NAFTA Verifications: New Concerns for Exporters and Producers*

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Introduction

Securing the beneficial tariff treatment afforded to "originating goods" in NAFTA trading relationships requires the preparation of Certificates of Origin by producers and/or exporters. These Certificates must, under the NAFTA Agreement, supply necessary and truthful information, must be supported by documentary evidence of eligibility, and are subject to verification procedures.

Importers of goods into the NAFTA countries have long been subject to and familiar with documentary support and recordkeeping requirements. For many producers and exporters, however, these requirements, and the obligation to participate in verifications, are relatively new. These new, coupled with the increased enforcement activities of the US, Canadian, and Mexican Customs authorities in this area as they gain greater familiarity with NAFTA procedures and processes, have caused a number of producers and exporters to learn to their sorrow, after the fact, that they are being held to new and different standards than those which applied prior to NAFTA.

This article will discuss the nature of preference status and the Certificate of Origin requirement, the statutory and regulatory basis for origin verifications, and some specifics of verification practice by the Customs authorities. The article will close with a discussion of some of these new issues facing exporters and producers.

Preference Status and Certificates of Origin

The North American Free Trade Agreement[i] allows preferential duty treatment (after completion of the phase in, duty free treatment) upon the importation of goods from one NAFTA member country to another, provided the goods qualify as "originating goods" under the terms of the agreement.[ii] Originating goods are limited to those wholly obtained or produced entirely in the territory of one or more of the Parties, or to goods where any non-originating materials used in production undergo an applicable change in tariff classification or otherwise satisfy the applicable requirements (including regional value content, accumulation, and other special rules).[iii] Articles imported from one NAFTA country to another which do not meet preference requirements will continue to be subject to the applicable NTR (MFN) rates or other special rates depending upon the origin of the goods.[iv]

The Agreement further provides that preferential treatment for qualifying goods shall be claimed by submitting a Certificate of Origin. The importer must have a Certificate in its possession

at the time a declaration claiming preferential tariff treatment is made (either at the time of the original entry, or within in the permitted time for filing). Each NAFTA country (Party) shall:

(a) require an exporter in its territory to complete and sign a Certificate of Origin for any exportation of a good for which the importer may claim preferential tariff treatment on importation of the good into the territory of another Party; and

(b) provide that where an exporter in its territory is not the producer of the goods the exporter may complete and sign a Certificate on the basis of

(i) Its knowledge of whether the goods qualify as an originating good,

(ii) Its reasonable reliance on the producer's written representation that the good qualifies as an originating good, or

(iii) A completed and signed Certificate for the goods voluntarily provided to the exporter by the producer.

Producers are not required to provide Certificates to exporters; Certificates may cover single importations or multiple importations of identical goods.[v]

The NAFTA Agreement also establishes an obligation to correct any declaration when an importer finds reason to believe a Certificate is incorrect. It allows each NAFTA country to deny preferential treatment if an importer fails to comply with any requirements. Each country can require the exporter, or producer that has signed a Certificate, to provide a copy upon request, and to correct any Certificates subsequently found to be incorrect.[vi]

Each NAFTA country is required to establish rules providing that a false Certification by an exporter or producer shall "have the same legal consequences, with appropriate modifications, as would apply to an importer in its territory for contravention of its Customs laws and regulations regarding the making of a false statement or representation", and allow application of other sanctions when an exporter/producer fails to comply with any requirements.[vii]

Origin Verifications

Article 506 of the NAFTA Agreement provides for origin verification. This section allows the Customs authorities of one country to conduct a verification of the originating status of a good imported into its territory from any other NAFTA country, by means of written questionnaires to an exporter or producer in the territory of another country, visits to the premises of the exporter or producer and observation of the production facilities, or any other procedures agreed to by the Parties. Verification visits are subject to specific limitations, including written notification of both the exporter or producer whose premises are to be visited and the Customs administration of the exporting country. Written consent is required, and the exporting country can provide observers if desired. There are provisions for postponement of verification visits for specified time periods, supply of a written determination including findings of fact and the legal basis for that determination, and procedural limitations on the implementation of that verification. Failure of a good to qualify

after review, or refusal of a verification visit within the prescribed time limit, allows denial of preferential treatment to the goods that were or would have been the subject of the visit.

The detailed procedural requirements and limitations on administrative actions reflect a significant concern by the Parties for an arrangement which allows an enforcement arm of one sovereign Party to investigate the activities of companies and individuals domiciled in the territory of another Party. The very specific and complete written descriptions probably also reflect concerns involved with the interaction of the civil law established in Mexico, the common law in the United States, and the common law (at the federal level) but with civil law influences in Canada.

