RULE: AN ATTEMPT TO REMOVE FAIRNESS IN THE INTERESTS OF RAISING REVENUES, WITHOUT IMPROVING LEGAL CERTAINTY

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Abstract

The World Trade Organization (WTO) Valuation Agreement sets out rules to determine the customs value of imported goods. However, imports of the same goods in different countries are valued using different valuation methodologies. Currently, major trading nations of the world — the European Union (EU), the United States (US) and Japan — accept some form of a 'first sale rule'. This article summarises the current application of the first sale rule in the EU and the US, analyses and rebuts the position taken in the World Customs Organization (WCO) Commentary 22.1, and discusses recent developments in both the EU and the US. It concludes that the reasoning of the Commentary is flawed and that the first sale rule should not be discarded.

Introduction

The customs value of imported goods is determined on a case-by-case basis. The national legislation of most World Trade Organization (WTO) countries follows the rules set out in the WTO Valuation Agreement (Valuation Agreement), but the Valuation Agreement rules leave room for differing interpretations. As a result, imports of the same goods in different countries are valued using different valuation methodologies. Needless to say, this lack of legal certainty is complicating the life of global companies.

Recently, the World Customs Organization (WCO) discussions have attempted to clarify customs value determinations, especially valuation in the context of a series of transactions. Currently, major trading nations of the world — the European Union (EU), the United States (US) and Japan — accept some form of a 'first sale rule'. Under this rule, when goods are sold and resold several times before importation, customs duties may be assessed using the price of the first sale, provided certain conditions are met. If the customs value of imported goods is determined on the basis of this first sale price, that is, the price of the transaction between the manufacturer and a middleman, the value added in subsequent sales is effectively ignored. Thus, an importing company may achieve considerable savings on duties by using the first sale as the basis for the customs value.

Since 2007, WCO discussions have weakened support for the first sale rule on both sides of the Atlantic. The recently published WCO Commentary 22.1 (Commentary) has been particularly influential.[2] The

Commentary argues that in a series of sales, the first sale should not be allowed as the basis for customs valuation. Rather, it puts forward a sort of 'last sale rule': duties should be assessed using the price paid in the last sale prior to the physical introduction of goods into a country, that is, the price of the transaction between a middleman and an importer. However, this recommendation is based on several incorrect assumptions about cross-border trade.

This article summarises the current application of the first sale rule in the EU and the US, analyses and rebuts the position taken in the Commentary, and discusses recent developments in both the EU and the US. It concludes that the reasoning of the Commentary is flawed and that the first sale rule should not be discarded.

Assessing the customs value of imported goods in the US and the EU

The Valuation Agreement provides a set of rules for establishing the value of goods for the purposes of customs duty assessment. Most imports are appraised based on their transaction (invoice) value: the price paid or payable for the goods in a sale for export, adjusted in accordance with required additions and deductions. Many methods exist, however, to determine the customs value in addition to the transaction value of the imported goods. The Valuation Agreement allows the use of the transaction value of identical goods, the transaction value of similar goods, the deductive or 'sales minus' method, the computed or 'cost plus' method, and, when all else fails, a (reasonable) residual method. In a series of transactions, the question arises as to which transaction must be used as the transaction to determine customs value.

In the US, with its common law system, the first sale rule was first confirmed through a series of court rulings.[3] This was followed by the publication of a Treasury Decision on the requirements for establishing the application of the first sale rule.[4] That publication confirms that the transaction value is the primary method of appraising imported goods, and is defined as 'the price actually paid or payable for merchandise when sold for export to the United States', plus specified additions to that amount.[5] This normally equates to the commercial invoice price paid by the importer on an FOB US basis. In the EU, by contrast, the transaction value is the commercial invoice price paid by the importer on a CIF EU basis.

Where a series of sales occurs during the process of exportation, US Customs and Border Protection (CBP) has taken the position that the transaction value can be the price paid in the first sale, so long as:

- the first sale between the factory and the middleman is a *bona fide* sale
- the goods were demonstrably, clearly destined for the US at the time of the first sale, and
- the sale was made at arm's length in the absence of any non-market influences that affect the legitimacy of the sales price.

Evidently, CBP imposes a significant burden on importers to establish a *bona fide* case for the application of the first sale rule. To avoid discussions with the US authorities, importers usually label products specifically for the US.

