The United States Generalized System of Preferences: The Problem of Substantial Transformation

Thomas P. Cutler
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I. Introduction

The substantial transformation requirements of the United States Generalized System of Preferences (GSP) for developing countries have quickly become the most complex aspect of this program. These requirements lie at the heart of many of the most complicated decisions involving the origins of articles imported under the scheme. An article being imported into the United States which cannot satisfy the rules of origin and qualify as being from a beneficiary developing country cannot receive the preference. Thus in the first four and one-half years of the program's existence, the substantial transformation requirements have become the subject of numerous Treasury (T.D.) and Customs Service Decisions (C.S.D.) as well as of an even greater number of less formal Customs rulings.

II. Summary of the U.S. GSP Program

Before turning to the problems of substantial transformation, some general background on the U.S. GSP program might be of use.3

A. Background, Beneficiaries, Product Coverage.

The U.S. Generalized System of Preferences was enacted as Title V of the Trade Act of 1974 and went into effect on January 1, 1976, pursu-
ant to Executive Order No. 11,888. Title V was amended slightly in 1976 and somewhat more significantly by the Trade Agreements Act of 1979. The program has been authorized to last for ten years. It is one of a considerable number of similar programs which have been adopted by most of the developed countries since the late 1960s in response to the demands of the developing countries as voiced through UNCTAD. The programs are designed to stimulate industrialization and economic development in the developing countries by providing them with export markets for their goods.

Under the United States GSP program, the President has been given the power, subject to certain limitations, to designate both the beneficiary developing countries (BDCs) and the articles for which the preference is to be granted. Communist countries and OPEC members constitute the majority of the developing countries which remain excluded. Furthermore, certain articles listed in the Act are automatically excluded from preference while others are excluded if they are either "import-sensitive" or "import-sensitive in the context of the Generalized System of Preferences." Items which are the subject of either import relief actions under section 203 of the Trade Act of 1974 or na-

9 For a good summary of the international background and domestic legislative history of the GSP program, see Graham, The U.S. Generalized System of Preferences for Developing Countries: International Innovation and the Art of the Possible, 72 AM. J. INT'L L. 513 (1978).
11 See 19 U.S.C.A. §§ 2461-2465 (West 1980). It should be noted that the President is authorized to provide that all designated BDC members of one of any of several types of associations of BDCs may be treated as one country for all GSP purposes, with the exception of the competitive need limitations. See 19 U.S.C.A. §§ 2462(a)(3), 2464(c)(3) (West 1980). To date two associations have requested such treatment but the President has not yet acted.
12 See Graham, supra note 9, at 539. See also 19 U.S.C.A. § 2462(b)(1)-(2), (d)(1)-(2) (West 1980). President Carter has recently designated Ecuador, Indonesia, Uganda, Venezuela, and Rhodesia (Zimbabwe) as BDCs. Exec. Order No. 12,204, 45 Fed. Reg. 20,740 (1980), reprinted in 19 U.S.C.A. § 2462 app. (West 1980). Ecuador, Venezuela, and Indonesia are the first OPEC members to be so designated. These latter designations were permitted because the three countries "entered into bilateral specific trade agreements with the United States ... before January 3, 1980." See Letter from Jimmy Carter to Congress On the Designation of Five New Beneficiary Developing Countries, reprinted in 16 WEEKLY COMP. OF PRES. DOC. 429 (Mar. 10, 1980).
13 19 U.S.C. § 2463(c)(1)(A), (B), (E) (1976). Textile and apparel articles which are subject to textile agreements, watches, and most footwear articles are listed in the Act as excluded from preference.
14 19 U.S.C. § 2463(c)(1)(C), (D), (F) (1976). Import-sensitive electronics, steel, and semimanufactured and manufactured glass products are also listed as specifically excluded from preference.
tional security measures under the Trade Expansion Act of 1962 are also excluded from preference for the duration of such action.\textsuperscript{16}

Once an article has been designated by the President as eligible, it is placed on the list of eligible items and an "A" or "A\textsuperscript{*}"\textsuperscript{17} is placed next to its TSUS\textsuperscript{18} number in the U.S. Tariff Schedules.\textsuperscript{19} The item is then granted duty-free entry if it meets the requirements of the rules of origin.\textsuperscript{20} At present over 2,750 articles\textsuperscript{21} in the Tariff Schedules of the United States and some 130 developing countries and territories\textsuperscript{22} are designated as eligible to receive the preference.

\textbf{B. The Rules of Origin}

The rules of origin of the U.S. GSP program provide criteria to determine whether a particular eligible article originated in a BDC for GSP purposes. The rules are necessary to prevent producers in non-beneficiary countries from obtaining preference under the program for their eligible exports by simply transshipping those products to the U.S. through a BDC.\textsuperscript{23} These rules also provide the criteria used to determine the point at which materials imported into a BDC have undergone sufficient processing to permit them to qualify as products of that country. This, as will become evident, is where the problem of substantial transformation becomes most complex. The rules serve both to protect U.S. domestic industries from duty-free imports from highly competitive countries and, more importantly, to insure that the benefits of the GSP program are reserved solely for the developing countries.

There are four parts to the U.S. GSP rules of origin: the documentation requirement,\textsuperscript{24} the direct shipment requirement,\textsuperscript{25} the country of origin requirement,\textsuperscript{26} and the 35% value-added requirement.\textsuperscript{27} The documentation requirement is met by supplying U.S. Customs with a copy

\textsuperscript{17} An "A" is used if preference is to be granted when the article is imported from all of the designated BDCs. An "A\textsuperscript{*}" is used if one (or more) BDC is ineligible to receive preference for that item due to the competitive need limitations. \textit{See} 19 U.S.C.A. § 1202, General Headnote 3(c)(ii) (West Supp. 1980).
\textsuperscript{18} TSUS stands for Tariff Schedules of the United States.
\textsuperscript{21} DEP'T OF TREASURY, U.S. CUSTOMS SERVICE, EXPORTING TO THE UNITED STATES 72 (1977).
\textsuperscript{22} 44 Fed. Reg. 48,855 (1979).
\textsuperscript{23} Nemmers and Rowland, \textit{supra} note 3, at 872.
\textsuperscript{24} 19 C.F.R. § 10.173 (1979). A Generalized System of Preferences Certificate of Origin Form A is required to be filed with each shipment of eligible merchandise valued in excess of $250.00 which is imported into the U.S. under the scheme. The Form A is an UNCTAD document used with all GSP schemes worldwide. In addition, imports under GSP may be required to be accompanied by documentary evidence of direct shipment from the BDC. 19 C.F.R. § 10.174 (1979).
\textsuperscript{26} 19 C.F.R. § 10.176 (1979).
\textsuperscript{27} 19 U.S.C.A. § 2463(b)(2) (West 1980).
of an international GSP Certificate of Origin Form A showing that the article for which GSP treatment is being claimed originated in a BDC.\textsuperscript{28} The direct shipment rule requires simply that eligible articles be shipped directly to the United States from the BDC in which they were produced without entering into the commerce of any third country while in route.\textsuperscript{29} The country of origin rule, by contrast, requires that an eligible article meet the normal U.S. country of origin requirements for marking and statistical and perhaps other purposes.\textsuperscript{30} This means that the eligible article must be able to qualify both as a "product of" a BDC for the purposes of the GSP and as a "product of" the same BDC for normal customs requirements.\textsuperscript{31} As we shall see, this rule may require a substantial transformation. Finally, but of equal importance, the 35% value-added rule requires that 35% or more of the appraised value of the eligible article at the time of its entry into the United States have been added in the BDC.\textsuperscript{32} This rule may in some instances require two substantial transformations of materials imported into the BDC and incorporated into the ultimate eligible article.

