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INSIGHT: U.S. Trade Tariffs—The ‘Origin’ Story



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The reliance on high tariffs as a tool of U.S. trade and foreign policy has significantly increased in recent years. For example, to address unfair trade practices alleged against China, the U.S. implemented a series of “Section 301” measures on *products of* China, including tariffs of up to 25% on a wide range of goods comprising roughly \$370 billion of imported Chinese goods; and imposed “Section 232” national security tariffs of 10-25% on imported aluminum and steel from most countries.

In this volatile and high-tariff environment, companies are considering new ways to strategically blunt or avoid these high costs, including altering their production operations or supply chains to effect favorable changes to the “country of origin” of imported goods. For instance, companies have considered relocating some or all production operations outside of China to impart a different “country of origin” on the imported goods and avoid the “Section 301” tariffs.

This article discusses key considerations and U.S. Customs and Border Protection (CBP) rules and decisions that companies should take into account when altering supply chains or manufacturing operations to obtain different “origin” outcomes for tariff purposes.

BACKGROUND

Generally, there are different and distinct customs rules of origin that may apply to imported goods, including, but not limited to: (1) the general marking rules of origin, addressing how goods of foreign origin shall be marked to indicate to an ultimate purchaser in the U.S., the country of origin of the good (19 U.S.C. Section 1304); (2) the North American Free Trade Agreement (NAFTA) marking rules, specifically for goods produced in a NAFTA country (19 C.F.R. Part

102); and (3) the respective “preferential” rules of origin to determine whether goods are eligible for a reduced tariff based on a free trade agreement.

In some cases, it is possible to have two distinct country of origin rules and determinations for the same product. For example, an electric motor assembled in Mexico from Chinese-origin components may be of Mexican origin for marking purposes under the NAFTA marking rules, but when determining the country of origin for purposes of applying current trade remedies, for example under Section 301 or Section 232, the motor may be considered a product of China if the assembly operations in Mexico do not amount to a “substantial transformation” of the Chinese-origin components. See for example, CBP Headquarters Letter Ruling (HQ) H301619 (Nov. 6, 2018), modifying HQ H300226 (Sept. 13, 2018). Moreover, with the anticipated replacement of the NAFTA by the Agreement Between the United States of America, The United Mexican States, and Canada (the “USMCA”), the replacement origin rules would also need to be considered.

Thus, in any country of origin analysis it is important to first identify the purpose of the enquiry and then determine which set of origin rules apply to the specific facts.

As it applies to the special tariffs imposed pursuant to Section 301 or Section 232, the statutes and regulations do not specify how the origin of goods should be determined for said purposes. However, over the course of decades, the federal courts and CBP have determined that where special tariffs are imposed on the “product of” a particular country, that term at the least includes manufactured articles of such country or articles that have undergone a “substantial transformation.” In HQ H301619 (Nov. 6, 2018), CBP, in reliance on [Belcrest Linens v. United States](#), stated that “[w]hen determining the country of origin for purposes of applying current trade remedies under Section 301, Section 232, and

Section 201, the substantial transformation analysis is applicable.” Thus, consistent with the general customs marking rules, if a product’s components originate, or operations are undertaken, in multiple countries, the components must undergo a “substantial transformation” to render a particular country the “country of origin” for purposes of determining whether the special tariffs apply.

Over a century ago, the U.S. Supreme Court, in *Anheuser-Busch Brewing Ass’n v. United States*, articulated that goods are considered to be manufactured for customs purposes when a new and different article emerges “having a distinctive name, character, or use.” This principle has evolved to become part of the “substantial transformation” lore. More recently, in 2016, the U.S. Court of International Trade (CIT) determined in *Energizer Battery v. United States*, that for the purposes of government procurement under the Trade Agreements Act of 1979 (TAA), “in order for a product to be substantially transformed, it must become 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.”

As the following discussion highlights, the application of the “change in name, character or use” standard can be complex and fact intensive, and is generally determined on a case-by-case basis requiring both quantitative data and qualitative judgements.

SUBSTANTIAL TRANSFORMATION

The concept of “substantial transformation” is not a bright-line rule, and can be viewed as more art than science, resulting in varying outcomes. Importers are often challenged to distill guiding principles from the many, sometimes seemingly conflicting, customs rulings and court cases to determine whether a particular manufacturing process or assembly operation is sufficiently substantial to effect a “change in name, character or use.” Coupled with the fact that CBP inconsistently considers various “subsidiary” factors to determine whether a substantial transformation has been effectuated, it can be challenging to make these origin determinations

Change in Name

The first disjunctive prong of the substantial transformation test is whether the processing effected a change in name. The key question here is whether the discrete components retain their names after they are assembled into the finished good. For example, in the *Energizer* case, the CIT found that the components, such as the “switch lever” and “TIR lens” did not lose their individual names as a result of the assembly of the components into the final flashlight. Thus, the discrete components retained their names even after they became a part of the whole.

