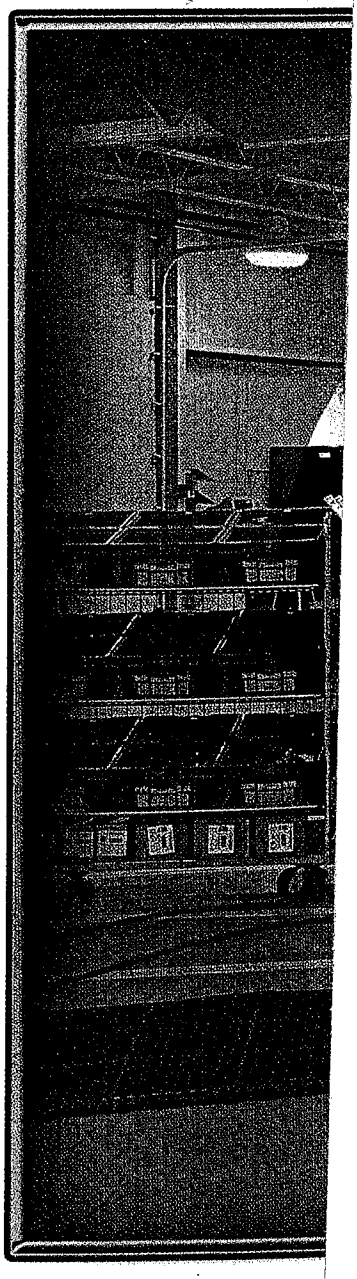
Painting is Painting,

Here is a riddle:

When is painting not painting? The answer, according to the U.S. Bureau of Customs and Border Protection, is when the painting is decorative. Customs' long-standing policy, however, has recently been overturned. As a result, maquiladora operations have new freedom to fully assemble goods, including the application of attractive finish-coat paints.



In an important decision, the U.S. Court of Appeals for the Federal Circuit has issued an opinion that a Customs' regulation restricting a duty preference for U.S.-origin materials that have been decorated with paint as part of assembly in Mexico is invalid. The decision in DaimlerChrysler v. United States can be found at http://fedcir.gov/opinions/03-1192e.doc. The decision corrects Customs' previous practice of denying a duty exemption for essentially all U.S.-origin components that are painted during assembly in Mexico and re-imported in the United States as part of a finished good.

Decoration not permitted

For many years, a company wishing to export U.S.-origin components for assembly abroad and re-import the finished product into the United States has paid duty only on the value of the finished product, excluding the value of U.S.-origin components. The authority for this partial duty exemption is item 9802.00.80 of the Harmonized Tariff Schedule of the United States (HTSUS). This tariff item allows the partial duty exemption provided the U.S.-origin component was exported in condition ready for assembly without further fabrication, has not lost its physical identity, and was not advanced in value or improved in condition other than by assembly and "operations incidental to assembly such as cleaning, lubricating, and painting." This provision has helped both U.S. industry and Mexico industry: it encouraged the use of U.S.-origin components and it enabled more operations to be performed in Mexico than would otherwise be the case.

Customs had limited 9802.00.80 by passing a regulation stating that only painting that is preservative in nature and is not primarily decorative is "incidental to assembly." Painting abroad that was decorative, as is most painting, would cause the importer to lose the duty exemption for the value of the painted U.S.-origin components.

GM and Chrysler cases

This presented a serious limitation to foreign assembly operations for many U.S. importers with assembly operations in Mexico. Auto manufacturers, for example, often fabricate sheet metal body components in the United States for use in vehicle assembly in Mexico for export to

