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**North American Free Trade Agreement:
Customs and Trade Rules
In a Nutshell**

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On October 7, 1992, President George H.W. Bush of the United States, President Carlos Salinas de Gortari of Mexico, and Prime Minister Brian Mulroney of Canada witnessed the initialing of the North American Free Trade Agreement (NAFTA). At the time, NAFTA created the largest trading community in the world.

NAFTA influences many different areas of law. This White Paper summarizes the current provisions pertaining to customs and international trade issues, particularly the trade in goods and services, rules of origin, and customs procedural issues.

I. Trade in Goods

The establishment of NAFTA greatly reduced obstacles to the movement of goods across material borders by eliminating or reducing tariffs, customs charges, and import and export restrictions, as well as by creating uniform rules applicable to duty drawback programs and the temporary admission of goods.

A. Elimination of Tariffs

NAFTA provides for the progressive elimination or reduction of tariffs on thousands of products qualifying as “North American.” For most goods, tariffs were either eliminated immediately or phased out in five, 10, or 15 annual stages.

B. Rules on the Refund, Reduction, or Waiver of Customs Duties

NAFTA limits the use of “drawback” or similar programs that permit the refund or waiver of duties paid upon goods previously imported and incorporated into domestically produced articles, or kept in their original condition and subsequently exported. Pre-NAFTA “drawback” programs terminated January 1, 2001.

For the most part, merchandise imported from one NAFTA country and subsequently exported to the territory of another NAFTA country, or used as material in production of another good that is exported, is assessed duties as if the merchandise was withdrawn for domestic consumption. However, duties may be refunded or reduced only when the refund or reduction does not exceed the lesser of:

- Duties owed or paid on imported, non–North American materials used in the production of a good subsequently exported to another NAFTA country; or
- Duties paid to that NAFTA country on the importation of a particular good.

NAFTA countries are permitted to refund or waive customs duties only in the following situations:

- When goods entered for processing, testing, cleaning, sorting, repacking, etc., are subsequently exported to another NAFTA country
- When goods are imported for duty-free shops, used in ships' stores, or used as supplies for ships or aircraft
- When goods do not conform to a sample or specification

C. Temporary Admission of Goods

NAFTA permits temporary, duty-free entry of certain goods in limited circumstances. For example, professional equipment and "tools of the trade" are permitted temporary duty-free entry. NAFTA countries can impose a bond on merchandise temporarily admitted duty-free, as long as the bond is not greater than 110% of the charges that would otherwise be owed upon entry of the merchandise. NAFTA specifically prohibits a country from imposing a bond on any vehicle or railroad traveling in transit through a NAFTA nation destined for an alternative NAFTA country, even if the entry and departure points are different, or the vehicle entering is different from the vehicle departing. All goods, regardless of origin, that are returned after repair or alteration in another NAFTA country will be permitted duty-free re-entry.

D. Import and Export Restrictions

NAFTA contains detailed provisions on export taxes, licensing, and quantitative restrictions affecting the importation of products. NAFTA prohibits the United States, Canada, and Mexico from levying export taxes unless such taxes are also applied on goods consumed domestically. A limited exception applies to Mexico, which may impose export taxes in order to relieve critical shortages of foodstuffs and basic goods.

The three NAFTA countries are permitted to limit or restrict imports and exports from non-NAFTA countries as long as the supply of that product to other NAFTA countries is not reduced. Import and export restraints that disrupt "normal" supply channels also are prohibited under NAFTA.

Additionally, NAFTA eliminates quantitative restrictions such as quotas and import licenses. However, each nation maintains the right to impose border restrictions in limited circumstances, for example, to protect human, animal, or plant health, or the environment. NAFTA also incorporates detailed rules regulating quantitative restrictions applicable to the trade in automobiles, textiles, energy, and agriculture.

E. Customs User Fees

The United States, Canada, and Mexico have agreed not to impose customs user fees on goods originating in a NAFTA country.

F. Marking Requirements

In an attempt to minimize unnecessary costs and facilitate the flow of trade, NAFTA includes uniform country-of-origin marking rules. NAFTA marking rules are similar to

current U.S. marking regulations, with the added difference that country of origin markings may be in English, French, or Spanish.