It is also notable that the CIT stated that the “change in name” criterion is generally considered the least compelling of the three disjunctive factors to support a substantial transformation determination. As a result, in order to establish that a substantial transformation has occurred, it would behoove importers to consider the other two prongs: either a change in character or use.

Change in Character

Generally, the second disjunctive prong requires a physical change or a substantial alteration to the characteristics of the article or components; and cosmetic changes will be deemed insufficient to effect a substantial transformation. For example, in *Ferrostaal Metals Corp. v. United States*, the CIT found that a process whereby raw steel sheets are subjected to an irreversible “continuous hot dip galvanizing” process that transforms the hard steel into a more malleable product changed the character of the steel sheets. Specifically, the CIT found that the article emerging from the galvanizing process had a different atomic pattern, different mechanical properties and a different chemical composition. As a result, the galvanized steel would last up to 10 times longer, could be sold for 57-80% more in price, and could be used in a wider range of commercial applications than un-galvanized steel. In that case, the physical changes were sufficient to find there was a substantial transformation of the un-galvanized steel.

Many cases, however, do not involve subjecting an article to an obvious and physically transformative process, but rather involve the more challenging scenario whereby various components are merely assembled together to produce a distinct finished article.

Generally, simple assembly will not result in a substantial transformation of the components. However, the line can become blurry in situations even where the assembly process is arguably complex or involves the production of several major subassemblies comprised of many, sometimes hundreds, of smaller components. Take for example the *Energizer* case, where the assembly of approximately 50 components, including lens heads, light-emitting diodes, wires, fasteners, etc., into a flashlight did not result in a substantial transformation of the components. In fact, there is no change in the shape or material composition, or the character, of any of the discrete components even after they became part of the whole.

Also, consider two of CBP’s origin decisions concerning passenger automobiles: in HQ H302821 (July 26, 2019), CBP determined that assembling five subassemblies together into an automobile in Sweden did not result in a substantial transformation, and that the origin of the automobile was China for the purpose of applying Section 301 tariffs; contrasted with HQ 563403 (March 27, 2006), where CBP determined that the assembly of only two subassemblies into an automobile did result in a change in character and underwent a substantial transformation. Notably, in HQ 563403 the two subassemblies themselves were substantially transformed from hundreds of parts in a two-stage assembly process (i.e., there was a “double substantial transformation” whereby hundreds of components were substantially transformed into two distinct subassemblies, and then the two subassemblies were substantially transformed into a final automobile).

These decisions illustrate that “change in character” assessments can be painstakingly fact specific, and may be difficult to discern or establish for assembly operations without the necessary experience or knowledge of customs rules and precedent.

Change in Use

Generally, the third disjunctive prong, a “change in use,” exists when the end-use of the imported product

is no longer interchangeable with the end-use of the product after processing. For example, in the *Ferrostaal Metals* case, the court found that the use of unprocessed and ungalvanized steel was not interchangeable with the processed galvanized steel, in part, because the governing building and construction codes would prevent substitution by requiring that only galvanized products be used.

In assembly scenarios, it must be considered whether the end-use of the discrete components is pre-determined before assembly into the finished good. For example, in *Energizer*, the court determined that all of the foreign components were in a prefabricated form with a predetermined end-use as parts and components of the final flashlight, finding that even the wires were pre-cut to assembly length, and therefore there was no change in “use” resulting from the assembly operations.

While a pre-determined end-use has not always precluded a finding of a substantial transformation, there has been an apparent recent trend in CBP decisions following *Energizer*. These decisions have focused on the existence of a pre-determined end-use of the components to preclude a finding that there is a substantial transformation, as was the case in the assembly of automobiles (HQ H302821 (July 26, 2019)), electric motors (HQ H301619 (Nov. 6, 2018)), and cable modems (HQ H302480 (Sept. 13, 2019)). In all three rulings, the origin was determined to be China for the purpose of applying Section 301 tariffs.

Thus, it is important to keep in mind that the proper enquiry is not whether individual discrete components have a different use and function than the final complete article but whether the discrete components shed their predetermined end-use, vis-à-vis as a discrete component, after undergoing the processing or assembly operations.

Subsidiary/Additional Factors

While the courts and CBP have adopted the “change in name, character or use” standard to determine whether an article has substantially transformed, CBP and the courts have also, albeit inconsistently, considered other factors, commonly referred to as “subsidiary” or “additional” factors, to evaluate “the totality of the circumstances.”

