



# Is the CIT's recent *Cyber Power Systems* decision on customs "origin" substantially transformative?

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Determining the "country of origin" of imported goods for customs purposes is generally not a straightforward or objective exercise, and the consequences of getting it incorrect can be costly, subjecting imported goods to marking penalties and potentially significant Section 301 tariffs as high as 25 percent. Goods not properly marked with the country of origin may also be considered restricted and excluded from entry into the United States. These determinations have been made more challenging over the years by seemingly arbitrarily and subjectively applied tests which the Court of International Trade (CIT) recently called into question in *Cyber Power Systems (USA) Inc v. United States*, Slip-Op. 23-24 (February 27, 2023).

This article discusses how the decisions in *Cyber Power Systems* arguably challenges precedent concerning U.S. Customs and Border Protection's (CBP) "substantial transformation" standard for determining the country of origin of imported goods, and may spur companies who have considered altering supply chains or manufacturing operations in order to obtain different "origin" outcomes for tariff purposes to reassess their analysis or seek reconsideration of past CBP origin determinations.

## Discussion

### Cyber Power Systems I & II

In a previous article we raised the specter that some of CBP's seemingly subjective origin determinations, under the cover of the CIT's decision in *Energizer Battery v. United States*, 190 F. Supp. 3d 1308 (2016), may have been colored by short term policy or revenue goals concerning trade with China.<sup>1</sup> The *Energizer* decision effectively determined that assembly operations could not result in a substantial transformation if the foreign components had a predetermined end-use. That decision made it difficult to confer a change in the country of origin of a good produced through assembly operations.<sup>2</sup>

The dispute in *Cyber Power Systems* centered on whether the country of origin of imported uninterruptible power supplies (UPS) and surge voltage protectors (SVP) assembled in the Philippines from a majority of Chinese components, should be the Philippines or China for both marking and Section

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<sup>1</sup> *U.S. Trade Tariffs – The 'Origin' Story*, Bloomberg Tax (March 24, 2020).

<sup>2</sup> See, for example, *CBP Headquarters Ruling Letter* ("HQ") H30281 (Jul. 26, 2019).

301 tariff purposes. CBP regulations explain that “further work or material added to an article in another country must effect a **substantial transformation** in order to render such other country the ‘country of origin’ within the meaning of this part.”<sup>3</sup> (emphasis added). Courts have defined that a “substantial transformation” occurs “when an article emerges from a manufacturing process with a name, character or use which differs from those of the original materials subjected to the process.”<sup>4</sup>

In the CIT’s decision in *Cyber Power Systems (USA) Inc v. United States*, Slip-Op 20-130 (September 2, 2020) (*Cyber Power Systems I*), denying plaintiff’s motions for preliminary injunction, the court determined that the importer may still prevail if it can establish that the Philippine processing is sufficiently complex to justify a substantial transformation, notwithstanding the component-by-component approach espoused in *Energizer*. The court also acknowledged that the application of the substantial transformation test had resulted in seemingly disparate results, potentially colored by whether the underlying statutory and regulatory purposes were served by a finding of a substantial transformation.

In the CIT’s subsequent decision in *Cyber Power Systems (USA) Inc v. United States*, Slip-Op 22-17 (February 24, 2022) (*Cyber Power Systems II*), denying cross-motions for summary judgement, the court again questioned the CIT precedent set out in *Energizer*. The court in *Cyber Power Systems II* rejected the component-by-component analysis that served as the basis of many CBP origin determinations in recent years, namely rejecting the theories that the analysis should focus on the origin of the majority of the components or the origin of the critical component(s) that imparts the “essence” to the produced good.<sup>5</sup>

The court also declined to focus on whether there was a predetermined end-use to the components to determine whether the produced product emerges with a new name, character or use. The court was clear “[t]hat is not, and cannot be the law.” To hold otherwise would mean there can never be a substantial transformation because components will always have a predetermined end-use. Thus, rather than focusing on whether the discrete components shed their predetermined end-use after undergoing the processing or assembly operations, *Cyber Power Systems II* opened the door to instead focus on whether the final complete product in its totality has a different character or use than its discrete components.