Each country has implemented verification procedures in its Customs regulations. In the United States, these are set forth in 19 CFR 181, Sub-part G. Section 181.71 provides that where a Certificate of Origin is supplied, US Customs may deny preferential treatment only after initiation of a verification which results in a determination that the good does not qualify or should not be accorded preferential treatment for any other reason specifically provided. The regulations allow for verification by written questionnaire (with specifications for forms of sending and proof of receipt and for verification visits upon proper notification and agreement). Any failure to respond to the letter or questionnaire by the exporter or producer must be followed up by a second request, again with receipt verification. Non-response to a follow up letter or questionnaire can result in denial of status as an originating good. Similarly, failure to agree to a verification visit within the time limits provided may result in denial of preferential treatment.

Where written responses are provided, or verification visits do occur, the inquiring Customs authority is to make a determination regarding eligibility for origin under the criteria established by the NAFTA Agreement. The written determination must describe the subject of the verification and the findings of fact made in connection with the verification. Any negative origin determination must be sent to the exporter or producer with confirmation of receipt, with notification to the Customs administration of the exporting country. Restrictions are placed on the timing for application of negative determinations, provision is made for appeal and review, and in appropriate instances delayed implementation may occur if the importer or exporter relied to its detriment on rulings or determinations made by the Customs administration of one the NAFTA member countries.

Similar provisions are implemented in the Canadian and Mexican regulations.[viii]

Verification Practice

The verification is designed to secure documentary evidence indicating that the preference criteria established by NAFTA have been met. The information must be maintained in a format that can be retrieved, printed, and made available in any required verification. Specific documents and materials that are required will depend upon the product, the input materials, any processing which occurred, and the basis on which preference is claimed. Goods subject to regional content requirements, accumulation, and other special requirements for origin criteria must of necessity have more detailed and comprehensive documentation. US Customs does provide review, through the

protest process, of denials of preferential treatment based on verification determinations.[ix]

A detailed manual setting forth verification procedures has been produced by each of the NAFTA countries. The US and Canada verification manuals can be accessed on the internet.[x] Although these detailed manuals provide a good understanding of the procedures actually used by the various Customs officials, and in theory conform to the Agreement itself and the implementing regulations, at least in the United States they do not have the force of a regulation and are not applicable if a conflict exists between the manual and the regulations. In a January 2000 ruling, Customs Headquarters reversed a denial of preference status based on an origin verification where the denial was based on the exporter's failure to respond within 30 days to the first inquiry. Customs then denied eligibility based on a Customs directive issued in 1994 regarding origin verification. Upon review, Customs Headquarters found that the exporter had responded in a timely manner to the second request, and that the NAFTA and the Customs Service own regulations permitted a proper response and submission of materials to a second request to fulfill verification requirements.[xi]

The United States has implemented the written portion of the verification process largely through use, with modifications as appropriate, of the Customs Form 28 Request for Information, with further notices using Customs Form 29 Notice of Action. These procedures must be carefully followed. In a 1998 Ruling[xii], Customs Headquarters found that a port notice sending a written request (on Customs Form 28) to the exporter, care of the importer, asking for the Certificate of Origin, did not meet procedural requirements. The Certificate could have been requested from the importer, but the request to the importer merely asked that it be forwarded to the exporter. The verification letter to an exporter must be directed to that exporter (or producer), generally in a form receiving acknowledgment of receipt. Because the Certificate request was directed to the exporter through the importer, it met neither of the requirements for asking an importer for the Certificate, or for proper delivery of a request to the exporter. Therefore, Customs could not deny preferential treatment because no actual verification had been initiated pursuant to the NAFTA and Customs regulatory requirements.

During the first several years of NAFTA importations, verifications were initiated almost exclusively by Import Specialists at the various ports reviewing particular import transactions. These Import Specialists would make their determinations about the scope of further inquiry necessary and initiate the procedures they felt appropriate. Customs has noted that "a detailed NAFTA verification process is costly and time consuming." In 1998, it determined that NAFTA issues should be specifically covered in the Compliance Measurement process, and added a NAFTA module to the FY 1998 Compliance Measurement program.

