UNUSED DRAWBACK REQUIREMENTS
UNDER NAFTA AND THE CUSTOMS MODERNIZATION ACT

I. Drawback Has Changed Under The NAFTA And MOD Act Statutes

With the passage of the North American Free Trade Agreement ("NAFTA") on December 8, 1993, which included the Customs Modernization Act, there have been major revisions in the administration and enforcement of the drawback laws (19 U.S.C. §1313, §1593, and §3333).[1/] Major changes that will directly impact exporters to Canada and Mexico who claim drawback, are:

- the special NAFTA restrictions:
  - ◊ elimination of *substitution, unused drawback* for exports to NAFTA countries, and
  - ◊ "lesser of the two" provision for both *manufacturing drawback* and *direct identification, unused drawback*, and
- the implementation of the concept of "informed compliance" which includes, for the first time, civil penalties for non-compliance.

Although there are more than a dozen types of drawback provided for under the law (19 U.S.C. §1313), under the NAFTA, exporters of *unused* duty-paid merchandise are concerned mainly with the following provisions:

- *Unused merchandise, direct identification* [19 U.S.C. §1313(j)(1)];
- *Same condition unused merchandise, direct identification* [19 U.S.C. §3333, as eligible under 19 U.S.C §1313(j)(1)];

A claimant who is denied drawback under one provision will be allowed to raise alternative claims under other provisions (e.g., *manufacturing drawback*, etc.), by protest [§1313(r)]. However, to be allowable under another provision, the claim must meet each of the requirements of such other provision.

II. Exports To NAFTA Countries Are Limited To Unused Merchandise, Direct Identification Drawback

Drawback claims involving exports to Canada and Mexico, after January 1, 1994, are subject to the provisions of the NAFTA [19 U.S.C. §3333; 19 C.F.R. §181, Subpart E] Because of restrictions in the NAFTA, drawback cannot be claimed under the *unused merchandise, substitution* drawback provisions of 19 U.S.C. §1313(j)(2), on exports to these countries. Therefore, under the NAFTA, all *unused merchandise* drawback claims are limited to the *direct identification* provisions of 19 U.S.C. 1313(j)(1). Additionally, as of January 1, 1996, for exports to Canada, and as of January 1, 2001, for exports to Mexico, drawback claims will be limited to the lesser of:

1) 99% of the duties paid or owed on the merchandise at the time of its importation into the United States; or
2) 99% of the duties paid or owed on the merchandise upon its subsequent exportation to a NAFTA country [19 C.F.R. §181.44].

This is known as the **"lesser of the two"** rule.

The exportation of merchandise claimed for *unused merchandise, direct identification* drawback must occur before the close of the 3-year period which begins on the date of importation of the identified duty-paid merchandise (i.e., the "drawback period").

However, duty-paid merchandise that was imported into the United States and subsequently exported to Canada or Mexico, in the *same condition* as when imported [19 U.S.C. §3333; 19 C.F.R. §181.45(b)], although eligible for drawback under the provisions for *unused merchandise, direct identification* drawback [19 U.S.C.

[1/] "Drawback" means the refund or remission, in whole or in part, of ordinary customs duties, marking duties, and internal revenue taxes which were imposed on imported merchandise under Federal Law because of its importation.

§1313(j)(1)], is not subject to the "lessor of the two" NAFTA limitation on the amount of drawback that can be claimed.[2/]

The claimant must either have imported the duty-paid merchandise, have *possessed* the merchandise at some time during the 3-year drawback period, or must have been the exporter (or destroyer) of the merchandise.

A. Incidental Operations Allowed

All merchandise that is considered in the *same condition* as when imported is always also considered *unused*. However, not all *unused* merchandise is in the *same condition* as when imported.

1. Unused Merchandise, Not In Same Condition

Under the *unused* drawback provisions, the performance of any operation that does not amount to manufacture or production for drawback purposes, will not be considered *use* of the duty-paid merchandise. Such operations include (but are not limited to) testing, cleaning, repacking, inspecting, sorting, refurbishing, freezing, blending, repairing, reworking, cutting, slitting, adjusting, replacing components, re-labeling, disassembling, and unpacking.

All claims for merchandise exported to a NAFTA country under the *unused merchandise, direct identification* drawback provision [19 U.S.C. §1313(j)(1)] are subject to the "lessor of the two" NAFTA limitation on the amount of drawback that can be claimed. However, if the *unused* exported merchandise conforms to the *same condition* criteria outlined below, the "lessor of the two" NAFTA limitation does not apply.

