

Rules of Origin

Purpose

NAFTA grants benefits to a variety of goods from the NAFTA region. Maximum benefits are reserved for those goods that **originate** in the NAFTA region. The Agreement's rules of origin establish which goods originate, and prevent goods from other countries from obtaining those benefits by merely passing through Canada, Mexico, or the United States. Within the context of NAFTA, the words **origin**, **originate**, or **originating** are used differently than in the context of determining country of origin. It is possible, for instance, for goods not to originate in Canada, Mexico, or the United States, as that term is defined in NAFTA, but still be an article of Canada, Mexico, or the United States for **country - of - origin marking**, statistical, or other purposes.

Article 401 of the Agreement defines **originating** in four ways: goods wholly obtained or produced in the NAFTA region; goods produced in the NAFTA region wholly from originating materials; goods meeting the **Annex 401 origin rule**; and unassembled goods and goods classified with their parts which do not meet the Annex 401 rule of origin but contain 60% **regional value** content using the transaction method (50% using the **net cost method**).

Wholly obtained or produced

Goods wholly obtained or produced entirely in Canada, Mexico, or the United States contain no foreign materials or parts from outside the NAFTA territory. Article 415 defines goods wholly produced in the NAFTA region as:

- mineral goods extracted in Canada, Mexico, or the United States;
 - Silver mined in Mexico is originating because it was extracted in the territory of one of the parties.
- vegetable goods, as such goods are defined in the Harmonized System, harvested in Canada, Mexico, or the United States;
 - Wheat grown in Canada is originating because it is harvested in the territory of one of the parties.
- live animals born and raised in Canada, Mexico, or the United States;
- goods obtained from hunting, trapping, or fishing in Canada, Mexico, or the United States;
- goods (fish, shellfish, and other marine life) taken from the sea by vessels registered or recorded with Canada, Mexico, or the United States and flying that country's flag;
- goods produced on board factory ships from the goods referred to in subparagraph e), as long as such factory ships are registered or recorded with that country and fly that country's flag;
- goods taken by Canada, Mexico, or the United States, or a person of these countries, from the seabed or beneath the seabed outside territorial waters, as long as Canada, Mexico, or the United States has rights to exploit that seabed;
- goods taken from outer space, as long as they are obtained by Canada, Mexico, or the United States, or a person of these countries, and not processed in a non-NAFTA country;
- waste and scrap derived from:
 - production in Canada, Mexico, or the United States; or
 - used goods collected in Canada, Mexico, or the United States, as long as such goods are fit only for the recovery of raw materials; and
 - Copper recovered in Canada from scrap telephone or electrical wires is wholly obtained or produced in Canada, regardless of where the wire was originally produced.
- goods produced in Canada, Mexico, or the United States exclusively from goods referred to in subparagraphs a) through i), or from their derivatives, at any stage of production.
 - Silver jewelry made in the United States from silver mined in Mexico is wholly obtained or produced in the NAFTA territory because it is made exclusively of a mineral good extracted in Mexico.

Meets Annex 401 origin criterion

Article 401(b) indicates that goods can **originate** in Canada, Mexico, or the United States, even if they contain non-originating materials, as long as the materials satisfy the rules of origin specified in Annex 401 of the Agreement.

The Annex 401 rules of origin are commonly called **specific rules of origin**, and are based on a change in tariff classification, a regional value content requirement, or both. Since Annex 401 is organized by Harmonized Tariff Schedule (HTS) number, one has to know the HTS number of a good to find its specific rule of origin. Annex 401 gives the applicable rule of origin opposite the HTS number.

Tariff change.

When a rule of origin is based on a change in tariff classification, each of the non-originating materials used in producing the goods must undergo the applicable change because of production occurring entirely in Canada, Mexico, or the United States. This means that the non-originating materials are classified under one tariff provision before processing, and classified under another once processing is complete. The specific rule of origin in Annex 401 defines exactly what change in tariff classification must occur for the goods to be considered **originating**.

Example

Frozen pork meat (HTS 02.03) is imported into the United States from Hungary, and is combined with spices imported from the Caribbean (HTS 09.07-09.10) and cereals grown and produced in the U.S. to make fresh pork sausage (HTS 16.01). The Annex 401 rule of origin for HTS 16.01 states: A change to heading 16.01 through 16.05 from any other chapter. Since the imported frozen meat is classified in Chapter 2 and the spices are classified in Chapter 9, these non-originating materials meet the required tariff change. One does not consider whether the cereal meets the applicable tariff change, since it is originating - only **non-originating** materials have to undergo the tariff change.