The first sale rule is also recognised in EU legislation. Article 147 of the current implementing provisions of the Customs Code states:

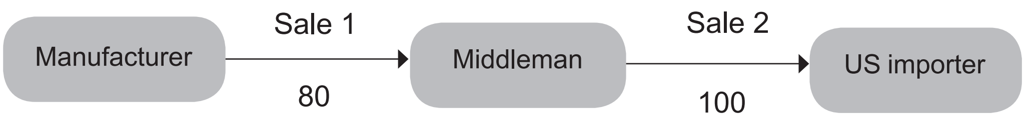
> [W]here a price is declared which relates to a sale taking place before the last sale on the basis of which the goods were introduced into the customs territory of the Community, it must be demonstrated that this sale of goods took place for export to the customs territory in question.[6]

Like the US Treasury Decision, this Article places the burden on importers to prove a *bona fide* case for the application of the first sale rule. In practice, customs authorities of the various EU Member States interpret the rules differently.

The application of the first sale rule

Ordinarily, the declared customs value using the first sale invoice is lower than the declared customs value using the FOB/CIF invoice. The former is usually based on the price paid by a middleman to the manufacturer, while the latter is based on the price paid by an importer to the middleman. The example in Figure 1 illustrates this.

Figure 1: Example of first sale rule



Duty 15% of 100	15
Duty 15% of 80	12
Saving by applying the first sale rule	3

In this example, a company makes shoes in China and exports them for US$80 per pair to a middleman which, in turn, sells the shoes for US$100 per pair to a retailer in the US. Provided that each sale in this series of transactions is carried out at arm's length, and that the shoes the manufacturer sold to the middlemen were clearly destined for the US, the importer would have the choice of using the first sale to calculate the duty (*ad valorem* duty of 15%). When the duty savings per pair of shoes (US$3) is multiplied by the 40,000 pairs in that order, it is clear that the application of the first sale rule represents significantly lower customs charges (US$120,000).

The changes brought about by WCO Commentary 22.1

At the 24th session of the WCO Technical Committee on Customs Valuation (Technical Committee), held 23–27 April 2007, experts discussed the concept of the first sale rule in the Valuation Agreement. The Valuation Agreement provides that the customs value of imported merchandise 'shall be the transaction value, that is the price actually paid or payable for the goods when sold for export to the country of importation, adjusted in accordance with the provisions of Article 8'. But it does not define or otherwise address the phrase 'sold for export to the country of importation'. In a series of sales, it is unclear whether a first sale can be a 'sale for export to the country of importation'[7].

To answer this question, the Technical Committee evaluated the intent of the use of the transaction value as the basis for a customs value declaration under Article 1 of the Valuation Agreement. It examined this in conjunction with the proviso for the use of Article 8 of the Valuation Agreement which covers amounts to be added to the price paid by the importer in order to arrive at an appropriate transaction value. The Technical Committee then issued a Commentary which states that:

> [T]he underlying assumption of Article 1 is that normally the buyer would be located in the country of importation and that the price actually paid or payable would be based on the price paid by this buyer. The Technical Committee concludes that in a series of sales situation, the price actually paid or payable for the imported goods when sold for export to the country of importation is the price paid in the last sale occurring prior to the introduction of the goods into the country of importation, instead of the first (or earlier) sale. This is consistent with the purpose and overall text of the Agreement.[8]

In other words, the Commentary argues that a sort of 'last sale rule' should be preferred over the first sale rule. In a series of sales, it does not consider the first sale to be a sale for export, even if the later transaction with the EU importer has already been made, or the goods are labelled according to the requirements in the country of importation. The Commentary advances the following five arguments in support of this conclusion:

1. The implicit underlying assumption of Article 1 of the Valuation Agreement is that the buyer is located in the country of importation, as it refers to possible restrictions in the country of importation that have an impact on the declared value.
2. The terms 'buyer' and 'importer' are used interchangeably among the provisions of the Valuation Agreement and the various explanatory or additional texts. This implies that the drafters took the position that the buyer in the sale for export and the importer are one and the same.
3. Article 8 of the Valuation Agreement requires certain additions to an invoice price, such as:
    - selling commissions incurred by the buyer
    - apportioned costs of goods provided by the buyer free-of-charge for the production of the imported goods (also known as 'assists')
    - royalties payable by the buyer in relation to the imported goods
    - proceeds of resale in the country of import that accrue to the seller.

