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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548



AUGUST 27, 1984

GENERAL GOVERNMENT
DIVISION

B-215319



The Honorable George J. Mitchell
United States Senate

Dear Senator Mitchell:

Subject: Requirements for Duty-Free Status
of Articles Imported From U.S.
Insular Possessions (GAO/GGD-84-94)

As requested in your letter of July 18, 1983, we have reviewed certain aspects of U.S. trade with its insular possessions (see enc.). Specifically, as agreed with your representatives during meetings on August 1, 1983, and September 26, 1983, we compared

--the duty exemption provisions for imports from insular possessions under Headnote 3(a) of the Tariff Schedules of the United States with the duty exemption provisions under (1) the Generalized System of Preferences (GSP) program for designated beneficiary developing countries and (2) the Caribbean Basin Economic Recovery Act, commonly referred to as the Caribbean Basin Initiative (CBI) for nations of the Caribbean and Central America; and

--U.S. Customs' procedures for verifying whether certain articles qualified for duty exemption under each program.

In conducting our review of the programs' operations, we interviewed officials of the U.S. Customs Service, the U.S. Customs Regional Offices in Miami and New York City, and U.S. Customs Districts in Miami, New York City, Puerto Rico, and the Virgin Islands. We also reviewed procedures for implementing the programs, documentation supporting duty-free entries, investigative reports and audits, and data accumulated to date on a current customs audit. We also met with officials of a major importer in the Virgin Islands.

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Except for not obtaining agency comments, our review was conducted in accordance with generally accepted government auditing standards. We began our audit work in October 1983 and completed it in April 1984.

COMPARISON OF IMPORT DUTY
EXEMPTION PROVISIONS

By providing that certain articles may qualify for duty exemption, the basic objective of all three programs is to promote the economic development of eligible countries and U.S. insular possessions. Headnote 3(a) of the Tariff Schedules provides, with few exceptions, that an article imported directly from an insular possession--e.g., the Virgin Islands, Guam, and American Samoa--may be exempt from duty. Specifically, an article is exempt from duty if

--it was grown or mined in the possession or it was produced or manufactured in that possession from the materials, the growth, product, or manufacture of any such possession or the customs territory of the United States or both; and

--the value of foreign material(s) does not exceed 70 percent of Customs' appraised value¹ for the article. For example, an import would not qualify for duty exemption if the value of foreign material(s) was \$75 and the appraised value of an article was \$100, since the value of the foreign material content exceeds 70 percent of the product's appraised value.

For certain Headnote 3(a) items, including textiles and petroleum products, the value of foreign material content cannot exceed 50 percent of an article's appraised value. Watches and watch movements qualify for duty exemption, without regard to foreign content, provided they meet quota restrictions established by the Secretaries of Commerce and Interior. Materials that can be imported into the United States duty-free (except from Cuba and the Philippines) are not counted as foreign materials for purposes of the foreign content limitation.

With respect to the GSP and CBI programs, the President designates the countries that can participate and, under GSP, the articles that may be exempt from duty. Under CBI, with few exceptions, articles are usually accorded duty-free treatment by statute. To qualify for duty exemption, the direct costs of processing operations plus the cost or value of the materials produced in the designated country or countries used to produce

¹The Customs process of determining a unit value for imported merchandise according to statutory requirements.

an article cannot be less than 35 percent of Customs' appraised value for the article. Under the CBI provisions, U.S. made components may comprise up to 15 percent of the 35-percent requirement.

The primary difference among the three programs is that the duty exemption provisions for an article under GSP and CBI are specific as to what the percentage of value added must be in the designated country or countries as well as what makes up that percentage--materials plus direct costs (excluding profit and overhead). The Headnote 3(a) provisions are specific as to what the percentage for foreign materials can be, but silent as to the composition of the value added (material, direct costs, overhead, and profit) in an insular possession. Thus, a company in an insular possession could increase its profit margin and thereby decrease the foreign material percentage value until the required percentage is met, as illustrated in the following example. An article with a Customs' appraised value of \$100--composed of \$72 in foreign materials; \$23 in direct costs, material, and overhead; and \$5 in profit--would not qualify for duty exemption under the Headnote 3(a) provision. The cost of foreign materials comprises 72 percent of the article's appraised value, which exceeds the 70-percent limitation. However, using the same costs but increasing the profit from \$5 to \$8 would increase the article's appraised value to \$103. The article would now qualify for duty-free treatment because the value of the foreign material is 69.9 percent of its appraised value.

