RULES OF ORIGIN: CONSIDERATIONS FOR INVESTMENT AND TRADE IN NORTH AMERICA

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I. INTRODUCTION

The growing number of multicountry preferential trade arrangements and preferential duty programs being adopted by developed and developing countries alike is becoming an increasingly important factor influencing international trade and investment determinations of companies manufacturing goods for sale in international markets. Whether or not a particular imported product will benefit from the preferential tariff treatment accorded by such arrangements and programs will depend primarily upon the application of rules of origin to such products and the processes used to manufacture them. Rules of origin are also key determinants of the application of nonpreferential trading measures, such as anti-dumping and countervailing duties, quantitative restrictions (quotas), buy-national government procurement requirements; country of origin marking requirements, all of which have a significant impact on the international trade of goods.

These preferential duty agreements and programs, and the desire to optimize and rationalize the production of finished goods, have led manufacturers to increase the use of multicountry sources of raw materials and components in the production of finished products. Likewise, manufacturing operations are being split up into various processing stages, which are often performed in more than one country. Accordingly, at the same time rules of origin are growing in importance, they are becoming more complex to administer in circumstances where the sourcing of raw material and parts and the production of goods are being segmented and disbursed.

The application of rules of origin can serve as an impediment to trade in many circumstances. On the other hand, such rules of origin are for the most part transparent, well-defined, and predictable. Thus, a proper understanding of the applicable rules of origin can enable companies to plan their investment, production, and distribution strategies so as to minimize the cost of multimarket production and

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sales operations and, therefore, maximize the profits generated from such operations.[1]

This article provides a brief review of the rules of origin which impact trade in goods, with a primary focus on importation and sales in the U.S. market. It addresses factors relating to rules of origin which should be considered by companies wishing to produce and distribute goods for sale in the U.S. and other North American markets. Part II of this article provides a general discussion of rules of origin and the various tests which are used to determine the origin of imported goods. Parts III and IV cover rules of origin used to determine the eligibility of imported goods for preferential duty treatment under free trade agreements and other preferential duty programs. Part V covers the use of rules of origin and country of origin marking requirements applicable to imported goods. Part VI discusses the effort underway in the World Trade Organization (WTO) to harmonize nonpreferential rules of origin applied by WTO member countries. The seventh and final part contains general points and observations which should be taken into consideration by companies in analyzing the impact of rules of origin upon the application of customs duty programs affecting the importation of products manufactured for sale in the U.S.

In writing this article, I have attempted to take a practical approach, focusing on requirements and issues of concern to business managers who must make investment and production decisions relating to the establishment of offshore manufacturing operations for the production of goods for sale in the U.S. Rules of Origin are usually drafted in the context of competing industry and economic interests. As such, they may be subject to conflicting views and analyses as to whether they are protectionist in nature, or necessary and appropriate to accomplish the purpose of a particular agreement or program. In preparing this article, I have attempted to avoid espousing positions on these issues. Rather, I have tried to explain the rules as they exist, pointing out, where appropriate, the degree to which they may be restrictive or liberal in application.

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1. For recent general discussion of rules of origin see Joseph A. LaNasa, III, *Rules of Origin and the Uruguay Round's Effectiveness in Harmonizing and Regulating Them*, 90 AM. J. INT'L L. 625 (1996); Mark R. Sandstrom et al., *Market Access*, *in* THE WORLD TRADE ORGANIZATION: MULTILATERAL TRADE FRAMEWORK FOR THE TWENTY-FIRST CENTURY AND U.S. IMPLEMENTING LEGISLATION (Terence P. Stewart ed., 1996) [hereinafter Sandstrom et al.]; Mariana C. Silveira, *Rules of Origin in International Trade Treaties: Towards the FTAA*, 14 ARIZ. J. INT'L & COMP. L. 411 (1997); RULES OF ORIGIN IN INTERNATIONAL TRADE: A COMPARATIVE STUDY (Edwin A. Vermulst et al. eds., 1997) [hereinafter Vermulst et al.].

II. RULES OF ORIGIN IN GENERAL

A. Subjective Tests

Where a product is produced in one country from raw materials and components originating in that country, the question as to the country of origin of that good is easily answered. However, where a good is produced from raw materials or intermediate components sourced from more than one country and/or where the manufacturing processes necessary to complete the finished good are performed in more than one country, the question as to country of origin of the finished good becomes more difficult to answer. In order to establish the country of origin in such cases, rules of origin apply certain tests which must be satisfied in order determine the country of origin of the good. The tests applied under rules of origin may be divided into those which are subjective in nature and those which apply objective criteria subject to little room for interpretation.

In the U.S., the primary test used to determine the country of origin of a good involving materials or processing from more than one country is the substantial transformation test. In order for a product to be considered a product of a certain country, it must be substantially transformed in that country. Since there can be only one country of origin for rules of origin purposes, the test refers to the country in which the "last" substantial transformation takes place. A definitive statement of the substantial transformation test as applied in the U.S. was made by the U.S. Supreme Court in 1908 in *Anheuser-Busch Brewing Association v. United States*.[2] In that decision, the Supreme Court stated that a product is substantially transformed when it is transformed into a "new and different article . . .having a distinctive name, character or use."[3] While this statement makes logical sense, it represents a test whose application has been fraught with subjectivity and unpredictability.

The U.S. Customs Service (Customs Service) and U.S. courts have issued many substantial transformation decisions that often provide little foundation for predictability.[4] The U.S. Customs Court has held that the machining and finishing of rough castings into fittings and flanges constitutes substantial transformation,[5] while its successor court, the U.S. Court of International Trade, has ruled that the

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2. *See* Anheuser-Busch Brewing Ass'n v. United States, 207 U.S. 556 (1908). *See also* Hartranft v. Wiegmann, 121 U.S. 609 (1887); United States v. Gibson-Thomsen Co., 27 C.C.P.A. 267 (Cust. Ct. 1940).

3. *Anheuser-Busch*, 207 U.S. at 556.

4. For a general discussion of U.S. court decisions and Customs Service rulings on substantial transformation see CUSTOMS LAW & ADMINISTRATION, 53 (Ruth F. Sturm ed., 2d ed. 1998).

5. *See* Midwood Indus. v. United States, 313 F. Supp. 951 (Cust. Ct. 1970).

conversion of footwear uppers into shoes by the addition of outsoles does not.[6] The Customs Service has ruled that the roasting and blending of coffee beans constitutes substantial transformation of coffee beans,[7] but that the heating, mixing, and milling (grinding) of peanut slurry into peanut butter does not.[8] The Customs Service has also determined that the hand-cutting of crystal stemware constitutes substantial transformation of the uncut stemware,[9] while the attachment of decorative decals to porcelain plates does not.[10]

In applying the "name, character, or use" test, the Customs Service and the courts have analyzed each case on the basis of the specific facts presented, using a variety of criteria. In addition to whether the transformation creates a new name, character, or use, three other tests have been applied: the "article of commerce" test, the "essence" test, and the "value added" test.[11] As observed by the court in Koru:

> The plethora of tests results from the cases on substantial transformation being "very product specific and . . .often distinguishable on that basis, rather than by their statutory underpinnings." Courts have not adhered rigidly to a single test because of the "importance of focusing on the facts of each case." . . . Courts find it "difficult to take concepts applicable to products such as textiles and apply them to combinations of liquids or fabrication of steel articles."[12]

B. Objective Tests

In recent years, there has been an increase in the use of objective tests to determine the country of origin of an imported product. By objective, it is meant

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6. *See* Uniroyal, Inc. v. United States, 542 F. Supp. 1026 (Ct. Int'l. Trade 1982).

7. *See* Country of Origin Marking, C.S.D. 92-3, 26 Cust. B. & Dec. 393 (1991).

8. *See* Customs Headquarters Ruling HRL 557994 (Oct. 25, 1994). The Customs Service ruling was subsequently upheld by the U.S. Court of International Trade in the case of *CPC International, Inc. v. United States*, 933 F. Supp. 1093 (Ct. Int'l. Trade 1996).

9. *See* Country of Origin Marking of Certain Lead Crystal Stemware C.S.D. 93-2, 27 Cust. B. & Dec. 352 (1992).

10. *See* Country of Origin Marking of Finished Porcelain Plates C.S.D. 93-1, 27 Cust. B. & Dec. 347 (1991).