These subsidiary factors include, but are not limited to, the complexity and nature of the operations performed; the costs and time of assembly; the use of specialized machinery or equipment; special skills or certifications needed by the employees involved in the operations; the value-added in terms of increase to the resale price as a result of the processing; and the “essential character” or “essence” of the finished article.

For instance, where there are various components used in production, CBP has in some cases focused on the component that imparts the “essence” of the finished article to determine the origin. In HQ H240193 (July 29, 2013) CBP determined that the production of a pharmaceutical tablet, involving the mixing of various stabilizer and excipient ingredients, did not result in a change in the chemical or physical properties, or the medicinal use, of the foreign active pharmaceutical ingredient (API); and, therefore, the origin of the tablet was conferred by the origin of the API, rather than where it was produced.

In addition, where the processing operation involves assembly operations, the courts have considered whether the assembly operation is sufficiently complex or meaningful as opposed to assembly operations that are minor or simple. However, proving that an assembly operation is sufficiently complex can itself be a complex task.

Other contrasting examples can be found in the recent decisions in HQs H303864 (Dec. 26, 2019) and H303865 (Jan. 23, 2020) involving the assembly of electric motors into a pump. In H303864, CBP determined that the country of origin of an automobile windshield-washer pump assembled in Mexico and incorporating Mexican and Chinese origin components, was China for the purpose of applying Section 301 tariffs because the Chinese electric motor was the most expensive component and imparted the “essence” of the pump, while the assembly was simple.

In H303865, however, the country of origin of a dishwasher pump assembled in Serbia, from a majority of Chinese components, was determined to be Serbia because the discrete Chinese parts were first assembled into subassemblies in Serbia, including the electric motor, and then the subassemblies were assembled into the pump, also in Serbia. In the latter case, the first, or intervening, *subassembly* operation caused the Chinese parts to lose their identity when finally assembled into the final pump. This highlights another instance where the apparent “double substantial transformation” and totality of the circumstances was critical to the origin outcome.

As these decisions demonstrate, caution should always be exercised when relying on subsidiary factors alone as there is no exhaustive list of acceptable factors and, as noted by the CIT in *Energizer*, the application of these factors has been historically inconsistent, not only with respect to the weight that the courts and CBP have respectively given to each factor, but also in deciding whether they apply at all. For instance, the CIT in *Energizer* declined to adopt an “essential character” analysis, calling it a subsidiary consideration “at best,” notwithstanding that CBP had adopted said analysis at the administrative level to determine the origin of the flashlight, *see* HQ H215657 (April 29, 2013).

Thus, a sound approach is to consider the relevant subsidiary factors primarily as a cross-check to the “name, character or use” analysis. For example, if an importer is claiming Vietnamese origin for an article assembled in Vietnam, but the overwhelming majority of significant or “essential” components and costs are conferred by components originating in China, there would be a significant risk the final assembled article may be of Chinese origin. In such a case, the importer should otherwise establish, and support, a change in “character” or “use” as an exercise in reasonable care.

Industry Specific Considerations

To add to the complexity, there are nuanced and evolving considerations to these determinations that vary by industry. For instance, it is a long-standing CBP position that the assembly of watch components (e.g., battery, movement, dial, case, band, etc.) into a finished watch is generally not considered to be a substantial transformation and thus, the country of origin of the entire watch, for tariff purposes, is determined by the

country of assembly of the watch movement—the “essence” of the watch. Thus, the watch maintains a unitary country of origin for *tariff* purposes, irrespective of its different components.

For *marking* purposes, however, the watch band (or strap) generally maintains its separate identity and origin, apart from the rest of the watch, based on where the band was produced, unless the band is assembled into the finished watch in the same country where the movement is assembled, in which case it need not be marked separately.

Recently, in HQ H304105 (June 25, 2019), CBP seemingly departed from its precedent and merged the separate “marking” and “tariff” positions to determine that, in scenarios where the movement assembly and watch assembly are undertaken in different countries, the other components, i.e., the case and band, retain their own respective country of origins for tariff purposes also, and more specifically, for the purpose of assessing Section 301 tariffs on Chinese origin components. Thus, under this new approach a single watch could now have several countries of origin (by component) for the purpose of assessing tariffs. This novel departure from the unitary “origin” approach to tariffs has created significant consternation within the watch industry, leaving observers to wonder whether trade policy is imbuing technical customs determinations to reach specific outcomes.

