KPMG

First sale for export retail industry benchmarking

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Contents

1. First sale for export and the retail industry

Retail companies worldwide are realizing the economic pressures caused by a decrease in consumer spending, increase in costs of production, and a rise in global competition. Many companies are actively managing this business risk through participation in customs duty savings programs when importing products into the United States.

The First Sale for Export (First Sale) principle is a U.S. customs program that continues to generate millions of dollars in duty savings annually for retailers. Typically, customs duties are assessed on merchandise imported into the United States and appraised according to the commercial value of the sale by the foreign supplier to the U.S. importer, which may also be the U.S. retailer. First Sale, however, allows importers to pay duty on the lower appraised First Sale price paid by the foreign supplier (buyer) to the foreign manufacturer (seller) when there is a multitiered transaction, provided certain requirements are satisfied. Generally, these requirements include:

1. **Bona fide sale** – Circumstances and documentation demonstrate that a "sale" (the transfer of ownership in property for consideration) has occurred from the seller to the buyer in the First Sale transaction.
2. **Clearly destined for export to the United States** – The goods must be clearly destined for exportation to the United States at the time the merchandise is sold by the seller to the buyer.
3. **Arm's-length price** – The manufacturer's or seller's price to a related supplier must be at arm's length from a customs perspective (sales between unrelated parties are presumed to be arm's length).
4. **Full documentation and record keeping** – A full documentation trail that supports the above requirements and clearly establishes the role and purpose of each party in the transaction.

While the program has been available to retailers for decades,[1] it has gained prominence among retailers in recent years and is a common aspect of most retail businesses. This increase is attributable to the need for marketplace competitiveness and the desire to reduce landed costs where possible.

It is important to note, however, that several years ago U.S. Customs and Border Protection (CBP) challenged the use of the First Sale principle by trying to reinterpret the meaning of "sold for exportation to the United States" under a multitiered transaction. If CBP's proposed interpretation had been adopted, First Sale would no longer have been a viable savings opportunity. After much feedback from the importing community, CBP dropped the challenge in 2010, paving the way for more companies to implement a First Sale program.[2] Likewise, in 2014, CBP drafted a revised internal compliance publication that appeared to include additional requirements to substantiate the use of First Sale. Ultimately, the draft never became final.

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[1] The First Sale principle was articulated by the U.S. Court of Appeals for the Federal Circuit in Nissho Iwai American Corp. v. U.S., 982 F.2d 505 (Fed. Cir. 1992).

[2] On January 24, 2008, CBP published in the Federal Register (73 FR 4254) a notice that CBP was proposing a new interpretation of the expression "sold for exportation to the United States" for purposes of applying the transaction value method of valuation to merchandise in a multitiered transaction. On September 29, 2010, CBP withdrew that notice. If CBP's proposal had been adopted, it would have eliminated an importer's ability to use the price from a foreign manufacturer to a middleman (i.e., First Sale price) to value its merchandise.

As a result, many retailers have been able to take advantage of First Sale appraisement since that time, which has led to immediate and significant duty and fee savings on imports.

The objective of this survey is to document the various approaches commonly employed by U.S. retailers when participating in the First Sale program and share perspectives on the costs, benefits, and challenges of using First Sale appraisement.

KPMG LLP (KPMG) conducted this survey in 2018 with more than 29 participants in leading retail companies in the United States who are presently using the First Sale program when importing products into the United States. The survey also includes retailers who are not utilizing First Sale at this time.[3]

As part of this study, KPMG examined risk areas and other issues retailers may encounter when considering and implementing the savings opportunity.

Although this survey focused on the retail industry, the information compiled may be applicable to many other industries as well.

[3] Survey data was sourced by KPMG from the companies participating in the survey and any additional sources have been cited. Individual survey responses are confidential and results only appear in the aggregate.

