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The Increase in NAFTA Verifications by the Government of Mexico: *What Exporters, Importers and Manufacturers Need to Know to Survive Such Audits*

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Due to concerns about potential underpayment of duties and the misuse of North American Free Trade Agreement (NAFTA) claims, governments of the NAFTA countries (the United States, Canada, and Mexico) have increased the rate of NAFTA audits in recent years. The audits (technically called “verifications”) are specifically authorized by NAFTA – under Article 506 of the NAFTA, each of the countries that are parties to NAFTA is given the authority to conduct verifications of the books and records of the exporter or producer located in the territory of another NAFTA country.

The government of Mexico in particular launched an initiative in 2009 targeting industries it believes are improperly using NAFTA for goods imported into Mexico. These industries include automotive, chemicals, coffee, and pharmaceuticals. Mexico’s Tax Administration Service, the Servicio de Administración Tributaria (SAT), increased the rate of NAFTA audits, mostly in these industrial sectors, more than seven-fold from only 20 in 2008 to 150 in 2009. Mexico’s SAT expects to continue NAFTA audits at this level in 2010 as well.

While the rules governing NAFTA audits apply equally to all three NAFTA parties, our experience is that each of three governments conducts its NAFTA audit in a slightly different manner. Our objective here is to provide insight on the particularities of a NAFTA audit conducted by Mexico’s SAT. We also will suggest ways on how to best work with the SAT auditors and offer additional tips to maximize your chances of a positive result, whether you are a United States or Canadian producer or exporter.

Specifically, this article will discuss:

- The purpose of a NAFTA audit generally.
- How an SAT NAFTA audit gets started.

- Preparing for a SAT NAFTA audit.
- Documents that should be gathered and reviewed.
- What to expect regarding the on-site portion of the SAT audit.
- Actions that companies may take after the on-site portion of the SAT audit.
- Discussion of tips and best practices throughout the article.

What is the Purpose of a NAFTA Audit?

The purpose of the NAFTA audit is to allow the NAFTA country into which goods were imported to verify that (1) the goods in question actually qualify for NAFTA, (2) the NAFTA certificates were issued properly; and (3) the responsible parties are able to support NAFTA claims.

Toward that end, the auditors will verify:

- That the importer had a valid NAFTA certificate at the time of import that was signed by the exporter, is complete, and matches import documentation;
- That the exporter who signs the NAFTA certificate is able show that the product(s) listed qualifies for NAFTA, and
- The responsible parties have retained the records necessary to support the NAFTA claim.

It is important to note that a U.S. company does not have to consent to a Mexican (or Canadian) NAFTA audit request. However, the consequences are severe for such non-consent – the Mexican or Canadian importer will be required to pay duties to its respective customs authority on entries that are covered by the “unaudited” NAFTA certificates, and future NAFTA certificates issued by the Company could be rejected.

How Does a NAFTA Audit Start?

NAFTA party authorities may verify NAFTA eligibility either by issuing a written questionnaire seeking information from the producer or exporter, or by scheduling an on-site visit.¹ Once the subject producer or exporter is identified for an NAFTA audit, SAT sends the questionnaire or notification of an on-site audit by courier with acknowledgement of receipt to the company listed on the NAFTA certificate.

In the case of Mexico's SAT, the agency will issue an initial questionnaire and, if the exporter or producer does not respond to it, SAT will issue a second questionnaire with the intention to deny preferential treatment.² Regarding the notification of an on-site visit, if there is no reply within 30 days consenting to the on-site visit, the NAFTA preference is cancelled.

In the past, a U.S. exporter or producer that timely completed a NAFTA Questionnaire response stood a good chance of avoiding an on-site audit if the response unequivocally supported the NAFTA origin of the products that are being investigated. However, our recent experience is that SAT has been frequently skipping the NAFTA Questionnaire and sending the notification of an on-site audit to U.S. producers and exporters without the benefit of a NAFTA Questionnaire response.

Specific Tips

At this stage of the NAFTA audit, U.S. companies will fare better than others by adopting the following actions:

- Institute a policy that all letters, notices, and documents in a foreign language received at the company must be sent to its legal department.
- Respond timely in writing to all SAT communications.
- If a NAFTA Questionnaire is received, provide thorough and accurate responses. Even if an on-site audit cannot be avoided, a professional response will provide the SAT auditors with a good first impression that will carry forward to the on-site portion of the audit.
- If a NAFTA notice regarding an on-site audit, request reasonable alternative dates (within one month of the requested date) for the visit if more time is needed to prepare for the on-site audit. Reasons in the past for SAT granting the audit have included unavailability of key company personnel and previously scheduled manufacturing shut downs.
- If the company is unfamiliar with NAFTA, hire U.S. counsel to review and assist in the preparation of the response.

