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A Preliminary Review of the Operation and Effect of the NAFTA Rules of Origin

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A PRELIMINARY REVIEW OF THE OPERATION AND EFFECT OF THE NAFTA RULES OF ORIGIN

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Traditionally the preserve of back-room boffins in Customs Departments, rules of origin have never played much of a role in the cut and thrust of international trade policy.[1]

INTRODUCTION

On August 12, 1992, the United States, Canada, and Mexico[2] announced the conclusion of the negotiations to establish a North American Free Trade Agreement ("NAFTA").[3] NAFTA was credited as creating the single largest market in the world, and hailed as the vehicle for a new prosperity for North American countries.[4]

From the outset of the NAFTA negotiations,[5] considerable attention was focused on the rules of origin negotiations. Much of this attention was due to concerns that NAFTA would create incentives that would turn Mexico into an "export platform," whereby goods produced in

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1. Peter Montagnon, *Rules of Origin Weave a Very Tangled Web*, FIN. TIMES, Nov. 22, 1989, at 7.

2. Hereinafter, the United States, Canada, and Mexico are jointly referred to as "parties," and singularly as a "party," when referred to in the context of their participation as a NAFTA country. Non-NAFTA countries are jointly referred to as "third-countries," and singularly as "third-country."

3. Oct. 7, 1992 draft, U.S.-Can.-Mex. [hereinafter NAFTA]. President Bush officially notified Congress on September 18, 1992, of his intention to enter into NAFTA, a procedure required under section 1103(a)(1)(A) of the Omnibus Trade and Competitiveness Act of 1988, to initiate the final stages of the fast track process. *See Intention To Enter a North American Free Trade Agreement With Canada and Mexico*, Proclamation No. 183, 57 Fed. Reg. 43,603 (1992).

4. NAFTA reportedly created a market with over 360 million consumers and $6.4 trillion in annual output. *The North American Free Trade Agreement: Official Notification of Congress, Fact Sheet*, White House Press Release, Sept. 18, 1992.

5. On June 10, 1990, President George Bush and President Carlos Salinas de Gotari announced that the United States and Mexico intended to enter into negotiations to establish a free trade agreement. USTR Joint Statement, June 10, 1990. On February 5, 1991, the United States, Canada, and Mexico jointly announced that Canada would enter into negotiations with the United States and Mexico to establish a North American Free Trade Agreement. USTR Press Release, February 5, 1991; *see U.S., Canada and Mexico to Negotiate A North American Free-Trade Pact*, WALL ST. J., Feb. 6, 1991, at 8. The NAFTA negotiations were formally launched on June 12, 1991. *U.S., Canada and Mexico Begin Free Trade Talks*, N.Y. TIMES, June 13, 1991, at D-8.

third-countries would qualify for NAFTA preferential duties as a result of undergoing assembly or minor production in Mexico.[6]

But the rule of origin negotiations implicated more than just the "export platform" issue. The negotiations presented an opportunity to improve existing rules of origin, such as those established under the U.S.-Canada Free Trade Agreement ("FTA"),[7] and the establishment of adequate rules for sectors of particular importance to North America, such as the automotive and textile sectors.

This paper reviews the NAFTA rules of origin in two parts. Part I provides a general overview of United States rules of origin and of some of the policy objectives involved in the establishment of the NAFTA rules of origin. Part II reviews the NAFTA rules of origin,[8] and provides comparisons between some of the NAFTA provisions and the FTA rules of origin. In addition, part II discusses the role of the NAFTA rules as a model for other trade agreements.

PART ONE

I. OVERVIEW OF RULES OF ORIGIN

A. What Are Rules of Origin

Generally, rules of origin are measures, i.e., laws, regulations, or administrative procedures and practices, that are used to ascribe nationality to goods (or services) in international commerce.[9] As reviewed in this part, because there are numerous reasons why nationality must be ascribed to goods, there are many different types of rules of origin.

B. Historical Overview

Until the end of the nineteenth century, there was little need to establish the country of origin of goods. Goods generally were wholly produced

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6. *President's United States-Mexico Free Trade Letter: Hearing Before the Senate Committee on Finance*, 102nd Cong., 1st Sess. 32 (1991) (statement of Carla A. Hills, United States Trade Representative); *see U.S. Canada, Mexico Begin Free Trade Talks, Disparities Expected to Complicate Efforts*, WASH. POST, June 13, 1991, at A40.

7. Jan. 2, 1988, U.S.-Can., *reprinted in* BASIC DOCUMENTS OF INTERNATIONAL ECONOMIC LAW 353 (Stephen Zamora & Ronald A. Brand eds., 1990) [hereinafter FTA].

8. The rules of origin reviewed in this article are those contained in the Oct. 7, 1992, draft text of NAFTA.

9. Only one statute, the government procurement statute, provides a definition for "rules of origin":

> An article is a product of a country or instrumentality only if (i) it is wholly the growth, product, or manufacture of that country or instrumentality, or (ii) in the case of an article which consists in whole or in part of materials from another country or instrumentality, it has been substantially transformed into a new and different article of commerce with a name, character, or use distinct from that of the article or articles from which it was transformed.

19 U.S.C. § 2518(4)(b) (1989).

in one country, so determining their nationality was neither difficult nor complex and there was little need for elaborate rules of origin. This trend was changed by three factors: (1) towards the turn of this century, goods increasingly underwent production processes in more than one country, or they were produced in one country from parts and components originating from different countries, or both; (2) the United States increasingly sought as a policy to undertake measures to advance the competitiveness of U.S.-produced goods against imported goods; and (3) beginning in the mid-1970s the United States entered into various trade agreements, the objective of which was to provide preferential tariff treatment to imports from designated countries as a means to achieve certain foreign economic policy.

1. The Advent of Multinational Production and Enhancing the Competitiveness of U.S. Products

During the late 1880s, Congress addressed rising concerns that cheap imports, and imports falsely labeled to represent more expensive goods, were having an injurious effect on U.S.-produced goods and were causing losses in American jobs, and that potential losses to the U.S. revenue were caused by claims that goods manufactured in bonded warehouses, wholly or in part of duty free imported materials, were a "manufacture" of the United States and thus entitled to duty free importation into the United States.[10]

As a result, Congress required in the Tariff Act of 1890 that, among other things, duties be imposed on materials imported into the United States for manufacturing into finished articles or goods, and that such duties would be subject to "drawback" (reimbursement) upon the exportation of the finished article or good.[11] In addition, the legislation required that imported goods be conspicuously marked with the name of the country where it was "manufactured."[12] Little guidance, however,

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10. *McKinley Report 1890, To Reduce the Revenue and Equalize Duties On Imports, and for Other Purposes*, H.R. REP. No. 1466, 51st Cong., 1st Sess. 7 (1890), *reprinted in* S. REP. No. 547, 60th Cong., 2nd Sess. 242, 248 (1908) [hereinafter *McKinley Report*]. The *McKinley Report* noted that:

> [t]he admitted superiority of certain lines of American goods has induced the importation of foreign imitations of inferior quality, with American brands, to be put on our market as the superior goods of American manufacture. Inferior goods, the manufacture of one country, have also been imported and sold bearing the marks of the superior manufacturers of established reputation of another country. A practice has grown up of importing foods under invoices authenticated in a country other, and in a currency of less value, than the country of manufacture.

Id. at 248.

11. *An Act to Reduce the Revenue and Equalize Duties on Imports and For Other Purposes*, § 25, (26 Stat.) at L. 617 (1890) [hereinafter Act or *Tariff Act of 1890*]. The Act provided that "where imported materials on which duties have been paid are used in the manufacture of articles manufactured or produced in the United States, there shall be allowed on the exportation of such articles a drawback equal . . . ." *Id.* The current duty drawback statute is codified at 19 U.S.C. § 1313 (1989 and Supp. I 1992).

12. The statute required that unless the imported goods were "so marked, stamped, branded, or labelled they shall not be deemed entry." *Tariff Act of 1890, supra* note 11, § 6. The purpose

was provided in the legislation for determining what constituted "manufactured," and the courts were called upon to provide an interpretation.

a. The Substantial Transformation Rule

In 1908, the Supreme Court in *Anheuser-Busch Ass'n v. United States*, for purposes of section 25 of the Tariff Act of 1890, ruled that a change in an article was not necessarily a manufacture: "[t]here must be a transformation; a new and different article must emerge, having a distinctive name, character, or use."[13] The "transformation" test articulated in *Anheuser* laid the foundation for the development of the "substantial transformation" test under which an article was considered the product of the country where the last substantial transformation occurred.[14]

Since its inception in the *Anheuser* case, the substantial transformation test has served as the principal U.S. rule of origin for goods not wholly the product of a single country.[15] But during the last decade, the substantial transformation test has increasingly been criticized for being inefficient, and for creating arbitrary, inconsistent, and unpredictable results.[16]

The problem with the substantial transformation test is that it is applied on a case-by-case basis to the specific manufacturing processes which the

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of the marking requirement was to protect "both our own people from the imposition of inferior goods and the revenue from possible loss through undervaluation." *McKinley Report*, *supra* note 10, at 7. *See* Globemaster Inc. v. United States, 340 F. Supp. 974, 976, (Cust. Ct. 1972) (marking statute allows purchasers to decide whether or not to buy goods on basis of their country of origin). Note that while the purpose of the marking statute was to protect the public from inferior goods, Congress intended the marking statute to confer a competitive advantage on U.S. goods. United States v. Ury, 106 F.2d 28, 29 (2d Cir. 1939) (legislative intent of marking statute to confer advantage on U.S. goods). The U.S. marking statute is codified at 19 U.S.C. § 1304 (1989).

13. Anhuesher-Busch Ass'n v. United States, 207 U.S. 556 (1908).

14. The critical factor in the test lies in how "substantial transformation" is defined and interpreted. Substantial transformation is generally defined as the emergence from a manufacturing process of a new and different article or material, having a distinctive name, character, and use than that possessed by the article or material prior to entering the manufacturing process. Texas Instrument, Inc. v. United States, 681 F.2d 778, 782 (C.C.P.A. 1982).

15. *The Impact of Rules of Origin On U.S. Imports and Exports,* ITC Inv. No. 332-192, 37, USITC Pub. 1655 (1985) [hereinafter *Impact of Rules of Origin*].

16. On September 25, 1991, the U.S. Customs Service published in the *Federal Register* proposed amendments to its regulations in order, among other things, to provide a new definition for "substantial transformation." *Proposed Customs Regulations Amendments Regarding Rules of Origin Applicable to Imported Merchandise*, 56 Fed. Reg. 48,448 (Dep't Treasury 1991). Customs noted that:

> [t]he 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 problem: 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 some uncertainty both within Customs and in the trade community as regards the effect which a particular type of processing should have on an origin determination.

56 Fed. Reg. at 48,449.

John Simpson, Deputy Assistant Secretary for the Department of the Treasury and chief U.S. negotiator on rules of origin, noted that:

> [w]hen origin decisions have been required to be made, the Customs service has applied a body of imprecise, subjective, and often *contradictory rules handed down in the manner of folklore* in opinions of the U.S. Customs Court (and later the

good under consideration underwent.[17] The number of different types of products and manufacturing process, however, are so great that a single rule cannot uniformly capture all their nuances and differences. Moreover, the manufacturing industry is ever-changing and new manufacturing process and techniques, and new product lines, are continuously being developed.[18]

Court interpretations and Customs rulings on substantial transformation, therefore, changed from one case to another, and new rationale were developed for novel instances. As a result, substantial transformation decisions and rulings have produced inconsistent and, from the perspective of the losing party, arbitrary results.

For example, substantial transformation has been decided on whether a change in tariff classification occurred,[19] on the amount of costs and complexity involved in the manufacturing process,[20] and on whether "double transformation" occurred.[21] In one case, the court ignored the substantial transformation test altogether and based country of origin by identifying the country where the good began its journey to the United States.[22] Given the varied court interpretations, Customs over time adopted conflicting definitions for substantial transformation.[23] It is not surprising, then, that there are over twenty different variations of the substantial transformation test in current use.[24]

U.S. Court of International Trade).

Remarks by John Simpson, Deputy Assistant Secretary (Regulatory, Tariff and Trade Enforcement), Department of the Treasury, before the Seventh Annual CIT Judicial Conference, Fall 1992, at 1 (emphasis added).

17. 56 Fed. Reg. at 48,449.

18. The conclusion of World War II saw dramatic developments and improvements in communications and travel which enabled multinational corporations, whose marketing and production strategies were carried out on a global basis, to flourish. As a result, the incidence of goods and materials being produced in different countries increased significantly. N. GIMWALDE, INTERNATIONAL TRADE: NEW PATTERNS OF TRADE, PRODUCTION AND INVESTMENT 142 (1992).

