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It's Time to Take a Second Look at Your Products' Countries of Origin

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Alongside the plethora of changes to daily life and business that we've grown accustomed to during the coronavirus ("COVID-19") pandemic, supply chains likewise appear to be facing a new normal—one filled with delays, shortages, and sourcing challenges. Supply chain interruptions are ubiquitous. Ninety-four percent of Fortune 1000 companies faced supply chain disruptions resulting from COVID-19, according to a report by Accenture.[i] As a result, many businesses have changed sourcing or suppliers for certain components, and the need for supply chain flexibility persists as economic activity rebounds and pandemic-related challenges remain uneven across major exporting countries.[ii] A survey of small businesses performed by the U.S. Census Bureau showed that, as of July 2021, domestic and foreign supplier delays, as well as delivery and shipping delays, had all *increased* since April 2021.[iii] As supply chains continue to face global disruptions, stable sourcing of product inputs is a thing of the past and ongoing compliance will require that companies develop systems for real-time monitoring of their declared and marked countries of origin.

Given the turbulent nature of supply chains in this new normal, we suggest that our clients and friends confirm the accuracy of declared and marked countries of origin of finished products, and promptly remediate any needed changes in declarations, certifications, marking, labeling, or duties, as discussed below.

Overview of Country of Origin Requirements

Country of origin analyses are fact intensive. The sourcing of a single component or the movement of a single production process of a good could change its country of origin.[iv] Although a complete discussion of all rule of origin schemes is outside the scope of this article, generally, the country of origin which must be declared and marked for a product containing components of more than one country is the country in which the product was last "substantially transformed."[v]

Whether a product has been substantially transformed can be an extremely complex and fact-intensive question. Moving production processes or component suppliers can quickly change the analysis. To create a modern example based on a common substantial transformation scenario, similar to that described in U.S. Customs and Border Protection ("CBP") Headquarters Ruling HQ 560115,[vi] if a major component of a product is manufactured in Vietnam, such that the Vietnamese component serves as the "essence" or "essential character" of the finished good, then the substantial transformation may be deemed to occur in Vietnam, despite the addition of components manufactured in other countries and the ultimate assembly taking place in the United States. However, changing the sourcing of the single Vietnamese component to China as a result of supply chain modifications would change the outcome of the country of origin analysis—likely requiring that China be declared and marked as the country of origin (and, pursuant to the Section 301 action against China, that additional 7.5% to 25% tariffs be paid on the goods at the time of import).[vii]

Ensuring that the proper country of origin is determined for all products is far from a clerical requirement. On the contrary, different country of origin analyses are critical to:

- Defining the rates of duty and safeguard actions that may apply to goods;[viii]
- Determining the country that should be marked on a product pursuant to marking rules;[ix]
- Determining labeling requirements, such as under the Federal Trade Commission's ("FTC") "Made in USA" standard ("Made in USA");[x] and
- Compliance with government procurement regulations, such as the Buy American Act ("BAA").[xi]

Each of the above regulatory schemes is distinct, and not all use the substantial transformation test. Under each of the schemes, however, small changes as to the sourcing of inputs into finished products may result in analyses leading to different country of origin determinations. Furthermore, the country of origin for purposes of one regulatory analysis may not be the country of origin for another due to their different tests and standards. Consequently, the risk is high that a sourcing change may alter a prior country of origin determination and result in errors in your declarations, certifications, marking, labeling, or duties.

Businesses must be aware of the potential fines and penalties for incorrectly determining a product's country of origin. For imported products with country of origin declaration errors, depending on the level of culpability of the error, penalties per violation could range from 20% of the dutiable value of the merchandise, to two to four times the underpaid lawful duties, taxes, and fees, up to even the domestic value of the merchandise.[xii] And, as discussed below, there are additional collateral consequences to inaccurate country of origin determinations, including tariff over- or underpayment, violations of Made in USA or other consumer protection labeling requirements, and additional avenues of liability for government contractors, such as under the BAA or Buy America statutes.

Small Sourcing Changes Can Dramatically Impact Tariff Calculations

Changes to supply chains or component sourcing due to supply chain disruptions also affect country of origin determinations under trade preference programs and free trade agreements, which may impact tariff calculations. Although this risk has always been present when dealing with cost-sensitive rules of origin, the dramatic increase in supply chain disruptions has heightened the possibility of errors in this area. Many of these programs and agreements use one or more of the below types of rules of origin:[xiii]

- Minimum local value content requirements
- Tariff-shift rules
- Regional value content requirements
- A de minimis test

Under these methods, the origin and value of certain components are critical. Any changes in the sourcing of components may upset a previously determined country of origin. In fact, *even without any changes to suppliers*, changes in value alone of certain inputs into finished products may alter the country of origin. For example, where there is a minimum local value content or regional value content requirement, *any* valuation changes must be accounted for in the final determination of what percentage of the value of a product is "local" or "regional."

