

HONG KONG OFFICE:
Suite 706 Ocean Centre, Harbour City
5 Canton Road, Tsimshatsui, Kowloon, Hong Kong
Tel: (852) 2810-5777
Fax: (852) 2810-5288
Emails: roydelbyck@delbycklawoffices.com
tracyheung@delbycklawoffices.com

US OFFICE:
215 Benson Circle
Mill Valley, CA 94941, U.S.A.
Tel: (1-415) 389-1155
Fax: (1-415) 389-6886
Emails: roydelbyck@delbycklawoffices.com
tracyheung@delbycklawoffices.com

May 19, 2005

Article on First Sale

by

Roy Ian Delbyck

Importers in the US (and other jurisdictions too) often find themselves in a purchasing arrangement where the vendor is a middleman, not the manufacturer. Thus, the importer buys from a middleman, which in turn buys from the factory. In many of these arrangements, the middleman and factory are related. This is often a consequence of the middleman being located in a jurisdiction, such as Hong Kong, in which it has become too expensive to manufacture. To preserve its customers, the middleman has established factories in a jurisdiction, such as the PRC, with lower manufacturing costs.

From a US customs perspective, the goal would be to pay duty on the basis of the first sale (the factory's price) rather than the second sale (the middleman's price). This is possible under US law so long as two factors are present: first, the goods sold by the factory are clearly destined for export to the US, and second, the factory and the middleman deal with each other on an arm's-length basis.

The first factor is usually not a problem. The second factor presents some difficulty where the middleman and the factory are related. Often, using my example above, the HK middleman and the related PRC factory may not deal with each other at arm's-length, for example, there may be irregular documentation between the Hong Kong middleman and the PRC factory, the HK middleman may dictate pricing, etc. Part of the exercise on my firm's part would be to regularize the dealings between the Hong Kong middleman and the related PRC factory to better support a claim of arm's-length dealing in a ruling request that we would submit to US Customs Headquarters or the port (it may be quicker to deal with the US Customs officials in the port, if all or most of the goods enter a single port).

Some practical concerns. The ideal buy-sell arrangement is one in which the importer and middleman are related but the factories are unrelated. Besides there being no question of arm's-length dealing between the middleman and the factories in this arrangement, the middleman here should have no reluctance in disclosing its markup to the related importer (such disclosure would be necessary because US Customs would

need to be presented with the factory prices in order to assess duty thereon). However, where the middleman is unrelated to the importer (regardless of whether the middleman is related to the factories), the middleman may not wish to disclose the factory's price, fearing that the importer will try to go around the middleman and/or try to bargain down the middleman's mark-up ("I didn't realize you were making that much money!"). To incentivize the middleman, the importer might consider sharing some of the duty savings with the middleman. This is the classic win-win arrangement. Undoubtedly, a first-sale arrangement will require more work on the middleman's part, as, among other things, the middleman will now need to present the importer with two sets of documents (those between it and the importer and those between it and the factory), but the potential duty savings are considerable, even for products with low duty rates.

For example, assume that a factory's sales to the middleman are US\$30 million/annum, the middleman's markup averages 15% and the duty rate averages 3%. If first-sale treatment were obtained, US\$135,000 in duty would be saved per annum (US\$30 million x 15% x 3%). You can work the savings up and down depending on the duty rate, markup and sales volume.

I have also seen buy-sell arrangements where the importer, middleman and factory are all related. This will most often occur where a Hong Kong or other Asian group has pushed forward into the US and established or acquired a US affiliate, and the US affiliate then buys from the HK parent which in turn buys from a related factory in the PRC or some other lower-cost manufacturing jurisdiction. First-sale treatment is also possible in this type of buy-sell arrangement. As PRC manufacturing companies are increasingly moving into the US and establishing US affiliates, obtaining such treatment will become a more pressing concern.