Proposed Change in Country of Origin Rules By US Customs May Leave Government Contractors in Limbo On TAA Compliance

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In July 2008, U.S. Customs and Border Protection ("CBP") announced a proposal to change the country of origin rules for most goods imported into the United States. If adopted, CBP would determine the country of origin for imported goods by using a "tariff shift" analysis, rather than the long-standing "name, character or use" test. The proposal specifically includes language that would apply this change to CBP's rulings on country of origin for Government procurement purposes under the Trade Agreements Act ("TAA"), 19 USC § 2501, *et seq*. However, there has been no indication of any concurrent change in the Federal Acquisition Regulation ("FAR"), which applies the traditional "name, character or use" test in determining TAA compliance in federal procurements. If adopted without further consideration of its potential impact on federal procurement, CBP's proposed change would create uncertainty and new compliance issues for the government and its contractors.

The current system

For most goods imported into the United States, CBP's current regulations consider the country of origin of an item to be the last country before importation in which it experiences "substantial transformation," that is, a processing that results in an item with a new "name, character or use." If goods are made in Country A, then shipped to country B for some minor finishing operation that does not change the item's "name, character or use," then it must be declared to CBP as a product of Country A at the time of importation. In addition, this country of origin must be marked on the imported good when sold to the ultimate purchaser in the United States, unless it experiences another change in "name character or use" in the United States. See 19 C.F.R. § 134.35.

This "name, character or use" test is not required by statute but was developed through judicial precedent and later adopted in CBP's regulations. See, e.g., *Anheuser-Busch Brewing Association* v. *United States*, 207 U.S. 556, 562 (1908) (a new manufacturing requires a "transformation; a new and different article must emerge, 'having a distinctive name, character or use.'") (quoting *Hartranft* v. *Wiegmann*, 121 U.S. 609, 615 (1887)). This test is also now supported by accumulated CBP rulings and court decisions that give fairly consistent guidance within various product types and industries. To determine whether a product has been substantially transformed, importers can review the published rulings from CBP and relevant court decisions and come to a good faith conclusion regarding compliance with relevant import regulations. In addition, an importer can request a ruling from CBP, which will be binding on both the importer and CBP unless it is formally revoked, which requires notice and the opportunity to comment.

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The FAR applies this same "name character or use" test for purposes of determining TAA compliance in connection with federal procurements. Contractors must complete a Trade Agreements Certificate which requires them to certify that each end product is a "U.S.-made or designated country end product." FAR 52.225-6. A "U.S.-made" product is one that is "mined, produced, or manufactured in the United States or that is substantially transformed in the United States into a new and different article of commerce with a name, character or use distinct from that of the article or articles from which it was transformed." FAR 52.225-5(a). Similarly a "designated end country product is one that is (1) "wholly the growth, product, or manufacture of [such a country];" or (2) "[i]n the case of an article which consists in whole or in part of materials from another country, has been substantially transformed [in a designated country] into a new and different article of commerce with a name, character, or use distinct from that of the article or articles from which it was so transformed." Id.; see The Basics of The Trade Agreements Act, http://www.steptoe.com/assets/attachments/1062.pdf.

Contractors evaluating TAA compliance can refer to the accumulated body of CBP rulings and court decision regarding "name, character or use" determinations in order to make good faith assessments regarding whether their products meet the conditions under the TAA. They can also obtain a higher level of certainty by seeking a ruling from the CPB, whose regulations provide for issuance of advisory rulings and final determinations for procurement purposes. See 19 C.F.R. 177.21 & 177.22; see also, e.g., 73 Fed. Reg. 64,978 (for an example of a recent CBP country of origin ruling for government procurement purposes involving an item assembled in Hong Kong from parts shipped from China.)

CBP's proposed change

CBP proposes to replace the "name, character or use" test with "tariff shift" rules that already exist in Part 102 of the Customs Regulations for NAFTA goods. Under these tariff shift rules, a good originates in a processing country if the tariff numbers before and after processing show a large enough shift (along with other possible conditions for some products), under specific rules listed for the finished good. Determining whether a good meets the "tariff shift" requires a complete bill of materials listing all inputs. For any inputs that do not originate in the country of processing, the analysis must look to the tariff shift rule for the finished good. The rule may require that inputs change to the tariff number for the finished good "from any other heading." This means that if the inputs have tariff classification numbers with a different first four digits ("the heading" in CBP parlance) from those of the finished good, the tariff shift has been met. (The rule might also refer to a change in the "chapter" (the first two digits) or the "subheading" (the first six digits) and may also contain some other exceptions or requirements specific to the finished end product.) This comparison is required for every item on the bill of materials that did not originate in the country of processing. Items from the bill of materials may be disregarded only if the value of those materials totals no more than seven percent of the value of the finished good (with some small exceptions listed in the CBP regulations). If any substantial input does not make the required shift, the finished good cannot be considered a product of the processing country.