19. Ferrostaal Metals Corp. v. United States, 664 F. Supp. 535, 541 (Ct. Int'l Trade 1987).

20. Superior Wire v. United States, 669 F. Supp. 472, 480 (Ct. Int'l Trade 1987).

21. Torrington Co. v. United States, 596 F. Supp. 1083, 1085, *aff'd*, 764 F.2d 1563 (Fed. Cir. 1985).

22. United States v. Friedlaender & Co., 27 C.C.P.A. 297 (1940) (court overturned opinion of trial court that found Germany to be the country of origin for a product that was manufactured in Czechoslovakia, because Germany was the country from which the "merchandise started on it journey to the United States").

23. Compare, for example, the country of origin definition adopted by Customs with respect to the marking statute in 1938 with the definition provided in current regulations:

> (c) The country of origin means the country of manufacture or production. Further work or material added to an article in another country must effect a substantial transformation in order to render such other country the "country or origin" within the meaning of this article.

T.D. 49658, 74 Treas. Dec. 43 (1938).

Current Customs regulations state that:

> (1) If an imported article will be used in manufacture, the manufacturer may be the "ultimate purchaser" if he subjects the imported article to a process *which results in a substantial transformation of the article even though the process may not result in a new or different article.*

19 C.F.R. § 134.1(d)(1) (1990) (emphasis added).

24. *EC Accepts Proposed General Principles on Rules of Origin at GATT Meeting*, Daily Rep. for Executives (BNA), Feb. 16, 1990, at A2.

2. Non-Reciprocal Preferential Trade Agreements

Another factor accounting for the proliferation of rules of origin is the adoption by the United States of non-reciprocal preferential trade agreements/programs[25] ("preferential programs") to achieve certain foreign economic policies. As noted above, the substantial transformation test was developed to help achieve the general policy objective of certain provisions of the Trade Act of 1890; namely, to foster and promote American production and diversification of American industry.[26] In contrast, the general policy objective of preferential programs is outward looking; i.e., to assist the economic development of targeted developing countries ("beneficiary countries") by promoting the production and diversification of their industries.[27] Generally, the assistance provided under a preferential program is reduced or duty-free entry for imports of eligible products from the beneficiary countries.[28]

The use of preferential tariffs to assist developing countries, however, raises two major concerns related to rules of origin. First, low wages in developing countries,[29] in combination with duty-free entry into the United States, create an incentive for third-countries to establish in the beneficiary countries pass-through (assembly operations, or minor production facilities) operations in order to gain preferential entry into the U.S. market. While these operations provide employment, they generally do not significantly contribute to the overall development of the industrial base of the beneficiary countries. Hence, in order to ensure that the industries of the beneficiary countries make a significant contribution to goods eligible for preferential duties, rules of origin for preferential programs have required that eligible goods meet, in addition to a substantial transformation test, minimum local content requirements. Since each program has its distinct policy objectives, the rules of origin for preferential programs vary from one program to another.[30]

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25. A preferential trade program is non-reciprocal where the preferential trade benefits under the program are extended by the United States to countries designated as beneficiary countries on a non-reciprocal basis. Under a reciprocal trade agreement, such as a free trade agreement, preferences are extended between the parties to each other on a reciprocal basis.

26. *McKinley Report*, *supra* note 10, at 243. In particular, the marking and drawback provisions of the Act were intended to confer a competitive advantage on American goods. *See supra* note 12.

27. For example, the U.S. Generalized System Program ("GSP") was established under the Trade Act of 1974, *amended by* Pub. L. 573, tit. V, § 502, 98 Stat. 3019 (1984), 19 U.S.C. §§ 2461-2465 (Supp. 1990), to assist the economic development of designated developing countries by providing duty-free treatment for their products. *See* S. REP. No. 1289, 93rd Cong., 2d Sess. pt. 111, *reprinted in* 1974 U.S.S.C.A.N. 7186, 7187.

28. For example, under the GSP program, the President has authority to grant duty free status to products from beneficiary countries that are deemed eligible under the program. Other non-reciprocal preferential programs include the Caribbean Basin Initiative ("CBI") and Products of Insular Possessions. For a discussion of the rules of origin in preferential programs, see *The Impact of Rules of Origin On U.S. Imports and Exports*, 11-37, ITC Inv. 332-192, USITC Pub. 1695 (1985).

29. *See generally* INTERNATIONAL LABOR OFFICE, YEARBOOK OF LABOR STATISTICS 822-30 (1992).

30. For a discussion and comparison of the rules of origin for preferential programs, see *Impact of Rules Of Origin*, *supra* note 15, at 11-26.

Second, inherent with preferential programs is the concern that they create the potential for the beneficiary countries to become "export platforms," whereby goods produced in third-countries would qualify for preferential duties as a result of minor assembly or production in the beneficiary countries.[31] Industries producing like products in the United States would face increased competition and potential injury by reason of imports from third-country goods which are benefitted by the preferential duties. As a result, the concerns of parties regarding export platform issues, and who advocate high content value percentages to ensure that third-country goods will not pass-through the beneficiary countries, must be balanced with the policy objective of enabling the beneficiary to attract foreign investment.[32]

3. Reciprocal Preferential Trade Agreements

Under reciprocal preferential duty agreements such as the FTA and NAFTA, preferential duties are negotiated on a reciprocal basis with the expectation that economic development will result to all the parties to the agreement. The policy objectives for rules of origin underlying preferential programs—that the objective of creating investment in another country must be balanced with the objective of restricting third-country participation in the program—are fundamental to reciprocal trade agreements. There is, however, one significant additional objective associated with reciprocal trade agreements: the objective of ensuring that sources for low-cost foreign materials and components are maintained for domestic industries.[33]

II. POLICY OBJECTIVES IN THE ESTABLISHMENT OF THE NAFTA RULES OF ORIGIN

The negotiating objectives undertaken by the parties, both jointly and individually, during the NAFTA negotiations with respect to specific issues are discussed throughout this paper. There were, however, at the outset of the negotiations several policy objectives common to the parties which endured throughout the negotiations.

A. The Rules Should Have Five Characteristics

The negotiations presented an opportunity to formulate rules of origin having the five characteristics that are of importance to both the public

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31. *See, e.g.*, The Caribbean Basin Economic Recovery Expansion Act of 1989, WMCP 101-06, 108 (1989): *Hearings on H.R. 1233 Before the Subcomm. on Trade of the House Comm. on Ways and Means*, 101st Cong., 1st Sess. (1989) (written comments of the Amalgamated and Textile Workers Union, AFL-CIO).

32. *Proposal To Strengthen United States-Caribbean Economic Relations: Hearing Before The Subcomm. on International Economic Policy and Trade and On Western Hemisphere Affairs of the House Comm. on Foreign Affairs*, 102nd Cong., 2d Sess. 135 (1988) (statement of Mr. McDonnough concerning attempts to raise content value requirements in the CBI program from 35% to 50%).

33. *See The U.S.-Mexican Free Trade Agreement: Hearing Before the Subcomm. on International Development, Finance, Trade and Monetary Policy of the Comm. on Banking, Finance and Urban Affairs*, 102nd Cong., 1st Sess. 47, (1991).

and private sectors: objectivity, reasonableness, uniformity, predictability and consistency.[34] From the U.S. perspective, achieving such an objective was particularly important, and difficult, given the confused state of its general rule of origin (substantial transformation), and the numerous and varied rules existing under the U.S. preferential programs.

The fact that Canada and the United States had completed the FTA was, of course, an advantage. Indeed, the negotiations began with the adoption of the basic principles underlying the FTA rules as the starting point for the NAFTA rules.[35]

But the presence of Mexico in the NAFTA negotiations brought issues to the rules of origin negotiations that were significantly different from those considered in the FTA. One factor accounting for those differences are the substantial economic disparities that exist between the United States, Canada, and Mexico.[36] Moreover, the parties were cognizant of the "grave problems" encountered by the public and private sectors with the FTA rules.[37] Thus, while the FTA rules offered some guidance, the NAFTA negotiations in some respects started with a clean slate.

B. The Rules Should Eliminate Free Riders

A primary goal of the negotiations was to ensure that the preferential duty benefits of the agreement would be limited to the parties.[38] This was particularly important in NAFTA because, as a reciprocal trade agreement, duty preferences would be negotiated in NAFTA on a give-and-take basis. A third-country using one of the parties as an export platform would obtain a free ride not only as a result of accessing to the preferential duties, but also by not having to give-up a trade concession for those preferences. In addition, participation of free-riders would unbalance the predicted trade-flow on which negotiated rates were based.

C. The Rules Should Not Unduly Restrict Trade

Another factor which the parties had to consider in structuring the NAFTA rules of origin is that NAFTA as a whole, and the rules of origin in particular, could not unduly restrict trade, or discourage investment, between the parties and third-countries.

As members of the General Agreement on Tariffs and Trade ("GATT"),[39] the parties were guided by Article XXIV of GATT, which provides GATT

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34. *See Rules of Origin Related to NAFTA and The North American Automotive Industry*, 23, 26, ITC Inv. 332-314, USITC Pub. 2460 (1991); and *Standardization of Rules of Origin*, 18, ITC Inv. 332-239 (Preliminary) (1987).

35. *NAFTA Negotiators Said To Agree On Basic Methods For Rules of Origin*, INSIDE U.S. TRADE, July 26, 1991, at 3.

36. For example, per capita GDPs for 1990: U.S., $22,091; Canada, $21,768; Mexico $2,716. Minimum wages per hour for 1990: United States, $4.25; Canada, $3.42; Mexico, $0.54. Total trade in billions of dollars; U.S., $889; Canada, $250; Mexico $83. 1990 inflation rates: U.S. 5.4%; Canada, 4.8%; Mexico 29.9%. Stuart Auerbach, *U.S., Canada, Mexico Begin Free Trade Talks: Disparities Expected to Complicate Efforts*, WASH. POST, June 13, 1991, at A40.

37. SECOFI, *Tratado de Libre Comercio en America del Norte, Sector Automotriz*, MONOGRAPHIA 10, 24 (1991).

38. *Operation of the Trade Agreements Program* 1991, 3, 43rd Rep. (U.S. Int'l Trade Comm'n Aug. 1992).

39. Apr. 10, 1947, 55 U.N.T.S. 194, *reprinted in* BASIC DOCUMENTS OF INTERNATIONAL ECONOMIC LAW 3 (Stephen Zamora & Ronald A. Brand eds., 1990) [hereinafter GATT].

members the authority to enter into free trade agreements. Articles XXIV(4) and XXIV(5)(b) provide, respectively, that a free trade agreement should not raise barriers to the trade from countries that are not a party to the agreement, and that new regulations created under the agreement should not be more restrictive to trade than those which existed prior to the establishment of the agreement.[40]

For example, the GATT Working Party, established to review the compatibility of the FTA with GATT provisions, heard comments from one participant that an increase in the content percentages, or modification of the rules, established in the FTA could have adverse effects on trade with third-countries and could cause trade disputes.[41] While there is some question on whether rules of origin are the type of "regulations" contemplated under Article XXIV:5(b), the prohibition against raising barriers to trade with third-countries was a constant concern of, on a constraint on, the NAFTA negotiators.

D. The Rules Should Be Administratively and Economically Efficient

Some importers and producers found the financial or administrative cost for satisfying the FTA rules of origin to be so high that they outweighed the benefits of preferential duties, and, as a result, the preferential duties were out of reach for some businesses.[42] Given that the purpose of establishing preferential duties is to facilitate trade, a rule of origin that makes it difficult or impossible for otherwise eligible parties to obtain the preferential duties is self-defeating. Similarly, a rule of origin should not impose an undue financial or administrative burden on the customs authorities which administer it.

PART II

I. THE NAFTA RULES OF ORIGIN: STRUCTURE AND OPERATION

NAFTA (or "Agreement") provides that only goods and services that are deemed to be of North American origin ("originating")[43] pursuant

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40. *Id.* at 41, 42.

41. *Working Party On The Free-Trade Agreement Between Canada and the United States Report*, 13, L/6927, Oct. 31, 1991. The Working Group was established by the GATT Council on April 12, 1989 to examine the FTA in light of the provisions of the GATT.

42. *See, e.g., The U.S.-Mexican Free Trade Agreement: Hearing Before the Subcomm. on International Development, Finance, Trade and Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs*, 102nd Cong., 1st Sess. 47 (1991) (statement of Collen Morton).

43. "Originating" is defined in the Agreement as meaning goods deemed to be of North American origin under the Agreement's rules of origin. NAFTA, *supra* note 3, art. 201. Conversely, "non-originating" goods are goods deemed not to be North American under the Agreement's rules of origin.

to the Agreement's rules of origin shall be eligible for preferential tariff treatment[44] and other NAFTA benefits.[45] Although the general rules of origin are located in Chapter 4, certain rules of origin are located in different parts of the Agreement. Special rules applicable to textiles are located in Chapter Three (Annex 300-B) and to services are in Chapter Twelve (Article 1211). Customs procedures for the administration of the rules of origin are contained in Chapter Five.

