

# Making use of free trade agreements: Automation of trade preference management

## Table of content

- 1 Trade preference management**
- 2 Production phase: Rules of origin**
  - 2.1 Sufficient processing
  - 2.2 Tolerance rule
  - 2.3 Bill of Materials
  - 2.4 Build-down vs build-up method
  - 2.5 Frequency of the origin re-calculation
  - 2.6 Retroactive transfer pricing adjustments
  - 2.7 Duty-drawback
- 3 Production phase: Long Term Supplier's Declaration**
- 4 Distribution phase: Proof of origin**
- 5 Conclusion**

***Trade wars and current developments in various countries around the globe are making the topic of trade preference management more relevant than ever. Companies can benefit from new or existing free trade agreements by means of trade preference management procedures.***

International trade is characterised by shipments of goods between countries. In principle, the importer pays import duties on goods coming into the country. Customs duties are applied to protect the domestic market and its producers from foreign competition. The amount of import duties payable is based on the customs tariff (rate) for that product. However, customs tariffs discriminate between goods with different countries of origin. While

they are used to protect the domestic market, they also have the effect of stimulating trade between certain countries when preferential trade agreements are in place that reduce or abolish import duties. This is the reason it could benefit companies by saving costs to improve their trade preference management procedures. In order to make use of trade agreements, one or two conditions must be met. It should be established whether the specific trade agreement covers the eligible products: each agreement specifies in detail the products for which a preferential duty rate is provided. There might also be specific conditions within the agreement regarding production processes and transport routes. Finally, proof of preferential origin of the goods must be documented in order to claim preferential origin. These issues can be quite complex and time-consuming when products consist of many different components and raw materials that are sourced from various countries.

This article provides information about preferential trade agreements and gives an insight into the complexities of their application. It also shows how companies could use automated solutions to ease the administrative burden of their trade preference management.

## 1 Trade preference management

By making use of applicable free trade agreements (FTAs), a company can benefit from preferential duty rates (reduced or zero) when importing eligible products. An FTA is a bilateral or multilateral agreement, where each participating country gives preferential treatment to imports of the other's products. In addition to FTAs, there is also the Generalized System of



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Preference (GSP), which applies unilaterally. The purpose of the GSP is to give developing countries easier market access to the country (e.g. Switzerland) by granting them zero/reduced rates of import duty. The benefits of the GSP scheme are granted at the sole discretion of the destination country.

In order to be eligible for preferential duty treatment under the GSP scheme or an FTA, goods have to fulfil a set of conditions that apply to the production and the distribution stages.

### 2 Production phase: Rules of origin

To determine whether a product has preferential status, each FTA incorporates its own set of rules of origin, known as «list rules». These specify the conditions that a product must fulfil at the production stage in order to be eligible for preferential treatment.

If a company has a Global Trade Management (GTM)/FTA Calculation Tool, these list rules need to be integrated into the software either manually or they can be uploaded in electronic form. So-called «content providers» offer list rules in the appropriate digital format for this purpose.

The list rules take into account the value added by the manufacturing processes and the source of the components and materials that are used. Preferential status is usually determined by a certain threshold value to be reached by comparing the value of non-originating materials and the value of originating materials, or by means of a change in the HS-classification of the product. A change in HS-classification is an indicator of sufficient processing for preferential status. List rules can also require specific production processes for certain products, for example some food products.

The result will also depend on the methodology used to assess the Bill of Materials. Subsequently, the assessment will have to be reviewed continually to ensure that variations in the price of raw materials, finished products or transfer pricing are correctly factored into the calculation.

#### 2.1 Sufficient processing

The list rules of an FTA can be sub-divided into three categories. (As mentioned above, these rules can be obtained from content providers and loaded into a GTM system in order to calculate the preferential eligibility status of a product automatically.)

The «**Value Added Rule**» requires that the value of all the materials used in the manufacture of the finished product should not exceed [X]% of its ex-works price.

The customs value of all the non-originating materials used in the manufacturing process for the finished product is compared against its value when leaving the production site (the ex-works price). The total value of these non-originating materials cannot exceed a defined percentage. The «**Value Added Rule**» applies to specific goods, for example musical instruments. Take for example a guitar, classified in chapter 92, with an ex-works value of CHF 400.–. The list rule requires the value of all the non-originating materials used should not exceed 40 per cent of the ex-works price of the product. If the strings of the guitar are non-originating, the guitar can still have a preferential origin status if the value of the strings or the sum of all non-originating materials does not exceed CHF 160.–.

