

Where Companies Struggle with Product Classification

by Jerry Peck

A QAD Precision Leadership White Paper for Trade Compliance

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WHERE COMPANIES STRUGGLE WITH PRODUCT CLASSIFICATION

ABOUT THE AUTHOR

Jerry Peck has over 35 years of experience in Global Trade Management. His career has uniquely encompassed nearly every facet of GTM, including third-party logistics, trade operations within Fortune 300 multinationals, and professional services consulting firms, with such companies as Kuhne + Nagel, Mattel Toys, KPMG and CapGemini-Ernst & Young, respectively. Jerry is a contributing author to the Dictionary of International Trade (World Trade Press), and has been a featured columnist with The Journal of Commerce since 2002.

INTRODUCTION

As a global trade professional and Licensed Customs Broker with over three decades of experience in regulatory compliance and supporting processes and systems, the one area that I have consistently seen companies struggle with throughout my entire career is with product 'Classification'. That is, the assignment of a good's identifying numerical code from within the Harmonized System (HS) tariff schedule, as a required condition for Customs entry.

SO WHAT IS THE HARMONIZED SYSTEM (HS)?

The Harmonized System was introduced in 1988 by the World Customs Organization (WCO), to serve as a standardized nomenclature for the classification of trade goods in which all participating countries (with some minor exceptions), classify products in the same way.

Each country's tariff, comprising approximately 5,300 article/product descriptions, is uniformly structured in that all goods align or 'harmonize' through the tariff's first six digits. This allows one country's export Classification to align with the importing country's Classification thus facilitating the uniform identification and treatment of goods between Customs regimes. After six digits, participating countries can extend the nomenclature for statistical recording purposes. In the United States, for example, the HS Code is ten digits in length and known as the Harmonized Tariff Schedule (HTSUS).

For exports, the United States also uses a 10-digit code based on a scaled-down version of the HTSUS known as the "Schedule B" in which the first six digits align with the HS.



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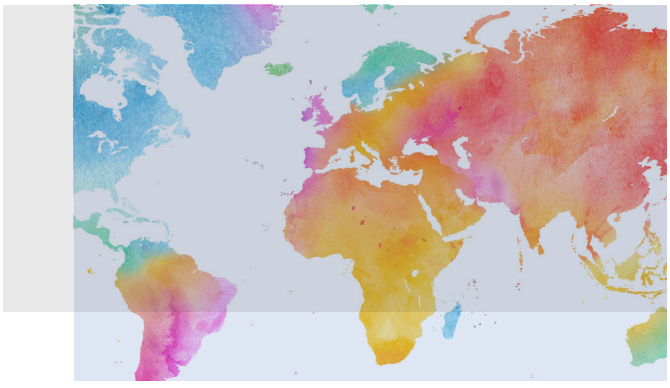
The assigned HS Code is arguably the most important data element in international trade as it's used to:

- Identify the product for Customs' purposes
- Determine a product's admissibility as well as subjectivity to Customs' and/or other Government agency requirements
- Assess import duties and taxes
- Determine a good's eligibility to Free Trade Agreements (FTA)
- Collect international trade statistics

In addition, the reported HS Codes are collected as part of for international trade statistics and are used in:

- Determining Rules of Origin
- Trade negotiations (e.g., the WCO's schedules of tariff concessions)
- Transport tariffs and statistics
- Monitoring of controlled goods (e.g., wastes, narcotics, chemical weapons, ozone layer depleting substances, endangered species)
- Areas of Customs controls and procedures, including risk assessment, information technology and compliance

To date, over 211 countries, territories and economic/Customs unions are participants in the Harmonized System.



THE IMPORTANCE OF ACCURATE CLASSIFICATION FOR COMPANIES

For importing companies which have Importer of Record (IOR) responsibility, the most immediate impact of the assigned HS Code is with regard to duty liability. By ensuring the accuracy of its product Classifications, companies are ensuring that they're paying the correct amount of import duties – no more, no less. However, it also includes their ability to identify and confidently enter qualifying products for duty-free treatment under an eligible Free Trade Agreement (FTA).

Conversely, there are numerous cases of companies which failed to apply the proper level of 'Reasonable Care', as required by US Customs in the handling of their customs business, which were subsequently hit with actions for up to five years of additional back duties and interest, some equating to several hundreds of thousands of dollars. For context, it would be hard to imagine a company's Corporate Tax Department not ensuring the accuracy of its corporate tax liability for exactly the same reasons.

Duties aside, an incorrect HS Code can subject a company to unnecessary quota, antidumping, or other Government admissibility requirements which could add damaging time, cost and oversight to its trade operations.

And then there's potential penalties. In the US, for example, a company's failure to demonstrate reasonable care can subject itself to 'Negligence" or "Gross Negligence" penalties which, in the case of the latter, equate to either 4 times the loss of revenue, or 40 percent of the dutiable value of the goods, per instance. In fact, other published similarities between corporate tax and corporate trade compliance responsibilities have found that Import-Export penalties have been estimated to be as much as 8 times higher than those of the Internal Revenue Service.[1]

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Having personally experienced a U.S. Customs Focused Assessment (FA) audit, I can attest to the fact that, given its potential impact on revenue collection, Classification is among the top areas that CBP officers will examine. As part of a FA, one of the very first things they will ask for is a copy of your written policies and procedures for Classification, together with a demonstration that you are actually following those procedures. CBP will then select a number of products from your Item Master to review your assigned Classifications, and request supporting documentation on how you arrived at the determined HS Code. In short, even a correct HS Code in absence of a supporting documented procedure, is counted as a failure.