11. *See* Koru N. Am. v. United States, 701 F. Supp. 229 & n.9 (Ct. Int'l. Trade 1988). The article of commerce test focuses on whether there is a new article of commerce. The essence test is whether the transformed component is an integral part of the finished product. The value added is concerned with the value added in transforming the imported article into the finished product. *See id.*

12. *Id.*

that the country of origin or a particular product can be determined on the basis of specifically defined or quantitative criteria which can be applied to a particular fact situation to yield an unambiguous and consistently repeatable result.

Several factors have driven a shift to objective rules of origin tests over the past decade. The disadvantages of the subjective substantial transformation test have been referenced in the preceding discussion. These disadvantages have been acknowledged by the Customs Service. In 1994, the Customs Service published a proposal which would have applied the objective rules of origin under the North American Free Trade Agreement (NAFTA) to imports from all countries.[13] As a rationale for the proposal, The Customs Service acknowledged:

> Notwithstanding the long history of the substantial transformation rule, its administration has not been without problems. These problems devolve from the fact that the application of the substantial transformation rules is on a case-by-case basis and often involves subjective judgments as to what constitutes a new and different article or as to whether processing has resulted in a new name, character and use .... The very fact that the substantial transformation rule has been the subject of a large number of judicial and administrative determinations is testament to the basic problems: the case-by-case approach, involving application of the rule based on specific sets of facts, has led to varied case-specific interpretations of the basic rule, resulting in a lack of predictability which in turn has engendered a significant degree of uncertainty, both with the Customs Service and in the trade community as regards the effect that a particular type of processing should have on origin determinations .... The change in tariff classification standard was specifically developed as an alternative to the traditional substantial transformation rule in order to obviate the problems described above. The Customs Service believes that rules based upon the change in tariff classification approach, would provide by virtue of their greater specificity, more objectivity, transparency, and predictability in origin determinations.[14]

Another compelling reason for the adoption of objective rules of origin tests is the necessity for harmonizing the rules of origin determinations of the

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13. *See* Customs Notice of Proposed Rule Making, 59 Fed. Reg. 141 (1994). The proposal was later withdrawn due, in large part, to opposition from import-sensitive industries in the U.S.

14. Customs Notice of Proposed Rule Making, 59 Fed. Reg. at 142.

customs authorities of member countries to a free trade area or customs union.[15] Goods traded within free trade areas and customs unions must be given consistent and predictable tariff treatment by all members of such trading arrangements. Otherwise, significant distortions can occur in trade to and within such geographic areas to the economic detriment of individual industries and whole economies in one or more participating member countries. For the U.S., this issue arose in connection with the U.S.-Canada Free Trade Agreement (CFTA), which went into effect January 1, 1989. The CFTA was the first major, all-sector free trade agreement entered into by the U.S. The primary rule of origin test adopted under the CFTA was the requirement of a change in tariff classification, the so-called tariff-shift test.[16] This tariff-shift rule of origin test was also utilized, in a much more detailed and complex form, when the CFTA was expanded to include Mexico under the NAFTA, which became effective January 1, 1994.[17]

It should be noted that, prior to 1989, it would have been very difficult for the U.S. to have adopted tariff-shift rules of origin in common with Canada and Mexico because it was not until then that the U.S. modified its system of tariff schedules to conform with those used by most of its trading partners.[18] For more than twenty-seven years prior to 1989, the U.S. tariff system was the Tariff Schedules of the U.S. (TSUS), which was adopted under the Tariff Classification Act of 1962.[19] During the same period, most of its trading partners applied tariff schedules based upon a different nomenclature, promulgated under the auspices of the international Customs Cooperation Council, based in Brussels, Belgium. The dissimilarities between the TSUS and the tariff schedules applied by the trading partners had already created significant difficulties in the negotiation of tariff

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15. Free trade areas involve agreements among member countries to reduce and eliminate duties on goods traded across national borders within the free trade area, while permitting each member country to maintain its own, separate system of tariffs on imports from non-member countries. Customs union agreements involve the elimination of duties on trade within the customs union, combined with the establishment of a common external tariff on third country imports.

16. *See* Free Trade Agreement, Dec. 22, 1987, U.S.- Can., at art. 301(2), 27 I.L.M. 281 [hereinafter CFTA]. The CFTA rules of origin were contained in Annex 301.2 of the Agreement. *See id.* at annex 301.2.

17. *See generally* North American Free Trade Agreement, Dec. 17, 1992, 32 I.L.M. 289 (1993) [hereinafter NAFTA].

18. *See* Mark D. Berniker, *Tariff Code Going Easier Than Expected*, J.OF COM., Jan. 6, 1989, at 1A (discussing the first week of adjustment after the implementation of the new U.S. Harmonized Tariff Schedules). *See also* Christina Lee, *Customs Code May Spawn Litigation*, J. OF COM., Dec. 28, 1988, at 3A (speculating about the impact the harmonized Commodity Description and Coding System will have upon trade in the U.S.).

19. *See* Tariff Classification Act of 1962, tits. I & II, Pub. L. No. 87-456, 76 Stat. 78 (1962) (amending 19 U.S.C.A. § 1351 at § 2(e) (1998)).

reductions under the Kennedy and Tokyo Rounds of Multinational Trade Negotiations conducted under the General Agreement on Tariffs and Trade (GATT). In order to compare tariff concessions proposed by the U.S. with those proposed by other countries, it was often necessary to spend as much time preparing concordances relating to the tariff treatment of individual products under the various tariff schedule systems as it took to conduct the negotiations themselves.[20]

During the 1980s, the U.S. drafted a revision of its tariff schedules in coordination with its participation in the negotiation of the International Convention on the Harmonized Commodity Description and Coding System (Harmonized System) under the auspices of the Customs Cooperation Council. The Harmonized System became effective January 1, 1988.[21] One year later, the Harmonized Tariff Schedule of the U.S. (HTSUS) a new tariff schedule system based upon the Harmonized System, went into force in the U.S.[22]

The 147 member countries of the Customs Cooperation Council, which has been renamed the World Customs Organization (WCO), have adopted tariff schedule systems modeled upon the Harmonized System.[23] The tariff schedules of all countries adopting the Harmonized System are identical up to the first six-digit tariff subheadings.[24] Uniformity in tariff schedule classifications up to the six-digit level is generally sufficient to determine the appropriate classification of most products and the corresponding rules of origin which will apply to an imported good. Furthermore, uniformity in the first six digits of the tariff schedules should permit uniform determinations to be made under rules of origin based upon tariff shift requirements. In any case, it would have been extremely difficult to have negotiated the CFTA in 1989, or NAFTA in 1994, had the U.S. tariff schedules not been harmonized with those of Canada and Mexico.

Another widely used objective rule of origin test is the so-called local or, in the case of a free trade arrangement, regional value (or value-added) test. As discussed in more detail below, a local value test generally stipulates a minimum percentage of the total value of a product which must be accounted for by the value of materials, labor, and other processing costs originating or performed in a

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20. *See* MICHAEL LUX, THE HARMONIZED COMMODITY DESCRIPTION AND CODING SYSTEM: CURRENT SITUATION AND CONSIDERATION § 2.1.2 (1981).

21. *See* The International Convention on the Harmonized Commodity Description and Coding System, June 14, 1983, pmbl., 1989 U.K.T.S. 15.

22. *See* The Harmonized Tariff Schedules of the United States, Pub. L. No. 100-418, 102 Stat. 1107, 1147-63 (codified in scattered sections of 19 U.S.C.A. §§ 3001-3012).

23. *See, e.g., Global Economy: WTO Explores Ways to Ease Cargo Delays at Borders*, J. OF COM., Oct. 13, 1998 (discussing the growing membership of the WCO).

24. Duty rates are established at the 8-digit level, and statistical subheadings may be established at the 10-digit level. There is no uniformity of the tariff schedules of WCO members at the 8-digit and 10-digit subheading levels. For a general discussion of the structure of tariff schedule systems see Sandstrom et al., *supra* note 1, at 120.

particular country in order for that product to qualify as "originating" in that country.

A final objective test, which is applied more rarely to rules of origin, is a test which requires that certain processing operations be performed on a raw material or components to produce the finished good. For instance, a process-based rule of origin could require that a finished textile article be cut and sewn or otherwise assembled in a particular country in order for that country to be deemed the country of origin of the finished textile article.