by Lawrence M. Friedman
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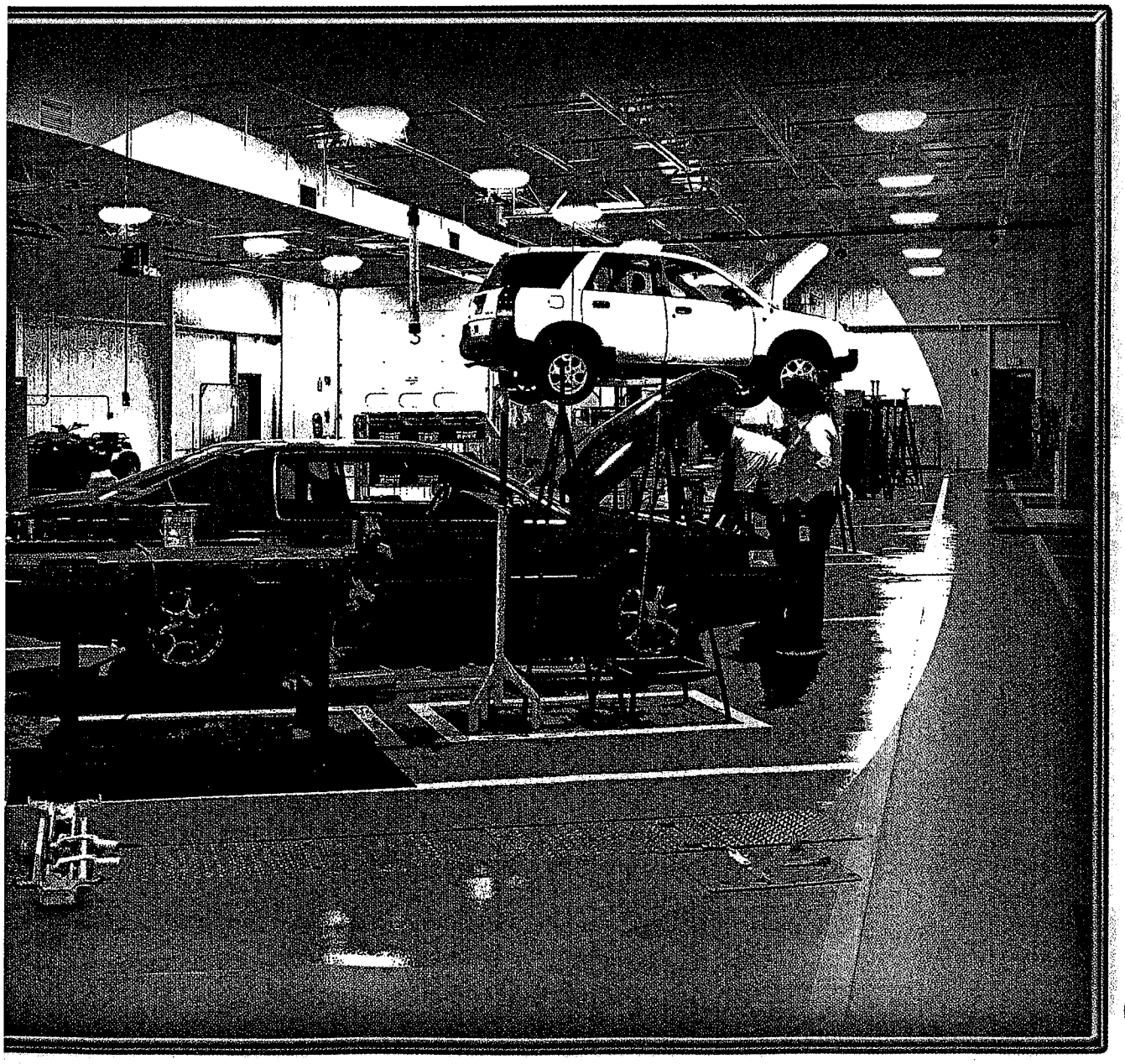
Finally



AUTO MANUFACTURERS, FOR EXAMPLE, OFTEN FABRICATE SHEET METAL BODY COMPONENTS IN THE UNITED STATES FOR USE IN VEHICLE ASSEMBLY IN MEXICO FOR EXPORT TO THE U.S. MARKET.

the U.S. market. Customs, however, applied its regulation to deny the duty exemption to the U.S.-origin sheet metal that had been topcoat painted in Mexico as part of the vehicle assembly process. Painting the sheet metal in Mexico, therefore, had the effect of eliminating the duty exemption for this valuable assembly input. U.S. industry suffered in the face of this disincentive to use U.S.-origin steel. Mexico industry also potentially suffered as 9802 assembly programs lost some of their appeal to U.S. importers.