2. Pre-implementation considerations – Where to begin?

When considering whether to implement First Sale, it is important to recognize that every situation is unique, and as a result, a decision needs to be based on the specific facts and circumstances. To determine the overall benefit, many of the retailers we spoke to conduct a number of feasibility steps prior to implementation.

First Sale feasibility steps may include an analysis of the following:

— Import volume and value

— Duty spend by supplier

— Potential duty savings

— Priority suppliers for implementation

— Future sourcing volumes with select suppliers

— High-level questionnaires from select suppliers to gather initial information

— Current import and sourcing operations of select suppliers

— Possible obstacles to implementation (in the United States and foreign jurisdictions)

— Internal and external costs to implement

— A cost/benefit analysis for select suppliers.

A primary consideration for most retailers when determining which suppliers to approach for First Sale implementation is the current duty spend and potential savings. Based on discussions with our clients, the savings threshold also depends on the size of the retailer, the total number of suppliers used by the company, and the relative impact of these savings to the bottom line.

In addition to considering the current duty spend and potential savings, survey participants also considered several facts as equally important when conducting their benefit assessment. These included:

— Long-term supplier relationship

— Supplier's compliance with other requirements

— Difficulty of implementation

— Future sourcing volumes

— Supplier's sourcing structure and number of factories that manufacture goods for the retailer.

The sourcing structure is an important consideration during the benefit assessment. Often companies believe that if there are more than three tiers in the supply chain or multiple parties involved in the transaction, the transaction may not qualify for First Sale. This is not the case, although it is an important consideration. However, there are many supply structures that can use First Sale. For example, the fact that a supplier uses an agent or a raw material supplier should not sway a company's willingness to participate in First Sale. The First Sale principle is compatible with a wide array of transactional structures between the manufacturer and supplier, including three-tier, four-tier, finished goods, contract manufacturing, related-party, and principle structures.

3. Implementation

After deciding to move forward with a supplier, the importer generally begins an implementation phase involving a more detailed analysis to help satisfy the First Sale requirements. Since the First Sale principle is compatible with a wide range of transactional structures, the analysis required during implementation can be complex.

Supplier due diligence can include, but is not limited to, the following:

- Understanding the transactional structure (i.e., buyer/seller versus agent structures)
- Conducting supplier meetings
- Addressing confidentiality and other supplier concerns up front
- Reviewing transactional documentation
- Conducting an arm's-length analysis for related parties
- Using implementation tools (e.g., checklists and questionnaires) for a streamlined approach.

When implementing First Sale, retailers should conduct an analysis of each supplier/factory structure to consider certain variables, such as:

- Available documentation
- Incoterms
- Supply or sales contracts
- Contingency of diversion
- Relationship of the supplier to its factories.

Notably, the savings opportunity is typically not a supplier's top priority. More commonly, importers will find that suppliers are focused on ensuring that their production and supply chain continue to operate smoothly. As a result, common challenges during First Sale implementation include lack of timely responses, incomplete information, and language barriers. To help avoid some of these potential challenges, it is essential that suppliers understand that implementing First Sale will not typically change their current supply chain structure and, in fact, can strengthen their relationship with the retailer.

Supplier confidentiality

A common challenge with implementing First Sale is the suppliers' concern with confidentiality, specifically surrounding its pricing in the First Sale. As an example, one such challenge for many importers during implementation is conducting an arm's-length analysis for related supplier/factory scenarios. Many suppliers do not want to disclose prices, costs, and profits to their customers and fear that by disclosing their cost structure, the retailer's sourcing teams may try to decrease the price or negotiate directly with the factory. Although receiving financial information from the suppliers and factories to satisfy CBP's arm's-length requirement can be challenging, it is often obtained through negotiation and discussions.

There are a variety of ways in which retailers can seek to help ensure confidentiality during implementation. The most widely used method is offering a nondisclosure agreement between the importer and suppliers who participate in their First Sale program.

Although only 10 percent of survey participants reported using the reconciliation prototype program for claiming First Sale appraisement, it is a leading practice to help ensure confidentiality.

