Free Trade Agreements – An opportunity for duty savings

In a globalised world, Free Trade Agreements ('FTA') are an important tool of implementation for international trade. By entering into FTAs, countries obtain easier market access into other partnering countries. This also leads to increased foreign trade, which results in robust foreign investment for all partner countries.

India has always viewed FTAs as an important tool to enhance its trade and investments and has therefore signed a number of such trade agreements with various countries. However, reports suggest that while FTA utilization is as high as 70-80% in developed countries, in India - by Indian exporters and importers, the FTA utilisation is significantly low as compared to the available opportunity. The low utilization highlights the alarming failure to utilize the benefits available to the industry through bilateral and multilateral trade agreements.

Before diving deeper into the discussion, it is important to discuss the concept of FTA. Ordinarily, whenever a product is traded across international borders, the importing and exporting countries apply certain charges in the nature of tariffs or duties on the products being exchanged. Such an imposition of tariff/ duty invariably increases the cost of procuring the products. FTAs seek to reduce or eliminate such tariffs and thereby make available easy access to the domestic markets of partner countries.

FTAs are therefore treaties between two or more countries whereby parties agree to reduce or eliminate customs tariffs and other non-tariff barriers on the trades executed between them. The cornerstone of FTAs is the concept of Rules of Origin ('RoO'), which helps in determining the national source of a product. Different criterion are applied by each participating Government, and the most widely used conditions are:

i. Substantial transformation of input products;
ii. Change in tariff classification;
iii. Specific manufacturing or processing involved;
iv. Extent of manufacturing or processing carried out in the exporting country

In order to qualify for an exemption/ preferential tariff under an FTA, a Certificate of Origin (CoO) is required to be obtained by the exporter, for the subject product. The said CoO is issued on satisfying the RoO conditions, as may be provided by the respective FTAs. Certificate of origin is an instrument which establishes evidence on origin of goods imported into any country. These certificates are essential for exporters to prove where their goods come from and therefore stake their claim to whatever benefits such goods may be eligible for in the country of import. This CoO is required to be submitted at the landing port of the importing country by the importer, to avail FTA benefits.

India has signed more than eighteen trade agreements, including with ASEAN countries, Japan, Korea, Singapore, SAARC countries and SAPTA countries. Organizations engaged in global trade and cross-border supply of eligible goods, should explore this opportunity to reduce costs, be competitive in the global market and become profitable.

How can organizations maximize the FTA benefits?

For Exporters – Complying with 'Rules of Origin' conditions

Organizations should set up a mechanism (of origin management), based on their supply chain, manufacturing process, products exported and applicable FTA, which successfully evaluates the FTA benefits/ conditions. The mechanism should be transparent, auditable and provides sufficient self-checks and also fulfills Government audit requirements, if any.

A typical origin management process involves:

i. Identifying the raw material, components, inputs, etc used for manufacturing of export product;
ii. Computing the value addition or local value content;
iii. Determining whether the significant transformation requirements, as may be prescribed by RoO, are satisfied;
iv. Tracking the supply chain and costing/ pricing information of inputs and raw material sourced and used;
v. Creating an automated system, which is integrated with the organizations ERP and supports extraction of necessary data/ information for a CoO;

A well thought through and mature system, allows organizations to standardize the entire process, measure the benefits, raise red flags for any non-compliances, as well as supports during audit proceedings by the tax authorities.

For Importers – Creating awareness of potential duty benefits under various FTAs

Organizations should invest and make efforts to:

i. Evaluate and identify the products qualifying for FTA benefits;
ii. Impart appropriate trainings on the processes involved to claim the benefit;
iii. Increase coordination with the exporter of goods to understand satisfaction of RoO and not rely solely on the CoO received;
iv. Maintain appropriate data, information and documents to support any queries that may be received from the tax authorities

Imparting appropriate and timely trainings on FTA benefits can result in substantial cost savings for importers, resulting in better profitability and competitiveness.

Preparedness for audit and investigation

Preferential benefits and duty concessions are extended by the importing country and hence also exercises control by examining the accuracy and correctness of origin claims. In India, the responsibility lies with Customs authorities to investigate for any fraudulent or wrongful claim of preferential duty.
To address this issue specifically, Union Budget 2020-21 has in fact introduced a new chapter in the (Indian) Customs Act, 1962 to lay down the powers and process for examining preferential duty claims.

This newly introduced chapter, empower the customs authorities to restrict/ deny benefits if the response to their preliminary enquiry is not satisfactory.

In light of this, importers in India should not solely rely on the CoO as may be provided by the supplier of goods, but instead, maintain sufficient information/ checks to avoid any conflicts with the customs authorities. Similar to exporters, the importers should also install appropriate processes to be able to demonstrate the following in case of enquiry, audit or investigation by customs:

i. Goods brought into India satisfy the conditions of RoO;
ii. Duty benefit has been correctly claimed and that the same can be supported through relevant documents/ information;
iii. "Reasonable care" was exercised while claiming the preferential duty benefits;
iv. The classification and valuation of products is correct and can be corelated with the import invoice and CoO

Overall, FTAs provide an opportunity for exporters to expand their footprint in the global markets, by marking their products more affordable. On the other hand, importers with a good understanding of FTA conditions and processes, can seek to reduce the applicable duties and taxes.