

**COMMENTS AND AMENDED PROPOSALS ON RULE 2 OF APPENDIX 2
OF THE HARMONIZED RULES OF ORIGIN**

Communication from the United States

The following communication, dated 7 February 2000, has been received from the Permanent Mission of the United States.

The United States submits the following comments and amended proposals regarding the scope of application and text of Rule 2 of Appendix 2 of the Harmonized Rules of Origin.

We note that there is general agreement with respect to the following items:

- (a) origin is to be determined according to the sequence provided in Appendix 2, Rule 2;
- (b) applicable primary rules that specify origin to be where the good was obtained in its natural or unprocessed state require origin to be in that country no matter where or how the good was subsequently processed;
- (c) the origin of a good is the last country of production provided a primary rule applicable to the good was satisfied in that country; and
- (d) the utility of a rule that provides for the concept of origin retention.

What has yet to be agreed upon includes the drafting of the so-called "origin-retention rule", the placement or location of the chapter residual rule provisions, and the application of the residual rules.

For reasons described in more detail below, we bring to the Committee's attention the US proposal made at its November 1999 session for a rule that requires origin to be in the country where a specified process was carried out, whether or not further processing was carried out in another country. See page 35A to the Integrated Negotiating Text for the Harmonization Work Programme (G/RO/41).

Outstanding Architectural Issues:

A. NEED FOR NEW RULE: APPENDIX 2, RULE 2 (A)(II)

As to the question of the rules that confer origin on the basis of a designated stage of manufacture, a specific rule dealing with that situation is necessary for the same reason that Rule 2 (a) is needed: to clarify that the origin of the good is the country in which the designated processing

operation took place, regardless of whether the good is further processed beyond the designated stage of manufacture.

Example 1: Certain delegations have proposed that the country of origin for the electronic integrated circuits of heading 85.42 should be the country in which diffusion takes place. For proponents of that proposal, the primary rule of origin for the electronic integrated circuits can only be satisfied in the country where diffusion takes place regardless of whether any subsequent processing occurs in any other country.

Example 2: Another example where this rule would be applicable is in the case of headings 26.18, 26.19 and 26.20 where the primary rule is based on where a particular stage of production was reached.

B. THE PLACEMENT OF CHAPTER SPECIFIC RESIDUAL RULES

The Committee has discussed at great length the question of the order of application of Rules 2 (c) and 2 (d). Upon further reflection, we can accept reversing the sequence of Rule 2 (c) and Rule (d), provided that (1) the primary or residual status of the product specific rules can be redesignated at the chapter level and (2) the text of redesignated Rule 2 (c) be modified to avoid ambiguity.

C. TEXT FOR ORIGIN-RETENTION RULE: NEW RULE 2 (C)

In view of the ambiguities found in the current text to Rule 2 (c) at the last session of the Committee, we believe the actual intention and scope of the rule is better reflected by the following text:

When a good undergoes one or more operations that do not result in a change in its classification, the origin of the resulting good is the country from which the good originated immediately prior to such operations, provided that any material added satisfies a primary rule applicable to the good.

Attached as an annex to this note is a modified Appendix 2, Rule 2 which reflects the above-mentioned changes. We shall submit any necessary revisions to our product proposals at a later date.

D. PRINCIPLES FOR THE APPLICATION OF RESIDUAL RULES

We note that in the case of nearly all residual rule proposals an examination of the nature and importance of the materials and components used in the good is necessary in order to fix the country of origin of the good.

1. When All the Materials or Components Originate in a Single Country

Current Appendix 2, Rule 2 (e) specifies that when all the materials in a good have origin in a single country, the country of origin of the good is that country. The United States can accept this rule where it is currently located; that is, after the rule on origin retention and after the rule for chapter-specific residual rules. We note that for purposes of this rule, the reference to the origin of the materials means their origin as determined on the basis of the applicable primary or residual rule.

2. When a Good Contains Materials Which Originate in More Than One Country

The United States is firmly of the view that when a good contains materials or components of more than one country, the residual rules must base origin on the materials or components in the good

that fail to satisfy a primary rule in the last country of production. The reason for this is of fundamental importance: such materials and components have been identified by proponents of such rules to be the materials or components that must change classification for the good to have undergone a substantial transformation.

Thus, for purposes of such residual rules, the good is considered to originate in the country of origin of the materials or components that have failed to meet the rule. Not recognizing the priority of such materials or components in the general residual rules would create inconsistency and a lack of coherence with the primary rules themselves. Moreover, it is essential that in applying these rules no distinction be made between originating and non-originating materials and components. This is because from a technical point of view the importance of the material or component to the character or essence of the good is not affected by whether the material or component is originating or non-originating.

The following discussion is intended to explain the principles that should form the foundation of the residual rules.

(a) The Meaning of Origin Rules Expressed as a Change in Classification.

Nearly all proposals for rules of origin include a primary rule based on a tariff shift or change in classification. The reason for this is that a change-in-classification rule represents the transformation of all foreign or non-originating materials or components used in the final good in the country in which the good was produced.