\textbf{C. The Competitive Need Limitations}

The U.S. GSP program also places limits on the extent of the benefits which any single BDC may receive without penalty under the program in any one year for any single article.\textsuperscript{33} As a general rule, if a BDC's exports to the United States of any eligible article in any given calendar year exceed an annually adjusted dollar amount\textsuperscript{34} or more than 50% of total U.S. imports of the good in question\textsuperscript{35} for that year, that BDC automatically loses its preference for that particular item for at

\textsuperscript{28} See note 24 supra.


\textsuperscript{31} \textit{Id.} at 871.

\textsuperscript{32} 19 U.S.C.A. § 2463(b)(2) (West 1980). Prior to the amendments of the United States GSP program in the Trade Agreements Act of 1979, Pub. L. No. 96-39, § 1111, 93 Stat. 315 (codified at 19 U.S.C.A. §§ 2462-2465 (1980)), if an article was a product of an association of BDCs, 50% of the value of the article was required to be added within the association. In 1979, this value-added requirement for associations was changed to 35% also. This was one of the 1979 amendments which made it more likely that some BDCs may seek association status in the future.

\textsuperscript{33} 19 U.S.C.A. § 2464 (West 1980).

\textsuperscript{34} \textit{Id.} § 2464(c)(1)(A).

\textsuperscript{35} \textit{Id.} § 2464(c)(1)(B). The 50% limitation does not apply with respect to any eligible article if a like or directly competitive article was not produced within the United States as of January 3, 1975. \textit{Id.} § 2464(d). Additionally, "the President may disregard [the 50% limitation] with respect to any eligible article if the appraised value of the total imports of such article into the United States during the preceding calendar year [fails to exceed an annually adjusted minimum dollar amount]." \textit{Id.}
least the following GSP year. These limitations, which have been
termed the competitive need limitations, are intended to help preserve a
share of the preferential market for the least developed of the BDCs and
to provide some measure of protection for U.S. domestic producers.

D. Administration

The administration of the U.S. GSP program is primarily the re-
sponsibility of the Office of the United States Trade Representative
(USTR) and the U.S. Customs Service, although many other govern-
mental bodies may and often do play important roles. The USTR has
been given the responsibility, along with the State Department, of ad-
ministering the program on an overall basis. The Office of the USTR
supplies the public with much of its information concerning the pro-
gram and also provides the chairmen for the interagency Trade Policy
Committee and for each of its subordinate committees. These inter-
agency committees, particularly the GSP Subcommittee, are responsible
for administering the annual review of products covered by the scheme
and for making recommendations to the President for changes in the pro-
gram. Each year interested parties and foreign governments are permit-
ted to submit petitions to the Office of the USTR requesting additions to
or deletions from the list of eligible products for which the scheme grants
preference. Changes are then made by Executive Order. Meanwhile, the Customs Service decides as each individual article arrives at
the border whether that item is to be classified as eligible and whether it
meets the requirements of the rules of origin. Interested parties may then
submit protests or petitions concerning these decisions through the nor-
mal Customs channels.

E. International Reception

The U.S. GSP program has been generally well received interna-

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36 19 U.S.C.A. § 2464(c) (West 1980).
AD. NEWS 7186, 7357.
38 See id.
39 Prior to the fall of 1979, this office was known as the Office of the Special Trade Repre-
sentative (STR).
41 The Office of the USTR publishes an annual summary of the GSP program in the
Federal Register and it also issues occasional press releases which explain, among other things,
the changes in the GSP program effectuated by each Executive Order. The recently released
Presidential report on GSP states, however, that a "GSP information center" will be established
43 See id. § 2007.
tionally and its major problems at present seem to lie in the disproportionate distribution of its benefits. The system seems to have worked well and the vast majority of imports under the scheme are apparently being processed and entered duty-free without undue problems or complications. When questions do arise under the rules of origin, however, they can become very complex, especially if substantial transformation is involved.

III. The Contexts and Nature of the Problems Involving Substantial Transformation in the U.S. GSP Program

A. Contexts

The practitioner who is dealing with GSP may encounter the problem of substantial transformation in at least four different contexts. First, it can be encountered in the context of petitions to add items to the list of eligible articles. Here the issue would seem most logically approached as part of a question of standing. Second, the issue may arise when a client’s goods arrive at the U.S. border or when, prior to that time, request for a letter ruling is made to Customs. In the first of these cases, the issue is raised by Customs itself while, in the second, the businessman seeks a ruling by Customs prior to the actual arrival of his goods at the border. Third, the issue may arise in protests under section 514. This would be the case, for example, if a businessman decides to challenge an unfavorable decision on his imports made by the Customs

46 See, e.g., Brief presented by Mr. H. Cubillos, Director GSP Project UNCTAD/UNDP INT/77/002, to the public hearings for the five year review of the GSP scheme of the United States of America, at 1, (Sept. 18 to 21, 1979); see also UNCTAD Brief to the Public Hearings on the Five-Year Review of the United States Generalized System of Preferences Program, at 2, (Sept. 18, 1979 Washington D.C.). In the latter brief it was stated that “[f]rom its introduction the U.S. GSP has made important contributions to the GSP system as a whole. . . . [I]n 1976 the U.S. accounted for roughly one-third of all of the OECD trade which actually received duty-free treatment under the GSP.” Id. at 2.


48 Telephone conversations with Customs entry officers (Fall 1979). On the other side of this ledger, however, representatives of UNCTAD stated in a brief submitted to the GSP five-year review hearings held by the U.S. Government in September 1979 that there have been “constant queries” concerning the application of the U.S. rules of origin and that the U.S. needs to develop “a more clear-cut definition for substantial transformation.” See Brief to be submitted by Mr. H. Cubillos, supra note 46, at 2-3.

49 See note 43 and accompanying text supra.

50 Due to the informality of the annual review hearings and given the broad discretion granted to the GSP Subcommittee in conducting them, it is unclear how closely or at which point the Committee investigates the issue of whether the particular exports of a petitioner who is requesting that a product be added to the scheme would meet the 35% value-added requirement. Nonetheless, the regulations of the USTR state that a petitioner must be either an “interested party” or a foreign government. 15 C.F.R. § 2007.0(a) (1979). Presumably one could not qualify as an “interested party” if it were clear that the exports for which one was requesting designation would not satisfy the 35% requirement.


Service at the time of entry. Finally, the issue may also arise in section 516 petitions\textsuperscript{53} to Customs by domestic manufacturers seeking to prove that otherwise eligible items being imported under the GSP program should not receive preference because they fail to meet the requirements of the rules of origin.

\textbf{B. Problems}

At least four problems arise in the area of substantial transformation. First, one must locate the sources and describe the purposes of the substantial transformation requirements relevant to GSP. Second, it is necessary to determine when a substantial transformation is required. Third, and related to the second problem, one must determine how many substantial transformations are required. Finally, one must also determine what qualifies as a substantial transformation in any given instance. The answers are complicated by the fact that the sources and purposes of the substantial transformation requirements in the GSP context are confusingly intertwined and overlapped, and by the fact that the language of the Treasury and Customs Service Decisions published on the subject to date has not always been clear and sometimes appears contradictory.

\section*{IV. The Sources and Purposes of the Substantial Transformation Requirements in the U.S. GSP Program}

A significant portion of the confusion surrounding substantial transformation in the GSP context seems to stem from a misunderstanding in any given instance as to the particular substantial transformation requirement under discussion.