CBP has used these tariff shift rules for over a decade to determine the country of origin under the NAFTA for goods imported from Canada and Mexico. CBP believes that tariff shift is a more objective and predictable method of finding substantial transformation than determinations based on "name, character or use." CBP's proposal

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would apply these tariff shift rules to the goods which currently use the "name, character or use" test. Currently, the majority of goods imported into the United States are subject to "name, character or use" analysis.

CBP's proposed rule specifically states that it intends to change the definition section of its regulations on government procurement rulings so that

> a substantial transformation into a "new and different article of commerce" occurs when the country of origin of an article which is produced in a country or instrumentality from foreign materials is determined to be that country or instrumentality under §§ 102.1 through 102.21 of this chapter [the location of the tariff shift rules in the CBP Regulations].

73 Fed. Reg. 43,385, 43,394 (July 25, 2008). In other words, CBP proposes to take the position that substantial transformation has occurred when items meet the tariff shift rules, rather than making a finding regarding "name, character or use."

Issues for government contracting

CBP's proposal does not discus in any detail the potential impact of its proposed approach on government procurement. However, the proposal raises several questions and potential concerns for both the government and its contractors.

First, there is arguably a disconnect between the proposed new CBP standard that considers a "substantial transformation into a new and different article of commerce" to have occurred when the tariff classification number of inputs has changed sufficiently under the tariff shift rules, and the FAR standard which focuses on whether there has been a change in "name, character or use." When called on to assess TAA compliance, contracting officers might continue to rely on the "name, character or use" test in determining if there has been substantial transformation, or they may look to the new CBP tariff shift standard. (Contracting officers are required to look beyond a contractor's TAA Certification when they have reason to believe that a contractor may be providing non-compliant products. See And You Thought You Were Confused: GAO and COFC Reach Different Results on TAA Compliance, http://www.steptoe.com/assets/attachments/3512.pdf.) The absence of a reconciliation or further guidance could leave contracting officers uncertain as to the applicable standard and creates a risk of lack of uniformity and consistency.

This situation also creates uncertainty for contractors. For example, can or should they continue to rely on the "name, character or use" test in FAR 52.225-5 or will they have to assess their TAA compliance under the new CBP tariff shift standard or, potentially, under both standards? Similarly, what effect will or should be given to CBP country of origin determinations issued under the new standard and should contractors continue to request them?

Second, if the proposed new CBP standard were also to become the standard for determining substantial transformation for procurement purposes, the potential impacts of such a change on the procurement process also merit further consideration. For example, adoption of a new standard for procurement purposes may have

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consequences for product availability -- if the tests are different, it seems likely that there will be some differences in outcomes. While the net impact on product availability of a change in standards is difficult to assess, there is some risk that certain products which the government currently acquires may not be found to comply with the TAA under the tariff shift methodology. In addition, if the tariff shift standard is adopted for procurement purposes, will contractors need to reassess the compliance status of products that qualify under the current FAR standard or would the new standard apply only to new contracts/product offerings? Similarly, the status of previous CBP country of origin determinations under the "name, character or use" standard is uncertain, and CBP has made no statement regarding whether those rulings will be "grandfathered," even for products that receive different treatment under the proposed new rule.

Third, as the discussion above suggests, the CBP's proposed rule is likely to impose additional burden and expense on contractors. In addition, a failure to reconcile the FAR and CBP standards unnecessarily increases the possibility of disputes as to the applicable standard and whether a product substantively complies with the TAA.

Finally, the CBP regulations indicate that its country of origin rules are "intended to be applied consistent with the [FAR]." 19 C.F.R. 177.21. However, as discussed above, there is an apparent disconnect between CBP's proposed tariff shift standard and the "name, character or use" standard in FAR 52.225-5. Further, CBP's proposed rule does not address that issue or purport to provide reconciliation; nor could the CPB necessarily do so as it does not have authority with respect to the FAR. However, there is no indication that the apparent difference in standards or the potential impacts of the CBP's proposed new rule on federal procurements were considered on an interagency basis prior to the issuance of the proposed rule, but this can and should occur before the that rule becomes final.

The CBP Proposal and Tariff Shift Regulations

CBP's proposal was published in the Federal Register at 73 Fed. Reg. 43,385 (July 25, 2008) and is available in full at: http://edocket.access.gpo.gov/2008/pdf/E8-17025.pdf .

CBP's notice extending the comment period on its proposal to December1, 2008 is available at: http://edocket.access.gpo.gov/2008/pdf/E8-25731.pdf .

CBP's tariff shift rules at 19 C.F.R. Part 102.20 are available at: http://edocket.access.gpo.gov/cfr_2008/aprqtr/pdf/19cfr102.20.pdf, and its recent revisions to those rules is available at: http://edocket.access.gpo.gov/2008/pdf/E8-25734.pdf .

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