Most countries apply rules of origin in cases where materials and/or processing from more than one country is involved, using rules of origin based upon subjective and/or objective tests similar to those applied by the U.S. For example, Japan's rules of origin generally apply objective tests based upon tariff shifts, processing requirements, local content (preferential duty programs), and minimum operations tests.[25] In the European Union, the rules of origin are based primarily upon the subjective last substantial transformation test in the case of nonpreferential rules and objective tests involving tariff shift and specific processing requirements in the case of preferential rules.[26]

Before reviewing the use of rules of origin for various purposes and programs, a few general comments are in order. The current trend is toward increasing use of objective rules of origin tests and away from subjective tests exemplified by the concept of substantial transformation. Given the growing integration of national economies into the world economy and the increasing number of free trade arrangements, consistency in the application of rules of origin of traded products will become increasingly necessary. In 1994 the Customs Service attempted to introduce the use of objective, tariff-shift rules of origin for goods from all countries and for all customs purposes. While this effort failed, the question will be posed again for the U.S. and all members of the WTO when the Technical Committee on Rules of Origin issues its report this year pursuant to the WTO Agreement on Rules of Origin (See discussion, Part VI). It is the expectation of the author that most rules of origin will be based primarily upon objective tests used in the U.S. and in most other trading countries within the next five to ten years.

As will become evident in the following discussion, rules of origin based upon tariff shifts may in many cases be difficult to apply, since they depend upon two or more often subtle tariff classification determinations. On the other hand, the

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25. For a general discussion of the rules of origin applied in Japan, see Norio Komuro, *Japanese Rules of Origin, in* Vermulst et al., *supra* note 1, at 301-43. For a general discussion of Japan's customs laws and procedures, see MITSUO MATSUSHITA &THOMAS J. SCHOENBAUM, JAPANESE INTERNATIONAL TRADE AND INVESTMENT LAW 57-89 (1989).

26. For a general discussion of the rules of origin applied in the European Union, see Paul Waer, *European Community Rules of Origin, in* Vermulst et al., *supra* note 1, at 85-194.

advantage of such rules is that a single, "correct" determination can be made in most cases. Furthermore, that determination will remain correct over time under changing economic conditions.

Objective rules of origin tests based upon minimum local value requirements can be very burdensome for manufacturers to apply in light of the need to collect and analyze cost and other manufacturing data necessary to calculate the particular local value percentage which may apply. Furthermore, unlike the tariff-shift test, determinations made under local value tests may, in "close" cases, not remain constant over time. Changes in the cost of materials or labor may affect the results of the calculations in cases where the local value is near the percentage required under the particular test. External factors, such as fluctuations in foreign exchange rates, can also alter the determination in close cases.

However, despite their complexity, objective rules of origin tests do generally enable the structure of investment, manufacturing and sales operations to be analyzed from the standpoint of tariff and other trade considerations well in advance of the undertaking of any planned transaction and with a high degree of predictability as to the duty and customs consequences of any particular determination which is made.

III. NAFTA

NAFTA has significantly altered and enhanced trade among the U.S., Canada, and Mexico. It has also had a significant effect upon trade in products produced by third-country producers, both outside and within North America. Trade in "originating goods" between the U.S. and Canada is, as of 1998, duty-free for most products. Tariffs on dutiable items traded between Mexico on the one hand and the U.S. and Canada on the other have been cut in half since NAFTA was implemented and will be reduced, in annual stages, to zero for most products by 2003.[27]

In order to obtain the benefit of NAFTA preferential rates on goods imported into one NAFTA country from another, the good must "originate" in a NAFTA member country. Whether a good is an originating good is determined by the application of the NAFTA rules of origin.[28] Chapter Four of NAFTA provides

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27. *See, e.g.*, NAFTA, *supra* note 17, at art. 302 (establishing the progressive elimination of duties on originating goods); *id.* at art. 302.2 (specifying the base rate of duty and staging categories as the method whereby duties shall be eliminated).

28. For a general discussion of the NAFTA rules of origin see U.S. CUSTOMS SERVICE, CUSTOMS PUBLICATION NO. 571, NAFTA: THE NORTH AMERICAN FREE TRADE AGREEMENT: A GUIDE TO CUSTOMS PROCEDURES (1994); and JIMMIE V. REYNA, PASSPORT

the general principles applicable to the rules of origin, while the rules themselves may be found in Annex 401 of NAFTA.[29] The U.S., Canada, and Mexico have adopted essentially identical rules of origin as part of their implementation of NAFTA.[30] The U.S. enactment of the NAFTA rules of origin are set out in the General Note 12 of the HTSUS.[31] The NAFTA countries have also adopted essentially identical regulations which serve as guidelines for the implementation of the rules of origin in each of the NAFTA countries.[32]

Given the uniformity of the NAFTA rules of origin, the implemention regulations, and the tariff schedules of the three NAFTA member countries, determinations concerning the NAFTA eligibility of a good produced in one NAFTA country and imported into another NAFTA country will apply to production and importation of the good in any of the other NAFTA countries.[33]

The NAFTA rules of origin are classification-specific, in that individual HTSUS classifications or groupings of classifications are assigned a separate,

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29. *See* NAFTA, *supra* note 17, at art. 401 (setting forth the criteria an article must satisfy in order to be classified as "originating" in a particular party's territory); Harmonized Tariff Schedule of the United States 1998, USITC Publication 3001 (1998) general note 12(b) (discussing same) [hereinafter HTSUS 1998]; NAFTA, *supra* note 17, at annex 401 (enumerating specific rules of origin applicable to identified goods and materials); HTSUS 1998, *supra* note 29, at general note 12(t) (identifying rules of origin applicable to listed goods and materials).

30. The U.S. implemented the NAFTA rules of origin pursuant to the North American Free Trade Agreement Implementation Act, 19 U.S.C.A. §§ 3301-3473 (1998).

31. *See* HTSUS 1998, *supra* note 29, at general note 12.

32. The general U.S. NAFTA regulations are set out in Section 181 of Title 19 of the Code of Federal Regulations. *See* Customs Duties, North American Free Trade Agreement, 19 C.F.R. § 181 (1999). The U.S. regulations concerning the NAFTA rules of origin are found in Section 181.131 of the NAFTA regulations and the very useful Appendix to Section 181—Rules of Origin Regulations. *See* Customs Duties, NAFTA Rules of Origin, 19 C.F.R. § 181.131, app. (1999).

33. While the test for eligibility of a good for NAFTA duty treatment will be uniform among the NAFTA countries, the actual NAFTA duty rate which will apply to a good imported into a NAFTA country will vary from country to country. While Canada, Mexico and the U.S. have agreed to reduce and eventually eliminate duties on goods traded within the NAFTA territory, they did not agree to harmonize their non-preferential Most-Favored-Nation (MFN) tariffs applicable to third country imports. Since those differing MFN tariffs were the starting point for the staged reduction of duties on goods traded within NAFTA, the NAFTA duty rates will not be uniform until the tariffs are reduced to zero through annual staged reductions. The duty rate on most NAFTA goods traded between the U.S. and Canada was reduced to zero as of January 1, 1998. *See generally* NAFTA, *supra* note 17.

specific rule of origin. It is not possible to determine the rule of origin applicable to a good to be imported into the customs territory of a NAFTA member country until the tariff classification of the good is established.

Under the NAFTA rules of origin, goods will be deemed originating goods, eligible for preferential NAFTA tariff treatment only if:

(i) they are goods wholly obtained or produced in the territory of Canada, Mexico and/or the United States: or

(ii) they have been transformed in the territory of Canada, Mexico and/or the United States so that—

  (A) except as provided in subdivision (f) of this note [the de minimis rule], each of the non-originating materials used in the production of such goods undergoes a change in tariff classification described in . . .this note or the rules set forth therein, or

  (B) the good otherwise satisfies the applicable requirements of subdivisions (r), (s) and (t) where no change in tariff classification is required, and the goods satisfy all other requirements of this note; or

(iii) they are goods produced in the territory of Canada, Mexico and/or the United States exclusively from originating materials[.][34]

Subparagraph (i) of General Note 12(b) is self-explanatory. Subparagraph (ii) refers to the main body of NAFTA rules of origin, set out in General Note 12(t) of the HTSUS, which apply to goods produced, in whole or part, from materials sourced from non-NAFTA countries. Subparagraph (iii) is similar to the preceding subparagraph in application since it covers situations in which each component of the finished good satisfies the NAFTA rule of origin. For purposes of the NAFTA rules of origin, the term "good" refers to the product subject to the rule of origin determination in the state in which it is imported into a NAFTA country, and the term "material" refers to an intermediate article that is used in the production of the good in question and includes a part, component, or an ingredient of such good.

The NAFTA rules of origin are based primarily on the two objective tests: the tariff-shift test and the regional value content tests. In rare cases, primarily with respect to textile products, the NAFTA rules of origin also incorporate tests based upon required manufacturing or processing operations.[35]

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34. HTSUS 1998, *supra* note 29, at general note 12(b)(i)-(iii).

