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Brazil: New transfer pricing rules and their impact on customs valuation

The Brazilian government has published new transfer pricing (TP) rules adopting the arm's-length principle. These rules could impact the current process of using TP information for assessing customs valuation when importing goods from related parties.

Alignment of Brazilian TP rules to OECD TP standards

On 29 December 2022, the Brazilian government published Provisional Measure 1,152/2022[1] adopting the TP standards of the Organisation for Economic Co-operation and Development (OECD).[2] The new legislation revokes current Brazilian TP rules. New rules, which should be approved by the Brazilian Congress within 120 days, will be in effect from 1 January 2024, but companies may adopt the new standards in 2023.

What will change?

The implementation of the new TP rules seeks to:

- Align Brazilian TP rules to OECD standards.
- Adopt the arm's-length principle for all cross-border intercompany transactions.[3]
- Avoid double taxation and double "nontaxation" outcomes.
- Remove one of the main obstacles to the recognition of tax credits in the US for income tax paid in Brazil.

The traditional Brazilian approach to TP has not previously been aligned to OECD standards. Rather than applying the arm's-length principle to define and prove that intercompany transactions were not controlled by the relationship between the parties, the Brazilian legislation defined fixed margins on cross-border intercompany transactions; any variation between the statutory margins and the actual margins practiced by the parties would then be subject to TP adjustments. Converging the Brazilian legislation to OECD standards, the fixed margins will no longer be applied, and transfer pricing studies on the arm's-length principle will be the new approach for companies to base, test and support their transfer prices and margins.

Transfer pricing and customs valuation in Brazil — background

On 23 June 2022, through Normative Instruction 2,090 (IN RFB 2.090/22), the Brazilian Federal Revenue Service (RFB) formalized the possibility of

1 "Brazilian Government publishes Provisional Measure adopting arm's-length principle", *EY website*, 30 December 2022. **Find it here**

2 "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022", *OECD website*, January 2022. **Find it here**

3 The arm's-length principle is endorsed by the OECD and is outlined in Article 9 (the Associated Enterprises Article) of the OECD Model Tax Convention on Income and on Capital.

Insights
Tax alerts
Additional resources
Contacts

using certain TP information for the purposes of assessing the customs value declared by Brazilian importers when importing goods from related parties. This procedure has been adopted for customs audit purposes in recent years.

However, the use by the Brazilian customs authorities of parameter prices established by the TP rules on a product-by-product basis to validate the customs value has triggered different interpretations between taxpayers and tax authorities. Taxpayers have asserted that the parameter prices do not reflect the reality of prices actually applied to the local sales and, therefore, they were not a suitable basis for challenging the taxpayers' declared customs values in Brazil.

With the introduction of PM 1,152, which has modified the TP rules in Brazil, the possibility that TP studies will be used to facilitate the auditing of declared customs values has potentially been strengthened. The new TP rules differ from the former rules as they are not based on deemed and fixed margins. Instead, they are focused on an analysis of the functions performed and risks assumed by each party in the transaction, as well as on the methods geared to identifying a proxy value that would be practiced between independent parties, aligned with the arm's-length principle. This new approach is broadly aligned with the goals of the customs valuation rules.

Customs valuation insights and considerations based on new legislation

- The adoption of the new arm's-length principle will increase the focus on transfer pricing studies performed by importers in a way that has not been done before, in order for the customs authorities to test the conditions of sale and that the relationship between the buyer and seller has not influenced the price paid.
- With the new focus on local TP studies as a form of defending declared customs values, it will be important for importers in Brazil to validate that TP studies performed in Brazil are adequate from a customs standpoint and pass the arm's-length principle "condition of sale test" (i.e., whether an examination of the conditions of the sale between the related parties indicates that their relationship did not influence the price paid or payable for the goods imported into Brazil).
- If the Brazilian customs authorities maintain their high level of auditing focus on intercompany transactions but adopt the arm's-length principle approach through the new TP rules, it will be important for Brazilian importers to examine their intercompany pricing closely.
- Even though Brazilian regulations allow TP studies to be used as a basis for the conclusion that the relationship between the parties influenced the price in a given intercompany transaction, it may not be the exclusive factor taken into account, particularly if the attempt is to use transfer pricing studies as the basis for the company's customs valuation, because customs authorities would still seek to apply their own tests and regulations, in addition to TP studies, in line with the World Customs Organization and Technical Committee on Customs Valuation notes, for example. Therefore, direct tax and Customs agencies within the Brazilian government will still adopt slightly different approaches when investigating significant fluctuations in intercompany pricing.

What's next?

The new TP rules will be in force as of 1 January 2024, but taxpayers may choose to follow and apply them in 2023. It is important to note that if the option is exercised to follow the rules for 2023, it will be irreversible.

Under these circumstances, a harmonized approach between the customs valuation rules and the content of a company's TP studies becomes essential. This will help Brazilian importers to demonstrate that the price paid or payable in intercompany transactions has not been influenced by the relationship between the parties such that the price practiced is divergent from a fair and logical market price. This will consequently help to manage the risk that the Brazilian customs authorities could reject the transaction value as an appropriate parameter for evaluating the declared value of the goods at import.

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Canada: Border Services Agency (CBSA) releases guidance on Select Luxury Items Tax enforcement and administration

On 1 September 2022, the Select Luxury Items Tax Act (SLITA) came into force. The SLITA imposes a "luxury tax" on the importation of certain vehicles, aircraft and vessels valued above certain price thresholds. Importers of these vehicles, aircraft and vessels are required to pay this tax on the subject item, in addition to any other applicable customs duties and taxes.

The CBSA published Memorandum D18-4-1: *Select luxury items tax on importation*[1] to clarify how the agency enforces and administers provisions under the SLITA and the Customs Act specific to subject imported items. This article summarizes the key guidelines in that memorandum.

1 "Memorandum D18-4-1: Select luxury items tax on importation," *Government of Canada website*, 6 October 2022. Find it here

Luxury tax application

The new tax is assessed on imports into Canada of subject goods, as set out in subsection 2(1) of the SLITA. Tax applies to vehicles and aircrafts valued at CAD100,000 or more and vessels valued at CAD250,000 or more.

Insights
Tax alerts
Additional resources
Contacts

Subject vehicle means a passenger motor vehicle that:

- Is designed or adapted primarily to carry individuals on highways and streets
- Has a seating capacity of 10 individuals or fewer
- Has a gross vehicle weight of 3,856 kg or less
- Is manufactured after 2018
- Is designed to travel with four or more wheels in contact with the ground

This includes sedans, coupes, hatchbacks, convertibles, SUVs and light-duty pickup trucks. Ambulances, hearses, motor vehicles that are marked and equipped for policing, vehicles used in emergency medical and fire response activities, or recreational vehicles that are designed or adapted to provide temporary residential accommodation are excluded.