Example. Product X is imported into the United States and the U.S. importer pays duty of $10.00. Upon inspection, the importer discovers minor in-transit damage and repairs the damage. Product X is then sold to a Canadian buyer who pays Revenue Canada the equivalent of US$5.00 in duties. The exported merchandise is eligible for *unused merchandise, direct identification* drawback because the repair of in-transit damage is an allowable operation under that provision (but does not conform to the *same condition* criteria). Because Product X was exported to a NAFTA country, the "lessor of the two" rule limits the drawback payment to $4.95 (i.e., 99% x $5.00).

2. Same Condition Merchandise

Where an *unused merchandise, direct identification* drawback claim is restricted to merchandise exported in the *same condition* as when imported, the "lessor of the two" NAFTA limitation on the amount of drawback that can be claimed does not apply.

The incidental operations that *same condition* merchandise may be subjected to are limited to any of the following, provided that no such operation materially alters the characteristics of the merchandise:

- Mere dilution with water or another substance;
- Cleaning, including the removal of rust, grease, paint, or other coatings;
- Application of preservative, including lubricants, protective encapsulation, or preservation paint;
- Trimming, filing, slitting, or cutting;
- Putting up in measured doses, or packing, repacking, packaging, or repackaging; or
- Testing, marking, labeling, sorting, or grading.

Specifically absent from the allowable *same condition* operations are the following operations that are allowed under the general *unused* drawback provisions: refurbishing, freezing, blending, repairing, reworking, adjusting, and replacing components.

Example. Product Y is imported into the United States and the U.S. importer pays duty of $10.00. The importer unpacks, inspects, and removes a temporary protective coating from Product Y, then repacks it for

---

[2/] Goods not conforming to sample or specification, or shipped without consent of the consignee, that are claimed under 19 U.S.C. §1313(c), are also exempt from the "lesser of the two" NAFTA limitation.

George R. Tuttle, A Professional Corporation, Three Embarcadero Center, Suite 1160, San Francisco, CA 94111; Phone: (415) 986-8780; Fax: (415) 986-0908; E-Mail info@tuttlelaw.com.

shipment. Product Y is then sold to a Canadian buyer who pays Revenue Canada the equivalent of US$5.00 in duties. Upon exportation to Canada, Product Y is eligible for *unused merchandise, direct identification* drawback. However, because the operations that were performed after importation are allowed for purposes of *same condition* drawback, the "lessor of the two" NAFTA limitation does not apply. The claimant is entitled to a drawback payment of $9.90 (i.e., 99% x $10.00).

B. Direct Identification Of Duty-Paid Lots To be Claimed For Unused Drawback

The principles of direct identification drawback require that there be a direct relationship between the claimed exported merchandise and the identified duty-paid merchandise. This relationship may be established either by *specific identification* or by use of an approved alternative inventory method.

1. Specific Identification Method

The *specific identification* method is used where each lot or batch of like merchandise is uniquely identified and physically segregated in storage, and the original lot or batch identifier has been preserved. In this way, each export can be directly identified to its origin and, if duty was tendered on the identified merchandise, it is drawback eligible.

2. Alternative Inventory Identification Methods

Where two or more *fungible*[3/] lots or batches of merchandise are commingled, identification of the specific duty-paid lot(s) that is(are) the subject of a drawback claim requires one of the approved inventory identification methods. "Fungible merchandise" means merchandise which for commercial purposes is identical and interchangeable in **all** situations (regardless of origin). To be considered *commingled* for drawback purposes, the fungible lots must be stored in the same location, i.e., not company-wide storage of like products at different locations.

The most commonly used inventory identification methods that are approved for drawback purposes are "*low-to-high" and "FIFO*."

- *Low-to-high* assumes the lot having the lowest drawback benefit was shipped first.
- *FIFO* (first-in, first-out) assumes the "oldest" lot in inventory was shipped first.

These methods must be applied in such a manner that the claimant receives no more drawback than if it could have identified the specific lots of duty-paid merchandise used to make the exports. Therefore, a *direct identification* inventory system must track all inputs (imported and domestic receipts) and all withdrawals (domestic sales and exports). Inventory records must be maintained showing the total fungible input commingled in storage at a given location and all withdrawals.

At the time of withdrawal the quantity to be exported must be directly identified to one or more duty-paid lots to be drawback eligible. If the identified lot is not duty-paid (i.e., duty-free or domestic), drawback cannot be claimed on the export. Conversely, where there is a domestic sale and the inventory procedure identifies a duty-paid lot, that duty-paid lot is lost for drawback identification on future exports.

a. Low-To-High Method May Reduce Drawback Benefits

The low-to-high method (also known as "blanket identification") is useful where there are many lots of like merchandise having varying unit duty-paid amounts ("drawback factors") and there is no inventory method in place such as FIFO or LIFO. Exports are identified to lots (domestic, non-duty-paid foreign, and duty-paid foreign) having the lowest drawback factor until all are accounted for, than to the lot with the next highest drawback factor. Obviously domestic origin and non-duty-paid foreign lots will be the first selected for identification since they have a drawback factor of zero ("0").