35. *See* NAFTA, *supra* note 17, at annex 300(B) (setting forth tariff and related regulations solely applicable to textile and apparel goods). *See also* HTSUS 1998, *supra* note 29, at general note 12(d) (specifying rules applicable to automotive parts).

A. Tariff Shift

A tariff shift test generally requires that the processing of material into a finished good shifts the tariff classification of the material from a permissible tariff classification to the tariff classification of the finished good corresponding to the pertinent rule of origin. A representative example of the tariff-shift test is the rule of origin applicable to carbon steel seamless standard pipe classified under HTSUS subheading 7304.39, which covers "tubes, pipes, . . . seamless, of iron or nonalloy steel, [not cold-drawn or cold-rolled] . . .."[36] The NAFTA rule of origin applicable to this subheading, which is set out in HTSUS General Note 12(t), requires: *"A change to subheading 7304.10 through 7304.39 from any other chapter."* HTSUS subheadings 7304.10 through 7304.39 cover all types of carbon steel seamless pipe. In order to be eligible for NAFTA duty rates, i.e., in order to be deemed an "originating product," the process of manufacturing the seamless pipe must involve a raw material classified outside of Chapter 73,[37] which covers fabricated articles of iron and steel. Carbon steel seamless pipe is generally produced by the extrusion of a heated billet over a mandrel, or by the rotary piercing of heated round steel bar. Steel billets and steel bar are classified under Chapter 72 of the HTSUS, which covers basic iron and steel mill products. Thus, the process of producing carbon steel welded pipe satisfies the applicable NAFTA rule of origin since it "shifts" the classification of the raw material from a chapter outside HTSUS Chapter 73 to the specified subheading for the seamless pipe, consistent with the requirement of the rule of origin corresponding to that subheading. Accordingly, any carbon steel seamless pipe produced from a billet or bar in any NAFTA member county would, by the nature of the manufacturing process, be eligible for NAFTA duty rates upon importation into any of the other NAFTA countries.

The NAFTA rules of origin require that all non-originating materials satisfy the tariff shift requirement in order for a finished good to be considered

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36. Under the NAFTA Rules of Origin, chapters of the tariff schedules of the U.S., Canada, and Mexico are defined by the first two digits of a particular 10-digit classification. Headings are defined as the first four digits of a classification, and subheadings are defined as any subcategory of the heading at the 6-digit, 8-digit, or 10-digit level. The NAFTA rules of origin are generally established at the heading level or at the 6-digit and 8-digit subheading levels. *See* Sandstrom et al., *supra* note 1, at 120.

37. *See* HTSUS 1998, *supra* note 29, at general note 12(r). General note 12(r) provides guidance in interpreting the NAFTA rules of origin set forth at general note 12(t), including the instruction that "a requirement of a change in tariff classification applies only to non-originating materials." *Id.* at general note 12(r)(iii). Accordingly, the HTSUS general note 12(t) provision applicable to carbon steel seamless pipe provides an avenue whereby the non-originating raw materials can be reclassified as "originating products," provided they undergo some sort of "change" involving a product covered under a classification in any other chapter of the HTSUS. *See id.*

eligible for NAFTA treatment.[38] Thus, if any non-originating material does not satisfy the tariff shift requirement, the finished good would not meet the test and the good would not qualify for NAFTA duty treatment. However, an exception is made in the case of non-originating materials with insignificant value.[39] The de minimis provision of the NAFTA rules of origin permits a good to qualify as originating if the value of any non-originating material which does not meet the tariff shift requirement is not more than seven percent of the value of the finished good.

Accessories, spare parts, and tools that are delivered with originating goods and that form part of the goods' standard accessories, parts, or tools are considered originating and are also disregarded in determining whether all the non-originating materials undergo the requisite tariff shift. However, accessories, parts, and tools are not disregarded for purposes of calculating regional value content (See discussion, Part II, Section B).

Even if a good satisfies a tariff-shift rule of origin requirement, it will not be considered an originating good if the shift in tariff classification results from: (1) mere dilution with water or another substance that does not materially alter the characteristics of the good, or (2) any production or pricing practice with respect to which it may be demonstrated, on the basis of a preponderance of evidence, that the object was to circumvent the NAFTA rules of origin.[40]

As indicated earlier, certain import-sensitive products are accorded very strict rules of origin which ensure that NAFTA eligibility will be granted only if a substantial amount of material and processing will be sourced or conducted in one or more NAFTA countries.[41] The tariff-shift rules applicable to textile articles are an example of such a strict requirement. Most textile articles will qualify for

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38. NAFTA, Article 401 provides:

> Except as otherwise provided in this Chapter, a good shall originate in the territory of a Party provided that:
> . . . (b) each of the non-originating materials used in the production of the good undergoes an applicable change in tariff classification described in Annex 401.1 as a result of production occurring entirely in the territory of one or more of the Parties[.]

NAFTA, *supra* note 17, at art. 401(b). *See also* HTSUS 1998, *supra* note 29, at general note 12(b).

39. *See* NAFTA, *supra* note 17, at art. 405. *See also* HTSUS 1998, *supra* note 29, at general note 12(f).

40. *See* NAFTA, *supra* note 17, at art. 412. *See also* HTSUS 1998, *supra* note 29, at general note 12(m).

41. *See generally*, LaNasa, *supra*, note 1, at 625-27; 632-33 (discussing NAFTA eligibility for products only if substantial marketing or production had been conducted in a NAFTA country).

NAFTA treatment only if they are made from fabric produced from yarn or fiber produced in a NAFTA country. These textile rules of origin are known as "yarn-forward" or, in the case of man-made-fiber articles, the "fiber-forward" rules.

B. Regional Value Content

Negotiators of NAFTA were concerned that a tariff-shift requirement, particularly in the case of import-sensitive products such as automobiles and textiles, might not ensure that a sufficient amount of local materials and value-added processing would be required in order to qualify for NAFTA eligibility. There was concern, particulary on the part of the U.S. and Canada, that third-country companies, including those in Japan, could use minor processing operations in one NAFTA country as a platform for shipments to the other NAFTA countries at low or zero duty rates. Accordingly, many of the NAFTA rules of origin incorporate a regional value test (RVC) in lieu of, or in conjunction with, a tariff-shift test.

In the case of most goods, two alternative methods are available for calculation of the RVC: the Transaction Value method and the Net Cost method. Under the Transaction Value method, the value of the goods and processing originating or conducted in one or more NAFTA countries must equal sixty percent or more of the transaction value of the good. Under NAFTA, the transaction value of a good is defined as the transaction value of the good for purposes of customs appraisal under generally accepted customs valuation principles set out in the WTO Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994.[42] As defined, the transaction value generally approximates the ex-factory price of a good sold to an independent buyer on an arms-length basis. The formula used to calculate RVC on the basis of Transaction Value is as follows:

$$RVC = \frac{TV - VNM}{TV} \quad x\ 100$$

where *RVC is the Regional Value Content*
TV is Transaction Value
VNM is the value of nonoriginating materials used by the producer in the production of the good.

A second basis for calculating RVC is the Net Cost method. Under the Net Cost method, fifty percent of the net cost to produce the good must be based upon costs incurred in one or more NAFTA countries. Net cost is defined as all costs of producing the good, including materials, labor, and overhead (but not profit), less expenses for sales promotion (including marketing and after sales service), royalties,

42. *See* NAFTA, *supra* note 17, at art. 415.

shipping and packing costs, and nonallowable interest costs.[43] The percentage content requirement for the Net Cost method is lower than that of the Transaction Value method, since certain costs are excluded in the calculation of the former method. The formula used to calculate RVC on the basis of the Net Cost method is as follows:

$$RVC = \frac{NC - VNM}{NC} \times 100$$

where *RVC is the Regional Value Content*
NC is the Net Cost
VNM is the value of nonoriginating materials used by the producer in the production of the good.

An example of the application of the RVC test is provided by the NAFTA rule of origin applicable to another steel product classified under HTSUS Chapter 73. Portable steel hibachis, used to grill meat outdoors, are classified under HTSUS subheading 7321.13.0020. For purposes of this example, it is assumed that a hibachi is fabricated in Mexico using parts from various countries. The steel shell of the hibachi is imported from Japan and is valued at four dollars. The legs of the hibachi are imported from Canada and have a value of two dollars. The grill used on the hibachi is produced in the U.S. with a value of three dollars. The legs of the hibachi and the grill are "originating" materials since they are sourced from NAFTA countries. The steel shell of the hibachi is a non-originating material since it is sourced from Japan. The transaction value of the finished hibachi is twelve dollars.