A separate module was used to generate a sample of 1000 NAFTA claims which would undergo a detailed NAFTA verification process. These verifications were in addition to verifications identified and initiated by Import Specialists based on transaction review. A test was performed both to allow a comparison of the results of the mandatory procedures under Compliance Measurement and the "third party test" (Import Specialist) generated procedures, and to maximize accuracy of

NAFTA compliance statistics.

The results, reported in the FY 1998 Trade Compliance Measurement Report[xiii], found some striking differences between the "third party" tests and the mandatory verification. (The "third party" test has a group of experienced personnel look at the selected sample and identify those which appear to have eligibility issues.) The overall NAFTA sample showed a compliance rate of 93.82%, compared with a compliance rate of 99.36% based on the third party test process. Although these were preliminary results and subject to further analysis, the vast majority of claims had been completed and were used to generate the compliance statistics.

There was no significant difference between importations from Canada and those from Mexico with regard to compliance; Canada's compliance rate was at 94% and Mexico at 93.45%.

The mandatory NAFTA sampling was repeated in FY 1999 and reported in the FY 99 Trade Compliance Measurement Report[xiv]. The third party test used in 1998 was abandoned because of its operational ineffectiveness.

Although the reported results are based on only the first three quarters of FY 1999, the overall NAFTA sample was slightly more compliant at 94.33%. The compliance rate for Mexico increased to 95.80%, while Canada's was essentially unchanged at 93.73%.

The FY 99 Report excluded certain merchandise (automobiles) due to resource limitations. It did, however, look at compliance rates in specific primary focus industries, finding compliance at close to 96% for agriculture and auto and truck parts, and over 97% for steel mill products. Telecommunications, however, had a compliance rate of only 85.83%.

A verification report is not necessarily the final word on a particular issue. US Customs has issued several rulings dealing with appeals from negative verification findings. In one June 1997 Ruling, the Customs representatives were originally unable to verify the inventory management system. A follow up verification visit found that a FIFO inventory management system did exist, but could not trace individual components to specific exported products. On appeal, Customs Headquarters found that the inventory management system was acceptable for use in fungible materials inventory systems, but also found that a portion of the units did not qualify under the FIFO analysis. The protest was therefore granted in part and denied in part.[xv] In a September 1999 Ruling, the issue was whether a certain chemical, shown to be of US origin, lost its origin status by having been shipped to and stored in a free zone in Germany before re-exportation to Canada. The verification visit concluded that shipment from the US to Germany removed NAFTA eligibility, as it was withdrawn from German Customs control. Upon review, while upholding the validity of the "withdrawn from Customs territory" principle and the coverage of crude materials by that principle, it was determined that the warehousing in the free port left the goods under Customs control in Hamburg. The results of the verification visits were therefore overturned, and the protest allowed.[xvi]

Verification Issues for Exporters and Producers

The NAFTA has been in effect since 1994, and the US-Canada Free Trade Agreement since 1989. The Certificate of Origin and verification procedures have, therefore, been in effect for a significant period of time. During the start up period under these Agreements, however, only limited questioning of Certificates of Origin and use of the verification process took place, as the Customs authorities recognized that a period of time to "phase in" the new procedures would be necessary. Generally, only Certificates of Origin that on their face had clear errors, contradictory information, incorrect dates, or similar obvious issues were challenged. Verifications were limited to situations initiated by Customs Field Officers, who themselves were having to learn new requirements and procedures.

The nature of verification practice, with the detailed procedural limitations outlined above, results in activities which can be extended over significant periods of time. Because of the limited number of verifications which were taking place and the amount of time required for verification practice itself, there was a considerable delay after the implementation of the Free Trade Agreements before individual producers and exporters were requested to supply the documentary support and verification assistance that is supposed to underlie the completion of a Certificate of Origin. Many of these producers and exporters were not importers, and therefore not familiar with the detailed recordkeeping and documentary support requirements required by Customs. A number of the producers and exporters were new to international trade altogether, and even those with some international trade experience did not have experience with preferential regimes and the documentary support required to qualify "originating goods". It has not been surprising, therefore, that there has been a considerable educational and informational aspect in implementation by the various Customs Services of verification authority.

The addition of mandatory NAFTA verifications by the US Customs Service in its 1998 Compliance Measurement process resulted in inquiries, due to the random selection process, regarding exporters and producers for whom the local Customs Officers had never had any questions concerning eligibility of the goods for preferential treatment. Some of these cases resulted in determinations that the goods were not eligible, not because they were not actually products of the supplying NAFTA country, but because the producers could not support the claims through the required documentary materials.