In this regard, while reiterating that “simple assembly” does not substantially transform products, the court in *Cyber Power Systems II* directed the parties to address the factual dispute as to whether the plaintiff’s Philippine operations were sufficiently complex and critical to confer a change in character or use. It is also important to note that the court acknowledged that Cyber Power’s deliberate de-coupling from China and its significant capital equipment investment in its Philippine operations were in line with the intended purpose of the Section 301 tariffs.

## Cyber Power Systems III

Following a trial to determine the country of origin of the devices in question, the CIT recently issued its decision in *Cyber Power Systems (USA) Inc v. United States*, Slip-Op. 23-24 (February 27, 2023) (*Cyber Power Systems III*) concluding that only one of the five models of UPS devices (i.e., model no. CP600LCDa) was substantially transformed to confer Philippine origin, whereas the country of origin for the remaining four UPS models, and the SVP, is China. In acknowledging the difficulty in applying the substantial transformation test, the court reiterated its rejection of two alternative approaches to the “change in name, character, or use” test: (1) an “essence”-based approach that would look only to whether the essential or critical component of a product had been transformed; and (2) a “component-by-

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<sup>3</sup> 19 C.F.R. § 134.1(b)

<sup>4</sup> *Torrington, Co. v. United States*, 764 F.2d 1563, 1568 (Fed. Cir. 1985); see also *Gibson-Thomsen Co. v. United States*, 27 C.C.P.A. 267, 273 (1940).

<sup>5</sup> The defendant had proposed, but the court rejected, a focus on the printed circuit board assembly (PCBA) as the “essential” or “critical” component to assess origin of the overall finished good.

component” based approach that would *per se* determine whether a substantial transformation occurs by looking at whether each discrete component had undergone a change in name, character or use.

However, despite the court’s explicit rejection of these two approaches, the court’s opinion seemingly laid its focus and dedicated a significant portion of its discussion on one component, the printed circuit board assembly (PCBA) and its production operations. The court noted that for five of the six devices, it was undisputed that the main PCBAs were manufactured in China, whereas the main PCBA for the CP600LCDa was manufactured in the Philippines and employed the following operations: Surface Mount Technology, Auto-Insertion and Dual in-line packaging.<sup>6</sup> The opinion also notes that the CP600LCDa’s firmware was designed and coded in Taiwan and loaded in the Philippines.<sup>7</sup>

After concluding that the PCBA for the CP600LCDa originated in the Philippines, the court then determined that the “entirety” of the CP600LCDa’s production occurred in the Philippines (i.e., including both the multi-phase assembly of its main board/PCBA, and assembly, testing and packaging of the UPS device itself). Accordingly, the court declined to make a determination as to whether the assembly process of the UPS device **alone** was sufficient to effect a substantial transformation.

The court concluded that the entirety of the operations in the Philippines resulted in a “new and different article” under the change in name, character, or use test. Specifically, the court determined that the CP600LCDa satisfied all three factors: change in name (from PCBA and UPS component parts to a finished UPS device); change in character (from component parts not capable of being electronically programmed to a functioning device capable for performing intelligent functions); and change in use (from component parts to a device geared towards a specific purposes). Notably, the court avoided a detailed discussion of whether a component’s predetermined end-use effectively precludes a substantial transformation, which would have presented a clear departure from the approach in *Energizer*.

For the other five devices, the court identified several outstanding questions that were unanswered during the trial: details concerning the production process in the Philippines; when and where discrete steps of the assembly process (including firmware burning) were taken; and whether the company could provide evidence of the assembly procedures that depicted the manufacturing process of the devices. As a result, the court concluded that Cyber Power failed to prove that a substantial transformation had occurred in the Philippines for the other five devices, and therefore the origin for said devices is China, which is the country of origin for the majority of their components, including the PCBA.

On the issue of the U.S.’s Section 301 policy objective of encouraging importers to de-couple sourcing from China, the court in *Cyber Power Systems III* clarified that despite the Cyber Power’s attempt to de-couple its manufacturing from China, “the mere fact that Cyber Power was attempting to meet the policy objective does not overcome its inability to demonstrate that five of the six devices were substantially transformed in the Philippines.” Thus, the court made clear that the underlying U.S. policy objectives of the Section 301 tariffs should not influence technical origin outcomes.

