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Since the last NAFTA Insights, the Mexican presidential election has occurred and the mid-term elections in the US are fast-approaching. Following a NAFTA negotiations overview from Eurasia Group, this edition of NAFTA Insights reports on the s232 tariffs to date and their implications in the near term.

The latest on negotiations from Eurasia Group

With the victory of president-elect Andres Manual Lopez Obrador in Mexico, Eurasia Group believes that policy decisions in Mexico are set to be more politicized with centralized decision-making, which means less influence from ministers and advisors than in the past and possibly higher uncertainty in the years to come.

Lopez Obrador's share of vote is the largest a presidential candidate has obtained since elections have been transparent in Mexico. He will begin his presidency in a very strong position politically.

The appointment of the politically experienced Marcelo Ebrard to Foreign Affairs Secretary signals that Lopez Obrador realizes that US-Mexico and other foreign relations will be a priority. On 2 July, President Trump called Lopez Obrador to congratulate him on his victory. It has been reported that the two discussed projects that boost employment in both countries, reduce migration and improve security conditions – and a bilateral trade agreement, although Eurasia Group believes a bilateral agreement remains unlikely given the incentives for Mexico and Canada to work together.

With a new government in Mexico that will bring new people and a new set of ideas, Eurasia Group believes that NAFTA negotiations will at least be delayed and could get more challenging. While Lopez Obrador remains committed to maintaining NAFTA, he will want to incorporate topics like wages, energy and agriculture into the discussions.

During an interview on 1 July, President Trump said that he wants to wait until after the US midterm elections this November before finalizing a deal on NAFTA.

The US administration is also reported to have considered imposing tariffs on autos. Should such tariffs be imposed, direct retaliation is complicated for Canada and Mexico due to the integration of North American automotive supply chains. However, Eurasia Group believes that the reactions of both Mexico and Canada to the steel and aluminium tariffs already imposed suggests that a response to any auto tariffs is plausible. Eurasia Group believes that the current NAFTA is most likely to survive, but under a cloud of uncertainty, and combined with US midterm elections, applying the new s.232 action could further delay the renegotiation of NAFTA beyond 2018 or even 2019.

Trade tensions: s.232 tariffs

NAFTA negotiations have been overshadowed publicly, at least temporarily, by the US government's decision not to extend the s.232 tariff exemption granted to Mexico, the EU and Canada.

Effective 1 June, a wide range of steel and aluminum products became subject to 25 percent and 10 percent tariffs respectively. The goods subject to customs duties in the US are classified under the following Harmonized Tariff provisions:

- **Steel:** 7206.10 to 7216.50, 7216.99 to 7301.10, 7302.10, 7302.40 to 7306.90, 7304.10 to 7306.90.
- **Aluminum:** 7601, 7604 to 7609, 7616.99.51.

Both Canada and Mexico have responded with retaliatory countermeasures.

Mexico

Faced with this situation, the Ministry of Economy informed exporters and importers that the Mexican government will impose equivalent measures to goods such as flat steel (hot and cold sheets, including coated and tubes), lamps, pork, ham, apples, grapes, cranberries, cheese, among others.

On 5 June, the Mexican government published in the Federal Official Gazette countermeasures against the customs duties imposed by the United States for failing to comply with NAFTA, which requires the US to notify the other parties involved in a process of imposition of emergency measures, consulting the affected party, offering compensation options, as well as notifying the Free Trade Commission.

These aforementioned measures include:

- Suspension of NAFTA preferential tariff treatment and application of import duties ranging from 7 percent to 25 percent to 71 products from US origin classified in chapters 02, 04, 08, 16, 20, 21, 22, 72, 73, 76, 84, 89 and 94, which include pork, cheese, apples, ham, cranberries, Tennessee or Bourbon whisky, and diverse steel products, among others.

  The tariff rate will be applicable only in permanent imports including those under the Sectorial Relief Program (PROSEC) and those made in the border region and northern border area.