The «**Tariff Shift Rule**» (or change in HS classification rule) requires that the materials used in production should belong to any HS heading (4 digits) except that of the finished product. This means that the HS classification of the finished product should be different from the HS classification(s) of the raw materials. In this case, the change in classification is an indicator that sufficient processing has taken place. An example of the «**Tariff Shift Rule**» in practice is the list rule for specific types of potato chips classified under heading 2004 and 2005. The list rule requires manufacture from materials of any heading, except that of the product. This means materials can be used as long as they are not classified under heading 2004 and 2005. Another example is a stainless steel wire classified under heading 7223. The list rule requires manufacture from semi-finished materials under heading 7218.

The «**Manufacture from certain products Rule**» requires the use of certain non-originating materials in the manufacture of the finished product. This is typically the case for fashion articles, for example «**Manufacture from: natural fibres, man-made staple fibres, not carded or combed or otherwise processed for spinning, or chemical materials or textile pulp or paper**», such as for products classified under heading 5208 until 5212. Typically, this rule creates a difficulty for the automation of the preference determination process by the GTM, as it requires human intervention to indicate that the specific criteria have been complied with.

Another example of this rule is for meat products classified in chapter 2. The list rule requires manufacture in which all the materials of chapter 1 and 2 used are «**wholly obtained**». The FTA prescribes the conditions for the materials to be considered «**wholly obtained**». The

materials used in the manufacture of meat products should be products from live animals raised by one of the contracting parties or products obtained from hunting or fishing conducted by one of the contracting parties. Finally, it should be noted that list rules may combine one or more of these three rules for certain HS codes.

## 2.2 Tolerance rule

Tolerance rules, also known as «de minimis» rules, enable economic operators to claim preferential status for a particular product even though the list rule requirements have not been met. The tolerance rule is included in many FTAs (both EU and Swiss) and generally permits a variation of between seven and 15 per cent. The tolerance rule is commonly applied when the list rules require a change of tariff classification and not all non-originating components fulfil this requirement. Provided that the value of non-originating products not undergoing a tariff, shift is less than or equal to the percentage set by the tolerance rule, the economic operator will still be able to claim preferential status on the finished product. An example of the tolerance rule can be found in the FTA between the EU and Switzerland where the tolerance rule is 10 per cent of the ex-works price of the product. For bread, pastry, cake and biscuit products classified under heading 1905, the list rule requires manufacture from materials from of any heading except chapter 11. Applying the tolerance rule, materials from chapter 11 can be used in the manufacture provided that their value does not exceed CHF 1.–, for example, if the ex-works price of the product is CHF 10.–. The de minimis rule should not be confused with the list of operations that are always considered to consist of insufficient working or processing to confer the status of originating product.

## 2.3 Bill of Materials

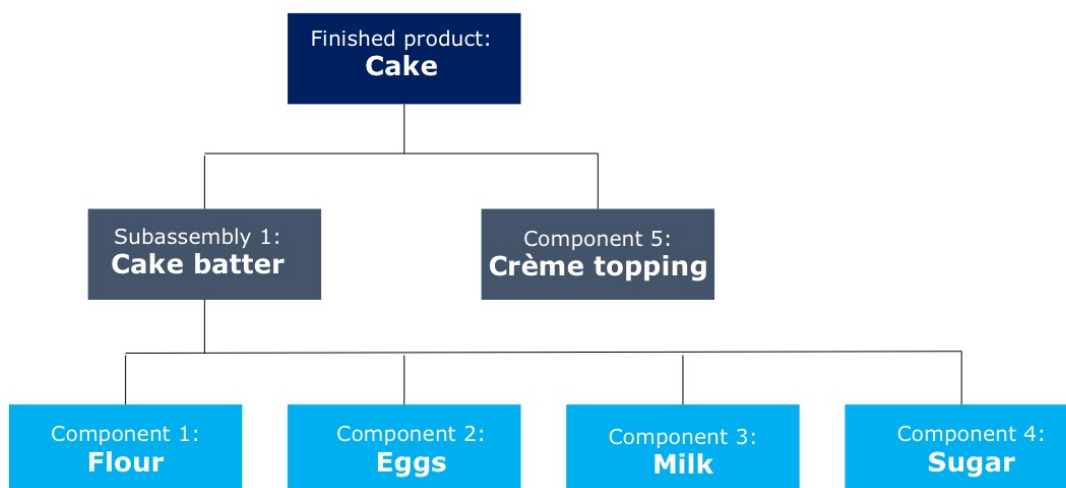
The Bill of Materials (BoM) plays a key role in determining the eligibility of a product for trade preference. It contains details of the raw materials, components, sub-assemblies, and their value and quantities used in the manufacture of a product. It may also contain information as to whether components have been manufactured internally or procured externally and for which a Long Term Supplier's Declaration (LTSD) is required. In order to determine the origin determination of a product, each of the components used in the BoM has to be classified with its correct HS code. The HS code is the critical link between the components and the list rules for

a particular FTA in the GTM system. In case the relevant master data is not available, it is recommended from a risk perspective to set-up your system so that it always considers these components to be non-originating. Depending on the complexity of the manufacturing process, a BoM can have a hierarchical structure with multiple levels, and the GTM system will apply the list rules from the FTA to each of them. The determination of trade preference occurs during the so-called «BoM explosion» where all the elements relevant to the calculation are isolated, for example procurement types and costs. If the BoM contains multiple levels, the calculation occurs at each level. Different methods of calculation may be applied (build-down or build-up) in accordance with the provisions of the FTA.

