Offshoring and the "Country of Origin" Rule:
What It Means for Businesses

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Fitch Ratings recently reports that Chinese manufacturers are increasingly investing in production facilities abroad to navigate trade barriers and geopolitical tensions. This trend, aimed at enhancing supply-chain resilience and market share, began in 2018 as companies started shifting away from China. These investments are not limited to low-cost regions; the ASEAN countries, the EU, and the US are notable targets for sectors ranging from traditional manufacturing to high-tech and electric vehicles.

In the past, such manufacturing offshoring was usually motivated by lower costs and higher profit margins but increasingly for Chinese manufacturers, it is to make their products eligible to be labelled as being produced outside China.

The "Country of Origin" rule

Country of Origin refers to the country where a product was manufactured or deemed to be manufactured. Under this rule, imported products must be marked with their origin for customs purposes and to help determine applicable tariffs, quotas, duties, and admissibility of imported goods. It also provides transparency to consumers of their information purposes.

Determining the Country of Origin

The rules for determining the Country of Origin can be complicated especially in manufacturing where intermediate products may be manufactured in different countries and finally assembled in one country.

Each country has its own set of laws that determine how the country of origin is established. In addition, international agreements such as bilateral trade agreements, regional agreements (like ASEAN Free Trade in Goods (AFTIGA), US-Mexico-Canada agreement (USMCA) and the EU), and multilateral agreements under the World Trade Organization (WTO) also have regulations dealing with the rules of origin.

Hence, the application of rules of origin can vary greatly depending on the specific agreement or law/policy in effect at the relevant place.

Common principles

Notwithstanding this, there are a few common relevant guiding principles:

Wholly Obtained or Produced: This criterion applies to products that are fully obtained or produced in one country, such as agricultural products harvested there, or mineral products extracted from its soil. The Country of Origin is normally very clear.

Last Substantial Transformation: For products that are assembled or processed in multiple countries, the origin is typically assigned to the country where the last substantial transformation occurred. This is the stage where the product gains its essential character or is transformed into its final form.

Cumulation: This allows for the origin criteria to be met cumulatively across multiple countries, usually within a trade bloc or among parties to a trade agreement. For example, inputs from any member country of a trade agreement can be considered as originating when determining the final product's eligibility for preferential treatment.

Minimal Operations or Processes: Minor operations or minimal processes are usually not enough to confer origin. Therefore, simple packaging, sorting, or washing of products is unlikely to be sufficient to find the product originated from that place.

Direct Consignment: This rule often requires that the product must be shipped directly from the country of origin to the country of importation to be eligible for preferential treatment. Transshipment through another country may invalidate a preferential treatment unless specific conditions are met.

The specific application of these rules can be complex and is governed by the legal texts of individual trade agreements and national regulations.

Last Substantial Transformation

For most Chinese manufacturers looking at offshoring, the determination of the "last substantial transformation" of a product is key.

If the Chinese manufacturer were to ship unfinished or semi-finished products to another country where they are assembled into final products, how would one determine if the final products are deemed manufactured in the final country of assembly?

There are also several common principles here:

- **Classification Changes**: Generally, a product is considered to have undergone a substantial transformation when it emerges from a process with a new name, character, or use different from that which it had before the process. Hence, a product is considered to have undergone substantial transformation if it changes tariff classification under the Harmonized System (HS) when it is processed in a country.

- **Regional Value Content (RVC)**: This requires that a certain percentage of the value of the product is added within the last country or region. If the value added in the final processing is significant, that could indicate a substantial transformation. RVC can be calculated using different methods, such as the transaction value method or the net cost method. As a rule of thumb, a value add of at least 40% is required to establish a place of origin (see insert).

- **Complexity of the Process**: The complexity and extent of the processing can be a factor. Simple processes like packaging or sorting might not be substantial, whereas manufacturing processes that result in a new product typically are.

- **Specific Processing**: Some rules require that a specific process must take place in the exporting country for the good to be considered as originating from there.

ATIGA

Under the ASEAN Trade in Goods Agreement (ATIGA). goods shall be deemed to be originating in a member state where working or processing of the goods has taken place by reference to these:

(i) if the goods have a RVC of not less than forty percent (40%) calculated using the formula set below; or

(ii) If all non-originating materials used in the production of the goods have undergone a change in tariff classification at four-digit level of the Harmonized System.

The formula:

Calculation of Regional Value Content

1. For the purposes of Article 28, the formula for calculating ASEAN Value Content or RVC is as follows:

(a) *Direct Method*

$$RVC = \frac{\text{ASEAN Material Cost} + \text{Direct Labour Cost} + \text{Direct Overhead Cost} + \text{Other Cost} + \text{Profit}}{\text{FOB Price}} \times 100\ \%$$

or

(b) *Indirect Method*

$$RVC = \frac{\text{FOB Price} - \text{Value of Non Originating Materials, Parts or Goods}}{\text{FOB Price}} \times 100\ \%$$

Different countries and trade agreements have specific rules and interpretations for what constitutes a "substantial transformation". It is important to consult the relevant customs regulations and trade agreements applicable to the countries involved in the manufacturing and import/export process.

Advice for Businesses

If it is important for a manufacturer to be able to designate their products as "Made in [Country X]", then before offshoring, the manufacturer should understand the "Country of Origin" rules in the applicable country and in the export destinations.

It is also important for business to maintain accurate and detailed document trails to prove the origin of their goods. Such information might be required by customs; most of whom have the right to request documentation and conduct verifications to ensure that the claimed country of origin is correct.

Conclusion

The determination of the last substantial transformation can be complex and is highly fact-specific, each product may require its own analysis. Sometimes, the process involves seeking advance rulings from customs authorities to avoid disputes or delays at the time of importation/exportation.

When in doubt, companies should consult with customs brokers, legal experts, or consultants specializing in international trade law to ensure compliance and avoid potential penalties.

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