Consider the simplified case of a widget produced in and imported from Mexico under the U.S.-Mexico-Canada Agreement ("USMCA"), which operates primarily through tariff-shift rules, but allows for a "de minimis" amount of non-originating content up to 10% of the total cost or transaction value of the finished good.[xiv] If the total cost of the widget is $10, and it has a single

non-originating component that did not meet the widget's tariff-shift rule with a cost of $0.95, that widget qualifies for USMCA treatment (given that the percentage of non-originating content is 9.5%) and could enter duty-free and be marked as a product of Mexico. However, if a supplier cost increase due to supply shortages or a sourcing change bumps that non-originating component cost to $1.05, resulting in an increased total cost by $0.10 to $10.10, the percentage of the total cost of the non-originating component now exceeds 10% of the total cost of the good (at 10.40%), despite only a $0.10 increase in the component cost. The finished product would no longer qualify for USMCA duty-free treatment, and may even need to be marked with a different country of origin pursuant to the substantial transformation test.

Alternatively, there are circumstances in which failing to regularly update country of origin analyses could lead to an overpayment of duties. To elaborate on the widget example, if the widget did not already qualify for USMCA duty-free treatment due to a single non-USMCA originating component that exceeded the 10% de minimis threshold, changing the supply chain to instead source that component from Mexico, the United States or Canada could qualify that product for USMCA duty-free treatment, resulting in an overpayment of duties.

Failing to identify these critical changes to small supply chain shifts could therefore lead to improper duty-free treatment claims, resulting in significant duty calculation errors and/or stiff penalties. In both scenarios, importers with systems in place to regularly review and evaluate their countries of origin will not only remain compliant with U.S. laws and regulations, but will also benefit from the ability to make critical changes to the advantage of their bottom lines.

Made in USA Labeling Requires Careful Attention

Aside from declared and marked countries of origin in the import context, sourcing changes due to supply chain disruptions could also implicate Made in USA labeling. The FTC has been increasingly focused on combatting false Made in USA claims over the past few years. In March 2020, the FTC announced a $1 million settlement with Williams-Sonoma, Inc. for what it described as "false, misleading, or unsubstantiated" Made in USA claims on various product lines, a breach of commitments made by Williams-Sonoma stemming from an earlier investigation into its improper use of Made in USA labels.[xv] The final FTC order restricts Williams-Sonoma's ability to make unqualified and qualified Made in USA claims on a going-forward basis, requiring that it be able to fully substantiate the claims under FTC standards.[xvi]

Just this year, the FTC codified its longstanding Made in USA labeling policies and incorporated civil penalty amounts for violations.[xvii] To label a product as being made in the United States, "the final assembly or processing of the product" must occur in the United States, "all significant processing" must occur in the United States, and "all or virtually all ingredients or components of the product" must be made in the United States.[xviii] The FTC has interpreted this to mean that only negligible, if any, foreign content is present in the end product.[xix] Under the "all or virtually all" standard, therefore, labeling could be impacted by even small sourcing changes. Under the new rule, making an improper Made in USA claim on a label qualifies as an "unfair or deceptive act or practice," exposing improper labelers to civil penalties up to $43,792 per violation.[xx]

Outside of labeling, the FTC has also been actively enforcing the use of Made in USA claims in advertising, including statements on company websites. The FTC imposed a $146,249.24 monetary judgment and restrictions on future use of Made in USA claims against Gennex Media LLC and its owner for "claiming on their…website that the products they sell are made in the United States, when in fact in numerous instances they are wholly imported from China"[xxi] in an April 2021 final consent order. Changes to supply chains, therefore, will likely require a review of any advertising or website-based Made in USA claims, as well, in order to ensure that all claims remain proper.

Producers of products bearing any variations, qualified or unqualified, of Made in USA labels or advertising should take steps to ensure their continued review and compliance with the "all or virtually all" standard, or include proper qualification language where appropriate to prevent the imposition of large civil penalties.

Tougher Domestic End Product Rules in the Pipeline for Government Contractors

Lastly, country of origin analyses for purposes of government procurement may also be affected by sourcing changes due to supply chain disruptions, opening contractors up to possible penalties, debarment, or prosecution under the False Claims Act.[xxii]

Pending regulations pursuant to the BAA will require even greater domestic content for certain products, which will require even closer attention to sourcing changes. President Biden issued Executive Order 14005 on January 25, 2021, focused on strengthening and increasing the procurement of U.S. goods and services.[xxiii] On July 30, 2021, proposed rules were issued under the BAA which would, among other things, modify certain origin calculations performed by government contractors pertaining to many manufactured products.[xxiv] Currently, in order for most[xxv] items manufactured in accordance with government specifications to qualify as domestic end products under the BAA, the products must: 1) be manufactured in the United States and 2) include at least 55% domestic components, measured by the cost of domestic components compared to the cost of all components (subject to certain exceptions and waivers).[xxvi] The proposed rule would modify the 55% domestic content threshold, increasing it initially to 60%, with subsequent increases within two and five years to 65% and 75% respectively.[xxvii] These more stringent criteria will restrict supply chain flexibility and require close monitoring.