FIVE RESPONSES TO A COMPANY QUESTIONING ON CLASSIFICATION

Throughout my career I've performed dozens of trade compliance reviews with regard to a company's people, processes and supporting technology in support of their trade operations. The following five responses with regard to Classification procedures illustrate a dangerous lack of understanding that exists for this important area.

1. **"Our suppliers provide us with the Classifications for their products."**

   While better supported for the receipt of Export ECCNs, it is frowned upon by Customs for Import Classifications, for four key reasons:

   – Foreign suppliers don't typically have knowledgeable resources for Classifying products within another country tariff. In addition, suppliers have actually been caught in intentionally providing an incorrect tariff in order for their customer to pay lower duties, or to avoid an admissibility requirement such as a required FDA approval.

   – As described earlier, global HS Codes only align through the first six digits, however tariff rates are established at the 8-digit subheading. As a result, a supplier's HS Code would not be relevant.

   – The Importer of Record is ultimately responsible for the accuracy of the Classification and other key data elements provided to Customs authorities, regardless of the original source.

   – As previously discussed, a failure to demonstrate sound procedures in support of product Classification is considered by Customs to be a failure of the Importer's obligation to demonstrate 'Reasonable Care' in the handling of its trade business.

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2. **"Our customs broker classifies our products for us."**

   It's certainly allowable for an IOR to engage a customs broker, trade consultant or other knowledgeable professional to perform Classification on their behalf. However, as the party of ultimate responsibility, the IOR is still expected to demonstrate oversight of its third-party service providers to ensure accuracy. Should Customs discover an error, they will hold the IOR responsible, not the broker or other third-party.

3. **"We let our buyers assign the Classification and we've never had a problem."**

   Buyers may know the details of the product but they are not typically trained in the complex methodology of how to Classify in accordance with the HS, such as understanding the General Rules of Interpretation (GRI). The simple fact that the company has yet to be questioned or audited by Customs is irrelevant and should never be interpreted as being an indicator of having an acceptable Classification program.

4. **"If there are a couple of possible choices, we go with the HS Code that has the lowest duty rate."**

   This response was quite alarming as it not only portrayed a total lack of understanding and adherence to Classification principles, but more concerning, the knowing selection of HS Codes based on their respective tariff rates to deliberately underpay their lawful amount of import duties could easily expose the company to a potential CBP charge of fraud.

5. **"We use an automated Classification system which saves us from hiring a Classification expert."**

   The structure of the HS Tariff Schedule by product attributes, combined with set rules which govern how to Classify within the Tariff, lends itself nicely to the application of Artificial Intelligence (AI). Today there are a few companies which are making interesting strides, but there is still much to be done. Consider that to create an expert system for Classification one would need to catalog every attribute option for approximately 5,300 products, cross reference each line against both Section and Chapter Notes and any applicable Customs Rulings, while automatically applying the correct application of the General Rules of Interpretation. Instead, what are deemed as today's 'AI Classification Systems' can be little more than word-association engines, which means that the person using it will still need to have knowledge of the above Classification principles, as well as knowledge/access to the product attributes which are called out for in the tariff.



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INDUSTRY BEST PRACTICES FOR CLASSIFICATION

There are a number of industry best practices around Classification which savvy trade-dependent companies have learned to implement in order to generate both process efficiencies as well as competitive advantages. One of the most important is the strategy of integrating Classification into formal business planning decisions.

The Classification of goods is traditionally thought of as a back-end step which occurs as part of the Customs clearance process at the time the goods arrive at the Port of Entry. But waiting to Classify at this late stage is problematic for two important reasons:

- It limits the amount of time the Classifier has to fully research each product on the manifest against the tariff attributes. Placing the Classifier, whether in internal or external, to time-sensitive pressures can lead to incorrect Classifications just to get the shipment moving.
- If the resulting HS Code is subject to an admissibility requirement, such as a Chemical Statement, FDA approval, or any number of other Partnering Government Agency (PGA) certificates that are required as a condition of import, it may not be possible to secure the document in time before costly airport/ocean terminal storage charges begin.

Instead, by walking the Classification process upstream to the earliest beginnings of new product build/buy decision making, early visibility to Trade & Customs considerations such as duty/tax liability, PGA admissibility or other regulatory requirements can be identified and weighed. For manufacturers, this advanced review can also present opportunities for "Tariff Engineering", the strategic process whereby proactive changes in product design, functionality and/or materials can lawfully lead to Classification under a more advantageous HS Code.

ABOUT QAD PRECISION – TRUSTED GLOBAL TRADE AND TRANSPORTATION EXECUTION

QAD Precision, a division of QAD Inc., provides industry-leading global trade compliance, and multi carrier transportation execution solutions from a single, integrated platform. An ISO-certified company, QAD Precision assists companies to streamline their import, export and transportation operations, optimize deliveries, and increase logistics ROI. QAD Precision's scalable and extensible solution easily integrates with existing ERP and WMS solutions. Industry leaders in every region of the world rely on QAD Precision's global support centers to leverage thousands of carrier services and manage millions of global trade and shipping transactions every day.

For more information about QAD Precision, contact us today.

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