Specifically, a rule based on change of heading means that when a material or component from a heading other than that of the good is used to produce the good, the material or component is considered to be transformed as a result of the manufacturing process.

Example 1: heading 48.20 provides for diaries. It is a basket 1 CTH rule. Under this rule, any material of a different heading that is used in the production of a diary, whether it is paper of chapter 48 or leather of chapter 41 for the cover of the diary, is considered substantially transformed when used to produce the diary (as both the paper and the leather change classification when used to make the diary).

There can be no doubt about this approach when a change-in-classification rule is satisfied in the last country of production. Therefore, the Committee has agreed to Appendix 2, Rule 2 (b) which explains that the country of origin is the last country of production if a primary rule applicable to the good is satisfied in that country.

To date, the Committee has yet to agree on all the rules that should come into play when a rule of origin is not satisfied in the last country of production. We believe that appropriate rules will emerge if we continue to apply the same basic concepts to these scenarios as we do in the above mentioned first example or scenario.

(b) The Need for Consistency with the Concept of Origin Retention

(i) *Where One Material or Component Fails to Change Classification*

In the above-mentioned example of the diary, if leather from country A and paper from country B are used to make a diary in country C, the resulting diary would be a product of country C (as both the paper and leather underwent a change in classification when made into a diary in country C). If the diary were then sent to country D where it is engraved on the outside cover with gold

lettering and then sent to country E, it would appear that we all would agree that the origin of the diary would remain country C because the engraving did not cause the diary to change classification.

Certain countries have referred to this last operation as an "origin-retaining scenario". We agree. It is useful, however, to analyze this scenario as involving two materials that make up the engraved diary: (1) the gold used to engrave it and (2) the unengraved diary itself. We believe that the principle involved is that the origin of the final good is that of the material that did not undergo the change in classification provided for in the rule, i.e., the unengraved diary.

By contrast, the gold used to engrave the outside cover of the diary underwent a change in classification when it was applied to the outside of the diary. In view of its transformation, it seems clear that the origin of the gold should not govern the origin of the engraved diary.

Appendix 2, Rule 2 (d) of the draft compromise solution proposed by the EC provides for this result by, in effect, referring to the diary as "an article which has already the essential characteristics of the good as is classified in the same (sub)heading as the good."

There seems to be consensus that the origin should be the origin of that article.

Example 2: An identical example of this origin-retaining principle can be found in the rule of origin for waffles of heading 19.05. The agreed upon rule for waffles of this heading is CTH. If flour and milk from country A and eggs from country B are used to make waffles in country C, the waffles would be products of country C (as the flour, milk and eggs change classification when made into waffles). If the waffles are then sent to country D to be coated with chocolate from country E, and then sent to country F, the waffles remain products of country C (because the chocolate coating did not cause the waffles to change classification). The chocolate would then assume the origin of the waffles because the chocolate underwent a change in classification when used to coat the waffles.

The concept of origin retention is correct and valid. Moreover, we believe that in order to be coherent and consistent, the principles underlying origin retention must also be applied in those circumstances and situations described and addressed in the residual rules that follow Appendix 2, Rule 2 (d); Rules 2 (f) and 2 (g).

(ii) *Where One Material or Component Comes from an Excepted or Excluded Heading or Subheading.*

The Integrated Negotiating Text for the Harmonization Work Programme contains many proposals for primary rules based on a change in classification that explicitly exclude a named material or component of an enumerated provision even if it undergoes a change in classification. These rules are expressed as a "change in heading or subheading, except from...".

The basis of rules containing excepted or excluded materials or components is that despite the change in classification, the excepted or excluded material or component did not undergo a substantial transformation. In such instances, it is claimed that no substantial transformation occurs because the operation involved in the production of the good was too simple or the excepted or excluded material or component imparts the essential character to the good.

The basic approach or principle that an excluded or excepted material or component is not transformed has never been doubted or challenged during the harmonization work program.

Example 3: Billets of iron or non-alloy steel of heading 72.07. This is a basket 1 rule which states that "CTH except from 72.06". Suppose that ingots of heading 72.06 from country A are made into billets (72.07) in country B. Even though the ingots changed heading, the rule is not met in country B. Determining the origin of the billets requires a residual rule. Clearly, the origin of the billets would be country A, the origin of the ingots, for it is these ingots that were not substantially transformed in country B.

Thus, in the examples discussed above, whether the rule is not met because a material or component did not change classification, or whether it is not met because one of the materials or components changed classification but such a change does not satisfy the primary rule, the fundamental approach to change-in-classification rules requires resort to those materials or components that did not meet the rule in order to fix the origin of the good.

There seems to be agreement among proponents in simple situations such as that presented above with the ingots and the billets. It may be suggested that the example of the ingots is too simple because it presents the situation in which the final good consists of only one material which is then processed in the last country of production. On the contrary, we believe that the same approach can and should be followed even when more complex scenarios are presented.

