

C-144

Information for Importers, Exporters or Producers

NAFTA Rules of Origin

Please note that this guide is not legislation or regulation. To provide plain language explanations, we have omitted many of the technical details and exceptions to the rules of origin. For the actual rules of origin, please see Memorandum D11-5 series.

La version française de cette publication est intitulée *Règles d'origine de l'ALENA*.

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What is the purpose of rules of origin?

We need rules of origin to provide objective criteria for determining whether or not goods are eligible for the benefits that NAFTA provides.

Sometimes it is obvious that a product originates in a particular country. For instance, if paper is made in Canada from Canadian trees, the paper obviously originates in Canada. However, if envelopes are folded in Canada from paper made in Brazil, which one is the country of origin? The NAFTA rules of origin provide precise answers to such questions.

On page 10, we provide a step-by-step guide that explains how to determine whether a good originates in a NAFTA country.

How do goods qualify as originating?

We consider a good to be an **originating good**, if it meets one of the five requirements set out in the NAFTA rules of origin.

These five requirements are as follows. We consider a good to be originating if:

- the good is **wholly obtained or produced** in a NAFTA country (including those goods that are entirely grown, fished, or mined in a member country – it does **not** include goods purchased in a NAFTA country that were imported from a non-NAFTA country);
- the good is made up entirely of **components and materials** that qualify in their own right as goods that originate in a NAFTA country;
- the good meets the requirements of a **specific rule of origin** for that product, as listed in NAFTA Annex 401;
- the good qualifies under NAFTA **article 401(d)**, which only applies to a few cases; or
- the good is automatic data processing equipment or parts qualifying under the provisions of Annex 308.1.

Of these five requirements, the most common is the third, which applies to a good that includes any non-originating materials in its production.

What are non-originating materials?

The non-originating materials used to produce the good are those materials or components that would not qualify as originating under the NAFTA rules of origin.

Non-originating materials are:

- materials or components you import from a non-NAFTA country; **or**
- materials produced in a NAFTA country but, because of the high level of offshore input used to produce them, do not meet the rule of origin.

Note

You have to treat any material of unknown or unconfirmed origin as a non-originating material.

How do the specific rules of origin work?

NAFTA provides a specific rule of origin for every type of good that incorporates non-originating materials. In many cases, two different rules may apply to a good, and the good may qualify under either rule.

Generally, a good qualifies as originating in one of the NAFTA countries if its last place of manufacture was within the NAFTA territory, and if the manufacturing process resulted in a significant change in all of the components or materials not of Canadian, American, or Mexican origin. To test whether a significant change has occurred, we use a tariff classification change test.

When a product is transformed from all materials and components used into the finished good, there is a resulting change from the tariff classifications of the materials and components to that of the finished good.

Harmonized System of tariff classification

A good's specific rule of origin is based on its tariff classification under the Harmonized System (HS). The HS organizes products according to the degree of manufacture, and assigns them classification numbers. It is arranged into 97 chapters covering all products. Each chapter is divided into headings, subheadings, and tariff items.

Example

Chapter 95 Toys, games and sports requisites
 Heading 95.04 Table or parlour games
 Subheading 9504.20.....Articles for billiards and accessories
 Tariff item 9504.20.21..... Billiard tables

9504.20.21

As shown above, headings are identified with a four-digit number, subheadings with a six-digit number, and tariff items with an eight-digit number. As you can see, subheadings give a more specific description than headings, and tariff items give a more specific description than subheadings.

Under the **Harmonized System**, the chapter, heading, and subheading numbers for any good are identical in any country using the HS. Please note, however, that the final two digits of the tariff items are not harmonized – they are individually assigned by each importing country.

Example

All tomato sauces are classified in the HS subheading 2103.20, regardless of the country of import. However, tomato ketchup is specifically classified by tariff item 2103.20.10 in Canada, 2103.20.40 in the United States, and 2103.20.01 in Mexico.

The specific rules of origin in NAFTA Annex 401 are organized using the HS classification numbers. Therefore, once you have determined the HS classification of the good, use that classification to find the specific rule of origin in Annex 401 that applies. If the good meets the requirements of the rule of origin, it is an originating good.

HS classification change

Most of the specific rules of origin require a certain **HS classification change** from the non-originating materials to the finished good. This change must be a result of production in one or more of the NAFTA countries.

Example

Orange marmalade is classified under heading 20.07. Fresh oranges are classified under heading 08.05. The specific rule of origin for orange marmalade requires a chapter change. If fresh oranges from Brazil are transformed into orange marmalade in the United States, the orange marmalade is an originating good, because a change from chapter 08 to chapter 20 has occurred.

In most cases, the only requirement of a rule of origin will be an HS classification change specified by Annex 401. Therefore, to determine whether a good qualifies as an originating good under NAFTA, after looking up the specific rule of origin, exporters or producers will need to know only the HS classification of the good, and the HS classification of any non-originating materials.