Innovation has also forced CBP and importers to reconsider how the concept of “substantial transformation” applies in the consumer electronics industry, specifically whether traditional notions of “character” or “use” apply. Many electronic products imported into the U.S. today incorporate at least some basic level of technology. For example, household appliances, work tools, and automobiles generally incorporate firmware, software and/or printed circuit board assemblies (PCBA) that generally are considered the “brains” of the product. However, do these components provide or merely enhance the functionality or use of the product and do they modify the product’s physical characteristics? The federal courts have recognized that these issues are often a mixed question of technology and customs law.

An often-asked question with respect to the origin of consumer electronics is whether the assembly of foreign components into a PCBA constitutes a substantial transformation of the PCBA components. Generally, CBP has determined that where complex surface mount technology is used to load a raw printed circuit board with diodes, transistors, capacitors, memory chips, and task-specific integrated circuits, there is a substantial transformation of the components into the PCBA. This is consistent with the court decision in [Texas Instruments, Inc. v. United States](#). However, the number of components, steps involved, skill of workers, complexity of assembly, and cost of machinery, are factors for consideration.

The more challenging question is whether a PCBA imparts or confers the “essential character” (and origin) to the article/machine in which the PCBA is incorporated or assembled. There is no bright-line rule here, with the answer to be determined on a case-by-case basis. Take for example, HQ 561232 (April 20, 2004) where it was determined that the PCBA conferred the essence (and origin) to an FM radio tuner; or HQ H303140 (April 19, 2019) where the PCBA did not con-

fer the essence to an electric motor; or HQ H301910 (August 5, 2019) where the PCBA plus other components such as the firmware, together, conferred the essential character to a mailing machine engine.

The existence of software and firmware further complicates the origin story by adding unique qualities and characteristics to a product. In most instances, the absence of required software and firmware means the product cannot function as intended. Thus, when software or firmware is incorporated into a product, there are additional considerations that must be taken into account when assessing whether a “substantial transformation” has taken place. For instance, does the mere downloading of software or firmware generally result in a substantial transformation?

Generally, merely loading a product with software or firmware does not on its own result in a substantial transformation; however, it is a factor among several factors to be considered. Products incorporating software or firmware must still satisfy the change in name, character, or use standard. In this regard, although often loosely referred to interchangeably, “loading” (or installing) software is considered to be distinct from “programming,” the latter generally determined by the CIT in the case of [Data General Corp. v. United States](#), to involve a *physical* and *permanent* change to the fuses and patterns of interconnectors within the PROMs that result in a substantial transformation, whereas the former may be rewritable. Thus, generally, the location where software/firmware is embedded into a product is, by itself, not determinative of the origin of the product, as the operation does not typically result in a change in physical character.

Whether the software/firmware results in a change in “use” should also be considered. In this regard, factors to be considered include the origin of where the software/firmware is developed; and whether the software/firmware completely provides or changes the function of the product rather than merely enhancing or adding to existing functionality.

As a result, importers are cautioned to exercise due diligence and, where appropriate, consider seeking a binding-ruling concerning novel issues representing mixed questions of technology and customs law.

CONCLUSION

The “country of origin” is a concept of significant importance in administering the customs and trade laws and to determine, *inter alia*, the tariffs (or tariff preferences) that apply to imported products. Companies often consider making modifications to supply chains or manufacturing operations to achieve a particular “origin,” and corresponding tariff, outcome. However, the “origin” story can be a complicated one, generally, determined on a case-by-case basis requiring both quantitative data and qualitative judgements, and often should take into account unique industry perspectives. When a significant investment is involved, it may be advisable to consult with an expert with the necessary experience and knowledge of customs rules since it may be possible to modify or move only certain critical operations to achieve a change in origin, as was the case in HQ N302435 (March 4, 2019).

An important first step should be to identify the purpose of the “origin” enquiry to determine which set of origin rules apply (e.g., for *tariff* or *marking* purposes).

If a “substantial transformation” is required, the “name, character or use” standard should be applied, taking into account the totality of the circumstances. In an assembly operation, the discrete components should generally be constructively segregated after assembly to assess whether the key components have undergone a change in character or use post-assembly, bolstered by “subsidiary” factors. The analysis should also be documented to demonstrate the exercise of reasonable care to avoid costly customs penalties and, if the story is complex, importers may consider seeking a binding ruling from CBP.

As if this *origin* story isn’t complicated enough, the high tariffs of the current trade wars raise the stakes for both importers and the government. This has resulted in heightened compliance scrutiny of origin issues and recent CBP determinations that seemingly depart from precedent, raising speculation that specific “country of origin” outcomes may be colored by short term policy goals, but may leave long-lasting technical uncertainty in this field. And so the plot thickens. . . . and like any good story, we continue to turn the page to the next chapters to find out how it ends.

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