Example 4: Cocoa beans (heading 18.01) from country A are crushed in country B where they are combined with extenders or emulsifying agents from countries C and D to make cocoa paste (heading 18.03). Suppose, for purposes of this illustration, that the rule of origin for cocoa paste is agreed to be "CTH except from 18.01".

In the above example, all of the materials used in the production of the cocoa paste have been substantially transformed except for the cocoa beans. Under such circumstances, it seems unnecessary and inconsistent with the primary rule to examine the origin of the extenders or emulsifying agents. Rather, it is only the origin of the material that did not meet the rule that is relevant in the origin analysis.

(iii) *Where More than One Material or Component Fails to Change Classification or Comes from an Excepted or Excluded Provision, or Both, the Residual Rules Should Provide a Basis for Determining Origin from among the Countries of Origin of Such Materials or Components.*

The foregoing examples or scenarios are limited to the context in which there is only one country that has contributed materials or components that did not meet the rule of origin. Suppose, however, that more than one country has contributed materials or components that did not meet the rule of origin.

This scenario has been the subject of proposals in the Committee which have been referred to as the "major-portion rule". These proposals specify that the origin of the good is the country that contributed the major portion of certain materials or components. It is expected that the major-portion rule will be based on some quantitative factor such as weight or volume.

The United States believes that for reasons of coherence and consistency, the major-portion rule should be applied with reference only to those materials or components, whether foreign or domestic, that do not meet the change in classification or other requirements of the rule. It is these materials or components that have not been substantially transformed as required by the primary rule. Therefore, they are of the greatest importance in terms of the character or essence of the good.

Example 5: A chemical product from country A and a chemical product from country B are mixed in country C together with inert ingredients from Country C.

The materials of countries A and B do not undergo any applicable change of classification or meet any other primary rule in country C. The inert ingredients, however, do meet the change-of-classification rule in country C. Origin should be based on the country of the chemical product of country A or B that furnished the major portion of the final product rather than on the inert ingredients (even if the inert ingredients predominated by weight or volume). This is because the inert ingredients, unlike the materials of countries A and country B, were transformed in country C.

3. In Determining Origin at the Residual Level, Originating and Non-Originating Materials and Components Merit Equal Consideration.

Example 6: A chemical product from country A and a chemical product from country B are mixed in country B. No change in classification or other primary rule is met in country B. There are two materials, one from country A and one from country B, which did not change classification. Origin should be based on the country of the chemical product that furnished the major portion of the final product whether or not that portion was originating or non-originating.

The fundamental approach to origin under the Agreement on Rules of Origin is that the country of origin of a good shall be the country that converted or transformed each non-originating material or component into a new or different article of commerce.

If in the last country of production, a primary rule has not been met for the subject good, then, the origin determination should be based on the applicable residual rule which is expressed as the origin of an appropriate material or component in that good. For that purpose, originating and non-originating materials and components must be given equal consideration in the origin analysis.

Not according equal importance to the originating materials or components in a product would result in originating materials and components never conferring origin on a product. There exists no logical reason for such a result. Moreover, treating originating materials and components on a basis different from non-originating materials and components is contrary to the principles set forth in the Agreement on Rules of Origin.

Conclusion

At each step in the architecture, the principles of substantial transformation should be followed. This means that whenever a primary rule is not met in the last country of production, origin should be determined based on the material or component that did not satisfy the primary rule of origin, whether by not changing classification or whether by coming from a heading from which a change in classification is not permitted.

Where there is only material or component from one country that did not satisfy the primary rule, the origin of the good should be the origin of that material or component. Where more than one country provides such materials or components, origin should be based on the country that contributed the major portion of such materials or components.

Amended Rule 2 of Appendix 2

APPENDIX 2 - Product Specific Rules of Origin

Rule 2: Determination of Origin

The country of origin shall be determined in accordance with the following provisions, applied in sequence:

- (a) when a primary rule requires that the country of origin of a good is the country in which:
 - (i) the good was obtained in its natural or unprocessed state, the country of origin of the good shall be the country in which the good was obtained in that condition; or
 - (ii) a specifically designated stage of production was attained, the country of origin of the good shall be the country in which such stage of production was attained;
 - (b) the country of origin of a good is the last country of production, provided a primary rule applicable to the good was satisfied in that country;
 - (c) when a good undergoes one or more operations that do not result in a change in its classification, the origin of the resulting good is the country from which the good originated immediately prior to such operations, provided that any material added satisfies a primary rule applicable to the good;
 - (d) the country of origin shall be determined as indicated in the applicable residual rule specified at the chapter level;
 - (e) when the good is produced from materials all of which originate in a single country, the country of origin of the good is the country of origin of those materials;
 - (f) when the good is produced from materials of more than one country, (whether or not originating) the country of origin is the single country of origin of the material that did not undergo the change of classification or otherwise satisfy a primary rule applicable to the good;
 - (g) when the good is produced from materials (whether or not originating) of more than one country that did not undergo the change of classification or otherwise satisfy a primary rule applicable to the good, the country of origin of the good shall be the country in which the major portion of those materials originated, as determined on the basis specified in each chapter.
-