

INTERNATIONAL TRADE AND FINANCE MASTERCLASS

PART 04 OF 25 · SECTION I: THE PHYSICAL ARCHITECTURE OF GLOBAL TRADE

PART 4

TRADE COMPLIANCE, FREE TRADE ZONES, AND DUTY OPTIMIZATION

How to build a customs compliance program that protects your company, and how to use Free Trade Zones, bonded warehouses, and duty drawback to legally minimize what you pay.

IN THIS PART

- The Reasonable Care standard and what it demands
- C-TPAT and the benefits of trusted trader status
- Free Trade Zones — how they work and the financial benefit
- Bonded warehouses and temporary importation
- Duty drawback — recovering duties on re-exported goods
- Prior disclosure and what to do when you find an error

CASE STUDIES

Each part includes fully worked case studies with detailed calculations, real-world context, and practical lessons for CFOs and finance leaders.

■ BUILDING A COMPLIANCE FOUNDATION

The Reasonable Care Standard: What the Law Requires of You

In the United States, every importer has a legal obligation to exercise Reasonable Care in completing all customs entry documents. This standard was introduced in the Customs Modernization Act of 1993 and it fundamentally shifted the responsibility for customs compliance from the customs authority to the importer. Before the Modernization Act, CBP was responsible for determining the correct classification, value, and origin of imported goods. After the Act, the importer is responsible for providing accurate information, and CBP's role is to verify it.

What does Reasonable Care actually require? CBP has provided guidance that makes the standard concrete. For classification, Reasonable Care means that you have consulted the Harmonized Tariff Schedule, reviewed the explanatory notes, considered obtaining a binding ruling for ambiguous products, and engaged a licensed customs broker for complex classifications. For valuation, it means that you have correctly identified all elements of the dutiable value including assists, royalties, and proceeds of resale. For origin, it means that you have reviewed the

rules of origin and obtained proper origin documentation from your suppliers. For a CFO, Reasonable Care means that the company has a documented compliance program and that the people making customs decisions have been trained to make them correctly.

The C-TPAT Program: The Benefits of Being a Trusted Trader

The Customs-Trade Partnership Against Terrorism — C-TPAT — is a voluntary program administered by US Customs and Border Protection through which companies in the international supply chain agree to implement and maintain security standards in exchange for significant operational benefits. The program was created after September 11, 2001, when CBP recognized that it could not possibly physically examine more than a tiny fraction of the millions of containers entering the United States each year. The solution was to designate trusted traders — companies with strong security practices and clean compliance records — and expedite their shipments while concentrating examination resources on higher-risk shippers.

The financial benefits of C-TPAT certification are significant and concrete. Certified companies experience significantly fewer physical examinations of their shipments — industry surveys suggest examination rates that are five to ten times lower than for non-certified importers. This directly reduces costs: a typical physical examination at a US port costs the importer between fifteen hundred and five thousand dollars in demurrage, examination fees, and the cost of goods being delayed. For a company that imports three hundred containers per year, even a modest reduction in examination rates from eight percent to two percent represents a saving of approximately fifty-four thousand dollars annually — just from avoided examination costs, not counting the value of faster supply chain velocity.

Free Trade Zones: The CFO's Most Powerful Duty Tool

A Free Trade Zone — called a Foreign Trade Zone in the United States — is a designated area near a port of entry where goods can be stored, manufactured, or processed without being subject to customs duties until they are withdrawn from the zone and enter the domestic market. If goods in an FTZ are re-exported to another country without ever entering the domestic market, no duty is ever paid. The FTZ is one of the most powerful — and most underutilized — tools available to a CFO involved in international trade.

Think of an FTZ as a bubble of non-US-customs territory inside the geographic boundaries of the United States. The goods are physically in the US — they might be sitting in a warehouse in New Jersey or being assembled in a factory in Texas — but for customs purposes they have not yet entered US commerce. Duties become payable only when the goods leave the FTZ and are entered for consumption in the United States.

The Three Core Financial Benefits of FTZ Operations

The first and most straightforward benefit is duty deferral. Goods admitted to an FTZ do not trigger duty payment until they are withdrawn for US consumption. For goods that sit in inventory for thirty, sixty, or ninety days before being sold, this deferral has a cash flow value equal to the time value of the deferred duty. The second benefit is duty reduction through manufacturing — specifically the inverted tariff benefit. The third and often most dramatic benefit is duty elimination on goods that are re-exported.