A. General Rules

The general rules of origin are contained in Chapter 4, Article 401 of the Agreement. Article 401 applies to all goods, except that special provisions for autos and apparel and textiles were established which operate in addition to Article 401. Article 401 covers goods in three categories: goods that are wholly grown, raised, or obtained in North America; goods that are produced entirely of materials originating in North America; and goods that are produced with both originating and non-originating materials.

1. Goods Wholly Obtained or Produced Entirely

Under Article 401(a), a good is originating if it was wholly obtained or produced entirely in North America.[46] This rule applies to, among other things, minerals extracted from the territory of the parties, seafood and articles taken from the territorial seas and seabeds of the parties,[47] waste and scrap derived from production in the territory of a party, and goods taken from outer space by a party.[48]

The wholly grown/obtained rule traditionally has been relatively easy to apply, and it presented no difficulty in the negotiations.[49] Article 401(a)

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44. The preferential duty provisions of NAFTA, pursuant to Chapter 3, and Annex 302.2, apply only to goods that are "originating." *Id.* ch. 3 and annex 302.2.

45. Other benefits include, for example, national treatment and market access provisions contained in Chapter 3. *Id.* ch. 3.

46. Article 401(a) provides in pertinent part:

> Except as otherwise provided in this Chapter, a good shall originate in the territory of a Party where:
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> (a) the good is wholly obtained or produced entirely in the territory of one or more of the Parties, as defined in Article 415.

Id. art. 401(a).

47. The sea and seabed territories of the parties are defined in Chapter 2, Annex 201.1. *Id.* annex 201.1.

48. *Id.* art. 415 (Definitions).

49. American grain producers expressed considerable concern over competition from Canadian imports of wheat which they claimed, among other things, was commingled with U.S. wheat and had benefitted from U.S. grain programs. *See, e.g., The North American Free Trade Agreement: Hearings Before The Subcomm. on International Economic Policy and Trade and on Western Hemisphere Affairs of the House Comm. on Foreign Affairs,* 102nd Cong., 1st Sess. 285 (1991) (statement of Neal Fisher). While this question involves marking and end-user certificate issues, the American grain producers sought to address their concerns in the context of the NAFTA rules of origin. While their efforts apparently did not succeed, the Agreement contains provisions on marking (Article 306) and Certificates of Origin (Chapter 5) which may address some of the concerns raised by the U.S. grain producers.

is almost identical to its counterpart provision in the FTA.[50] The chief difference between the two provisions is that the word "entirely" is not used in the FTA provision. This difference is minor, however, given that any disputes concerning whether a good is wholly grown (or obtained), entirely or otherwise, would be resolved under Article 401(b).

2. Goods Produced Entirely Of Originating Materials

Article 401(c) provides that goods that are produced exclusively from originating materials shall be deemed to be originating.[51] The entire production must have occurred in the territory of one or more of the parties. Under this provision, as long as only originating materials are used, the production of a good may be shared between two (or three) countries, e.g. the United States and Mexico. The FTA does not have a provision comparable to Article 401(c).

3. Goods Produced With Non-Originating Materials

a. Change In Tariff Classification

Article 401(b) applies where one or more of the materials used to produce a good are non-originating.[52] Under Article 401(b), a good shall be deemed to be originating where each of the non-originating materials used in the production of the good undergo an applicable change in tariff classification (as set forth in Annex 401) as a result of production that occurs entirely in the territory of one or more parties.[53]

Article 401(b) is an extension of Article 301(2) of the FTA.[54] But under the FTA rule, change in tariff classification is presented as the definition

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50. FTA, *supra* note 7, art. 301. Article 301 of the FTA provides that:
Goods originate in the territory of a Party if they are wholly obtained or produced in the territory of either Party or both Parties.

51. Article 401(c) provides in pertinent part:
Except as otherwise provided in this Chapter, a good shall originate in the territory of a Party where:
(c) the good is produced entirely in the territory of one or more of the Parties exclusively from originating materials.

NAFTA, *supra* note 3, art. 401(c).

52. Article 401(b) provides in pertinent part:
Except as otherwise provided in this Chapter, a good shall originate in the territory of a Party where:
(b) each of the non-originating materials used in the production of the good undergoes an applicable change in tariff classification set out in Annex 401 as a result of production occurring entirely in the territory of one or more of the Parties, or the good otherwise satisfies the applicable requirements of that Annex where no change in tariff classification is required, and the good satisfies all other applicable requirements of this Chapter.

Id. art. 401(b).

53. *Id.*

54. FTA, *supra* note 7, art. 301(2). Article 301(2) provides that:
2. In addition, goods originate in the territory of a Party *if they have been transformed* in the territory of either Party or both Parties so as to be subject to a change in tariff classification as described in annex 301.2 or to such other requirements as the annex may provide when no change in tariff classification occurs, and they meet the other conditions set out in that annex.

Id. (emphasis added).

for "transformation," and the term "substantial transformation" was not used.[55] In NAFTA, both words were omitted, a circumstance that does not bode well for adherents of the substantial transformation test.

In addition, the FTA rule applies to "goods" in general, whereas the NAFTA rule is aimed at changes that are caused to "each of the non-originating materials"[56] used in production of a good.

The applicable change in tariff classifications required for non-originating materials to become originating materials or goods are set forth in Annex 401 of the Agreement. Annex 401 is fairly detailed, and is comprehensive compared to the FTA schedule. The Annex is a list approximately forty-four pages in length consisting of products arranged by Harmonized Tariff System ("HTS") numbers. The FTA schedule was only fifteen pages long. In addition, NAFTA Annex 401 contains special rules for specific products, such as computers, glassware, and textiles and apparel.

b. Regional Content Value

In addition to, or in lieu of, a change in tariff classification, Annex 401 requires that some products satisfy certain regional value content ("RVC") requirements.[57] Regional value content requirements also apply to a good where a change in tariff classification is not possible because the good was imported in an unassembled form, but is classified as an assembled good, or where the heading, or subheading, for the good provides for both the good and its parts.[58]

NAFTA provides two methods for calculating the RVC of a good: the transaction value method and the net cost method. With certain limited exceptions, producers/exporters may decide which method to use.[59]

i. Transaction Value Method

Under Annex 401, a good will be considered originating if it has a RVC of sixty percent (sixty-five percent in some cases) based on the transaction value method. The RVC of a good based on the transaction value method is calculated on the following basis:

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

RVC is the regional value content expressed as a percentage,

55. *Id.*
56. NAFTA, *supra* note 3, art. 401(b).
57. *Id.* ch. 4, annex 403.3.
58. *Id.* art. 401(d).
59. *Id.* arts. 402(1), 402(4) .

TV is the transaction value of a good adjusted to an F.O.B. basis,

VNM is the value of non-originating materials[60] used by the producer in the production of the good.

Except with respect to intermediate materials, the transaction value of a material used in the production of a good must be determined in accordance with Article 1[61] of the Customs Valuation Code ("Code").[62] Where transaction value cannot be determined in accordance with Article 1 of the Code, then the value shall be determined in accordance with Articles 2 through 7[63] of the Code.[64] Transaction value shall include, to the extent not already included, the value of the following costs:

1. all costs incurred in transporting the material to the producer including freight, insurance, and packing;
2. duties, taxes and brokerage fees paid in the Parties' territories;
3. and the cost of waste and spoilage, minus the value of reusable scrap or byproduct, resulting from the use of the material.[65]

Where an exporter or producer is notified during the course of a verification[66] that the transaction value, or the value of a material, is not in accordance with the Code, the exporter or producer may, if possible, establish RVC on the net cost basis.[67]

ii. Net Cost Method

Under Annex 401, a good will be considered originating if it has a RVC of fifty percent based on the net cost basis. The RVC of a good based on the net cost method is calculated as follows:

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

RVC is the regional value content expressed as a percentage,

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60. Note that under both the transaction value and the net cost methods, and except for purposes of calculating the RVC of certain automotive goods pursuant to Articles 403(1) and 403(2)(a)(i), the value of "non-originating materials" shall not be included in the value of non-originating materials which were used to produce originating materials used in the production of a good. *Id.* art. 402(4).

61. The Customs Valuation Code is an agreement on the implementation of Article VII (Valuation for Customs Purposes) which sets forth the general principles of valuation for Customs purposes. *See* GATT, *supra* note 39, art. VII. Generally, Article 1 of the Customs Valuation Code provides that transaction value is the price [basically F.O.B. price] actually paid or payable, adjusted pursuant to Article 8 [which sets forth ex-factory costs that are not to be included in transaction value including commissions, brokerage, cost of containers and shipping, packing, royalties, and insurance] provided that a) there are no restrictions as to the disposition of the good, b) price is not subject to conditions for which value cannot be determined, c) no part of the proceeds of the sale will accrue to the seller, and d) the buyer and seller are not related. *Id.*

62. NAFTA, *supra* note 3, art. 402(9)(a).

63. Articles 2 through 7 of the Code set forth the criteria for valuation on the basis of the transaction value for identical goods. GATT, *supra* note 39, at 119-23.

64. NAFTA, *supra* note 3, art. 402(9)(b).

65. *Id.* art. 402(9)(c).

66. *Id.* art. 506. Article 506 contains the origin verification procedures.

67. *Id.* art 402(6).

NC is the net cost of the good,
VNM is the value of non-originating materials used in the production of the good.

Although a producer or exporter may choose either the transaction value method or the net cost method as the basis for RVC, the net cost method must be used to determine RVC where:

1. the RVC of a good is accumulated;[68]
2. there either is no transaction value or it cannot be established in accordance with the Code;
3. the good is sold by the producer to a related person[69] and the volume of sales of similar or identical goods to related persons during the six months immediately preceding the month the good was sold in exceeds 80% of total sales of that producer with respect to such goods;
4. the goods involved are: certain automotive goods, footwear, word processing machines, or goods designated as intermediate materials which are subject to an RVC requirement.[70]

The net cost method is required for many of the products that constitute trade between the U.S. and Mexico.[71] But unlike transaction value, which can readily be established by objective criteria such as invoices and purchase orders, the cost of production of a good typically involves a complex calculation, application of generally accepted accounting principles, and the exercise of judgment in attributing and allocating costs. The Agreement provides limited guidance as to the type of costs, and the allocation of costs, for purposes of establishing the "net cost" of a good.

The "net cost of a good" is defined as "the net cost that can be reasonably allocated to a good using one of the methods set out in Article 402(8)."[72] Article 402(8) provides three different allocation methods which a producer may use to calculate the net cost of a good.[73]

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68. *See id.* art. 404 (Accumulation).

69. Under Article 415, a person is "related" to another where they are: officers or directors of one another's business; partners; employer and employee; one owns 25% or more of outstanding voting stock or share of the other's interest; one directly or indirectly controls the other or both are controlled by a third person; or they are members of the same family. *Id.* art. 415.

70. *Id.* art 402(5).

71. For example, the majority of manufactured goods in the top 30 U.S. imports from Mexico in 1989-90 is accounted for by automobiles and automotive parts. *The Likely Impact on the United States of a Free Trade Agreement With Mexico*, ITC Inv. 332-297, USITC 2353 (1991).

72. NAFTA, *supra* note 3, art. 415 (definition of "net cost of a good").

73. Article 402(8) provides:

> For purposes of calculating the net cost of a good under paragraph 3, the producer of the good may:
>
> (a) calculate the total cost incurred with respect to all goods produced by that producer, subtract any sales promotion, marketing and after-sales service costs, royalties, shipping and packing costs, and non-allowable interest costs that are included in the total cost of all such goods, and then reasonably allocate the resulting net cost of those goods to the good;
>
> (b) calculate the total cost incurred with respect to all goods produced by

Under each of the allocation methods, the producer must first calculate the "total cost" incurred in the production of the subject good, or of all the goods it produces including the subject good. "Total cost" is broadly defined as "all product costs, period costs and other costs incurred in the territory of one or more of the Parties."[74]

In addition, producers are expected to "reasonably allocate" production costs to the good(s) claimed to be originating.[75] Exactly what constitutes a "reasonable allocation" is often a contentious issue in trade cases,[76] and was an underlying cause of various disputes under the FTA rules of origin.[77] The Agreement provides that the allocation of costs shall be made in accordance with the Uniform Regulations.[78] The deadline for issuance of the Uniform Regulations is January 1, 1994, which should prove to be a tight, if not impossible, deadline to meet.[79]

Significantly, general and administrative expenses were not excluded from the definition of "total costs." Indeed, under Generally Accepted Accounting Principles, "period costs" include general and administrative expenses such as executive, accounting, and legal services, costs for telephone and mail, rent, depreciation on buildings, taxes, and the cost of utilities for property used by administrative personnel.[80]

Under the FTA, only costs *directly* incurred in the production (or assembling) of a good(s) can be included in the calculation of value content of a good.[81] All costs related to the general and administrative

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that producer, reasonably allocate the total cost to the good, and then subtract any sales promotion, marketing and after-sales service costs, royalties, shipping and packing costs, and non-allowable interest costs that are included in the portion of the total cost allocated to the good; or

(c) reasonably allocate each cost that forms part of the total cost incurred with respect to the good so that the aggregate of these costs does not include any sales promotion, marketing and after-sales service costs, royalties, shipping and packing costs, and non-allowable interest costs,

provided that the allocation of all such costs is consistent with the provisions regarding the reasonable allocation of costs set out in the Uniform Regulations, established under Article 511 (Customs Procedures - Uniform regulations).

