THE ABCs OF HST:

Understanding the Harmonized System of Tariffs



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Introduction

An audit by the Canadian government found that as many as one-third of shipments arriving at its border on any given day are misclassified, meaning they have been assigned an improper tariff code. For the Canadian government, this has significant implications, namely, the possibility that improper classifications will result in shippers paying incorrect amounts of duties. A sampling of just three percent of shipments found almost CAD $60 million in underreported duty obligations.

While the Canadian government, all governments in fact, worries about misclassifications generating too little revenue, businesses need to be concerned that misclassified shipments result in too much duty being paid. A 2014 survey by the International Chamber of Commerce of global managers representing 19 different industrial sectors revealed that "classification uncertainty" was the top "barrier to business" for 12 of the sectors, followed by delays and unnecessary inspections.

TOP FIVE BARRIERS TO BUSINESS OTHER THAN DUTY AND VAT

Industries Listing "Classification Uncertainty" among Top Barriers	Industries Listing "Customs Delays" among Top Barriers	Industries Listing "Unnecessary Physical Examinations or Inspections" among Top Barriers
Apparel	Apparel	Agribusiness
Automotive	Electronics	Consumer Hard Goods
Beverages	Energy, Utilities, including Mining	Energy, Utilities, including Mining
Consumer Products	Engineering and Construction	Retail Distribution
Electronics	Forest, Paper, and Packaging	
Energy, Utilities, including Mining	Industrial Machinery	
Engineering and Construction	Metals	
Industrial Machinery	Retail Distribution	
Metals		
Retail Distribution		
Consultants		

Source: International Chamber of Commerce

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What exactly is tariff misclassification, and how can a business take steps to guard against its shipments being miscoded?

Every government has in place a classification system for monitoring the flow of goods crossing its borders. For the vast majority of the world, classification systems are rooted in the Harmonized Commodity and Coding System (Harmonized System, or HS) developed and maintained by the Brussels-based World Customs Organization (WCO).

Through the Harmonized System, goods are assigned a six-digit classification code, selected from a library of more than 200,000 different commodity listings. In addition to the six-digit Harmonized Codes, countries are able to add subsequent digits as a way to personalize the system for their own customs purposes. In the United States, for example, imports are assigned a 10-digit code from the Harmonized Tariff Schedule of the United States (HTS), administered by the International Trade Commission. Products destined for sale in Canada must also be assigned a 10-digit classification code as determined by Canada Border Services Agency's Customs Tariff.

With thousands of classification codes from which to choose, there is a tremendous margin for error. And while misclassifications are not uncommon, they can be costly. For example, Chapter 57 of the tariff schedule includes codes for "Carpets and other Textile Floor Coverings." Within that chapter, subsection 5701.90.10 covers carpets and textile floor coverings "with pile inserted and knotted during weaving or knitting," while 5701.90.20 includes products that were "handhooked, that is, in which the tufts were inserted and knotted by hand or by means of a hand tool."

Sounds like a slight product variation, but mistakes can be costly! For one thing, different codes trigger different tariff liabilities. And eligibility for free trade agreement benefits, which generally outline preferential duty treatment for designated categories of goods, is determined by tariff classification. A product that is miscoded will be denied benefits to which it is legally entitled.

Determining a product's correct tariff classification is a critically important part of the customs process and can also be one of the most confusing. In fact, the U.S. Customs Border Protection agency forewarns businesses: *"Be aware that the HTS*

"Be aware that the HTS can be very complicated. If you self-classify an item and the classification is incorrect, the mistake can be costly. Therefore, it is advised that you speak directly with an Import Specialist if duty rate information is crucial to your decision to import something."

Source: Customs and Border Protection website

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can be very complicated. If you self-classify an item and the classification is incorrect, the mistake can be costly. Therefore, it is advised that you speak directly with an Import Specialist if duty rate information is crucial to your decision to import something."

Most businesses enlist the services of a customs broker or logistics provider to ensure that all import and export codes are accurate. But within the universe of logistics providers there are varying degrees of customs expertise. With so much at stake, a business must take the time to confirm that its logistics partner is up to the task of ensuring shipments are properly classified and taking full advantage of all possible duty relief opportunities.

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Understanding the Harmonized System

Imagine a world in which there were no traffic laws: where everyone pretty much did what he or she wanted, and of course, your vehicle would always have the right of way. It'd be chaotic. Now imagine the same sort of scenario in the world of global trade: where each country had its own standards and rules and there was no compatibility among nations. Chaos, right?