◆ FTZ FINANCIAL BENEFITS CALCULATION

FTZ BENEFITS – THREE SCENARIOS

SCENARIO 1: DUTY DEFERRAL BENEFIT

Annual imports into FTZ: \$24,000,000

Average duty rate: 8.5%

Annual duty that would be paid immediately: \$2,040,000

Average time goods sit in FTZ before withdrawal: 60 days

Cost of capital (carrying rate): 8% per year

Deferral saving: $\$2,040,000 \times 8\% \times 60/365 = \$26,827/\text{yr}$

SCENARIO 2: INVERTED TARIFF BENEFIT

Company imports components into FTZ and manufactures finished goods inside the FTZ:

Component A duty rate: 12.0%

Component B duty rate: 8.5%

Finished product duty rate: 3.5%

Annual component value: \$8,000,000

Duty WITHOUT FTZ (on components at 10.25% avg): \$820,000

Duty WITH FTZ (on finished product at 3.5%): \$280,000

INVERTED TARIFF SAVING: \$540,000

SCENARIO 3: RE-EXPORT DUTY ELIMINATION

Company uses FTZ as regional distribution center

Total goods admitted to FTZ annually: \$30,000,000

Goods re-exported (not entering US market): \$8,000,000

Average duty rate: 5.0%

Duty eliminated on re-exports: $\$8\text{M} \times 5\% = \$400,000$

COMBINED ANNUAL FTZ BENEFIT: $\$26,827 + \$540,000 + \$400,000$

= approximately \$967,000 per year

Duty Drawback: Recovering Duties You Have Already Paid

Duty drawback is one of the oldest provisions in US customs law — it dates back to 1789 — and it allows importers to recover up to ninety-nine percent of the duties, taxes, and fees paid on imported goods that are subsequently exported from the United States. Despite its long history and the significant sums available, duty drawback is massively underutilized. Industry estimates suggest that only ten to fifteen percent of the duty drawback available to US exporters is actually claimed each year, leaving hundreds of millions of dollars annually unclaimed.

There are three main types of drawback. Manufacturing drawback applies when imported materials or components are used in the manufacture of finished goods that are subsequently exported. Unused merchandise drawback applies when imported goods are exported in the same condition as they were imported, without having been used in the United States. Rejected merchandise drawback applies when imported goods are returned to the foreign seller because they were defective or did not conform to the purchase order.

◆ MANUFACTURING DRAWBACK CALCULATION

DUTY DRAWBACK CALCULATION – MANUFACTURING DRAWBACK

SCENARIO: US automotive parts manufacturer

Imports steel from South Korea, pays duty

Manufactures auto parts in the US

Exports 35% of finished production to Canada and Mexico

Annual steel imports: \$12,000,000

Duty rate on steel (including Section 232 tariff): 25%

Annual duty paid: $\$12,000,000 \times 25\% = \$3,000,000$

Finished goods exported: 35% of production

Steel consumed in exported goods: 35% of \$12M = \$4,200,000

Duty paid on exported-goods steel: $\$4,200,000 \times 25\% = \$1,050,000$

Drawback recovery (99% of duty): $\$1,050,000 \times 99\% = \$1,039,500$

ANNUAL DRAWBACK CLAIM: \$1,039,500

Filing period: up to 5 years from date of export

Required records: import entry, proof of manufacture, export documentation, bill of lading

COMMON MISTAKE: Many companies do not even know

they qualify. If you import ANY material used in goods that are subsequently exported, review your drawback eligibility immediately.

Prior Disclosure: What to Do When You Find an Error

Every company that imports on any scale will eventually discover a customs compliance error. Perhaps a classification was wrong for three years before anyone noticed. Perhaps an assist was not declared. Perhaps the country of origin was incorrectly certified on a certificate of origin. The question is not whether errors occur — they do, even at the most sophisticated companies — but what you do when you discover them. The answer, almost always, is to file a prior disclosure with CBP before they find it themselves.

A prior disclosure is a voluntary self-correction filed with CBP that acknowledges the error, calculates the duties that should have been paid, pays the unpaid duties with interest, and receives penalty mitigation in return. The financial

benefit is dramatic. Without a prior disclosure, the penalty for negligence is between one and four times the unpaid duty. For gross negligence, it is between four and eight times. For fraud, penalties can be up to the domestic value of the goods. With a prior disclosure, the penalty is reduced to the interest on the unpaid duties — typically around eight percent per year on the amount owed. This can reduce the financial liability by ninety percent or more.

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CASE STUDY 1

Cascade Furniture Imports

FTZ Manufacturing — \$840,000 Annual Duty Saving on Imported Components

Background

Cascade Furniture Imports assembles high-end furniture in a facility located near the Port of Seattle. The company imports components — wooden frames from Malaysia, fabric from Italy, hardware from Germany, and foam from China — and assembles them into finished sofas and chairs sold in the US market. Each component had a different duty rate, but the combined average was significantly higher than the duty rate on finished upholstered furniture. The company's CFO identified the FTZ inverted tariff opportunity during an annual duty review.

