Tariff Engineering: Value-Added Compliance

By Lawrence M. Friedman (Barnes, Richardson & Colburn) and Josh Levy

Differences in customs duty rates applicable to similar products create an opportunity for savvy compliance managers and their counsel to suggest modifications to the design of imported products to reduce duty expenses associated with that product. This strategy is known as tariff engineering and has a long history in the U.S. When properly applied, tariff engineering allows companies to convert the step of classifying imported goods from a mandated compliance cost into a value-added exercise in cost savings.

Classification for Customs Purposes

Tariff classification is a necessary element of legal compliance for any company or individual that imports goods into the United States. In the U.S., tariff classifications are assigned based on the Harmonized Tariff Schedule of the United States,[1] which is known as the HTSUS. With few exceptions, every physical item that can be moved across the border and into the Customs Territory of the United States is assigned a 10-digit HTSUS classification number (including a two-digit statistical suffix).[2]

Often, there are differences in the rate of duty applied to merchandise that might otherwise appear to be relatively similar in nature. Tariff engineering can be applied during the classification of, for instance, a men's overcoat. When made of cotton, the overcoat is classifiable in 6101.20.0010 and subject to a 15.9 percent *ad valorem* duty.[3] However, a men's overcoat of manmade fibers containing 25 percent or more by weight of leather is only assessed duties at the rate of 5.6 percent under tariff item 6101.30.1000. Therein lies the opportunity for tariff engineering.

History

The history of tariff engineering starts in the 19th century. In 1881, the tariff code provided different rates of duty for sugar of different grades, determined by color.[4] In one famous instance, Customs believed that the importer intentionally colored sugar with molasses, lowering the grade to avoid higher duties. Customs conducted a chemical analysis and determined that the sugar was a higher grade than its color indicated. The U.S. Supreme Court held that manufacturing sugar with a dark color to evade duties was permitted, because Congress had adopted the color test, not a chemical test, for sugar classification. The Court recognized that an importer could configure merchandise to achieve the lowest rate of duty "so long as no deception was practiced."[5]

The Supreme Court refined the test for acceptable tariff engineering in *U.S. v. Citroen*.[6] The imported merchandise was a collection of unstrung pearls with drilled holes to allow for stringing. The collection was selected to form a complete necklace, which is how it was displayed when sold in France. Customs classified them as "pearls set or strung," dutiable at 60 percent, rather than as "pearls in their natural state, not strung or set," dutiable at 10 percent. The Court held that the classification of imported merchandise "must be ascertained by an examination of the imported article itself, in the condition it is imported."[7] According to the Court, unstrung pearls, even when drilled, remain unstrung and in their natural state. However, the Court warned that a "prescribed duty rate cannot be escaped by resort to disguise or artifice."[8]

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Customs rulings on the classification of footwear since 2000 illustrate how U.S. Customs and Border Protection differentiates between acceptable tariff engineering and an impermissible disguise or artifice. Footwear with rubber or plastic outer soles is subject to higher duties than where the outer soles are made of textiles.[9] To qualify for the lower duty, a manufacturer imported slip-on shoes with textile fabric glued over 70 percent of the outer sole. Customs determined the textile fabric was not an artifice, but a constituent material part of the shoe as imported.[10] In 2002, Customs issued another favorable ruling to an importer who embedded a thin layer of textiles into rubber soles of house slippers.[11] Domestic shoemakers claimed the textile sole was a deception that wore off after

Tariffs, continued on page 8

Tariffs from page 7

limited use. Customs sided with the importer. The product as entered was a "commercial reality" sold and worn by the consumer in its imported condition.[12]

Where Customs suspects that the importer has manufactured a fictional or temporary product, it has not permitted the tariff engineering to establish the lower rate of duty. In *Heartland By-Products v. U.S.*, a Canadian refiner manufactured sugar syrup and added sufficient molasses into a syrup to avoid a tariff rate quota. Before importing the syrup, the refiner requested a ruling classifying the product as not subject to quota. The importer disclosed that the molasses would be removed after importation. Customs classified the syrup in the provision not subject to the quota. When domestic refiners challenged the ruling, Customs reversed it. According to Customs, there was "no commercial purpose" for addition and removal of molasses and it is "not a genuine step in the manufacturing process."[13] The process "cross[ed] the line of permissible fashioning to one of artifice to obtain favorable tariff treatment by the avoidance of a tariff rate quota."

Heartland challenged the ruling, and the Court of International Trade reversed.[14] The combination of raw sugar with molasses before importation was a legitimate step in the refining process, analogous to "artificial steps in the manufacturing process" accepted by prior courts.[15] Customs appealed the decision to the Court of Appeals for the Federal Circuit, which ruled in Customs favor on other grounds not involving the tariff engineering question. A concurring judge stood behind Customs' ruling, writing "that the only purpose of this strange arrangement was to create a fictitious product that, because of the temporary presence of the molasses, qualified for the lower rate of duty on sugar imports."[16]

Customs' most recent ruling involves the classification of the Ford Transit Connect van.[17] Gasoline powered vans of this type are classified in either heading 8703, covering "motor vehicles principally designed for the transport of persons," with a duty of 2.5 percent, or in heading 8704, covering "motor vehicles for the transport of goods," dutiable at 25 percent. According to the facts as stated in Customs' ruling, in their imported condition, these vans had front seats, a rear bench seat, and rear side windows. Ford entered them in heading 8703 as passenger vans. Shortly after entry, Ford transported the vans to a nearby facility where the rear windows were removed and replaced with solid panels. Ford also removed the bench seat and installed a cargo bay. The bench seat was discarded and never used. Ford sells the transformed Transit Connect to consumers as cargo vans.