## 2.4 Build-down vs build-up method

There are two methods of calculation to determine the preference eligibility of a finished product. The «build-down» method is most often used when the list rules require a tariff shift. With this method, the system looks only at the HS codes of the lowest level components in the BoM hierarchical structure and compares these to the finished product HS code.

The second method is the «build-up» method or «absorption principle». This is usually applied when value-based list rules have to be complied with to reach preferential status. The difference to the build-down method is that the build-up does not ignore the different levels of the BoM (intermediary materials) but includes them in the final calculation of product preference eligibility. As its name indicates, the absorption principles increases the value of originating percentage as the entire value of the intermediary product could be considered as originating (even though it is made of non-originating lower level components), provided that the requirements of the list rules are met at the level of this sub-assembly. In other words, this method absorbs the non-originating value into originating value. For example, to determine the preferential eligibility of a cake according to the absorption principle, the status of the sub-assembly is determined first. The sub-assembly, the cake batter in this case, is made up of the following components: flour, eggs, milk and sugar. After the preferential status of the sub-assembly is determined, the status of the finished product can be determined based on the preferential status and tariff code of the subassembly (cake batter) and the crème topping, since the cake batter and crème topping together form the finished product.



Based on the method of calculation used, the conclusion about trade preference eligibility can be completely different. It is not uncommon for the preference eligibility of a product to differ according to the method used. The method to be used will depend on the provisions of the particular FTA. Most FTAs leave the choice to the economic operators in order not to disadvantage those who manufacture the intermediary products in-house, against those who procure them externally. In Switzerland, there remains a difficulty in proving the market value of the intermediary products. Often the sub-assemblies do not have a market value, but are simply stages in the overall manufacturing process. As such, it is difficult to prove to the Swiss customs authorities that the value of the intermediary product is not artificially inflated in order to increase the originating value when the absorption principle is used.

### 2.5 Frequency of the origin re-calculation

From an IT system perspective, running the calculation to determine whether the goods qualify for preferential treatment can be resource-intensive depending on the complexity of the Bill of Materials and the extent of the product catalogue. Depending on the volatility of the pricing and sourcing (e.g. changes of country of origin of the raw materials), the frequency of re-calculating eligibility for trade preference should be considered carefully by IT and the team responsible for customs and trade compliance matters.

### 2.6 Retroactive transfer pricing adjustments

Year-end or regular transfer pricing adjustments could potentially impact the preferential status of goods in some jurisdictions and under certain circumstances. Specifically, in cases where the preferential calculation is based on the «Value Added Rule» and the required threshold is barely reached, an adjustment of transfer prices might lead to the loss of the preferential status of an article. The same risk applies to retroactive transfer pricing adjustments. A retroactive reduction of the customs value could mean that a product that has already been exported with preferential status no longer reaches the minimal value threshold. To mitigate this risk, it is recommended to add a buffer of five to ten per cent to the calculation, so transfer pricing adjustments within that range do not impact the preferential status.

### 2.7 Duty-drawback

Duty drawback relates to the customs regimes, typically Inward Processing Relief (IPR), that enable an economic operator to avoid/suspend/recover payment of customs duties on raw materials that will be processed into a finished product and then re-exported. In order to avoid obtaining benefits from preferential status at the country of destination for raw materials originating from countries outside the FTA and for which import duties have not been paid in the country of production, most FTAs explicitly preclude the use of duty drawback regimes. However the EU GSP does not forbid the use of

drawback. Therefore, depending on the FTA used, a duty drawback may or may not be considered.

### 3 Production phase: Long Term Supplier's Declaration

The determination of the preferential origin is one part of the process. To claim that products have met the rules of origin and so achieve preferential origin status, a company needs to be able to document, to the satisfaction of the authorities, that the components used in the production process have the origin that is claimed for them. This proof is usually documented through a so-called «Long Term Supplier's Declaration» (LTSD): this is a document sent out to the supplier with a request for certification that the components sourced – over a certain time period – are indeed of preferential origin in accordance with the list rules of a specific FTA. LTSDs are particularly useful where the procurement process is relatively stable and the same component is sourced from the same supplier over time. LTSDs can also be requested on a transactional basis if it is a one-off purchase from a particular supplier.