Regional value content.

Some Annex 401 specific rules of origin say that a good has to have a minimum regional value content, which means that a certain percentage of the value of the goods must be from North America. Article 402 gives two formulas for calculating the regional value content. Usually, the exporter or producer can choose between these two formulas: the **transaction value method**, or the **net cost method**.

Having two methods gives producers more than one way to demonstrate that the rule of origin has been satisfied. The transaction value method is generally simpler to use, but a producer can choose whichever method is most advantageous.

The **transaction value method** calculates the value of the non-originating materials as a percentage of the GATT transaction value of the good, which is the total price paid for the good, with certain adjustments for packing and other items, and is loosely based on principles of the GATT Customs Valuation Code. The essence of this method is that the value of non-originating materials can be calculated as a percentage of the invoice price, which is usually the price actually paid for them. Because the transaction value method permits the producer to count all of its costs and profit as territorial, the required percentage of regional value content under this method is higher than under the net cost method.

However, there are a number of situations where the exporter or producer cannot use the transaction value method, and the net cost method is the only alternative. The net cost method must be used when there is no transaction value, for some related-party transactions, for certain motor vehicles and parts, when a producer is accumulating regional value content (**see page 14 for a discussion of accumulation**), and when determining the regional value content for designated **intermediate materials (see page 10)**. The producer can also revert to the net cost method if using the transaction value method is unfavourable.

The formula for calculating the regional value content using the transaction value method is:

$$RVC = \frac{TV - VNM}{TV} \text{ multiplied by } 100$$

where

RVC = is the regional value content, expressed as a percentage;

TV = is the transaction value of the good adjusted to a free-on-board (F.O.B.) basis; and

VNM = is the value of non-originating materials used by the producer in the production of the good.

The **net cost method** calculates the regional value content as a percentage of the net cost to produce the good. Net cost represents the costs incurred by the producer minus expenses for sales promotion (including marketing and after-sales service), royalties, shipping and packing costs, and non-allowable interest costs. The percentage content required for the net cost method is lower than the percentage content required for the transaction value method, since certain costs are excluded from the net cost calculation.

The formula for calculating the regional value content using the net cost method is:

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

where

RVC = is the regional value content, expressed as a percentage;

NC = is the net cost of the good; and

VNM = is the value of non-originating materials used by the producer in the production of the good.

Example

An electric hair curling iron (HTS 8516.32) is made in Mexico from Japanese hair curler parts (HTS 8516.90). Each hair curling iron is sold for US\$4.00; the value of the non-originating hair curler parts is US\$1.80. The Annex 401 rule of origin for HTS 8516.32 states:

- A change to subheading 8516.32 from subheading 8516.80 or any other heading; or
- A change to subheading 8516.32 from subheading 8516.90, whether or not there is also a change from subheading 8516.80 or any other heading, provided there is a regional value content of not less than:
 - 60%, where the transaction value method is used; or
 - 50%, where the net cost method is used.

The first of these two rules is not met, since there is no heading change. Therefore, the producer must verify whether the curling irons can qualify under the second rule. In the second rule, since the required subheading change is met (from 8516.90 to 8516.32), one proceeds to calculate the regional value content. The regional value content under the transaction value method is:

$(4.00 - 1.80) \div 4.00 \times 100 = 55\%$

The hair curler is not considered an originating good under this method, since the required regional value content is 60% when the transaction value is used.

Instead, the producer uses the net cost method. The total cost of the hair curler is US\$3.90, which includes US\$0.25 for shipping and packing costs. There are no costs for royalties, sales promotion, or non-allowable interest. The net cost is therefore US\$3.65. The regional value content under the net cost method is:

$(3.65 - 1.80) \div 3.65 \times 100 = 50.1\%$

The hair curler would be considered originating, since the required regional value content is 50% when the net cost method is used.

Produced in the NAFTA territory wholly of originating materials

Goods also originate if they are produced entirely in Canada, Mexico, or the United States exclusively from materials that are considered to be originating because they meet the specific **rules of origin in Annex 401**.

Example

Company A imports whole raw bovine skins (41.01) into Mexico from Argentina and processes them into finished leather (41.04). The finished leather is then purchased by Company B to make leather eyeglass cases (4202.31). The rule of origin for 41.04 states: A change to heading 41.04 from any other heading, except from heading 41.05 through 41.11.