\textbf{A. The Country of Origin Requirement}

Although it is arguable that the country of origin requirement is nowhere specifically mentioned in the implementing statutes, the Customs Service has written and interpreted its GSP regulations to require that merchandise which qualifies under the statute as originating in a BDC for purposes of the GSP must also qualify as a "product of [that BDC] in the normal country of origin sense."\textsuperscript{54} The Customs Service has read this requirement into the following language: "Merchandise which is the growth, product, manufacture, or assembly of a beneficiary developing country and which is imported directly . . . may qualify for duty-free entry under the Generalized System of Preferences only if [the 35%}


\textsuperscript{54} T.D. 78-398, 12 Cust. B. & Dec. 870 (1978) (the bracketed words within the quote have been added by the author for the purposes of clarification). Note that the statements "Good 'A' is a 'product of' country B" and "B is a good A's country of origin" are synonymous.
value-added requirement is met]."\textsuperscript{55}

To explain this requirement further, there are a number of other contexts in customs law aside from GSP which require a determination of the country of origin of various products.\textsuperscript{56} The most significant of these other contexts for purposes of this article are the marking and statistical areas. Section 304 of the Tariff Act of 1930,\textsuperscript{57} for example, requires that most articles imported into the United States be marked to indicate their country of origin\textsuperscript{58} and the relevant Customs regulations add that, "Further work or material added to the article in another country must effect a substantial transformation in order to render such other country the 'country of origin . . . .'."\textsuperscript{59} The regulations of the Census Bureau concerning statistical information on imports contain a similar requirement.\textsuperscript{60}

In sum, the laws in these two areas require that whenever materials are imported into a BDC from a third country for purposes of export to the United States they must undergo a substantial transformation if they are to be marked and recorded under U.S. law as a "product of" that BDC. According to the Customs Service, consistency requires that such a "product of" requirement also exist for GSP and that an article should not receive preference under GSP for being from a particular BDC if it is required to be marked and recorded as a "product of" a different country.\textsuperscript{61} The effect of this has been to add a substantial transformation requirement, as found in other country of origin cases, to the GSP requirements, regardless of whether or not the documentation, direct shipment and 35% value-added requirements are met.\textsuperscript{62} The ultimate eligible article must be a different article from the materials imported into the BDC.

Although this decision by the Customs Service to apply the country of origin requirement, nowhere specifically mentioned in the implementing statutes, to the GSP program may ultimately be challenged in court, there is an important policy reason for the requirement. Without this particular requirement a BDC would be able to import eligible items, take the steps necessary to allow them to meet the 35% value-added and other origin requirements, and then reexport them to the U.S. under GSP without changing the basic nature of the item. The BDC, for example, could simply decorate the articles with valuable domestic materials or imported materials which had been twice substantially

\textsuperscript{55} 19 C.F.R. § 10.176(a) (1979) (emphasis added).
\textsuperscript{56} See General Secretariat, Organization of American States, The United States Generalized System of Preferences, Coverage and Administrative Procedures in Force in 1978 [hereinafter cited as OAS] for a good discussion of this subject.
\textsuperscript{58} Id. § 1304(a).
\textsuperscript{59} 19 C.F.R. § 134.1(b) (1979).
\textsuperscript{60} 15 C.F.R. § 30.70(f)(1)-(2) (1980).
\textsuperscript{62} See id.
transformed, or decorate them with untransformed imported materials applied with sufficient domestic labor. Undoubtedly this would not be the type of industrialization and development the GSP program was designed to encourage.

B. The 35% Value-Added Requirement

The 35% value-added requirement is the second source of the substantial transformation requirements in the U.S. GSP program. The U.S. Customs Service has held that in order for the cost or value of incorporated imported materials to be included in the sum to meet the 35% requirement, they must have been twice substantially transformed.

The statutory language outlining the 35% requirement reads as follows:

The duty-free treatment provided under section 2461 with respect to any eligible article shall apply only if the sum of (A) the cost or value of the materials produced in the beneficiary developing country plus (B) the direct costs of processing operations performed in such beneficiary developing country is not less than 35% of the value of such article at the time of its entry into the customs territory of the United States. The Secretary of the Treasury shall prescribe such regulations as may be necessary to carry out this subsection.

An early Treasury Decision noted that the 35% value-added requirement "can be satisfied entirely by the cost or value of materials produced in the beneficiary developing country, the direct costs of processing operations, or, any combination of the two."

Thus, it is not always necessary that the cost or value of the materials incorporated into the eligible article be included in the sum to meet the 35% requirement because it may be possible to meet this requirement

63 The 35% requirement may be met by the direct cost of processing operations alone. See text accompanying notes 67-68 infra.
64 See text accompanying note 32 supra.
65 There would seem to be at least two possible distinctions between "cost" and "value". First, if the BDC manufacturer of an eligible article buys the imported materials for his product from a second manufacturer within the same BDC after they have already been substantially transformed into substantially transformed constituent materials of that BDC, then the amount which he paid would be his cost. If, however, the same producer of the ultimate eligible article imported and substantially transformed his materials himself into substantially transformed constituent materials, then the value of that resulting intermediate product would be his "value" for purposes of the 35% value-added requirements. It seems arguable thus that this value could include an amount for profit. Apparently, however, the direct costs of processing which would be included in this value can not be added in twice.

A second situation in which a distinction between cost and value might logically arise is in the case where the BDC manufacturer receives an "assist" in the production of the substantially transformed constituent materials. An "assist" is an aid such as a mold or blueprint which is used in the production of an article and which is received at less than fair value. It may be supplied, for example, by the U.S. importer. Although an assist is not a material, the use of an assist would help to make the "value" of the affected substantially transformed constituent material greater than its "cost" to the BDC manufacturer.

66 19 U.S.C.A. § 2463(b) (West 1980) (the portions of the statute relating to associations of BDCs have been omitted).
by the direct costs of processing operations alone. Nonetheless, in the usual situation this will often not be possible; therefore, it is necessary to address the question of what can qualify as "materials produced in the beneficiary developing country."

The Customs regulations explain the meaning of this phrase as follows: "[t]he words produced in the beneficiary developing 'country' [sic] refer to the constituent materials of which the eligible article is composed which are either: (1) Wholly the growth, product, or manufacture of the beneficiary developing country; or (2) Substantially transformed in the beneficiary developing country into a new and different article of commerce." It is clear from these regulations that the cost or value of constituent materials of the eligible article which are wholly the growth, product or manufacture of the BDC may always be included in the sum to meet the 35% value-added requirement. However, where the constituent materials were originally imported into the BDC from another country, the regulations state that they must first have been "substantially transformed in the beneficiary developing country into a new and different article of commerce" before their cost or value may be included.

The decisions and rulings have used a great variety of verbal formulas to interpret these last quoted words. Sometimes they will state, for example, that there must be an "intermediate article or material that qualifies as a substantially transformed constituent material." Probably most often however, they will say something like: "Materials which are not wholly the growth, product, or manufacture of the BDC must be substantially transformed into a new and different article of commerce...

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70 19 C.F.R. § 10.177(a) (1979).

71 Id. § 10.177(a)(1).

72 Id. § 10.177(a)(2).

73 Id. It should be noted that is is irrelevant under the U.S. scheme that the materials used by the BDC in the production of the eligible article may have been imported from the United States or from another BDC. The materials must still be twice substantially transformed if their cost or value is to be included in the sum to meet the 35% test. U.S. Customs Letter Ruling R:CV:S BB 055535 (March 24, 1978); U.S. Customs Letter Ruling CLA-2-R:CV:S 047092 RE (Feb. 1, 1977).