Id. art. 402(8).

74. *Id.* art. 415 (definition of "total cost").

75. *Id.* art. 402(8).

76. *See, e.g.*, Florex v. United States, 705 F. Supp. 583, 590 (Ct. Int'l Trade 1989) (allocation of flower production costs based on acreage).

77. *See Rules of Origin Issues Related to NAFTA and the North American Automotive Industry*, 41-42, ITC Inv. 332-314, USITC 2460 (1991).

78. Article 511 provides that the parties shall establish and implement through their respective laws and regulations Uniform Regulations regarding the interpretation of Chapter Four. NAFTA, *supra* note 3, art. 511.

79. *Id.* Note that U.S. Customs did not issue final regulations interpreting the FTA rules of origin until January of 1992. *Customs Regulations Amendments Relating to the United States-Canada Trade Agreement*, 57 Fed. Reg. 2447 (1992) (final rule). Information available at the time this paper was prepared indicated that the parties were informally consulting on the NAFTA Uniform Regulations and that the first Working Group meeting on this issue would occur during January of 1993. It is possible, therefore, for the Uniform Regulations to be "drafted" when NAFTA goes into effect.

80. JAE K. SHIM & JOEL G. SIEGAL, MANAGEMENT ACCOUNTANTS STANDARD DESK REFERENCE 8 (selling, general, and administrative expenses are period costs).

81. FTA, *supra* note 7, annex 301; *see also id.* art. 304 (definition of "direct cost of processing" and "assembly").

expenses of doing business were expressly excluded from the definition of "direct cost of processing."[82]

Moreover, NAFTA does not limit costs to those incurred "at the location of the process or assembly."[83] This is a significant development given the tremendous amount of *maquiladora* trade conducted between the United States and Mexico, which could prompt creative accounting methodologies for the allocation of expenses incurred in the United States to goods produced or assembled in Mexico.

As noted, during the negotiation there was pressure to require that NAFTA establish a higher regional content requirement than the fifty percent established under the FTA.[84] The NAFTA regional value content requirements (of fifty and sixty percent) were viewed as an improvement over the FTA rules on the grounds that the NAFTA rules were stronger and "tougher."[85] These views were consistent with the U.S. objective of establishing "strict" rules of origin.[86]

It is not clear, however, that the NAFTA rules are "stricter" than the FTA rules. Under the net cost method, producers will be able to include in the RVC net cost equation (general and administrative) costs that were not permissible under the FTA. Hence, it will be easier for producers to meet RVC requirements under the NAFTA net cost basis

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82. Article 304 of the FTA provides in pertinent part that:

> direct cost of processing or direct cost of assembly means the costs directly incurred in, or that can reasonably be allocated to, the production of goods, including:
>
> a) the cost of all labour, including benefits and on-the-job training, labour provided in connection with supervision, quality control, shipping, . . . *management at the location of the process or assembly*, and other like labour, whether provided by employees or independent contractors;
>
> . . .
>
> d) development, design, and engineering costs;
>
> e) rent, mortgage interest, depreciation on buildings, property insurance premiums, maintenance, taxes and the cost of utilities for real property *used in the production of goods*; and
>
> . . .
>
> but not including:
>
> g) costs relating to the general expense of doing business, such as cost of providing executive, financial, sales, advertising, marketing, accounting and legal services, and insurance;
>
> . . .
>
> i) costs for telephone, mail and other means of communication;
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> . . .
>
> l) rent, mortgage interest, depreciation on buildings, property insurance premiums, maintenance, taxes and the cost of utilities for real property used by personnel charged with administrative functions; or
>
> m) profit on the goods;

Id. art. 304 (emphasis added).

83. *Id.*

84. *The North American Free Trade Agreement: Hearings Before The Subcomm. on International Economic Policy and Trade and on Western Hemisphere Affairs of the House Comm. on Foreign Affairs*, 102nd Cong., 1st Sess. 285 (1991) (statement of Rep. Kolbe).

85. A. Driscoll, *Key Provisions of the North American Free Trade Agreement*, BUSINESS AMERICA 3-4 (Dep't Comm. 1992).

86. *President's United States-Mexico Free Trade Letter: Hearing Before The Senate Comm. on Finance*, 102nd Cong., 1st Sess. 32 (1991) (statement of Carla A. Hills, United States Trade Representative).

than under the RVC requirements of the FTA. In addition, the facts that producers may under NAFTA factor in general and administrative expenses, and that production costs are not limited to those incurred in the location where the production occurred, raise the question of whether NAFTA rules will result in an increase in the use of regional components and parts that are used in the production of goods.

iii. Intermediate Materials

For purposes of determining the RVC of a good (except with respect to certain automotive goods), a producer may designate any material produced by the producer and used in the production of a good(s) as an intermediate material.[87] If the intermediate material was subject to an RVC requirement, then the producer may not designate (as an intermediate material) any other self-produced material subject to a RVC requirement which was used in the production of the intermediate material.[88]

The RVC of an intermediate material must be determined on the net cost basis.[89] The allocation methods for establishing the value for intermediate materials are similar to those for regular goods.[90]

B. Miscellaneous Provisions

The parties adopted several miscellaneous rules concerning the application of the rules of origin. The following is a brief description of those rules.

Accumulation: Where a good has undergone production (by one or more producers) in two or more territories of the parties, a producer may cumulate the production value in each territory for purposes of establishing that the good is originating, provided that all non-originating materials used in the production of the good have undergone applicable change in tariff classification, and that applicable RVC requirements are satisfied, entirely in the territory of one or more of the parties.[91] The production of a producer that chooses to cumulate is deemed to be the single production of that producer with respect to non-automotive related intermediate materials.[92]

De Minimis: Under the de minimis rule, a good may be deemed originating despite the fact that non-originating materials used in the

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87. NAFTA, *supra* note 3, art. 402(10).
88. *Id.*
89. *Id.* art. 402(5)(f).
90. Article 402(11) provides that:

> [t]he value of an intermediate material shall be:
>
> (a) the total cost incurred with respect to all goods produced by the producer of the good that can be reasonably allocated to that intermediate material; or
>
> (b) the aggregate of each cost that forms part of the total costs incurred with respect to that intermediate material that can be reasonably allocated to that intermediate material.

Id. art. 402(11).
91. *Id.* art. 404.
92. *Id.* art. 404(2).

production of the good failed to satisfy the applicable change in tariff classification or RVC requirements. The de minimis rule provides that if the value of the non-originating materials used in the production of a good which did not undergo an applicable change in tariff classification is not more than seven percent of the transaction value of the good, then the good will be deemed an originating good. Where the good is subject to an RVC requirement, the value of all such non-originating materials must be taken into account in calculating the RVC of the good.[93] This rule does not apply to certain non-originating materials.[94] Where the subject good is a textile or fabric (accounted for in HTS Chapters 50 through 63), the good shall be deemed to originate despite the fact that the applicable change in tariff classification requirements in Annex 401 were not satisfied if the total weight of non-originating fibers or yarn used in the production of a component of the good do not exceed seven percent of the total weight of the good.[95]

In addition, a good that is otherwise subject to RVC requirements does not have to satisfy those requirements where the non-originating materials used in the production of the good account for a de minimis level of less than seven percent of transaction value, or of the total cost of the good (where transaction value cannot be used as the basis for RVC).[96]

Under the FTA, a good could not be claimed as North American if it contained *any amount* of non-originating materials which failed to undergo an applicable change in tariff classification, or otherwise satisfy the rules of origin. The inflexibility of this rule raised considerable concern, as evidenced by the comments submitted by interested parties to U.S. Customs in connection with its revision of the United States general rule of origin.[97]

As a result of the de minimis rule, some products that were ineligible for preferential duties in the FTA may qualify as originating in NAFTA. One negative consequence is that the rule could reduce the amount of materials and goods sourced within North America and, thereby, diminish the policy objective of strengthening the industrial sectors of the parties.

Fungible Goods and Materials: Where non-originating and originating fungible materials are used in the production of a good, or are commingled and exported in the same form, the determination of the good shall be

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93. *Id.* art. 405(1).

94. Non-originating materials that are excluded from application of the de minimis rule include, generally, those materials used in the preparation of dairy products, concentrated fruit or vegetable juices, instant coffees, lard and oils, sugar and chocolate products, alcoholic products, and various appliances (gas and electric stoves and ranges, trash compactors, and printed circuit assemblies). *Id.* art. 405(3)(a)-(j).

95. *Id.* art. 405(6).

96. *Id.*

97. *Proposed Customs Regulations Amendments Regarding Rules of Origin Applicable to Imported Merchandise*, 56 Fed. Reg. 48448 (Dep't Treasury 1991) (see comments submitted by interested parties).

made on the basis of inventory management methods to be set forth in the Uniform Regulations.[98]

Accessories, Spare Parts, and Tools: Accessories, spare parts and tools delivered with a good shall be deemed to originate if the good is originating and they are standard and invoiced with the good, and their quantities and value are customary. Such accessories, parts, and tools shall be disregarded in determining whether all non-originating materials used in the production of the good undergo the applicable change in tariff classification.[99]

If a good is subject to an RVC requirement, the value of accessories, spare tools, and parts must be counted as either originating or non-originating when calculating the RVC of the good.[100]

Indirect Materials: Indirect materials are deemed to be originating regardless of their origin.[101]

Packing Materials and Containers: Packing materials and containers used to pack a good for retail sale shall be disregarded when applying an applicable change in tariff classification requirement. If the good is subject to an RVC requirement, however, the value of such materials shall be taken into account as either originating or non-originating in the calculation of the RVC of the good.[102]

Packing materials and containers used to pack a good for shipment shall be disregarded in the application of both the change in tariff classification and RVC requirements.[103]

Transhipments and Non-Qualifying Operations: A good will lose its originating status if, subsequent to meeting applicable change in tariff classification and RVC requirements, the good undergoes further production or operation outside the territories of the parties, other than operations related to shipment of the good when in transit to the territory of a party, such as loading or unloading.[104] In addition, a good may not be deemed originating by virtue of either an operation involving mere dilution with water or other substances which does not materially alter the characteristics of the good, or a production or pricing practice which is demonstrably undertaken to circumvent the provisions of Chapter 4.[105]

Interpretation and Application: The basis of interpretation of Chapter 4 is the Harmonized Tariff System, its General Rules of Interpretation,

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98. NAFTA, *supra* note 3, art. 406.
99. *Id.* art. 407.
100. *Id.* art. 407(c).
101. *Id.* art. 408. An "indirect material" is defined to mean a good that is used in the production of a good which is not physically incorporated into the good, or which is used in the maintenance of buildings or in the operation of equipment used to produce the good, such as: fuels and energy; tools, dies and molds; lubricants and greases; gloves, clothing and safety equipment; solvents; and any good that is not incorporated but whose use can be demonstrated to be part of the production of the good. *See id.* art. 415 (definition of "indirect material").
102. *Id.* art. 409.
103. *Id.* art. 410.
104. *Id.* art. 411.
105. *Id.* art. 412.

and its applicable Chapter and Section Notes.[106] Where differences between the provisions and definitions of Chapter 4 and the Customs Valuation Code exist, Chapter 4 shall have precedence.[107] Costs referred to in Chapter 4 shall be recorded and maintained in accordance with the Generally Accepted Accounting Principles applicable in the territory where the good was produced.[108]

Consultation and Modifications: The parties agreed to consult regularly with respect to the administration of the provisions of Chapter 4.[109] Where a party believes that a modification to a provision in Chapter 4 is required due to a change in production processes or other developments, the party may submit a request for modification along with supporting arguments and materials (such as studies) for consideration of the parties.

Definitions: Article 415 contains definitions for terms used in Chapters 4 and 5.[110] The definitions in the Agreement are more numerous and detailed than those provided in the FTA.

C. *Special Rules of Origin for Specific Goods*

In addition to the general rules of origin that apply to all goods and materials for which preferential duties are claimed, the parties adopted special provisions for goods of significant importance, including automotive parts and textiles.

1. Automotive Goods

Under the FTA, automotive goods were subject to a fifty percent regional value content requirement.[111] In the United States, automotive producers, in particular auto part producers, complained that the fifty percent requirement was too low and advocated that the FTA content requirement be increased to sixty percent or higher.[112]

On September 11, 1990, the U.S.-Canada Automotive Select Panel recommended that North American content in cars be increased to sixty percent. The United States adopted the Panel's report, but the Canadian trade minister, John Crosbie, refused to adopt the report and the Panel's recommendations were never implemented.