This document has to be requested periodically (usually every 1–2 years) and filed in the event of an origin audit. During the validity period of the LTSD, it is the responsibility of the supplier to inform its customer of any changes to its initial statement.

Requesting and following-up on LTSDs from the various suppliers involved can be a time-consuming task, but it is a critical requirement as missing documentation will affect the calculation of preferential origin negatively.

In this respect, a GTM system can help simplify the task as it can request an LTSD from the suppliers via e-mail, based on the Purchase Order. The recipient is then able to complete the form by indicating for each product reference whether or not it has the preferential origin. The information is provided from the supplier in an email reply and can then be processed and stored by the system. Note that certain countries such as Switzerland do not recognise the validity of electronic LTSDs, and still require that in addition to the electronic version, the supplier should print out the form and return it signed.

Using a GTM system to automate the LTSD request process also makes it easy to track the answers and follow-up on the requests, as well as to centralise the preparation of a list of suppliers to whom the request should be sent. In general, LTSD requests should only be sent for components that are critical to the determination of preferential status. Other non-critical components can

be flagged as non-originating in order to alleviate both the burden on the supplier and also the maintenance and follow-up of the LTSD status.

On the outbound side, LTSDs can be provided to customers in a similar manner based on the Sales Order.

### 4 Distribution phase: Proof of origin

On the distribution side, the required proof that goods are eligible for preferential treatment in a specific trade agreement is the certificate or statement of origin. Depending on the terms of the FTA, it may be possible for companies to self-issue the required proof to their customers enabling the shipment to clear customs in the destination country at a reduced or zero rate of duty.

This proof of origin (also called origin statement) is usually a pre-defined text in the FTA and is inserted in a commercial document that sufficiently identifies the goods, e.g. pro-forma or final invoice, bill of lading, delivery note and accompanies the goods to their final destination. Most EU/CH/EFTA agreements will only allow the exporter to self-certify the preferential origin of the single shipment up to a certain maximum value. Above this threshold, the exporter will be required to obtain the status of «Authorized Exporter» with national customs authorities. This authorisation is granted pursuant to an audit by the authorities that focuses on whether the company has strong internal processes to indicate accurately the preferential status of goods when they are exported. In this respect, a GTM system for trade preference plays a key role.

Since 1 January 2017, the EU has rolled out the Registered Exporter (REX) system in the framework of its Generalised System of Preference (GSP). Economic operators located in GSP-countries (but also in Switzerland, for example in cases of re-dispatch to the EU of a GSP shipment) will have to be registered in the REX database in order to self-certify the origin of their products through a statement of origin.

The proof of origin can also be delivered through an Origin Certificate (e.g. EUR.1, EUR-MED). For some FTAs (such as CH-GCC), it is the only accepted proof of origin. The Origin Certificate is an official document (with unique sequential numbering) which must be stamped by the customs authorities or commercial register of the exporting country in order to be valid. The relevant authority often requests a break-down (list of components with HS code, value and origin) before affixing their official stamp.

Exporters are allowed to pre-complete the document indicating all the required information (goods descrip-

tion, weight, invoice number. etc.). In Switzerland, it is also required to show the Origin Certificate number in E-DEC Export. Hence, a GTM system that is used for e-filing but also has been pre-configured to print a correct list of relevant goods contained in the Export List on the Certificate of Origin in the format required could help to save time in complying with all export-related formal origin requirements.

Proof of origin can only be used in the country of destination if the so-called «direct transport» provision has been complied with. This rule is inserted in most FTAs to avoid the risk that goods are being modified in a third country during their transportation (other than operations required to maintain them in good condition for transportation) and ensure that the same goods arrive at their destination. As many European-based companies have hubs located abroad where shipments are consolidated, the European Union has tended to move away from the restrictive direct transport rule in its most recent FTAs and towards the more flexible «non-alteration» principle. This allows for operations to take place in third countries beyond those needed to maintain the merchandise in good

condition for transportation, for example splitting consignments, and affixing marks, labels and seals. If routes have been pre-configured in an GTM system for logistics purposes, it might be necessary to review them in order to ensure that the benefits of the FTA are not lost due to the choice of wrong transportation route.

## 5 Conclusion

As highlighted above, all the steps from production to distribution pose numerous challenges requiring extensive administrative effort to ensure that the entire process of origin determination and certification is performed correctly. A reliable audit trail will also need all supportive documentation in the case of an origin audit by the tax authorities.

Many companies are failing (intentionally or not) to take advantage of FTAs, as they lack the appropriate knowledge and tools. In this respect, the implementation of a GTM solution that supports trade preference management procedures can help companies by automating the process and allowing them to review, track and manage the status of their inbound and outbound shipments.



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