The NAFTA rule of origin applicable to HTSUS subheading 7321.13.0020 requires:

> A change to subheadings 7321.12 through 7321.83 from any other heading; or
> A change to subheadings 7321.12 through 7321.83 from subheading 7321.90 [parts of hibachis], whether or not there is also a change from any other heading, provided there is a regional value content of not less than:
>
> (1) Sixty percent where the transaction value method is used, or
>
> (2) Fifty percent where the net cost method is used.

The shell, legs, and grill of the Hibachi are classified as parts of a cooking appliance other than stoves or ranges under HTSUS subheading 7321.90.6030. The process

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43. *See id.*

of producing the hibachi transforms the tariff classification of the non-originating material, the steel shell, from HTSUS subheading 7321.90.6030 (parts) to subheading 7321.13.0020 (hibachi). However, the rule of origin requires a transfer from a heading outside 7321. Thus, any material classified under heading 7321, including parts, can never be transformed in a way which would satisfy the tariff-shift rule of origin.

However, the rule of origin also contains an alternative test which permits a hibachi manufactured from non-originating hibachi parts to qualify for NAFTA eligibility, provided the finished good contains sufficient NAFTA regional value. Applying the Transaction Value method, the RVC of the hibachi is 66.7%:

$$RVC = \frac{TV - VNM}{TV} \times 100\% = \frac{\$12 - \$4}{\$12} \times 100\% = \frac{\$8}{\$12} \times 100\% = 66.7\%$$

Thus the RVC of the finished hibachi is greater than the minimum sixty percent required by the Transaction Value method and the hibachi can be imported into the U.S. at the NAFTA rate of duty.

The RVC test for automobiles and certain significant automotive parts is more stringent than that applied generally to other products. For instance, major automotive components and subassemblies are subject to the "tracing" principle, whereby the value of any non-originating material remains non-originating, regardless the amount of processing and the number of transformations which the material may go through in one or more NAFTA countries before incorporation into the finished automobile. In addition, the RVC for automotive products subject to regional value tests must be conducted on the basis of the Net Cost method. Furthermore, the minimum RVC percentages for such products increased from 50% to 55-56% in 1998, and will be increased to 60-62.5% in 2002.

NAFTA provides flexibility in the calculation of RVC in certain cases to reflect differences in the methods of production used by vertically integrated and non-integrated producers. A non-vertically integrated producer may purchase a component from an independent vendor, which has been processed in such a way as to meet the NAFTA rule of origin for that component. In such a case, the full value of the component will be originating, even if it was produced from non-originating materials. On the other hand, a vertically integrated manufacturer might produce the component itself using non-originating materials. The integrated producer would be required to include as non-originating material the value of the non-originating material used to produce the same component incorporated into the finished product. Thus, the integrated producer would be placed at a distinct disadvantage in comparison with the producer who outsources the component. In order to eliminate this disadvantage, NAFTA permits a producer to designate as an "intermediate material" any self-produced originating material used in the production of a finished good. If the intermediate material must satisfy a RVC

requirement, the Net Cost method must be used to calculate the RVC. The full value of an intermediate material may be included as originating in calculating the RVC of the finished good incorporating the intermediate material. A producer may make any number of intermediate material designations, except that no material subject to an RVC requirement may be designated as an intermediate material if it contains submaterials which are also subject to an RVC requirement.[44]

As indicated, if a manufacturer purchases a component which is originating, the producer is permitted to treat the entire value of the component as originating in calculating the RVC of the finished good. This concept is known as "roll-up" under NAFTA. On the other hand, if a manufacturer purchases a component which is non-originating, it would normally be required to treat the entire value of the component as non-originating, even if the component contained originating material or value added in a NAFTA country. This phenomenon is known as "roll down." This result places the manufacturer at a disadvantage with an integrated producer, who would be permitted to include the value of originating material used to produce the component as originating for purposes of the RVC calculation. However, pursuant to the "accumulation" provision, NAFTA permits the nonintegrated producer in such a case to include any regional value added in the NAFTA territories to be incorporated in the component in the value of originating material included in the calculation of the RVC of the finished good.

C. Processing Operations

In a limited number of cases, the NAFTA rules of origin require that certain specified processing operations be conducted upon a good before it will be deemed originating and eligible for NAFTA duty treatment.[45] Such processing requirements are found primarily in the rules of origin applicable to textile articles. A representative example of such a requirement is found in the rule of origin applicable to men's and boys' wool overcoats and similar articles classified under HTSUS subheading 6101.10.0000. The NAFTA rule of origin corresponding to this subheading requires:

> A change to subheadings 6101.10 through 6101.30 from any other chapter, except from headings . . .[reference to excluded yarn, fiber and fabric headings], provided that:

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44. *See id.* at art. 402(10). *See also* HTSUS 1998, *supra* note 29, at general note 12(b)(iv).

45. *See, e.g.*, NAFTA, *supra* note 17, at annex 300(B), app. 6.

(A) *the good is both cut (or knit to shape) and sewn or otherwise assembled in the territory of one or more of the NAFTA parties, and*

(B) the visible lining fabric listed in chapter rule 1 for chapter 61 satisfies the tariff change requirements provided therein. (emphasis added).[46]

As is apparent, the NAFTA rules of origin are often complex. In fact, other more complex NAFTA concepts have not been covered in this article, such as cost averaging methods used in RVC calculations and inventory management methodologies used to determine the origin of fungible originating and non-originating materials used to produce a finished good. Furthermore, the burden of collecting and analyzing the data necessary to apply the RVC test can be very onerous. In fact, in certain cases involving complex RVC calculations, an importer may elect to accept the most favored nation (MFN) rate of duty on a product shipped from one NAFTA country to another, rather than bear the burden of proving NAFTA eligibility under the applicable rule of origin.

On the other hand, as indicated earlier, the NAFTA rules of origin, as drafted and implemented by the customs authorities of the three NAFTA countries, do enable companies to plan investment in manufacturing and distribution operations, knowing what is required to obtain eligibility for NAFTA and what the duty consequences of any particular combination of manufacturing and distribution operations will be.

IV. U.S. PREFERENTIAL DUTY PROGRAMS

The U.S., as well as Japan and most other developed countries, have adopted programs under which imports of specifically designated products from specifically designated beneficiary developing countries are eligible for duty free treatment. The principle U.S. preferential duty program is known as the Generalized System of Preferences (GSP).[47]

Under GSP, a wide range of products[48] imported from more than one hundred countries and territories may be imported duty free into the U.S., provided

46. *Id.* at annex 401. *See also* HTSUS 1998, *supra* note 29, at general note 12(t).

47. *See* 19 U.S.C.A. §§ 2461-2467 (1998).

48. Certain textiles and apparel, watches, import-sensitive electronic, steel articles and glass products, footwear, leather goods, and agricultural products are excluded from eligibility under GSP. *See* 19 U.S.C.A. § 2463(b).

that certain requirements are satisfied.[49] Among these is the GSP rule of origin, which provides:

> The duty free treatment provided under this subchapter shall apply to any eligible article which is the growth, product, or manufacture of a beneficiary developing country if—
>
> (1) that article is imported directly from a beneficiary developing country into the customs territory of the United States: and
>
> (2) the sum of—
>
> (a) the cost or value of the materials produced in the beneficiary developing country or any two or more such countries that are members of the same association of countries[50] and are treated as one country under section 2467(2) of this title, plus
>
> (b) the direct costs of processing operations performed in such beneficiary developing country or such member countries, is not less than 35 percent of the appraised value[51] of such article at the time its is entered.[52]

In order to be eligible for GSP duty treatment, an article must originate in an eligible country. Thus, the article must be substantially transformed in a beneficiary developing country (BDC) in order to be deemed as originating in that country. The article must be imported directly to the U.S. from that country.[53] Finally, the local value requirement of the GSP is similar to the Net Cost method of calculating regional value content under NAFTA, except that only thirty-five percent of the value must be local. Furthermore, only materials and direct costs of

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49. *See* HTSUS 1998, *supra* note 29, at general note 4.

50. *E.g.*, the Andean Group: Bolivia, Colombia, Ecuador, Peru and Venezuela.

51. In most cases under the customs valuation laws of most trading countries, the appraised value of an imported product will be its transaction value, the same value as referred to in the first of the NAFTA regional value content calculation methods discussed *supra*.

52. 19 U.S.C.A. § 2463(2)(a).

