



PREFERENTIAL RULES OF ORIGIN FOR LEAST-DEVELOPED COUNTRIES

RULES OF ORIGIN BASED ON THE CRITERION OF CHANGE OF TARIFF CLASSIFICATION

BACKGROUND NOTE BY THE SECRETARIAT¹

1 INTRODUCTION

1.1. When a product is manufactured in two or more countries, different criteria help identify meaningful manufacturing processes that can be considered to have "substantially transformed" or "sufficiently processed" the product in question. The outcome of such transformation is a new product the origin of which can be attributed to a single country. Three main types of criteria can be used to draft substantial transformation rules of origin:

- (i) a criterion based on a change of tariff classification: that is, a comparison between the tariff classification of the final product and the tariff classification of the inputs or raw materials used;
- (ii) a criterion based on the value of the material: that is, a threshold defining the minimum value that needs to be added locally or the maximum value of foreign inputs that may be used;
- (iii) a criterion based on specific manufacturing operations: that is, the enumeration of specific manufacturing or processing operations that must occur within a country.

1.2. The Bali (WT/L/917) and Nairobi (WT/L/917/Add.1) Ministerial Decisions on preferential rules of origin contain specific provisions covering these three criteria. This note focuses on the provisions and existing national practices in relation to the change of tariff classification criterion.

2 THE CHANGE OF TARIFF CLASSIFICATION (CTC) CRITERION

2.1. The change of tariff classification (CTC) criterion considers differences in tariff classification between a final product and the materials used in the manufacture of the product. It identifies minimum requirements that must be met in the classification of non-originating materials for origin to change. In general, non-originating materials will be deemed to have undergone a "substantial transformation" when their tariff classification is different from the ensuing final product for the manufacture of which they were used.

2.2. In designing rules using the CTC criterion, the following technical terms are commonly used.

- *Tariff classification* refers to the taxonomy of goods under specific chapters, headings, or sub-headings in the Harmonized System (HS).² The HS provides a coding system that is based on a hierarchical structure, starting with *section* at the highest level, and getting more specific at *chapter*, *heading* and *sub-heading* levels. Its nomenclature consists of 21 sections,

¹ This document has been prepared under the Secretariat's own responsibility and is without prejudice to the positions of Members or to their rights and obligations under the WTO.

² Harmonized System (HS) is the short form for the Harmonized Commodity Description and Coding System, a multipurpose international product nomenclature developed by the World Customs Organization (WCO). More detailed information on the HS Convention and the HS Nomenclature 2017 Edition can be found on the WCO's website: http://www.wcoomd.org/en/topics/nomenclature/instrument-and-tools/hs_convention.aspx.

arranged in 97 chapters, and further divided into around 1,200 four-digit headings, and 5,000 six-digit sub-headings. All products of a single industry are generally grouped together in one chapter or a group of chapters. Within the same chapter, headings and sub-headings are generally arranged by stage of processing, starting with raw materials and progressing to finished products³;

- *Change in tariff classification* means that the tariff classification of the final product is different from the tariff classification of all non-originating materials used. The minimum requirement of change is defined by the rule of origin and may take place at different levels: chapter (two-digit level), heading (four-digit level), or sub-heading (six-digit level). In other words:
 - *Change in chapter (CC)* means that all non-originating materials are not classified in the same chapter as the final product;
 - *Change in tariff heading (CTH)* means that all non-originating materials are not classified in the same heading as the final product;
 - *Change in tariff sub-heading (CTSH)* means that all non-originating materials are not classified in the same sub-heading as the final product;
- *Non-originating materials* refers to all raw materials, inputs, or components, that do not originate in the country of manufacturing or the country where the last substantial transformation has occurred (that is, the preference-beneficiary LDC). Materials of indeterminate origin will also be considered as non-originating. A change of tariff classification rule focuses only on non-originating materials. That is, when verifying if the rule has been met, only non-originating materials must have undergone the minimum prescribed tariff classification change;
- *Tolerance (or de minimis)* rule is a derogation for products containing minor amounts of non-originating materials that have not met the minimum changes stipulated in the rule of origin. Sometimes the tolerance rule also applies to sub-headings, headings, or chapters, that are excluded from consideration, or to the sub-headings, headings or chapters that are identical to those of the final product⁴;
- *Insufficient operations* rules (or *minimum processing* rules) refer to simple or minimal working processes, such as storage or packaging, that do not confer origin. These operations are disqualified for the purpose of origin determination even if they result in changes in tariff classification.