Subject aircraft means an airplane, glider or helicopter, as defined in subsection 101.01(1) of the Canadian Aviation Regulations, that is manufactured after 2018 and is equipped:

- Only with pilot seats and cannot have any other seating configuration
- Only with pilot seats or is not equipped with any seats, and cannot have a seating configuration, excluding pilot seats, of 40 or greater
- With one or more pilot seats and one or more passenger seats and has a seating configuration, excluding pilot seats, of 39 or fewer

Subject aircraft does not include an aircraft designed and equipped for military activities or an aircraft equipped only for carrying goods.

A *subject vessel* is a vessel that is designed or adapted for leisure, recreation or sport activities and was manufactured after 2018. It does not include floating homes, commercial fishing vessels, ferries or cruise ships. For SLITA purposes, vessel means a boat, ship or craft that is designed or is capable of being used solely or partly for navigation in, on, through or immediately above water, without regard to the method or lack of propulsion.

Luxury tax calculations on imports

When calculating the taxable amount of certain luxury goods at importation, the applicable goods and services tax (GST)/harmonized sales tax (HST) and provincial sales tax (PST) are not included in the tax base. In addition, any deductions for a trade-in or down payment do not reduce the taxable amount of a subject item.

All duties and taxes payable must be included in the taxable amount for luxury tax purposes. The taxable amount is the value for duty (VFD) of the item as determined under sections 48 to 53 of the Customs Act, plus any duties and taxes related to customs, other than the GST/HST and PST.

The applicable luxury tax is the lesser of:

- 20% of the taxable amount above the relevant price threshold of the subject item
- 10% of the taxable amount of the subject item

GST/HST and PST

GST/HST applies to the final value of the subject item (as determined in accordance with the Excise Tax Act), inclusive of the amount of luxury tax. Where applicable, PST also applies to the final value of the subject item.

Duties and taxes payable

In addition to the luxury tax, all applicable customs-related duties and taxes (e.g., levies imposed under the Customs Tariff, the Excise Tax Act or the Special Import Measures Act) are payable for the import of a subject item, inclusive of GST/HST and PST (if applicable).

Luxury tax payable on import

A person liable under the Customs Act to pay duty on an imported subject item, or who would be liable if the item were subject to duty, must pay luxury tax if the item's taxable amount exceeds the applicable price threshold, unless an exemption applies.

Luxury tax for a subject item is paid and collected in accordance with the Customs Act. Any related interest and penalties must be imposed, calculated, paid and collected in accordance with that act, as if the tax were a customs duty levied under the Customs Tariff.

Exemptions

Section 21 of the SLITA sets out exemptions from the luxury tax for certain imports of subject items. Specifically, an exemption applies if:

- A subject item is imported by a registered vendor for that type of subject item.
- A purchaser and a vendor have entered into a written agreement for the sale of the subject item before January 2022.
- In the case of a subject vehicle, the vehicle was registered with the government of Canada or a province before importation.
- The subject items are subject vehicles that are equipped for policing activities and imported by a police authority or a military authority, or are equipped for military activities and imported by a military authority.
- In the case of a subject aircraft or vessel, a tax-paid certificate issued by the Canada Revenue Agency (CRA) for the aircraft or vessel is in effect.
- In the case of a subject aircraft or vessel, a special import certificate issued by the CRA in respect of the importation is in effect, unless the item is a subject vessel that qualifies as a "select subject vessel."

In addition, subsection 21(6) of the SLITA sets out "special cases" where tax does not apply for certain temporary importations. For example, the luxury tax on importation is not payable if:

Insights
Tax alerts
Additional resources
Contacts

- The subject item is classified under heading No. 98.01 or tariff item No. 9802.00.00 or 9803.00.00 of the Schedule to the Customs Tariff and no duties are payable in respect of the subject item.
- The subject item is imported solely for maintenance, overhaul or repair of the subject item in Canada.
- Neither title to nor beneficial use of the subject item passes to a person in Canada while the subject item is in Canada.
- The subject item is exported as soon as the maintenance, overhaul or repair is completed.

Temporary importation under tariff item No. 9993.00.00

Luxury tax relief may apply for temporary importations of subject vehicles and subject aircraft under tariff Item No. 9993.00.00 when they qualify as a special case under subsection 21(6) of SLITA.

A subject vessel imported for storage and/or repair under tariff Item No. 9993.00.00 for 12 months may be granted an additional 12 months under that tariff item for the relief of the GST/HST. However, no such additional tax deferral is available for the luxury tax.

Supporting documents — requirements

The CBSA may require supporting documentation for the importation of a subject item if the importer claims an exemption. Such documents may include a proof of valid registration number under the luxury tax regime, a special import certificate, a tax certificate or a written agreement for the sale prior to January 2022.

Declaration and accounting

Commercial goods

Declaration and accounting of items that are commercial goods subject to the SLITA are made in the same way and within the same prescribed time that customs duties and taxes are payable. When accounting for subject vehicles, aircraft or vessels, the importer should complete Form B3-3 (B3), using the method it would normally use when accounting for commercial goods. To account for subject vehicles, aircraft or vessels where luxury tax is payable on the importation, the importer must include the appropriate excise tax code in field 34 of the B3. This code is based on the goods imported and the method used to calculate the luxury tax. For example, excise tax code 61 is used if the item is a subject vehicle, and luxury tax applies at the rate of 10% of the vehicle's taxable amount.

To account for subject vehicles, aircraft or vessels that qualify for exemption, the importer must include the appropriate excise tax code in field 34 of the B3. For example, excise tax code 66 is used if exemption applies because the importer is a registered vendor for the applicable type of subject item.

Casual good (noncommercial)

Declaration and accounting of subject items that are casual goods are made in the same way and within the same prescribed time that customs duties and other taxes are, or are not, payable. If the luxury tax has already been paid, importers should keep any documentation, receipts and/or certificates that demonstrate payment.

Special cases

Luxury tax is payable in full when the subject item is classified under tariff item nos. 9806.00.00 (goods bequeathed to a resident of Canada) or 9807.00.00 (settler's effects).

If the subject item cannot be classified under heading Nos. 98.04, 98.05 and 98.16 because the VFD exceeds the amount specified for these headings, the VFD is reduced in accordance with sections 83, 84 and 85 of the Customs Tariff. The reduced value is used to establish the taxable amount and determine whether the tax applies.

Correction, refund, redetermination and further redetermination

Commercial goods

An importer who has reason to believe that a declaration of origin, tariff classification or value for duty is incorrect is required to correct it. The 90-day period to make a correction starts on the date the importer has, or is deemed to have had, specific information that a declaration is incorrect. Corrections to declarations and requests for refunds should be made on Form B2, *Canada Customs Adjustment Request*.