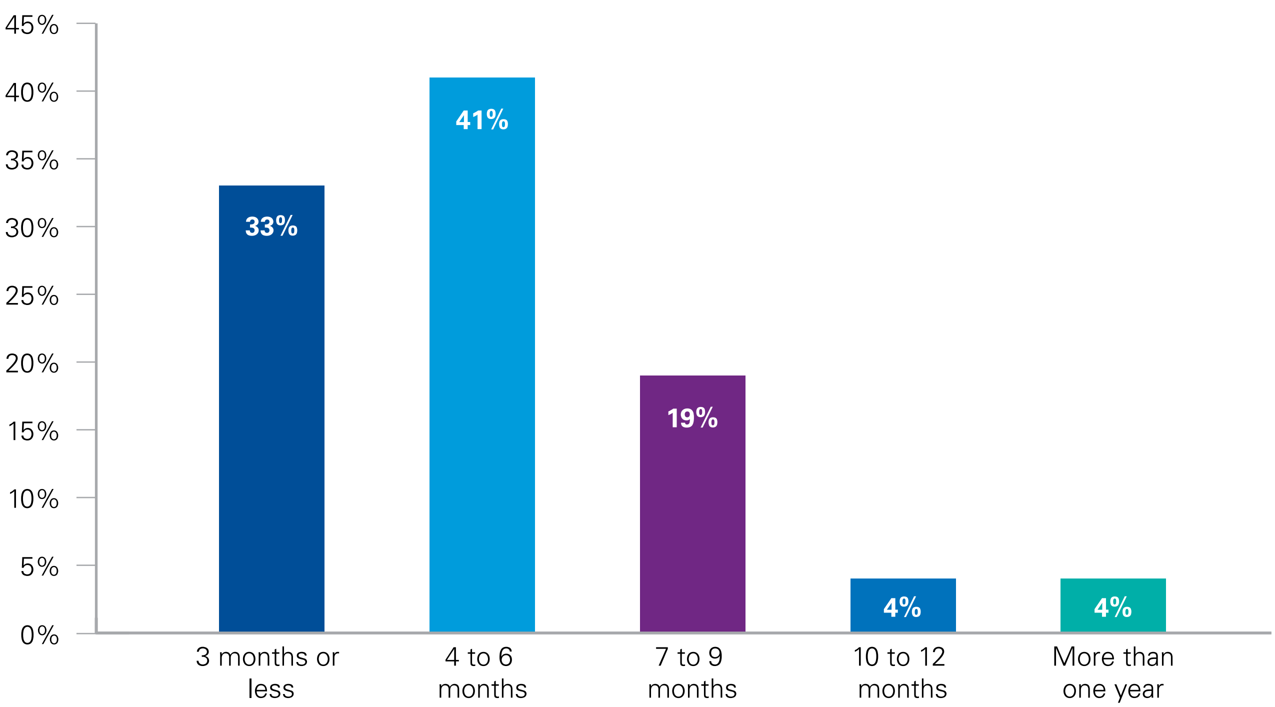
The reconciliation program allows an importer to claim the higher price paid by the importer/retailer upon entry and then to subsequently reconcile to the lower First Sale price at a later time and receive a refund of overpaid duties. This method allows First Sale documentation to be sent only to select trade personnel within the company and provides suppliers with additional time to provide accurate First Sale documentation.

Timing – How long does it take?

As stated previously, every supplier/factory implementation is unique, and as a result, implementation time lines can vary. The time line for implementation often depends on the transaction structure and the complexity of the issues involved.

As illustrated below, more than 68 percent of survey participants stated that they experienced an average implementation time of four months or more, while 27 percent reported the average implementation time taking more than six months.

What was the average time line to implement each supplier transactional structure?