53. An article may be transshipped through an intervening third country, provided that it does not undergo processing in, or otherwise enter into the commerce of that country.

processing may be included, which excludes overhead and other nonallocable general and administrative costs. As under NAFTA, no article is deemed eligible for GSP benefits merely by undergoing simple combining or packing operations, or mere dilution with water or other substance which does not materially alter the characteristics of the article.

If an intermediate component incorporated into a finished product within a BDC includes materials or parts imported from a non-BDC country, it may be possible to include the entire value of the component as local value added, provided that the component undergoes a "dual substantial transformation."[54] For example, if a valve is imported into a BDC and incorporated into a pump, the valve will be considered substantially transformed in the process of manufacturing the pump. If the pump is then incorporated into a washing machine, the pump will also be considered to have been substantially transformed. In such a case, the entire value of the pump may be included in the local value content of the washing machine produced in the BDC, including the cost of the imported valve. However, if the pump were to be exported to the U.S., the article would not be deemed to have undergone dual substantial transformation. In such a case, only the direct cost of processing the valve into a pump in the BDC would be considered local value added. The cost of the imported valve itself would not be included in the local value of the pump.

Another duty preference program in effect in the U.S. is the so-called Caribbean Basin Initiative (CBI), established under the Caribbean Basin Economic Recovery Act.[55] The CBI program is similar to GSP, except that it is limited to countries in the Caribbean basin including countries in the Caribbean Sea and in Central America. The cost or value of materials produced in other CBI countries and in the customs territory of the Commonwealth of Puerto Rico (which is normally included as part of the U.S. Customs Territory) and the U.S. Virgin Islands may be included for purposes of calculating the minimum local value. Otherwise, the CBI rule of origin is the same as that for GSP, with one important exception. Up to fifteen of the required thirty-five percent local value can be made up of the cost or value of materials produced in the U.S., excluding Puerto Rico.[56]

In 1991 the U.S. Congress enacted the Andean Trade Preference Act (ATPA).[57] The ATPA created a preferential duty program for the four members of the Andean Pact: Bolivia, Ecuador, Colombia, and Peru. The ATPA rules of origin

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54. *See* Torrington Co. v. United States, 764 F.2d 1563 (Fed. Cir. 1985) (holding dual substantial transformation in a BDC to be prerequisite for GSP treatment).

55. *See* Caribbean Basin Recovery Act, tit. II, 19 U.S.C.A. §§ 2701-2707 (1998) (originally enacted as Pub. L. No. 98-67, 97 Stat. 384 (1983)).

56. *See* 19 U.S.C.A. § 2703(a)(1).

57. *See* Andean Trade Preference Act, tit. II, 19 U.S.C.A. §§ 3201-3206 (1998) (originally enacted as Pub. L. No. 102-182,105 Stat. 1236 (1991)).

are for the most part the same as those which apply to the CBI.[58] The direct costs of materials and processing occurring in any CBI country can be included with the local costs accruing in one or more of the ATPA countries in applying the thirty-five percent minimum local test. As with the CBI, the cost or value of U.S. materials may also be included, up to fifteen percent of the local value.

In 1985 the U.S. implemented a free trade agreement with Israel, under which preferential duty treatment is accorded to designated imports from that country.[59] The rules of origin established under the Israel Free Trade Agreement are essentially the same as those established under the CBI and ATPA, including the provision permitting up to fifteen percent of the cost or value of U.S. materials to be included within the thirty-five percent minimum local value requirement. However, the value or cost of goods from other countries eligible for duty preference under other programs may not be included in the calculation of the local value requirement.

If a company in Japan has the capability of establishing offshore manufacturing operations in order to produce or process goods for sale in the U.S. market, an analysis of the rules of origin applied under the various preferential duty agreements and programs in force in the U.S. can enable the company to structure the offshore operations so as to minimize the impact of duties upon the sales of the goods. In making such analyses, the differences between the rules of origin applied under NAFTA and those applied under GSP and other preferential duty programs should be taken into consideration. Thus, in situations where it may not be possible to meet the sixty percent transaction value regional value content test under NAFTA, the thirty-five percent test applied under GSP, CBI, or ATPA may be obtainable. From the viewpoint of a company based outside of North America which desires to produce offshore for sale in the U.S., it may make little difference whether a plant is located in Mexico (NAFTA) or Costa Rica (GSP, CBI). The fact that the cost or value of U.S. materials may be applied (up to fifteen percent) toward determining the thirty-five minimum local value percent under the CBI or ATPA, but not under GSP, may also influence the decision as to the location of the offshore manufacturing operations.

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58. On January 30, 1998, the Customs Service published revised ATPA regulations for the purpose, in part, of bringing the regulations more into conformity with those of CBI. *See* Proposed Rules, Dept. of Treasury, Andean Trade Preference, 63 Fed. Reg. 4601 (1998).

59. *See* The United States-Israel Free Trade Agreement Implementation Act of 1985, 19 U.S.C.A. 2112(b) (1998) (as amended by Pub. L. No. 104-234, § 1, 99 Stat. 82 (1985)).

V. COUNTRY OF ORIGIN MARKETING

A. General

Most nations require that foreign articles imported into their customs territory be marked so as to indicate to consumers in that country the foreign country in which the good was produced. By statute[60] and by regulation,[61] the U.S. requires that imported articles of foreign origin be marked so as to indicate to the ultimate purchaser in the U.S. the country of origin of the article. In cases where the foreign article incorporates materials from more than one country and/or is processed in more than one country, the foreign country in which the last substantial transformation of the article occurs is the country of origin of the article. The article must bear marking indicating the name of that country, such as "Made in [the foreign country]" or words to similar effect, upon importation into the U.S.

The substantial transformation test is also used to determine the identity of the "ultimate purchaser" within the U.S. The ultimate purchaser is defined as the last person in the U.S. who purchases the article in the form in which it was imported. If a manufacturer "substantially transforms" the imported article into a new product with a different name, character or use, the manufacturer is deemed to be the ultimate purchaser of the imported article. The determination of the ultimate purchaser is important, since the foreign country of origin marking is not required to remain on an article once it leaves the ultimate purchaser's facilities for distribution further down the channel of sale.

The earlier example of imported steel bars used to produce seamless steel pipe is illustrative of the application of this rule. The steel bar which is imported by the U.S. pipe manufacturer must be marked with the name of the foreign country in which the bar is produced. By fabricating the bar into seamless pipe, however, the U.S. manufacturer is deemed to have substantially transformed the bar, as reflected in various rulings issued by the Customs Service. Accordingly, the manufacturer is not required to mark the pipe which it sells in the U.S. with the foreign country of origin of the imported bar.

B. Products from NAFTA Countries

Products imported from the NAFTA countries of Canada and Mexico are subject to NAFTA country of origin marking rules.[62] These marking rules are based upon objective tests which are similar, but generally more liberal, than the tests

60. *See* 19 U.S.C.A. § 1304 (1998).
61. *See* Customs Duties, Country of Origin Marking, 19 C.F.R. § 134 (1999).
62. *See* NAFTA, *supra* note 17, at art. 311 annex 311.

applied under the NAFTA rules of origin used to determine eligibility for NAFTA preferential duty rates. The general principles of the NAFTA marking rules are set out in Annex 311 of the Agreement. Pursuant to those principles, each of the NAFTA countries has adopted their own marking rules. Unlike the NAFTA rules of origin discussed in Part III,[63] the national NAFTA marking rules adopted by each country, while consistent with the principles set out in Annex 311, are not uniform.[64] The U.S. NAFTA marking rules are set out in Part 102 of the U.S. Customs Regulations.[65]

It is important to distinguish the NAFTA marking rules from the NAFTA rules of origin determining eligibility for NAFTA duty rates. It is possible for a good to be deemed a product of a NAFTA country for marking purposes without being eligible for NAFTA duty treatment.[66] The NAFTA marking rules are used to determine the NAFTA country whose name should be marked upon the good at the time it is imported into a NAFTA country. The NAFTA marking rules are also used to determine which NAFTA duty rate will apply to a good using materials from and/or produced in more than one NAFTA country, given that each NAFTA country imposes different NAFTA rates of duty on imports from each of the other NAFTA countries.

The NAFTA marking rules are also used to determine whether or not a manufacturer who processes a good imported from a NAFTA country is the ultimate purchaser of the good. However, the U.S. Court of International Trade has recently held that the traditional substantial transformation test may also be used to determine whether the manufacturer of a good imported from a NAFTA country is the ultimate purchaser of that good.[67]

C. Textile Products

From the standpoint of rules of origin, textile products are given special, and usually more restrictive, treatment in most situations in which rules of origin tests are applied. For country of origin marking purposes, imported textile products are subject to special separate regulations, regardless of whether the textile products

63. See discussion *supra* notes 27-35, and accompanying text.

64. *See* REYNA, *supra* note 28, at 289.

