

United States - Mexico - Canada Agreement to replace NAFTA

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Executive summary

On 1 October 2018, the United States (US) President announced a preliminary agreement with Canada to revise the terms of the existing North American Free Trade Agreement (NAFTA) between the US, Mexico and Canada.¹ The proposed agreement with Canada follows seven rounds of NAFTA renegotiations between the three nations which took place over the course of 13 months and comes roughly 30 days after the US and Mexico announced a similar "preliminary agreement in principle" to modernize the rules of NAFTA.²

The United States Trade Representative (USTR) subsequently published the full text of the proposed agreement on 1 October 2018,³ which is named the United States - Mexico - Canada Agreement (USMCA), and released details on how the USMCA will achieve stated objectives to modernize previous commitments made under the NAFTA, including major changes to trade in agricultural products, automobiles and automotive parts and textiles; increased thresholds for low-value (de minimis) shipments subject to informal entry procedures; enhanced data protection for biologic drugs; and other provisions as discussed below.⁴

The proposed USMCA consists of 34 chapters, which exceeds the 22 chapters contained in the NAFTA, and covers new areas such as labor, the environment, anti-corruption and regulatory policy, among others. Notably, it also includes 11 annexes and 12 side letters. Four of those side letters specifically grant

Canada and Mexico important concessions pertaining to the ongoing US investigation into imported automobiles and automotive parts.⁵ A similar agreement however was not reached on the punitive duties presently being imposed on imported Mexican and Canadian steel and aluminum.

As discussed below, the preliminary agreement requires ratification by all three countries. Ratification is likely, and publication of the text provides businesses with a critical opportunity to now analyze the proposed text in advance, assess its impact on their operations, and evaluate necessary changes to business to take advantage of the new rules.

Detailed discussion

Key provisions of the USMCA

Rules of origin (Chapter 4)

The USMCA proposes major changes to the way that automobiles and automotive parts qualify for preferential treatment. The USMCA raises the regional value content (RVC) threshold for automobiles from 62.5% to 75%.⁶ Particular RVC requirements vary based on the type of vehicle or parts under consideration.⁷ While tariff shift rules (where applicable) remain in the proposed USMCA, the tracing list is eliminated.⁸ The USMCA also adds a new labor value content rule requiring that 40%-45% of auto content be produced by workers earning at least US\$16 per hour.⁹ Lastly, finished vehicle producers will be required to purchase 70% North American steel and aluminum.¹⁰

The USMCA also includes stricter rules of origin for other industrial products such as chemicals, steel-intensive products, glass, and optical fiber. For textiles and apparel, the USMCA limits rules contained in the NAFTA which permitted the use of certain non-NAFTA inputs. In order for a textile or apparel finished product to qualify for preferential treatment under the USMCA it requires that certain inputs incorporated into the finished product, such as sewing thread, pocketing fabric, narrow elastic bands, and coated fabric, also be made in the same region as the finished product. For example, if the finished blouse is manufactured in Mexico, these inputs must originate in Canada, Mexico and/or the US.

Trade in agriculture – market access (Chapter 3)

Under the proposed USMCA, Canada has agreed to provide limited market access to US exports of dairy, poultry (turkey and chicken) and eggs. Likewise, the US has agreed to provide limited market access to Canada exports of dairy, peanuts and peanut products, and sugar and sugar products. New tariff

rate quotas will be introduced by both nations in order to facilitate these concessions. Canada also agreed to eliminate milk price classes 6 and 7 and adopt measures to limit the impact of its surplus skim milk production on external markets such as the introduction of export surcharges.

Other significant provisions

The USMCA includes the following key provisions:

- ▶ Establishes procedures that streamline certification and verification of rules of origin
 - Certification of origin is now allowed to be made by the exporter, producer or importer of the goods
- ▶ Maintains duty free treatment for originating goods, prohibition on export duties and other charges, as well as waiver of customs processing fees
- ▶ Adds transparency to import and export licensing procedures
- ▶ Increases de minimis shipment values for Canada and Mexico (Chapter 7):
 - Mexico will provide duty free entry for shipments valued at or below US\$100, while maintaining duty and tax free treatment for shipments at or below US\$50. Shipments at or below US\$100 will be subject to minimal formal entry procedures
 - Canada will provide duty free entry for shipments up to CA\$150 and raise its de minimis level from CA\$20 to CA\$40 for shipments eligible for non-taxable importation under federal taxation regimes (e.g., imported free of import Goods and Services Tax). However, provincial taxes, which may apply in the case of business-to-consumer import transactions, are not covered by the negotiated outcomes. Shipments at or below CA\$150 will be subject to minimal formal entry procedures, assuming they otherwise qualify for informal line clearance options
- ▶ NAFTA's Article 303 restrictions on duty deferral and duty drawback have been incorporated into Chapter 2 of the USMCA
- ▶ Chapter 20 includes 10 years of data protection for biologic drugs and a robust scope of products eligible for protection
- ▶ Incorporation of NAFTA Chapter 19 dispute settlement provisions into the USMCA
- ▶ Section 232 relief for Mexico and Canada:
 - Two side letters provide Mexico and Canada with relief in the event that the US imposes punitive tariffs on imports of automobiles and automotive parts under Section 232 of the *Trade Expansion Act of 1962* (Section 232)

- ▶ Exclusion from Section 232 duties for the first 2.6M passenger vehicles imported from Canada and for the first 2.6M passenger vehicles imported from Mexico
- ▶ Exclusion from Section 232 duties for light trucks imported from Canada and Mexico
- ▶ Exclusion from Section 232 duties for the first US\$32 billion worth of auto parts imported from CA and the first US\$108 billion worth of parts imported from Mexico
- Two side letters establish a mandatory consultation process in the event that the US imposes Section 232 measures:
 - ▶ The US must provide a 60-day grace period from the date of imposition of any Section 232 duties before they take effect in order to allow for consultations
 - ▶ Mexico and Canada have the right to take measures of equivalent commercial effect, including World Trade Organization rights to challenge a Section 232 measure
- Importantly, nothing in the USMCA addresses the existing punitive tariffs imposed by the US under Section 232 on Canada and Mexico origin steel and aluminum products
- ▶ Cultural institution exemptions currently in the NAFTA are preserved in the USMCA
- ▶ Entry into force, expiration, renewal and withdrawal are described in Chapter 34:
 - The agreement will enter into force on the first day of the third month following the notification of the last country to complete its domestic processes required for implementation of the agreement
 - The agreement will automatically terminate after 16 years of entry into force unless each country agrees to extend for another 16 years
 - The agreement will be reviewed by the countries every six years to determine whether changes are needed
 - Countries may withdraw from the agreement with a six-month written notice. In the event that one country withdraws, the agreement remains in effect for the other countries

What to expect next?

Once signed by the Presidents of the United States and Mexico and by the Prime Minister of Canada, the USMCA must be subsequently ratified by the legislatures of all three countries before it will enter into force. In the US,

under Trade Promotion Authority (TPA) legislation, the US President must provide Congress with 90 days' notice before signing a trade agreement and the legal text of the agreement 60 days before signing. The US President provided Congress with the requisite notice on 1 September, and the release of the text meets the second requirement.

While the US President is authorized to negotiate trade agreements, only Congress has the authority to implement them.¹¹ Accordingly, once the agreement is signed by the President, an implementing bill must be submitted for Congressional approval. Once the implementing bill is introduced, Congress has a maximum of 90 days in session to enact it. Under TPA rules, the bill is subject to a simple yes or no majority vote, which means that amendments are not allowed to the text of the agreement. Until implementing legislation for the USMCA is passed by Congress, the NAFTA will remain in effect. Final Congressional action is expected this year.

A similar process is required under the laws of Mexico and Canada. In Mexico, the USMCA must be submitted to the Senate and for revision by the "Foreign Relations Ordinary Commission" to be considered and ratified. A two-thirds majority of the Mexican Senate must vote in favor of the agreement to ratify the agreement (the Mexican Senate is composed of 128 Senators). Notice of an agreement to terms between the US and Mexico was provided on 27 August 2018, which is significant, because it will give Mexican President Enrique Peña Nieto's Administration enough time to sign the USMCA, which is a priority of his Administration, before he leaves office on 1 December 2018.¹²

In Canada, after being introduced in the form of an implementing bill by Government, the USMCA must first be put to a vote in the House of Commons and Senate after a full review by Parliament pursuant to Parliamentary Sub-Committees' reports and debate. This process will likely take several months.¹³ Supplemental legislation would then need to be drafted and passed where required, although much of this would already be in existence under the existing NAFTA or CUSFTA (Canada-United States Free Trade Agreement) legislation.