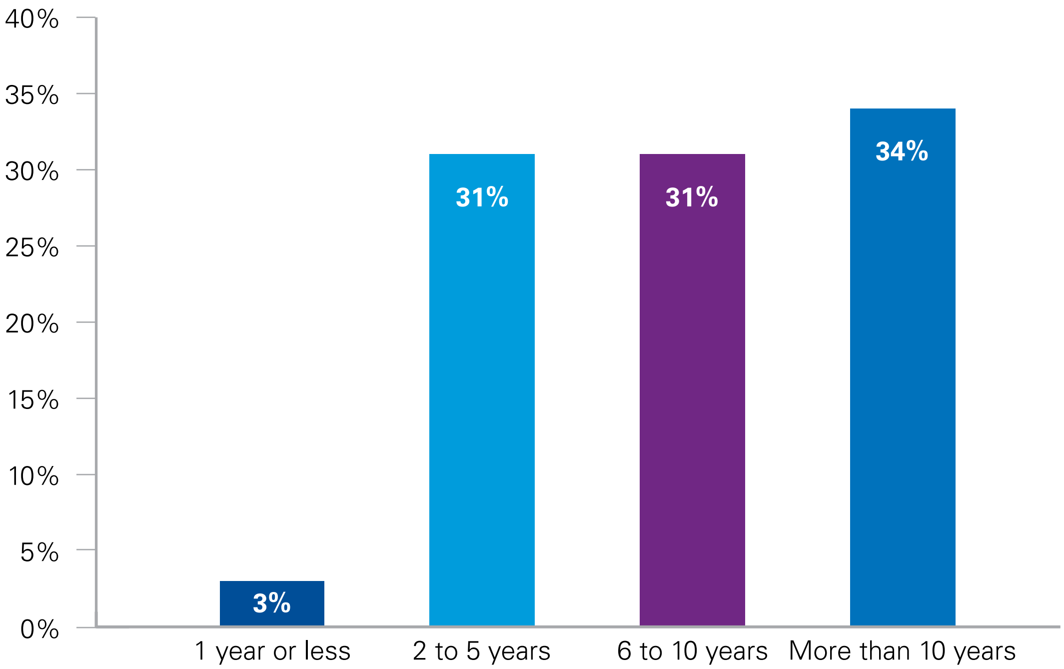
N=27

Source: KPMG LLP First Sale for export study, April 2018

4. First Sale program trends

In recent years, more retailers have been using First Sale appraisement than ever before. This trend was clear from our benchmarking study where 62 percent of all survey participants reported utilizing First Sale appraisement in the past 2 to 10 years, and 34 percent of the survey participants reported using First Sale appraisement for even longer.

Duration of First Sale program



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Source: KPMG LLP First Sale for export study, April 2018

Despite the First Sale appraisement method existing for more than 20 years, a recent spike in popularity resulted from:

— An increasingly competitive environment

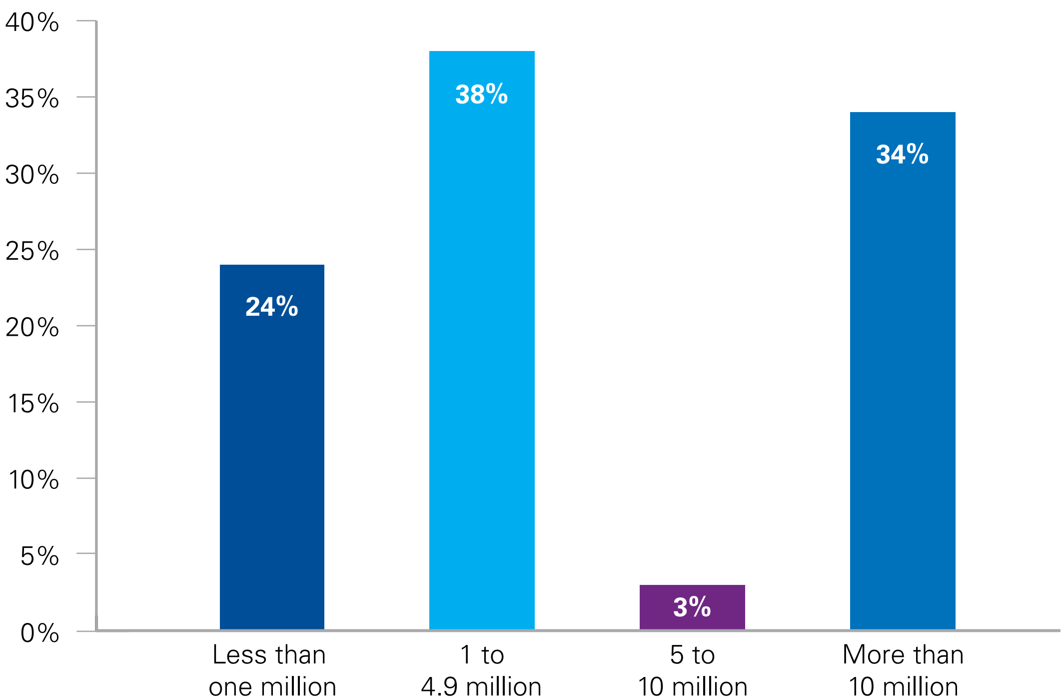
— A fiscal responsibility to reduce costs

— Increased expectations by upper management on the trade teams to develop strategic initiatives and procure additional savings.

Savings

All survey participants reported that their First Sale program represented significant savings for their companies and was highly thought of within their organizations. However, as the chart below demonstrates, the amount of annual savings[4] among study participants varied considerably, likely due to the number of First Sale implementations and size of the company.

Approximate yearly savings



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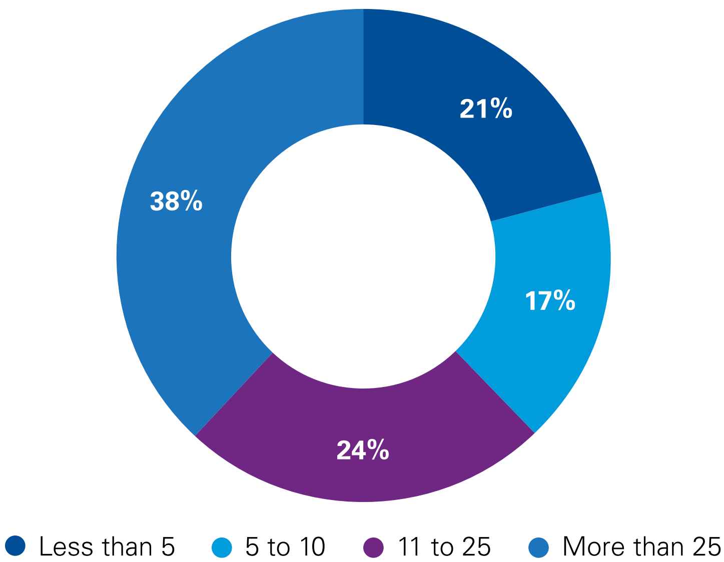
Source: KPMG LLP First Sale for export study, April 2018

[4] The figures reported may include the cost of implementing and managing First Sale appraisement, which may negatively impact the reported savings figures.