Insights
Tax alerts
Additional resources
Contacts

If an importer is required to pay additional luxury tax or is entitled to a refund, the CBSA will issue a Form B2-1, *Canada Customs – Detailed Adjustment Statement* (DAS), which serves as a notice of refund or assessment, in response to an adjustment request or in response to a review or redetermination initiated by the CBSA. Note that the CBSA will not grant any drawback in respect of the luxury tax.

Casual good (noncommercial)

Where there is overpayment of luxury tax, an importer may submit Form B2G, *CBSA Informal Adjustment Request*, to the appropriate CBSA Casual Refund Centre to request refund of the amount overpaid.

Commercial goods and casual goods (noncommercial)

The CBSA may redetermine or further redetermine the origin, tariff classification or VFD on its own initiative or in response to an adjustment request. As with customs duties and taxes, the CBSA may assess any undeclared amount of luxury tax.

The Customs Act and the regulations made under that act apply to the determination of the tax status of a subject item as if it were the determination, redetermination or further redetermination of the item's tariff classification. Similarly, the Customs Act and the regulations made under that act apply to the appraisal, reappraisal or further reappraisal of a subject item's value as if it were the appraisal, reappraisal or further reappraisal of the subject item's VFD.

Rebate

An importer seeking a rebate for luxury tax paid under sections 39, 40, 41, 42 and 43 of the SLITA must submit a rebate application to the CRA.

Review

Following a determination, redetermination or further redetermination of the origin, tariff classification or VFD made by the CBSA, an importer may request a redetermination or further redetermination of origin, tariff classification or VFD under the Customs Act.

Administration and enforcement

Examinations and verifications

Importers are required to demonstrate that the goods are not subject to the SLITA and that the importation is not prohibited. They must also provide supporting required documents when an exemption applies.

Importations may be subject to examination at the time of import and to post-release verification for compliance with the origin, tariff classification, VFD, marking programs, and any other applicable programs or provisions administered by the CBSA. If the CBSA encounters noncompliance, in addition to assessments of any applicable duties and taxes, penalties may be imposed and interest will be assessed, where applicable.

Actions for business

The CBSA published Memorandum D18-4-1 to eliminate ambiguity around how SLITA will be enforced effective 1 September 2022. The move to impose a luxury tax on most recreational vehicles, aircraft and vessels of a certain threshold may become a deterrent to importers of subject items, or it may encourage the increased manufacturing of luxury items within Canada, which in turn will foster local production and the export of luxury items.

It is paramount that manufacturers, wholesalers, retailers and importers of subject items assess and monitor their product offerings and pricing to ascertain where they stand within the scope of the luxury tax regime and the relevant price thresholds. Importers of both commercial and casual goods subject to SLITA may find themselves vulnerable to different circumstances of noncompliance and penalties unless well-advised on new legislation. ■

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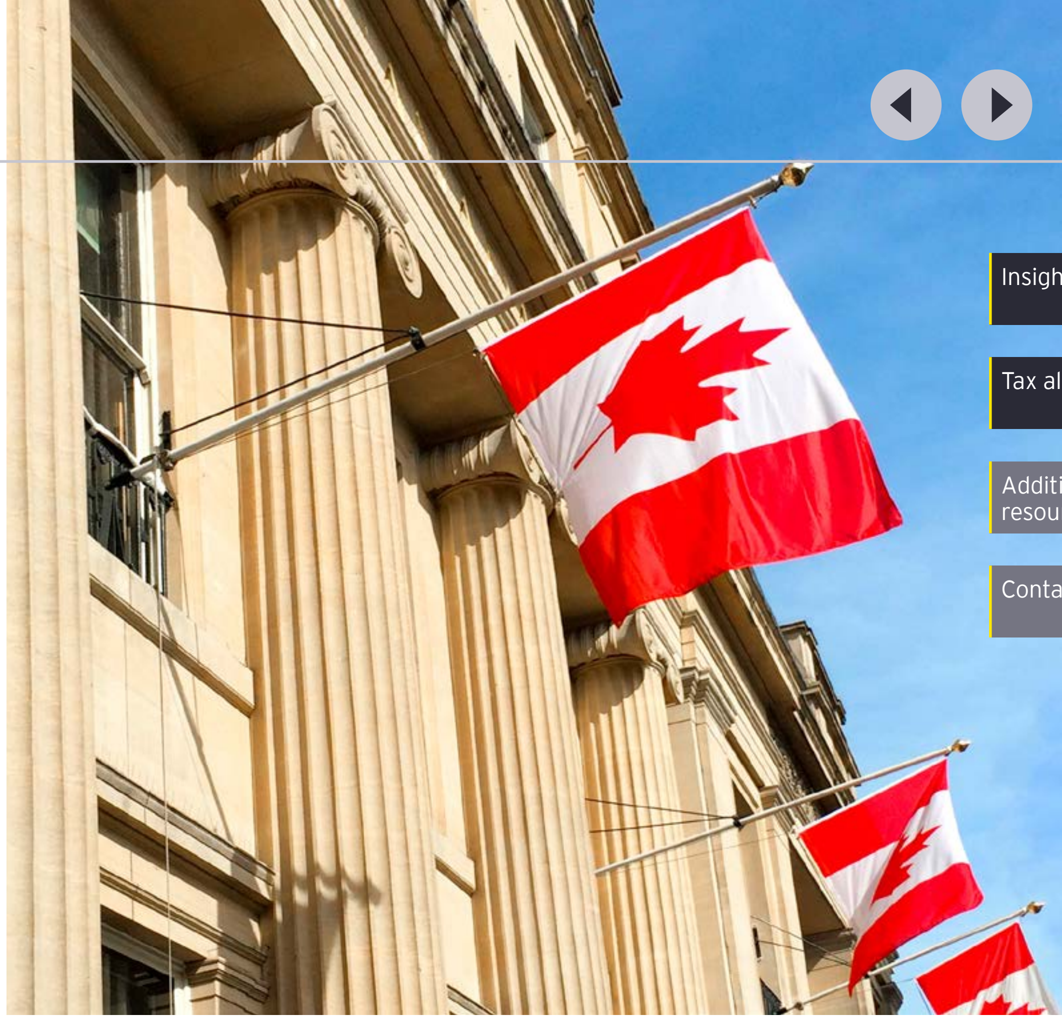
Canada: Proposes new reporting obligations on modern slavery in supply chains in 2024



Countries around the world are becoming more aware of the need to enact measures to combat modern slavery, both in domestic and international supply chains. The Canadian government is implementing legislation to combat the use of forced labor and child labor in Canadian supply chains. In this article, we consider some recent developments and the reporting obligations that these measures may place on Canadian importers.

