How SOX and C-TPAT Impact Global Supply Chain Security

By Mitch McGhee and
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In a letter from the AFL-CIO to Wal-Mart's accounting firm Ernst & Young, LLP, the AFL-CIO raised concerns regarding Wal-Mart's internal financial controls over inventory moving through its international supply chain and regarding its security controls of shipping containers carrying its inventory. "Consequently, we believe Wal-Mart's assessment of its internal controls must include an assessment of whether or not there are adequate controls in place affecting its supply chain and the supply chain's relationship to Wal-Mart's financial statements in the areas of inventory and contingent liabilities," wrote Richard L. Trumka, secretary-treasurer of the AFL-CIO.

Why is the AFL-CIO concerned about financial statements and security of companies like Wal-Mart? The international supply chain has always contained subtle complexities driven by market demands and creative corporate financial reporting. But since the attacks of 9/11 and the corporate scandals like Enron, Global Crossing, and WorldCom beginning in that same infamous year of 2001, the international supply chain has taken on new meaning. No longer can publicly traded firms use inventory to manipulate and distort income reporting and, ultimately, the income statement and balance sheet used to reflect a firm's financial condition.

Two federal actions have changed the business world and the international supply chain from a market-dominated and -oriented activity to a rules-driven activity: the Sarbanes-Oxley Act of 2002 (SOX) and the Customs and Border Protection (CBP) program, Customs Trade Partnership Against Terrorism (C-TPAT). SOX alone has changed the face of corporate governance and corporate responsibility by making the CEO and CFO as signing officers personally responsible for establishing and maintaining internal controls embodied in rules, documentation, and disclosures. SOX is applicable to both U.S. and non-U.S. firms publicly registered and traded in the United States. C-TPAT is a voluntary partnership between CBP and industry and involves most of the biggest importers in the U.S. While each is different, they are connected.

In this article we'll look at the impact of SOX and C-TPAT on the international supply chain. Specifically, we'll focus on the need to tighten control over international sales activities and inventory to prevent the disclosure of a more favorable than accurate financial picture in reporting to stockholders and potential investors while, at the same time, diminishing the appearance of risk and security liability inherent in the international supply chain. Inventory control and title transfer, in particular, are vital to accurate financial reporting and critical to the security of the United States. Now it's the duty of the CEO and CFO to be responsible for both.

OWNERSHIP AND TITLE

Inventory alone can be used to manipulate and distort a company's financial picture. In general, a sale is defined as the exchange of ownership for a price. Therefore, if there's no transfer of ownership, there's no sale. The problem in international business, given the distances and options available to buyer and seller, involves the locus of exchange. For instance,

- Does a U.S. importer take ownership of the goods in the foreign nation, aboard the vessel en route, when the goods are discharged from the vessel, or when they reach the company's warehouse in the U.S.?
- If it is someone else's merchandise until it reaches the U.S. destination, who has the security risk and liability?
- Where does the merchandise become the buyer's inventory?
- Are assets determined at the time of the sale or on taking custody?
- How are these inventories reported?

Two legal sources have been used in the U.S. to explain the legality of transferring title: the *Uniform Commercial Code* (UCC) and the *United Nations Convention on Contracts for the International Sale of Goods* (CISG). Both relegate the passing of title as a component of contract law.

1. The Uniform Commercial Code

The passing of title is a matter of contract law. In general, title passes as intended by the buyer and seller, but under the UCC there are four accepted rules to use in determining when title changes from the seller to the buyer:

1. No title can transfer unless the goods are first identified in the contract providing an insurable interest in them by both the buyer and seller. Title transfers upon the agreement of the seller and buyer.

2. Unless the buyer and seller explicitly agree otherwise, title passes at the time and location where the seller completes its obligation for physical delivery of the goods to the buyer. In this case of title transfer at physical delivery, the time and place of the transfer of an actual document of title is preempted by physical delivery of the identified goods. Additionally, if the seller is required by contract to send the goods to the buyer but not to the destination, the title passes at the actual time and place of shipment. Finally, if the contract requires delivery at destination, title passes at the destination.

3. If delivery is made without moving the goods, title transfers at a time and place the document of title is delivered, or if the goods are already identified at the time of contract and no documents are to be delivered, title passes at the time of contracting.

4. A refusal to accept or keep the goods reinvests the title of the goods in the seller.

Therefore, according to the UCC, the passage of title of contractually identified goods passes from seller to buyer at a time and place specifically agreed upon by them, at the time of physical delivery of the goods at shipment or destination, at the time of physical delivery of the documents of title (normally a warehouse receipt or bill of lading) or time of contracting, or, finally, if the goods are rejected, title is reinvested in the seller.

