Customs Issues with Vendor Managed Inventory Programs*

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I. Introduction

Vendor Managed Inventory (VMI) programs have become an important tool in supply chain operations. When the vendor is located in another country, however, and the goods must cross an international border, significant Customs and tax issues can arise. Delaying the shift in ownership (passage of title) can affect the right to make entry, have an impact on determining the appropriate Customs value, may incur certain tax responsibilities and can subject a foreign vendor to the legal jurisdiction of the delivery location.

VMI programs may be established by vendors to better serve distributors or end users, or be required by purchasers to reduce costs and improve timely supply. In operation, the manufacturer or vendor is responsible for maintaining the inventory of the customer, based on access to the customer's inventory and usage data. The process requires a significant level of information sharing and cooperation among the parties.

In the "traditional" type of international business transaction, the buyer makes a purchase from a foreign manufacturer or vendor, and either arranges for the transportation of the goods and entry into the buyer's country, or pays the seller to perform some or all of the transportation and entry responsibilities. When the goods reach the importing country, a sale has already occurred, and in most circumstances there are no issues regarding the right to enter the goods or a method to satisfy Customs valuation requirements. After entry into the destination country, the purchaser owns the goods, and is responsible for any tax implications. The seller can usually arrange the transaction so that it does not become subject to the jurisdiction of the importing country.

VMI programs, on the other hand, usually require that the goods be held in inventory near the purchaser's location or locations, whether for supply as parts for manufacturing operations or inventory for a retail operation. Title to the goods, and responsibility to make payment, generally does not pass from the seller to the buyer until the goods are withdrawn from warehouse, or, perhaps, delivered to the customer's location. The price for the goods may not be determined until the withdrawal from warehouse or delivery to the customer's facility. The foreign manufacturer or vendor must use or establish a branch office, subsidiary or appropriate agents to hold and manage the inventory and process its release. Integrated logistics companies are often engaged to transport, warehouse, repackage, and ship the goods to the purchaser.

For the purposes of this article, the specific laws and policies discussed and procedures reviewed will relate to an import transaction into the United States. Similar issues will exist, with possible small differences due to the requirements of different importing countries, where another destination country is involved.

II. Right To Make Entry

The United States restricts the right to make entry of merchandise into the country to the owner or purchaser of the goods, or a formally authorized party with a financial interest in the goods, such as a commission agent; or to a licensed customs broker.[1] Due primarily to the responsibilities and liabilities imposed on the Importer of Record (IOR), few customs brokers, other than those performing courier services, are willing to act as an IOR.

In the "traditional" transaction described above, even if the seller is arranging for the transportation of goods to the United States, the buyer has already made a purchase, so that it can act as the IOR as a purchaser. In VMI operations, however, no sale to the final buyer takes place until after the goods have arrived and been warehoused at some location in the United States. In certain situations, US Customs and Border Protection (Customs) has found an "agreement to sell" that allowed the prospective purchaser to act as the IOR, although value was based on actual sale prices of identical merchandise.[2] In other situations, however, Customs has found that there was no sale at the time of importation.[3] Therefore, the vendor, as the owner of the merchandise, is normally responsible for entry of the goods. Also, in many situations the purchaser will require the vendor to take on the importing obligations as part of its contract.

A foreign company or individual can legally act as importer of record into the United States. However, any such transaction by a corporation must involve an agent resident in the United States (often fulfilled by a licensed customs broker) to whom that foreign party has granted authorization to serve as the agent for service of process in connection with any legal proceedings which may relate to that importation. A non-resident importer must also have the bond required for entry issued by an authorized resident surety company.[4] In some instances, a foreign vendor may have an established or newly formed subsidiary in the US act as the importer of record, either as an agent for the foreign seller or as a "middleman" technically purchasing and then managing the inventory before re-sale to the ultimate purchaser. Unless the agent or subsidiary has an established financial record sufficient for underwriting by a surety company, however, the foreign seller may be required to provide sufficient collateral (such as a standby letter of credit) for the bond amount.

III. Customs Value

Under the Customs laws, both in the United States and in all countries that are members of the World Trade Organization (WTO), the preferred basis for determining value for Customs purposes is “transaction value” .[5] Transaction Value is defined as “the price paid or payable for the merchandise when sold for exportation to the United States”.[6] There are certain specified adjustments which may or must be made in appropriate circumstances. Use of this basis of valuation does, however, require an actual sale transaction.

