

US and Mexico reach agreement on trade relations; NAFTA fate uncertain

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The North American Free Trade Agreement (NAFTA), which entered into force on 1 January 1994, created one of the world's largest free-trade areas. Under NAFTA, import duties on all covered goods traded within the United States (US), Canada and Mexico were gradually phased out and, as scheduled, on 1 January 2008, all remaining duties and most quantitative restrictions on imports were eliminated.

While heavily relied on by businesses to integrate the North American economy, NAFTA has become a focal point of President Trump's efforts to establish a trade policy that promotes America's security and prosperity by, among other initiatives, strengthening the US economy, negotiating new and renegotiating or withdrawing from other trade agreements and enforcing US trade laws and US rights under existing trade agreements.¹ For example, President Trump during the 2016 Presidential campaign, stated that he would end US participation in the Trans-Pacific Partnership as it was viewed as "... another massive international agreement that ties us up and binds us down."

A key tenet of the Trump Administration's Trade Policy Agenda is the successful renegotiation of the terms of NAFTA "to get a better deal for American workers and to improve the U.S. trade balance" by updating NAFTA with "modern provisions representing a 21st-century, high-standard agreement and to rebalance NAFTA for fair, reciprocal trade."

On 27 August 2018, after more than a year and seven NAFTA renegotiation rounds, Mexico and the US announced a “preliminary agreement in principle.” The agreement is not final, but rather it is subject to finalization and implementation that replaces the 24-year old original trade deal.² Canada has now officially rejoined the US and Mexico negotiators to potentially join and maintain a trilateral agreement but the ultimate outcome remains uncertain.

The agreement reached between the US and Mexico provides a path forward for modernizing NAFTA, but as the negotiations were between the US and Mexico, many of the agreed upon points are specific to those two countries interests. While final text in detail has not been made available, statements released by both governments offer further details of the agreement and include, among others, the following key provisions:

Rules of origin

- ▶ Increasing the regional value content (RVC) threshold for automobiles from 62.5% to 75%.
- ▶ Adding a new labor value content rule requiring 40-45% of auto content to be produced by workers earning at least US\$16³ per hour.
- ▶ Strengthening rules of origin for chemicals, steel intensive products, glass, optical fiber and textiles.
 - New textile rules requiring a greater use of Made-in-the-USA fibers, yarns, and fabrics by limiting the use of non-NAFTA inputs in textile and apparel trade and requiring that sewing thread, pocketing fabric, narrow elastic bands, and coated fabric, when incorporated in apparel and other finished products, be made in the region for those finished products to qualify for trade benefits.

Enforcement

- ▶ Establishing procedures that streamline certification and verification of rules of origin.

Market access (exceeding standards established in NAFTA 1.0 and previously proposed under the Trans-Pacific Partnership)

- ▶ Maintaining duty free treatment for originating goods, prohibition on export duties and other charges, as well as waiver of customs processing fees.
- ▶ Adding transparency to import and export licensing procedures.

- ▶ Strengthening e-commerce retailing by raising Mexico’s de minimis value level from \$50 to \$100, whereby customs entries at or below the de minimis threshold would be exempt from customs duties and taxes and subject to minimal entry procedures.

Intellectual property

- ▶ Enforcing intellectual property rights at the border.
- ▶ Enhancing protection for copyright, trademarks and patents, including in pharma and agriculture.
- ▶ Increasing data protection for biologic drugs to 10 years and expanding the scope of products eligible for such protection.

Digital trade

- ▶ Prohibiting customs duties and other discriminatory measures from being applied to digital products distributed electronically such as software, music, etc.
- ▶ Facilitating digital transactions by ensuring that suppliers are not restricted in their use of electronic authentication or electronic signatures.

Agriculture

- ▶ Tariffs on agricultural products will remain zero rated.
- ▶ Enhanced standards for both geographical indicators and sanitary/phytosanitary measures, including the establishment of consultation mechanisms to resolve issues between the two nations.

Evergreen clause

- ▶ Agreement remains in effect for 16 years and will be reviewed every 6 years. If agreed after the first review, the arrangement will be extended for another 16 years.⁴

Section 232 tariffs

- ▶ Tariffs imposed on Mexico and Canada steel and aluminum exports to the US will remain in effect.⁵

What’s next?

While President Trump stated his preference in reaching separate bilateral deals with Mexico and Canada in lieu of maintaining NAFTA, both Mexico and Canada continue to push for a trilateral agreement.⁶ Canada has been asked to negotiate on an urgent basis this week on a trilateral or bilateral basis. As the issues are not with Mexico, it really amounts to the same thing for Canada. The issues are Canada’s supply management tariff rate quotas (with high

ad valorem tariffs over certain quota levels) with dairy being the focus, the Chapter 19 trade dispute resolution mechanism, cultural safeguard protections and the length of pharmaceutical patent protection (the generic drug market issue).