One final word about the UCC: In 2004, the American Law Institute (ALI) and the National Conference of Commissioners on Uniform State Laws (NCCUSL) deleted the "shipping and delivery" terms contained in the UCC and replaced them with Incoterms 2000, which await approval by each state's legislature. The future, then, will see the inevitable use of Incoterms, which are the current international commercial terms that are published in *Incoterms 2000*. Each term defines the place of delivery and the obligations of the buyer with respect to costs and risks, but *Incoterms 2000* clearly cautions the buyer and seller that the Incoterms do *not* deal specifically with title—they deal only with delivery, risks, and costs.

2. United Nations Convention on Contracts for the International Sale of Goods

The CISG treats the transactional aspect of a contract and not property aspects. There are no articles within the Convention that specifically treat the passing of title. Instead it treats the elements of title transfer contained in the UCC and more, specifically delivery of goods and handing over documents (Articles 31, 53, 57, 60), payment and possession (Articles 59, 85), the right to reject the goods (Articles 39, 58, 86), and even the passing of risk (Articles 67, 68, 69). Of all the treatments of contractual components within the CISG, it appears that title relates directly to the international terms of sale used in the contract.

Both the UCC and the CISG contain too much vagueness and ambiguity to satisfy SOX. Under SOX, clear, consistently applied rules must establish ownership. According to SOX Section 103, the internal control structure and procedures:

"(aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer…"

So where does title transfer, and why does it matter? It matters because SOX and C-TPAT say it does but in different ways. With respect to SOX, simply look at the issue of tax and financial reporting. The U.S. tax code does treat the question of title transfer and taxation.

"For the purposes of Part I (Section 861 and following), Subchapter N, Chapter 1 of the Code, and the regulations thereunder, a sale of personal property is consummated at the time when, and the place where, the rights, title, and interest of the seller in the property are transferred to the buyer. Where bare legal title is retained by the seller, the sale shall be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss..." (IRC Sec. 1.861-7, Sale of personal property, as cited in *Tax Analysts,* February 2002, p. 1)

When two parties, one a domestic company and the other a foreign company, enter into a transaction, where title passes will normally determine where the income is sourced. Why should this be an issue to the parties involved? The answer is that it will determine under whose tax jurisdiction the income from the sale will fall. Other issues that come into play are whether it's personal or real property and, if personal property, whether it's purchased inventory or manufactured inventory. Real property is sourced based on its location, according to IRC Sections 861(a)(5) and 862(a)(5). The general rule for personal property is that the seller's residence determines the sourcing of the gain. Therefore, a U.S. resident selling personal property would generate U.S.-source income from the sale of personal property, and a nonresident would generate foreign-source income.

As is the case in many situations dealing with the tax code, there are exceptions to this rule. One of the exceptions deals with inventory and is divided into two categories: purchased and produced. IRC Section 865 contains the source rules for personal property sales, while IRC Sections 861, 862, and 863 deal with the sale of inventory property.

Purchased inventory provides the greatest opportunities to structure transactions to minimize the company's U.S. tax liability. This is because the income from the sale of purchased inventory is sourced in the country where the sale/passing of title takes place. Since this can be negotiated by the parties involved, it's within the control of the seller and buyer to determine where they would like the transaction to be subject to taxation first. Because the U.S. taxes its citizens and residents on worldwide income, there are mechanisms in place to reduce/eliminate double taxation. Foreign taxpayers aren't subject to U.S. taxation unless they have effectively connected income or U.S.-source income. "Effectively connected income," as defined by the *U.S. Master Tax Guide* from CCH, is that income that is directly linked to the conduct of a trade or business in the United States (Code Secs. 871(b) and 882(a)).

Let's now consider two scenarios.

Scenario 1

Let's assume that **Powers International, Inc.**, a U.S. company, has foreign-source income of $10,000,000, worldwide income of $30,000,000, and a U.S. tax liability on the foreign-source income of $3,500,000. But it also has foreign taxes of $2,500,000 that are eligible to be used as a credit against its U.S. tax liability. Powers International is negotiating a deal with the **Smith Group, Pty., Ltd.**, a South African firm, that would result in an additional $5,000,000 of income. If the sale is considered to be U.S.-source income, Powers International could owe an additional $1,750,000 to the U.S. Treasury, depending on the applicable tax provisions.

If the sale is considered to be foreign-source income, Powers International's U.S. tax liability could actually be reduced. If the taxes paid by Powers International on this sale exceeded $1,750,000, then worldwide tax liability would increase by $1,750,000, but the U.S. tax liability would decrease by the amount of the foreign tax exceeding $1,750,000. This assumes that the foreign tax on this transaction doesn't exceed $2,750,000. This amount was determined as follows: $3,500,000 U.S. tax liability on foreign-source income (this assumes a marginal U.S. tax rate of 35%) – $2,500,000 of foreign tax plus the U.S. tax liability on the additional income. This is due to the limitation imposed by the Foreign Tax Credit rules that limit the amount of the credit to the amount of U.S. tax liability on foreign-source income. In this situation, Powers International might want to have the sale be treated as foreign-source income.