CUSTOMS PROCEDURES FOR
VERIFYING WHETHER AN
IMPORT IS EXEMPT FROM DUTY

Customs' import specialists review entry documentation for any discrepancies and can request an audit or investigation of a company's operations or records to verify any questions concerning whether an import from a U.S. insular possession is exempt from duty under Headnote 3(a). In contrast, import specialists usually only review the importers' documentation to verify the accuracy of other countries' duty-exempt certification for imports under the GSP program because Customs does not have the authority to audit or investigate the operations of a foreign company. Customs officials advised us that the CBI verification procedures are expected to be similar to the GSP program.

Under the GSP program, an import is certified exempt from duties if a Certificate of Origin Form A, signed by the exporter and a government official of the exporting country, is submitted with the entry documentation. The form certifies that GSP duty exemption requirements have been met. A customs import specialist reviews the certificate and other entry documentation for

discrepancies. Any questions as to the duty-exempt eligibility of an article are coordinated with the U.S. State Department through diplomatic channels. The import specialists we talked to said it usually takes a year or more to obtain a response to an inquiry, and none could remember any imported articles being ruled ineligible for duty exemption.

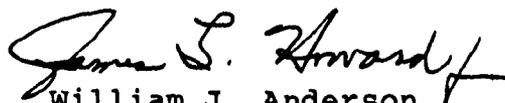
Under Headnote 3(a) provisions, the importer must submit a certificate of origin with the entry documentation certifying that the article is duty exempt. The importer usually attaches the exporters' documentation showing the value of the finished article and the value of foreign materials included in it. However, the Headnote 3(a) certificate is signed by a Customs official or other U.S. official located in an insular possession and this official can periodically verify the accuracy of the entry documentation provided by the exporter. Customs' investigators or auditors also can be used to verify the accuracy of the entry documentation when an import specialist has questions as to whether an article is duty exempt.

Customs has recently completed audits of the operations of a company in the Virgin Islands and one in Guam to determine whether articles imported from these companies should be exempt from duties under Headnote 3(a). The results of the audit in Guam disclosed that the imports qualified for duty exemption under Headnote 3(a). However, the audit report on the Virgin Islands company recommended that Customs collect additional duties of \$370,000 for imports identified by the audit that did not meet the foreign material content requirements.

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At your request, we did not obtain official agency comments. We hope the above information responds to your concerns. As arranged with your office, unrestricted distribution of this report will be made 5 days after the date of the report or at the time of public release of the report's contents by your office.

Sincerely yours,


William J. Anderson
Director

Enclosure

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United States Senate

COMMITTEE ON FINANCE
 WASHINGTON D.C. 20510

ROBERT E. LIGHTWEISER, CHIEF COUNSEL
 MICHAEL STERN, MINORITY STAFF DIRECTOR

July 18, 1983

Charles A. Bowsher
 Comptroller General of the United States
 General Accounting Office
 441 G Street
 Washington, D.C. 20548

Dear Mr. Bowsher:

I am requesting that the General Accounting Office undertake a study of U.S. trade with its insular possessions. One of my concerns in this area is that some of our insular possessions are being used to transship goods in order to avoid duties and quotas on certain textile products.

The study should examine current use of General Headnote 3(a) of the Tariff Schedules of the United States, its origin and valuation requirements, and the effect of this trade on the economies of both the U.S. and its insular possessions. The study should specifically address the regulations and guidelines that the U.S. Customs Service uses to administer and monitor this trade.

Tom Gallagher of my staff can answer any questions you may have regarding this request. He can be reached at 224-5344.

I look forward to working with the GAO on this issue. Thank you for your attention to my request.

Sincerely,

George J. Mitchell
 George J. Mitchell
 United States Senator