2.3. The CTC criterion can be used to establish general rules of origin for all products, or specific rules of origin for certain products or sectors. The stringency of rules of origin using this criterion depends on the tariff classification changes required. A change at chapter level is the most demanding, while a change at sub-heading level is the least demanding, thus the order of rules in descending stringency is CC, CTH, and CTSH. Moreover, the stringency also depends upon additional requirements that may be attached to each individual rule, which are often provided as restrictions or exclusions.

2.4. An example of such additional requirements, which may be combined with CTC rules, can be found in the rule for heading 18.06 in a Member's Generalized System of Preferences, which requires "chocolate and other food preparations containing cocoa" to be "manufactured from products other than those of heading 18.06, provided that the value of non-originating products used does not exceed 40% of the value of the products and the sugar and milk (including cream) used is originating." This rule not only sets a value threshold in addition to the CTC rule, but also demands specifically that the sugar and milk used in the manufacture be originating in the beneficiary country.

³ It is common for many countries to use two additional digits for tariff duties and another two digits for more specificity in their trade statistics. These additional breakouts beyond the six-digit codes are referred to as national tariff lines, or national breakouts.

⁴ For instance, the rule for Chapter 32 in a Member's GSP scheme provides: "*Manufacture from materials of any heading, except that of the product. However, materials of the same heading as the product may be used, provided that their total value does not exceed 20% of the ex-works price of the product.*"

2.5. The CTC criterion is widely used because it is based on the HS, a comprehensive and widely used nomenclature. Since the HS is a common language for traders and customs officers worldwide, rules based on it should have a coherent and uniform application. As a consequence, the outcome of the application of CTC rules of origin is generally objective and predictable. This criterion can also be used across all product categories, with specific adaptations to specific circumstances. For these reasons, the CTC criterion was the criterion of choice for the harmonization of non-preferential rules of origin under the WTO Agreement on Rules of Origin.⁵

2.6. However, this criterion also has its shortcomings, linked mostly to the structure of the HS convention itself. In fact, the HS was not designed for origin determination purposes and may impose limitations when raw materials and final products are classified in the same classification unit (i.e. when both the unprocessed materials and the processed final product have the same tariff classification). For this reason, drafting and applying CTC rules of origin requires extensive knowledge not only of the HS convention itself, but also of the manufacturing processes of specific products or sectors. In addition, there remains a risk of classification divergence, which means that the authorities in the exporting and importing countries may disagree on the tariff classification of inputs and final products. Finally, a significant complication is that the HS Nomenclature is amended regularly, creating a need to update CTC rules of origin accordingly.

3 BENCHMARKS OF THE BALI AND THE NAIROBI MINISTERIAL DECISIONS

3.1. The Preamble of the Bali Ministerial Decision (WT/MIN(13)/42) states that *"the objectives of transparent and simple rules of origin that contribute to facilitating market access of LDC products can be achieved in a variety of ways, and that no one method is preferred to another."* Paragraph 1.2 of this Decision recommends that preferential rules of origin *"should be as transparent, simple and objective as possible. It is recognized that other than wholly obtained products, origin may be conferred by substantial or sufficient transformation, which can be defined in a number of ways, including through: (a) ad valorem percentage criterion; (b) change of tariff classification; and (c) specific manufacturing or processing operation. It is also recognized that these methods in certain cases may be used in combination."*

3.2. Paragraph 1.5 of the Decision also specifies that, upon applying rules based on the change of tariff classification, *"a substantial or sufficient transformation should generally allow the use of non-originating inputs as long as an article of a different heading or sub-heading was created from those inputs in an LDC, notwithstanding that product specific rules with different requirements may also be more appropriate."*