Number of vendors participating



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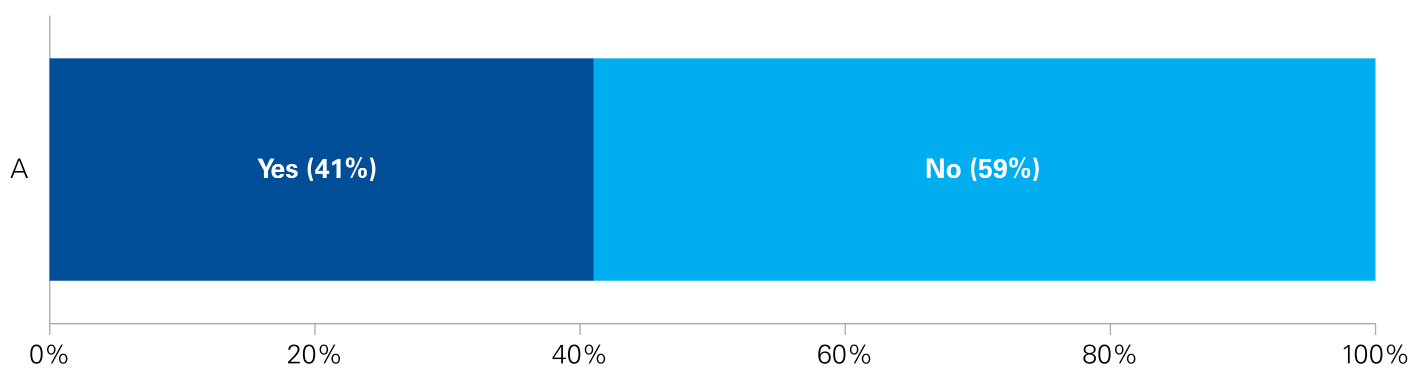
Source: KPMG LLP First Sale for export study, April 2018

Furthermore, approximately 79 percent of the participants surveyed have implemented five or more vendors into their First Sale program. The remaining 21 percent of the participants reported implementing fewer vendors into their First Sale program, probably because those companies only recently started using First Sale appraisement.

In addition, the study participants note that many companies are initially hesitant to implement First Sale because they do not want additional scrutiny from CBP. However, the chart below demonstrates that a majority of the participants have not been audited by CBP regarding their First Sale program.

Has your First Sale process ever been audited by CBP?



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Source: KPMG LLP First Sale for Export Study, April 2018

It is important to note that on July 9, 2014 CBP released a proposed updated draft of the Informed Compliance Publication (ICP) concerning *sales for exportation to the United States*, which includes First Sale valuation. According to the CBP's comments, the proposed revisions were intended merely to rectify the "lack of clarity and consistency" in customs audits to substantiate First Sale claims and do "not reflect a change in policy by CBP." Most importantly, the proposed revisions were withdrawn without any changes to the ICP.

5. Post-implementation testing

Since CBP has the authority to detain, seize, and reject merchandise; issue monetary penalties, and even deny certain importations for noncompliance with customs laws and regulations, it is critical for retailers to monitor their supplier transactions on an ongoing basis where First Sale appraisement is used. One method to foster ongoing compliance with customs laws and regulations is to conduct postentry testing or risk monitoring on First Sale transactions to continuously validate that they satisfy CBP's First Sale requirements.