74 U.S. Customs Letter Ruling R:CV:S R:CV:S RE 049625 (March 10, 1977). See also U.S. Customs Letter Ruling R:CV:S JLV 055722 (Aug. 14, 1979) which states that "[t]he processing [must] result in intermediate products which are themselves articles of commerce distinct from the materials as imported and from the eligible article." U.S. Customs Letter Ruling R:CV:S JLV 061562 (Sept. 20, 1979) states that "[t]he processing performed on the imported material must result in an intermediate product having a new name, character or use. The intermediate must then be used in the production of the eligible article..."
which is then *used to produce* the eligible article before their cost or value can be included in the 35-percent requirement." This latter language specifically refers to only one substantial transformation and states that the result of this transformation must then be "used to produce" the eligible article.

C.S.D. 79-312,\(^7\) however, which appears likely to become a more definitive statement of the double substantial transformation test in the 35% value-added requirement, states that: "[T]he [imported] materials must be *substantially transformed* into a new and different article of commerce prior to being used in the production of the eligible article. The production of the eligible article must then constitute the second substantial transformation so as to be considered a growth, product, manufacture or assembly of the BDC under GSP."\(^7\)\(^7\) Thus it is clear that there must be two substantial transformations before the cost or value of the imported materials may be included to meet the 35% value-added test.\(^7\)\(^8\) This conclusion can also be inferred from the words of the regulation quoted above\(^7\)\(^9\) because the regulation refers to the substantial transformation which results only in materials from which the ultimate article will be produced.\(^8\)\(^0\)

C. The Overlap

One final point remains to be made. The decisions of the Customs Service equate the country of origin substantial transformation requirement with the second of the two substantial transformations which are required to permit the cost or value of imported materials to be added into the sum to meet the 35% value-added test.\(^8\)\(^1\) The Customs Service considers the role of the first of the two substantial transformations of the double requirement to be that of transforming the imported materials into substantially transformed constituent materials produced in the BDC. It considers the role of the second of the two substantial transformations to be that of rendering the ultimate eligible article a "product

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\(^{77}\) Id. at 37 (emphasis added).

\(^{78}\) See also C.S.D. 79-4, 13 Cust. B. & Dec. No. 5, at 30 (weekly ed. 1979), which states that "the substantial transformation test is used a second time." Id. at 31.

\(^{79}\) 19 C.F.R. § 10.177(a) (1979). See text accompanying note 70 supra.

\(^{80}\) T.D. 76-100, 10 Cust. B. & Dec. 176 (1976), and T.D. 77-273, 11 Cust. B. & Dec. 551 (1977), have interpreted the words "new and different article of commerce" in 19 C.F.R. § 10.177(a)(2) (1979) as referring to the results of the first of the two substantial transformations which are required to permit the cost or value of imported materials to be added into the sum to meet the 35% value-added test. These results were termed "substantially transformed constituent materials." T.D. 76-100, 10 Cust. B. & Dec. at 177 (1976) (emphasis added). This decision also states that "materials" are "[g]enerally goods that are undefined in final dimensions and shapes . . . while goods that have been processed into a completed device or contrivance ready for ultimate use are not considered materials." Id. Logically, then, there will have to be a second substantial transformation when these materials become the ultimate eligible article.

V. When is a Substantial Transformation Required and How Many Are Required in a Given Instance?

The simplest situation, of course, is that in which no substantial transformation is required at all. This must always be the case if none of the materials incorporated into the finished eligible article were imported into the BDC. In this situation the "country of origin" substantial transformation requirement is automatically met.\(^8\)\(^2\) Nonetheless, one must remember that the single substantial transformation of the country of origin requirement is often required independently of any situation in which two substantial transformations are used to render the cost or value of imported material eligible for inclusion in the sum to meet the 35% test.


\(^8\)3 See 19 C.F.R. § 10.176(c) (1979).

\(^8\)4 See 19 C.F.R. §§ 10.176(c), 178(b) (1979). If the percentage of indirect costs vis-a-vis total costs incurred in the production of the eligible article exceeds 65% of the appraised value, then the article will not qualify for the U.S. GSP even if wholly produced within the BDC. Further, prior to the abolition of the American Selling Price system (ASP) in the agreements reached in the Tokyo Round, some items, particularly chemicals, were appraised for customs purposes at their American Selling Price. See Trade Agreements Act of 1979, Pub. L. No. 96-39, Title II, §§ 201-204, 93 Stat. 194 (to be codified in scattered sections of 19 U.S.C.). The use of this higher appraised value occasionally made it virtually impossible to add enough value in the BDC to meet the 35% requirement. Presumably a similar situation could still arise under the new transaction-price based valuation rules if the BDC exporter charged too high a price for his product. See also UNCTAD, Harmonization and Simplification of the Percentage Criterion, U.N. Doc. TD/B/C.5/WG(VIII) para. 51 & n.1, at 20-21 (Jan. 1980).


82 Nonetheless, one must remember that the single substantial transformation of the country of origin requirement is often required independently of any situation in which two substantial transformations are used to render the cost or value of imported material eligible for inclusion in the sum to meet the 35% test.
also meet the 35% value-added requirement. In a second example, the
country of origin requirement was held not to have been met. In this
case porcelain vases were manufactured in Japan and imported into
Hong Kong where they were fired and hand painted. Although Hong
Kong was a BDC and the vases were eligible articles, the U.S. Customs
Service ruled that the vases were ineligible for duty-free treatment
because they had not been substantially transformed in the BDC. The
vases remained vases and Japan remained their country of origin. A
later Treasury decision confirmed that even if the firing and the hand
painting in the BDC had added sufficient value to permit the vases to
meet the 35% requirement, the articles still would not have qualified for
GSP treatment.

Once imported materials have been incorporated into the eligible
article and it is desired to use the cost or value of those imported materi-
als to meet the 35% value-added requirement, there must be at least two
substantial transformations of the imported materials concerned. Once
again two simple examples should be of use. First, if raw hides are im-
ported into a BDC where they are tanned into leather which is then used
in the manufacture of a leather coat, the imported hides will have under-
gone at least two substantial transformations and their cost or value
may be included in the sum to meet the 35% value-added requirement.
Likewise, if gold bars are imported into the BDC and then melted and
cast into ring mountings which are then set with a stone of the BDC,
the gold will also have been twice substantially transformed. First it be-
came a ring mounting and then an article of jewelry. The value of the
gold will then be includible to meet the 35% value-added requirement.

Any situation which requires more than two substantial transforma-
tions must logically involve some combination of the cases already dis-
cussed and more than one imported material. For example, if several
different types of imported materials are incorporated into an eligible
article in a BDC and the cost or value of one or more of those materials is
used to meet the 35% requirement for the eligible article, then each of the

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87 Id. In this case, the 35% value-added requirement would have to be met by the direct
costs of processing operations alone.
89 Id.
91 See text accompanying notes 64-80 supra. See also C.S.D. 79-312, 13 Cust. B. & Dec. No.
92 In fact, the raw hides would have undergone three substantial transformations. First,
they would have been tanned into leather, then the leather would have been cut to size, and
finally, the coat would have been assembled by sewing. See T.D. 76-100, 10 Cust. B. & Dec. 176
94 The reason why T.D. 76-100 requires that the stone be "of" the BDC is apparently
because if the stone were sufficiently valuable and were not a product of the BDC, the finished
ring could fail to meet the 35% value-added requirement.
materials the cost or value of which is so used must be twice substantially transformed. \(^9^6\) Likewise, if a number of different imported materials are incorporated into the eligible article and only some of them are used to meet the 35% test, then only those few must be twice substantially transformed. The others need be only substantially transformed once to meet the country of origin requirement. \(^9^7\) Two examples should make this clear.