Bill S-211

Bill S-211: *An Act to enact the Fighting Against Forced Labour and Child Labour in Supply Chains Act and to amend the Customs Tariff*[1] will impose mandatory annual reporting obligations on government institutions and certain private entities that produce or import goods into Canada. Assuming the bill receives Royal Assent in 2023, covered entities will be subject to the reporting requirements of the bill potentially as early as 1 January 2024; subject entities should begin mapping possible exposure in their supply chains sooner rather than later. Persons or entities that fail to comply with the reporting obligations of the act may be charged with a summary conviction and be liable to a fine not exceeding CAD250,000.

Background

In 2018, the House of Commons Subcommittee on International Human Rights of the Standing Committee on Foreign Affairs and International Development (SDIR) issued a report recommending that Canadian businesses increase their capacity to monitor their supply chains and that greater incentives should be created to eliminate forced labor and child labor from supply chains.[2]

1 "Bill S-211: An Act to enact the Fighting Against Forced Labour and Child Labour in Supply Chains Act and to amend the Customs Tariff," *Parliament of Canada website*, 22 November 2021. Find it here

2 "A Call to Action: Ending the Use of All Forms of Child Labour in Supply Chains," *House of Commons Canada*, October 2018. Find it here

Insights
Tax alerts
Additional resources
Contacts

The federal government broadly agreed with the SDIR's report and has since launched several initiatives that aim to promote responsible business practices, including with respect to forced labor and child labor in supply chains. Since the release of the SDIR report, three bills were introduced into Parliament to implement the SDIR's recommendations relating to business supply chains and forced labor and child labor:

- Bill C 423, *An Act respecting the fight against certain forms of modern slavery through the imposition of certain measures and amending the Customs Tariff*[3] was introduced as a private member's bill in the House of Commons on 13 December 2018. Bill C 423 would have created an obligation for certain entities to report on measures taken to address forced labor and child labor in their supply chains. It would also have amended the Customs Tariff to prohibit the importation of goods manufactured or produced through forced labor or child labor.
- Bill S 211: *An Act to enact the Modern Slavery Act and to amend the Customs Tariff*[4] was introduced as a Senate public bill and received first reading on 5 February 2020; it was substantially similar to the previous Bill C 423.
- Bill S 216: *An Act to enact the Modern Slavery Act and to amend the Customs Tariff*[5] was introduced as a Senate bill on 29 October 2020. Although similar to the previous two bills, it added a requirement that the Minister of Public Safety and Emergency Preparedness maintain an electronic registry of reports. It also contained somewhat broader definitions of child labor and forced labor to ensure that those terms would include child labor and forced labor as defined in the Worst Forms of Child Labor Convention 1999[6] and in the Forced Labor Convention 1930, respectively.[7]

All three bills died on the Order Paper before their third reading, and none were considered in Committee. Therefore, none of them was enacted as law.

The current Bill S-211 is similar to Bill S-216, with the added reporting obligation for government institutions. Bill S-211 was introduced in the Canadian Senate (the Upper House of the Canadian Parliament) in 2021. The bill passed all three required readings in the Senate on 28 April 2022.

As of January 2023, the bill has passed a second reading in the House of Commons (the Lower House of Parliament) and is currently at the report stage. Bill S-211 will need to pass a third reading in the House of Commons before it can receive Royal Assent and enter into force. According to section 28 of the bill, the provisions of the bill come into force on 1 January of the year following the year in which it receives Royal Assent (therefore, 1 January 2024, if it receives Royal Assent in 2023).

Reporting requirements for nongovernment institutions

Part 2 of Bill S 211 requires entities that produce, sell or distribute goods, or import goods into Canada, and that meet certain threshold requirements, to submit a report to the federal government.

An "entity" is defined as a corporation, trust, partnership or other unincorporated organization that:[8]

- Is listed on a stock exchange in Canada
- Has a place of business in Canada, does business in Canada or has assets in Canada and that, based on its consolidated financial statements, meets at least two of the following conditions for at least one of its two most recent financial years:

  (i) It has at least CAD20 million in assets.

  (ii) It has generated at least CAD40 million in revenue.

  (iii) It employs an average of at least 250 employees.
- Is prescribed by regulations

3 "Bill C-423: An Act respecting the fight against certain forms of modern slavery through the imposition of certain measures and amending the Customs Tariff," *Parliament of Canada website*, 13 December 2018. Find it here

4 "Bill S-211: An Act to enact the Fighting Against Forced Labour and Child Labour in Supply Chains Act and to amend the Customs Tariff," *Parliament of Canada website*. Find it here

5 "Bill S-216: An Act to enact the Modern Slavery Act and to amend the Customs Tariff," *Parliament of Canada website*. Find it here

6 "Worst Forms of Child Labour Convention, 1999 (No. 182)," *United Nations website*. Find it here

7 "Forced Labour Convention, 1930 (No. 29)," *United Nations website*. Find it here

8 Bill S-211, Section 2.

Entities that meet the above definition must submit an annual report on or before 31 May of each year to the federal government.

The report must outline the steps, if any, that the entity has taken in the previous fiscal year to prevent and reduce the risk of forced labor or child labor being used at any step of the production of goods by the entity or of goods imported into Canada by the entity.[9] If the entity is incorporated under the Canada Business Corporations Act[10] or any other act of Parliament, the entity must provide the report, including any revised reports, to each shareholder along with its annual financial statements.[11]

The report must include the following information in respect of each entity[12]:

- Its structure, activities and supply chains
- Its policies and its due diligence processes in relation to forced labor and child labor
- The parts of its business and supply chains that carry a risk of forced labor or child labor being used and the steps it has taken to assess and manage that risk
- Any measures taken to remediate any forced labor or child labor
- Any measures taken to remediate the loss of income to the most vulnerable families that results from any measure taken to eliminate the use of forced labor or child labor in its activities and supply chains
- The training provided to employees on forced labor and child labor
- How the entity assesses its effectiveness in ensuring that forced labor and child labor are not being used in its business and supply chains

The report must be approved by the entity's governing body. In the case of a joint report, either the governing body of each entity included in the report must provide approval or approval must be given by the governing body of the entity that controls each entity included in the report.

Penalties

Under section 19 of Bill S-211, every person or entity that:

- Fails to submit a report
- Fails to make the report publicly available after submitting it to the government
- Fails to comply with an order made by the Minister to take measures considered necessary to ensure compliance with submitting a report and/or making the report publicly available
- Obstructs or hinders a verification of compliance by the government

9 Bill S-211, Subsection 11(1).
10 "Canada Business Corporations Act," Canadian Government website. Find it here
11 Bill S-211, Subsection 13(2).
12 Bill S-211, Subsection 11(3)

Insights

Tax alerts

Additional resources

Contacts

may be guilty of an offense punishable on summary conviction and liable to a maximum fine of CAD250,000.