Fortunately, the world's nations recognized the need for uniformity in global trading practices and commissioned the World Customs Organization (WCO) to establish the rules and police enforcement. Located in Brussels, Belgium, the WCO is the self-defined "only international organization with competence in Customs matters and can rightly call itself the voice of the international Customs community."

Central to the WCO's work is its development, implementation, and upkeep of a uniform system of codes to identify international trade shipments. The system, known as the Harmonized System (HS), includes unique six-digit codes for roughly 200,000 different commodities. The system is used by roughly 98 percent of the world's trade merchandise.

Because of HS, a product originating in one country will carry the same identifying code as the same product manufactured in a different country. Without HS, worldwide commerce would be a mishmash of disconnected codes and identifiers.

According to the WCO, the Harmonized System provides a "logical" structure within which more than 1,200 headings are grouped in 96 chapters. The 96 chapters are arranged in 21 sections. Each of the 1,200 headings is identified by a four-digit code, the first two digits of which indicate the chapter wherein the heading appears, while the latter two digits indicate the position of the heading in the chapter.

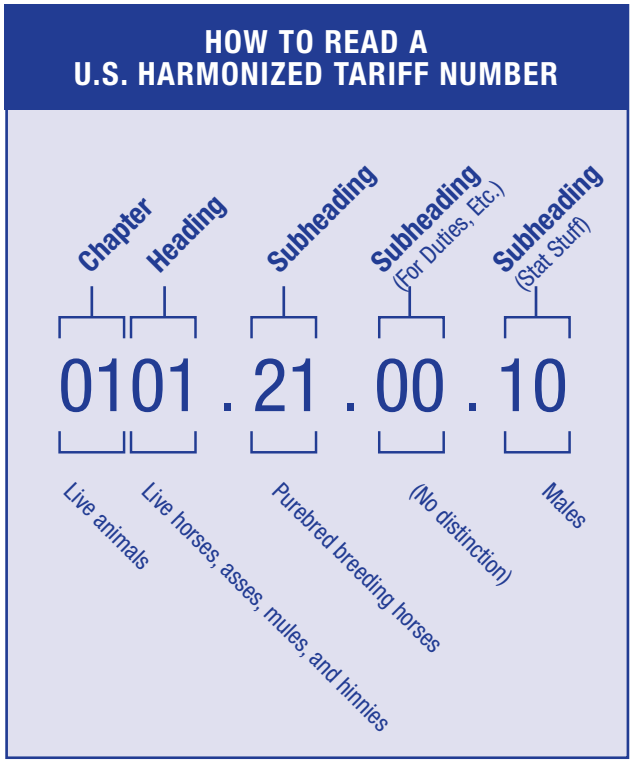
For example, heading 10.01 (wheat and meslin) is the first heading of chapter 10, which is dedicated to "cereals."

Most headings are then subdivided into subheadings, which offer further delineation between products:

- HS code 0205.00 means the fifth heading of chapter 2, which has not been subdivided.
- HS code 0103.10 means the third heading of chapter 1, first subheading, which has not been further subdivided.
- HS code 0303.11 means the third heading of chapter 3, which has been subdivided and then further subdivided.

The harmonized codes are updated every five years, most recently in 2012 when 220 changes were implemented. Because the Harmonized System truly is the law of the land, every country must adjust its own import and export practices to ensure that they are in sync with HS revisions.

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Source: Customs Info, 2012

The WCO allows countries to add additional qualifying codes as a way to capture data about the flow of goods crossing their borders. In the United States, for example, import codes, known as the Harmonized Tariff Schedule of the United States (HTS), are administered by the International Trade Commission. A U.S. import code is 10 digits long—the first six digits, the "root" of the code, are based on the worldwide Harmonized System, while the following four digits are unique to the United States.

"The HTS is designed so that each article falls into only one category," the ITC explains in a web-based tutorial. "It is divided into chapters, each of which has a two-digit number. Each product category within the various chapters is designated by 4, 6, 8, or 10 digits. The 4-digit categories are called 'headings,' and the 6-,8-, and 10-digit classifications are called 'subheadings.'"

A similar system is in place in Canada, which is the United States' largest trading partner. Canada's import coding system is known as the Canadian Customs Tariff. Similar to the system in place in the U.S., Canada requires that exports supplement the 6-digit harmonized code with a 4-digit Canadian code.

Exports are also subject to proper coding. U.S. export codes, known as "Schedule B," are administered by the U.S. Census Bureau. Schedule B export codes are also based on the worldwide Harmonized System.