The first example is a hypothetical formulated from the vase situation outlined earlier. \(^9^8\) If two different types of materials (gold ore and a vase) are imported into the BDC and one of them (the gold ore) is twice substantially transformed (once into gold bars and then again into gold leaf which is applied to the vase) to allow the eligible article (the vase) to meet the 35% value-added requirement, then the eligible article still would not qualify for GSP treatment for want of another substantial transformation to make the vase a “product of” the BDC. \(^9^9\) Thus, three substantial transformations would be required in this case and only if the BDC manufacturer were to import the clay and substantially transform it into a vase in the BDC would the vase qualify for GSP although the cost or value of the clay would not be permitted to be added into the sum to meet the 35% requirement.

The second example of a case requiring multiple substantial transformations was published as a Treasury Decision. In T.D. 78-400 \(^1^0^0\) there were five different eligible articles: a 600 series D.C. electric motor, a gear motor, a universal A.C. electric motor, a rectifier, and an armature. Each article was composed of a series of subassemblies, each of which was composed of numerous pieces and components. Most of the individual pieces and components were made from materials and/or components which had been imported into the BDC. The decision analyzed the manufacturing and processing operations performed for each individual piece or component to determine whether the imported materials and/or components had each been substantially transformed prior to inclusion in the final assembly so as to permit its cost or value to be added into the sum to meet the 35% value-added requirement. Then the final assembly of the individual pieces and components into the eligible article was considered a substantial transformation sufficient to “satisfy the country of origin criteria for the eligible article which is exported to the United States.” \(^1^0^1\)

Finally, it must be remembered that the situation will not always be

\(^9^7\) Id.
\(^9^8\) See notes 88-90 and accompanying text supra.
\(^1^0^0\) 12 Cust. B. & Dec. 875 (1978).
\(^1^0^1\) Id. As noted earlier, the Customs Service conceives of the country of origin requirement and the second of the two substantial transformations required by the 35% test as identical. See note 81 and accompanying text supra.
VI. What is a Substantial Transformation?

A. General Considerations

The question of what constitutes a substantial transformation is complex and multifaceted. In some cases, a number of different acts of processing may fail to result in a substantial transformation, while in others one simple act may suffice. Furthermore, a given act such as cutting or painting can result in a substantial transformation in one context but not in another. Or, in the context of GSP, a given act (in particular, an assembly) may result in a substantial transformation for one purpose but not for another. Because almost every case is unique, and perhaps because of the related uncertainty of the doctrines of res judicata and stare decisis in customs law, customs rulings and decisions concerning GSP are often made on a case-by-case basis although reference will occasionally be made to previous decisions. Predictability of the outcome is not always high and thus it is generally advisable to seek an advance letter ruling from the Customs Service when important decisions hang on the result. Despite these caveats, a general feel for what a substantial transformation is can be gained by approaching the problem from several different directions.

B. What a Substantial Transformation is Not

There are at least two categories of processes and operations which can be effectively eliminated as candidates for substantial transformation status from the start. These are operations which would not be considered substantial transformations in any area of customs law. The first

102 In U.S. Customs Letter Ruling R:CV:S JLV 055722 (Aug. 14, 1979), for example, it took six separate machining operations to substantially transform an imported steel bar into a gear blank. In U.S. Customs Letter Ruling CLA-2-R:CV:S 047771 RE (Feb. 1, 1977), by contrast, imported metals were substantially transformed by being melted and poured into a mold.

103 Compare, e.g., C.S.D. 79-62, 13 Cust. B. & Dec. No. 11, at 24 (weekly ed. 1979), where imported leather was substantially transformed by cutting to pattern, with T.D. 78-400, 12 Cust. B. & Dec. 875 (1978), where plastic tubing was not substantially transformed by being simply cut to length. See also C.S.D. 79-441, 13 Cust. B. & Dec. No. 52, at 37 (weekly ed. 1979), where bulk recording tape was held not to have been substantially transformed although it had been cut several times, both to length and to width.

104 Compare, e.g., T.D. 78-324, 12 Cust. B. & Dec. 699 (1978), where plastic fish lure bodies were substantially transformed by painting because this enabled them to attract fish, with U.S. Customs Letter Ruling CLA-2-R:CV:S RE 045196 (Jan. 6, 1977), where vases were held not substantially transformed by being hand painted.

105 See note 181 infra.


108 Additionally, an operation "incidental to an assembly" is not a substantial transformation. See notes 189-91 and accompanying text infra.
of these is a "finishing operation." Sanding, waxing, painting, gold-leafing, and trimming off rough edges are typical examples of the type of operation which would generally fall into this category. Second, operations which merely "advance" an article towards a substantial transformation are also not considered substantial transformations. For example, in a case in which a lens blank was held to have been substantially transformed into a "lens" after one side had been ground, the grinding of the second side was then held to be simply a "further advancement."

C. The Distinctive Name, Character and [or] Use Rule

The substantial transformation test is also known as the distinctive "name, character and [or] use" rule. While the Customs Service has generally preferred to use the former terminology the courts have generally stuck with the latter. There seems, however, to be no difference in meaning. The test has a long history in customs law. It has been used in a considerable number of customs contexts prior to GSP. Aside from the marking and statistical situations it has also been used in column 1/column 2 cases, drawback cases, classification cases, and repair or alteration cases.

While there is no difference in meaning, the alternative phraseology of the rule does offer some further insights into its meaning and content.

In a number of early customs cases, the United States Supreme Court adopted the rule that when the article resulting from the processing had a name, character or use which was distinct from that of the material prior to processing, then a new and different article of commerce was created.

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110 Id.
112 Id. Presumably also, in a situation where six separate machining operations were required to substantially transform a steel bar into a gear blank, the first five operations would be merely advancements. See U.S. Customs Letter Ruling R:CV:S JLV 055722 (Aug. 14, 1979).
113 See OAS, supra note 56, at 75-78.
114 Id. at 75.
115 Id. at 75-76.
116 Id. at 76. See also U.S. Customs Letter Ruling R:CV:S DAL 854227 (Jan. 31, 1978) which specifically equates the two formulas. We will see, however, that the general rule seems to have been slightly modified in the case of the first substantial transformation of the 35% requirement. See text accompanying note 180 infra.
117 See OAS, supra note 56, at 75.
118 See text accompanying notes 56-61 supra.
119 See OAS, supra note 56, at 67.
120 Id. at 78.
121 Id. at 79.
122 Id. at 78. To some extent the decisions reached in these cases may provide analogies for cases in the GSP context, but this subject has been covered well elsewhere. See id., at 76-88. Thus, this paper concentrates solely upon those cases which have been more recently decided and which specifically concern GSP. In any case, Customs generally refrains from citing non-GSP cases in its decisions concerning substantial transformation in the GSP context.
123 Id. at 75; see Hartranft v. Wiegmann, 121 U.S. 609, 615 (1887).
This is the general rule from which one starts in attempting to decide whether a given operation results in a substantial transformation. Some significant additional considerations may need to be taken into account in the GSP context but the Customs Service, though it generally uses the terminology of "substantial transformation," does occasionally mention changes, or the lack of them, in one or more of the three factors of "name, character and [or] use" to buttress its decisions.

