Trade Compliance Flash: Proposed New Rule for Country of Origin Determinations for Products of Canada and Mexico Could Have Big Implications

International Alert
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Background

Earlier this month, U.S. Customs and Border Protection (CBP) issued a notice of proposed rulemaking and request for comments that would change the rules for certain country of origin determinations for goods imported from Mexico or Canada. Under the proposed rules, non-preferential country of origin determinations (*i.e.*, determinations other than for the purpose of determining eligibility for preferential tariff treatment under a trade agreement, such as the United States-Mexico-Canada Trade Agreement (USMCA)) for goods from Canada and Mexico would be determined based on the tariff shift tests of 19 C.F.R. Part 102, rather than the substantial transformation test.

An article's non-preferential country of origin is important for several reasons – including duty/tariff assessment, origin marking, eligibility for certain government procurement contracts, admissibility determinations, and administering tariff quotas. Two different methods exist for determining whether manufacturing operations confer origin – the traditional substantial transformation test, and the North American Free Trade Agreement (NAFTA) Marking Rules set forth in 19 C.F.R. Part 102, which consist of a series of tariff shift tests.

Impact on Section 301 Tariff Applicability

Section 301 tariff applicability is currently determined for goods of all countries by applying the "substantial transformation test." Under this test, components from one country (say, China) that are further manufactured in a second country (say, Mexico) are considered a good of the second country for U.S. tariffs purposes only if they are "substantially transformed" in the second country. In this context, "substantially transformed" is defined as an article having a new "name, character, or use." The test is notoriously subjective and difficult to apply, in spite of (or perhaps because of) decades of court and administrative rulings applying it. For now, substantial transformation remains the test for purposes of Section 301 tariff applicability for goods further manufactured in all countries other than Canada and Mexico.

Under the proposed rules, Section 301 tariff applicability for goods further manufactured in Canada or Mexico are determined under the tariff shift tests of the NAFTA Marking Rules found at 19 C.F.R. Part 102. These tariff shift tests require each of the non-originating components used in the production of a good to meet the requirements of the test (*i.e.*, a change in classification, unless a de minimis or other exception applies). For example, to determine the country of origin a good further manufactured in Mexico from components sourced from China under NAFTA Marking Rules, one must first identify the six-digit tariff classification code of the finished product, and then apply the rule of origin set forth in 19 C.F.R. § 102.20 that applies to that six-digit tariff code. If the Chinese components meet the applicable tariff shift rule for that classification, the country of origin of the product is Mexico. If it does not, the country of origin is China – and thus any additional Section 301 tariffs applicable to the tariff classification must be paid.

The tariff shift tests of the NAFTA Marking Rules are generally more predictable and easier to meet than the substantial transformation test. When this is true, it gives products further manufactured in Canada or Mexico an advantage over products further manufactured in other countries due to the increased certainty in determining the country of origin – and it could even mean that the Mexican and Canadian products stand a greater chance of avoiding Section 301 tariffs. For example, flashlights are classified in subheading 8513.10.2000. The tariff shift test for goods classified in subheading 8513.10 requires "[a] change to subheading 8513.10 from any other subheading." Thus, if all components of the flashlight were Chinese and the flashlight was

assembled in Mexico, so long as none of the components were classified in 8513.10 in their condition as imported into Mexico, the assembled flashlight would become a product of Mexico for purposes of determining whether Section 301 tariffs apply. However, if the same Chinese components were assembled in Vietnam, the substantial transformation test, rather than the NAFTA Marking Rules, would be used. The product would almost certainly fail the substantial transformation test (as currently interpreted by CBP), meaning that the product would be China-origin for tariff purposes and subject to tariffs.

On balance, using the NAFTA Marking Rules to determine whether tariffs apply could significantly impact whether certain manufactured or assembled goods are considered goods of Canada or Mexico for purposes of Section 301 tariffs, prompting companies to re-evaluate whether moving assembly or manufacturing operations to Canada or Mexico would allow them to legally avoid those tariffs. It would also prevent the confusing result that has occurred in the past where a good is marked with one country of origin (say, Mexico) but nonetheless subject to Section 301 tariffs because it considered a product of China under the substantial transformation test.[1]

Impact on the COO for Government Procurement Purposes

In U.S. government procurements covered by the Trade Agreements Act (TAA), federal agencies must give equal treatment to U.S.-made end products and the end products of certain designated countries with which the United States has trade agreements, including Canada and Mexico. Under the TAA, a product is a "a product of a country" if it: (1) is wholly the growth, product, or manufacture of that country; or (2) meets the substantial transformation test (*i.e.*, if the product is transformed into a new and different article of commerce with a name, character, or use distinct from that of the articles from which it was transformed). Companies that contract with the U.S. government have for years relied on this test and structured their supply chains, logistics, and manufacturing operations to satisfy its requirements.

Under the new proposed rules, however, the country of origin for goods imported from Mexico or Canada ostensibly would be determined under the tariff shift tests found in 19 C.F.R. Part 102, rather than under the traditional TAA test. Apart from introducing further complexity in an already complex area of procurement compliance, this change undoubtedly will cause confusion for government contractors because the TAA statute requires the country of origin to be determined under one of two alternative tests, but the new rules call for the use a tariff shift test. In the notice of proposed rulemaking, CBP appears to attempt to sidestep the issue by stating that the Part 102 tariff shift rules "codify, rather than constitute an alternative to, the substantial transformation standard." 86 Fed. Reg. 35422, 35423 (July 6, 2021). Still, the new rules could be vulnerable to legal challenges asserting that: (1) there is no statutory basis to extend what were originally NAFTA Marking Rules to government procurement determinations now that NAFTA has expired and (2) using a different country of origin test for products assembled or manufactured in Mexico or Canada may violate international trade rules or the terms of U.S. multilateral or bilateral trade agreements.

Impact on Country of Origin Marking

Unlike NAFTA, the USMCA does not contain any marking rules, nor does it require the parties to agree on joint set of marking rules. This led many to speculate that there would be no longer be special marking rules for goods from Canada and Mexico when USMCA replaced NAFTA on July 1, 2020. However, pursuant to interim final rules introduced the same day as the proposed rules discussed in this alert, goods from Canada and Mexico – regardless of whether they qualify for duty free treatment under the USMCA – will continue to be marked according to the NAFTA Marking Rules of 19 C.F.R. Part 102.

Impact on Antidumping and Countervailing Duties

The proposed rules do not impact the country of origin for purposes of applying antidumping and countervailing duty orders.

Takeaways

- If adopted, the new rules could mean that further manufacturing components from China in Mexico or Canada, rather than in any

other country, will allow the product to legally avoid Section 301 tariffs. This would occur if the tariff shift rules of 19 C.F.R. Part 102 result in a change of the country of origin to Canada or Mexico, but application of the substantial transformation test does not result in a change of country of origin. Companies should re-evaluate whether moving assembly or manufacturing operations to Canada or Mexico would allow them to legally avoid Section 301 tariffs.

- The proposed rules could also mean that further manufacturing components in Mexico or Canada is more likely to result in a change to country of origin Mexico or Canada for government procurement purposes, compared to the same manufacturing processes being performed in countries other than Mexico or Canada. This is because the tariff shift test is generally considered easier to meet than the substantial transformation test.

CBP is accepting comments on the interim final rules until **August 5, 2021**. Please contact us if you would like to discuss submitting comments or the impact of the new rules on your business.

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[1] *See, e.g.*, Headquarters Ruling H301629 (Nov. 6, 2018) (electric motors had to be marked as a product of Mexico but were also subject to additional Section 301 tariffs as a product of China).

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