3.3. Building upon these recommendations, subparagraph 1.2 (a) of the Nairobi Ministerial Decision requires that, as a general principle, such rules shall *"allow for a simple change of tariff heading or change of tariff sub-heading."* The requirement of "simple change" is partly interpreted in subparagraph 1.2(b) of the Decision, which provides that preference-granting Members shall *"eliminate all exclusions or restrictions to change of tariff classification rules," except where they deem that "such exclusions or restrictions are needed, including to ensure that a substantial transformation occurs."* The Decision further requires preference-granting Members to *"introduce, where appropriate, a tolerance allowance so that inputs from the same heading or sub-heading may be used."*

3.4. In short, the benchmarks provided by the Nairobi Decision include: the adoption of a simple change of tariff classification (CTH or CTSH), avoiding exclusions and restrictions whenever possible, accompanied by an appropriate tolerance allowance for inputs that do not fulfil the requirements.

4 DESCRIPTION OF PREFERENCE-GRANTING MEMBERS' PRACTICES

4.1. Currently, some preference-granting Members apply the CTC as a general or main rule, including China (as an alternative to the *ad valorem* criterion); India (in combination with the *ad valorem* criterion); Japan; Norway (excluding products of Chapters 50-63); and Switzerland (as the general rule, for products of Chapters 1-24). Other Members generally apply the CTH rule, with the exception of India, which applies the CTSH rule. The EU applies the CTC criterion in its

⁵ See Agreement on Rules of Origin, Article 9(2)(c).

product specific rules of origin, either separately or in combination/alternation with the *ad valorem* percentage criterion.

4.2. All other preference-granting Members, that have notified their rules of origin to the Secretariat, do not apply this criterion at all in their preferential rules of origin for LDCs, including Australia; Canada; Korea; New Zealand; Russia; Chinese Taipei; Thailand; and the US.

4.3. Most preference-granting Members that apply this criterion still maintain various exclusions or restrictions; these commonly take the form of provisions precluding materials of specific chapters or headings, or provisions setting additional requirements to the change in tariff classification. However, the legislations of China and India, for example, allow for a simple change in tariff classification without any additional requirements.

4.4. All preference-granting Members that apply this criterion have also provided indicative lists of insufficient (minimal) operations in their rules of origin. With regard to the *de minimis* rule, most preference-granting Members that apply the CTC criterion also allow for tolerance levels, except for China and India, who do not indicate such allowances in their legislations or in their notification.

4.5. A summary of practices in preference-granting countries is provided in the tables below⁶:

Table 1: The use of the CTC criterion

Preference-granting member	In general rules	In product specific rules	Restrictions or exclusions	Note
China	CTH	No	No	The CTC criterion is used as an alternative to the <i>ad valorem</i> percentage criterion
EU	No	Mostly CTH	Yes	
India	CTSH	No	No	The CTC criterion is used in combination with the <i>ad valorem</i> rule
Japan	CTH	CC/CTH	Yes	
Norway	CTH	Mostly CTH	Yes	
Switzerland	CTH	CTH/CTSH	Yes	

Table 2: Tolerance (*de minimis*) allowance

Preference-granting member	Tolerance allowance	Note
China	No	
EU	15% of weight (applied to HS Chapters 2, 4-24) or 15% of the ex-works price (applied to other products).	Specific tolerances applicable to textile products falling within HS Chapters 50 to 63 (in general, 10% of the total weight of all the basic textile materials used).
India	No	
Japan	10% of weight	Applied to goods of HS Chapters 50-63.
Norway	10 or 15% of ex-works price	The rule is not applied to textile products of HS Chapters 50-63. The tolerance can be 20% of the ex-works price for some products in the specific rules.
Switzerland	15% of ex-works price	The tolerance can be 20% of the ex-works price for some products in the specific rules. A tolerance of 10% of the total weight applies to mixed products made from at least two basic textile materials.

⁶ The information is extracted from the notifications by preference-granting members under the Nairobi Ministerial Decision, based on the template adopted by the WTO Committee on Rules of Origin (G/RO/LDC/* and template adopted in document G/RO/84).