The NAFTA negotiations inherited the dispute over the content requirement for automotive goods. Generally, the United States favored a sixty percent content requirement, though there was pressure from Congress for a content value of sixty percent and higher.[113] The focus of

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106. *Id.* art. 413(a)-(c).
107. *Id.* art. 413(d).
108. *Id.* art. 413(e). This provision may present problems given the major differences that exist between the tax and record-keeping requirements of the United States and of Mexico.
109. *Id.* art. 414(1).
110. *Id.* art. 415.
111. FTA, *supra* note 7, art. 301.
112. *See Rules of Origin Issues Related To NAFTA and The North American Automotive Industry*, Private Sector Proposals, app. L, ITC Inv. 332-314, USITC 2460 (1991).
113. *See Lawmakers Gear Up To Press Higher North American Content For Autos*, INSIDE U.S. TRADE, Aug. 7, 1990, at 7.

the U.S. concerns was on the Canadian automotive transplants (foreign-owned auto assembly plants that used regional labor and, for the most part, imported parts and components, to produce goods eligible for preferential duty treatment under the FTA). In particular, U.S. interests were concerned over the Canadian practice known as "roll-up," whereby imported parts and materials (in particular, Asian power trains) lose their foreign identity as a result of assembly or finishing in one country into an intermediate good, and the cost of that entire intermediate good is then counted (i.e., rolled-up) towards the FTA requirement.

Canada, however, viewed the transplants (who tended to rely on a higher proportion of imported parts) as a critical element of its economic development and favored their establishment in Canada. Moreover, Canadian studies indicated that while the FTA resulted in an increase in sourcing of regional automotive goods, U.S. producers benefitted the most from the increase.[114] As a result, Canada favored keeping the content percentage at fifty percent, given that an increase in the content percentage would primarily benefit U.S. producers and would reduce the incentive for foreign auto producers to establish operations in Canada.[115]

Initially, Mexico sought to keep regional content percentages at thirty-five percent. Mexico later changed its position and supported Canada's position of keeping the content percentage at fifty percent, given that its labor rates would make a higher percentage relatively more difficult to meet.

The roll-up issue flared up during the negotiations as the result of a U.S. Customs report that was leaked to the press concerning the results of an audit conducted by U.S. Customs which reportedly determined that the production of a Canadian Honda auto plant failed to meet FTA content requirements and, consequently, that Honda was potentially liable for duties of over twenty million dollars.[116]

One result of the Honda dispute was that U.S. and Canadian auto producers complained that the FTA origin rules were burdensome and costly to administer.[117] These complaints were consistent with the experience of United States and Canadian Customs authorities who encountered difficulties in administering the FTA rules.[118] Hence, the public and private sectors shared an objective in the NAFTA negotiations which was to streamline and improve the FTA rules with a view to making them less costly and less difficult to administer and implement.[119]

Generally, the NAFTA rules on automotive goods add two special provisions to the general rules of origin; namely, special provisions for

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114. *See, e.g., Canadian Auto Panel Voice Concerns Over Crosbie Rejection of 60% Content Rule*, INSIDE U.S. TRADE, Aug. 24, 1990, at 6.

115. *Id.*

116. Stuart Auerbach, *Treasury Accused of Forcing Customs Service*, WASH. POST, July 30, 1991, at 5.

117. *NAFTA Benefits Could Be 'Obliterated' By Strict Rules Of Origin, Conference Told*, Daily Rep. for Executives (BNA), May 29, 1992, at A7.

118. *See Rules of Origin Issues Related To NAFTA and The North American Automotive Industry*, 40-41, ITC Inv. 332-314, USITC 2460 (1991).

119. *U.S. Automakers Press For Preferences During 15 Year NAFTA Transition*, INSIDE U.S. TRADE, Sept. 23, 1991.

calculating RVC, and special RVC percentages to be implemented over the transition period of the Agreement.

a. Calculation of Non-Originating Materials

The sole basis for calculating the RVC for motor vehicles[120] and automotive parts[121] is the net cost method.[122] For purposes of calculating the RVC of passenger vehicles and light trucks,[123] and the parts used in their production,[124] the value of non-originating materials shall be the sum of the values of all non-originating materials determined (on transaction value method) at the time the materials are received and title is taken by the first person in the territory of a party.[125] This provision will require producers to trace the non-originating materials that are incorporated in the production of autos, and was adopted in connection with the "roll-up" practice.[126]

For purposes of calculating the RVC for all other motor vehicles (that transport sixteen or more passengers),[127] or for components identified in Annex 403.2[128] that are used as original equipment in the production of those vehicles,[129] the value of the non-originating materials used by the producer in the production of a good shall be the sum of: 1) for materials listed in Annex 403.2 whether or not produced by the producer, the value of such materials that are non-originating, or, at the choice of the producer, the value of non-originating materials used in the production of such materials; and 2) the value of other non-originating materials used by the producer that are not listed in Annex 403.2.[130]

b. Averaging

For purposes of calculating the RVC for certain motor vehicles,[131] a producer may average the RVC calculation over its fiscal year on the

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120. NAFTA, *supra* note 3, art. 402(5)(d)(i) (provided for in headings 87.01 or 87.02; subheadings 8703.21-8703.90; or heading 87.04, 87.05, or 87.06).

121. *Id.* art. 402(5)(d)(ii) (provided for in Annex 403.1 or 403.2 and which are for use in the production of a motor vehicle provided for in headings 87.01 through 87.06).

122. *Id.* art. 402(5)(d). Under the FTA, there was a change in tariff classification requirements if the goods were not "parts."

123. *Id.* art. 403(1)(a) (provided for in subheadings 8703.21 - 8703.90, 8704.21, or 8704.31).

124. *Id.* art. 403(1)(b) (those automotive goods listed on Annex 403.1 which are subject to RVC requirements and which are used in the production of a vehicle provided for in subheadings 8703.21-8703.90, 8704.21, or 8704.31).

125. *Id.* art. 403(1). There was a considerable lobbying effort to get certain goods on and off the lists of articles that would be subject to the tracing requirement. *See id.* and annex.

126. For a discussion of the "roll-up" practice, *see Rules of Origin Issues Related To NAFTA and The North American Automotive Industry*, 33-40, ITC Inv. 332-314, USITC 2460 (1991).

127. NAFTA, *supra* note 3, art. 403(2) (provided for in heading 87.01 subheadings 8704.10, 8704.22, 8704.23, 8704.32, 8704.90, and headings 87.05 or 87.06).

128. Annex 403.2 lists two components—or engines and transmissions—and all the materials that make up those components, such as: for engines; cast block, fuel injector pumps glow plugs, turbochargers, alternators, starters, air cleaners, pistons, flywheels, oil pans and pumps, and radiators; and for transmissions; clutch, gears, synchronizers and shafts, transmission cases and housings. *Id.* annex 403.2.

129. *Id.*

130. *Id.* art. 403(2)(a), (2)(b).

131. *See supra* notes 124, 128.

basis of either all motor vehicles in a category,[132] or only those motor vehicles in a category that are exported to the territory of one or more of the parties.[133]

In addition, for purposes of calculating the RVC for goods (auto parts) identified in Annex 403.2, or materials or components identified in Annex 403.2, that were produced in the same plant, the producer of a good may average its calculation over the fiscal year of the motor vehicle producer to whom the good was sold, on a quarterly or monthly basis, or over its own fiscal year if the good is sold on an aftermarket basis.[134] The producer may calculate the average separately or for all the goods sold to one or more auto producers,[135] or calculate the average separately for those goods exported to the territory of one or more of the parties.[136]

c. Special RVC Percentages

Special RVC percentages were established in the Agreement to be phased-in over increasing stages commencing in January 1998. This four year grace period was extended as a concession for Canada in exchange for its willingness to accept RVC percentage increases. The special RVC percentages for automotive goods are as follows:

1. The RVC percentage under the net cost method for passenger cars and light trucks[137] and their engines and transmissions (both in component form and in the form of the separate materials that make up the components)[138] shall increase to fifty-six percent on January 1, 1998, and to 62.5% on January 1, 2002.

2. The RVC percentage under the net cost method for all other motor vehicles[139] and their engines and transmissions (both in component form and in the form of the separate materials that make up the components)[140] shall increase to fifty-five percent on January 1, 1998, and to sixty percent on January 1, 2002.

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132. NAFTA, *supra* note 3, art. 403(3)(a)-(d). The motor vehicle categories are:
   (a) the same model line of motor vehicles in the same class of vehicles produced in the same plant in the territory of a Party;
   (b) the same class of motor vehicles produced in the same plant in the territory of a Party;
   (c) the same model line of motor vehicles produced in the territory of a Party;
   (d) on the basis set out in Annex 403.3, if applicable.

133. *Id.* art. 403(3).

134. *Id.* art. 403(4)(a)(i)-(iii).

135. *Id.* art. 403(4)(b).

136. *Id.* art. 403(4)(c).

137. *Id.* art. 403(5)(a)(i) (provided for in subheadings 8703.21, through 8703.90, 8704.21, and 8704.31).

138. *Id.* art. 403(5)(a)(ii) (provided for in heading 84.07 or 84.08, and subheading 8708.40).

139. *Id.* art. 403(5)(b)(i) (provided for in heading 87.01, and subheading 8702.yy, 8704.10, 8704.22, 8704.23, 8704.32, and 8704.90 or heading 87.05 or 87.06).

140. *Id.* art. 403(5)(b)(ii) and (iii) (provided for in heading 8407 or 8408, and subheading 8708.40, except for a good identified in heading 84.07, 84.08, or subheading 8704.40, 8482.10 through 8482.80, 8483.20, and 8483.30, and goods identified in Annex 403.11 that are used in a motor vehicle identified under the special RVC percentage rules).

3. An RVC percentage requirement of fifty percent shall apply to motor vehicles identified in paragraphs 1 and 2 for the first five years from the date that the first prototype of the vehicle was produced in a plant by a auto assembler where: it is of a class, marque, size category, and underbody not previously produced (except for a motor vehicle identified in paragraph 2 above);[141] the vehicle was assembled in a new plant or building;[142] and the vehicle was assembled with substantially new machinery.[143] The fifty percent RVC requirement will also apply for the first two years from the date that the first motor vehicle prototype is produced at a plant that was refitted,[144] if the vehicle produced is of a different class, marque, size category, and underbody from those that were assembled prior to date that the plant was refitted.[145]

d. CAMI Annex 403.3

Special rules were also established with respect to CAMI Automotive, Inc. ("CAMI"), a joint venture between Suzuki and General Motors that is headquartered in Ontario, Canada. The special rules are contained in Annex 403.3 of the Agreement and provide that CAMI may average the RVC of a class or model line of vehicles with the calculation of RVC content for the corresponding class or model line of vehicles produced in Canada by General Motors ("GM"), or Canada Limited, in a fiscal year that corresponds most closely with CAMI's fiscal year, if at the beginning of the fiscal year GM owns fifty percent or more of CAMI's voting stock, and GM (of Canada, the U.S., or Mexico) acquires seventy-five percent of CAMI's production of the class or model line for resale in one or more of the territories of the parties.[146]

If GM acquires less than seventy-five percent, CAMI may still average, but only with respect to those vehicles acquired by GM for distribution under the GEO marque, or other GM marque.[147] CAMI may average over the period of two fiscal years where a CAMI plant, or a plant operated by GM that CAMI was using for averaging purposes, is closed for more than two consecutive months for retooling for model change or due to circumstances[148] that CAMI or GM could not reasonably have averted through corrective action, or exercise of due care and diligence, including shortages of fuel and material, or inability to obtain fuel, materials, and parts.[149] CAMI may average in a fiscal year in which a CAMI or GM plant was closed with either the year previous or subsequent

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141. *Id.* art. 403(6)(a)(i).
142. *Id.* art. 403(6)(a)(ii).
143. *Id.* art. 403(6)(a)(iii).
144. *Id.* art. 415. "Refit" is defined to mean a plant closure for at least three months for the purposes of plant conversion or retooling.
145. *Id.* art. 403(6)(b).
146. *Id.* annex 403.3(1)(a) & (b).
147. *Id.* annex 403.3(2).
148. *Id.* annex 403.3(3)(b) (except for circumstances due to imposition of anti-dumping and countervailing duties, events related to labor strikes, and disputes).
149. *Id.*

to the closure. If the closure spans more than two fiscal years, then the averaging may be only for those two years.[150] In the event a motor vehicle producer acquires all or substantially all of the assets used by GM, and the successor producer is controlled either directly or indirectly by GM, or both are controlled by the same person, then the successive producer shall be deemed to be GM.[151]

2. Textiles

NAFTA provides a special rule for textiles and apparel which provides that in order to be deemed originating, those goods must undergo in North America an applicable change in tariff classification as set forth in Annex 401[152] and, in most instances, the goods must be cut, sewn, and assembled in North America.[153] If a lining is included in a garment, then the lining must have undergone a change in tariff classification.[154] Hence, for some products, the rules require a triple transformation.