Customs ruled that Ford's configuration of the vehicles as passenger vans was a disguise or artifice. According to Customs, the addition and removal of the rear bench seat and windows served no manufacturing or commercial purpose other than to manipulate the tariff schedule.[18] Relying on the concurring opinion in *Heartland*, Customs concluded "that the only purpose of this arrangement is to create an ephemeral product that, because of the temporary presence of the rear seats and windows, would appear to qualify for the lower rate of duty on imports of passenger vehicles, but which will never be entered into the stream of commerce."[19]

The Ford case is presently before the Court of International Trade. It remains to be seen whether the facts as presented by Customs in its ruling can be proven in court. For example, practical experience in taxi cabs, hotel shuttles and other similar applications shows some Transit Connects make it to market as passenger wagons. Further, Ford markets them as such, complete with rear seats and rear windows.[20] Thus, an important question may be whether the sale of any vehicles in their imported condition is sufficient to establish the classification of all such vehicles. This case, therefore, may set important parameters for future tariff engineering decisions. Including whether, as the Court of International Trade found in Heartland, the temporary nature of a modification for purposes of tariff engineering does not trump the legal proposition that Customs must classify the goods in their condition as imported.

Conclusion

Tariff engineering is not always a viable option. This is particularly true where the technical specifications or contractual requirements dictate the details of product design. However, it may pay dividends to remind classifiers to check whether similar products made of different materials, with slightly different specifications, or from a different country of origin might be subject to a lower rate of duty. When that is the case, the classifier should be trained to make that opportunity known to the relevant people who can evaluate whether the change is viable within other business constraints, including whether the change will cost more than the duty savings. Further, while the scope of disguise and artifice remain to be litigated, an effort should be made to ensure that any product imported with the benefit of tariff engineering is a

commercially real product that is truly offered for sale in its imported condition. Customs' current position is that fictional or temporary products cross the line into disguise or artifice. Final word on that will come from the courts. ❑

1 19 U.S.C. § 1201. The actual tariff schedule is not reproduced in the statute. Rather, it is maintained by the U.S. International Trade Commission as Publication Number 4446 available here http://www.usitc.gov/publications/docs/tata/hts/bychapter/1400htsa.pdf.
2 Because of the importance of classification for Customs processing and duty assessment, an incorrect classification can result in civil penalties under 19 U.S.C. § 1592.
3 The duty is calculated as a percentage of the entered value of the merchandise. This is usually the price paid or payable for the goods when sold for export to the U.S. 19 U.S.C. § 1401a.
4 The grading scale was known as the "Dutch standard of color." The darker the shade of sugar, the lower the grade, and the lower the corresponding duty.
5 *Merritt v. Welsh*, 104 U.S. 694, 704 (1881)
6 *U.S. v. Citroen*, 223 U.S. 407 (1912)
7 *Id.* at 415
8 *Id.*
9 Footwear classification generally depends upon the materials that make up the outer sole. Footwear with rubber or plastic outer soles, classified under headings 6402 and 6404, is typically subject to higher duty rates than footwear with outer soles of textile or other materials classified under heading 6405. Shoe importers have historically engineered footwear to contain just enough textile material added to a rubber or plastic outer sole to avoid higher tariffs.
10 HQ 964978 (Apr. 18, 2002)
11 HQ 965751 (Nov. 18, 2002)
12 Id.
13 33 *Cust. B. & Dec.* 41 (Sept. 8, 1999)
14 *Heartland By-Products, Inc. v. U.S.*, 23 C.I.T. 754, 770 (1999)
15 *Id.* at 1341 citing *Citroen, supra.*
16 *Heartland-By-Products, Inc. v. U.S.*, 264 F.3d 1126, 1137-38 (Fed. Cir. 2001)
17 HQ H220856 (Jan. 30, 2013)
18 *Id.*
19 *Id.*
20 See, for example, http://www.ford.com/trucks/transitconnect/trim/wagonxlt/.

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MERCOSUR and EU Struggle to Make Progress in FTA Negotiations

By Daniel Wu (White & Case)

On March 21, 2014, MERCOSUR and EU senior trade officials met in Brussels to advance negotiations toward a MERCOSUR-EU Association Agreement (AA). If concluded, this Agreement would consist of three pillars, namely frameworks for (i) political dialogue; (ii) cooperation; and (iii) a bloc-to-bloc free trade agreement (FTA), and would encompass a market of more than 700 million consumers and an annual bilateral trade volume of approximately USD 120 billion.

According to European Commission (EC) Trade Commissioner Office Spokesperson John Clancy, both sides met to discuss the state of preparations regarding their respective market access proposals in the areas of goods, services, investment, and government procurement. It is worth noting that the Parties originally scheduled the exchange of offers to take place in March 2014; however, both sides failed to meet this deadline. Consequently, negotiators from both sides agreed to continue their internal work and consultative processes with the objective of exchanging offers in the coming months, possibly in May 2014.

At the meeting, both sides expressed their commitment towards negotiations to reach a "global, balanced, and ambitious agreement." MERCOSUR and EU launched AA negotiations in 1999, suspended such negotiations in 2004, and

FTA Negotiations, continued on page 10