The finished leather originates in Mexico, because it meets the Annex 401 criterion. Assuming the eyeglass cases do not contain any non-originating materials, they originate since they are made wholly of a material that is originating (because it satisfied the Annex 401 criterion).

Unassembled goods and goods classified with their parts

In some cases, a good that has not undergone the required tariff change can still qualify for preferential NAFTA treatment if a regional value content requirement is met. This NAFTA provision can only be used under two very specific circumstances. However, it can never be used for wearing apparel provided for in Chapters 61 and 62, and textile articles of Chapter 63 of the Harmonized System. The two circumstances where the provision can be used are when goods do not undergo the **tariff change required by Annex 401** because:

- the goods are imported into Canada, Mexico, or the United States in an unassembled or a disassembled form, but are classified as assembled goods pursuant to the General Rule of Interpretation 2(a) of the Harmonized System; or
- the goods are produced using materials imported into a NAFTA country that are provided for as parts according to the Harmonized System, and those parts are classified in the same subheading or undivided heading as the finished goods.

Other Instances to Confer Origin

The four main criteria set out in **Chapter 2** of this publication are the basic conditions to confer origin. However, a good that does not meet these requirements may, in some cases, qualify as originating by using the additional options described below.

Intermediate materials

For the purpose of calculating the **regional value content** of final goods (using either the **transaction value method** or the **net cost method**), article 402(10) allows a producer to designate as an intermediate material any self-produced, originating material used in the production of the final goods. As long as the intermediate material qualifies as an originating material, its entire value can be treated as originating to determine the regional value content of the finished goods.

The purpose of the intermediate material designation is to treat vertically integrated manufacturers in as close to the same way as producers who purchase materials from independent suppliers are treated. If you produce your own materials from non-NAFTA inputs, the intermediate-materials provision may help your goods to originate. This provision covers all goods and materials except:

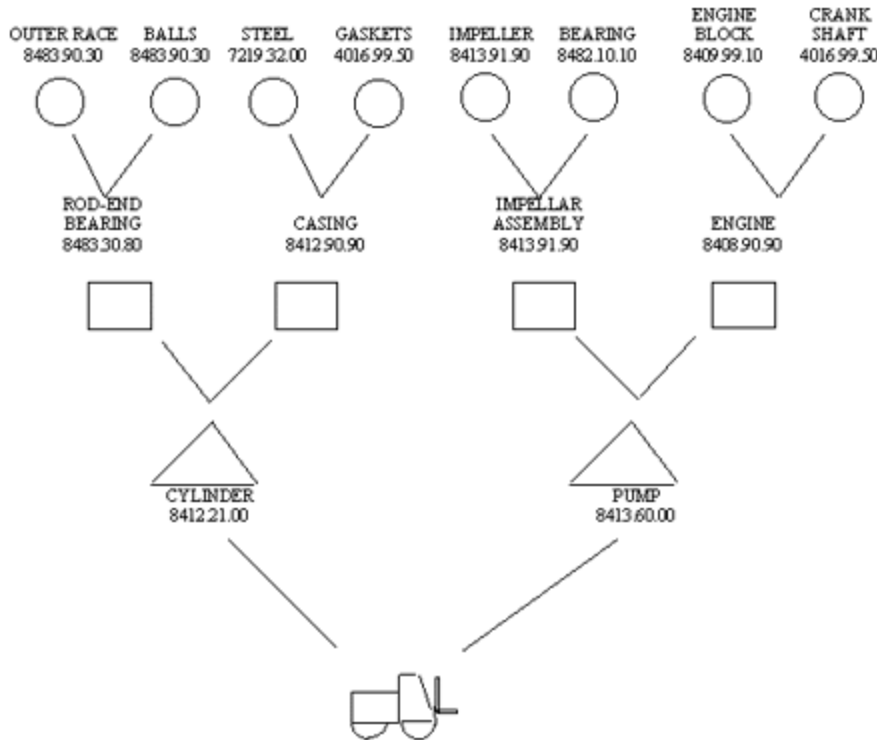
- automotive goods defined in article 403(1) and described in Annex 403.1; and
- components described in Annex 403.2, specifically engines and gearboxes.

An intermediate material is a self-produced material, designated by the producer, that meets the **rules of origin of Annex 401** and that is incorporated into the final good. Article 415 defines a self-produced material as a material produced by the same party that produced the final goods, and which is used in the production of those final goods.