The rules prohibit, however, a change in tariff classification from headings that include coarse or fine wool, cotton, hair, or fibers.[155] The effect of this provision, known as the "yarn-forward" rule, is that in order to be deemed originating, most textile and apparel goods must be produced from the yarn spinning stage forward entirely in a NAFTA country. Goods produced with yarns or fabrics obtained in third-countries will not result in originating goods. Annex 300-B provides that under certain exceptions, under which preferential status may accrue to products produced from yarns or fabrics obtained from third-countries, but only up to certain limits set by the parties in schedules contained in Appendix 6(B) of Annex 300-B.

The consideration of the yarn-forward rule, which was supported by Mexico and the United States, prompted Canada to threaten to pull out of the textile negotiations and to seek a separate agreement with Mexico and maintain the FTA provisions with respect to trade with the United States.[156] Under the FTA, only dual transformation was required: Canada was permitted to produce goods from yarn and fabrics obtained in third-countries. Canada agreed to the yarn-forward rule only after the United

150. *Id.* annex 403.3(3).
151. *Id.* art. 403(4).
152. *Id.* annex 300-B, § 2(1).
153. *See id.* annex 401, ch. 61, subheading 6204.19.
154. *Id.*
155. *Id.* ch. 51-60, subheadings 51.06 through 51.13 (yarn of carded wool, yarn of fine animal hair, yarn of coarse animal or horse hair, woven fabrics of carded or combed wool, or of coarse animal hair); 52.04 through 52.12 (cotton: thread, yarn, woven fabrics,); 53.07 through 53.08 (yarn of jute or vegetable fibers); or 53.10 through 53.11(woven fabrics of jute or vegetable fibers); ch. 54 (manmade threads, filaments, fibers, and cloths, and fabrics of those items); 5508 through 5516 (sewing threads, yarns, filaments, and woven fabrics of man-made staple fibers); 5801 through 5802 (woven pile fabrics, chenille fabrics of cotton, vegetable, man-made fabrics, and terry toweling) 6001 through 6002 (pile fabrics, other knitted or crocheted fabrics).
156. *Canada May Pull Out of NAFTA Textile Agreement As U.S., Mexico Near Deal*, INSIDE U.S. TRADE, May 8, 1992, at 1.

States agreed to increase by six percent Canada's wool apparel quota.[157]

Opposition in Canada to the yarn-forward rule was joined by (mostly) small apparel producers who believed the rule would encourage some U.S. and Canadian producers to close down operations and move to Mexico, where labor is cheaper.[158]

The yarn-forward rule requires that certain operations, i.e. producing threads from coarse materials and weaving fabrics, be performed in North America. As a result, the yarn-forward rule could result in the establishment of operations in Mexico to perform those operations. Canadian and American producers are hopeful that such Mexican operations will yield low-priced yarns and fabrics for their use, given that the availability of such materials from third-countries will have been eliminated. This problem, however, may be resolved by the de minimis rule for those producers whose minimal use of foreign materials exempts their goods from having to qualify as originating.

In any event, given that the NAFTA will require that certain additional operations be performed in North America, third-country producers of yarns and fabrics that previously supplied Canadian and American producers are likely to complain that the yarn-forward rule has, contrary to Article XXIV of the GATT, raised a barrier to trade.

D. Rules of Origin Covering Trade in Services

In addition to trade in goods, the NAFTA also establishes rules for trade in services. Articles 1201 through 1213 of Chapter 12 of the Agreement set forth the general rules governing trade in services between the parties.[159] In addition, specific rules for certain service sectors are contained in other chapters: Chapter 11—Investment Services and Related Matters; Chapter 13—Telecommunications; and Chapter 14—Financial Services.

1. Rules of Origin in Trade in Services

There are various reasons why rules of origin are necessary in trade in services, some of which are similar to those supporting the use of rules of origin in trade in goods. In general, rules of origin are needed to compile and maintain statistics and trade data on cross-border flows of services, to enforce technical regulations and standards, and to monitor activity in important service sectors such as financial services. In the context of a preferential agreement, rules of origin are necessary to ensure that the preferential treatment provided under the Agreement (e.g., most

157. *Textiles, Autos Dominated Final Stages of Negotiations*, J. COMMERCE, Aug. 13, 1992, at 4A.

158. *Small U.S. Apparel Manufacturers Oppose N. American Trade Pact*, J. COMMERCE, Oct. 5, 1992, at 5A.

159. NAFTA, *supra* note 3, ch. 12.

favored nation treatment, and the right to establish a commercial presence) are restricted to the parties to the Agreement.

2. Difficulties in Establishing Rules For Trade in Services

The establishment of rules of origin in trade in services, however, has proven to be difficult because the issues involved in trading a service are distinctly different from those in trading a good, and because there is relatively little experience in the international regulation of trade in services.

A major difference between trade in services and trade in goods is that goods are tangible items while services, such as a telephone call, are often intangible. One result is that services are not delivered in the same fashion as goods and are not susceptible to traditional customs procedures. Indeed, in some cases the delivery of some services requires a commercial presence in the territory of another country, so the service never crosses a border in the traditional sense. In addition, services tend to be heavily regulated as some services (e.g. banking and telecommunications) are extremely important to a country's economic and social structure. Barriers to trade in services, therefore, are typically entrenched in a wide spectrum of domestic regulations, as opposed to barriers to trade in goods which chiefly consist of border-related matters, such as tariffs.

Another difficulty with the establishment of rules of origin for trade in services is that there is relatively little experience for regulating trade in services on an international basis. Attempts to create rules of origin for trade in services[160] in the Uruguay Round negotiations[161] of GATT have not been completed.[162]

3. The Focus of Rules of Origin for Trade in Services

Given the differences between the issues and concerns involved in trade in services and trade in goods, the focus of rules of origin for services is different than that of trade in goods. The focus of rules of origin for goods rests primarily in the manufacturing process of the good, e.g., substantial transformation, change in tariff classification, and content value. The focus of rules of origin for services generally is on the nationality of the providers of the service.[163]

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160. For a discussion of rules of origin in trade in services, see *Rules of Origin and Services: Conceptual Issues, Informal Note by the Secretariat*, GNS ORG-BH, Sept. 27, 1991.

161. The Uruguay Round negotiations, launched on September 16, 1986 at Punta Del Este, Uruguay, are the eighth round of multilateral trade negotiations sponsored by GATT.

162. The Uruguay Round negotiations mark the first attempt to establish international rules for governing trade in services. The results of the trade in services negotiations are contained in the Draft Final Act Embodying The Results of The Uruguay Round of Multilateral Trade Negotiations, 328-378, UR-91-0185 GATT Secretariat (Dec. 20, 1991) [hereinafter Dunkel Draft]. The Dunkel Draft provides that rules of origin in services are to be formulated in connection with the rules of origin negotiations for goods in trade. Under the Dunkel Draft, substantive work on rules of origin for trade in goods take places after the Uruguay Round is concluded. *Id.*

163. The national identity of producers of goods is increasingly becoming an issue of significant importance in trade-related matters. For example, the International Trade Administration faced in

Generally, the trade in services provisions contained in the Agreement apply and pertain to measures related to the *providers* (of the service) of the parties.[164] "Service provider of a party" means "a person of a Party that seeks to provide or provides a service."[165] A "person" can either be a natural person or a business enterprise.[166]

Determining the nationality of a natural person is relatively easy, but such determinations are made on the basis of domestic immigration laws, which are outside the scope of the Agreement.[167] Determining the origin of an enterprise, such as a corporation, however, can be complicated and may involve various criteria, including criteria which focuses on the *geographic location* of the ownership or activity of the corporation (such as place of incorporation, nationality of control, nationality of ownership, principal place of business, location of headquarters or location where management/decision-making resides) or on the basis of criteria that focuses on the *location of production* of the service (such as origin of value added, origin of materials, and origin of intangible inputs).[168]

While the nationality of a corporation is generally determined under international law according to country of incorporation,[169] the use of place of incorporation for purposes of a preferential agreement could pose serious problems. A corporation may have its place of incorporation in one country, but its ownership, control, place of headquarters, and source of inputs located jointly or separately in other countries. Hence, for example, an origin rule based solely on place of incorporation could grant to a branch of a foreign-owned bank located (and incorporated) in the territory of one party the right to establish a commercial presence in the territory of another party.

4. The NAFTA Rules of Origin for Trade in Services

Under NAFTA, the criteria for determining the origin of a service provider (producer) is based on the geographic location of ownership

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an antidumping duty case the issue of whether a foreign producer of portable electric typewriters was a U.S. manufacturer or producer, and hence had standing to bring an anti-dumping case, by virtue of its ownership of a U.S. plant alleged to be little more than an assembly plant. *See Rescission of Initiation of Antidumping Duty Investigation and Dismissal of Petition: Certain Portable Electric Typewriters from Singapore*, 56 Fed. Reg. 49,880 (1990).

164. For example, Chapter 12 applies to measures related to cross-border trade in services "by the service providers of another Party." NAFTA, *supra* note 3, art. 1201. Similarly, the provisions of Chapter 11 apply to "investors" and "investments of investors of another Party . . . ." *Id.* art. 1101. Chapter 13 applies to access to and use of public telecommunication services "by persons of another Party . . . ." *Id.* art. 1301(1)(a), (b). Chapter 14 applies to measures related to "financial institutions of another Party" and "investors of another Party . . . ." *Id.* art. 1401(1)(a), (b). In addition, Article 1005 sets forth a (ownership and control) rule for denial of government procurement benefits to a "service supplier of another Party . . . ." *Id.* art. 1005(2).

165. *Id.* art. 1213.

166. In addition, "enterprise" means any entity constituted or organized under applicable law, including any corporation, trust, partnership, sole proprietorship, joint venture, or other association. *Id.* art. 201.

167. Article 1607 states that no provision in the Agreement imposes any obligation on a Party respecting its immigration laws. *Id.* art. 1607.

168. *Rules of Origin and Services: Conceptual Issues, Informal Note by the Secretariat*, GNS ORG-BH, Sept. 27, 1991, at 8.

169. *See* JOSEPH G. STARKE, INTRODUCTION TO INTERNATIONAL LAW 344 (7th ed. 1972).

and control.[170] The Agreement provides that a party may deny, without prior notice or consultation, the benefits of Chapter 12 to service providers of another party if the service is being provided by an enterprise "owned or controlled by nationals of a non-party" and diplomatic relations are not maintained with the non-party, or transactions with the enterprises of the non-party are prohibited.[171] Otherwise, a party may deny, but only with prior notice and consultation, the benefits of Chapter 12 to service providers of another party if the service is provided by an enterprise "owned or controlled" by nationals of a non-party.[172]

Under the FTA, a party could, subject to prior notice and consultation, deny the benefits of Chapter 13 where the "covered service is indirectly provided by a person of a third country."[173] While the term "indirectly provided" has not been defined in the FTA, a party seeking to establish that a service is indirectly provided by a person of a third-party would presumably be limited to criteria related to the geographic location of the ownership and control of an enterprise. Concern over the lack of formal criteria for determining when a service is being "indirectly provided" was expressed, on behalf of a group of countries, by a member of the Working Party on the FTA.[174] The U.S. representative on the Working Party noted that there was no case history or discussion between the United States and Canada as to how the denial of benefits provisions would operate.[175]

NAFTA also does not define what constitutes "ownership and control." The terms themselves, however, constitute criteria for determining when services are non-originating and, from this perspective, the NAFTA rules are more concise and transparent and therefore less subject to arbitrary interpretation than the FTA rules.

It is too early, of course, to determine whether the NAFTA rules on services will avoid the historical difficulties encountered by the rules on goods. But given the parties' objective of restricting NAFTA's preferential treatment to the service providers of the parties, the parties may in the future find it necessary to use production-based criteria (origin of value added, origin of materials, and origin of intangible inputs) to determine the origin of a service provider.

II. THE ADMINISTRATION OF THE NAFTA RULES OF ORIGIN

In order to ensure efficient and consistent administration of the NAFTA rules of origin, the parties adopted special customs procedures applicable to goods for which preferential treatment is sought. The provisions

170. NAFTA, *supra* note 3, art. 1211.
171. *Id.* art. 1211(1).
172. *Id.* art. 1211(2).
173. FTA, *supra* note 7, art. 1406(1).
174. *Working Party On The Free-Trade Agreement Between Canada and the United States Report*, L/6927, Oct. 31, 1991, at 24.
175. *Id.*

contained in Chapter 5 (Customs Procedures) center on the requirements related to a Certificate of Origin for certifying that goods exported from the territory of a party are originating. Special obligations for producers/exporters, such as record-keeping requirements, are also created under Chapter 5.

