Weathering the Tariff Storms: Navigating U.S.-China Trade Tensions by Strengthening Customs Compliance

Contributed by Victor Ban and Dana Watts

If your company imports goods into the U.S., then the challenges of customs clearance and compliance are nothing new. To properly document each shipment, importers need to report to customs authorities the country of origin, value, and tariff classification of the imported goods, among other information. What is relatively new these days is the markedly higher stakes resulting from tariffs imposed by the Trump Administration—in particular the multiple tranches of Section 301 tariffs on imports from China implemented starting in July 2018 in response to problematic Chinese intellectual property policies that have injured U.S. industry. On May 10, tariffs on $200 billion in Chinese imports increased from 10 percent to 25 percent. Three days later, the Administration proposed a new tranche of tariffs on $300 billion in goods, essentially all Chinese imports not already subject to Section 301 duties. These tariffs could remain in place longer than many observers had anticipated.

Given these new trade frictions, many companies are now undertaking a fuller review of their customs compliance posture, particularly with respect to tariff classification and country of origin. Importers are asking whether their products are correctly classified and whether they are in fact products of China. Because U.S. Customs and Border Protection ("CBP") uses this information to determine the nature and amount of any tariffs assessed and the applicability of tariff exclusion requests, getting to the right answers—and ruling out wrong ones—could translate into substantial bottom-line impact during a protracted period of increased tariffs. Below, we share stories from actual importer experiences, offer tips and strategies, and explain some of the consequences that can result from missteps.

Classification conundrums

Each good imported into the U.S. must be classified under one unique, correct tariff classification out of over 18,000 listed in the Harmonized Tariff Schedule of the United States ("HTSUS"). Clarifying a good's classification can have significant payoff when it comes to duty liability. First, as noted above, because Section 301 tariffs have taken effect in multiple tranches, and not all Chinese imports are subject to these tariffs (for now), detecting misclassification could make a significant difference in duty—and penalty—exposure. Second, accurate classifications and product descriptions are necessary elements of successful tariff exclusion requests; a new exclusion request process for the $200 billion list is anticipated. [1] Third, even if a company missed prior tariff exclusion request deadlines, it could still benefit if its imports fall within one of over 1,900 exclusions that have been granted so far, but that determination hinges on having correctly classified the imports.

What does confirming a good's tariff classification entail? In the best cases, classification review involves a quick study of a product's characteristics and the language of the HTSUS. Sometimes, however, there is more nuance to a classification problem than initially meets the eye. Below are some tips for resolving particularly thorny classification problems based on our experience with tariff exclusion requests and customs compliance reviews for companies representing a range of industries and levels of sophistication with respect to customs compliance. Given that classification often requires fact-intensive analysis involving highly confidential information, we recommend early consultation with outside legal counsel or classification experts once potential problems are surfaced.

Conflicting CBP rulings

CBP issues classification rulings when asked to do so by an importer or other interested party. Classification rulings are only binding with respect to the particular product at issue in the ruling, although they are instructive in classifying similar products. It sometimes happens that a ruling classifies a particular product one way, and another ruling classifies what appears to be a very similar product in a different way. When classification rulings appear to conflict with each other, the importer must, as always, use reasonable care to classify its own product. In reviewing classification rulings, we consider rulings with detailed explanations as to why a particular product is classified in a particular way to be more supportive than rulings that summarily state the correct classification with little or no explanation. We also consider rulings that were issued more recently to be more authoritative than older rulings. Importers should also check to see whether an apparent conflict can be explained by an intervening change in the tariff schedule itself (more on this below). When CBP knows that a ruling it is issuing conflicts with one of its earlier rulings, it will revoke the earlier ruling and note the revocation in the new ruling.

Competitor using different classification

Sometimes it comes to an importer's attention, through industry intelligence or otherwise, that a competitor is entering a similar product under a different tariff classification. If the other tariff classification has a lower duty rate, the company may be tempted to begin entering its own products under that classification. However, companies should know that, in CBP's view, there is only one correct tariff classification for any given product. Importers have an affirmative duty to use reasonable care to determine that one correct classification. Evidence that a competitor is using a different classification cannot be used to support a particular classification, unless that evidence is in the form of a public ruling issued to the competitor in which CBP has verified the correct tariff classification for that product. While such rulings are only binding on the particular product that was at issue, they can be used to support the same classification for substantially similar products.

If a company believes that a competitor is using an incorrect tariff classification when entering its product in order to avoid customs duties, it can report its competitor using the e-Allegations portal on CBP's website. If the company suspects the products are being misclassified in order to avoid antidumping and countervailing duties, the behavior can be reported using the same website; the investigation process and remedies would be governed by statutory authority provided in the Enforce and Protect Act.

