

Thoughts on the ‘first sale’ rule

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Abstract

The ‘first sale’ rule is a method used to arrive at the transaction value of merchandise which is the subject of multi-tiered sales. Because the first sale price is always lower than any subsequent resale price, the use of the first sale appraisal method results in substantial savings in duty. The main commercial blocks of the world – the European Union (EU), United States (US) and Japan – accept the first sale appraisal and in the US, this process has been validated through a series of court decisions. Recently, however, a move to ‘last sale’ appraisal has been proposed. This has prompted many substantial importers, trade groups and industry organisations to file comments and legal briefs in strong opposition to the proposal. This article considers the position being taken by the EU Commission, the likely result in a change to the World Trade Organization (WTO) Agreement on Customs Valuation, and concludes with the hope that customs administrators in the US and EU will heed the comments of the international trade community and continue the ‘first sale’ rule.

In modern cross border trade, goods are often subject to a series of sales before importation (for example, from a foreign factory to a middleman and then to a final buyer). At each level of sale the parties in the commercial chain include a mark up.

The ‘first sale’ rule is a special method used to arrive at the transaction value of merchandise which is the subject of these multi-tiered sales.

In the United States (US), current law allows importers, under certain conditions, to base the valuation of product entering the US on the first or earlier sale price in a series of transactions, rather than the last one. Because the first sale price is always lower than any subsequent resale price, the use of the first sale appraisal method results in substantial savings in duty. For example, if items produced in Italy were sold to a middleman in the United Kingdom (UK), and that middleman sold the items to an American buyer/importer, the US importer would normally pay duty based on the price paid to its UK vendor. On the other hand, if the sale qualifies under the first sale rule, the importer may import the product and pay duty based on the price paid by the UK middleman to the Italian vendor. The middleman’s mark up would, therefore, be excluded from duty assessment thereby allowing the importer to achieve substantial savings in duty.

Presently, all the main commercial blocks of the world – the European Union (EU), US and Japan – accept the first sale appraisal. If the merchandise and transaction qualifies for first sale appraisal, the importer can reduce by as much as 50 per cent the amount of *ad valorem* customs duties paid.

In the US, the propriety of appraisal under the first sale method has been validated through a series of court decisions.¹ The US Bureau of Customs and Border Protection (CBP) generally accepts this methodology provided:

1. the transaction between the vendor and the middleman represents a *bona fide* sale of merchandise
2. the sale is an arm's length transaction²
3. the goods are clearly destined for export to the US without any contingency of diversion to other markets.

The US has been appraising merchandise on the first sale basis since 1994 but in January 2008, CBP proposed the elimination of first sale and proposed that the transaction value should be based on the 'last sale'. At that time, CBP provided the reasons for suppressing the rule, in particular, stating that its abolition will:

- assure components of value such as commissions, packing and assists (which may not be included when using the first sale) are properly included in the value
- reduce the amount of time and resources spent by the importer or CBP to verify the requirements of T.D. 96-87 (that should, therefore, also be revoked) have been met
- provide a straightforward rule for determining value in a series of sales
- reduce post-entry audit verification issues, including the need to review production of records
- reduce importer's burden for compliance in properly declaring the value 19 U.S.C. 1484.

The response of the American importing community to this proposal is best described as outrage. Many substantial importers, trade groups and industry organisations filed comments and legal briefs in strong opposition to the proposal. As a result of the controversy, Congress passed legislation requiring the CBP to collect data on the use of 'first sale' to evaluate the impact that the suppression of the rule could have on US importers and postpone any action on the first sale rule until January 2011.³ To this end, the legislation also required the US International Trade Commission (ITC) to draft a report based on the data collected by CBP which would provide a specific analysis relating to the actual use of the rule in the US. As a result of this legislation, CBP formally withdrew its revocation proposal and implemented an interim rule entitled 'First Sale Declaration Requirement'⁴ that obliged importers to comply with a new one year first sale data reporting requirement. The CBP began to enforce this requirement in September 2008.