Two major provisions in Chapter 5, verification and advance origin rulings, are designed to ensure that claims for preferential eligibility are based on accurate and reliable information.[176] The verification procedures are to assist the parties' customs authorities verify claims that goods are originating. The advance origin rulings procedures are to enable producers/exporters to ensure that their claims for preferential treatment are valid.

A. Verification

Concerns about circumvention of rules of origin were fueled by the leaked draft report on the U.S. Customs audit on Honda Civics.[177] Members of Congress expressed frustration at Customs' refusal to provide copies of the report.[178] The incident made apparent that NAFTA should contain a transparent, non-arbitrary mechanism for verifying claims for preferential duties.

NAFTA provides that a party's customs authorities may conduct verification to determine whether a good from a territory of another party actually qualifies as an originating good.[179] Verification may be conducted through written questionnaires served on a producer/exporter located in the territory of the other party, on-site visits at the premises of the producer/exporter in order to review records (maintained pursuant to Article 505(a)) and to observe the production of the good, or pursuant to any other procedure agreed to by the parties.[180]

The immediate image conjured by the prospect of a verification procedure is that of customs agents making late night border crossings and crashing through doors at production facilities. But such images are dissipated by the various notification requirements[181] and other forms of

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176. Although all of Chapter 5 pertains to the NAFTA rules of origin, this paper addresses only two key provisions of Chapter 5, verification and advance origin rulings.

177. Robert Pear, *U.S. Says Honda Skirted Customs Fees*, N.Y. TIMES, June 17, 1991, at D1. The story reported that the draft report indicated U.S. Customs had found that Hondas had a value content of 38% instead of the 50% required under the FTA, and that there was evidence which suggested that Honda Civics were being sold in the United States at prices less than fair value, i.e., at dumped prices.

178. *See e.g., Hearing Before the Senate Finance Committee, Enforcing Rules of Origin Requirements Under the United States-Canada Free Trade Agreement Before the Senate Committee on Finance*, 102d Cong., 1st Sess. (1991). The final report was eventually released in March, 1992.

179. NAFTA, *supra* note 3, art. 506(1).

180. *Id.* art. 506(1)(a)-(c).

181. Notification of an intended verification is to be delivered to the producer/exporter, to the customs authorities in the territory where verification is to take place, and, if requested, to the embassy of the party to be verified that is located in the territory of the verifying party. *Id.* art. 506(2)(a)(i)-(iii). Notification shall include detailed information (names, places, dates) concerning the verification. *Id.* art. 506(3). Written consent of the producer/exporter must first be obtained, *id.* art. 506(2)(b), and, if consent is not given in accordance with the notification, preferential treatment may be denied after 30 days have elapsed. *Id.* art. 506(4). Verification may be postponed up to 60 days. *Id.* art. 506(5).

due process measures built into NAFTA's verification provisions.[182] Significantly, a copy of the results of the verification determination, including findings of fact and law, are required to be provided to the producer/exporter that was subject to the verification.[183]

There are no provisions, however, on whether private parties may instigate a verification, or the basis on which verifications will be initiated. Unless such standards are developed through the Uniform Regulations, or in the implementing legislation of the parties, the verification process could be open to charges of abuse and arbitrariness.

The initiation issue also relates to the extent of the administrative and economic burden which could be imposed on customs authorities of the parties and their producers/exporters: the easier to initiate a verification, the greater the burden. But having a verification process in place should reduce incentives to abuse or circumvent the rules of origin, especially given the serious consequences and penalties that could result from a violation of the rules of origin.[184] Hence, the need to conduct verifications should diminish over time.

B. Advance Origin Rulings

The Agreement provides that the customs authorities of each party shall provide "expeditious" written advance rulings concerning: whether a good satisfies applicable change in tariff classification and RVC requirements, or other requirements under Chapters 4 and 5; the appropriate method (net cost or transaction value) for determining the RVC of a good; the allocation of costs under the Uniform Regulations; proposed markings; and whether a good is otherwise originating.[185]

The advance origin ruling provisions give importers and producers/exporters (or whoever signs the Certificate of Origin) the advantage of obtaining a ruling *prior* to the importation of a good. The process should result in consistency in origin determinations between the parties,[186] and should reduce fears that a claim for preferential treatment may be er-

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182. For example, producers/exporters may have their own "observers" attend a verification visit, *id.* art. 506(7), and verifications of RVC must be conducted in accordance with the Generally Accepted Accounting Principles of the territory where the verification is conducted. *Id.* art. 506(8). Adverse determinations do not become effective until the person signing the Certificate of Origin is notified, *id.* art. 506(11), and is given an opportunity to show that it relied in good faith on tariff classifications or prior rulings made by a party. *Id.* art. 506(13). Finally, Chapter 5 requires that a party grant to persons of another party substantially the same rights to a review or appeal concerning an origin determination (or advance ruling determination) that it grants to importers within its territory. *Id.* art. 510.

183. *Id.* art. 506(9).

184. Unsupported claims that a good is originating may result in denial of preferential treatment. *Id.* art. 502(2)(a). In the Honda case, Honda was subject to potential additional duties of $20 million. In addition, violations of Chapter 5 provisions can result in civil and criminal penalties. *Id.* art. 508.

185. *Id.* art. 509(1)(a)-(i).

186. Parties shall forward to each other advance origin rulings, and one party will notify the others whenever such rulings are inconsistent with a prior ruling or other measures maintained by the party. *Id.* art. 512(1).

roneous, thereby encouraging producers/exporter to seek preferential eligibility for their goods.

Parties seeking an advance origin ruling must exercise caution in formulating their requests or on relying on prior rulings, as advance origin rulings will be made on the basis of facts and circumstances that are presented by the requesting party.[187] Penalties may be applied against a requesting party that has omitted or misrepresented material facts in its request for a ruling.[188]

A key to the success of the advance origin ruling process will lie in the timeliness of the rulings. For example, U.S. Customs has a procedure for issuing rulings on marking, origin, tariffs, and tariff classification,[189] but obtaining such a ruling may take extended periods of time. Given that the NAFTA rulings are for the benefit of goods prior to their importation,[190] a quick turnaround time would encourage parties to request and rely on advance origin rulings. The time limitations for the issuance of the advance rulings are expected to be contained in the Uniform Regulations.[191]

III. NAFTA RULES AS A MODEL

As the countries of the world observe the advent of NAFTA, the operation of the NAFTA rules of origin are likely to come under scrutiny by countries which will examine how the rules should impact their trade with North America, and whether the rules will be used as a model for future development of rules of origin. Indeed, three months before the NAFTA negotiations were concluded, the NAFTA rules of origin were described in the media as a model for efforts in GATT to develop an international harmonized rule of origin.[192] Countries that expect to accede to NAFTA are also likely to examine the conformity of their own rules with the NAFTA rules.

A. International Rules of Origin

The only existing international agreement on rules of origin, known as the Kyoto Convention, was developed in 1973 by the Customs Cooperation Council ("CCC")[193] during a meeting held in Kyoto, Japan. The principal rule of origin established under Annex D.1:1 of the Kyoto

187. *Id.* art. 509(1).

188. *Id.* art. 509(12). But note that a requesting party will not be subject to penalties where it demonstrates it used reasonable care and acted in good faith in presenting facts and circumstances in its request. *Id.* art. 509(11).

189. 15 C.F.R. pt. 177 (1991).

190. NAFTA, *supra* note 3, art. 1509(1).

191. *Id.* art. 509(3)(b).

192. *N. American Rules of Origin Could Be Model in Global Talks*, J. COMMERCE, May 22, 1992, at 3A.

193. *Convention Establishing A Customs Cooperation Council*, Dec. 15, 1950, 22 U.S.T. 320, T.I.A.S. No. 7063 (effective January 1, 1989).

Convention is based on the substantial transformation principle.[194] The NAFTA parties are not signatories to the Kyoto Convention.

B. *Attempts To Establish an International Harmonized Rules of Origin*

The NAFTA parties, however, actively participated in GATT efforts to establish a universal rule of origin. The GATT Uruguay Round negotiations on rules of origin were conducted as part of the Non-Tariff Measures negotiations. One of the main objectives of the negotiations was to establish a single harmonized rule of origin for application to imports of goods from contracting members of GATT.

The United States position in the negotiations was that work should be undertaken by the CCC to establish a universal rule that would define (substantial) transformation on the basis of change in tariff classification.[195]

The draft of the final agreement on rules of origin—which reflects the U.S. proposal[196]—provides for a work program to be carried out between a GATT Technical Committee and the CCC to establish, within three years of entry into force of a Uruguay Round agreement, harmonized rules of origin which shall be based on substantial transformation defined as change in tariff classification.[197]

However, predictions that the NAFTA rule will serve as a model for a universal rule may be premature.[198] Concern about a universal rule has been increasing in the United States as evidenced by the recent issuance of customs "final" regulations, under which the U.S. general rule of origin (substantial transformation) was patterned after the FTA's change in tariff classification rule.[199] The regulations drew sharp criticism from

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194. *See International Convention On The Simplification And Harmonization of Customs Procedures, Message from the President of the United States Transmitting the International Convention on the Simplification and Harmonization of Customs Procedures ("Convention"), Which Entered Into Force on September 25, 1974, With Annexes and Reservations to Annexes*, 97th Cong., 2nd Sess. 226-236, Treaty Doc. No. 97-23 (1987).

195. Group of Negotiations on Goods (GATT), Negotiating Group on Non-Tariff Measures, *Rules of Origin*, Communication from the United States, UR-89-0249 (on file with the *New Mexico Law Review*).

196. *See Text of Draft Rules of Origin Agreement*, MTN.GNG/NG2/W/85, Nov. 2, 1990. The United States proposed a work program with three parts: that GATT should enlist the technical expertise of the CCC to formulate the universal rule and provide reports on GATT on a variety of related topics within a year of entry into force of a Uruguay Round agreement; that the contracting members would enter negotiations on the basis of the reports and with the assistance of the CCC, with the view to achieve within one year harmonization of rules of origin; and that the harmonized rules should be based on four principles (they should express a positive standard, they should be applied in a consistent manner, they should be stated in an understandable manner, and their application should be subject to judicial or administrative review).

197. *Id.*

198. *GATT Signatories Seen Using Universal Rule of Origin Within the Next Decade*, Daily Rep. For Executives (BNA), Nov. 20, 1990, at A-2.

199. *See Proposed Customs Regulations Amendments Regarding Rules of Origin Applicable to Imported Merchandise*, 56 Fed. Reg. 48,448 (1991).

an overwhelming number of the interested parties that submitted comments.[200]

Given that the FTA rule was established to determine whether a good is entitled to preferential duties, there is doubt whether such a rule is responsive to non-preferential policy objectives and purposes, such as preventing circumvention of antidumping and countervailing duty orders.

In addition, the purposes behind the development of the Harmonized Tariff Schedule ("HTS") were to standardize classifications of products to, collect methods for gathering trade statistics, and to harmonize shipping and transport documents.[201] It is not clear that the non-flexibility of the HTS lends itself to origin determinations,[202] especially in view of the fact that the HTS was not developed for origin purposes.

Some of the concerns about using the FTA rules as a model, however, may be addressed by NAFTA. That NAFTA contains an extensive annex detailing the applicable changes in tariff classifications, and numerous provisions where RVC and other special rules for certain products apply, may result in greater support in favor of using it as a model for a general (or international) rule or origin.

CONCLUSION

The NAFTA rules of origin are in many respects an improvement over the FTA rules. The NAFTA rules are clearer and more concise and detailed than the FTA rules, and they address a variety of problems that American and Canadian producers and exporters had under FTA rules.

In addition, Chapter 5 should make the administration of the NAFTA rules easier than was experienced with the FTA rules. In particular, the advance origin rulings provision should lend security and predictability to parties claiming preferential eligibility, and the ability to obtain such rulings should promote their participation in the NAFTA framework. The verification provision should discourage abuses and circumvention of the NAFTA rules, and should instill a higher degree of adherence to the rules than experienced under the FTA. These two provisions alone should facilitate trade between the NAFTA parties.

However, the structure of the NAFTA rules is very dependent on the Uniform Regulations. For example, whether the NAFTA general rules are "stricter" than the FTA rules will depend to a large extent on the criteria and definitions contained in the Uniform Regulations regarding the allocation and calculation of costs for purposes of determining RVC under the net cost basis. The Uniform Regulations could also have a determinative effect on the uniformity and consistency of the rules of origin for services depending on the extent to which they articulate criteria

200. *Id.* (author's review of public documents maintained by U.S. Customs).

201. *See* RUTH STURM, CUSTOMS LAW & ADMINISTRATION, § 50.4 at 10 (3rd. ed. 1990).

202. *U.S. Customs Plan on Metal Origins Again Under Attack by Trade Group*, J. COMMERCE, Mar. 4, 1992, at 5A.

and definitions for determining when the control and ownership of a corporation is in the hands of third-country persons.