Of the three factors, a change in "use" is generally considered to be the most important. The distinctive "name, character, or use" rule has also occasionally been stated as the distinctive "name, character, and use" rule and this latter phraseology has been said to more accurately reflect the application of the rule. Furthermore, if one omits those situations involving either assemblies or the "of commerce" rule, the published decisions to date concerning substantial transformations in the context of GSP generally reflect the use of this criterion. Occasionally, the fact that there has or has not been a change in use will be explicitly mentioned in the decision, but more often this will simply be evident from the facts of the case.

Problems can arise in this analysis when several distinct steps are required before a given material has been sufficiently altered to allow it to acquire a new use. After which step or steps may the materials be considered to be substantially transformed? Though each step may be necessary, it must be determined whether the materials have been substantially transformed, merely finished, or simply advanced towards a transformation. The same problem arises when new and different characteristics are concerned.

124 See text accompanying notes 152-93 infra.
126 OAS, supra note 56, at 84.
127 Id. (emphasis added). See also U.S. Letter Ruling R:CV:S JLV 055703 (Sept. 24, 1979). In this latter case, however, it is arguable that the phrase should be interpreted as referring to what actually happened in the case. The ruling stated that, "the imported forgings are processed . . . by . . . operations which result in new articles having a new name, character, and use." Id. at 2.
128 OAS, supra note 56, at 84.
129 See notes 151-93 and accompanying text infra.
130 It is necessary to limit generalizations to the published decisions because one can never be sure one has all the unpublished rulings. However, the 1978 bound volume of Custom Bulletins and Decisions, which was released in the summer of 1980, does contain a descriptive list of the 1978 unpublished decisions. See 12 Cust. B. & Dec. 1201-42 (1978).
133 See, e.g., U.S. Customs Letter Ruling R:CV:S JCH 049096 (April 14, 1977), which raises this issue and states that, "when a processing operation involves several steps, we do not believe that a substantial transformation and intermediate product should necessarily be regarded as resulting at the end of each step." Id. at 2.
The question of what is a change in use seems often to shade off imperceptively into the question of what is a change in character and this may be one reason for the alternative statements of the distinctive "name, character and [or] use" rule mentioned above. It would seem also that the same acts which result in a change in use will also generally result in a change in character. The character criterion has been described as "nebulous"\(^\text{137}\) and as involving such things as "physical characteristics or physical form of the material."\(^\text{138}\) Standing alone, it is not a very reliable indicator of a substantial transformation.\(^\text{139}\) Occasionally it has been specifically cited as a factor when a substantial transformation has been found in a GSP case\(^\text{140}\) but generally when this is done, a new use is also claimed.\(^\text{141}\) In one letter ruling in which a substantial transformation was found due to a change in "characteristics," the allegation of a new use seemed somewhat dubious although arguable.\(^\text{142}\) More often no substantial transformation will be found despite what could arguably be termed a change in character.\(^\text{143}\)

The Customs Service will also occasionally use a change in the name of materials, or a lack of one, as evidence to support its decisions. In some cases the name change, or lack of one, will be specifically mentioned\(^\text{144}\) and in other cases the significance of this factor may be inferred from the facts.\(^\text{145}\) In a case involving semi-finished lens blanks for spectacles, Customs decided that, because semi-finished lens blanks which had been worked on one side and finished lenses which had been worked on both sides were both listed in the merchandising literature under "lenses," a substantial transformation had not occurred when the second side of the blank was worked.\(^\text{146}\) Nonetheless, this factor has been said to be the weakest of the three indicators of the "name, character and [or]
use" rule.\textsuperscript{147} It is more likely to be an indication of a substantial transformation if the new name is one in general commercial use rather than merely a proprietary one.

Finally, Customs will also occasionally support its decisions in GSP substantial transformation cases by noting that a given operation has or has not resulted in a change in the TSUS number of the original material or article.\textsuperscript{148} In C.S.D. 79-263,\textsuperscript{149} for example, Customs specifically based its finding of no substantial transformation on a lack of change in the TSUS number, although from the facts other reasons could also have been given. Nonetheless, because of the narrowness of some TSUS categories, the Customs Service apparently refuses to accept a change in TSUS number as an invariable indication of a substantial transformation\textsuperscript{150} and it is conceivable that a substantial transformation could be found despite a lack of change in the TSUS number if both products were in the same broad "basket" category.\textsuperscript{151}

In some instances, an apparent change in "name, character and [or] use" may not be enough to qualify a processing operation as a substantial transformation for GSP purposes. This may be the case if the resulting item is either a "mere assembly"\textsuperscript{152} or not an article "of commerce."\textsuperscript{153}

\textbf{D. The "Of Commerce" Requirement}

The Customs regulations state that in order for an imported material to be considered a product of the BDC for purposes of the inclusion of its cost or value in the 35% value-added test, it must first have been "[s]ubstantially transformed in the [BDC] into a new and different article of commerce"\textsuperscript{154} before becoming part of the final eligible article.

In T.D. 77-273,\textsuperscript{155} this language was interpreted to mean that the intermediate constituent materials or, otherwise stated, the substantially transformed constituent materials resulting from the first of the two substantial transformations which may be required to meet the 35% test, must be marketable and salable in their own right in order to qualify as having been substantially transformed. Furthermore, if the intermediate was "not normally bought and sold commercially," the opinion also apparently held that it was not enough that it was nevertheless "capable of

\textsuperscript{147} See OAS, supra note 56, at 84. See also United States v. International Paint Co., Inc., 35 C.C.P.A. 87 (1948).
\textsuperscript{149} Id.
\textsuperscript{150} OAS, supra note 56, at 68.
\textsuperscript{151} "Basket" categories of goods, for tariff purposes, are often labeled "other".
\textsuperscript{154} 19 C.F.R. § 10.177(a)(2) (1979)(emphasis added).
being bought and sold and [that] such sales [had] occurred.\textsuperscript{156}

This requirement that the result of a substantial transformation be marketable does not appear to have been regularly or consistently mentioned with substantial transformation requirements in other areas of customs law, although the issue has been raised with the country of origin substantial transformation requirement in the GSP context.\textsuperscript{157} In the GSP context, the "of commerce" requirement seems likely to be of most concern only with the first of the two substantial transformations which may be required to meet the 35% test because if the articles resulting from the second substantial transformation requirement in the 35% test or from the country of origin substantial transformation requirement were not for sale, the question as to whether they had met their respective substantial transformation and marketability tests would never arise. In most cases the results of these other two substantial transformations seem likely to be the eligible articles themselves. Nonetheless, marketability was a crucial factor in one GSP country of origin case. In that case, which involved the imported lens blanks worked on one side in the BDC, the Customs Service held that the semi-finished lens blanks could be considered to have been substantially transformed so as to be classifiable as "lenses" and as products of the BDC because they were "a recognized item of commerce regularly sold."\textsuperscript{158}

The Customs Service has accepted various forms of evidence as proof that a particular intermediate product is an "article of commerce." In one case, a letter "in which an unrelated party indicated willingness to produce and sell this product at a specific price"\textsuperscript{159} was held sufficient.\textsuperscript{160} In another, various catalogue listings and other trade information showing that the intermediates were a recognized item of commerce regularly sold satisfied the requirements.\textsuperscript{160} In a third, invoices were enough\textsuperscript{161} and in still a fourth, excerpts from the \textit{Wire Journal} showing that the item was a separate and distinct article of commerce bought and sold as such, were also found sufficient.\textsuperscript{162}

Finally, it must be noted that the Customs Service has not always

\textsuperscript{156} Id. at 554. Other Letter Rulings which have raised this issue, however, have not been so strict. \textit{See}, e.g., C.S.D. 80-34, 14 Cust. B. & Dec. No. 11, at 8 (weekly ed. 1980); U.S. Customs Letter Ruling CLA-2:R:CV:S MH 045602 (Nov. 29, 1976). Also, in U.S. Customs Letter Ruling CLA-2:R:CV:S MH 045202 (April 30, 1976) it was stated that the substantially transformed constituent materials "need not enter the stream of commerce of the beneficiary developing country in order to be included as part of the GSP 35% requirement." \textit{Id.} at 2. By this it was apparently meant that it is irrelevant whether the BDC manufacturer of the eligible article produces the substantially transformed constituent materials of that article himself or purchases them from another firm within the same BDC.