An intermediate material may be composed of originating and non-originating submaterials. After determining that an intermediate material satisfies the applicable rule of origin under article 401, the total cost to produce that intermediate material is treated as an originating cost. In other words, the producer does not include the value of the non-originating materials used to produce the intermediate material as part of the value of non-originating materials in the final goods. The benefit of designating an intermediate material is that producers can treat self-produced materials close to the same way they treat an originating material purchased at arm's length for the purposes of determining the value of the non-originating materials of the final goods.

If the Annex 401 rule of origin for the material requires a minimum regional value content, the net cost method must be used to calculate that regional value content. A producer can make any number of intermediate material designations, as long as no material subject to a regional value content requirement can be designated as an intermediate material, if it contains submaterials also subject to a regional value content requirement that were also designated as intermediate materials.

Example



Company Z manufactures forklift trucks in Canada and makes some of the materials used in their production. As illustrated in the graphic on page 11, each geometric symbol represents a material used in the production of the forklift truck. The circles (i.e., outer races, balls, steel, gaskets, impellers, bearings, engine blocks, crank shafts) are materials acquired from sellers in non-NAFTA countries. The squares (i.e., rod-end bearings, casings, impeller assemblies, engines) are self-produced materials. They are considered horizontal materials in relation to each other. The impeller assemblies cannot be designated as intermediate materials because they do not meet the Annex 401 rule of origin ("a change to subheading 8413.91 from any other heading"). However, the rod-end bearings, casings, and engines could all be designated intermediate materials, as long as they satisfy the applicable Annex 401 rules of origin. (The casings undoubtedly meet the rule of origin, which provides for "a change to subheading 8412.90 from any other heading." The engines and rod-end bearings meet the required tariff change prescribed in the Annex 401 rules of origin, but would also have to meet a regional value content requirement to qualify as originating.) We assume that the regional value content is met throughout this example. The rod-end bearings and casings are used in the production of the cylinders. Likewise, the impeller assemblies and engines are used in the production of the pumps that drive the hydraulic mechanisms of the forklifts. The cylinders and pumps (represented by triangles) are intermediate materials that are horizontal in relation to each other, and vertical in relation to the materials from which they were made. As long as there is no regional value content requirement for more than one intermediate material in the vertical stream, each new material can be designated as an intermediate material. The cylinder qualifies as originating under article 401(c) because it is made in Canada exclusively from originating materials. Here, however, both the engine and the pump are subject to regional value content requirements.

Thus, Company Z can choose to designate the engine **or** the pump as an intermediate material, **but not both**. Therefore, Company Z must choose which is most advantageous: to designate the engines as an intermediate material, or to designate the pump. The forklift truck will then qualify as an originating good.

When a single producer designates intermediate materials that qualify as originating solely based on a tariff change (i.e., without having to satisfy a regional value content requirement), subsequent designations can be made with previously designated intermediate materials. Therefore, in the example above, if the engine had not been subject to a regional value content requirement, both it and the pump could have been designated as intermediate materials.

There are two ways to determine the value of an intermediate material:

- the total cost incurred with respect to all goods produced that can be reasonably allocated to that intermediate material; or
- the aggregate of each cost that forms part of the total cost incurred with respect to that intermediate material that can be reasonably allocated to that intermediate material.

The two methods allow producers to select the one that best fits their production and accounting practices. The value of the intermediate material should be about the same using either method.

However, the net cost method must be used for intermediate materials subject to a regional value content requirement. Article 402(8) of the Agreement lists those costs that cannot be included when calculating the regional value content of the intermediate material using the net cost method:

- sales promotion, including marketing and after-sales service costs;
- royalties;
- shipping and packing costs; and
- non-allowable interest costs.

Although these costs are excluded in the net cost calculation, they do form part of the total cost of the material. Accordingly, costs such as royalties are excluded when calculating the net cost for purposes of determining whether the material satisfies a regional value content requirement (and thus originates and can be designated an intermediate material), but are included in the total value of the material once its origin has been determined. As noted above, the total value of an intermediate material can be counted as an originating cost.

Accumulation

When producers determine the regional value content of goods, the entire value of the materials used in the production of the goods that they acquire from suppliers is considered as wholly originating or wholly non-originating, as appropriate. The accumulation provision allows the producer or exporter of goods to choose to include as part of the goods' regional value content any regional value added by suppliers of non-originating materials used to produce the final goods. Thus, accumulation allows the producer to reduce the value of the non-originating materials used in the production of the good, by taking into account the NAFTA inputs incorporated into those materials.

