NAFTA Rules of Origin:
An Explanation

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*The views expressed in this paper are those of the authors and do not necessarily reflect the views of the **United States Customs Service**.

Forward

The Texas Legislature established the **Texas Centers for Border Economic and Enterprise Development** during its 70th Session. The **Texas Centers** program is a consortium effort between Texas A&M International University, the University of Texas - El Paso and the University of Texas - Pan American. The primary purpose of the **Texas Centers** is to provide leadership and support to Texas border communities in their economic development efforts.

The legislature provides funds to support the efforts of the **Texas Centers** in three principal activity areas:

1) Development and maintenance of an economic database;
2) The conduct of economic development research and planning; and,
3) The provision of technical assistance to industrial and governmental entities.

Texas A&M International University's **Texas Center** operates under the direction of the Graduate School for International Trade and Business Administration's **Institute for International Trade** (IIT).

This report "***NAFTA Rules of Origin: An Explanation***" by Dr. Jim Giermanski and Cathy Sauceda contributes to the goals of the **Texas Centers**.

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NAFTA Rules of Origin: An Explanation

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*The following explanation of the Rules is the first of a series of treatments of Chapter 4 of the **North American Free Trade Agreement (NAFTA)**. Others will include an explanation of the transaction value and net cost method of calculating regional value content, the De Minimis factor and other issues.*

Since one of the primary objectives of a free-trade agreement is to reduce and eventually eliminate all tariffs among the Party nations, it is essential that rules are established to identify which products produced in the countries involved in the agreement will receive the preferential tariff treatment. These rules, then, become the essential core of the agreement and insure that the benefits of the agreement are accorded to the signatory nations while at the same time precluding a non-party nation from accessing these benefits. The North American Free Trade Agreement (NAFTA) explains these rules in Chapter 4, entitled Rules of Origin. While the application of the rules may seem complicated, the rules themselves are clear. There are four basic rules.

A. WHOLLY OF U.S., MEXICAN, OR CANADIAN ORIGIN

The first rule covers goods wholly obtained or produced in the territory of a Party and is almost the same as in the U.S. Canadian Free-Trade Agreement with the exception that NAFTA contains a de minimis section which will be covered in later papers. "The good is wholly obtained or produced entirely in the territory of one or more of the Parties as defined by Article 415." Article 415 defines WHOLLY OBTAINED OR PRODUCED ENTIRELY IN THE TERRITORY OF ONE OR MORE OF THE PARTIES to mean:

a) mineral goods extracted in the territory of one or more of the Parties;
b) vegetable goods, as such goods are defined in the Harmonized System, harvested in the territory of one or more of the Parties;
c) live animals born and raised in the territory of one or more of the Parties;
d) goods obtained from hunting, trapping or fishing in the territory of one or more of the Parties;
e) goods (fish, shellfish and other marine life) taken from the sea by vessels registered or recorded with a Party and flying its flag;
f) goods produced on board factory ships from the goods referred to in subparagraph
e) provided such factory ships are registered or recorded with that Party and fly its flag;
g) goods taken by a Party or a person of a Party from the seabed or beneath the seabed outside territorial waters, provided that a Party has rights to exploit such seabed;
h) goods taken from outer space, provided they are obtained by a Party or a person of a Party and not processed in a non-Party;
i) waste and scrap derived from
   (i) production in the territory of one or more of the Parties, or
   (ii) used goods collected in the territory of one or more of the Parties, provided such goods are fit only for the recovery of raw materials, and
j) goods produced in the territory of one or more of the Parties exclusively from goods referred to in subparagraphs (a) through (i) inclusive or from their derivatives, at any stage of production;"

What Does It Mean?

Preferential tariff treatment will be given to the raw materials of the land of the United States, Mexico, and Canada; animals born and raised there; natural resources of the sea entitled to be removed; their products produced aboard ships registered in one of these countries; goods from outer space not processed in a country other than the NAFTA countries; waste and scrap from the above which are good only for recovery value of the raw materials contained in them, and waste and scrap of goods produced from the above or from their derivatives at any stage of production. In other words, if the product is there naturally or caught by and then produced or altered by a party nation, and no non-party nation had any substantial contribution to its existence as an end product, it will probably qualify for reduced or tariff-free treatment. No foreign material may be used under this rule except that permitted by Article 405: De Minimis.

B. TRANSFORMED WITH A CHANGE OF TARIFF CLASSIFICATION AND/OR REGIONAL VALUE CONTENT

Rule B consists of three means whereby foreign material can be sufficiently transformed in a NAFTA territory to qualify as a NAFTA originating good. These methods, treated in Annex 401, are:

1) Tariff Shift,

2) Tariff Shift plus Regional Value Content (RVC),

3) RVC alone.

1. Tariff Shift

A change of tariff classification can qualify a product for special tariff treatment when there are components originating outside of the U.S., Mexico, and Canada.

What Does It Mean?