Source: Customs Info 2012

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Important to note is while the International Trade Commission and the U.S. Census Bureau are instrumental in developing U.S. import and export codes, application and enforcement of the codes is the sole purview of the U.S. Customs and Border Protection (CBP) agency.

Purposes of Classification Codes

The Harmonized Tariff Schedule classifies more than 10,000 separate groups of goods based on their material composition, product name, and/or intended function. In doing so, it provides uniformity among nations for goods traveling across international boundaries. But the coding schedule has other another purpose as well:

Tariff Rates

Every tariff code has a corresponding rate of duty. Once a tariff code has been assigned to a particular shipment, a shipper will know the duty cost for importing that particular product into a particular country. However, a business must also be aware that the HTS includes "Notes" and "Rules," which describe special conditions that must be met to obtain a particular tariff treatment. Those special conditions could include free trade agreements, content "origination" requirements, or country-specific duty rates.

The example below, provided by the International Trade Commission, illustrates both the HS classification code and duty rate for "cotton sewing thread put up for retail sale."



PRODUCT

5202.20.00

CLASSIFICATION

4.4%

DUTY RATE

Source: International Trade Commission

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High Incidence of Classification Errors

Trade Data

Government agencies use HS data to track the flow of goods into and out of their country. Based on this information, a country will determine import/export volume. HS data is also used to monitor global trade activity.

Free Trade Agreements

Information about Free Trade Agreement tariff handling can be found in the "General Notes" section of the HTS. There are currently 32 General Notes, many of which deal specifically with specific free trade agreement provisions. General Note 12, for example, contains information about the North American Free Trade Agreement (NAFTA). NAFTA eliminates duties on all domestically produced products traveling between the U.S., Canada, and Mexico, but it contains very specific guidelines for what is considered "domestically produced." A shipper should be forewarned though that understanding the HST's "special requirements" can be confusing. The Chapter 12 guidance on NAFTA, for example, runs 648 pages.

Source: International Trade Commission

HTS General Notes provide rules and specific details for proper application of the HST.

TABLE OF CONTENTS | General Notes; General Rules Of Interpretation; General Statistical Notes

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Ensuring Proper Classification

By CBP's own admission, determining a product's correct classification can be a highly confusing endeavor. Differences between product categories can be slight but can trigger vastly different tariff obligations.

The easiest way to look up a classification code is via the Harmonized Tariff Schedule's Online Reference Tool. But, the ITC advises, finding the name of a product via its database does not guarantee a correct classification. *"Consider the classification of a kitchen paring knife with a ceramic blade. Either a word search or casual browsing through the Tariff Schedule might lead to heading 8211 ('Knives with cutting blades, serrated or not,….') However, Chapter 82, Note 1 excludes articles with a blade of ceramic from Chapter 82. The proper classification is in Chapter 69 as an article in ceramics."*

There may also be circumstances in which a product may seem to fall within the confines of multiple categories. Screws, for example, could fall under heading 7318, "screws, bolts, nuts," but also under "parts and accessories of motor vehicles," which is heading 8708. A general rule of thumb is to choose the heading that is most specific, which according to the ITC, describes a product's "essential character." In this example, heading 7318 would be most appropriate.

Shipments to Canada—Advance Ruling

Businesses sending goods to Canada can request an "advance ruling" from CBSA. This is especially useful for complicated situations in which there may be extenuating circumstances or in which a product's primary use might not be obvious.

A business—or more likely its designated customs broker or logistics provider—can submit a detailed request for guidance to the CBSA. In return, CBSA will provide the correct classification code to address that particular product. The advance ruling is binding and therefore provides a business with a degree of certainty in anticipating its border clearance process.

But not every business is eligible to apply for an advance ruling. A U.S. exporter must be a qualified "non-resident importer," which is a program offered by CBSA that allows U.S. businesses to act as "importers of record."

The most recent audit of customs processes by the Canadian government found that one of every three tariff classification codes was inaccurate. Further, one analysis concluded that, on a global basis, misclassified shipments result in more than

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USD $22 billion in duties owed to government treasuries. Several reasons contribute to the high incidence of misclassified shipments:

TOP REASONS FOR TARIFF CLASSIFICATION ERRORS

- HST codes are difficult to understand
- Tariff classifications can be open to interpretation
- Tariff classifications can change with little notification
- Improper training
- Technology issues

HST Codes are Complicated And Difficult to Understand

A cursory look at the U.S. Harmonized System of Tariffs reveals that the document is not for the faint of heart! The language is difficult to follow and at times can seem contradictory. Products are not defined in everyday English. And, as mentioned previously, a shipper trying to determine proper coding for a NAFTA-eligible product will have to navigate the HST's 648-page "note" that pertains to NAFTA.