    In a series of sales, the buyer in the first sale is not necessarily the party who pays royalties or provides assists. Thus the application of the first sale rule would allow such costs to be excluded from the transaction value which is against the intent of Article 8.
4. In a series of sales, the first sale usually involves a sale between a producer and a local distributor in the same country. Such sales cannot be used to determine the customs value under Article 7 of the Valuation Agreement which excludes the use of a price in the domestic market of the seller.
5. Member countries may find it difficult to verify the information related to the first sale. Therefore, they will find it difficult to use the first sale rule as a basis for determining customs value.

The Commentary concludes, based on the above arguments, that the WCO is of the opinion that the intent of the Valuation Agreement is not to allow the first sale rule, as it would cause inconsistencies in the application of the Valuation Agreement.

Analysis of the WCO arguments

While the WCO's objective of clarifying the transaction value determination is laudable, its arguments against the first sale rule are fragile to say the least. When looking at actual importation practices, one sees that the Commentary is based on several incorrect assumptions.

First, the Commentary ignores commercial reality and over-generalises when it claims that the Valuation Agreement assumes that the buyer is located in the country of importation. Though it may be the general situation envisaged by the Valuation Agreement, the commercial reality is that in modern cross-border trade, and particularly in raw material importation, there is often a series of sales of goods between the foreign factory and the ultimate user. Sometimes the middlemen are located in a third country, sometimes in the country of import, and sometimes in the country of export. Why should middlemen be defined as 'buyers' only when they are physically located in the country of import? This interpretation, rather than clarifying things, would actually render many situations less clear.

Consider the following hypothetical scenario: EU Company A purchases an excavator from EU Company B for EUR50,000. EU Company B then purchases this excavator from People's Republic of China (PRC) Company C for EUR30,000. PRC Company C ships the excavator directly to EU Company

A which handles the import formalities. The excavator is dutiable at 10%. Using the first sale rule, where Company B is accepted as a buyer, the duty payable would be EUR3,000; following the WCO recommendation, however, Company B would not be considered a buyer, and the duty payable would be EUR5,000. Both Company A and Company B are EU companies, and both transactions occur *before actual importation into the EU*: there is no substantial basis for considering Company A to be a buyer for customs purposes, but not Company B.

Second, the Commentary argues that the terms 'buyer' and 'importer' are interchangeable. In Article 1, however, the interchangeability is confined to the situation where the import transaction involves only one sale. Article 1 clearly does not refer to import transactions involving a series of sales. Accordingly, general reliance on the interchangeable use of 'importer' and 'buyer' in the context of Article 1 is simply misplaced.

Third, the Commentary argues that the first sale rule may not fully capture all the elements of valuation, such as assists. This argument confounds many experts on cross border trade but the concern is unfounded. Detailed guidance and procedures in US and EU case law have established criteria to ensure that all elements necessary to establish the transaction value are included, and these criteria cover the first sale situation as well.

In the US, the burden lies on importers to include all the value elements required to properly appraise the transaction value. If some elements are missing, the transaction value will not be deemed acceptable and the application of the first sale rule will similarly be denied.

In the EU, Article 32(1)(b) of the Community Customs Code[9] and the interpretative notes in Annex 23 of the Implementation Provisions of the Community Customs Code[10] provide importers with an exhaustive list of items to be added to the transaction value. Case law interprets this legislation. For example, in the IT sector, the European Court of Justice (ECJ) has specified that a buyer of a personal computer must adjust the value of the transaction if the buyer provides the manufacturer of the personal computer with free operating systems software.[11] The ECJ applied the first sale rule in that case, and even specified that the assists of the first buyer are relevant for the adjustment of the transaction value.

Fourth, the Commentary argues that the first sale price is usually a domestic sales price in the country of export. As the example above shows, there are many cases where this assumption is incorrect. Frequently, neither the first sale nor subsequent sales are between a producer and a reseller in the same country.

Finally, from a practical point of view, the Commentary worries that many customs authorities would not be in a position to verify the circumstances of a first sale as it takes place outside their jurisdiction. Therefore, they would find it difficult to accept such a first sale for the purpose of customs declaration.

This argument is entirely misconceived. Customs authorities have no more burden in the application of the first sale rule than in the application of the proposed last sale rule. WCO Member States can and do impose on the importer the burden of providing proper support for the application of the first sale rule; when the proof supplied is insufficient, customs authorities can simply deny the application of the first sale rule.