How Should a Company Prepare for an Audit?

Once a company learns it is subject to a NAFTA audit, there are various steps it should take to prepare. Organization of documents and analysis of information contained in documents done before the SAT auditors arrive is critical to a successful result.

The first step is for the company to identify all of the NAFTA certificates at issue for the audit. Next, the certificates must be carefully reviewed to ensure that the information included in them is correct and they were executed and signed correctly.

This may be more difficult than it sounds if the company does not have a central process for issuing NAFTA certificates. Company-wide inquiries should be made to all departments and offices that might be involved in the issuance of NAFTA certificates, including logistics, transportation, sales, customer service, sales, legal, and compliance departments.

Important: If the exporter or producer finds mistakes on the NAFTA certificate during the review, the certificates should be corrected by writing a letter to the importer identifying the error and providing the correct information. Incorrect NAFTA certificates should not be changed or altered.

The next step is to amass the host of documents necessary to support NAFTA eligibility for the goods covered by the NAFTA certificates being audited. Companies should review the production/manufacturing process involving each good for which NAFTA is claimed to make sure it qualifies for NAFTA based on the rules of origin.

SAT audits, unlike U.S. Customs and Border Protection audits, specify which documents its auditors will want to review. The category of documents generally will include:

- Vendor information for components and parts of the product;
- Bills of materials
- Production process records
- Transportation documents

Once all documents are assembled, the company's audit review team should perform the following tasks:

- Make sure all the sales information, such as invoices and shipping information, for exports made under the NAFTA certificates is included.
- Confirm Harmonized Tariff Schedule ("HTS") classification analysis of the components used to make the good under review, as well as HTS classification of the good itself.
- If the specific NAFTA rule of origin for the product being reviewed requires a value test (i.e., the good must have a minimum NAFTA value content), sales and cost accounting records need to be produced and

value calculations will need to be made by persons knowledgeable of the NAFTA regional value content rules.

In addition, because one of the main purposes of the audit is to determine whether a good originates within a NAFTA country as required by the applicable rule of origin, companies should be prepared to show auditors how they manufacture the goods at issue. For this reason, companies should identify employees who are knowledgeable about how the good was manufactured to be available to meet with the auditors.

Important: Should the company's review team discover any errors that affect the qualification of any goods certified as NAFTA qualifying by a NAFTA certificate, disclosure to the recipient of the NAFTA certificate and payment of any duties to the Mexican government should be made prior to the commencement of the on-site audit. We recommend outside experts assist the company with this exercise, including whether any disclosures to U.S. Customs and Border Protection regarding the erroneous NAFTA certificate(s) is necessary or advisable.

Specific Tips

Other hints to take into consideration when preparing for an SAT Mexico audit:

- Make two sets of all documents – one copy for the SAT auditors and one copy to keep track of what the company has provided to the SAT auditors.
- Clearly identify and label documents to be provided to the SAT auditors – you may know the form of your commercial invoices, but remember that the auditors are unfamiliar with your company and your documents.
- Connect and trace all relevant documents by identifying unique identification numbers, such as part, serial, or lot numbers, and provide a road map that links these numbers to the SAT auditors.

The Audit Itself

SAT officials conduct their on-site visits relatively quickly, typically within one week. Executing your company's game plan the moment the SAT auditors arrive greatly assists in confining the on-site portion of the audit to a week or less.

First, after the necessary introductions and allowing the SAT auditors to state their objectives with respect to the audit, we recommend that the company undergoing the audit start the process by giving a brief presentation about the facility and the production processes for the product(s) under review. It is also helpful to provide a tour of the manufacturing facilities to allow the auditors to see first-hand that the good(s) subject to the audit

are produced at the facility at which the audit is being conducted.

Next, the auditors likely will want to review the NAFTA certificates and supporting documentation.³ While some auditors may wish to perform their review independently, in some cases the SAT audit team allows – and even encourages – the company to present the information, particularly as it relates to production information and tying in transportation documentation with export and import documentation.