If a person or an entity commits an offense, any director, officer, agent or mandatary of the person or entity who directed, authorized, assented to, acquiesced in or participated in the commission of the offense is a party to and guilty of the offense and is liable on conviction to the punishment provided for the offense, whether the person or entity has been prosecuted or convicted.

In a prosecution for an offense under subsection 19(1), it is sufficient proof of the offense to establish that it was committed by an employee, agent or mandatary of the accused, whether the employee, agent or mandatary is identified or has been prosecuted for the offense or not, unless the accused establishes that they exercised due diligence to prevent its commission.

Actions for businesses

Although the potential entry into force of Bill S-211 is no earlier than 1 January 2024, the reporting requirements of the bill are significant, so businesses are encouraged to become familiar with the contents of Bill S-211 to get a head start and begin planning the format and drafting of their reports. It is important to note that as the bill is still at the report stage, there is a possibility that the existing provisions of the bill may be amended with more stringent requirements before it receives Royal Assent.

Furthermore, there is a wider push at the federal level to combat forced labor and child labor. As of 1 July 2020, in line with the ratification of the US-Mexico-Canada Agreement (USMCA), the Customs Tariff was amended to add a provision to Chapter 98 of the Schedule to the Customs Tariff prohibiting entry into Canada of goods that are mined, manufactured or produced wholly or in part by prison labor or forced labor.[13] In addition, two other bills were deposed in Parliament that passed first reading in early 2022 that address issues similar to Bill S-211:

- Bill C-262, *An Act respecting the corporate responsibility to prevent, address and remedy adverse impacts on human rights occurring in relation to business activities conducted abroad*[14]
  - The purpose of this bill is to prevent, address and remedy the adverse impacts on human rights that occur in relation to business activities conducted by entities abroad.
  - The bill imposes on subject entities a duty to prevent adverse impacts on human rights occurring outside Canada and a requirement to develop and implement due diligence procedures in respect of its activities, affiliates and business relationships.
- Bill C-243, *An Act respecting the elimination of the use of forced labour and child labour in supply chains*[15]
  - The purpose of this bill is to implement Canada's international commitment to contribute to the fight against the use of forced labor and child labor in supply chains through the imposition of reporting obligations on entities involved in the production of goods in Canada or elsewhere or in the importation of goods produced outside Canada.
  - This bill's reporting requirements and other provisions are similar to S-211. In mid-2022, the bill's status was officially pending and is not being considered in the current parliamentary session, but it may be reinstated in the next parliamentary session, should Bill S-211 fail to be enacted.[16]

These legislative initiatives make it clear that the Canadian government is (1) investing in combating the use of forced labor and child labor in Canadian supply chains and (2) responding to growing pressure from consumers and the general public, who are increasingly involved in and aware of human rights issues in the global supply chain. It appears the Canadian government is aiming to align with other jurisdictions in its efforts at tackling human rights issues and environmental, social and governance (ESG) and corporate social responsibility (CSR) matters more broadly, especially with respect to the US,[17] where ESG and CSR regimes have developed significantly in recent years.

13 Tariff item No. 9897.00.00 of the Customs Tariff.

14 "Bill C-262: *An Act respecting the corporate responsibility to prevent, address and remedy adverse impacts on human rights occurring in relation to business activities conducted abroad*," *Parliament of Canada website*. Find it here

15 "Bill C-243: *An Act respecting the elimination of the use of forced labour and child labour in supply chains*," *Parliament of Canada website*. Find it here

16 "Similarities Between Bill C-243 and Bill S-211," House of Commons Debates, Official Report (Hansard), 6 June 2022. Read it here

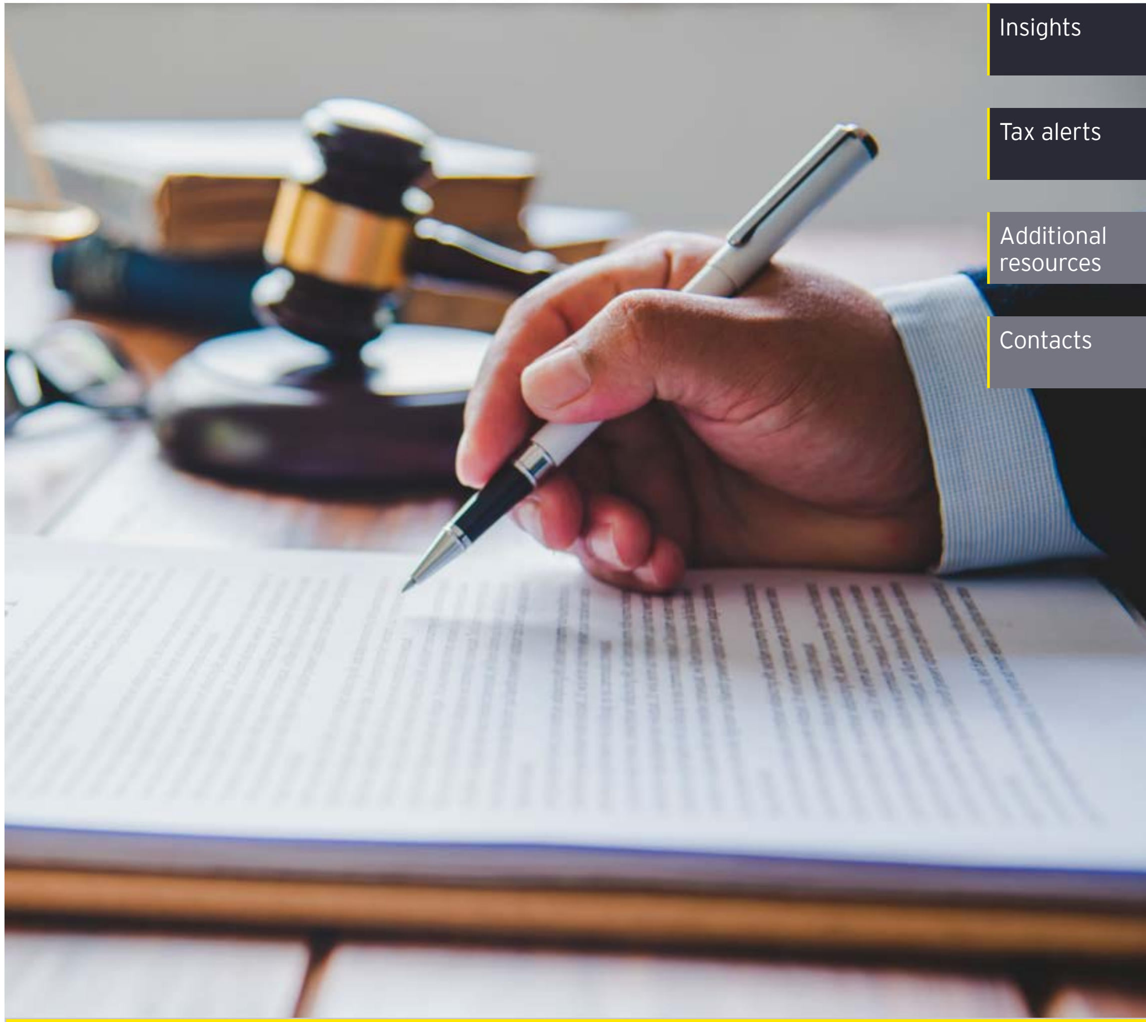
17 Further information is provided in our article "US: Uyghur Forced Labor Prevention Act goes into force," TradeWatch Issue 3 2022, page 31, *EY website*. Find it here