Scenario 2

Let's assume that **Powers International, Inc.**, has no foreign-source income or foreign taxes that would be eligible for the Foreign Tax Credit and that it is at the 35% marginal tax rate. If Powers International has an opportunity to make a sale to **Smith Group, Pty., Ltd.**, the location of the sale as indicated by where title is transferred could determine the worldwide tax liability of Powers International. If the South African tax liability is 35% of the income or less, then worldwide tax liability would be the same whether the sale occurs in the U.S. or in a foreign location. But if the South African tax liability exceeds 35% of the income, then Powers International would have a worldwide tax liability that exceeds its U.S. tax liability for the current year as a result of the limitation placed on the amount allowed as a credit against U.S. taxes. In this situation, Powers International should prefer to have the sale occur in the U.S. to minimize worldwide tax liability.

In both scenarios, it's assumed that only the foreign taxes paid would be eligible for the foreign tax credit and that the additional income would be placed in the same "basket" for determining the eligible amount of foreign taxes. Depending upon a nation's tax code, the buyer and seller have options to minimize tax liability, but this option isn't without some restrictions.

Two important considerations directly influence a firm's tax strategy as it relates to title transfer. If the transaction is determined to be structured primarily for the purpose of tax avoidance, the IRS may deny the title-passage strategy, and the sourcing will be determined by other factors, such as where the negotiations took place, where the agreement was executed, location of the property, or how payment was made, according to IRC Reg. 1.861-7 (c). In order to show another motivation for selecting a particular point to transfer title, the security considerations mentioned earlier could be used to justify the transfer of title at a given location.

Personal property that any taxable entity produces doesn't qualify for the title-passage rule—it must be allocated between the country of manufacture and the country where the sales occur. Because of this requirement, there's less flexibility in sourcing the income to a particular country. But the portion of the income that isn't allocated to the country of production still can provide some planning opportunities for the parties to the transaction.

INCOTERMS AND TITLE

While Incoterms don't specifically treat the issue of title transfer, they do specifically treat the components used in determining the issue of title transfer. There are 13 Incoterms, and each has a specific delivery component and the documents typically used in determining title transfer: bills of lading, warehouse receipt, delivery receipts, etc. See Table 1 for a list of Incoterms, their delivery point, and documents involved.

If we assume that the seller completes its obligation to deliver at the delivery points included in the Incoterms and/or has provided the appropriate document of title (bill of lading, warehouse or other receipt), title is likely

Table 1: List of Incoterms

INCOTERMS			DELIVERY	DOCUMENTS
1.	**EXW**	Ex Works (...named place)	Seller's premises Unloaded	Buyer's receipt or acceptable document
2.	**FCA**	Free Carrier (...named place)	Carrier nominated by buyer	Evidence of delivery
3.	**FAS**	Free Alongside Ship (...named port of shipment)	Alongside vessel	Alongside Receipt
4.	**FOB**	Free On Board (...named port of shipment)	Over rail of vessel port of export	Clean On-board Receipt
5.	**CFR**	Cost and Freight (...named port of destination)	Over rail of vessel port of export	Clean Bill of Lading
6.	**CIF**	Cost, Insurance and Freight (...named port of destination)	Over rail of vessel port of export	Clean Bill of Lading
7.	**CPT**	Carriage Paid To (...named place of destination)	First Carrier	Transport Document
8.	**CIP**	Carriage and Insurance Paid To (...named place of destination)	First Carrier	Transport Document
9.	**DAF**	Delivered at Frontier (...named place)	Place at disposal of buyer at frontier	Transport Document or warehouse warrant
10.	**DES**	Delivered Ex Ship (...named port of destination)	Port of Destination aboard ship	Bill of Lading or delivery order
11.	**DEQ**	Delivered Ex Quay (...named port of destination)	Port of Destination on dock	Bill of Lading or delivery order
12.	**DDU**	Delivered Duty Unpaid (...named place of destination)	Named Place of Destination	Delivery Document
13.	**DDP**	Delivered Duty Paid (...named place of destination)	Named Place of Destination	Delivery Document

Jan Ramberg, *ICC Guide to Incoterms 2000, Understanding and Practical Use*, International Chamber of Commerce, 1999, pp. 39–171. It should be noted that, in addition to the specific transport-related documents cited, the commercial invoice is a required document for each of the 13 terms.

to have transferred from the seller to the buyer at the point of delivery. Certainly, all risks and costs transfer at the point of delivery. Therefore, unless the buyer and seller agree otherwise in the contract of sale, title passes at the point of delivery and/or the furnishing of documents. Thus, in a CIF (Cost, Insurance and Freight) sale connected to a documentary credit payment, unless otherwise stipulated, title would pass from the seller to the buyer when the seller presents to the bank an "order bill of lading" along with other documents stipulated in the credit. An order bill of lading like a bill of exchange can be made out to the bearer of the bill of lading or to the order of a particular person. Therefore, when the exporter presents documents required by the documentary credit to the bank for payment, the exporter is essentially turning over the goods by virtue of turning over the order bill, which is a negotiable bill of lading. Essentially, the order bill demonstrates that the seller performed its obligation to deliver to the buyer by virtue of the goods crossing over the rail of the vessel at the port of shipment, and this was evidenced by the carrier issuing a clean bill of lading.