Therefore, when producers find they are unable to satisfy a regional value content requirement based on: (i) their own processing costs and

(ii) the value of originating materials they use to produce a good, accumulation allows them to include (iii) any regional value added in the NAFTA territory by other persons who produced non-originating materials that were later incorporated into the final good.

The conditions for using accumulation are:

- producers/exporters who choose to use accumulation must use the net cost method to calculate any regional value content;
- producers/exporters of goods must obtain information on the regional value content of non-originating materials used to make their goods from the producers (suppliers) of those materials. It will not be obtained by government authorities;

- all non-originating materials used in the production of the goods must undergo the tariff classification change set out in Annex 401 of the Agreement, and the goods must satisfy any applicable regional value content requirement, entirely in the territory of one or more of the NAFTA countries; and
- the goods must satisfy all other applicable requirements of the rules of origin.

Example

Company A imports unfinished bearing rings (HTS 8482.99) into Canada from Japan and further processes them into finished rings (HTS 8482.99.11 in Canada). Since the finished bearing rings contain non-originating materials, they must satisfy the Annex 401 origin criterion to be considered originating. The Annex 401 origin criterion for HTS 8482.99 is: A change to subheading 8482.91 through 8482.99 from any other heading.

Since the unfinished bearing rings are classified in the same tariff subheading as the finished rings, there is no change in headings. Accordingly, the finished bearing rings cannot be considered originating, even though they contain some regional value content by virtue of the labour and other costs associated with the finishing operations.

Company A's per-unit cost is:

\$0.75 Non-originating materials
 \$0.15 Originating materials
 \$0.35 Labour
 \$0.05 Overhead

 \$1.30 Total cost

Subsequently, Company A sells the finished rings (HTS 8482.99.11 in Canada) for \$1.45 to Company B in the United States, who incorporates the rings into ball bearings (HTS 8482.10). Company B exports the bearings to Mexico and wants to claim NAFTA preferential treatment. The rules of origin for HTS 8482.10 are:

- A change to subheading 8482.10 through 8482.80 from any subheading outside that group, except from Canadian tariff item 8482.99.11 or 8482.99.91, U.S. tariff item 8482.99.05, 8482.99.15 or 8482.99.25 or Mexican tariff item 8482.99.01 or 8482.99.03; or
- A change to subheading 8482.10 through 8482.80 from Canadian tariff item 8482.99.11 or 8482.99.91, U.S. tariff item 8482.99.05, 8482.99.15 or 8482.99.25 or Mexican tariff item 8482.99.01 or 8482.99.03, whether or not there is also a change from any subheading outside that group, provided there is a regional value content of not less than:
 - 60%, where the transaction value method is used; or
 - 50%, where the net cost method is used.

The bearings do not meet the tariff change described in the first rule. They do, however, meet the tariff change described in the second rule and, as long as they satisfy one of the two regional value content requirements, can be considered originating. Since Company B knows it is short in meeting the regional value content under either method, it decides to accumulate its regional value content with that of Company A. Assuming Company A sold the rings to Company B for \$1.45 per unit, and A is willing to disclose to B the regional value content in the finished rings that it sold to B, the following demonstrates accumulation:

Without accumulation

\$1.45 Non-originating ring (A)
 \$0.45 Originating material (B)
 \$0.75 Labour (B)
 \$0.05 Overhead (B)

 \$2.70 Total

With accumulation

\$0.75 Non-regional value content of ring (A)
\$0.55 Regional value content of ring (A)
\$0.45 Originating material (B)
\$0.75 Labour (B)
\$0.05 Overhead (B)

----- \$2.55 Total

The \$0.75 represents the value of the non-originating materials, which in this case are the unfinished bearing rings imported into the United States from Japan.
The regional value content, using the net cost method, is:

$RVC = NC - VNM \text{ divided by } NC \text{ multiplied by } 100$

RVC = regional value content

NC = net cost

VNM = value of non-originating materials

Accordingly, the regional value content calculation, with and without accumulation, is:

Without accumulation - $\$2.70 - \$1.45 \text{ divided by } \$2.70 \text{ multiplied by } 100 \text{ equals } 46\%$

With accumulation - $\$2.55 - \$0.75 \text{ divided by } \$2.55 \text{ multiplied by } 100 \text{ equals } 71\%$

Therefore, accumulation allows Company B to qualify the bearings as originating by aggregating the regional value content of both Company A and Company B.