  Regarding Immex companies ("maquiladoras" enterprises that perform temporary importations), the retaliation from Mexico will not have a significant impact as long as they continue to import goods under temporary basis. These companies would be affected if they perform permanent imports or when they carry out changes of regime from temporary to permanent importation of goods with US origin.
- Rise of 15 percent in the general import duty rate of 186 steel products contained in headings 7208 to 7214, 7216, 7219, 7225 to 7228, and 7304 to 7308 for their importation into Mexico.
- Addition of different HTS codes from Chapter 72 into Article 5 (raw materials) of the PROSEC on Sectors I "Electric", IIb "Electronic" and XIX "Automotive and auto parts": for these HTS codes a total exemption of the import duty is granted for companies that carry out manufacturing activities.

Canada

In response to the section 232 tariffs, Canada imposed US$16.6 billion in countermeasures, on a "dollar-for-dollar" basis, on US goods imported into Canada. On 31 May, a proposed list of items to be subjected to a retaliatory surtax was released, followed by a public consultation period. A final list of impacted products was released on 29 June 2018.

These retaliatory countermeasures, which came in to effect 1 July 2018, impose a 25 percent surtax on a wide range of steel products, as well as a 10 percent surtax on a wide range of aluminum products. In addition, the countermeasures included a 10 percent surtax on a variety of other, mostly consumer, products. These products included yogurt, cucumbers, ketchup, mayonnaise, toilet paper, among other items.

Whither NAFTA?

Despite the imposition of retaliatory measures, the governments of the US, Canada and Mexico have restated their commitments to re-negotiating NAFTA. Although no formal Round 8 is scheduled, talks have been ongoing among the three countries.

A NAFTA "sunset clause" has been requested by the US. Such a clause would effectively put an expiry date on NAFTA every 5 years if all parties do not agree to re-sign. The intention of the clause is said to be to encourage the three countries to make updates and modifications on a regular basis. Canadian Prime Minister Trudeau has been quoted as saying that a sunset clause is "unacceptable to Canada".

Other points of continued contention include automotive rules of origin, Chapter 19 dispute settlement, Canada's supply management program, and government procurement.

Actions to consider in your supply chain management

- **Continue to model the overall impact**, including any impact from US additional tariffs and countermeasures. Analyzing supply chain and mitigating any labor disruptions should remain a top priority for businesses engaged in cross-border trade.

  Companies should understand how a termination of, or substantial change to, NAFTA will affect them. It is clear that, as a general matter, a termination of NAFTA would likely cause tariff rates to revert to Most Favored Nation ("MFN") rates. Companies are also advised to review and understand the risks associated with their current-state importing activity.

  This should also encompass any US Tax Reform planning that impacts the supply chain. Both US and non-US multinationals are in the midst of evaluating the impact of US Tax Reform on various intercompany and third party relationships that in some cases will change the location of certain manufacturing and processing activities. Such planning cannot be done in a vacuum and it is possible that scenario planning for changes in trade matters will trigger a different long-term conclusion.
- **Assess the impact on Transfer Pricing and Customs Value**. The importer of record generally bears initial responsibility for an increase in tariffs, which ultimately become part of the importer's COGS. Those costs are generally allocated among related parties, provided such allocation is at arm's length. The tariff treatment, however, could raise a number of considerations including comparability (e.g. if a tested party is exposed to NAFTA and comparable companies are not), acceptable arm's length range for tax purposes (e.g. an increase in COGS would decrease the operating margin of the importer of record, which could necessitate a transfer price adjustment), and the impact of a transfer price adjustment on the customs value (e.g. an increase to the transfer price may increase the customs value, resulting in additional duties owed).

As always, please reach out to us any questions, queries or opportunities: GO-FM Geopolitics.

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KPMG in Canada, Mexico and the US and Eurasia Group have jointly published this briefing to provide clients with leading insights that combine Eurasia Group's analysis of NAFTA-related developments with KPMG's knowledge and experience across audit, tax, advisory and company-level business implications.

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