According to the agreement, goods that meet any of the following criteria are exempt from marking requirements when the importations from another NAFTA country:

- Can only be marked at an expense that would materially discourage its exportation
- Cannot be marked prior to exportation without causing injury or impairing the function of the good
- Are packaged in a container that is marked in a manner that reasonably indicates the country of origin to the ultimate consumer
- Are imported for use by the importer and are not intended for resale
- Will be processed so that the goods “result in a change” of origin for marking purposes
- When, by reason of the character of the goods, the ultimate purchaser knows the country of origin

NAFTA also limits fines and penalties imposed on an importer by customs authorities for marking violations. A NAFTA country may not impose penalties for an importer’s failure to properly mark a product unless the importer is a repeat offender, the good is removed from customs control, or the good has deceptive markings.

G. Rules of Origin

The benefits of NAFTA only apply to goods “originating” in a NAFTA country. As a result, rules of origin were created to determine which goods are eligible for preferential treatment. This section of the NAFTA is designed to accomplish the following:

- Ensure that NAFTA benefits are afforded only to goods produced in the North American region
- Provide clear rules to importers and exporters
- Minimize administrative burdens for exporters, importers, and producers trading under the NAFTA

A good is “North American” if it is “wholly obtained or produced” in the territory of Mexico, Canada, or the United States. Goods containing nonoriginating material are considered North American if the nonregional material is “sufficiently transformed” in the territory of a NAFTA country so as to undergo a change in tariff classification. This standard varies from the “substantial transformation” approach embodied in other trade agreements.

Assembled or imported goods containing non-NAFTA parts must satisfy a “regional value content” analysis in order to qualify as an “originating” good. Regional value content is calculated as a percentage using either the “transaction value” method or the “net cost”

method. Transaction value is based on the “price paid or payable” for a good, minus the value of nonoriginating parts and materials used in the production of the good.

With some exceptions, a good is considered a product of a NAFTA country even if it does not meet applicable tariff shift rules, if the value of the nonoriginating material is not greater than 7% of the transaction value of the finished good. The net cost method is based on the total cost of the good minus the cost of royalties, sales promotion costs, and packing and shipping costs. Although producers generally have the option of choosing either method, the net cost method must be used for automotive goods if (i) there is no transaction value for the good, (ii) more than 85% of sales during a six-month period are to a related party, or (iii) the regional value content is based on “accumulation.”

Automotive goods must contain the following percentages of North American materials and parts, based on the net cost method, in order to qualify for preferential tariff treatment:

- 56% for a producer’s fiscal year beginning January 1, 1998 and 62.5% for a producer’s fiscal year beginning January 1, 2002 for passenger automobiles and light trucks.
- 55% for a producer’s fiscal year beginning January 1, 1998 and 60% for a producer’s fiscal year beginning January 1, 2002 for other vehicles and automotive parts.
- The value of imported, nonoriginating parts will be traced through the production chain to improve the accuracy of the content calculation.

Finally, parts, tools, and accessories that accompany an item are not considered in the determination of whether a good has undergone a change in tariff classification, provided that the parts, tools, and accessories are not invoiced separately and are of a quantity and value that are customary for the good. This rule also applies to packing materials and containers for retail sale.

H. Customs Procedures

In order to ensure that only goods satisfying the rules of origin are entitled to NAFTA preferential tariff treatment, and to provide certainty and uniformity for importers, exporters, and producers, NAFTA includes provisions on customs administration.

1. Certificates of Origin

The United States, Canada, and Mexico have adopted procedures whereby an exporter or producer may present a “Certificate of Origin” to the customs office in the NAFTA country of importation for purposes of certifying that the good being exported qualifies as an “originating” good. If a good would have qualified as an “originating” good when it was imported into the territory of a NAFTA country, but no claim for preferential tariff treatment was made, then the importer may, within one year of the date of importation, apply for a refund of any excess duties paid upon presentation of a Certificate of Origin. Certificates of Origin are not required for goods valued at less than \$1,000.

NAFTA also gives the customs administrations of United States, Canada, and Mexico the authority to verify the origin of a good imported into their territories by administering

written questionnaires to exporters or producers and by visiting the premises of an exporter or producer. NAFTA permits customs administrations to impose criminal, civil, and/or administrative penalties for violations of the rules and regulations relating to Certificates of Origin.