[3/] The term "*fungible"* is used only in connection with alternative inventory recordkeeping procedures and should not be confused with the unused merchandise, substitution drawback term *"commercially interchangeable."*

George R. Tuttle, A Professional Corporation, Three Embarcadero Center, Suite 1160, San Francisco, CA 94111; Phone: (415) 986-8780; Fax: (415) 986-0908; E-Mail info@tuttlelaw.com.

b. FIFO Method Tends To Provide More Drawback Benefits Than Low-To-High

The FIFO method means that the first withdrawals of merchandise are assumed to come from the first receipts of merchandise irrespective of any drawback considerations. This method is the most widely used since most inventory systems are based on FIFO valuation concepts for accounting purposes. However, this method may result in no drawback being received where a portion of the inventory is of domestic or non-duty-paid origin.

III. Exports To Non-NAFTA Countries May Utilize The Provisions For Unused Merchandise, Substitution Drawback

With the passage of the NAFTA on December 8, 1993, *unused merchandise, substitution* drawback was prohibited on all exports to Canada and Mexico. Therefore, this provision may only be used where there are exports to non-NAFTA countries.

Unused merchandise, substitution drawback may be allowed upon the exportation or destruction under Customs supervision of substituted merchandise that is commercially interchangeable with the designated imported merchandise and which has not been *used* within the United States. The exportation or destruction must occur before the close of the 3-year period beginning on the date of importation of the duty-paid merchandise.

IV. FIFO Integrity Must Be Maintained Where There Are NAFTA And Non-NAFTA Claims

Where there are exports of the same product to NAFTA and non-NAFTA countries, care must be exercised to ensure that the integrity of the FIFO system is not compromised for NAFTA claims. Where *substitution* merchandise that is exported to a non-NAFTA country is designated from duty-paid lots under *substitution* claims, such merchandise cannot be eliminated from the sequential FIFO identification system, although it is no longer eligible for future drawback claims. Such an elimination would destroy the strict sequential properties of a FIFO identification system, thereby rendering it inadequate for *direct identification* claims.

Therefore, it is suggested that a designation under *unused merchandise, substitution* drawback first be made using FIFO as though it were a direct identification claim. If the FIFO system identifies a lot that is not drawback eligible, under the substitution rules any other drawback eligible lot that was imported within three years prior to the date of export, may be designated (e.g., duty-paid lots not previously claimed under *direct identification*). However, where a FIFO identified merchandise lot is used for designation under *substitution*, the record of such merchandise must remain in the FIFO system for sequential accounting purposes, but be deemed ineligible for drawback (i.e., drawback cannot be claimed twice on the same merchandise).

V. Recordkeeping Requirements To Substantiate A Drawback Claim

Records that are essential to establish compliance with the legal requirements of *unused merchandise* drawback [19 U.S.C. §1313(j)] must be retained for at least 3 years after the payment of such claims. Although there are certain records and documents that must be included with the drawback claim that is filed with Customs, there are also many underlying source documents and accounting records that must be maintained to substantiate the claim. Merchandise that is subject to drawback under the *unused* drawback provision must be accounted for in a manner which will enable the claimant to determine, and Customs to verify, the applicable import entry, the related imported duty-paid merchandise and the time and fact of exportation. A recordkeeping program should be established to ensure that the drawback claims are properly prepared and the required supporting records are properly maintained and available for Customs review.

One of the new provisions added to the drawback law by the Customs Modernization Act is the establishment of civil penalties for those persons who are found to have been negligent or to have committed fraud in obtaining drawback either for themselves or others (19 U.S.C. §1593a). Fraudulent violations are punishable by a civil penalty in an amount not to exceed 3 times the actual or potential loss of revenue. A negligent violation is punishable by a civil penalty in an amount not to exceed 20 percent of the actual or potential loss of revenue. A second negligent violation of the same issue increases the civil penalty to an amount not to exceed 50 percent of

George R. Tuttle, A Professional Corporation, Three Embarcadero Center, Suite 1160, San Francisco, CA 94111; Phone: (415) 986-8780; Fax: (415) 986-0908; E-Mail info@tuttlelaw.com.

the actual or potential loss of revenue. The penalty amount for each succeeding repetitive negligent violation shall be in an amount not to exceed the *actual or potential loss of revenue*.