While the trend to date is for Canada and the US to separately implement ESG and CSR compliance regimes as opposed to a harmonized bilateral approach, there is enough of a crossover in compliance requirements that would warrant businesses with US-Canada cross-border operations to address forced labor and child labor reporting and other ESG and CSR compliance requirements from a regional perspective, while tracking changes to the compliance or regulatory environment within each jurisdiction.

Going forward, it will be imperative for the supply chain and customs functions of a business to work together with other internal stakeholders not only to comply with reporting requirements but to also plan for and assess the potential financial impacts of any supply chain or sourcing restructuring that may be necessary to comply with legislation or to reduce reputational risk among consumers. The reputational risks are too material and complex to be dealt with by the supply chain function alone and will require close coordination with legal, corporate affairs, procurement and customs functions.

One approach includes the following actions:

- Adopt a North American or regional approach to compliance with forced labor and child labor reporting and compliance issues.
- Identify individuals within the business who should form part of a working group or committee to be responsible for reporting and compliance for this topic.
- Prior to the entry into force of the reporting requirements, conduct a current state assessment and document the processes and information gaps for meeting reporting requirements that may exist, along with an action plan to address the gaps.
- Implement issue escalation procedures.
- Determine whether partnering with an external advisor is needed and what role external service providers may play in the company's compliance program. ■



Insights
Tax alerts
Additional resources
Contacts

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Colombia: Government increases customs tariff for apparel and footwear imports

Since Colombia has signed more free trade agreements (FTAs)[1], Colombian companies have been able to trade their products on a larger scale. However, the industrial development of each country in the region differs, and this may cause domestic production in certain sectors to be adversely affected by trade agreements. In the case of Colombia, the apparel and footwear industries had not developed technical and operational capacity, which prevented local producers from competing on an equal footing with foreign producers of these items. This created unemployment and economic instability in the country as well as a lack of innovation and competitiveness in this important sector.

The decrees

At the end of 2022, the Colombian government issued two decrees increasing the customs tariff for imports of apparel and footwear:

- Decree 2598 was issued on 23 December 2022. In this decree, the government partially amended Decree 1881 of 2021 (the National Customs Tariff Code) to establish a 40% ad valorem tariff on imports of any products with most-favored-nation origin for products classified in Chapters 61 and 62 of the National Customs Tariff Code. Chapter 61 contains knitted garments and accessories, while Chapter 62 contains garments and accessories made from flat fabrics. These tariffs will not apply to imports of goods that are shipped to Colombia, nor will they modify any special and differential treatment program in force in Colombia.

1 For further information, please refer to 'Colombia: Examining the impact of tax reform on free trade zones' on page 19 of this publication.

- Decree 2632 was issued on 30 December 2022. In this decree, the government extended Decree 2279 from 2019, which established a 35% ad valorem tariff on imports of footwear whose declared free-on-board (FOB) value is less than or equal to the threshold determined in the following table.

Customs heading	Threshold USD/ pair of shoes
6401	6
6402	6
6403	10
6404	6
6405	7

Regulatory background

Since 2013, the government has issued decrees aimed at increasing the customs tariff for imports of apparel and footwear. It issued decrees that established compound tariffs that sought to counteract unfair trade competition practices and prevent the importation of apparel and footwear at ostensibly low prices.

At the outset, the compound tariffs used could reach 80% of the customs value of the merchandise. However, the Colombian Tax Highest Court determined that to comply with the maximum tariff levels established in the General Agreement on Tariffs and Trade (GATT), only a tariff of 40% for apparel and 35% for footwear could be established. Therefore, the last decrees have gone from having compound tariffs to having ad valorem tariffs of 40% and 35%.

Although, in principle, these measures seek to protect, promote and develop the national industry, it may be that at the end of the exercise, the final consumer will see the consequences in the increase of prices for the acquisition of such products, since the importer will have to assume an additional value in the import of its merchandise. In addition, other countries may take actions in connection with the measures, claiming them to be a possible breach of Colombia's commitments before the World Trade Organization (WTO).

FTAs

The regulations establish that the tariff will not affect the special and differential treatment programs in force in Colombia, which means that the benefits of the FTAs that Colombia has signed with different countries in the region, such as Mexico and Peru, will be maintained.

The tariff increases for imported apparel and footwear may increase the level of inflation, if the prices in such an important sector of the economy rise. If so, this could also lead to an increase in smuggling of these items.

However, the decrees may also present an opportunity for Colombian importers operating in this sector to restructure their apparel and footwear import operations, such as by switching to importing these goods from countries that Colombia has FTAs with (e.g., Mexico and Peru). This could, therefore, also be an opportunity for countries in the region to increase their operations with Colombia in the apparel and footwear trade.

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Insights
Tax alerts
Additional resources
Contacts

Colombia: Examining the impact of tax reform on free trade zones

On 13 December 2022, Colombia's tax reform law was sanctioned by the President of the Republic, after approval from the Chamber of Representatives. This approval introduces significant changes for free trade zones in Colombia.

Importance of free trade zones in Colombia

Five decades ago, when the free trade zones were created in Colombia, they were established as a national public establishment intended to speed, simplify and facilitate international trade, with special emphasis on the export of products to the international market. However, due to the country's commitments to the World Trade Organization (WTO) to dismantle all subsidies aimed at increasing exports, it was necessary to amend Law 109 of 1985 with Law 1004 of 2005, which is the current basis of the free trade zone regime.

Law 1004 said companies in free trade zones were no longer compelled to export all of their products and that instead their goods could be sold into the domestic market without limits. In addition, free trade zones stopped being public sector establishments and started to be administered and used by the private sector, allowing new companies to access these benefits, through formal requests.