2. Advance Ruling Procedures

The United States, Canada, and Mexico have adopted regulations assuring the “expeditious issuance of written advance rulings” to an exporter, importer, or producer who requests from customs a ruling pertaining to whether any of the following has occurred:

- Material imported from the territory of a non-NAFTA country has undergone a change in tariff classification for rule of origin purposes
- A good satisfies a regional value content requirement
- A good that re-enters its territory after repair or alteration in the territory of another NAFTA country qualifies for duty-free treatment
- A proposed or actual marking satisfies the country of origin requirements

Each NAFTA country must grant substantially the same right to review and appeal advanced ruling determinations as it provides to importers in its own territory.

3. Trilateral Working Group

In order to ensure consistent interpretation, application, and administration of the rules of origin, NAFTA created a trilateral working group that meets four times a year or at the request of a NAFTA country. The working group also monitors NAFTA provisions relating to the elimination of tariffs and duty-free entry of merchandise.

I. Technical Barriers to Trade

NAFTA includes provisions to ensure that the United States, Canada, and Mexico do not use health and safety standards as unnecessary obstacles to trade. For example, before adopting a standard-related measure, a government agency in each country must conduct an “assessment of risks,” taking into account available scientific evidence, the production process, public comments, and environmental conditions. According to NAFTA, this assessment will eliminate arbitrary and unjustifiable measures that discriminate against imports. Each country will designate or create a government agency that will answer questions raised by interested parties, conduct risk-assessment analysis, and provide notice to the public on standard related measures.

The NAFTA Committee on Standards-Related Measures facilitates the attainment of compatibility. Subcommittees have also been formed to monitor standard-related measures applicable to transportation, telecommunications, textiles and apparel, and automotive goods.

J. Antidumping and Countervailing Duty Investigations

NAFTA establishes procedures for the review of proposed modifications to existing antidumping and countervailing duty laws and creates a system of binational panels to review antidumping and countervailing duty determinations issued by administrative authorities in each country.

NAFTA explicitly preserves the right of each country to retain or amend its antidumping and countervailing duty laws. An amendment may be subject to review by a binational panel, however, if a NAFTA country believes the amendment is inconsistent with NAFTA's goal of eliminating barriers to trade. If the panel recommends a modification to the amending statute to remedy a nonconformity that it has identified, then the parties must immediately begin consultations to achieve a solution to the matter, and the offending party must enact corrective legislation within nine months from the end of the consultation period.

NAFTA also establishes a mechanism for independent binational panels to review final antidumping and countervailing duty determinations issued by administrative authorities.

II. Trade in Services

NAFTA is the first multilateral trade agreement to extend the benefits of "national treatment" to the trade in services. In other words, each NAFTA country agrees to treat service providers no less favorably than it would treat its own service providers. However, NAFTA provides an exception to "national treatment" for the federal, state, and local laws that each NAFTA country has listed in the appendix to the Agreement. Additionally, the benefits of the agreement do not apply to most air services, basic telecommunications, energy and petrochemicals, the maritime industry, and social services provided by a NAFTA government. Each NAFTA country reserves the right to deny "national treatment" to service providers owned or controlled by persons from a non-NAFTA country.

NAFTA countries may maintain quantitative limits on service providers and can continue to require professional licensing and certification, as long as objective standards are maintained. Each country has listed in the appendix to the Agreement their nondiscriminatory measures that limit the number of service providers in a particular sector. Any NAFTA country may request consultation regarding such measures with the intention of negotiating their removal or liberalization. The Agreement requires that professional licensing be based solely on education, examinations, experience, consumer protection, and ethical considerations. Each NAFTA country has established a program aimed at developing common procedures for the licensing and certification of foreign legal consultants and engineers. NAFTA also contains detailed provisions regulating energy, investment, and financial service providers.

Finally, NAFTA prohibits the United States, Canada, and Mexico from requiring a service provider from another NAFTA country to establish or maintain a representative office, branch, or any other form of enterprise in its territory as a condition for the provision of services.

Morgan, Lewis & Bockius LLP advises clients on a broad range of NAFTA compliance matters.

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