Tariff Classifications Can Be Open To Interpretation

Perhaps not surprisingly, importers looking to minimize tariff obligations sometimes have a difference of opinion with border agents regarding a product's tariff code assignment. When that happens, a business can challenge the CBP and seek a legally binding ruling. To facilitate the process, CBP maintains a database of all prior tariff classification challenges. That database, the Customs Rulings Online Search System (CROSS), provides an updated list of all prior customs rulings, which can serve as precedents when establishing rationale for use of a lower-tariff category. Importers to Canada may also dispute a CBSA advance ruling tariff classification.

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Tariff Classifications Can Change With Little Notification

The U.S. government regularly updates the HTS, and the onus is on an importer to beware of any changes that may affect product classifications. The International Trade Commission issues an updated HTS each year, but supplemental revisions are released throughout the year. It is possible to stay abreast of changes to specific HTS codes through a paid subscription to services offered by any number of third parties. However, this would require dedicating manpower to review the subscription feed and understanding the implications of any HTS rule changes for a particular shipment.

Improper Training

While most businesses make the wise decision to outsource their compliance management processes to a third party, not every third party dedicates the proper resources to the complicated task of product classification. A World Customs Journal report on tariff classification found "many third-party service providers treat HS classification as a clerical or data entry function rather than as one of knowledge management." As a result, many of the people tasked with code assignment do not have the proper training or understanding of the classification process or the necessary tools at their disposal.

Incapability of Electronic Systems And Nuances of the Tariff System

As much as the Harmonized System of tariff codes has helped bring uniformity to international trade, the process of identifying a proper code remains highly complex, which frequently necessitates specialized instruction from government trade specialists. This individualized attention does not translate to computerized classification systems, which assign codes based on more generalized assumptions about product attributes.

Further, the World Customs Journal cites the "pervasive use of keyword-based search tools," which can generate long lists of possible codes but are incapable of applying HS classification rules or special rules and notes. For example, a keyword search for a tariff classification for "paper shredder" resulted in hundreds of suggested codes—none of which turned out to be correct.

Whatever the reason, a misclassified shipment runs the risk of missing out on trade benefits, to which it is legally entitled, or of overpaying duties, and it also faces potential fines and legal repercussions. CBP collects more than $61 million annually in fines and penalties and, in fact, is under pressure from some members of Congress to increase vigilance for potential violations. The bulk of fines results from improper listing of a product's tariff classification and mistakes in valuation for country of origin designation.

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Any importer determined to have misclassified goods will (a) be required to pay the duties that were originally owed and (b) face penalties that could amount to several times the value of the merchandise in question.

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Conclusion

Although payment of duties is an integral part of the import/export process, there is nothing to gain from paying more duties than necessary. There is much to gain though from taking the time to ensure that products entering the country are charged the least amount of duty possible. A key step in that process is ensuring that products are assigned the proper tariff classification code. But as we have seen, finding the correct code is no easy task.

As CBP's own website warns, "Be aware that the HTS can be very complicated. If you self-classify an item and the classification is incorrect, the mistake can be costly." Customs compliance can be an exceedingly complicated process, and failure to properly complete paperwork could result in denial of benefits, shipment delays, and even fines.

Businesses do not have to take on this confusing responsibility alone. A qualified customs broker or logistics provider can manage the process and ensure that all recordkeeping and compliance mandates are satisfied. But it is essential to take care to partner with a third party who truly has the necessary experience.

A business will need to spend the time to thoroughly research a potential logistics partner and obtain thorough answers to pertinent questions:

- What experience does the logistics provider have in transporting shipments across international borders?
- Can you speak with current customers about their experiences?
- How can the logistics provider ensure accurate compliance with all customs regulations, including proper tariff classification?
- What is the provider's success rate for hassle-free no-delay cross-border shipments?
- What if there is a problem? Will the logistics provider be there to address any issues that may arise should a customs agent question a tariff classification or some other type of customs documentation?

When it comes to finding the right partner to handle your customs management process—in addition to all other supply chain needs—a logistics provider needs to be as open and transparent as possible in discussing its capabilities. Failure to provide the requested information is a good sign that the provider may not be up to the task.

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