A major issue for exporters and producers, therefore, has been learning just what the requirements are, the types of records that must be maintained, the time period (5 years) for record maintenance and the procedures for responding to verification requests. Now that the Customs Services have fully established their procedures, and now that exporters and producers have at least theoretically had more than sufficient time to become aware of the requirements, more stringent enforcement of verification issues is being encountered.

The NAFTA provisions which allow an exporter who is not the producer of the goods to supply a Certificate of Origin raise some interesting issues. If the producer voluntarily supplies a

Certificate of Origin, provided it appears valid on its face the exporter can rely on that Certificate. The exporter is also, however, able to prepare a Certificate based on its own knowledge that the goods qualify as "originating", or based on the producer's written representation (other than a certificate) that the goods are of North American origin.

In one situation involving a processed agricultural product, the US exporter provided Certificates of Origin based on knowledge that at least some of the raw agricultural product was of Mexican origin, and receipt of a series of statements (but not NAFTA Certificates) provided by the producer indicating that the processed product was of United States origin. Hacienda, the Mexican Customs authority, initiated a verification. Upon visiting the exporter, the Certificates and the back up documentation were found as required. Hacienda sought further verification from the producer, however, regarding the source of the raw materials and the production process. The producer requested delays in the verification visits extending beyond the time permitted in the regulations. Hacienda subsequently denied preferential status based on the failure to permit verification, and collected additional duties from the Mexican importers. US Customs, based on advice from Hacienda, initiated investigations of both the exporter and the producer to determine whether false Certifications had been supplied.

For the exporter, the primary concern is its ability to demonstrate that the completion of the certificate was done with reasonable care, based upon the actual knowledge of the exporter and the representations made to it by the producer. For the producer, after initial inquiry as to why it failed to permit verification, the questions concern whether it acted reasonably in the representations made to the exporter and the Mexican customers.

Producers can, in general, avoid any direct liabilities for preparing false Certificates of Origin by refusing to supply them at all. This could, of course, create some marketing difficulties where significant duty rate differentials exist. Even when the producer does not supply an actual NAFTA Certificate of Origin, however, Customs may still investigate its activities to see whether it participated in a scheme designed to produce false certifications, or otherwise was involved in the making of a false statement or representation.

Conclusion

Eligibility for NAFTA tariff preferences requires the supply of Certificates of Origin, and the preparation of Certificates of Origin places obligations on exporters and producers both to ensure that the goods meet preference criteria, and to establish and maintain the records necessary to support that determination. NAFTA producers and exporters supplying goods for shipment to other NAFTA countries must be fully aware of the requirements, and establish formal recordkeeping procedures to ensure compliance. In addition, they must be aware of the detailed, formalized nature of the verification process, and take the necessary steps to comply with those requirements whenever they may become part of a formal verification.

Endnotes

1. North American Free Trade Agreement (herein cited as NAFTA) Article 302. The Agreement is reproduced in North American Free Trade Agreements, Holbein and Musch, Oceana Publications 1994, updated regularly; and is accessible on the internet at the Commerce Department's Trade Compliance Center, under Agreements.

2. Tariffs were eliminated for all originating products between the US and Canada on January 1, 1998, and will be fully eliminated between the US and Mexico on January 1, 2003, except for a few sensitive items, which will be fully eliminated January 1, 2008. NAFTA Annex 302.2

3. A detailed discussion of NAFTA rules of origin is included in the chapter "A Practical Guide to Customs, Tariffs and Rules of Origin Under NAFTA", by Harry B. Endsley and Steven Baker, contained in North American Free Trade Agreements, Holbein and Musch, supra note 1.

4. NAFTA Article 401; NAFTA Annex 401.

5. NAFTA Article 501.

6. Ibid

7. NAFTA Article 504.

8. For Canada see D Memorandum D 11-4-20.

9. 19 CFR 181.75(b) (iv).

10. www.nafta.customs.org

11. HQ 227853, January 11, 2000. Customs Rulings can be accessed onthe Customs website at as well as through several commercial services.

12. HQ 959068, February 17, 1998.

13. FY 98 Trade Compliance Measurement Report, U.S. Customs Service, January 1999.

14. FY 99 Trade Compliance Measurement Report, U.S. Customs Service, April 2000.

15. HQ 546569, June 19, 1997.

16. HQ 560950, September 22, 1999.

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 This article was first published in the summer 2001 edition of Currents, The International Trade Law Journal of the South Texas College of Law, Volume X, Number 1, at page 3.

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