## Conclusion

The *Cyber Power Systems* decision purports to present a clear rejection of several alternative “substantial transformation” approaches previously employed by CBP and the CIT (i.e., rejecting the “essential” component and “component-by-component” approaches). This pronouncement is significant; however, the particular facts and analysis of this decision make it difficult to distill any meaningful application beyond this specific case.

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<sup>6</sup> The court’s focus on the main PCBA in its substantial transformation analysis is consistent with some prior CBP rulings that determined the origin of the PCBA, an essential component, imparted the origin to the overall product incorporating the PCBA. See HQ H030645 (Sep. 15, 2008), HQ 561232 (Apr. 20, 2004); *but see* HQ H290670 (Jan. 29, 2019), HQ H250154 (Feb. 23, 2018).

<sup>7</sup> The court determined that firmware “burning” or “burn-in” for the other devices either occurred in China or there was insufficient information to conclude where the firmware had been burned.

For starters, for the device that was found to have substantially transformed in the Philippines (model CP600LCDa), the “entirety” of its production occurred in the Philippines, including the PCBA manufacture, burning of firmware, and assembly of the finished device itself. Thus, hardly a surprising “origin” result for said device. Notwithstanding the majority Chinese components, CBP and the courts have generally determined that PCBA production operations using Surface Mount Technology and programming that result in irreversible distinct physical changes to circuit patterns are transformative in nature.<sup>8</sup> Would the outcome have been different for this device if the PCBA had been produced in China? Will CBP stop employing the “essential” component approach as a result of this decision? It is difficult to say since the court acknowledged it did not need to determine the illuminating question of whether the UPS assembly process alone constituted a substantial transformation. This would have required the court to weigh the respective transformative nature of the device’s assembly operation, if any, against the PCBA operation, and would have provided meaningful guidance to importers to determine origin outcomes when the entirety of the production operations is not in one country.

Nonetheless, one can glean a possible answer from the court’s decision itself, where it found that the other five devices were of Chinese origin because the plaintiff failed to provide sufficient information concerning the Philippines operations, effectively defaulting to CBP’s decision that the devices were of Chinese origin. Incidentally, the PCBAs were also produced in China for said devices, suggesting that arguably the same outcome could have been reached had the court applied an “essential” component approach.

While the court may be correct that the “component-based” approach to assembly operations would never result in a substantial transformation because components will always have a pre-determined use, arguably the converse, an approach that seeks to compare the respective use of the discrete components to the function of the ultimate assembled good, may always result in a substantial transformation since any given part, on its own, generally cannot perform the function of the whole. Neither approach seems to present a bright line rule.

The *Cyber Power Systems III* decision does, however, bring into sharp focus the fact that the “change in name, character, or use” test turns on the nature of the transformative process for the components (e.g., physical, chemical, mechanical, etc.) considered in the context of the particular good being produced, or as the court put it:

The CP600LCDa began its manufacturing journey in the Philippines as a set of [majority Chinese] components not yet functional as a power source of any kind (128 types of components were combined in Philippines to assemble CP600LCDa’s main PCBA). After several stages of manufacturing, each involving numerous steps directed toward *changing the electronic properties of the device as a whole*, the CP600LCDa left the Philippines as fully functioning UPS. [*emphasis added*].<sup>9</sup>

For companies that were waiting to see whether this decision might significantly impact their production or supply chain strategies, the court’s statements arguably open the door for those companies to reassess prior origin analyses or seek reconsideration of past CBP origin determinations under a new lens. In practice, however, the outcomes may remain the same. In any case, importers are encouraged to continue to analyze and document their country of origin determinations in advance to demonstrate the exercise of reasonable care and avoid costly customs penalties, as country of origin compliance will continue to receive heightened scrutiny from CBP.

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<sup>8</sup> See, for example, *Data General Corp. v. United States*, 4 CIT 182 (1982)

<sup>9</sup> *Cyber Power Systems III* at page 26.

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