Moreover, active enforcement of government procurement regulations is a clear focus of the Biden Administration. In September 2021, a defense contractor entered into a settlement with the Department of Justice, agreeing to pay $900,000 to resolve allegations that it violated the False Claims Act when it "provided unapproved substitute parts through the U.S. Army's Simplified Nonstandard Acquisition Program (SNAP) and violated the Buy American Act by providing parts manufactured in a non-qualifying country."[xxviii] The settlement clearly highlights the compliance issues that can arise when companies switch out parts and components used in their supply chains. Ensuring that such changes are accounted for under the relevant regulations is critical.

To prevent the incorrect certification of a product as a domestic end product, businesses should ensure that they are properly measuring the domestic content for items made to government specifications, and updating this analysis regularly in the event of any supply chain changes.

Conclusion

The confluence of regulatory attention to country of origin issues with supply chain disruptions due to the pandemic has dramatically increased the risk that import issues could become a distraction or serious liability. If an updated analysis on products' countries of origin has not been performed recently, now is the time.

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ENDNOTES

[i] *Supply Chain Disruption*, Accenture, https://www.accenture.com/us-en/insights/consulting/coronavirus-supply-chain-disruption (last visited Oct. 4, 2021).

[ii] *See generally* Jane Callen, *Census Bureau's Small Business Pulse Survey Reveals Delays From Domestic, Foreign Suppliers*, U.S. Census Bureau (Aug. 9, 2021), https://www.census.gov/library/stories/2021/08/united-states-small-businesses-suffer-supply-chain-disruptions.html (indicating that 39% of manufacturing industry respondents to a small business survey would need to identify new supply chain options within six months); Mike Cherney, *Firms Want to Adjust Supply Chains Post-Pandemic, but Changes Take Time*, Wall St. J. (Dec. 27, 2020), https://www.wsj.com/articles/firms-want-to-adjust-supply-chains-post-pandemic-but-changes-take-time-11609081200); *Gartner Survey Reveals 33% of Supply Chain Leaders Moved Business Out of China or Plan to by 2023*, Gartner (June 24, 2020), https://www.gartner.com/en/newsroom/press-

releases/2020-06-24-gartner-survey-reveals-33-percent-of-supply-chain-leaders-moved-business-out-of-china-or-plan-to-by-2023#:~:text=A%20Gartner%2C%20Inc.,next%20two%20to%20three%20years.&text=As%20a%20result%2C%20a%20new,of%20more%20regional%20manufacturing%20emerged).

[iii] Jane Callen, *Census Bureau's Small Business Pulse Survey Reveals Delays From Domestic, Foreign Suppliers*, U.S. Census Bureau (Aug. 9, 2021), https://www.census.gov/library/stories/2021/08/united-states-small-businesses-suffer-supply-chain-disruptions.html.

[iv] *See, e.g.*, Country of Origin Marking for Ugly Stik Fishing Rods; Component Parts; Substantial Transformation; Multiple Countries of Origin, HQ 560115 (Mar. 7, 1997) ("HQ 560115")(finding that the country of origin of a fishing rod is the origin of the rod blank which imparts the essential character to the good); The Tariff Classification of A Valve Kit Packaged in Canada., NY N272737 (Mar. 9, 2016) (finding that the country of origin for a complete valve kit is the origin of the valve cartridge which imparts the essential character to the good).

[v] A good has been substantially transformed in a country when it undergoes processing operations beyond "minor manufacturing and combining operations or simple assembly" that result in a "new and different article of commerce" having a new name, character, and use. *See Energizer Battery, Inc. v. United States*, 190 F. Supp. 3d 1308 (Ct. Int'l Trade 2016).

[vi] *See* HQ 560115.

[vii] *See* Notice of Determination and Request for Public Comment Concerning Proposed Determination of Action Pursuant to Section 301: China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation, 83 Fed. Reg. 14906 (Apr. 6, 2018); Notice of Modification of Section 301 Action: China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation, 85 Fed. Reg. 3741 (Jan. 22, 2020).

[viii] *See generally* General Note 3, Harmonized Tariff Schedule of the United States (HTSUS) (2021) (outlining the rates of duty for "products of" different countries and regions); *Belcrest Linens v. United States*, 741 F.2d 1368, 1370-71 (Fed. Cir. 1984) (upholding use of the substantial transformation test for determining whether an item is a "product of" a certain country under the HTSUS); The Application of Section 301 Remedies for Elec. Motors from Mexico, NY N302707 (Mar. 18, 2019) (holding that the substantial transformation test must be used to determine whether country-specific safeguard actions apply to certain goods).