Companies can help to make an on-site NAFTA audit go more smoothly by taking the specified actions:

- Make sure to have knowledgeable employees available to discuss important issues that are likely to come up during the audit, such as the production process, accounting, sales documentation, and similar information. In this regard, it is always a good idea to appoint one or two persons to act as the "official spokespersons."
- While companies undergoing a NAFTA audit should do their best to cooperate and comply with reasonable requests from the auditors, it is certainly acceptable to request changes and make suggestions to the audit plan discussed at the beginning of audit if circumstances dictate.
- While the auditors may want to visit a specific facility, the company personnel should suggest changes or additions to the audit schedule, where appropriate. Remember, you know your company best.
- As mentioned above, because NAFTA auditors are looking to see whether the goods under review qualify for NAFTA, we encourage companies to provide auditors with a tour of manufacturing facilities and to allow them to observe the production process. If possible, have the plant manager provide the guided tour as this person typically has the most knowledge about each and all of the production steps.
- At the end of each day, review with the auditors the documents and results reached and then discuss what the auditors would like to review for the following day. This way, when the auditors walk in the door the following morning, you will have the appropriate documents for them to review at your finger tips. This will help to speed up the audit.
- In the case of SAT audits by the government of Mexico, we suggest having a fluent Spanish speaker present or "on call" while the audit is ongoing.

The Conclusion of the Audit

On the last day of the on-site audit, the SAT auditors will prepare a written findings report, which will detail the documents presented by the company and the qualification status of the goods being reviewed. It is imperative

that you review these findings very carefully. The report will be written in Spanish so it is critical to have someone present, whether a company official or an outside NAFTA expert, who reads and writes Spanish.

The official company representative and an observer – these two individuals may be company employees or outside experts hired by the company – will be asked to initial each page of the findings report. Therefore, if you have a disagreement with the SAT auditors on any finding or conclusion, it is vital to make your views known prior to initialing the report.

Our experience is that there are typically some mistakes in the initial draft of the findings report presented to the company due to either transcription errors or an honest misunderstanding with respect to a fact or facts presented in the documents. We find that the SAT auditors will readily correct these mistakes and appreciate the identification of such errors, so do not be afraid to point them out. However, if there is a true disagreement as to a fact or conclusion, make every effort to have the unresolved issue fully documented in the final draft of the findings report.

Post-Audit Follow-up

If any requested document is unable to be produced during the on-site audit, the audit findings report will note that the document was not provided and that the good(s) to which it corresponds does not qualify for NAFTA. However, the SAT auditors will usually allow additional time after the conclusion of the on-site audit – typically 30 days – to produce such documentation.

Therefore, we recommend that you review with the auditors all outstanding documents and request that the company be allowed a specified amount of time to produce them. However, do so only when you reasonably believe that the document exists – do not postpone the inevitable if the document never existed or you know you will not be able to locate it.

Most importantly, after negotiating with the auditors to allow for a reasonable time for any follow-up items, make sure you do the actual follow-up! When you locate the documents to be produced, make an extra effort to organize them along with a detailed explanation – remember, you will not be able to explain the documents to the auditor in person this time. And if it turns out you cannot locate some or all of outstanding documents, let the auditors know that up front – eventually, they will find out.

After the follow-up documents are submitted to SAT, the company will receive an official final findings report. Review it carefully, and if you disagree with any findings or conclusions that affect the qualifying status of the goods, take advantage of the appeal rights specified in the report. While the Mexican government will not assess your company duties for any goods that do not qualify for NAFTA,

it will issue a duty demand against your Mexican customer that imported the goods.

Conclusion

NAFTA provides many potential financial benefits to companies that manufacture and sell products within North America. Indeed, NAFTA was enacted to provide an economic advantage to such companies. However, NAFTA also provides the three NAFTA governments with the tools to identify which companies are not legitimately entitled to such benefits -- namely NAFTA verifications or audits.

In most cases, U.S. companies are selected for NAFTA audits by the government of Mexico because they deal with high risk shipments – i.e., their goods carry a high duty rate – and no specific wrongdoing is suspected. So, if you are selected for a NAFTA audit, do not panic. By careful planning, doing your homework (which may include working with outside NAFTA experts), and following the tips and suggestions in this article, a U.S. company will increase its chances of continuing to avoid the imposition of duties with respect to its shipments destined for Mexico, as well as Canada.

1 Be on the lookout for import audit program called “ValuNet.” The government of Mexico has appointed a private firm, SGS (Societe Generale de Surveillance) to conduct value verifications of goods imported into Mexico. This is not a NAFTA verification questionnaire or a request for a NAFTA audit visit. We recommend that you consult with your international trade expert as to whether you should respond to any requests or notices issued by SGS.

2 Because the questionnaire or notification is not addressed to a specific individual, it may take a company some time to discover that they are subject to a NAFTA audit. The confusion can be compounded in the case of audits by Mexico’s SAT because the document issued is in Spanish.

3 Even before this stage, it may be wise to tell the auditors while on the manufacturing tour that the NAFTA certificates are on-site and will be produced immediately upon completion of the tour, as this usually is the main focus of the SAT audit team.

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