Regional value content test

Sometimes a specific rule of origin will require you to meet an additional requirement for a good to qualify. Usually, this additional requirement tests the good's **regional value content (RVC)**, which requires that a certain percentage of the good's value originates in a NAFTA country.

For example, some rules may specify that a good must have at least 65% RVC. To qualify for originating status under NAFTA, therefore, you have to demonstrate that at least 65% of the good's value originated in Canada, the United States, or Mexico.

If a rule requires an HS classification change **and** an RVC test, the good has to meet **both** of these requirements to be an originating good.

For many manufactured items, NAFTA provides two alternative specific rules of origin. The first requires only an HS classification change. The second requires a lesser degree of HS classification change, such as a change of subheading instead of heading, but also requires an RVC test.

Example

Powdered laundry soap is classified in subheading 3401.20. Annex 401 provides two specific rules of origin for this product. For instance, if imported fatty acids (classified in chapter 15) are transformed into powdered laundry soap, this is sufficient for us to consider the powdered soap as an originating good.

However, if laundry soap is imported into North America in solid form and transformed into powdered laundry soap, we can only consider it to be an originating good if a certain percentage of the final good's value is added in North America.

Calculating regional value content

NAFTA provides two alternative formulas that exporters or producers can use to calculate the regional value content of their goods:

- the **transaction value method**; and
- the **net cost method**.

In most cases, exporters or producers can choose either method.

Transaction value method


Under the transaction value method, exporters or producers have to subtract the value of any non-originating material used to produce the good from the actual price paid for the good. In most cases, the **value of a non-originating** material is the total amount it costs producers to purchase the material and get it to the production site.

Then, exporters or producers have to divide the difference by the price, and convert the result to a percentage to get the RVC.

The formula is as follows:

$$\frac{\text{transaction value} - \text{value of} \\ \text{non-originating materials}}{\text{transaction value}} \times 100 = \text{RVC}$$

In most cases, if exporters or producers use the transaction value method, the specific rule of origin will require that the RVC for an originating good be at least 60%.



Example

A producer sells a good for \$100 in an arm's-length sale. The value of the non-originating materials used in the good is \$30.

Using the transaction value method, the producer calculates the RVC as follows

$$\frac{\text{transaction value} - \text{value of non-originating materials}}{\text{transaction value}} \times 100 = \text{RVC}$$

$$\frac{\$100 - \$30}{\$100} \times 100 = 70\%$$

Therefore, using the transaction value method, the RVC of the good is 70%.

Note

The RVC percentage is only relevant if the production results in the necessary HS classification change **and** the specific rule of origin that applies requires an RVC.

In the following circumstances, exporters or producers cannot use the transaction value method, so they have to apply the net cost method:

- the good has no transaction value (e.g., barter);
- the transaction value of the good is unacceptable under the Customs Valuation Code ;
- related-party transactions where most of the producer's sales are to related parties;
- the goods being imported are certain motor vehicles or automotive parts; and
- the goods being imported are footwear or word processing machines.

Exporters or producers who are not sure whether they can use the transaction value method should call a regional Trade Administration Services office. You will find addresses and telephone numbers on the back cover of this publication.

Net cost method

Under the net cost method, exporters or producers have to subtract the value of non-originating materials used to produce the finished good from the **net cost** of the good.

In most cases, the **value of a non-originating** material is the total amount it costs producers to purchase the material and get it to the production site.

Then, exporters or producers have to divide the difference by the net cost, and convert the result to a percentage to get the RVC.

The net cost formula is as follows:

$$\frac{\text{Net cost} - \text{value of non-originating materials}}{\text{Net cost}} \times 100 = \text{RVC}$$

In most cases, if exporters or producers use the net cost method, the specific rule of origin will require that the RVC for an originating good be at least 50%.

Determining the net cost of a good

To determine the **net cost** of a good, begin with all the costs of producing the good, and then subtract any costs that are specifically excluded. Specifically excluded costs are costs for:

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

Example

A producer sells a good for \$100 but is not sure whether this price is acceptable under the Customs Valuation Code. The producer chooses to use the net cost method. The value of non-originating materials is \$30.

Using the net cost method, the producer has to calculate as follows:

Step 1

The total cost of the good is \$90. Sales, shipping, and royalty costs that can be allocated to the good are \$10. Therefore, the net cost of the good is \$80.

Step 2

$$\frac{\text{Net cost} - \text{value of non-originating materials}}{\text{Net cost}} \times 100 = \text{RVC}$$

$$\frac{\$80 - \$30}{\$80} \times 100 = 62.5\%$$

Therefore, using the net cost method, the RVC of the good is 62.5%.

Note

The RVC percentage is only relevant if the production results in the necessary HS classification change **and** the specific rule of origin that applies requires an RVC.