The legal effect of WCO Commentary 22.1

Despite the significant impact of the Commentary, it has only an advisory status. As stated in Annex II, Para. 2(a) of the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994:

> The Responsibilities of the Technical Committee shall include the following: (a) to examine specific technical problems arising in the day-to-day administration of the customs value system of Members and to give <u>advisory opinions</u> on appropriate solutions based upon the facts presented.

The Commentary is therefore only a WCO opinion, not an amendment by the WTO of the Valuation Agreement. Notwithstanding the Commentary, there is thus no inconsistency in principle with WTO obligations for a WTO Member to continue to apply the first sale rule.

Recent developments in the US: the Commentary is likely to be transformed into law

So far, the Commentary has had a significant impact in the US. On 24 January 2008, US CBP published a Federal Register Notice proposing to reinterpret the term ‘sale for export’ so as to eliminate the first sale rule.[12] Based on WCO Commentary 22.1, the CBP notice concludes that the current interpretation of transaction value in a series of sales situation is incorrect. It proposes that in a transaction involving a series of goods, the price actually paid or payable for the imported goods when sold for exportation to the US should be defined as the price paid in the last sale occurring prior to the introduction of the goods into the US, instead of as the first or earlier sale. CBP argues that its proposal would bring US law into conformity with the non-binding views of the Technical Committee. Furthermore, CBP states, shifting to the ‘last sale’ interpretation would obviate the importer’s need to engage in ‘formidable fact-finding’ to determine whether a first sale was at arm’s length and whether the merchandise at the time was clearly destined for the US.

This proposal, however, prompted opposition from importers, especially because of its potential to drive up duties (and thus costs). CBP received dozens of comments criticising its proposal on both legal and policy grounds. The legal objections were mainly of a procedural nature, that is, that the CBP cannot change established US law through an administrative rule-making process. In order to do that, congressional legislation is required.

So far, the US industry’s decisive action has been effective. When Congress passed the Food, Conservation, and Energy Act of 2008 (known as the Farm Bill) on 22 May 2008, it inserted a ‘sense of Congress’ provision requiring CBP to obtain permission before changing its interpretation of the First Sale Rule.[13] Under that provision, CBP may not change the first sale rule until 1 January 2011. Further, any future attempt by CBP to revoke the first sale rule would be subject to a number of congressionally imposed standards. For example, it would have to consult with the Commercial Operations Advisory Committee (COAC), a group of industry experts who advise CBP, and with the House Ways and Means and Senate Finance committees which have oversight of the agency. Several months of consultation would be required prior to a rule change. CBP would also have to obtain the ‘explicit approval’ of the Secretary of the Treasury before publishing a change.

Finally, under immense pressure from industry and Congress, CBP formally withdrew its proposal. The withdrawal is included in an interim rule entitled ‘First Sale Declaration Requirement,’ published in the Federal Register on 25 August 2008.[14] The interim rule obliges importers to comply with a new one-year first sale data reporting requirement. The CBP began to enforce this requirement in September 2008.

Recent developments in the EU: The EU is examining whether to include (aspects of) the Commentary in its revised customs legislation

The EU attempted to abolish the first sale rule as early as 1994. Now, in light of the recent Commentary of the WCO Technical Committee, the European Commission and the EU Member States are returning to the theme. Discussions are under way on whether, how, and when to change the EU’s interpretation and application of the ‘first sale’ rule. The matter has recently been discussed within the Valuation Committee, a sub-group of the Customs Code Committee which consists of experts from the 27 EU Member States.

These discussions are part of the review of the Community Customs Code and its implementing provisions that are under way.[15] With regard to the Modernised Community Customs Code, the sale for export concept in a series of sales is to be covered in Article 230 of the Implementing Provisions of the Modernised Customs Code (MCCIP). However, the consolidated preliminary draft of the MCCIP, published on 30 June 2008, is silent on this issue.[16] It seems that the EU Member States have not yet agreed on a proposed text on the first sale rule. Presumably, one of the reasons for this is that the various EU Member States have applied the first sale rule differently. Nonetheless, the final implementing provisions of the MCC are scheduled to come into force at some point between 24 June 2009 and 24 June 2013. Whether these provisions will entail the abolition of the first sale rule remains to be seen.