Transactional complexities

Transactions can present new customs compliance challenges. For instance, when a company's trade compliance team reviewed customs entry records following an acquisition, they discovered that for several years, the newly acquired subsidiary had been importing the same product as the parent, but under a completely different tariff classification. The use of conflicting classifications by the same, newly integrated Importer of Record seemed to be a ready target for possible enforcement and made for a strong case for submitting a prior disclosure under 19 U.S.C. § 1592(c)(4). A prior disclosure tells CBP that a violation occurred and provides a vehicle for the importer to pay unpaid or underpaid duties related to the violation.

A thorough customs compliance review should be built into pre-transaction diligence wherever possible. Following a transaction, pre-existing problems such as conflicting classifications can be augmented and complicated, thereby increasing enforcement exposure.

Broker errors

Although customs brokers can facilitate the process of reporting classification and other information to CBP, importing companies are ultimately responsible for the accuracy of the information declared. In one case, a company had believed for years that its broker was using one classification, only to discover in the course of a review of its entry documentation that its broker had actually been using a different classification. The first step, of course, was to determine which classification was correct. In this case, it turned out that neither looked right, though the issues were far from straightforward. We prepared a prior disclosure coupled with a request for "internal advice," i.e. CBP guidance on the proper approach to correcting the disclosed errors.

This experience underscores the importance of close coordination with brokers. A compliant internal controls program includes broker management procedures, which can include written letters of instruction, a classification database, and a regular review or audit of broker entries to ensure that importer instructions are accurately implemented. For particularly egregious broker errors, companies may consider reporting the issues to CBP, which can discipline broker misconduct.

Changes to the HTSUS over time

Importers should also periodically review the HTSUS to ensure that their classifications have not been invalidated by changes to the tariff schedule. The HTSUS is based on the Harmonized Commodity Description and Coding System ("Harmonized System"), which is maintained by the World Customs Organization. Contracting parties to the International Convention on the Harmonized Commodity Description and Coding System, to which the Harmonized System is appended as an annex, must use all of the headings and subheadings (the first six digits) without addition or modification. The contracting parties can add extra digits for use within its borders. The U.S. has added four such digits; the resulting 10-digit system is the HTSUS. The Harmonized System is amended only once every four years, but the HTSUS is amended multiple times a year. The U.S. International Trade Commission administers the HTSUS and publishes these amendments.

The bottom line is that it is important to make sure all imported merchandise is properly classified. Importers must use "reasonable care" to classify goods, and importers should regularly audit entry documents to make sure that there have been no errors. Further, importers should be alert to any changes to the imported merchandise or to the HTSUS over time that could impact the classification.

Country of origin and supply chain strategies

Of course, classification diligence is only one element of a company's Section 301 tariff mitigation toolkit. Here, we briefly review other strategies for lowering tariff exposure, related to the country of origin of imports and other sourcing strategies.

First, and likely most favored by the Trump Administration, companies can consider sourcing from countries other than China. Where feasible, diverting supply chains away from China can result in greater stability and certainty as U.S.-China trade relations remain tense and may see further disruptions in the coming years. Such supply chain shifts are often costly, and may also be "sticky" once new supplier relationships are established. Accordingly, companies are often reluctant to resort to this option without a longer-term sourcing strategy.

A potentially less disruptive way to accomplish the same objective might be to continue sourcing components from China, but further manufacture or assemble the components in a third country before importing them into the U.S. If the manufacturing or assembly performed in the third country is enough to constitute a "substantial transformation" under U.S. law, the country of origin becomes the third country rather than China. And because Section 301 tariffs apply only to Chinese goods, such a product would no longer be subject to Section 301 duties. Proceed with caution in this area, however, as substantial transformation analyses are complex and fact-specific. It may be useful to seek an advance advisory ruling from CBP prior to investing substantial resources in reconfiguring operations and also to consider whether the company's existing operations might effect a “substantial transformation” outside of China.

Even where an imported product is subject to Section 301 duties, its Chinese-origin components might not be if they are imported separately before assembly in the U.S. But be careful not to ship the components in such a way that they take on the “essential character” of the finished good. If this is done, under General Rule of Interpretation 2(a) of the HTSUS, the components must be classified in the same way as the complete, assembled item, which would mean that Section 301 duties would still apply.[2] For example, if the finished article has 10 components, the importer should not import 100 of each of the 10 components in a large single box, as this would be classified the same way as 100 finished, assembled articles. Also, even if the components can be classified as such rather than as the finished good, they might still be subject to Section 301 duties. Be sure to check whether the tariff classifications of the individual components are subject to Section 301 duties if your plan is to continue sourcing the components from China. Of course, if the fourth tranche of Section 301 duties is implemented, virtually all imports from China will be subject to additional Section 301 duties, so this strategy could have limited utility unless a significant portion of the components are sourced from countries other than China.