Thus, the extent to which the NAFTA rules attain the five characteristics of a rule of origin that is responsive to both the public and private sectors—objectivity, reasonableness, uniformity, predictability, and consistency—will depend on the Uniform Regulations. The parties should view, and treat, the promulgation of the Uniform Regulations as an opportunity to achieve, as near as possible, those five characteristics.

The NAFTA rules will probably raise complaints from third-countries, some of which will be heard in GATT. This is to be expected. The NAFTA negotiations gave notice of the fact that rules of origin have fully arrived as tools in the cut and thrust of international trade policy. Given the enormity and importance of NAFTA in the world trading system, the NAFTA rules of origin will, in the future, be a focus of international attention.

COMMENTS ON THE ADVANTAGES AND DISADVANTAGES OF THE NAFTA RULES OF ORIGIN

MANUEL GALICIA R.*

In January of 1991, the Mexican private sector, represented by different business, commercial, and industrial chambers and associations, started identifying major issues in the process of negotiating a free trade agreement. One of the first issues was the determination of the private sector position on the rules of origin.[1] A critical underlying fact is that the territories comprising the free trade area will retain their import duties with respect to third countries. It was clear that rules of origin were necessary to determine what goods are eligible for lower duty or non-duty treatment. In the absence of rules of origin, products from third countries would be able to avoid the import duties of one member state by importing via another member state imposing a lower import duty. From the beginning the Mexican private sector acknowledged this situation, as well as the fact that the development of agreed rules of origin should benefit the business community in two major respects.

First, rules of origin should provide more uniformity in the treatment of products than under ordinary trading circumstances. Second, the drafting of objective rules allows trade and industry to determine with confidence whether they can produce goods eligible for free trade area treatment, and, consequently, whether they will be subject to lower import duties and be free from quantity and other restrictions. Based on these principles, the Mexican private sector proceeded to analyze which method would be most helpful to achieve such benefits.

Each of the existing methods presented different advantages and disadvantages. On the one hand, the substantial transformation test has been severely criticized because it generates a high degree of uncertainty, especially in exports. In practice, it is highly imprecise and inconsistent. On the other hand, the use of other methods, such as the determination of specific productive processes, resulted in a very costly formula to administer because it requires the formulation of extensive lists describing the important productive processes. In addition, with the use of other methods, the rules must be continuously renewed to keep abreast of the technological developments. As a result, it appears that the rules based on regional content were the methods that provided the most precision, clarity, and simplicity.

As can be seen, the task of establishing the rules of origin was not easy because each of the different formulas has some disadvantages. From

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1. *See* the North American Free Trade Agreement, Oct. 7, 1992 draft, U.S.-Can.-Mex., ch. 4 (Rules of Origin).

the Mexican prospective, however, one of the basic objectives was to establish rules of origin that would encourage national producers to transform raw materials imported from third parties. Therefore, it was not just a matter of negotiating a low regional content. That would create the risk of allowing foreign manufacturers to transport products through Mexico into the United States or Canada with no additional processing, or to import third-country products into Mexico for light processing before shipping them over to Canada or to America.

On the contrary, the Mexican private sector assumes that once the Northern American Free Trade Agreement ("NAFTA")[2] is in operation, foreign manufacturers may try to overcome the disadvantages of selling in the United States and Canada from outside the North American block by setting up factories in Mexico. Therefore, a beneficial arrangement from our perspective could be set into motion. This includes the expectation that NAFTA would enhance Mexico's political stability and economic growth by accelerating foreign investment, thereby permitting Mexico to acquire new technology to become more competitive and, of course, to create new employment.

Representatives of the private sector described their objectives before the Mexican Senate as follows: first, clear rules; second, simplicity and low cost in the application of the formulas; third, the recognition of the de minimis clause;[3] and, fourth, the establishment of working groups that would update the rules on technological developments.

The private sector businessmen with whom I have worked believe that the establishment of a free trade zone among Mexico, Canada, and the United States, based on clear rules that provide foreseeable results, will support the economic growth of our country. Yet, the Mexican private sector has to react very fast. The ten or fifteen year grace period provided by some sections may be a very short period of time, and Mexico cannot rely only on having low cost labor.

2. Oct. 7, 1992 draft, U.S.-Can.-Mex.
3. *Id.* art. 405.

COMMENTS ON NAFTA'S CUSTOM PROCEDURES FOR CERTIFICATES OF ORIGIN

LYNN S. BAKER*

I would like to comment on the North American Free Trade Agreement's ("NAFTA") customs procedures for Certificates of Origin.[1] They are actually an extension of what we already have under the United States-Canada Free Trade Agreement. Many companies in the United States and Canada are used to filling out these certificates on export. This is not a big problem for us, but it is going to be a big adjustment for the Mexican exporters if they have not been exposed to it in the past. The companies which are not necessarily related to American companies, or which are going into other markets for the first time and may not have kept track of the source of their components and materials in the ways that NAFTA will require, will face the question of whether the sheer paperwork is going to be worth it.

Although the rules will require that only one certificate be filed every twelve months, a manufacturer with shifting sources of supply must develop excellent record-keeping and notification procedures. If a plant closed down for emergency reasons and materials were not available locally, but were readily available in the Far East, this change in component source tracking could very easily knock a company out of preferential treatment under NAFTA. If you buy something from a producer and you are the exporter, and the producer does not notify you of a change in the source of components, then there will be a chain reaction all the way down the line. Those are some of the practical problems of the Certificates of Origin.

Some people have looked at this requirement in horror. I have been through a foreign verification. Although I have lived in America for many years, I still sometimes look at things from a European or a non-American point of view. It has always been amazing to me that the United States Customs Service will traipse all over the world investigating people. In 1983, I spent an excruciating week in Korea on a verification investigation concerning a customs issue, not a dumping issue. This had to do with whether we had a high enough percentage of leather in jogging shoes for them to be "leather footwear." To determine this, you measure

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1. Oct. 7, 1992 draft, U.S.-Can.-Mex., ch. 5.

the little bits of suede in the footwear. We spent a week translating Korean accounting records for the U.S. Customs officers. In 1986, I spent three more excruciating weeks in Singapore going through a verification under the Generalized System of Preferences. The common thread in both of these investigations is that in each case we had related companies. The manufacturing facility was a subsidiary of an American multinational corporation. Verification, therefore, can cause severe business disruptions.

DISCUSSION OF BORDER ENFORCEMENT ISSUES AND THE RULES OF ORIGIN

QUESTION: How long do you expect to have to wait for the Uniform Regulations to be adopted? It seems odd that everyone thinks we have the North American Free Trade Agreement ("NAFTA")[1] ready to go, but that one of the vital organs is not going to be functioning at all.

ANSWER, *Ms. Baker*: Under the U.S.-Canada Free Trade Agreement ("FTA")[2] we waited a couple of years. The system was literally working without a net on the American side and, when we got them, the regular implementing regulations for the Rules of Origin basically just parroted the Agreement. There was no interpretation.

ANSWER, *Mr. Reyna*: Until the Uniform Regulations are issued, parties should seek advance rulings and hope that those rulings give them support. As the Uniform Regulations have yet to be promulgated, the private sector may have an opportunity for input in the process, especially those parties that are not satisfied with the present shape of the NAFTA rules.

ANSWER, *Ms. Baker*: What will happen is what has been happening under the FTA and is something that American lawyers are familiar with. You go to the Customs Service in Washington, D.C. You submit a legal brief to the Office of Regulations and Rulings on why you should get preferential treatment, and they render a written, binding opinion. If you disagree with that, then you take them to court.

Basically, we are going to be taking a civil law approach to our process of advanced rulings because our briefs will be argued on logic. We have very little to go on in terms of legislative history or precedents. There probably will not be much in the congressional history because the agreement is subject to a straight up and down vote.

QUESTION: Will goods that come in before the rules are in place be grandfathered after the Rules of Origin are finally adopted? What would happen if an exporter, subsequent to issuance of uniform regulations, determined that it had made errors in prior declaration?

ANSWER, *Mr. Reyna*: The answer will depend on the Uniform Regulations. Note two things. First, rules of origin determinations are not subject to a special NAFTA review process: the parties' domestic review processes shall apply, which could lead to problems. Second, where an incorrect declaration is discovered in the course of a verification or audit,

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1. Oct. 7, 1992 draft, U.S.-Can.-Mex.
2. Jan. 2, 1988, U.S.-Can., *reprinted in* BASIC DOCUMENTS OF INTERNATIONAL ECONOMIC LAW 353 (Stephen Zamora & Ronald A. Brand eds., 1990).

the exporter could be liable for penalties, in addition to the duties that were not paid as a result of the incorrect declaration. On the other hand, if the error is disclosed voluntarily, then the exporter should be liable only for additional duties, and not for penalties.

ANSWER, *Ms. Baker*: Which is exactly what happened in the Honda case.[3] The American government said that the cars were Japanese and Honda owed duties. The Canadian government said that the cars were Canadian. There were differing interpretations of the value rules and we had no regulations. We can only hope that the Uniform Regulations come out quickly. How fast are we going to get them? I recently spoke with officials of the United States Customs Service and to the United States Trade Representative about this. They were both on the negotiation teams and they had no idea.

QUESTION: Have the negotiation teams considered changing the rules as to how much interest cost is allowable in determining the value of originating goods?

ANSWER, *Ms. Baker*: There are supposed to be rules on how much interest is allowable. That was one of the big issues in the Honda case, so they have thought about it. I think it is too early to tell, however, whether it will actually work. At least they have tried to approach the problem.

ANSWER, *Mr. Reyna*: Canadian officials were able to obtain a transition period for the elevation of content requirements for automobiles and auto parts. As a result, some believe that Honda will not have to pay additional duties, which are reported to be quite substantial. The Honda case relates to questions about interest expense calculations. The definition in Article 415 states that non-allowable interest costs means interests cost *actually incurred by the producer in the excess of the applicable federal government rate*, identified in the Uniform Regulations. So, we are back to the non-existing Uniform Regulations.[4]

ANSWER, *Ms. Baker*: Again, from a practitioners' point of view we can only predict trends as the clients ask us the questions and as we begin to see what sort of areas it's affecting. In a vacuum it's hard to come up with examples.

QUESTION: When must the cost basis be used, and would it apply to many products?

ANSWER, *Mr. Reyna*: The net cost basis must be used as a basis for regional value content for a number of products, including automobiles and auto parts. When you look at the products for which you must satisfy a regional value content requirement, and you compare those

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3. *See Customs, Honda Exchange Angry Charges in Rules of Origin Dispute*, INSIDE U.S. TRADE, Feb. 28, 1992, at 5-7.

4. *Id.*

products to the fifty top export/import products between the United States and Mexico, you find that a significant portion of the trade between the U.S. and Mexico shall be subject to the net cost test, or a regional value content requirement. Automobiles and auto parts, electrical harnesses, windshields and transmissions, are all subject to the net cost test.

ANSWER, *Ms. Baker*: That is why Mexican exporters prefer the transaction value method.

QUESTION: How will that work in the automotive industry?

ANSWER, *Mr. Reyna*: For the automobile trade, the net cost method must be used and there is a tracing requirement. That means that every single non-originating material that is used in the production of an automobile must be traced back to its initial entry into a NAFTA country. That is a substantial paperwork and record-keeping burden that is being placed on the automobile producers, albeit willingly. This is especially true for the auto parts industry. Let's say that a producer is subject to verification, Customs is going to request proof that value of non-originating components have been traced. They are going to say (Mr. Reyna holds up a tray), "Where did you get the paint to paint the bottom of this tray, where did you get the trim, and what was the value of those materials at the time they were received by the first person that took title to them within the territory of a party?"

ANSWER, *Ms. Baker*: It's like any other tracing requirement. We have had them in the generalized system of preferences. When you try to get the value of the components originating in or produced in the country eligible for preferences up to thirty-five percent, you start off with the bill of materials at the factory. In the verification investigations, U.S. Customs goes all the way back. They go to the bill of materials. If you are buying components, you have to get written assurances from your suppliers. It is not enough to say "I bought it from a company in America." The company in America may not necessarily have made it. They may have bought it from a company in England. You have to keep records.

QUESTION: Under the NAFTA rules, will the producer be required to furnish a Certificate of Origin?

ANSWER, *Mr. Reyna*: The producer is not required under the NAFTA rules to supply a Certificate of Origin, unless it also is the exporter. In other words, the burden will be directly on the exporter, not the producer, to supply the Certificate. The implication is that if you know that a product you produce is bound for export to another party, then you should keep the proper records to support a Certificate of Origin. To require otherwise would produce the absurd result that all producers would have to supply a Certificate, even in the instance where they had no reason to believe that the product will be exported to another party.

ANSWER, *Ms. Baker*: I think what will happen in practice is that this will become part of contract negotiations. If you are supplying screws to General Motors, and it is your main contract, General Motors is going to make you give some sort of written assurance. It may be just a simple letter on your letterhead saying "I hereby certify that I manufactured this product." It will be between the parties rather than the government stepping in all the way down the line.