Free trade zones are geographical areas defined within the national territory where industrial activities of goods and services or commercial activities are developed under special tax, customs and foreign trade regulations. The goods that enter these zones are considered to be outside the national customs territory for import and export purposes.[1] In addition to generating better, more productive supply chains, free trade zones in Colombia have fulfilled the purpose for which they were created,[2] that is they have:

1. Become a key mechanism for attracting foreign investment and for generating employment.
2. Promoted competitiveness in the regions where they are established, allowing the companies located in them to strengthen their trade activity, which has encouraged economies of scale.

1 Article 1 of Law 1004 of 2005.
2 Article 2 of Law 1004 of 2005

3. Promoted the improvement of highly productive industrial processes, with safety, transparency, technology, clean production and good business practices.

The free trade zone regime today

Although the free trade zone regime is a very significant mechanism for international trade in Colombia, it is important to highlight that for a company to enter into a free trade zone and be "qualified" as a user of it, it must comply with certain commitments in terms of investment and employment depending on the type of zone it wishes to trade in, as follows:

Permanent free trade zones

Permanent free trade zones are industrial parks built in a defined area of Colombia in which multiple industrial or commercial users are settled. Investment commitments for new users (either industrial or commercial) range between USD0 and USD1.9 million, depending on the value of the real productive fixed assets (known locally as AFRP)[3] that they acquire upon arrival in the free trade zone and during the first year.

Likewise, employment commitments range between creating seven to 50 new jobs, depending on the corresponding investment amounts.

Special permanent free zones

The term *special permanent free zone* refers to a single company (industrial user) located in a defined area of Colombia declared as a free trade zone.

- The investment requirement for special permanent free trade zones for goods is an amount equal to or greater than USD25 million within the first three years following the declaration of the existence of the free trade zone and a commitment to create 150 new direct jobs.
- For special permanent free trade zones for services, the investment within the first three years, the investment and employment requirements range between USD1.7 million and USD16.3 million and the creation of at least 150 new direct jobs.

In exchange for these commitments in terms of investment and job creation, the free trade zones have access to important benefits, such as:

- The nonpayment of customs duties (tariffs) and value-added tax (VAT) on the introduction of goods from the rest of the world into the free trade zone while they remain in the free trade zone
- Sales between industrial users exempt from VAT, in addition to a VAT exemption for raw materials, parts, supplies and equipment acquired from the national customs territory of Colombia that are necessary for the development of an industrial user's corporate purposes
- Corporate income tax at a preferential rate of 20% (not applicable to commercial users), compared to 35% for the rest of the companies in the national customs territory

What is changing with the tax reform?

During the tax reform approval process, the national government seemed to be considering ending the benefits of the free trade zones by imposing requirements that, if not met, would result in the regime ending for many companies. However, after several debates, an intermediate compromise was reached whereby a mixed taxation regime would be created depending on the destination of the sales.

According to article 11 of Law 2277 of 2022, which adopts the new tax reform, the corporate income tax rate for exports from the free trade zone will be 20%, while the tax rate for sales to the national customs territory will be 35% from the year 2024.

To access this mixed taxation regime, between 2023 and 2024, companies located in free trade zones must submit an internationalization and annual sales plan with the Ministry of Industry, Commerce and Tourism, which must contain a maximum net income goal from sales in the national customs territory. If a business does not submit the plan or does not comply with the maximum income objectives, the corporate income tax rate applicable will be the general rate (35%).

3 In Colombia, *real productive fixed asset* is a term incorporated by the Customs and Tax Administration into the national law to classify tangible fixed assets that are acquired to be part of the taxpayer's assets and that are used directly and permanently within the income-producing activity for the provision of goods and/or services and are subject to depreciation or amortization for tax purposes.

Insights
Tax alerts
Additional resources
Contacts

Some users will continue with the preferential tax rate of 20% until tax year 2025. This applies only to offshore free trade zones, industrial users of permanent special free trade zones of port services, industrial users of port services of a free trade zone, industrial users engaged in the refining of petroleum fuels or refining of industrial biofuels, users of services that provide logistics services, and operators and users who have had a growth in gross income of 60% in the year 2022 in relation to the year 2019.

What's next?

These changes present new challenges for the free trade zone regime in Colombia.

- Companies will be subject to an internationalization and sales plan established by the Ministry of Industry, Commerce and Tourism. This plan must be submitted and accepted before the end of 2024 for the company to be able to access the preferential corporate income tax rate. The process of creating this plan requires preparation, guidance and time, and may include adjustments to the business model when exporting to new markets.
- Companies that have benefitted from the free trade zone regime that cannot comply with these new rules in the future (e.g., because their focus is the domestic market) will need to change their business model with a new corporate income tax rate. Given the potential impact, we understand that some companies may consider challenging these changes as unconstitutional, and in this regard, some are filing lawsuits, arguing the provisions violate different constitutional principles, such as legality, investment protection, legal certainty and legitimate trust.
- In addition, it could be argued that these new conditions should not be aimed against some sectors that will be impacted by removing the preferential rate of 20% because the measures discriminate against activities that play a fundamental role in the economic and social development of the country, such as services provided by Business Processing Outsourcings (BPOs), data centers, tourism and health services. The exclusion of these activities from the legislation could trigger concerns for foreign investors in Colombia.

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US: WTO rules against the US in cases involving Section 232 tariffs, China origin-marking

In December 2022, the US lost two major trade disputes at the World Trade Organization (WTO). On 9 December 2022, the WTO ruled the US violated global trade rules when it imposed punitive tariffs on imports of steel and aluminum in the interest of national security. Separately, on 21 December 2022, the WTO found the US violated its obligations in requiring that imported goods produced in the Hong Kong Special Administrative Region (SAR) of China be marked to indicate their origin is China. Because the WTO Appellate Body does not have the requisite number of adjudicators to hear cases, the US' appeals will go unheard. Thus, affected businesses should be prepared to await the outcome.