Once the agreement is signed by the presidents of all three nations and then ratified by the legislatures of the US, Mexico and Canada, the USMCA will enter into force no sooner than three months from the date of the last country's notice. The ratification process is therefore likely to continue into 2019 before becoming effective.

Actions for businesses

With publication of the text of the new USMCA, businesses can begin to model the impact of the proposed changes on their operations. 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 and consumers, intellectual property rights holders such as drug manufacturers, among others, likely stand to benefit under the new terms of the preliminary agreement.

Based on the above, companies should further evaluate their current NAFTA footprint to quantify benefits presently recognized under the existing agreement and assess qualification benefits anticipated under the USMCA. By leveraging their customs data, companies can determine whether they are adversely impacted by the proposed changes. Specifically, companies should understand how their products satisfy existing RVC requirements and then explore potential changes or alternatives to sourcing that may be required to preserve originating status under the terms of the proposed USMCA. Also, with regard to those products subject to an increase of RVC, changes to the applicability of qualification by tariff shift, and for the auto industry the elimination of the tracing requirement, a closer look on origin qualification options and special methodologies is merited. For example, the use of the self-produced (intermediate) materials rules to aid NAFTA qualification have been quite effective in other industries which have been subject to similar rules under the NAFTA.

The following key actions should be considered:

- ▶ Assemble relevant data from Canada, Mexico and the US.
- ▶ Identify 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).
- ▶ Identify applicable rules of origin,¹⁴ how the existing rule is currently met and how it will change under the proposed USMCA.¹⁵
- ▶ Model the impact of proposed changes (per product) and explore solutions.
 - Would your company need to replace non-originating 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 provision, such as the self-produced (intermediate) materials rule assist in meeting qualification requirements?
- ▶ Be prepared for increased enforcement such as free trade agreement audits by local customs authorities.
- ▶ Review your company's import transactions into Canada to reevaluate taxable importation status with respect to both federal and provincial regimes, and to further determine any contingent requirements with respect to registration of your business in Canada, including any obsolescence of currently held registrations under the new de minimis value rules.
- ▶ Continue to monitor 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.

Endnotes

1. "President Donald J. Trump Secures A Modern, Rebalanced Trade Agreement with Canada and Mexico," Whitehouse Fact Sheet, 1 October 2018. See <https://www.whitehouse.gov/briefings-statements/president-donald-j-trump-secures-modern-rebalanced-trade-agreement-canada-mexico/>.
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. Text of the USMCA is available at: <https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/united-states-mexico>.
4. See USTR's US - Mexico - Canada Trade Fact Sheets, 1 October 2018. Available at <https://ustr.gov/about-us/policy-offices/press-office/fact-sheets>.
5. See United States-Mexico-Canada Agreement Text: Canada 232 Side Letter, US Mexico 232 Side Letter, US-Canada 232 Process Side Letter and US-Mexico 232 Process Side Letter.
6. USMCA Chapter 4.
7. For example, while light vehicles would require 75% RVC, heavy vehicles would require 70%. The RVC for auto parts, on the other hand, would range from 65-75% depending on whether these are considered "core," "principal" or "complimentary."
8. For origin qualification purposes, the tracing provision allows certain components to be deemed originating notwithstanding their country of origin.
9. The specific calculation of the labor value content considers manufacturing costs, technology and assembly expenditures.
10. Seventy percent of an Original Equipment Manufacturer's annual purchases of aluminum and steel would have to be from the US, Mexico or Canada.
11. Prior to a vote in Congress, the TPA legislation requires a series of actions, including an assessment of the agreement by the International Trade Commission; a description of the legal changes that would be required to comply with the provisions of the agreement; and submission of the final text of the agreement to Congress.
12. Mexico's President-Elect Andrés Manuel López Obrador supports the revised agreement but indicated that he might seek to renegotiate its terms if it is not signed before he takes office.
13. One issue to watch is the upcoming reactions of the provincial government elected in the province of Quebec on 1 October 2018. Canada has made concessions on access to its dairy market that are controversial in Quebec due to the size of its dairy industry, which could impact implementation of the USMCA's negotiated outcomes on dairy in Quebec.
14. Set forth in NAFTA Annex 401.
15. USMCA's Chapter 4.

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