This situation has been the subject of numerous legal challenges since 1987 when General Motors brought a case to the U.S. Court of International Trade. GM won this case, which did not squarely address the validity of the regulation. Unfortunately, on appeal, the Federal Circuit reversed, upholding Customs' reliance on older cases that did not apply the regulation. Following that decision, in 1992, Chrysler Corp. brought another case, which it lost due to the prior decision against GM.

Enter Haggar

Customs' regulation defining operations incidental to assembly addressed not only painting, but also operations not listed in the statute. For example, the regulation defined perma-pressing as an impermissible operation. The next court challenge to Customs' regulation questioned its authority to issue such a regulation on perma-pressing.

The importer in that case, Haggar Apparel Company, argued that Customs incorrectly denied it a duty exemption for U.S.-origin fabric that had been perma-pressed in Mexico. It claimed that Customs' regulation exceeded the authority Congress had given the agency to promulgate regulations to interpret the Tariff Schedule. The Supreme Court ultimately determined that, unlike the decisions mentioned above, the standard for deciding whether Customs was correct was to review whether the regulation was a reasonable interpretation of the statute. The Supreme Court contrasted operations not mentioned in the statute—such as perma-pressing— with the listed examples of incidental operations—such as painting. It held that for operations where the statute was silent,

there was room for a reasonable regulation as to whether the operation was an incidental operation. By contrast, where Congress had specifically listed permissible operations in the statute, there was no room for any regulation limiting the operation. In reaching this conclusion, the Supreme Court used painting as an example of a clearly expressed permissible operation.

DaimlerChrysler Corporation, therefore, again challenged Customs' application of its regulation to sheet metal that was painted in Mexico as part of the assembly process. DaimlerChrysler argued before the United States Court of International Trade that the clear language of the Tariff Schedule trumps the regulations. That court, however, held the regulation to be valid. Applying the regulation, the court further found DaimlerChrysler's painting to be primarily decorative and, therefore, not incidental to the assembly of the vehicles.

On appeal, the Federal Circuit, for the first time, directly addressed whether Customs' regulation was consistent with the language of the Tariff Schedule. The court found the Supreme Court's analysis in the perma-pressing decision to be decisive. It found that—unlike perma-pressing—cleaning, lubricating and painting operations are specifically defined by the statute as operations incidental to assembly and, therefore, are always permitted. Customs' regulation restricting the circumstances under which painting is allowable is, therefore, invalid.

Now, when all other requirements of HTSUS 9802.00.80 are met, U.S.-origin components can be painted in Mexico as part of the assembly process and retain their duty exemption upon re-import into the United States. Not just preservative painting. Not just unattractive painting. All painting. The Court did leave open the possibility that highly detailed custom painting may be beyond the scope of the tariff item. Painting of this type, however, is rarely—if ever—part of routine assembly line production.

This decision is very important on a number of fronts. First, it clarifies that Mexican assemblers can also paint U.S.-origin parts without risking increased duty in the U.S. In the bigger picture, the case reaffirms that the primary role of U.S. Customs and Border Protection is to enforce the law as written by Congress. CBP cannot, through an administrative process, limit what Congress intended.

As of this writing, the government has the opportunity to request a rehearing before the Federal Circuit, or to ask the Supreme Court to consider an appeal of the decision. DaimlerChrysler was represented by Lawrence M. Friedman, a partner at Barnes, Richardson & Colburn, and Harvey Karlovac, an associate at the firm. ■

Contact Larry Friedman at Barnes, Richardson & Colburn, tel. 312-565-2000, if you have any questions about this decision, or consult with your attorney, customs broker, or other customs expert regarding how you may be able to use this decision to benefit your import activities.