Changing the method of RVC calculation

If exporters or producers select the transaction value method, and they are advised by Revenue Canada that the transaction value of the good (or the value of any material used to produce the good) is unacceptable or needs to be adjusted, they can choose to use the net cost method.

However, if they select the net cost method initially and the results are unfavourable, they cannot switch to the transaction value method.

Special options

These are additional rules of origin that exporters or producers can use if their goods fail to qualify under the specific rules of origin.

De minimis exception to HS classification change requirement

NAFTA provides relief when a good does not qualify as an originating good only because some non-originating material of little value fails to meet an HS classification change requirement. If the value of the non-originating material in question is no more than 7% of the value of the good, we consider the good to be an originating good.

Example

A good uses two materials, A and B, and both are non-originating materials. As a result of its transformation into the finished good, A makes the required HS classification change, but B does not. Because B does not make the required change, the finished good will not qualify **unless** the value of B is no more than 7% of the good's value.

Please note that the test **only** considers whether the non-originating material that **does not meet** the HS classification change is not more than 7% of the total value.

As a general rule, a good can incorporate **any** amount of non-originating material and still be an originating good, as long as these materials meet the required HS classification change for the finished product.

In many cases, you cannot use the *de minimis* exception to the HS classification change requirement. Contact Revenue Canada officials to determine whether or not you can use the *de minimis* exception.

De minimis exception to RVC requirement

A producer of a good that is subject to an RVC requirement can disregard that requirement if the value of all non-originating materials in that good is less than 7% of the transaction value of the good.

Accumulation

A good may be produced partly in one NAFTA country, and completed in another, or may be produced partly by one producer and completed by another. To determine whether a good meets an HS classification change or an RVC test, treat the production done in both countries as if it occurred in one, and treat the production done by both producers as if it were completed by one.

Producers can only accumulate their suppliers' production costs if suppliers are willing to provide supporting documentation on their North American costs.

Accumulation is useful if you purchase a non-originating material and you know that the material contains some originating content.

Example

An American yacht producer calculates RVC and finds that the yachts produced have only 53% RVC under the transaction value method, and 44% under the net cost method.

However, the yacht's engine, which is a \$25,000 non-originating material, was supplied by a producer in Canada. The engine producer gives the yacht producer a letter stating that, although the engine is not an originating material, \$8,000 of the engine's value was incurred in North America.

With this information, the yacht producer can accumulate the \$8,000 as part of the North American content of the yacht. With this additional \$8,000 North American content, the yachts might satisfy the minimum RVC requirement (the net cost method has to be used with accumulation).

Intermediate materials

You can designate as an intermediate material any material you produce from non-originating materials. If this intermediate material has a different Harmonized System number than the finished product, you may find that using the rule of origin for the intermediate material may help you qualify the finished product.

Example

An American producer calculates the RVC and finds that the product does not pass the RVC test. However, a large part of the non-originating value is accounted for by non-originating materials X and Y. The producer manufactures X and Y into a material Z. Material Z has a rule of origin which allows for a change in heading from the headings for materials X and Y. Therefore, by designating Z as an intermediate material, the producer may recalculate the RVC of the product using the entire value of Z as an originating material. With X and Y no longer included as non-originating content, the product may pass the RVC test.

Step-by-step guide to determining a good's origin

Follow these steps to determine whether a good qualifies as an originating good under the NAFTA rules of origin.

Step 1

Was the good last processed in one of the NAFTA countries?

If *yes*, go to step 2.

If *no*, the good does not qualify.

Step 2

Do **any** of the materials or components used in the good come from outside Canada, the United States, or Mexico, or otherwise do not qualify as originating materials under the NAFTA rules of origin?

If *yes*, go to step 3. (If you do not know the origin of any material, you have to assume it does not originate in a NAFTA country.)

If *no*, the good qualifies. Go to Step 9.

Step 3

Determine the HS classification number of the good being imported into Canada. Usually, the six-digit subheading level is sufficient.

Step 4

Using the HS classification number, identify the specific rule or rules of origin in Annex 401 that apply to the good.

If two rules apply, you must meet one of them. One rule may require only an HS classification change, whereas the other requires an HS classification change and an RVC test. Select the rule that is most appropriate for the non-originating materials used to produce your goods.

Step 5

Determine the HS classification of the non-originating materials or components you use to produce the good in a NAFTA country.

Step 6

Does the change from the HS classification of the non-originating materials to the HS classification of the good imported into Canada meet the HS classification change required in the specific rule or rules of origin you identified in Step 4?

If *yes*, the HS classification change requirement is met. Go to Step 7.

If *no*, the good does not qualify, unless it falls under certain exemptions. If the value of the non-originating materials that do not meet the HS classification change requirement is not more than 7% of the value of the good, the *de minimis*

exemption may apply, and the good qualifies as an originating good, as long as it meets all other requirements of the rule of origin.