65. *See* Custom Duties, Rules of Origin, 19 C.F.R. § 102.11 (1999).

66. *See* Donna L. Bade, Comment, *Beyond Marking: Country of Origin Rules and the Decision in CPC International*, 31 J. MARSHALL L. REV. 179 (1997) (analyzing NAFTA country of origin markings in the context of production operations involving no materials that originated in NAFTA countries).

67. *See* CPC Int'l., Inc. v. United States, 933 F. Supp. 1093 (Ct. Int'l. Trade 1996).

are imported from NAFTA or non-NAFTA countries.[68] These rules, which became effective July 1, 1996, involve objective tests based primarily upon tariff-shift and processing requirements. The regulations were promulgated to implement statutory textile marking requirements enacted by Congress, at the urging of domestic textile manufacturers, as part of the Uruguay Round Agreements Act of 1994.[69] In many cases, particularly with regard to the "fabric-driven" textile marking requirements, these rules are inconsistent with the marking rules applied by other countries and with the substantial transformation rulings of the U.S., in effect prior to the effective date of these regulations of July 1, 1997.

In the case of flat goods, such as sheets, handkerchiefs, and towels, the textile rules of origin require that the country of origin of the imported good be the country in which the fabric was produced.[70] If a product is classified in an HTSUS classification to which the fabric-driven test applies, the country of origin remains the country in which the fabric is produced, regardless of the degree to which the fabric is processed to make the finished good. An example of a fabric-driven rule of origin is that which applies to products classified under HTSUS subheading 6307.90, which covers "[o]ther made up textile articles." The rule for this subheading stipulates that: "The country of origin of a good classifiable under subheading 6307.90 is the country, territory, or insular possession in which the fabric comprising the good was formed." Included in this subheading are numerous miscellaneous articles fabricated from textile materials. If such an article were produced, for example, in Japan from fabric made from China, the country of origin for U.S. purposes would be China. On the other hand, most other countries would consider the fabricated article to have been last substantially transformed in Japan and a product of that country. The discrepancy between the U.S. and its trading partners can cause significant problems—relating, for example, to country of origin marking or import quotas - for producers in other countries which produce for export to the U.S. and other countries.[71]

The U.S. textile rules of origin also determine the country of origin for purposes of administering U.S. quotas on textile products imposed under Section

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68. The textile marking rules are set out in Section 102.21 of the U.S. Customs regulations. *See* Textiles and Apparel Products Act, 19 C.F.R. § 102.21 (1999).

69. *See* 19 U.S.C.A. § 3592 (1998) (originally enacted as Pub. L. No. 103-465, 108 Stat. 4949 (1994)).

70. *See* 19 C.F.R. § 102.21.

71. *See* 19 U.S.C.A. § 3592. In 1997, the European Union (EU) threatened to initiate a WTO dispute settlement proceeding against the U.S. textile rules of origin, particularly as they applied to flat silk goods, such as handkerchiefs. The U.S. agreed to modify the rules to meet the objections of the EU. However, since such modifications can only be accomplished through legislation adopted by Congress, it is not clear if or when the U.S. agreement to modify the rules will be implemented.

204 of the Agricultural Act of 1956, as amended.[72] These quotas were implemented pursuant to the GATT Arrangement Regarding International Trade in Textiles, commonly referred to as the Multifiber Arrangement (MFA).[73] In 1994 the MFA was superceded by the Uruguay Round Agreement on Textiles and Clothing, which provides, in part, for a ten-year phase out of the quotas established under the MFA.[74]

D. Federal Trade Commission "Made in USA" Guidelines

The U.S. Federal Trade Commission (FTC), pursuant to its general authority under Section 5 of the Federal Trade Commission Act to prohibit unfair or deceptive acts or practices, regulates the labeling of products sold in the U.S. to ensure that such labeling is not inaccurate or otherwise deceptive.[75] The FTC is particularly concerned with labeling indicating that a product is "Made in the USA" or words to similar effect. The FTC requires that, in order to be labeled as "Made in the USA," a good must be completely or almost completely made in the U.S., including all materials and processing.[76] Although the FTC proposed in 1997 to liberalize this standard, pressure from certain domestic interests in the U.S. and from Congress forced the FTC to drop its liberalization proposal and retain the strict standard.

The FTC will permit a product produced from foreign components to be labeled as assembled or processed in the U.S. from imported components provided that the label accurately describes the operations actually performed in the U.S.[77] The FTC will defer to the requirements of the Customs Service regulations in cases where an imported good is required to be marked with the foreign country of origin.[78] Only if, and when, an imported good is substantially transformed by the importer or a subsequent processor of the good will the Customs Service marking rules cease to apply.[79] Unlike the Customs Service country of origin marking rules,

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72. *See* 7 U.S.C.A. § 1854 (1998).

73. *See* Multifiber Arrangement, Formerly the Arrangement Regarding International Trade in Textiles, Dec. 20, 1973, 25 U.S.T. 1001, T.I.A.S. No. 7840.

74. *See* Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Agreement on Textiles and Clothing, Apr. 15, 1994, 33 I.L.M. 1143 (1994) [hereinafter Agreement on Textiles and Clothing].

75. *See* 15 U.S.C.A. § 45 (1998).

76. *See* "Made in USA" and Other U.S. Origin Claims, FTC Enforcement Policy Statement on U.S. Origin Claims, 62 Fed. Reg. 63,756 (1997) [hereinafter "Made in U.S.A."].

77. *See id.* at 63,769-70.

78. *See id.* at 63,770-71.

79. *See id.* at 63,768-69.

the FTC labeling requirements also apply to claims made in advertising and other promotional materials.[80]

VI. HARMONIZATION OF RULES OF ORIGIN IN THE WTO

Among the trade agreements negotiated during the Uruguay Round of Multilateral Trade Negotiations was the Agreement on Rules of Origin (ARO).[81] The ARO establishes general principles relating to rules of origin applicable to nonpreferential commercial policy instruments, such as MFN tariff treatment obligations under Articles I, II, III, XI, and XIII of GATT 1994, anti-dumping and countervailing duties, safeguard measures, country of origin marking requirements, discriminatory quantitative restrictions or tariff quotas, government procurement, and import statistics.[82] The ARO also includes a common declaration of principles on preferential rules of origin, covering free trade agreements and preferential duty programs, which, although less legally binding than the principles on nonpreferential commercial policy instruments, are very similar to those principles.

The principles set out in the ARO with respect to nonpreferential rules of origin require that signatories to the Agreement ensure, *inter alia,* that:

> (a) when they issue administrative determinations of general application, the requirements to be fulfilled are clearly defined . . .;
>
> (b) notwithstanding the measure or instrument of commercial policy to which they are linked, their rules of origin are not used as instruments to pursue trade objectives directly of indirectly;
>
> (c) rules of origin shall not themselves create restrictive, distorting, or disruptive effects on international trade[;]. . . .
>
> (e) their rules of origin are administered in a consistent, uniform, impartial and reasonable manner; . . . .
>
> (j) any administrative action which they take in relation to the determination of origin is reviewable promptly by judicial, arbitral or administrative tribunals or

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80. *See id.* at 63,767-68.

81. *See* Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Agreement on Rules of Origin, Apr. 15, 1994, (1994) *reprinted in* RAJ BHALA, INTERNATIONAL TRADE LAW 253 [hereinafter ARO].

82. *See* LaNasa, *supra* note 1, at 637-40 (setting forth and analyzing the changes implemented as a result of the Uruguay Round).

> procedures, independent of the authority issuing the determination, which can effect modification or reversal of the determination. . . . [83]

The ARO delineates a work program with the objective of harmonizing the nonpreferential rules of origin of member countries. The harmonization is to be based upon specified principles, including that:

> [T]he rules of origin should provide that the country to be determined as the origin of a particular good to be either the country where the good has been wholly obtained or, when more than one country is concerned in the production of the good, the country where the last substantial transformation has been carried out.[84]

The ARO also stipulates that the rules of origin should be "objective, understandable and predictable."[85]

The reference to the last substantial transformation does not imply that the traditional subjective test of that name is to be the end result of the harmonization process. It is clear from the ARO that the harmonized rules of origin are to be based upon objective tests, namely tariff-shift, ad valorem percentages (minimum local value), and manufacturing or processing requirements.

