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The First Sale Rule: Reducing Landed Costs in Multi-Tiered Import Transactions

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The first sale rule—also known as middleman pricing—has been the law of the land in the United States since Sandler, Travis & Rosenberg, PA senior attorney Len Rosenberg won the seminal case establishing first sale as a viable option for valuation of merchandise in 1988.[1]

Simply, the first sale rule can be applied when there are two or more sales that give rise to an import of merchandise. As long as the rules substantiating first sale are met and documented, the basis for dutiable value can be the first sale between the factory and the middleman/vendor, rather than the middle- man/vendor and the importer.

For example, consider a circumstance in which a U.S. importer purchases 40,000 units of merchandise from a vendor at $25 per unit. This $10 million of merchandise, if it carries a duty rate of 25 percent ad valorem, would require an additional $2.5 million in duty. Now, consider using the price between the factory and the vendor (the first sale) as the basis for dutiable value instead. If the factory charges the vendor $21.25 per unit, the total cost for the merchandise from factory to vendor is $8.5 million. At the same ad valorem duty rate of 25 percent, the duty owed on this importation would be approximately $2.1 million, an annual savings of nearly $400,000 for first sales. Applying this formula to $100 million in sales would result in a savings of nearly $4.0 million annually in above-the-line expenses.

First Sale Benefits to a Multi-tiered Transaction

What's remarkable about using first sale import pricing is that it benefits every tier of a multi- tiered transaction. Factories and vendors do not have to lower their prices—or their margins—in order to attract U.S. buyers, and U.S. importers are able to reduce the landed cost of their goods. First sale is even allowed when all the parties to the transaction are related (have common owner- ship, share officers, etc.) as long as the rules and documentation requirements are met.

Substantiating the Right to First Sale

Incorporating the first sale rule (middleman pricing) into an import strategy is based on established law and is a sound business technique. But as with any complex business practice, especially one where the parties can legally reduce their tax liability, the user must be able to substantiate that it is entitled to benefit. With first sale, the importer must produce solid documentation stemming from a well-executed strategic plan.

In the 25 years since McAfee was decided, the courts and the government have refined the requirements for using first sale. Three factors must be present to establish the first sale as the basis for import valuation. First, the transaction upon which the value is based must be a bona fide sale for export; second, the goods must be destined for the United States; and third, the transaction must be at arm's length.

Once it is determined that these requirements are met, a clear documentation trail must be set up. The importer asserting first sale must be able to show a purchase order (PO) from the importer to the vendor, a PO from the vendor to the factory, an invoice from the vendor to the importer, and invoice from the factory to the vendor (provided with the shipment at the time of importation), payment from the importer to the vendor, and payment from the vendor to the factory. Depending on the complexity of the transaction, the paper trail could expand even further.

Practical Considerations: First Sale Development, Maintenance and Review

We usually recommend a feasibility analysis before embarking on a first sale program. Of para- mount importance is getting vendor support. First sale valuation

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requires a great amount of trust and transparency. It works best in cases where the importer and the vendor jointly plan on a long-term relationship and consider each other trusted business partners. The importer will ask its vendors to relinquish information about its actual costs, including documentation on any items it may be supplying to the factory that could influence the customs valuation of the goods.

After you've determined feasibility, you can establish the steps for capturing the first sale price. This is where the documentation trail is scrutinized. The importer must be able to prove the bona fides of the transaction upon which first sale is asserted. Purchase orders, invoices, actual payments, and any other elements of customs valuation must comport with the first sale rules.

Working with outside experts to pre-certify your transactions as first sale eligible is recommended.

Finally, it is important to develop a plan for independent recertification and annual maintenance at the outset. Even the most seemingly insignificant changes in sources or supply chain flow can upset the first sale equilibrium. By pre- planning for regular process and record keeping reviews, the importer builds assurances necessary to maintain a smooth first sale program. ❏

[1] See E.C. McAfee v. United States, 842 F.2d 314 (Fed Cir 1988).

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