

## What To Know Before Moving Your Supply Chain Out Of China

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A main weapon that the United States has used in the ongoing trade war with China has been import tariffs that target Chinese goods. These tariffs are often applied under Section 301 of the Tariff Act of 1974 and through anti-dumping and countervailing duty orders on Chinese goods.

Many U.S. companies are considering moving their supply chains out of China in the hopes that, if they are not importing goods from China, they can avoid these tariffs. For this strategy to be effective, supply chains need to be moved in a way that is cognizant of the complex analysis governing country-of-origin determinations used by U.S. Customs and Border Protection.

Additionally, where the product being resourced is subject to AD or CVD tariffs, U.S. companies need to consider that the U.S. Department of Commerce has authority to find that goods with a country of origin other than China are circumventing AD/CVD orders on Chinese goods and subject them to tariffs.

Below we provide an overview of CBP and Commerce Department practices and trends in these areas, and conclude with practical consideration for companies considering moving their supply chains.

### Country of Origin and Substantial Transformation

While claiming a country of origin other than China for your goods may seem like an easy way to avoid import tariffs targeting Chinese goods, an importer must use reasonable care when declaring a good's country of origin and a failure to do so can result in significant civil, and even criminal, penalties. To exercise reasonable care, an importer must determine the country of origin of its goods through application of the rules developed by CBP.

When a good is wholly the product of a single country, CBP's country-of-origin rule is simple — the good is a product of the country of production. However, goods often include material produced in more than one country in which case CBP employs what is known as a substantial transformation analysis to determine the country of origin.[1] Under this framework, a good is deemed to originate from the last country where it was substantially transformed.



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A substantial transformation occurs when a good is transformed into a new and different article of commerce with a name, character and use that differs from the article that preceded it in the production chain. Because the substantial transformation test is inherently fact driven and includes subjective components, there are few bright line rules for importers to follow.

Nevertheless, in general, minor production processes that leave the essential identity of the article intact — e.g., basic assembly operations, mixing components where the individual components maintain their identity, repackaging and dilution in water — do not constitute a substantial transformation.

For example, in one recent ruling, CBP determined that a valve actuator assembled in Mexico was Chinese-origin and thus subject to Section 301 duties because a key component, the electric motor, was produced in China with a predetermined end use that did not change upon assembly in Mexico.[2]

### **Possible Circumvention of AD/CVD Orders**

Shifting supply chains out of China poses a further challenge where the product in question is also subject to AD/CVD tariffs. Although AD/CVD orders cover many countries, China is the most frequent target with nearly 40% of the Commerce Department's active AD and CVD orders covering Chinese goods.

Moreover, Chinese goods covered by AD/CVD orders are often subject to steep duties that can in many instances approach or even exceed the value of the merchandise being imported. For example, the Commerce Department recently imposed AD tariffs of 1,731% on certain mattresses from China. This finding means that importers are currently required to pay cash deposits that are more than 17 times the value of the mattress.

With such high rates, AD/CVD tariffs provide another incentive for companies to shift their supply chains away from China. However, sourcing from a country outside of China does not guarantee that the product will be outside the reach of AD/CVD orders.

These orders are administered by the Commerce Department which is not bound by the country-of-origin rules or determinations of CBP. Thus, for example, even if Customs determines that a good has a country of origin other than China for purposes of Section 301 tariffs, the Commerce Department can find that, for AD/CVD purposes, the good is subject to AD/CVD tariffs on Chinese goods.

There are two main reasons that the Commerce Department might pull non-Chinese goods under AD/CVD orders on Chinese goods. First, many orders today expressly cover goods that undergo assembly or completion in a third country prior to exportation to the United States. Under these circumstances, even if the assembly or completion outside of China constituted a substantial transformation — meaning the goods would not have a country of origin of China — the goods might still be subject to the AD/CVD order on Chinese goods if the assembly or completion was of the kind explicitly articulated in the order.