The primary responsibility for undertaking the harmonization effort was delegated to the Technical Committee on Rules of Origin (Technical Committee), which is made up of delegates appointed by any member of the ARO who chooses to participate on the Committee. The harmonization work program is divided into various stages. The initial recommendations of the Technical Committee, which were due to be issued in 1998, have been delayed and will not be completed until 1999. It is not expected that a final set of harmonized rules will be adopted by the ARO member countries until at least the year 2000. The U.S. International Trade Commission (ITC), which has been leading the U.S. government's participation in the work of the Technical Committee, has recently published its schedule for its work on the harmonized rules of origin.[86] The ITC contemplates that a draft of the Harmonized Tariff Schedule proposal for the U.S. will be available for comment April 1,1999, and that the final ITC draft and report will be published February 28, 2000.

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83. ARO, *supra* note 81, at art. 2.

84. *Id.* at art. 9(1)(b).

85. *Id.* at art. 9(1)(c).

86. *See* Simplification of the Harmonized Tariff Schedule of the United States, 63 Fed. Reg. 10,411 (1998) (report of the United States International Trade Commission).

Given the conflict in the U.S. textile marking rules with rules of origin maintained by its trading partners, and given the resistance among certain U.S. industrial sectors to the original Customs Service proposal to adopt objective rules of origin for all purposes in 1994, it is expected that the effort to achieve agreement on harmonized nonpreferential rules of origin under the ARO will be, at the least, controversial. However, it is the view of this author that the U.S. will eventually agree to adopt harmonized nonpreferential rules of origin based upon objective tests similar to those found in the NAFTA rules of origin.

VII. POINTS FOR CONSIDERATION IN PLANNING OFFSHORE OPERATIONS FOR THE PRODUCTION OF GOODS FOR SALE IN THE U.S.

Companies seeking to undertake offshore manufacturing operations for the production of goods to be sold in the U.S. should consider, among other factors, the impact which free trade agreements and preferential duty programs may have on the duty rates applicable to the goods imported for sale in that market. An analysis of the applicable rules of origin assist such companies in structuring the offshore operations in such a way as to minimize the amount of duties imposed upon the imported goods. In conducting such an analysis, several factors should be kept in mind.

While the specific rules of origin will, for the most part, remain constant, the results of the tests based upon minimum local (or regional) value may change over time. Local value tests are based upon cost or values which fluctuate with changes in the price of materials, costs of processing, changes in currency exchange rates, or changes in the raw materials or components used to process the finished goods. The local value tests always involve a ratio or percentage relationship between the value of local inputs and the total value of the finished good. If either value changes more (proportionally) than the other, the results of the test and the eligibility of the product for preferential duty treatment can be altered diametrically. Thus, in situations where the calculated local value is close to the required minimum percentage, changes in costs and values must be monitored closely to ensure that eligibility is maintained.

It is also important to take into consideration changes in the nonpreferential duty rate, i.e., the MFN duty rate, which lessen the economic benefit of qualifying for preferential duty treatment. As with the NAFTA rates, MFN duty rates on a large number of imported products are also being reduced in annual stages by the U.S. and most other WTO member countries. As part of the Uruguay Round of Multilateral Trade Negotiations concluded in 1994, countries agreed to reduce MFN duties on a number of products in staged annual reductions over a

period of five to ten years, in most cases.[87] Initial reductions were implemented January 1, 1995, and final reductions on products subject to a ten-year phase out will be made on January 1, 2004. The duty reductions agreed to are included in each country's schedule of concessions annexed to the Uruguay Round Agreements. Neither the U.S. nor its trading partners agreed to reduce MFN duties on all products. Furthermore, in many cases only a percentage of the previously existing MFN duty will be eliminated after the staged reductions are completed. Nevertheless, decreases in the level of MFN duty rate on an imported product will diminish the benefit of any preferential duty rate on the same product. Thus, in determining the economic benefit which qualification for a preferential duty rate will generate, it is necessary to review the corresponding MFN duty rate on the product to be imported and the amount, if any, by which the MFN rate will be reduced through negotiated duty reductions.

While the rules of origin themselves would normally remain static over time, it is likely that the efforts in the WTO to harmonize rules of origin discussed earlier will result in a change in the rules of origin in the U.S. and in other WTO member countries, at least with respect to nonpreferential programs and commercial policy instruments. The impact of any such changes will be felt most strongly with respect to country of origin marking rules generally and, in the case of textiles, with respect to both country of origin making and the implementation of quotas.[88]

Although free trade agreements such as NAFTA may lead to the elimination of duties on goods traded among member countries, such agreements may also reduce or eliminate the benefits of other duty deferral or reduction programs with respect to trade within that free trade area. Under NAFTA, for example, the use of drawback on goods traded among the NAFTA countries has been significantly restricted. Drawback programs permit the refund of duties paid upon an article imported into one country which is subsequently exported from that country, in identical or processed form. NAFTA also modifies and restricts the application of other duty deferral programs, such as Foreign Trade Zones (including Mexican Maquiladoras), temporary importations under bond, bonded warehouses, and other inward processing programs.

The importation of a pump into Mexico to be incorporated into a washing machine to be sold in the U.S. can serve as an example of the impact of NAFTA upon duty drawback. A pump may be imported into Mexico from Japan subject to

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87. *See generally,* Uruguay Round Agreements Act, Pub. L. No. 103-465, 108 Stat. 4819 (1994) (embodying the U.S.'s commitment to tariff reduction). *See also* Catherine Curtiss & Kathryn C. Atkinson, *United States-Latin American Trade Laws*, 21 N.C. J. INT'L L. & COM. REG. 111, 141 (1995) (discussing the interaction of the Uruguay Round tariff reductions and NAFTA).

88. As indicated *supra,* textile quotas are due to be phased out completely by 2005 under the WTO ATC.

Mexican duties of ten percent. The pump is assembled into a washing machine and exported to the U.S., subject to a NAFTA duty rate of five percent. Normally, Mexico would be entitled to refund the entire ten percent duty paid on the imported pump, once it was processed and exported from that country. However, under NAFTA the total amount of duties which can be refunded under drawback cannot exceed the lesser of either the duty paid on importation into the first NAFTA country (Mexico), or the duty paid when exported to the other NAFTA country (U.S.). Since the lesser amount of duties paid in the present example was the five percent U.S. duty, Mexico can only refund five percent of the ten percent duties paid when the pump was originally imported into Mexico. Thus, under the proposed example a net five percent duty would be paid to Mexico and an additional five percent duty to the U.S., for a total duty of ten percent on the transaction. The net effect of the NAFTA drawback provision is that the total duties paid on products imported into one NAFTA country and subsequently exported to another will equal the amount of duties charged by the country with the highest duty rate. As duties are reduced to zero on goods traded within NAFTA countries, the amount of drawback which will be permitted on goods traded among NAFTA countries will also be reduced to zero.

In structuring manufacturing operations so as to minimize duty implications, consideration may be given to splitting up the manufacturing process into various stages which can be performed in different countries. When considering in which countries such operations are located, consideration should be given to those preferential duty programs which permit the cumulation of local value-added in more than one eligible country. Under GSP (only with respect to specially designated associations of countries), CBI, and ATPA, value-added in more than one designated country may be cumulated in order to satisfy the thirty-five percent minimum local value requirement. In addition, in the case of the CBI and ATPA (but not GSP), up to fifteen percent of that minimum local value may be made up of the value of materials sourced in the U.S. Under NAFTA, materials originating in any of the NAFTA countries (but only those countries) can be included in the value of originating materials for purposes of the RVC test.

Manufacturers which have the option either of outsourcing intermediate components or of producing such components themselves should carefully consider the application of the NAFTA provisions for intermediate materials and accumulation, discussed earlier,[89] in determining the structure of the manufacturing operations used to produce products subject to NAFTA Regional Value Content rules of origin.

Where the application of particular rules of origin are not clear and/or when absolute assurance is required with respect to the application of the NAFTA rules of origin to products produced under specific manufacturing conditions,

89. *See* discussion *supra* notes 45-46, 54-61 and accompanying text.

companies may request rulings from the customs authorities in any of the NAFTA countries.[90] These rulings generally provide clear guidance as to how the rule will be applied to the specific manufacturing operations described in the ruling request. Although the process is time consuming, NAFTA also provides for the reconciliation of conflicting rulings by the Customs Subgroup of the NAFTA Working Group on Rules of Origin.[91]

90. *See* NAFTA, *supra* note 17, at art. 509.
91. *See id.* at art. 513.