[ix] *See* 19 U.S.C. § 1304; 19 C.F.R. § 134.1.

[x] *See* 16 C.F.R. § 323.2.

[xi] *See* 19 U.S.C. § 2518(4)(B); 48 C.F.R. § 25.101.

[xii] *See* 19 U.S.C. § 1592(c).

[xiii] For an overview of the types of preferential rules of origin, *see What Every Member of the Trade Community Should Know About: U.S. Rules of Origin*, U.S. Customs and Border Protection (May 1, 2004), https://www.cbp.gov/document/publications/rules-origin.

[xiv] *See generally* General Note 11, Harmonized Tariff Schedule of the United States (HTSUS) (2021).

[xv] Press Release, Fed. Trade Comm'n, Williams-Sonoma, Inc. Settles with FTC, Agrees to Stop Making Overly Broad and Misleading 'Made in USA' Claims about Houseware and Furniture Products (Mar. 30, 2020), https://www.ftc.gov/news-events/press-releases/2020/03/williams-sonoma-inc-settles-ftc-agrees-stop-making-overly-broad.

[xvi] Press Release, Fed. Trade Comm'n, FTC Approves Final Order Settling Charges that Williams-Sonoma, Inc. Made Overly Broad and Misleading 'Made in USA' Claims about Houseware and Furniture Products (July 16, 2020), https://www.ftc.gov/news-events/press-releases/2020/07/ftc-approves-final-order-settling-charges-williams-sonoma-inc.

[xvii] *See* Made in USA Labeling Rule, 86 Fed. Reg. 37022 (July 14, 2021).

[xviii] 16 C.F.R. § 323.2.

[xix] *Complying with the Made in USA Standard*, Fed. Trade Comm'n, https://www.ftc.gov/tips-advice/business-center/guidance/complying-made-usa-standard (last visited Oct. 4, 2021).

[xx] *See* 15 U.S.C. §§ 45(m), 57a; 16 C.F.R. §§ 323.2, 323.4; Adjustments to Civil Penalty Amounts, 85 Fed. Reg. 2014 (Jan. 14, 2020).

[xxi] Press Release, Fed. Trade Comm'n, FTC Approves Final Order Requiring Gennex Media LLC and Owner to Pay Monetary Judgment and Stop Making Deceptive Claims (Apr. 14, 2021), https://www.ftc.gov/news-events/press-releases/2021/04/ftc-approves-final-order-requiring-gennex-media-llc-owner-pay; Press Release, Fed. Trade Comm'n, FTC Order Requires Gennex Media LLC and Its Owner to Pay $146,249, and Stop Making Deceptive 'Made in USA' Claims (Mar. 1, 2021), https://www.ftc.gov/news-events/press-releases/2021/03/ftc-order-requires-gennex-media-llc-its-owner-pay-146249-stop.

[xxii] *See, e.g.*, 42 U.S.C. § 5206; Press Release, U.S. Dep't of Just., Georgia defense contractor agrees to $900,000 payment to settle False Claims Act allegations (Sep. 10, 2021), https://www.justice.gov/usao-sdga/pr/georgia-defense-contractor-agrees-900000-payment-settle-false-claims-act-allegations; Daniel Seiden, *Biden's Biggest Stick in Buy American Push Is Anti-Fraud*

Law, Bloomberg Law (Jan. 28, 2021), https://news.bloomberglaw.com/federal-contracting/bidens-biggest-stick-in-buy-american-push-is-anti-fraud-law (highlighting the use of False Claims Act suits for violations of the BAA).

[xxiii] E.O. 14005, Ensuring the Future Is Made in All of America by All of America's Workers, 86 Fed. Reg. 7475 (Jan. 25, 2021).

[xxiv] Federal Acquisition Regulation: Amendments to the FAR Buy American Act Requirements, 86 Fed. Reg. 40980 (July 30, 2021).

[xxv] Commercially available off-the-shelf ("COTS") items, and products composed of wholly or predominantly iron and/or steel, are subject to separate requirements under the BAA. *See* 48 C.F.R. § 25.101; 48 C.F.R. § 52.225-1.

[xxvi] 48 C.F.R. § 25.101.

[xxvii] 86 Fed. Reg. at 40982.

[xxviii] Press Release, U.S. Dep't of Just., Georgia defense contractor agrees to $900,000 payment to settle False Claims Act allegations (Sep. 10, 2021), https://www.justice.gov/usao-sdga/pr/georgia-defense-contractor-agrees-900000-payment-settle-false-claims-act-allegations.