C-TPAT AND TITLE

Title or ownership is also related to security. Since September 11, 2001, the U.S. has become more and more concerned about the potential link between terrorism and trade. The Patriot Act, the Trade Act of 2002, the Maritime Port Security Act of 2002, and the creation of the new Department of Homeland Security and the Department's Bureau of Customs and Border Protection demonstrate the concern for the potential threat imposed by inbound traffic to U.S. seaports and land ports. As a result, two major CBP programs, CIS (Container Security Initiative) and C-TPAT have been launched to better control and fix liability for inbound shipments should they be linked to terrorism. Although it isn't yet law, and companies voluntarily join it, C-TPAT provides no choice with respect to following its rules. For example, participating U.S. importers must comply with C-TPAT mandates outlined in March 2005. At the top of the list of requirements is a security component titled "Business Partner Requirements," which says:

"Importers must conduct a comprehensive assessment of their international supply chains based on the following C-TPAT security criteria. Where an importer outsources or contracts elements of their supply chain, such as a foreign facility, conveyance, domestic warehouse, or other elements, the importer must work with these business partners to ensure that pertinent security measures are in place and adhered to throughout their supply chain. The supply chain for C-TPAT purposes is defined from point of origin (manufacturer/supply/vendor) through to point of distribution—and recognizes the diverse business models C-TPAT members employ."

Furthermore, and like SOX, "Importers must have written and verifiable processes for the selection of business partners including manufacturers, product suppliers, and vendors." C-TPAT is also available by invitation to foreign manufacturers in Mexico and to others around the world who must meet the same criteria with respect to business partners, according to the CBP's Online Application for Foreign Manufacturers.

The eight areas of security begin at point of origin with the "stuffing" of the container. Importers should ask themselves: Where should I take responsibility for and ownership of imported products? If the importer buys a containerload of goods CIF, the importer is likely to become the owner of the goods as they cross the ship's rail in the foreign port. The U.S. importer absolutely accepts any risk that container may pose by having illicit contents along with the legal contents. Or should the U.S. importer buy the goods on a DDU (Delivered Duty Unpaid) or DDP (Delivered Duty Paid) Incoterm where the foreign seller takes responsibility for and ownership of the contents of the container all the way through the U.S. port to the point of destination in the U.S.? Or is it better for the U.S. importer to buy EXW (Ex Works)? If the U.S. importer buys EXW, it actually takes possession of the goods unloaded in the foreign nation and accepts the responsibility to load its own goods into the container and clear outbound foreign Customs and inbound U.S. Customs.

Each Incoterm may pose a new dilemma for the U.S. importer. Each term also offers the U.S. importer the role it wants to assume in the international transaction and what risk and responsibility it wants with respect to the control of the container and the importer's obligations under U.S. law and CBP programs.

OUR RECOMMENDATION

You might say with absolute confidence that whether because of the law, Sarbanes-Oxley, or the program, C-TPAT, the market is certainly no longer the guiding principle. Through financial transparency and accuracy, inventory can no longer be used to manipulate financial reports. Therefore, title must be established consistently and with specificity. We recommend that financial procedures be written to set title transfer at the point of delivery for each of the Incoterms used, assuming, of course, that the company uses Incoterms.

Using Incoterms will accomplish two purposes. First, it will allow market issues like negotiations of a sale to be free from tight accounting rules yet, at the same time, establish and use rules that will always be employed to account for levels of inventory. Second, security procedures should be established with specificity to verify and report the actual security controls in place, beginning with stuffing at the foreign point of origin. This will be very difficult, if not impossible, to do in the case of U.S. importers buying less than full containers (cargo of multiple shippers in the same container). Even when buying a full container (cargo of only one shipper), only the use of smart containers that carry and report electronically logistics data to include the identity of the person supervising, arming, and locking the container will satisfy the new CBP mandates that are consistent with the World Customs Organization (WCO) standards. Whether financial controls, security controls, or both, the overriding and critical challenge for firms in the global supply chain is that of rule compliance, but rule compliance that's manageable, defendable, and ultimately as market friendly as possible. ■

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