\textsuperscript{157} \textit{See} text accompanying note 158 \textit{infra}.

\textsuperscript{158} U.S. Customs Letter Ruling R:CV:S JCH 052839 (July, 27, 1979); \textit{see} note 146 and accompanying text \textit{supra}.


\textsuperscript{161} U.S. Customs Letter Ruling R:CV:S RG 044009 (June 10, 1977).

\textsuperscript{162} U.S. Customs Letter Ruling R:CV:S RG 051870 (June 10, 1977).
raised the issue of the marketability of the intermediate product which results from the first of the two substantial transformations which may be required to meet the 35% test.\textsuperscript{163} This was the case in the electric motors case discussed above\textsuperscript{164} and in at least one other assembly situation.\textsuperscript{165} It thus appears that the Customs Service has not always applied this requirement strictly, although it seems most likely to do so in chemical cases.\textsuperscript{166}

\textbf{E. Assemblies}

The problem of assemblies is the final major consideration which must be taken into account when attempting to define a substantial transformation in the context of the GSP. As this article is being written, the issue is before the Customs Court in New York.\textsuperscript{167}

Assemblies are often permitted to qualify as substantial transformations in other areas of customs law,\textsuperscript{168} but in the context of GSP the issue must be discussed separately with regard to each of the separate sources of the substantial transformation requirement. It is clear that some assemblies may qualify as substantial transformations for purposes of the country of origin requirement. The GSP Customs regulations from which this requirement was interpreted state this explicitly,\textsuperscript{169} as do several published and unpublished decisions. The electric motor case, for example, stated that the final assembly qualified the eligible article as a product of the BDC.\textsuperscript{170} In another case involving electric coils, the assembly of these items by winding wire around a core, then gluing and removing the core was held to substantially transform the constituent materials so as to make the coil a product of the BDC.\textsuperscript{171} In another instance, however, the addition of light bulbs, a fuse and an ornament to an otherwise complete Christmas tree light set was held insufficient to qualify the light set as a product of the BDC.\textsuperscript{172} Apparently in this case


\textsuperscript{164} T.D. 78-400, 12 Cust. B. & Dec. 875 (1978); see text accompanying notes 100-01 infra.

\textsuperscript{165} U.S. Customs Letter Ruling R:CV:S JLV 055684 (undated).

\textsuperscript{166} See, e.g., T.D. 77-273, 11 Cust. B. & Dec. 551 (1977); letter from S. E. Caramagno, Director, Classification and Value Division, U.S. Customs Service, to District Director of Customs, San Juan, Puerto Rico (April 17, 1979) (response to Internal Advice Request No. 179/78, R:CV:S JLV 061031); letter from S. E. Caramagno to District Director of Customs, San Juan, Puerto Rico (May 25, 1979) (response to Internal Advice Request No. 182/78, R:CV:S JLV 061030); U.S. Customs Letter Ruling R:CV:S JLV 055716/055717 (July 12, 1979).


\textsuperscript{168} OAS, supra note 56, at 82-83.

\textsuperscript{169} 19 C.F.R. § 10.176(a) (1979). See text accompanying note 55 supra.


\textsuperscript{171} U.S. Customs Letter Ruling R:CV:S JLV 054831 (March 13, 1978). See also C.S.D. 79-312, 13 Cust. B. & Dec. No. 37, at 35 (weekly ed. 1979). In each of these cases the BDC manufacturer was required to meet the 35% value-added test by means of domestic materials and direct costs of processing alone. None of the imported materials included in the eligible articles was held to have been twice substantially transformed.

the Customs Service did not feel that the assembly involved was significant enough to satisfy the criteria of the "name, character and [or] use" rule.\textsuperscript{173}

Assemblies are just as permissible for purposes of the second of the two substantial transformations required by the 35% test as they are for the country of origin requirement.\textsuperscript{174} As noted above, the Customs Service equates these two requirements.\textsuperscript{175} Furthermore, in C.S.D. 79-312,\textsuperscript{176} the language we quoted concerning the second of the double substantial transformation requirements stated that this operation could be an assembly.\textsuperscript{177} Insignificant assemblies, however, which do not satisfy the distinct "name, character and [or] use" rule will fail in this situation just as they do in the country of origin cases.\textsuperscript{178} Thus the addition of eye screws, snap swivels, grommets and hooks to a fish lure body which Customs considered already to be a lure did not result in a substantial transformation capable of permitting the already once substantially transformed imported constituent materials of the lure body to be added into the sum to meet the 35% value-added requirement.\textsuperscript{179}

It is only for purposes of the first of the two substantial transformations required by the 35% test that Customs has, in effect, not permitted assemblies to qualify as substantial transformations.\textsuperscript{180} The same assembly operations which will qualify as a substantial transformation for purposes of the country of origin requirement will not result in "substantially transformed constituent materials."\textsuperscript{181} This rule was laid

\textsuperscript{173} Id. See also C.S.D. 80-111, 14 Cust. B. & Dec. No. 32, at 33 (weekly ed. 1980) (non-GSP decision).
\textsuperscript{174} See, e.g., C.S.D. 79-62, 13 Cust. B. & Dec. No. 11, at 24 (weekly ed. 1979) (leather pieces were assembled by sewing).
\textsuperscript{177} See text accompanying note 77 supra.
\textsuperscript{178} See text accompanying notes 172-73 supra.
\textsuperscript{180} T.D. 76-100, 10 Cust. B. & Dec. 176 (1976). The actual language which Customs used in T.D. 76-100 was that "assembled articles]]: are not considered substantially transformed constituent materials . . . [although they] may well have been substantially transformed. . . ."
\textsuperscript{181} Compare U.S. Customs Letter Ruling R:CV:S JLV 054831 (March 13, 1978) with U.S. Customs Letter Ruling R:CV:S JCH 051102 (July 28, 1977). These cases involved the assembly of electrical coils by wrapping wire around a core and gluing it in place. In one case the operation was held to substantially transform the materials for country of origin purposes, Letter Ruling 054831, while in the other case, the same operation was held not to substantially transform the materials for purposes of value in the sum to meet the 35% value-added requirement. Letter Ruling 051102. See also T.D. 78-400, 12 Cust. B. & Dec. 875 (1978).
down in T.D. 76-100,182 one of the earliest of the published Treasury Decisions concerning GSP. This decision stated that "[p]artially completed components which are completed and assembled in the beneficiary developing country into finished articles or components do not qualify as substantially transformed constituent materials. By the same token, most assembly operations and operations incidental to assembly will not qualify."183