If a producer in a party nation makes a product using materials which do not originate in the United States, Mexico, or Canada, that product is still capable of receiving preferential tariff treatment if there is a change in tariff classification, that is, if the new tariff classification is different from the component materials and the rules contained in Annex 401 are met.

An example of the first part of Rule B may be illustrated with the following example. A U.S. manufacturer of leather handbags imports leather from Sweden from which he manufactures the handbag which is the final product. This new handbag originates under the Rules of Origin with a simple tariff shift. Another example of a simple tariff shift as required by the Annex 401 rules may be seen when a Mexican manufacturer imports tomatoes, and onions from Guatemala. From these imported vegetables the firm manufactures Mexican tomato paste which may include garlic and other spices originating in Mexico. The tomato paste is, therefore, entitled to NAFTA preference as the applicable tariff shift has been met.

2. Tariff Shift Plus RVC

Some of the tariff shift rules require not only a tariff shift but also a percentage of regional value content added in the NAFTA territory. Regional value content will be addressed in detail in subsequent technical papers but is defined as the calculated percentage of the value of the product that represents North American content.

3. Regional Value Content

As listed in Annex 401, some items can become originating without a tariff shift but with the addition of the required regional value content alone.

Annex 401 serves as an interpretive section of the specific rules of origin, such as references to weights mean dry weights, etc. It also contains some new tariff items created out of NAFTA for which regional value content is necessary to qualify them for NAFTA treatment. Finally, Annex 401 makes it clear that the "change of tariff classification" rule only refers to non-originating materials.

C. WHOLLY PRODUCED IN THE U.S., MEXICO, OR CANADA EXCLUSIVELY FROM ORIGINATING MATERIALS

"The good is produced entirely in the territory of one or more of the Parties exclusively from originating materials;"

What Does It Mean?

The difference between Rule C and Rule A is that under Rule C, non-originating materials will be included in the product but will have become originating material prior to becoming a component in the final product.

For instance, foreign steel is imported into Mexico from Japan. In Mexico the steel was made into hardware and metal legs. In Mexico a desk manufacturer combined the legs and hardware with wholly grown Mexican wood to make a desk. The desk is originating under Rule C. The foreign steel underwent the applicable tariff shift in Mexico to become originating. And the wood was wholly obtained or produced in Mexico.

D. TRANSFORMED WITHOUT A CHANGE IN TARIFF CLASSIFICATION

The final rule is, perhaps, the most complicated and involves some choice in determining its applicability. The rule reads as follows:

"except for a good provided for in Chapters 61 through 63 of the Harmonized System, the good is produced entirely in the territory of one or more of the Parties but one or more of the non-originating materials provided for as parts under the Harmonized System that are used in the production of the good does not undergo a change in tariff classification because

(i) the good was imported into the territory of a Party in an unassembled or a disassembled form but was classified as an assembled good pursuant to General Rule of Interpretation 2(a) of the Harmonized System, or

(ii) the tariff heading for the good provides for and specifically describes both the good itself and its parts and is not further subdivided into subheadings, or the subheading for the good provides for and specifically describes both the good itself and its parts, provided that the regional value content of the good, determined in accordance with Article 402, is not less than

60 percent where the transaction value method is used, or not less than 50 percent where the net cost method is used, and that the good satisfies all other applicable requirements of this Chapter."

What Does It Mean?

First, the product subject to preferential tariff must be produced entirely in either the U.S., Mexico, or Canada. Second, it cannot be a product contained in Chapter 61 through 63 of the Harmonized Tariff Schedule. Chapters 61, 62, and 63 deal with knitted apparel, non-knitted apparel, and other man-made textiles and clothing. Those items are treated separately from these rules. Third, the product must contain a non-originating component, and that component when used in the newly made product does not undergo a change in tariff classification for one of two reasons.

a) The components, like parts of a kit, although unassembled or disassembled, were classified pursuant to General Rule of Interpretation (GRI) 2(a) in the same tariff provisions as the final product. An example would be a U.S. manufacturer who brings in Swedish parts, such as all the components of an unassembled bookcase, imported together. These parts are classified as a bookcase upon importation due to GRI 2(a). The assembled bookcase could qualify for NAFTA and be subject to preferential tariff treatment if exported to Canada or Mexico provided that the regional value content is met.

b) the tariff heading of the imported good includes not only the good itself but also its parts. For instance, if a U.S. manufacturer imported baby carriages (HTSUS tariff heading 8715)

from Mexico assembled with some parts produced in Japan, the baby carriage and its parts would be classified under one heading. The baby carriage could then qualify for preferential tariff treatment as a Mexican product if the regional value content of the completed baby carriage is not less than 60% as determined under transaction value method of calculation or 50% where the net cost method is used.

The rules of origin enable exporters and importers to take advantage of NAFTA by dealing in products which receive special tariff consideration. Understanding these rules is, therefore, essential not only for obtaining the benefits of reduced or eliminated tariffs but also for providing appropriate documentation which substantiates and ensures these benefits.