Lastly, in any mitigation strategy, it is crucial to pay attention to whether relocating production or sourcing may subject the importer to other customs duties, such as antidumping and countervailing duties or Section 232 duties on steel and aluminum products.

What not to do

It can be tempting to look for quick fixes to classification problems or to mitigate tariffs without undertaking the proper diligence. These shortcuts, however, can lead to major penalties down the road. Below, we outline a few examples of actions that should immediately raise red flags.

Reclassify without using reasonable care

The Customs Modernization Act went into effect in 1993. Under the amended 19 U.S.C. § 1484, importers are responsible for using “reasonable care” to enter, classify, and value their imports. Failure to use reasonable care violates 19 U.S.C. § 1592, which makes it illegal to enter merchandise into the commerce of the U.S. using materially false information. This includes incorrect tariff classifications. Violations of 19 U.S.C. § 1592 are subject to penalties.

Reclassify without disclosure to CBP

Because there is only one correct classification for every import, reclassifying an import generally means that the importer had previously misclassified it. Again, getting classification wrong violates 19 U.S.C. § 1592. To mitigate the possibility of penalties for past misclassification, if the importer determines that a product has been misclassified, it should file a prior disclosure under 19 U.S.C. § 1592(c)(4). For particularly difficult classification issues, importers can couple the prior disclosure with an internal advice request, as explained above.

Report an incorrect country of origin

The country of origin is not necessarily the same as the country from which the good was last exported before being imported into the U.S. Importers are required to perform a country of origin analysis to determine the correct country of origin for every imported article. For example, a good that was mostly manufactured in China but had some “finishing touches” performed in Thailand could still be a product of China, and subject to Section 301 duties.

The country of origin is “the country of manufacture, production, or growth of any article of foreign origin entering the United States.” [3] Further work or material added to an article in another country must effect a substantial transformation in order to render such other country the “country of origin” within the meaning of U.S. marking laws and regulations. In determining whether an article undergoes a substantial transformation in a particular country, and thus qualifies as a product of that country, the determinative issue is the extent of operations performed in that country and whether the parts lose their identity and become an integral part of the new article within that country. [4] Assembly operations that are minimal or simple, as opposed to complex or meaningful, will generally not result in a substantial transformation.

In order to determine whether an article is substantially transformed in a second country in which additional parts are added and further assembly is performed, CBP considers the totality of the circumstances and makes such determinations on a case-by-case basis. The country of origin of the article's components, the extent of the processing that occurs within a country, and whether such processing renders a product with a new name, character, and use are primary considerations. [5] This inquiry is fact intensive, and necessarily will be specific to the product being considered.

Importers that import goods from Mexico or Canada must be particularly alert. The NAFTA marking rules generally determine the country of origin that should be declared at entry for these goods. [6] These rules are set forth in 19 C.F.R. Part 102. They involve “tariff shift” and other rules, and are sometimes easier to satisfy (meaning that the product is more likely to be considered a good of Canada or Mexico) than the substantial transformation test. Importantly, however, the country of origin for purposes of applying additional Section 301 duties is determined by the substantial transformation test, *regardless of whether the goods are from Canada or Mexico*. [7] This can result in a product being marked as a product of Canada or Mexico, and still being subject to Section 301 duties as a product of China. [8]

Illegally “transship” goods

To the uninitiated, the difference between the country of origin and the country of export may seem rather abstract. However, the distinction is critical under the law. As discussed above, there are specific rules for determining an import's country of origin, independent of the good's country of export, which is the country from which it was shipped to the U.S. If goods are manufactured in Country A, merely shipping them to Country B and then importing them into the U.S. does not make Country B the country of origin for customs purposes. When used in order to avoid lawful import duties, the practice of shipping goods whose country of origin is Country A to Country B and then declaring Country B as the country of origin is called illegal transshipment. It is subject to penalties under 19 U.S.C. § 1592, the False Claims Act, and possibly other civil and criminal laws.

Consequences of improper classification

As tariff pressures mount, the consequences of making classification mistakes are ratcheting up as well. Below, we survey a few that should be top of mind for any importer. Although criminal penalties may also be implicated depending on the facts of a particular case, here, we forgo discussion of criminal liability in the interest of brevity.

CBP penalties

The sweeping breadth of Section 301 tariffs, covering over 6,800 HTSUS subheadings at the 8-digit level and $250 billion worth of imports from China, means that many goods previously subject to very low tariffs have seen substantial duty rate hikes. From the perspective of monetary fines, this means that if a good is misclassified, a violation discovered by CBP can result in heavier fines—civil penalties are calculated based on multiples of any unpaid duties, taxes, and fees that vary with the level of intent or, where there is no underpayment, are based on a percentage of the value of the imported merchandise. Classification errors can therefore now be much more costly.