In March 2018, the US levied additional duties of 25% ad valorem on steel imports and additional duties of 10% ad valorem on aluminum imports under the authority of Section 232 of the Trade Expansion Act of 1962 (Section 232).[1] Section 232 gives the US president broad authority to impose tariffs based on an affirmative declaration by the Secretary of Commerce that the targeted imports threaten to impair national security.[2] Section 232 further authorizes the president to take action as necessary to adjust the targeted imports so that they will not threaten to impair national security.[3]

Further, under the United States-Hong Kong Policy Act of 1992, Congress granted Hong Kong SAR differential treatment from mainland China in certain customs, immigration and trade matters, including country of origin marking.[4] This treatment was on the condition that China allowed Hong Kong SAR to exercise a high degree of political and economic autonomy. In June 2020, however, the US declared its opinion that the Hong Kong SAR was no longer sufficiently autonomous from mainland China and should no longer be considered a distinct foreign state. This led to a US Customs and Border Protection (CBP) notice that imported goods produced in Hong Kong SAR should no longer be

1 See Proclamation No. 9705, 83 Fed. Reg. 11,625 (8 March 2018); Proclamation No. 9704, 83 Fed. Reg. 11,619 (8 March 2018).
2 19 U.S.C. § 1862.
3 Ibid.
4 22 U.S.C. § 5701-5732.

marked to indicate Hong Kong SAR as their origin but must be marked to indicate China.[5]

The US has defended both the Section 232 tariffs and the China origin-marking requirement at the WTO by invoking Article XXI(b) of the General Agreement on Tariffs and Trade (GATT) 1994.[6] Under Article XXI(b), a member may take action it considers necessary to protect its essential security interests "in time of war or other emergency in international relations." Such measures taken for the purpose of protecting essential security interests have historically been understood to be self-judging and, therefore, non-justiciable by a WTO panel. In other words, the invoking member should decide what it considers necessary to protect its essential security interests. Several WTO members, most notably the US, have maintained the position that Article XXI(b) is self-judging.

WTO dispute settlement panels issued four separate reports against the Section 232 tariffs (*United States – Certain Measures on Steel and Aluminum Products*),[7] concluding the Section 232 tariffs were not "taken in time of war or other emergency in international relations."

In its WTO action against the US (*United States – Origin Marking Requirement*), Hong Kong SAR challenged the consistency of the CBP origin-marking requirement under most-favored-nation obligations enshrined in the GATT 1994 and the Technical Barriers to Trade Agreement.[8] As with Section 232, the US once again invoked the national security exception in Article XXI(b), arguing that the labeling rule was based on determinations implicating US essential security interests relating to democracy and human rights. The dispute settlement panel reviewing the case acknowledged that tensions had risen between the US and Hong Kong SAR but said these had not escalated to an emergency in international relations.

The US has articulated its position that the WTO's legal conclusions are fundamentally flawed[9] and has formally notified the Chairperson of the WTO's Dispute Settlement Body of the US decision to appeal both the *US – Certain Measures on Steel and Aluminium Products* and the *United States – Origin Marking Requirement* reports.

Implications for businesses

The appeal by the US likely means that the WTO rulings will not have any practical effects on businesses, at least for the foreseeable future. As discussed in *TradeWatch* Issue 1 2020 in the article "WTO's Appellate Body disbands,"[10] the WTO Appellate Body has not had the requisite number of judges since the end of 2019. Without a functional Appellate Body to hear and adjudicate cases, the country ruled against in a trade dispute can bypass a panel's decision simply by filing an appeal. In that case, it is possible that an appeal will be significantly delayed, preventing WTO members from adopting the panel reports.

Without adoption of the panel reports, businesses impacted by the Section 232 steel and aluminum punitive tariffs should continue to monitor developments and consider actions that provide alternatives for mitigating the overall impact, such as shifting supply sources and/or manufacturing locations to benefit from reduced tariffs from certain countries, utilizing origin or valuation planning, and various duty deferral regimes.

Similarly, businesses impacted by the China marking rule are encouraged to undertake non-preferential origin reviews (i.e., substantial transformation) to ensure that goods are properly marked. Affected businesses should also ensure supply chain partners can accommodate the conflicting responsibility between origin marking and origin reporting/duty payment for goods imported from Hong Kong SAR. ■

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5 See 85 Fed. Reg. 48551 (11 August 2020). Find it here

6 General Agreement on Tariffs and Trade, Art. XXI(b) (1994). Find it here

7 "United States – Certain Measures on Steel and Aluminium Products," WTO Doc. WT/DS544/R (adopted 9 December 2022). Find it here

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"United States – Certain Measures on Steel and Aluminium Products," WTO Doc. WT/DS556/R (adopted 9 December 2022). Find it here

8 "United States – Origin Marking Requirement," WTO Doc. WT/DS597/R (adopted 21 December 2022). Find it here

9 Statements by the US at the Meeting of the WTO Dispute Settlement Body (27 January 2023). Find it here

10 "WTO's Appellate Body disbands," in *TradeWatch*, Issue 1, 2020, page 12, *EY website*. Find it here

Americas

Brazil

- Brazil modifies taxation of fuels and crude oil
  (07 March 2023)
- Brazil's new transfer pricing rules and their impact on customs valuation
  (10 January 2023)

Canada

- Yukon issues budget
  (13 March 2023)
- Alberta issues budget 2023/24
  (08 March 2023)
- British Columbia issues budget 2023/24
  (08 March 2023)
- Nunavut issues budget 2023/24
  (28 February 2023)
- Northwest Territories issue budget 2023/24
  (21 February 2023)

Costa Rica

- Council of Ministers of Economic Integration of Central America establishes US$3 charge for each DUCA-F transmitted through the SIECA platforms
  (22 March 2023)
- Costa Rican Customs Authorities communicate end of temporary relief for maritime freight costs
  (16 March 2023)
- Costa Rican General Customs Directorate issues procedures for scanning of containers and goods at entry into the country
  (09 March 2023)
- Costa Rican Customs Authorities adjust Customs Information System (TICA) to eliminate 10% tax on imported beers
  (09 March 2023)
- Costa Rican Tax Authority modifies requirements for transportation services of goods destined for export to qualify for VAT exemption
  (07 March 2023)
- Costa Rica´s President signs law that eliminates 10% tax on imported beer
  (20 February 2023)

Dominican Republic

- Dominican Republic's Executive Branch publishes General Regulations to new Customs Law
  (30 January 2023)

El Salvador

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  (22 March 2023)

Global

- Global Tax Policy and Controversy Watch
  (20 January 2023)

Guatemala

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  (22 March 2023)

Honduras

- Council of Ministers of Economic Integration of Central America establishes US$3 charge for each DUCA-F transmitted through the SIECA platforms
  (22 March 2023)
- Honduran Government to file new tax reform before the National Congress
  (22 March 2023)

Nicaragua

- Council of Ministers of Economic Integration of Central America establishes US$3 charge for each DUCA-F transmitted through the SIECA platforms
  (22 March 2023)

Panama

- Council of Ministers of Economic Integration of Central America establishes US$3 charge for each DUCA-F transmitted through the SIECA platforms
  (22 March 2023)
- Panama's Ministry of Economy and Finance extends term for implementation of electronic invoicing system
  (01 February 2023)

United States

- Colorado's new plastic bag fee, effective January 1, 2023, creates new compliance obligations and issues
  (10 January 2023)

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Insights
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Insights

Tax alerts

Additional resources

Contacts

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