Merchandise imported by vendors in VMI operations ordinarily has not yet been sold at the time it enters into the United States, and the transfer occurs of goods owned by the same party both before and after entry. In some instances the end purchaser may act as importer of record based on an “agreement to sell” although an actual sale has not yet occurred. Alternatively, there may be a “sale” to a subsidiary, but the actual price at which the goods are sold (both by the vendor to the subsidiary, and by the subsidiary to the purchaser) may not be determined until the ultimate sale by that middleman subsidiary to the end purchaser. In all of these situations, creative solutions may be required to determine a value which will be acceptable to the Customs authorities for entry purposes.

In certain situations, Customs has found that the agreement between the vendor and the purchaser, although not constituting a sale at the time of importation, is still sufficiently binding that transaction value can be directly applied. In a 2007 ruling, Customs found that the purchaser was obligated to buy the imported inventory and also obligated to make payment for that inventory within 63-days even if it had not yet been removed from inventory. This was sufficient to allow a finding that a sale for exportation did exist, and the invoice price for the international shipment was an acceptable Customs value.[7]

More commonly, however, where the purchaser may not have an absolute obligation to buy merchandise from the imported inventory, and where the actual price paid or payable by the purchaser is not determined at the time of import, but rather at the time of withdrawal, Customs has determined that no transaction value exists. Whether the shipment is considered a transfer of inventory from one location to another, or a consignment to an agent of goods for future sale, no bona fide sale exists at the time of entry.

In the absence of a transaction value, the valuation statute provides a hierarchy of alternatives. These include the transaction value of identical or similar merchandise, deductive value (based on the price at which merchandise is sold in the US in its condition as imported), and computed value (based on the material and processing costs incurred in producing the merchandise.) If the vendor is selling the same product, or it or a competitor is selling a similar product, into the United States, it is possible that a transaction value for identical or similar merchandise can be found. Generally, however, either the information regarding competitor's sales activities are not available, or the product is being sold by the vendor only to a single customer (including customer branded items) so that it will not be possible to determine a transaction value for identical or similar merchandise.

Deductive value is commonly unavailable, because it must be based on sales of the actual merchandise imported into the United States in the greatest aggregate quantity at or about the time of importation or before the close of the 90th day after the date of importation. Where goods are held in inventory in excess of 90-days, or where procedures do not allow for the identification of specific products withdrawn from inventory to specific Customs entries, it may not be possible to make the necessary calculations. Computed value can only be used when the vendor is willing to provide the specific detailed information required by US Customs.

The final method of valuation available, often known as "the fallback method", is to determine the value for the goods derived from the statutory provisions, but "reasonably adjusted" as necessary to arrive at a value. In a number of situations, Customs has used this fallback method to determine the appropriate value for consigned inventory.

In one ruling, Customs found that, although the commercial invoice which accompanied the shipment to the United States was not the agreed upon price for the merchandise when withdrawn from inventory for delivery to the purchaser, most products remained in inventory for only a short period of time, and the price paid at release was normally the same as that on the international invoice. In another ruling, Customs found that the price at the time of export (which was reflected on the invoice accompanying the shipment) would match the price for goods withdrawn from inventory on that same date. Again, based on the “just in time” process meaning goods remained in inventory for only a limited period of time, use of the invoice reflecting the price in effect for inventory withdrawals on the date of export was allowed as a reasonable adjustment to transaction value. A third ruling involves international commercial invoices that reflected the most recent purchase order paid on withdrawal of the goods from inventory, treating this as a reasonable adjustment to transaction value.[8]

Many value issues (and right to make entry and taxation issues) can be resolved by the use of a US based sales subsidiary. If the subsidiary makes an arms length bona fide purchase of the goods there can be a valid transaction value. However, if the final price between the vendor/parent and sales subsidiary remains dependent on the price of the final sale to the end customer, the sales subsidiary acting as importer may have to use the reconciliation procedure established by Customs (if applicable) or consider the use of alternative valuation procedures. Prior notice to, and perhaps formal approval by, Customs may be necessary as well.

The importer, whether it is the foreign vendor, a US subsidiary, or the purchaser of consignment goods, has the obligation to value the goods, using reasonable care based on the applicable Customs laws. A recent court case, although not involving VMI merchandise, did review a situation where a “provisional” invoice was issued and used as the basis of value at the time of filing the entry. Customs was not advised that the invoice was “provisional” nor was Customs ever advised of additional payments made to the seller when the transaction was “settled” and a final invoice issued at a later date. The Court agreed with Customs that the importer had intentionally provided an invoice which it knew did not reflect the final transaction price, without advising Customs of that fact. This was found to be a fraudulent act, and the importer was subject to a multi-million dollar penalty in addition to payment of lost revenues and the interest thereon[9].