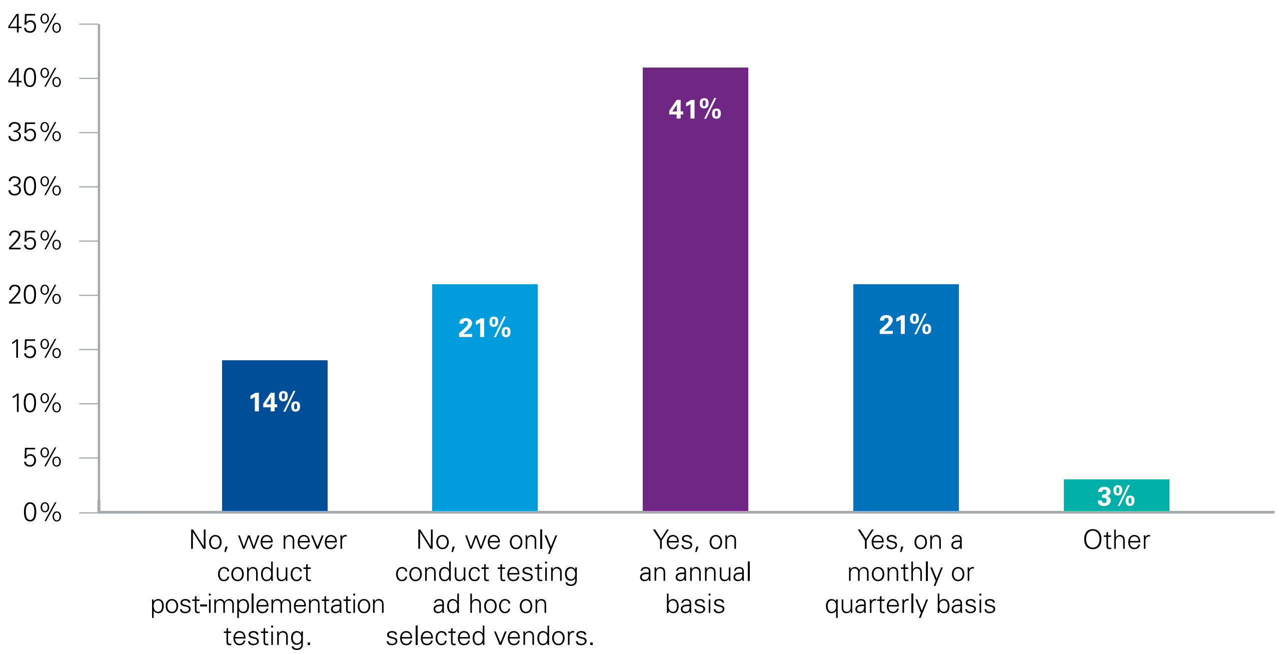
KPMG found that most of the retailers participating in the survey currently conduct or plan to conduct post-implementation testing in the near future.

In the past, retailers have reported that common challenges associated with testing and monitoring First Sale include the timely receipt of information, the manual process of document collection and tracking, ensuring that suppliers maintain internal controls, and the lack of consistency in First Sale documentation. Retailers can mitigate these obstacles with the allocation of dedicated internal resources and the assistance of experienced trade professionals.

Specifically, survey participants reported that, on average, their company allocates an average of two to three full-time employees to First Sale compliance monitoring.

As illustrated below, a majority of study participants test their First Sale transactions on an annual basis.

Frequency of post-implementation testing



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Source: KPMG LLP First Sale for export study, April 2018

6. Conclusion

As retailers experience increasing global competition, it is critical to realize the importance of duty-savings opportunities, such as First Sale appraisement. Given the competitive global economy and the pressure to manage the landed cost for imported products, it is no wonder that retailers are actively reshaping their organizational structures, reassessing their business, and developing tools and processes to facilitate First Sale, as well as other duty-savings opportunities.

Benchmarking retailers going through the First Sale implementation process allows retailers, even those who have already successfully implemented First Sale programs, to learn about leading practices, common struggles, and automated solutions. Benchmarking also allows trade professionals to develop tools and knowledge to bridge the efficiency gaps in current processes.

Through the benchmarking study, KPMG found that a majority of retailers are forging leading practices in this area by conducting the requisite due diligence during the implementation process as well as ongoing post-implementation testing. In addition, the supplier benchmarking demonstrates that overseas suppliers are receiving benefits from First Sale appraisement in the form of stronger business partnerships and often increased orders.

About KPMG's Trade & Customs Services practice

KPMG LLP's Trade & Customs Services professionals can assist your company in reducing costs, improving efficiency, and mitigating risk issues related to engaging in cross-border business. We have the knowledge and experience to help implement the processes and approaches that may boost your competitive advantage in the marketplace.

The members of our practice work closely with trade and customs professionals from more than 60 countries in our network of KPMG International member firms around the world to provide global, forward-thinking trade and customs insights and advice. In the United States, our professionals include former CBP import specialists and field auditors; former Bureau of Industry and Security personnel; customs brokers and certified customs specialists; professionals with advanced degrees in business, economics, and law; and experienced technology, transportation, and logistics specialists.

Contact us

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