De minimis

Although requiring a change in tariff classification is a very simple principle, it requires that **all** non-originating materials undergo the required change. A very low percentage of materials cannot undergo the tariff change, thus preventing the goods from originating. Therefore, the Agreement contains a *de minimis* provision that allows goods to qualify as originating, as long as such materials are not more than a certain percentage (7% in most cases) of the transaction value of the goods adjusted to a free-on-board (F.O.B.) basis or, in some cases, of the total cost of the goods.

However, if the goods must meet a regional value content requirement to qualify as originating, the value of such non-originating materials must be taken into account in calculating the **regional value content**.

Where the rule of origin contains a requirement for a minimum regional value content, the calculation of that content is waived if the value of **all** non-originating materials used in the production of the goods is not more than the specified *de minimis* amount.

Example

A manufacturer purchases inexpensive textile watch straps made in Taiwan (HTS 91.13), to be assembled with originating mechanical watch movements (HTS 91.08) and originating cases (HTS 91.12). The value of the straps is less than 7% of the transaction value of the final watch (HTS 91.02) adjusted to a F.O.B. basis.

The Annex 401 origin criterion for 91.02 is:

- A change to heading 91.01 through 91.07 from any other chapter; or
- A change to heading 91.01 through 91.07 from 91.14, whether or not there is also a change from any other chapter, provided there is a regional value content of not less than:
 - 60%, where the transaction value method is used; or
 - 50%, where the net cost method is used.

Only non-originating materials need to undergo the required tariff classification change: in this case, the textile straps. The straps do not satisfy either of the indicated tariff changes, but since their value is less than 7% of the transaction value of the finished watch adjusted to an F.O.B. basis, the *de minimis* rule applies and the watches can be considered originating.

Textiles.

For textile goods classified in Chapters 50 through 63 of the Harmonized System, the *de minimis* rule is applied by weight (instead of value) to the component of the good that determines its tariff classification, as determined according to the General Rules of Interpretation of the Harmonized System.

Example

A Mexican manufacturer produces women's shirts which have knit bodies and woven sleeves. The composition of the knit bodies is 60% cotton, 35% wool, and 5% rayon, by weight. The sleeves are made of Japanese fabric that is 100% polyester. Since the knit bodies give the garments their essential character, the shirts are classified under HTS 6106.10. The Annex 401 rule of origin criterion for 6106.10 is **yarn forward (see Chapter 5 of this publication)**. Assuming the cotton and wool portions of the bodies meet the yarn-forward rule, the garment can still be considered originating even if the rayon yarn was from China, since it falls under the *de minimis* provision. The sleeves are ignored in determining whether the shirts originate, because **only the component that determines the tariff classification** of the goods is considered when applying the *de minimis* provision.

Agricultural products.

The article 405 *de minimis* rule does not apply to agricultural goods provided for in Chapters 1 through 27 of the Harmonized System, unless the non-originating materials are classified in subheadings different from the subheadings in which the finished goods are classified.

Example

Ground coffee, sold in retail packages, is produced in Mexico (HTS 0901.21). Most of the beans are grown and roasted in Mexico but, to give the coffee a unique flavor, the producer adds some roasted beans from Kenya (HTS 0090.21). The value of the beans from Kenya is 5% of the transaction value, adjusted to an F.O.B. basis, of each retail package. The Annex 401 origin criterion for HTS 09.01 is:

- A change to heading 09.01 through 09.10 from any other chapter.

The coffee cannot be considered originating because the Kenya beans do not undergo the required tariff change. The *de minimis* rule does not apply because the Kenyan beans are classified in the same subheading as the final good. **Note**

If green (unroasted) coffee were imported from Kenya and roasted in Mexico, the *de minimis* rule would apply, because green coffee beans are classified in HTS 0901.11, a different subheading. Thus, the ground coffee in retail packages could be considered originating.

Cigars, cheroots, cigarillos, and cigarettes.

The *de minimis* amount for these products is 9%, not 7%, of the transaction value adjusted to an F.O.B. basis.

Excluded products.