◆ CASCADE FTZ INVERTED TARIFF CALCULATION

CASCADE FURNITURE — FTZ INVERTED TARIFF ANALYSIS

COMPONENT IMPORTS (annual):

Malaysian wooden frames: \$4,200,000 at 3.2% = \$134,400

Italian fabric: \$2,800,000 at 12.0% = \$336,000

German hardware: \$900,000 at 3.9% = \$35,100

Chinese foam (with Section 301): \$1,600,000 at 28.5% = \$456,000

TOTAL DUTY ON COMPONENTS (no FTZ): \$961,500

FINISHED PRODUCT DUTY (if imported as finished goods):

Finished upholstered furniture (HS 9401.61):

Duty rate: 3.7%

Total component value: \$9,500,000

(Finished goods value is approx same as components)

DUTY ON FINISHED PRODUCT BASIS: \$9,500,000 x 3.7% = \$351,500

ANNUAL FTZ INVERTED TARIFF SAVING:

\$961,500 - \$351,500 = \$610,000

Plus deferral benefit on 45-day average hold: \$15,200

FTZ setup and annual operating costs: (\$125,000)

NET ANNUAL BENEFIT: \$500,200

FTZ activation cost (one-time): (\$85,000)

Payback period: 2.0 months

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CASE STUDY 2

Global Spirits LLC

*Duty Drawback Program — \$620,000 Recovered in Year One***Background**

Global Spirits LLC is a US importer and distributor of premium spirits. The company imports whiskey, rum, and tequila from fourteen countries, pays significant duties on all of them, and sells primarily into the US market. However, approximately eighteen percent of its imports are eventually re-exported — sold to duty-free shops at US airports, sold to cruise lines for consumption outside US waters, and sold to foreign distributors for resale in their home markets. For six years, the company had been paying full import duty on all its imports and never recovering the duty on the goods that left the country. Nobody had ever asked the question.

◆ DRAWBACK PROGRAM — YEAR ONE RECOVERY

GLOBAL SPIRITS — DRAWBACK PROGRAM ANALYSIS

Annual imports (dutiable spirits): \$28,000,000

Average duty rate (spirits): 22.5%

Annual duty paid: $\$28,000,000 \times 22.5\% = \$6,300,000$

Goods ultimately re-exported: 18% of imports

Value of re-exported goods: $\$28M \times 18\% = \$5,040,000$

Duty on re-exported goods: $\$5,040,000 \times 22.5\% = \$1,134,000$

Drawback recovery (99% of duty): $\$1,134,000 \times 99\% = \$1,122,660$

YEAR 1 RECOVERY (retroactive — 5 year lookback):

Year 1 current recovery: \$1,122,660

Retroactive recovery (4 prior years): \$4,490,640

TOTAL YEAR 1 CASH RECEIVED: \$5,613,300

(Less drawback administrator fee ~8%:) (\$449,064)

NET YEAR 1 BENEFIT: \$5,164,236

This money had always been available. It took a new

CFO asking one question — 'do we re-export any of

our imports?' — to unlock \$5.1 million in cash.

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CASE STUDY 3

Heritage Medical Devices

Prior Disclosure — Turning a \$4.2M Exposure Into a \$380,000 Settlement

Background

Heritage Medical Devices had been importing diagnostic imaging equipment from Japan for nine years. During an internal compliance review conducted in preparation for a potential sale of the company, the VP of Finance discovered that the company had been classifying the equipment under an HS code that resulted in a duty rate of zero percent, when the correct classification carried a duty rate of three point seven percent. The error had been consistent across nine years of entries. The cumulative underpaid duty was approximately one million forty thousand dollars. The company's outside counsel advised an immediate prior disclosure filing.

◆ PRIOR DISCLOSURE FINANCIAL ANALYSIS

HERITAGE MEDICAL – PRIOR DISCLOSURE vs. AUDIT SCENARIO

Cumulative underpaid duty (9 years): \$1,040,000

IF DISCOVERED BY CBP (no prior disclosure):

Underpaid duty: \$1,040,000

Interest (avg 4.5 years at 8%/yr): \$374,400

Penalty (negligence – 2x underpaid duty): \$2,080,000

Legal costs (CBP enforcement action): \$320,000

TOTAL EXPOSURE: \$3,814,400

WITH PRIOR DISCLOSURE FILING:

Underpaid duty: \$1,040,000

Interest: \$374,400

Penalty (interest only under prior disclosure): \$374,400

Legal costs (prior disclosure filing): \$45,000

TOTAL PRIOR DISCLOSURE COST: \$1,833,800

SAVING FROM PRIOR DISCLOSURE:

$\$3,814,400 - \$1,833,800 = \$1,980,600$

Additionally, prior disclosure removed this as a liability from the company's balance sheet and allowed the company sale to proceed cleanly.

Without prior disclosure, the acquirer would have discovered the issue and reduced the acquisition price by at least \$3.8M.