

## Rules of Origin – Basic Principles

For each FTA there is a set of definitions that describe FTA origin (i.e., how a good meets the terms of the FTA as being produced or obtained in the region/country to qualify for special duty treatment). For NAFTA, Article 401 and its annex contain the defining set of origin specifications. Article 401 states that goods can be deemed to have origin in 4 ways:

1. Goods wholly obtained or produced in the NAFTA region;
2. Goods produced in the NAFTA region wholly from originating materials;
3. Goods meeting the Annex 401 origin rules; and
4. Unassembled goods and goods classified with their parts which do not meet Annex 401 rules of origin but that contain 60 percent regional value content using the transaction method, or 50 percent regional value using the net cost method.

For the purposes of the ongoing project providing ITC rules of origin advice to USTR, we are concerned with item 3 (goods that meet the Annex 401 origin rules) and item 4 (unassembled goods which meet regional value content requirements but not the Annex 401 origin rules). These rules are found in General Note 12 of the HTS (starts at p. GN-42 in the 2004 HTS). Annex 401 origin criteria explain how goods that contain non-originating materials (i.e., non-NAFTA, or those goods not obtained or produced in the NAFTA countries) can be determined to be originating in Canada, Mexico, or the United States. These rules of origin are referred to as product specific rules of origin, and are based on 1) a change in HTS classification (aka, a “tariff shift”), 2) a regional value content, or 3) both. Tariff shift rules may apply to chapters (2-digit HTS), headings (4-digit HTS), subheadings (6-digit HTS), or less frequently, tariff items (8-digit). Despite the differences in hierarchy among the four HTS categories, the underlying logic of the tariff shift rules applies to all. Tariff shift rules that apply to chapters are the most restrictive (they cover an entire chapter), whereas tariff shift rules applying to tariff items are the least restrictive (they cover only specific tariff item(s)). Inputs from North America need not meet tariff shifts, but their value content can be important in this analysis.

A tariff shift rule requires that EACH of the non-originating materials (parts) used in the production of a good MUST meet the requirements of the rule, i.e., a change in classification, unless the de minimis rule<sup>1</sup> applies to the shipment. For example, the rule for heading 1601 is “a change to headings 1601 through 1605 from any other chapter.” This means that each non-originating raw material and/or part that goes into making a product classified in headings 1601 through 1605 (Chapter 16) MUST be classified in another chapter (i.e., not Chapter 16) so the end product can qualify as an originating good under NAFTA. As an illustration: Pork sausage (HTS 1601) is produced in Mexico from imported frozen pork meat from Hungary (HTS 0203 – Chapter 2) and spices imported from Jamaica (HTS 0907 - 0910 – Chapter 9). Because each of the ingredients for pork sausage are classified in chapters other than Chapter 16, the resulting pork sausage meets the requirements of the tariff shift rule and would be considered an

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<sup>1</sup> The de minimis rule provides for goods that contain small amounts of non-originating materials that fail to undergo the applicable change in tariff classification. Under the de minimis rule, if the value of the raw material or component is 7 percent or less of the transaction value of the good. See the rule for more specific information.

originating “good of Mexico” under NAFTA. If one or more of the non-originating raw materials or components used to manufacture a good does not meet the tariff shift rule (i.e., the product is classified in one of the disallowed HTS chapters, headings, or subheadings), the good is considered not originating and generally does not qualify for NAFTA treatment (unless the de minimis rule applies).

If the phrase “except from” appears in the rule, it should be interpreted as an exclusionary phrase so that the inputs cannot come from the excluded provisions. If the third-country inputs were classifiable in the excluded provision, the end product is usually not eligible (unless the inputs were de minimis). In effect, the inputs falling in those provisions must be made in North America or the good is considered non-originating. For example, the rule for battery parts – “a change to subheading 8507.90 from any other heading, except from tariff items 8548.10.05 or 8548.10.15” – means that non-originating components from any heading other than 8507 can be used to manufacture battery parts to gain originating status, excluding those non-originating components classified in 8548.10.05 or 8548.10.15. Only originating (NAFTA) materials classified in these excluded subheadings are allowed under this tariff shift rule.

If the rule is based on a regional value content, which occurs under limited circumstances, either the transaction value method or net cost method can be used to determine content. The transaction value method calculates the value of the non-originating material as a percentage of the good’s transaction value (the price paid or payable for the good). The net cost method calculates the regional value content as a share of the net costs incurred by the producer less any expenses for sales promotion, royalties, shipping, and packing. The percentage content needed to qualify as originating is lower with this method because certain costs are excluded from the net cost.

Many rules offer the choice of using the tariff shift or regional value content (RVC) to determine if the good qualifies as originating. For those tariff shift rules that offer both options, the RVC option generally incorporates a more lenient tariff shift requirement as well as an RVC minimum. For example, the tariff shift rule for subheading 8483.10 requires:

“A change to subheading 8483.10 from any other heading; or

A change to subheading 8483.10 from subheading 8483.90, whether or not there is also a change from any other heading, provided there is a regional value content of not less than--

- 1) 60 percent where the transaction value method is used, or
- 2) 50 percent where the net cost method is used.”

In this case, the first alternative rule excludes non-originating inputs from heading 8483. The second (or RVC) rule, however, permits the incorporation of non-originating inputs from within heading 8483 (but only those from subheading 8483.90) into the good classified in subheading 8483.10, as long as the RVC meets the minimum levels indicated.

In many cases, it is likely that the NAFTA parties are considering a liberalization of the tariff shift rule because the good subject to the rule incorporates an excluded non-originating

component or raw material. This situation may arise because production or value content of the good has changed since 1993, when NAFTA was finalized. As part of this project, it is also necessary to consider the scope of the tariff provisions concerned to see if the specified tariff shift can occur, both technically and in relation to North American raw material and component manufacturing.

## Tariff Shift Examples

Rule: A change to heading 9023 from any other heading (requires that all non-originating inputs be classified in any heading other than heading 9023, the provision covering the actual U.S. import).

If non-originating components used in the manufacture of a good classified in heading 9023 include:

Input 1 from 7601  
Input 2 from 5402  
Input 3 from 9023

then the final good is considered non-originating because Input 3 is classified in the same heading (9023). If Input 3 was classified in HTS 8401, the finished good classified in 9023 would be considered originating.

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Rule: A change to subheading 8481.90 from any other heading (requires that all non-originating parts be classified in any heading other than heading 8481).

If non-originating components used in the manufacture of a good classified in subheading 8481.90 include:

Input 1 from 7601.01  
Input 2 from 5402.41  
Input 3 from 8481.80  
Input 4 from 8302.41

then the good is considered non-originating because Input 3 is classified in the same heading, although within a different subheading.

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Rule: A change to tariff item 9022.90.05 from any other tariff item (requires that all non-originating parts be classified in any tariff item other than 9022.90.05).

If non-originating components used in the manufacture of a good classified in tariff item 9022.90.05 include:

Input 1 from 7601  
Input 2 from 5402  
Input 3 from 9023

then the good is considered originating because all of the inputs are classified in tariff provisions other than 9022.90.05.