Because administrative regulations pertaining to 19 U.S.C. §1593a have not yet been published, we do not have an official definition that distinguishes the terms *actual or potential loss of revenue.* However, "loss of duties" and "potential loss of duties" are distinguished in 19 C.F.R. §162.71, the regulations pertaining to the companion statute for violations of import entries, 19 U.S.C. §1592.

Assuming the respective definitions for drawback violations will be similar to those for import entries, one could further assume that an *actual loss of revenue* on a drawback claim exists where, after liquidation of the claim, the proper amount is determined to be less than the amount claimed.

Similarly, one may assume that a *potential loss of revenue* exists where a drawback claim remains unliquidated, but Customs determines that the proper amount is less than the amount claimed. The *potential* loss in such cases equals the amount of revenue which would have been due had Customs not discovered the violation prior to liquidation and taken steps to correct the entry. Such corrections may be required by the discovery of errors during the course of an audit or by a review of the claim by a Customs drawback specialist (liquidator).

VI. Participation In The Drawback Compliance Program Reduces Penalties And Provides Eligibility For Certain Drawback Privileges

Integral to the implementation of the Customs Modernization Act are the concepts of "informed compliance" and "reasonable care," which place greater responsibility on the drawback claimant for ensuring accuracy of the claims, and require that supporting records are maintained that verify the information reported in such claims. Hence, a voluntary "Drawback Compliance Program" (hereinafter, "Program"), is specifically provided for in 19 U.S.C. §1593a(e). However, the Program will not be implemented until regulations and other directives pertaining to the administration of the Program have been approved.

Drawback claimants and other parties in interest will be able to participate in the Program, including any party who provides information or documentation to the party who files the drawback claims. This includes importers, exporters, and intermediate parties.

A. Basic Requirements Of Program

Any party participating in the Program must be capable of demonstrating that it:

- Understands the legal requirements for filing claims, including the nature of the records that are required to be maintained and produced and the time periods involved;
- Has in place procedures that explain the Customs Service requirements to those employees involved in the preparation of claims, and the maintenance and production of required records;
- Has in place procedures regarding the preparation of claims and maintenance of required records, and the production of such records to the Customs Service;
- Has designated a dependable employee or employees who will be responsible for compliance under the program, and maintenance and production of required records;
- Has in place a record maintenance program approved by the Customs Service regarding original records, or if approved by the Customs Service, alternative records or recordkeeping formats for other than the original records; and
- Has procedures for notifying the Customs Service of variances in, or violations of, the drawback compliance or other alternative negotiated compliance programs, and for taking corrective action when notified by the Customs Service of violations and problems regarding such program.

B. Benefits Of Participating In The Program

Under the Program, Customs is required to inform potential drawback claimants and related parties about their rights and obligations under the drawback law and regulations. In addition, the Program provides for reduced penalties and offers eligibility for special drawback privileges.

George R. Tuttle, A Professional Corporation, Three Embarcadero Center, Suite 1160, San Francisco, CA 94111; Phone: (415) 986-8780; Fax: (415) 986-0908; E-Mail info@tuttlelaw.com.

1. Reduced Penalties

A certified participant in the Program who is generally in compliance with the appropriate procedures and requirements of the Program is given special consideration where there is a violation. In the absence of fraud or repeated violations, a written notice of the violation will be issued to the participant in lieu of a monetary penalty. The participant is then required to notify Customs of the corrective steps that have been taken to prevent a recurrence of the violation. Repetitive negligent violations of the same issue are subject to the following penalties:

- Second violation -- An amount not to exceed 20 percent of the loss of revenue;
- Third violation -- An amount not to exceed 50 percent of the loss of revenue;
- Forth and subsequent violations--An amount not to exceed 100 percent of the loss of revenue.

Repeated violations by a participant may result in the issuance of penalties and the removal of certification under the Program until corrective action, satisfactory to Customs, is taken.

2. Special Drawback Privileges

Only those parties approved for participation in the Program will be eligible to apply for and take advantage of certain drawback privileges. These privileges consist of :

- Waiver of prior notice of intent to export (*unused merchandise* drawback) and
- Accelerated payment procedure.

Drawback claimants who are currently holding either or both of these privileges will have one year from the date the program becomes effective to become a participant in the Program or lose such privileges.

George R. Tuttle, A Professional Corporation, Three Embarcadero Center, Suite 1160, San Francisco, CA 94111; Phone: (415) 986-8780; Fax: (415) 986-0908; E-Mail info@tuttlelaw.com.