The article 405 *de minimis* rule does not apply to the following materials:

- certain dairy products and preparations that are used in the production of goods provided for in Chapter 4 of the HTS;

- goods provided for in Chapter 4 of the HTS and some dairy preparations that are used in the production of certain goods containing milk, milk solids, or butterfat;
- some fruits and juices used in the production of certain juices and juice concentrates;
- coffee beans used in the production of unflavoured instant coffee (note: the Annex 401 origin criterion for unflavoured, instant coffee allows up to 60% non-originating coffee, so substantial allowance is already made for non-originating inputs);
- fats, lards, oils, and related products provided for in Chapter 15 of the HTS that are used in the production of Chapter 15 goods (except olive, palm, and coconut oils, where the *de minimis* rule does apply);
- cane and beet sugar used in the production of sugars, syrups, and other products provided for in HTS headings 1701-1703;
- sugar, molasses, sugar confectionery, and other goods provided for in Chapter 17 of the HTS, and cocoa powder provided for in HTS 18.05, that are used in the production of chocolate and other food preparations containing cocoa;
- beer, wine, and other fermented beverages provided for in HTS headings 22.03-22.08 used in the production of alcoholic beverages and related products provided for in HTS headings 22.07 and 22.08;
- any non-originating material used in the production of many major appliances such as refrigerators, freezers, air conditioners, stoves, ranges, trash compactors, clothes-dryers, and washing machines; and
- printed circuit assemblies used in the production of a good, if the change in tariff classification prescribed by Annex 401 for that good places restrictions on their use.

Fungible goods and materials

According to article 415 of NAFTA, fungible goods are goods that are interchangeable for commercial purposes, and have essentially identical properties. When a producer mixes originating and non-originating fungible goods, so that physical identification of originating goods is impossible, the producer may determine origin of those goods based on any of the standard inventory accounting methods (e.g., FIFO, LIFO) specified in the Uniform Regulations. These provisions apply equally to fungible materials that are used in the production of a good.

Example

Company Y of Mexico supplies clips to airplane manufacturers throughout North America. Some of the clips Y supplies originate in Mexico, and others are made in China. All of the clips are of identical construction and are intermingled at Y's warehouse so that they are indistinguishable. On January 1, Company Y buys 3,000 clips of Mexican origin; on January 3, it buys 1,000 clips of Chinese origin. If Company Y elects FIFO inventory procedures, the first 3,000 clips it uses to fill an order are considered Mexican, regardless of their actual origin.

Other Provisions Relating to Origin

Accessories, spare parts, and tools

Accessories, spare parts, and tools that are delivered with the goods and that form part of the goods' standard accessories, spare parts, or tools, are considered originating if the goods originate, and are disregarded in determining whether all the non-originating materials undergo any **Annex 401 tariff change**. This provision applies as long as the accessories, spare parts, and tools are invoiced with the goods and the quantities and value are customary for the goods. However, if the goods are subject to a regional value content requirement, the value of the accessories, spare parts, and tools will be taken into account as originating or non-originating materials, whatever the case may be, in calculating the regional value content of the goods.

Example

A pump originating in Canada is sold with rubber suction and discharge hoses made in Taiwan. The hoses from Taiwan are invoiced and packed with the pump, and are customarily sold with pumps of this kind. Since the pump originates, the rubber hoses are considered originating for the purposes of satisfying the required change in tariff classification. Their value, however, has to be counted as non-originating materials in any regional value content calculation.

Packaging for retail sale

In NAFTA, packaging and packing are used in different contexts. Packaging is used when referring to retail sale, while packing is for shipping purposes. Packaging materials and containers in which goods are packaged for retail sale, if classified with the goods, are disregarded when determining whether all the non-originating materials used in the production of the goods undergo the applicable change in tariff classification set out in Annex 401. However, if the goods are subject to a regional value content requirement, the value of the retail packaging materials and containers is taken into account as originating or non-originating materials, whatever the case may be, when calculating the **regional value content** of the goods.

Example

Leather footwear (HTS 64.03) is made in Mexico. The shoes are wrapped in tissue paper and packed in cardboard boxes described with the brand logo for retail sale; both the tissue paper and the cardboard box are of Brazilian origin. The Annex 401 origin criterion for 64.03 is:

- A change to heading 64.01 through 64.05 from any heading outside that group, except from subheading 6406.10, provided there is a regional value content of not less than 55% under the net cost method.

Although the tissue paper and cardboard box are disregarded for the purposes of the tariff change, their value must be counted as non-originating when calculating the regional value content.

Packing for shipment

Packing materials and containers in which goods are packed for shipment are disregarded when determining whether the non-originating materials used in the production of the goods undergo an applicable change in tariff classification set out in Annex 401. They are also disregarded when determining whether the goods satisfy a **regional value content** requirement.