Second, even absent such express language, the Commerce Department can pull non-Chinese goods within the scope of an AD/CVD order on Chinese goods, if it finds that the goods are circumventing the order.

In relation to moving supply chains, the most likely kind of circumvention the Commerce Department

might find occurs when a good is further assembled in a third country or in the United States.[3] While the test that the Commerce Department applies looks similar to the substantial transformation test that Customs applies for country of origin, including examining the nature of the production processes, the tests are not identical, particularly as each agency has developed its own practice under these tests.

Furthermore, one of the Commerce Department's primary goals is vigorous enforcement of AD/CVD orders. To this end, in recent years, the Commerce Department has demonstrated its willingness to use circumvention proceedings frequently and aggressively, particularly in the case of Chinese goods.

Before President Donald Trump took office, the Commerce Department initiated, on average, six circumvention proceedings a year. Since 2017, however, the Commerce Department has initiated 32 circumvention inquiries, nearly tripling the historical annual average. Included in this list are three inquiries that the Commerce Department initiated on its own, something it had likely done only one other time since the circumvention laws were enacted in the 1980s.

Of the 32 circumvention inquiries initiated since the beginning of 2017, more than 60% have involved Chinese merchandise. And at least a handful of these inquiries have had broad-reaching implications.

For example, the Commerce Department recently issued circumvention determinations that expanded AD/CVD orders on corrosion-resistant, or CORE, and cold-rolled steel, or CRS, products from China to cover CORE and CRS finished in Vietnam using intermediate steel inputs from China. As a result of that finding, the Commerce Department now requires that all importers of CORE and CRS from Vietnam certify that their steel substrate was not produced in China or risk being required to pay AD/CVD tariffs.

These and other recent circumvention determinations are also notable because, while circumvention inquiries have historically been limited to specific companies found to have been engaged in circumvention, the Commerce Department has recently been applying circumvention determinations on a countrywide basis, thus affecting all exports of the product subject to the inquiry.

### **Practical Considerations for Shifting Supply Chains Out of China**

To improve the chance that a supply chain can be successfully shifted out of China to avoid tariffs imposed by the U.S. government on Chinese goods, a company may want to consider the following:

- The resourced good should be evaluated under CBP country-of-origin rules to determine if an importer exercising reasonable care can claim a country of origin other than China.
- If there is an AD/CVD order on the good, the scope of that order should be evaluated to determine whether it includes explicit language that pulls goods that undergo assembly or completion in a third country prior to exportation to the United States under the scope of the order.
- If there is an AD/CVD order on the good, the resourced good should be evaluated under the Commerce Department's circumvention rules to determine if there is a meaningful risk that the resourced good would be found to circumvent an AD/CVD order on Chinese goods.

- Moving a portion of production outside of China — rather than the entire production process — might not be sufficient to avoid Section 301 duties or AD/CVD duties because the nature of the production processes and the sourcing of production inputs is often crucial to claiming a country of origin other than China or avoiding a determination that your goods are circumventing AD/CVD orders.
  - Purchasers should ask prospective suppliers about the origin of their production inputs. Where a potential supplier reveals that they are sourcing all or a large portion of their inputs from China, the risk that the good will have a country of origin of China or be found to be circumventing an AD/CVD order on Chinese goods should be evaluated.
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[1] Although merchandise exported from a NAFTA country is normally subject to a different country-of-origin test, Customs has found that the substantial transformation test applies when determining the applicability of special tariffs such as Section 301 duties. See, e.g., HQ H302480 (Sept. 13, 2019).

[2] HQ H303140 (Apr. 19, 2019).

[3] Other kinds of circumvention include: (1) making minor alterations to a product that would otherwise be subject to an AD/CVD order; and (2) and importing a product developed after issuance of an AD/CVD order that has the same general physical characteristics of, and is used in the same way as, the product subject to the order. See generally 19 U.S.C. § 1677j.