Conclusions

Experience has shown that the WTO Valuation Agreement leaves substantial room for interpretation. While the Commentary serves as a valuable guide towards achieving uniformity in the Agreement's interpretation and application, its reasoning in the case of the first sale rule, as the analysis above illustrates, is rather inadequate.

Nevertheless, the Commentary has been influential in increasing the chances of the abolition of the first sale rule in the EU and the US. Canada and Australia have already abolished the first sale rule through legislation.[17] The US effort to abolish the first sale rule has been halted by intensive industry lobbying — for now. It is unclear what the EU will do.

What is clear, though, is that the potential impact on international trade of the abolition of the first sale rule in the EU and/or the US would be profound. At the micro level, it would immediately increase the dutiable value of many imports and force businesses to restructure or eliminate business units that were set up on the assumption that the first sale rule would apply. At the macro level, countries which currently do not apply the first sale rule will be less likely to reconsider it in the future.

The first sale rule has been in place in the EU and the US for more than 20 years and reflects a commonsense recognition that, in international trade, the first buyer for export may be located anywhere and a resale of the product before importation is not uncommon. In the absence of more compelling reasons than those cited by the Commentary, the first sale customs valuation rule should not be discarded.

Endnotes

1 Laurent Ruessmann and Arnoud Willems are working with Sidley Austin LLP, the law firm, in Brussels, Belgium. The views expressed in this article, however, are exclusively those of the authors and do not necessarily reflect those of Sidley Austin LLP nor of its partners. This article has been prepared for academic purposes only and does not constitute legal advice. The authors would like to thank Huijian Zhu for his help in preparing this article.

2 WCO Technical Committee, Commentary 22.1: Meaning of the Expression 'Sold for Export to the Country of Importation' in a Series of Sales.

3 *McAfee Co. v. United States*, 842 F.2d 314 (Fed. Cir. 1988); *Nissho Iwai America Corp*. v. *United States*, 982 F.2d 505 (Fed. Cir. 1992).

4 General Notice, Determining Transaction Value in Multi-Tiered Transactions, TD96–97, vols. 31/31 Cust. B. & D. 52/1 (January 2, 1997).

5 9 U.S.C. No. 1401a.

6 Commission Regulation (EEC) No. 2454/93 laying down provisions for the implementation of Council Regulation (EEC) No. 2913/92 establishing the Community Customs Code, OJ L 360, 19.12.2006, as amended.

7 Contrary to pages 98–103 in *Customs valuation — Commentary on the GATT Customs Valuation Code* by S Sherman and H Glashoff, ICC Publication 429, 1988, Kluwer Law and Taxation Publishers.

8 See Endnote 2.

9 Council Regulation (EEC) No. 2913/92 of 12 October 1992 establishing the Community Customs Code, OJ L 302 of 19.10.1992, as amended. The relevant valuation provisions of the Modernised Customs Code, Regulation (EC) No. 450/2008 of the European Parliament and of the Council, will only be applicable when the implementing provisions take effect.

10 Annex 23 of Commission Regulation (EEC) No. 2454/93 laying down provisions for the implementation of Council Regulation (EEC) No. 2913/92 establishing the Community Customs Code, OJ L 360, 19.12.2006, as amended.

11 C–306/04, *Compaq Computer International Corporation v. Inspecteur der Belastingdienst — Douanedistrict Arnhem* [2006] ECR I– 991.

12 Proposed Interpretation of the Expression 'Sold for Exportation to the United States' for Purposes of Applying the Transaction Value Method of Valuation in a Series of Sales, 73 Fed. Reg. 4254, 4255 (24 January 2008).

13 Public Law 110–234, 122 Stat. 1547 (19 U.S.C. 1484 note).

14 Federal Register, 25 August 2008, vol. 73, no. 165, pp. 49939–499.

15 Regulation (EC) No. 450/2008 of the European Parliament and of the Council of 23 April 2008 laying down the Community Customs Code (Modernised Customs Code), OJ 145, 4.6.2008.

16 Consolidated preliminary draft of a Commission Regulation of the Modernised Community Code Implementing Provisions (MCCIP), Taxud/1717/2008, Brussels 30.06.2008.

17 When the Canadian customs authorities lost in *Harbour Sales (Windsor) Ltd* v. *D/MNR* [1994] 4647 ETC., they succeeded in getting the valuation law changed to require a transactional value based on a sale to a purchaser in Canada.

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