Example

Company X makes chairs (HS 9401.69) in Mexico from Swedish furniture parts (HS 9401.90). Company Y of Canada buys chairs from Company X for C\$10.90. This price includes C\$0.90 for Guatemalan crates used to hold each chair during international transit. The Annex 401 criterion for HTS 9401.69 is:

- A change to subheading 9401.10 through 9401.80 from any other chapter; or
- A change to subheading 9401.10 through 9401.80 from subheading 9401.90, whether or not there is also a change from any other chapter, provided there is a regional value content of not less than:
 - 60%, where the transaction value method is used; or
 - 50%, where the net cost method is used.

The value of the Swedish parts is C\$4.10. Under the transaction value method, the regional value content is:

10.00 - 4.10 divided by 10.00 multiplied by 100 equals 59%

The chair does not originate because it does not meet the minimum regional value content of 60%. Note that the packing and shipping costs (\$0.90) were deducted from the transaction value before calculating the regional value content.

Transshipment

Goods that qualify as originating will lose that status if they later undergo any operation outside the NAFTA region, other than unloading, reloading, or any other operation necessary to preserve them in good condition or to transport the goods to Canada, Mexico, or the United States.

Example

Surgical instruments made in the United States (wholly of originating materials) and cotton gowns and bandages made in Mexico (from fibres and fabric wholly grown and produced in Mexico) are sent to the Dominican Republic, where they are packaged together and then sterilized for use in operating rooms. On their return to the United States, the medical sets are not eligible for preferential treatment under the NAFTA, because they underwent operations in the Dominican Republic that were not necessary to preserve the goods in good condition, or to transport them to the United States.

Operations that do not confer origin

Article 412 provides that goods will not be considered to originate if they are merely diluted with water or another substance that does not materially alter the characteristics of the goods. Thus, mere dilution—even if it results in a change in tariff classification—is not sufficient to confer origin. However, dilution coupled with another process may be sufficient to materially alter the characteristic of the goods and thereby confer origin.

Article 412 also indicates that goods will not be considered to originate if most of the evidence establishes that any production or pricing practice has been used to circumvent the intent of the Chapter 4 origin rules. The rules of origin are designed to ensure that the processing and costs incurred for the products are commercially significant and appropriate to the goods, as defined by the tariff change rules and, when applicable, the value content rules.

Provisions for Specific Sectors

Textiles

Rules of origin.

NAFTA provisions on trade in textiles and apparel are particularly detailed. The Annex 401 origin criteria aim to ensure that most of the production relating to textiles and apparel occurs in North America.

The basic origin rule for textile and apparel articles is **yarn forward**. This means that the yarn used to form the fabric (which may later be used to produce wearing apparel or other textile articles) must originate in a NAFTA country. Thus, a wool shirt made in Canada from fabric woven in Canada of wool yarn produced in Argentina is not considered originating, since the yarn does not originate within a NAFTA country. If, however, Argentine wool fibre was imported into Canada and spun into wool yarn, and was then used to produce the wool fabric, the shirt is considered originating.

Less demanding rules of origin govern certain knitted underwear, brassieres, and shirts made from fabric in short supply in North America, and textile and apparel articles made from fabric not commonly produced in North America. For example, silk and linen apparel articles follow a single-transformation instead of a yarn-forward rule. Thus, silk blouses are considered originating even if they are made from

non-originating fabric, as long as the fabric is cut and sewn in one or more NAFTA countries. These exceptions give producers flexibility to import materials not widely produced in North America. On the other hand, stricter rules of origin exist for certain textile and apparel articles made of fibres that are produced in abundance in Canada, Mexico, and the United States. For example, cotton yarn and cotton-knitted fabrics follow a **fibre-forward** rule for goods traded between the three countries, while man-made fibre sweaters follow a fibre-forward rule for trade between the United States and Mexico.

Tariff preference levels (TPLs).

To allow flexibility, textile and apparel exports will have access to tariff preference levels (TPLs). This means that specified quantities of certain fibres, yarns, and fabrics that do not meet the article 401 origin criteria, but which are subject to significant processing in one or more NAFTA countries, can still be eligible for preferential NAFTA rates. Amounts of these goods exceeding the tariff preference level will be subject to **most-favoured-nation (MFN)** rates of duty. Apparel goods made from non-originating fabric that is cut and sewn in North America may be eligible for TPLs.