Step 7

Does the specific rule also contain an RVC test?

If *yes*, choose whether to use the transaction value method or the net cost method.

If *no*, and the HS classification change requirement is met, the good qualifies as an originating good. Go to Step 9.

Be careful! Be sure you are eligible to use the transaction value method before you select it. In particular, be sure that the price paid for the good is acceptable under the principles of the Customs Valuation Code. If there is any doubt, contact your regional Trade Administration Services office (see back cover for addresses and telephone numbers) or use the net cost method. Please note that for certain types of goods you can only use the net cost method.

Step 8(a) – Transaction value method

Determine the actual price paid for the good and the value of the non-originating materials used to produce it. Using the transaction value formula, calculate the RVC percentage.

If the RVC percentage is **equal to or more than** the minimum percentage set out in the specific rule of origin for transaction value calculations, the good qualifies as an originating good, as long as you meet all other requirements of the rule. Go to Step 9.

If the percentage is **less than** the set minimum, try using the net cost method.

Step 8(b) – Net cost method

To determine the net cost of the good, deduct the specifically excluded costs from the total cost of the good. Then, determine the value of the non-originating materials and components. Using the net cost formula, calculate the RVC percentage.

If the RVC percentage is **equal to or more than** the minimum percentage set out in the specific rule for net cost calculations, the good qualifies as an originating good, as long as the good meets all other requirements of the rule. Go to Step 9.

If the percentage is **less than** the set minimum, try using the accumulation rule to see if you can increase your regional value content by counting your North American suppliers' costs as your own. You can also try to increase your regional value content by designating a material you produce as an intermediate material. If you are still below the set minimum, the good **does not** qualify.

Step 9

Complete a *Certificate of Origin* if the good is an originating good.

Need more information?

For general NAFTA enquiries, please contact the NAFTA Information Desk at 1-800-661-0965.

You will find the NAFTA rules of origin in Memorandum D11-5-1, *NAFTA Rules of Origin Regulations*. You can get copies of memoranda from:

Canada Communication Group
Ottawa ON K1A 0S9
Telephone: (819) 956-4802
Facsimile: (819) 956-4800

A *Trilateral Customs Guide to NAFTA* has been published by the customs administrations of Canada, the United States, and Mexico. In Canada, contact any of the regional Trade Administration Services offices listed on the back cover to obtain a copy. In the United States, you can get a copy from:

Superintendent of Documents
U.S. Government Printing Office
Washington, D.C. 20402-9328
Attn: Order Desk
Telephone: (202) 783-3238

In Mexico, you can obtain a copy from:

Instituto Nacional de Capacitación Fiscal
Allende Sur No. 8
Col. Centro
Querétaro, Qro. 76000, Mexico
Telephone: 14-28-86
12-60-93
14-33-51
Facsimile: 12-54-53

At Revenue Canada, we can provide information on current Canadian duties, Harmonized System (HS) classification, and rules of origin that apply to your products. Contact any of the regional Trade Administration Services offices listed on the back cover for details.

Regional Trade Administration Services offices

| Region | Address | Telephone (public enquires) |
|-------------------------|---|---|
| Atlantic | Ralston Building 1557 Hollis Street P.O. Box 3080 Stn. Halifax South Halifax NS B3J 3G6 | (902) 426-2911 |
| Quebec | 400 d'Youville Square Montréal QC H2Y 2C2 | (514) 283-9900 |
| | 130 Dalhousie Street P.O. Box 2267 Québec QC G1K 7P6 | (418) 648-4445 |
| Northern Ontario | 2265 St. Laurent Blvd. Ottawa ON K1G 4K3 | (613) 993-0534 (613) 998-3326 (after 4:30 p.m. and weekends) |
| Southern Ontario | 2nd floor 1 Front Street W. P.O. Box 10 Station A Toronto ON M5W 1A3 | (416) 973-8022 (416) 676-3643 (weekends and holidays) |
| | 26 Arrowsmith Road P.O. Box 2989 Hamilton ON L8N 3V8 | (905) 308-8715 and 1-800-361-5603 (Hamilton only) |
| | 10th floor 451 Talbot Street London ON N6A 4T9 | (519) 645-5843 |
| | P.O. Box 2280, Station A Walkerville Post Office Windsor ON N8Y 4R8 | (519) 257-6400 |
| Prairie | Federal Building 269 Main Street Winnipeg MB R3C 1B3 | (204) 983-6004 |
| | 720 Harry Hays Building 220 - 4th Avenue S.E. Calgary AB T2G 4X3 | (403) 292-4660 (403) 292-8750 |
| Pacific | 333 Dunsmuir Street Vancouver BC V6B 5R4 | (604) 666-0545 |