Based on information collected by CBP, on 23 December 2009, the ITC submitted to the Congress a report titled 'Use of the First Sale Rule for Customs Valuation of US Imports'.⁵ The observation period covered by the report concerns all the import transactions the subject of first sale appraisal between 1 September 2008 and 31 August 2009. The report revealed that during the period, a total of 23,520 importing entities, accounting for 8.5 per cent of all US importers, entered merchandise using the 'first sale rule.' Of the \$1.63 trillion in total of US imports during the period, \$38.5 billion was imported using the first sale rule, representing about 2.4 per cent by value of total US imports.

Finally, the ITC reported that, despite the fact that the main users of the first sale rule are high tariff rate importers (for example, textile apparel, leather goods and footwear companies), this method is also frequently used for duty free imports, that is, on transactions where no duties would ordinarily be paid (for example, for certain qualifying imports originating from Canada, Mexico and the US Virgin Islands, accounting for 21 per cent of all first sale imports).

Based on the data contained in the ITC report, most American companies felt confident that the revocation of first sale in the US was unlikely. At or about the same time that the US was examining the first sale rule, however, so was the European Commission (EC).

In the EU, the first sale rule is enshrined in Article 147, par. 1, of the Commission Regulation (EEC) No 2454/93⁶ (IP-CCC). According to this provision, if goods are introduced into the EU through a 'chain of sales', operators can report as the customs value the selling price in an earlier transaction (that is, of '*a sale taking place before the last sale*'). This means that importers can declare a lower price (the

‘first sale’ price) for assigning a customs value to goods, provided that they can demonstrate, to the satisfaction of the customs authorities, that a *bona fide* ‘sale for export’ to the EU has taken place.

Examples of how this sale for export can be evidenced are contained in the document TAXUD/800/2002 issued on 8 October 2003 (Compendium of Customs Valuation texts of the Customs Code Committee – Customs Valuation Section⁷), which lists the following cases:

1. the goods are manufactured according to EC specifications, or are identified (according to the marks, etc. they bear) as having no other use or destination
2. the goods were manufactured or produced specifically for a buyer in the EC
3. specific goods are ordered from an intermediary who sources the goods from a manufacturer and the goods are shipped directly to the EC from that manufacturer.

The legal framework for the determination of the customs value of imported merchandise is contained in the Agreement on Implementation of Article VII of GATT (1994), also referred as the ‘WTO Agreement on Customs Valuation.’⁸ This Agreement, whose rules have been transposed into legislation in the majority of World Trade Organization (WTO) member countries (including the US and the EU), provides, as the primary and preferred basis for determining the customs value of goods, the use of the so-called ‘transaction value’⁹ between buyer and seller (Art. 1), specifying alternative methods to be applied in sequential order for determining value when the transaction value cannot be applied.

Notwithstanding this attempt at achieving uniformity in customs appraisal in member countries, member country legislation implementing the customs valuation methodology contained in the WTO Valuation Agreement, leaves substantial room for differing interpretations. Accordingly, imports of the same goods in different countries can be appraised using different valuation methods. This lack of legal certainty makes the import and export planning processes particularly complex for companies.

To reduce such complexity, the World Customs Organization (WCO) recently tried to harmonise the interpretation of some of the customs valuation rules, namely those which relate to multi-tiered transactions. In April 2007, the WCO Technical Committee on Customs Valuation adopted Commentary 22.1,¹⁰ with the aim of clarifying the meaning of the sentence ‘*sold for exportation to the country of importation*’ referred to in Art. 1 of the WTO Valuation Agreement, in all those cases where multi-tiered sales exist.

Like the commentary accompanying CBP’s effort to revoke first sale, the Technical Committee, we believe incorrectly, states (point 26 of the Commentary), that where multi-tiered sales transactions exist, customs administrators face considerable problems in verifying information (including accounting records), related to the first sale, especially when such information is held by the foreign intermediary or seller. Accordingly, the Committee has suggested that the price actually paid or payable for the imported goods when sold for export to the country of importation should correspond to the price paid in the **last sale** occurring prior to the introduction of the goods into the country of importation, to ensure consistency in the application of the Valuation Agreement and minimise difficulties for Customs.

We believe that the reasoning of the WCO Technical Committee is faulty in this matter.¹¹ All the WCO Member States require that the importer provide proper support for the application of the first sale rule. If the party claiming first sale appraisal is unable to satisfy Customs’ criteria, first sale is disqualified. Accordingly, the customs authorities bear no greater burden in the first sale scenario than they would if ‘last sale’ rule were applied.

