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Trade War Continues: Potential Pitfalls of Moving Manufacturing Out of China

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It is becoming more and more apparent the U.S. trade war with China is here to stay, at least for the foreseeable future. U.S. Trade Representative (USTR) Robert Lighthizer recently stated in posted comments to the House Ways and Means Committee the Administration's position on the expansion of tariffs on Chinese goods, highlighting the importance of these actions as a negotiating tool:

"Currently the Administration's use of tariffs under Section 301 [of the Trade Act of 1974, 19 U.S.C. § 2411] is providing the United States with an important source of leverage to bring China to the table to negotiate an enforceable agreement that will address China's unfair trade practices. The Administration does not have a predetermined timetable for how long it will be necessary to leave these tariffs in place."

Not only is the end of the trade war out of sight, the battle is expanding. The USTR's office has announced new tariffs on \$300 billion worth of goods from China that were not previously subject to Section 301 tariffs, including consumer goods and electronics. These tariffs will be implemented in two phases on September 1, 2019 and December 15, 2019.

The most recently announced tariffs, so called Tranche 4, coupled with existing tariffs, will impact essentially every product of China imported into the United States, and China will likely fight back. China's State Council Tariff Commission has announced that it will take "necessary countermeasures" in response to these new proposed tariffs. China has also signaled that the new tariffs pose challenges to the Chinese economy, but the overall impact is controllable. It appears the risk of escalation is growing while the chance of a negotiated settlement is diminishing.

Expanding Trade War

More bad news for importers – the trade war may be going global. President Trump has voiced his frustration with other trading partners, including the European Union, stating that the EU is "worse than China, just smaller, it treats us horribly." The Administration is particularly concerned with France's new Digital Services Tax, which imposes a 3% tax on large technology companies (e.g., Amazon, Inc., Facebook, Inc.) operating in the country. While not directly related to trade in goods, the USTR held a hearing on the matter to solicit feedback from companies, industry groups, and other interested parties. This signals a potential

Section 301 tariff action in retaliation. Compounding the risk is the news that more countries, including the United Kingdom and Austria, are considering similar digital tax legislation.

All indicators point to the need for U.S. importers to develop a long-term plan to survive the trade war. A popular option is relocating manufacturing outside of China.

Moving Manufacturing Out of China

The Section 301 tariffs apply to products of China. Merely shipping goods from a third country does not avoid application of these tariffs. For example, finished goods made in China and shipped to Vietnam before being exported to the United States are still subject to applicable Section 301 tariffs – even if relabeled as Vietnamese origin.¹ However, shifting manufacturing, or in some cases final assembly, to a third country is a legitimate strategy for averting these tariffs.

To escape Section 301 tariffs the processing (manufacturing, assembly) in a third country must effect a change in the country of origin of the finished item. Customs and Border Protection (CBP) generally requires a good to undergo a “substantial transformation” to change its country of origin.

While several factors are considered when evaluating if components are substantially transformed in production of a finished product, CBP has clarified the applicable test for determining an item's country of origin for Section 301 tariff purposes. In CBP Ruling HQ H300226, the agency found that electric motors assembled in Mexico remained products of China and therefore subject to Section 301 tariffs. CBP held that the production process performed in Mexico constitutes mere simple assembly of the three China origin components used to produce the finished motors. To avoid this type of outcome, companies should perform a detailed substantial transformation analysis, applying CBP's criteria, before moving production out of China.

Substantial Transformation “Name, Character, and Use” Test

Citing to prior cases from the Court of International Trade, CBP applied the “name, character, and use” test to determine the country of origin of the electric motors in HQ H300226. This test includes the following elements:

the imported articles undergo a physical change;
the end-use of the items is not pre-determined at time of import; and
the processing is sufficiently complex such that individual parts lose their separate identity and become integral parts of a new article.
The physical change element requires the finished item to have a “new name, character, and use,” or in other words – be transformed through manufacturing into a different article of commerce.² Finished products manufactured using components or parts that do not lose their identity or individual names are generally not considered substantially transformed.

A pre-determined end-use refers to the components or parts being specifically designed solely for production of the finished product. For

example, foreign components used to assemble a flashlight were found to have a pre-determined end-use and therefore were not substantially transformed in the country of final assembly.

The final element, complexity of processing, is key to any decision to relocate manufacturing of a product in order to effect a country of origin change. CBP has consistently held that simple assembly is insufficient to confer origin. The term “simple assembly” is defined in CBP's regulations as “the fitting together of five or fewer parts all of which are foreign (excluding fasteners such as screws, bolts, etc.) by bolting, gluing, soldering, sewing or by other means without more than minor processing.”³ Other factors that impact the complexity of processing include: worker skill level, equipment type, value add, and time required for production.

Conclusion

The likely continuation of these additional tariffs on imports of Chinese goods, as well as the potential expansion of Section 301 tariffs to products of other countries, necessitates a long-term strategy for a company's international supply chain. Other options are available for reducing the impact of these tariffs, including submission to the USTR of exclusion requests or changing sourcing, but care should be exercised when shifting manufacturing to a third country not subject to these additional tariffs. Meeting the substantial transformation test can be complicated, and failure to make the proper determination could result in no relief from these tariffs, or worse, penalties for false country of origin declarations.

[1] Misleading country of origin declarations and labeling may also subject an importer to CBP penalties.

[2] See *United States v. Gibson-Thomsen Co., Inc.*, 27 C.C.P.A. 267 (C.A.D. 98) (1940).

[3] 19 C.F.R. § 102.1(o).

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