Beyond monetary penalties, however, seizure of goods at a port of entry can often be even more painful for an importer. While it rarely occurs, CBP has the authority to seize goods if the importer misclassifies the goods or provides other material and false information under certain circumstances. [9] These circumstances include situations where the port director has reasonable cause to believe that the party responsible for the violation is insolvent or beyond U.S. jurisdiction; where the seizure is "essential to protect the revenue" (i.e. where seized merchandise serves as security for a penalty payment); and where the merchandise is prohibited or restricted. [10] In industries with just-in-time inventory needs, having a supply chain disrupted at the border could mean financial losses to the business or damaged customer relationships that vastly outweigh any CBP fines.

A prior disclosure, referenced above, can help reduce penalty exposure significantly. For errors not involving fraud, monetary penalties are reduced to unpaid duties plus interest, and the merchandise will not be seized on the basis of incorrect documentation, under any circumstances.

False Claims Act liability

In addition to penalties under 19 U.S.C. § 1592, misrepresenting information on customs documents can lead to penalties under the False Claims Act. [11] The False Claims Act creates liability for an importer that "knowingly makes, uses, or causes to be made or used, a false record or statement material to an obligation to pay or transmit money or property to the Government, or knowingly conceals or knowingly and improperly avoids or decreases an obligation to pay or transmit money or property to the Government." [12] Many False Claims Act actions begin with a "whistleblower" within the company alleging customs violations. The U.S. Department of Justice can elect to intervene in the case, or whistleblowers can proceed on their own. The DOJ has investigated importers for False Claims Act violations for various customs-related violations, including misclassifying imports and misrepresenting imports' country of origin. In the past several years, the DOJ has reached settlements with importers for these alleged violations ranging from $100,000 to $45 million. Importantly, if the requisite intent can be proven, the False Claims Act provides for treble damages.

The road ahead

Absent a breakthrough in bilateral trade talks between the U.S. and China, 25 percent tariffs on $250 billion worth of imports from China will remain in place, with possible additional 25 percent tariffs on the remaining $300 billion in Chinese goods to follow later this summer. So long as a systemic reprieve from tariff pressures is elusive, importers may be able contain these new costs of global trade by getting their house in order from a customs perspective.

The upsides to a robust customs compliance function are numerous. Near-term, a company with accurate product classifications can more readily assess their exposure to Section 301 tariffs by determining whether their imports are subject to the additional duties and can also increase the odds of obtaining a product-specific tariff exclusion. A full understanding of country of origin can also help a company re-think its China supply chain strategy from an operational and legal perspective. Over the longer term, a company with a healthy compliance program can minimize the risk of penalties following from surprise audits; CBP may be stepping up enforcement efforts as both the Administration and Congress have urged broader efforts to crack down on duty evasion. Investing now in strengthening customs compliance can yield substantial dividends as U.S.-China trade tensions persist and global commerce appears to be headed for a new era of fragmentation.

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Endnotes

[1] On May 20, 2019, the Office of the U.S. Trade Representative released a notice indicating that it plans to launch a new process in late June for considering product-specific exclusions from the list of $200 billion in Chinese imports.

[2] General Rule of Interpretation 2(a) states that "Any reference in a heading to an article shall be taken to include a reference to that article incomplete or unfinished, provided that, as entered, the incomplete or unfinished article has the essential character of the complete or finished article. It shall also include a reference to that article complete or finished (or falling to be classified as complete or finished by virtue of this rule),entered unassembled or disassembled."

[3] 19 C.F.R. § 134.1(b).

[4] Belcrest Linens v. United States, 573 F. Supp. 1149 (Ct. Int'l Trade 1983), *aff'd*, 741 F.2d 1368 (Fed. Cir. 1984).

[5] *See, e.g.*, Customs Ruling HQ H114395 (May 18, 2011).

[6] 19 C.F.R. § 134.1(b) ("Country of origin" means the country of manufacture, production, or growth of any article of foreign origin entering the United States. Further work or material added to an article in another country must effect a substantial transformation in order to render such other country the 'country of origin' within the meaning of this part; however, for a good of a NAFTA country, the NAFTA Marking Rules will determine the country of origin.")

[7] *See* Customs Ruling HQ H301619 (Nov. 6, 2018).

[8] *Id.* (country of origin of an electric motor was Mexico for marking purposes under the NAFTA marking rules but the country of origin was China for purposes of applying Section 301 duties).

[9] 19 U.S.C. § 1592(a)(1).

[10] 19 C.F.R. § 162.75; 19 U.S.C. § 1592(c)(14).

[11] 31 U.S.C. §§ 3729-3733.

[12] 31 U.S.C. § 3729(a)(1)(G).