While the WCO Committee has merely an advisory function and its Commentaries have no binding effect,¹² Commentary 22.1 has been largely influential on both sides of the Atlantic. In Europe, the possibility for the importer to declare a ‘first sale’ value (currently foreseen in Article 147 IP-CCC, as indicated above), seems to be deleted from the new (provisional) draft of the implementing provisions to

the ‘Modernized Community Customs Code’ (MCCC).¹³ The MCCC will likely be adopted in 2010 and put into effect in the beginning of 2011. Article 230-02 of the Draft Implementing Provisions of the EU Modernized Customs Code,¹⁴ reflecting the content of the point 27 of the Commentary 22.1, states that:

1. ...[T]he customs value is determined under the transaction value method if the goods have been the subject of a sale for export to the customs territory of the Union at the time of acceptance of the declaration for free circulation. [As a general rule the last sale in the commercial chain, before introduction of the goods into the customs territory, meets this requirement: ...*to be completed*].
2. In the case of resale in the customs territory before release for free circulation, either the sale applicable under paragraph 1, or the last sale before the release of the goods for free circulation shall apply.

Even if the above provision is still incomplete, the EU Commission is clearly intentioned to replace the ‘first sale’ rule with a ‘last sale’ rule. It seems likely, however, that some exceptions will be introduced to the ‘last sale’ appraisal method and first sale opportunities will be further defined.

Discussions on the final version of this article in the customs code committee are still under way, but if enacted in its present form, the possibility of using the first sale appraisalment would be substantially reduced and such a change would certainly raise import duties and negatively affect a large number of European companies enjoying the first sale benefit. Additionally, it could encourage the CBP to renew its effort to revoke first sale in the US.

Fortunately, however, in response to the pending draft, members of the Trade Contact Group (TCG) and other industry groups¹⁵ provided comments which sharply criticised the possible elimination of the first sale valuation.

Although from the foregoing language it seems clear that the EU Commission initially intended to replace the ‘first sale’ rule with a ‘last sale’ rule, based upon the response of the TCG and other industry groups, we are hopeful that new language will be included which will provide opportunity for the continued application of the first sale concept in the EU. Discussions relating to the final version of this article in the Customs Code Committee are still under way.

The US rules and Article 230-02 IP-MCCC place the onus of establishing the propriety of applying the rule on the importer.¹⁶ This implies that the latter can be interpreted differently by the customs authorities of each EU Member State. Moreover, not all the EU Member States apply the first sale rule in the same measure (Belgium, Germany, The Netherlands, France and the UK are the EU countries where this appraisal methodology is most used, while in the other Member States it is not used at all). Apart from these considerations, it cannot be denied that if the proposed draft is implemented without modification, duties will be raised forcing many European companies to restructure business protocols (documentation, inventory management, etc.) which were designed and implemented to qualify for the application of the first sale rule.

Significantly, any change in the EU approach could result in a change in the WTO Agreement on Customs Valuation or the interpretation thereof and provide an opportunity for US Customs authorities to revisit their previous attempt to revoke the application of the ‘first sale’ rule in the US. In fact, although the publication of the ITC report in December 2009 provided a measure of comfort to the American importing community that ‘first sale’ would continue to prevail, the EU initiative has caused an elevated level of concern. On 24 March 2010, representatives of the US importing community wrote to ranking members of the Senate ‘Finance’ Committee and House ‘Ways and Means’ Committee to express strong support for preservation of the ‘First Sale Rule’.¹⁷

We are hopeful that the Customs administrators in the US and EU will heed the comments submitted by the international trade community and continue the ‘first sale’ rule. Any other conclusion would have a devastating impact on businesses and consumers throughout the world.

