CANADIAN TAX Highlights

NAFTA Rules of Origin

Among other things, NAFTA provides for duty-free trade between Canada, the United States, and Mexico for so-called NAFTA-originating goods. Some changes were made to the underlying rules of origin as of January 1, 2005.

NAFTA originating goods are those deemed to originate in one of the NAFTA countries and are thus eligible for the preferential nil rate of duty when traded between the countries. Simple manufacture or assembly of a good in one of those countries does not confer originating status on the good; reference must be made to the NAFTA rules of origin. The latest changes to those rules affect certain classes of goods, including precious metals, household appliances, speed drive controllers (and their printed assemblies), thermostats, and a number of parts for various types of machinery and equipment. Other goods-specific rule changes cover toys, loudspeakers, tea, spices, carrageenan, and seasonings. (These products represent an estimated US$20 billion in total trilateral trade.)

The changes are generally "liberalizing" in nature, aimed to ensure that more goods qualify as NAFTA goods and thus promote further duty-free trade between NAFTA countries. For example, under the old rules, if a Canadian manufacturer of children's tricycles that imported pedals and accessories from China and merely assembled the tricycles in Canada, the goods were not eligible for NAFTA benefits: the rules required a tariff shift, which flows from actual manufacturing. The new rules add a regional value content (RVC) test that deems the goods to be NAFTA-originating if sufficient Canadian, US, or Mexican value is added. RVC must be at least 50 percent of the tricycle's net cost or 60 percent of the tricycle's selling price. Using the net cost approach, if the non-NAFTA-originating pedals and accessories cost $15 and the tricycle's net cost is $50, the assembled tricycles qualify as NAFTA goods because the RVC is 70 percent.

The changes are expected to affect NAFTA exporters favourably by facilitating the conferring of NAFTA status on goods that are being imported or exported, thus helping to reduce the cost of those goods and improving the competitiveness of businesses that use them in further production processes. The impact on other persons in the relevant industries may be less than favourable. The changes are also a part of a continuing effort on the part of the three countries to liberalize trade, and they come two years after similar liberalizing changes to seven other classes of goods, including alcoholic beverages and petroleum and topped crude oil. However, the NAFTA rules of origin remain quite complex and are often difficult to understand; affected persons should seek professional advice on the rules' application.

Robert G. Kreklewetz and Vern Vipul
Millar Kreklewetz LLP, Toronto