Small differences in the details of the transaction, or the availability of alternative values, may have significant effects on the application of the value statute. Importers of VMI merchandise must take special care to understand the true nature of the transaction, apply the valuation requirements, and establish an ongoing program to ensure compliance with Customs requirements .

IV. Responsibilities of Importer of Record

An Importer of Record (IOR) incurs legal responsibilities by the act of filing a Customs entry. Whether this is done directly by the foreign vendor, or by its agent or subsidiary, the IOR is responsible for supplying true and correct information to US Customs regarding the nature of the goods and their value, including using reasonable care to classify and value the goods for entry purposes; and for ensuring the goods meet all country of origin marking requirements, not only of US Customs, but of other government agencies such as the Food and Drug Administration, the Federal Trade Commission, and the Environmental Protection Agency. In addition to marking requirements, many other federal agencies impose further requirements on specific types of products such as drugs, cosmetics, radiation emitting devices (including consumer devices such as televisions and CD players) and so forth. The IOR is responsible for the payment of Customs duties together with any liquidated damages or penalties that may imposed in connection with the import process. The importer of record may also, in certain circumstances be responsible for certain product liability obligations.[10]

The importer of record will also be subject to a new requirement for a Security Filing based on a Notice of Proposed Rule Making published by Customs. [11] A Security Filing must be made, for containerized and breakbulk maritime cargo, prior to the loading of the goods for shipment to the United States. It must indicate detailed information regarding the cargo, the importer, the purchaser, and the stuffing of the container or packaging of the goods.. This new requirement is expected to go into effect by the end of 2008.

Many government agencies place requirements on manufacturers or producers of various products. These include, in addition to those listed above, agencies such as the Consumer Product Safety Commission (product safety), the Department of Transportation (vehicle safety), the Department of Agriculture (meat and fish, agricultural pests), and the Department of Energy (energy efficiency). When the goods are produced outside the United States, the regulations often treat the importer of record as the manufacturer and impose all of the relevant responsibilities on the IOR.

V. Taxation Issues

In the "traditional" international sale transaction described above, the foreign vendor sells the goods for shipment to the United States. The sale may be direct to an end customer, or made to a US sales subsidiary. In either event the vendor will ordinarily not have sufficient business connection to the United Sates to subject it to federal or state taxing authorities, although a subsidiary operation established in the United States would be. In the VMI procedure, however, a foreign vendor arranges for goods owned by it to be imported into and held in the United States for subsequent sale in a domestic transaction; that sale could now subject the foreign company to US tax consequences. Tax treaties may define some of these obligations.

In addition to income taxes, goods held for sale in the United States may be subject to state and/or local inventory taxes. Even where a US subsidiary or agent is utilized to take title to and hold the goods, there are potential tax implications due to the delayed nature of many sales transactions (see above), in addition to the tax liabilities applicable to the US agent or subsidiary itself.

In some situations, some of these taxes, such as local inventory taxes, can be avoided by the use of Foreign Trade Zones (FTZs). Duty liability can also be deferred by using FTZs or Customs Bonded warehouses. Because those options are generally more costly than privately owned or public warehouse space, the relative cost and savings must be carefully examined.[12]

VI. Conclusion

Establishing a vendor managed inventory program where the inventory merchandise is imported from another country adds substantial levels of complexity to the process. Vendors must be aware of possible legal restrictions on the ability to file an entry, complexities in the Customs valuation process, the responsibilities that are taken on by an Importer or Record, and possible exposure to the taxing authorities in the importing country. Purchasing companies having vendors manage inventory on their behalf should be aware of how their product supply process may be affected by these issues.

VMI programs are now an integral part of supply chains, and have been proven to provide savings and other benefits when properly planned and implemented. Care should be taken to understand the Customs issues that may be involved whenever establishing such a process, and to conduct appropriate reviews to ensure ongoing compliance.

ENDNOTES

[1] 19 USC 1484
[2] HQ ruling 548574.
[3] HQ 548273; HQ 548236; HQ 548574.
[4] 19 CFR 141.17, 141.18.
[5] Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994.
[6] 19 USC 1401a(b).
[7] HQ H012659.
[8] See rulings listed in Endnote 3.
[9] United States v. Inn Foods, Inc., U.S. Court of International Trade Slip Op. 07-142, September 25, 2007.
[10] 19 USC 1592; 19 USC 1304; 19 CFR 12; 19 CFR 141.1.
[11] Federal Register January 2, 2008 (Volume 73, Number 1, pages 90-113).
[12] See HQ H017624 for a discussion of Foreign Trade Zone VMI issues.

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