The US Administration is expected to notify Congress by 31 August, in order to start the 90-day process for a trilateral NAFTA or a bilateral US-Mexico trade deal.⁷ If a trilateral agreement is not reached and no subsequent bilateral agreement is reached between the US and Canada, the Canada-US Free Trade Agreement (CUSFTA), which applied previously on a bilateral basis between the US and Canada and was suspended under NAFTA, will apply until terminated.

Preferential trade between Canada and Mexico could presumably continue under NAFTA or even under the CPTPP⁸ if the US withdraws from the NAFTA on six months' notice. Such action would presumably take place after bilateral agreement(s) are signed.⁹

From a Mexican perspective, the approval process for either NAFTA or a bilateral US-Mexico trade deal must be submitted to the Senate and for revision by the "Foreign Relations Ordinary Commission" to be voted and ratified. Two-thirds majority of the Mexican Senate must vote in favor of the agreement to be ratified (the Mexican Senate is composed of 128 Senators).

In Canada, NAFTA or any other trade agreement is implemented after a full review by Parliament pursuant to Parliamentary Sub-Committees' reports and debate, to be then put to a vote in the House of Commons and Senate. Such process would take several months and then be implemented (in Canada under constitutional law, treaties or international agreements are not directly applicable) by drafting and passing specific legislation where required (much of this would already be in existence under NAFTA or the CUSFTA).

While the changes announced in the preliminary agreement are not immediately applicable, as stated above, certain legislative requirements need to be satisfied prior to implementation of the agreement, companies operating in the region should be prepared for the impact of proposed changes on their businesses. For those in the automotive, textile and other industries, changes announced to the existing rules of origin will make qualification for benefits under the agreement more difficult. On the other hand, e-commerce retailers/consumers,

intellectual property rights holders such as drug manufacturers, among others, likely stand to benefit under the new terms of the preliminary agreement.

Preparing for change

Companies should evaluate their current NAFTA footprint in order to quantify benefits under the existing agreement. By leveraging their customs data, companies can determine whether they are adversely impacted by the proposed changes to NAFTA or any bilateral successor agreement that may ultimately be reached. Specifically, companies should understand how their products satisfy existing RVC requirements and then explore potential changes or alternatives to sourcing that may be required in order to preserve originating status under the terms of the preliminary agreement.

Key actions

Companies should take a strategic and proactive approach to deal with the potential changes emerging from the NAFTA renegotiations. The following key actions should be considered:

- ▶ Assembly of relevant data from Canada, Mexico and the US.
- ▶ Identification of the company's most significant products manufactured in North America, considering:
 - Customs data - to determine categories, amounts and highest duty savings;
 - Sales data - to determine highest volumes, values and sales forecasts;
 - Products that don't currently qualify;
 - Bills of material (e.g., product-specific data necessary for determining eligibility for trade benefits).
- ▶ Identification of applicable rules of origin,¹⁰ how the existing rule is currently met and how it will change.
- ▶ Modelling of the impact of proposed changes (per product) and exploration of solutions.
 - Would your company need to replace non-NAFTA components to comply with a stricter tariff shift rule or an increased RVC requirement?
 - How close are you to reaching the current RVC rule?
 - Would you need to use a special NAFTA provision to meet qualification requirements?

- ▶ Preparation for increased enforcement such as free trade agreement audits by local customs authorities.
- ▶ Assessment of the company's business traveler mobility reliance on NAFTA 1.0.
- ▶ Continued monitoring of the impact of the Section 232 US tariffs and Canadian and Mexican retaliatory tariffs and surtaxes and take advantage of drawbacks or remissions of such tariffs or surtaxes where applicable (as discussed in other [EY Global Tax Alerts](#)).

Endnotes

1. <https://ustr.gov/sites/default/files/files/Press/Reports/2018/AR/2018%20Annual%20Report%20I.pdf>.
2. See United States Trade Representative (USTR) Press Releases, 27 August 2018, "Strengthening NAFTA for Agriculture," "Modernizing NAFTA to be a 21st Century Trade Agreement," and "Rebalancing NAFTA to Support Manufacturing." Available at: <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018>.
3. Currency references in this Alert are to US\$.
4. The US dropped its initial "sunset clause" proposal whereby the agreement would be automatically terminated after five years if an extension was not agreed upon by the parties.
5. Mexico and Canada also applied retaliatory measures to specific US products which would likely remain while the US tariffs are in place.
6. Later statements by USTR Robert Lighthizer signaled the USTR's preference to pursue a revised NAFTA trilateral agreement rather than separate bilateral deals with Mexico and Canada.
7. Under TPA, the administration must first give Congress 90 days' notice of its intent to sign an agreement and sixty days before signing, the countries would have to release the legal text of the agreement. Once the implementing bill is introduced, lawmakers have a maximum of 90 days in session to enact it.
8. The "Comprehensive and Progressive Agreement for Trans-Pacific Partnership" is a new free trade agreement between Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam which has been signed but not yet entered into force.
9. Article 2205 of NAFTA provides that any party can withdraw from the agreement on six months' written notice. If withdrawal were to occur, the President would presumably have seek congressional approval to legislate to repeal existing provisions of law that were legislated as a result of NAFTA.
10. Set forth in NAFTA Annex 401.

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