Endnotes

- 1 First Sale valuation was successfully litigated in a 1988 case (*E.C. McAfee Co. v. United States*, 842 F.2d 314 (Fed. Cir. 1988)). US Customs authorities limited the application of the decision to its specific facts (made-to-measure clothing) and ‘first sale’ only became widely accepted four (4) years after the decision in *Nissho Iwai America Corp. v. United States*, 982 F.2d 505 (Fed. Cir. 1992) when it was formally adopted by Customs in a Treasury Decision (T.D. 96-87).
- 2 Where the sale is between unrelated entities, it is presumed to be ‘arm’s length’. Where, however, the sale is between related parties, it must be established that the ‘circumstances of sale’ indicate that the price was not influenced by the relationship of the parties. Failing the ‘circumstances of sale’ test requires the importer to establish that the sale price closely approximates certain test values set forth in the US value statute 19 U.S.C. § 1401a(b)(2)(B).
- 3 See Food, Conservation, and Energy Act of 2008, Public Law 110-246 (2008).
- 4 First Sale Declaration Requirement, published in the Federal Register on 25 August 2008, vol. 73, no. 165, pp. 49939-499.
- 5 Publication 4421 in Investigation No. 332-505. www.usitc.gov/publications/332/pub4121.pdf.
- 6 Regulation (EEC) No. 2454/93 of 2 July 1993, laying down provisions for the implementation of Council Regulation (EEC) No. 2913/92 establishing the Community Customs Code.
- 7 The Customs Code Committee is an advisory body to the EC. Its role is to provide assistance to the Commission with regard to the interpretation of customs legislation and to the adoption of amendments to customs implementing legislation.
- 8 The WTO Agreement on Customs Valuation, officially came into force on 1 January 1981. It establishes rules for the valuation of imported goods that must be applied by all member countries. It aims to determine a fair, uniform and neutral system for the valuation of goods for customs purposes on a global level and bans the use of arbitrary or fictitious customs values.
- 9 This value usually equates to the invoice price, adjusted in accordance with specific additions and deductions which are aimed to allow operators to determine correctly the taxable base on which customs duties must be applied. In the US, the commercial invoice price paid by the importer is calculated (on goods sold for export to the US) on an FOB (Free On Board) basis. In the EU, by contrast, the transaction value is the commercial invoice price paid by the importer on a CIF (Cost, Insurance and Freight) basis.
- 10 Annex C to Doc. VT0564E1a, VT/24/April 2007.
- 11 For an in-depth analysis of the most controversial aspects of the Commentary 22.1, see L Ruessmann & A Willems, ‘Revisiting the first sale for export rule: an attempt to remove fairness in the interests of raising revenues, without improving legal certainty’, *World Customs Journal*, vol. 3, no. 1, pp. 45-52.
- 12 Annex II, Par. 2(a) of the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 establishes that the responsibilities of the Technical Committee include the examination of specific technical problems arising in the day-to-day administration of the customs value system of Members, and the provision of advisory opinions on appropriate solutions based upon the facts presented.
- 13 Regulation (EC) No. 450/2008 of the European Parliament and of the Council of 23 April 2008 laying down the Community Customs Code (Modernized Customs Code). The aim of the modernisation process of the EU customs regulation is to replace the existing Community Customs Code (Regulation EEC No. 2913/1992 of 12 October 1992) and its implementing provisions (Regulation EEC No. 2454/93 of 2 July 1993) with new rules aimed to streamline customs procedures and lay the foundations for accessible, interoperable customs clearance systems at EU level.
- 14 TAXUD/1717/2008, Rev 1.3 of 6 January 2010, hereinafter ‘IP-MCCC’.
- 15 The EC holds regular consultation with representatives from industry associations for developments of Customs policy. The TCG, in particular, provides a forum for a mutual exchange of views between economic operators and the Commission’s services on all customs-related issues. Its members represent the main international associations involved in customs-related activities at the European level.
- 16 See T.D. 96-87 and ‘Compendium of Customs Valuation texts of the Customs Code Committee’ quoted above.
- 17 The list of signatories to the letter comprises important and high profile importers, industry groups and trade associations including: Eddie Bauer; Finlandia Cheese; Gap, Inc.; J.C. Penney Corporation; Levi Strauss; Walmart; Wine & Spirits Wholesalers of America; Alliance of Automobile Manufacturers; American Apparel & Footwear Association (AAFA); American Association of Exporters and Importers (AAEI); National Customs Brokers and Freight Forwarders Association of America (NCBFAA); National Retail Federation (NRF); Sporting Goods Manufacturers Association (SGMA); Toy Industry Association; Cheese Importers Association of America, etc.

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