By using the word "most"184 the decision seemed to leave open the possibility that some assembly operations might qualify. This interpretation was further strengthened by Customs' use of the phrases "in general"185 and "as a general rule"186 in similar contexts in two early Letter Rulings. In fact, however, no case permitting a pure assembly has thus far been the subject of a published decision. One early and ambiguously written Letter Ruling which could have been interpreted as permitting an assembly has apparently just recently been overruled187 and the issue is presently before the U.S. Customs Court in New York.188

In practice, this has meant that the part to be assembled must be created or changed in some essential way (substantially transformed) in the BDC prior to its assembly in order for the cost or value of the resulting substantially transformed constituent materials to be included to meet the 35% test.189 The part must, for example, be cast, stamped out, cut to shape, molded or created in some way prior to its assembly.190 It is not enough that an imported part is simply assembled or undergoes operations "incidental to assembly," or that it be finished and assembled. Operations such as gluing, soldering, riveting, welding, wrapping, swag-

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183 Id. at 178.
184 Id.
187 U.S. Customs Letter Ruling CLA-2:R:CV-S 047150 RG (Jan. 18, 1977) involved a printed circuit board. Raw fiberglass was imported into the BDC, printed with the required circuit diagram, etched, cleaned, lacquered and punched with holes into which electronic transistors, resistors, capacitors and diodes were "stuffed" to form individual circuit boards for inclusion in eligible security lights under GSP. The "circuit boards" were held to be "a new and different article of commerce," the value of which could be included to meet the 35% value-added test. Left unclear was whether the words "circuit board" referred to the entire assembly or just to the printed fiberglass portion of it. The former interpretation seems more likely, however, in view of the fact that the rationale given for the decision was that the operation was "more than a mere assembly." If this was the case, it should be noted that Customs has apparently chosen to overrule this ruling while the issue it concerns is before the Customs Court in New York. Conversation with Customs Officials (April 1980); see note 188 infra.
188 Texas Instruments, Inc. v. United States, Cust. Ct. No. 78-10-01812 (filed Feb. 21, 1980); see note 188 supra.
190 Id. See also U.S. Customs Letter Ruling CLA-2:R:CV-S RE 045950 (July 30, 1976) (creating alloys from imported gold and copper); U.S. Customs Letter Ruling CLA-2:R:CV-S MH 045202 (April 30, 1976) (sawing wooden parts to be assembled into doors); U.S. Customs Letter Ruling CLA-2:R:CV-S 047201 MH (Nov. 26, 1976) (cutting and bending or cutting and punching tubing and rods into components for assembly). In each case the results of these operations were held to be substantially transformed constituent materials.
ing, crimping, cleaning, trimming, polishing, mixing, grinding up, soaking, sorting, inspecting and cutting to length would be likely to fall into one of these last categories. Finally, the cases have held that because there must be an independent intermediate product, the part must be created prior to its assembly rather than simply during it. Thus, the cost or value of imported polyvinyl chloride pellets cannot be included in the sum to meet the 35% value-added test if they are molded directly onto the final article to serve as insulators. To qualify, they must have been separately molded into insulators before their assembly and not created and assembled by a continuous process.

VII. Conclusion

The U.S. definition of substantial transformation is vague, confusing and difficult to apply and has become even more so in the context of GSP. The definition is a general one which has been left to be filled in by case law. To the extent that the case law has developed in the context of GSP, this "definition" has become even more complex, problematic, and occasionally internally inconsistent.

The single major source of the difficulties which Customs is having with substantial transformation in the context of GSP lies in the requirement that there be two successive substantial transformations to render materials which have been imported into the BDC eligible for inclusion in the sum to meet the 35% value-added requirement. These successive requirements have led to problems in separating and distinguishing the two which do not seem to exist elsewhere in Customs law. If assemblies were to be permitted as substantial transformations for purposes of the first of the two tests, for example, at which point would it be possible to state that the first substantial transformation was complete and that the second one had begun? Yet there are some assembly operations which are so complex and require so many stages and so much capital equipment that it seems anomalous not to consider them substantial transformations for this purpose.

An analogous problem has arisen in other cases due to Customs insistence that there be an independent intermediate product and that there is no such product if the imported materials have been continuously and uninterruptedly processed from their imported condition into the ultimate eligible article. It seems strange to tell a manufacturer in a

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193 Id. It should be noted that one of the disadvantages of this requirement would seem to be that a BDC manufacturer could be required to use less sophisticated technology in such an instance in order to perform the operation in two steps rather than one. There is, of course, no rule against altering one's production processes to comply with customs requirements. See, e.g., U.S. Customs Letter R:CV:SP RG 049097 (March 1, 1977).
BDC that he must isolate, and perhaps even be willing to sell, an intermediate product when it is most efficient and economical for him to feed that product directly into the next machine in the process of producing the eligible article.

A third problem is that the double substantial transformation test has also led to the development of, or at least increased concern with, a marketability criterion with regard to the results of the first of the substantial transformations. This criterion has given rise to still further problems because Customs has apparently been having trouble applying it consistently. One major problem seems to be that some manufactured components are individually salable as spare parts while others are not and yet the processes by which those which are salable are made can not be easily distinguished from the processes used to produce those which are not.

Finally, the fourth major problem which has arisen is in part the culmination of the other three. The attempts to separate and distinguish the two substantial transformations have helped to contribute to the development of a somewhat different definition of substantial transformation insofar as the first of the two such tests of the double requirement in the 35% value-added test is concerned. The refusal of Customs to consider assemblies for this purpose seems to go against the grain of customs precedent in the substantial transformation area in general and this has caused confusion. The same seems to be true to some extent with the marketability criterion. Thus the words "substantial transformation" in the GSP context are being used to refer to two different tests, of which only one, the "country of origin" requirement, is the same as that used more generally in customs law. Despite this, however, no indication is given in the Customs regulations that there is any difference in these requirements. The Customs Service has also failed to distinguish between the two tests in its public statements and has instead simply referred the public to the existing body of customs precedents for guidance.194

Given this analysis, three questions naturally arise. The first is why the dual substantial transformation test is required at all. The second is where the present rules are taking us, and the third is what should be done.

The answer to the first question is somewhat complex. We have seen that some sort of substantial transformation test is required by the very nature of the GSP program. To require a substantial transformation is to require industrialization, the fundamental goal of GSP. UNCTAD does not disagree with this conclusion.195 Further, the dual

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195 See, e.g., UNCTAD, supra note 84, para. 33, at 12.
The substantial transformation test is only required by the United States to permit materials which have been imported into the BDC to be included in the cost or value of the ultimate article for purposes of meeting the 35% value-added test. While other individual GSP donor countries occasionally permit the cost or value of materials which have been purchased in that donor country to be included, the United States seems to be the only donor country which has a means of allowing all such imported materials be included. The double substantial transformation test thus benefits the BDCs. The question remains as to why two substantial transformations are required. The logical answer seems to lie in the fear that if the BDCs were only required to meet the present "product of" substantial transformation test they would exploit their abundant supply of cheap labor and simply become assembly platforms for components exported from the developed countries. If the cost or value of imported materials or components could be added in to meet the value-added requirement as a result of an assembly or manufacturing operation requiring only minimal skills or effort then the developed countries would simply use the BDCs as duty-free conduits to the U.S. markets for their goods. To permit simple assemblies to serve this purpose would most likely result in the transfer to the BDCs of little in the way of skills and technology needed for their development and would also undoubtedly raise a protectionist backlash within the U.S. against the GSP program. The rules of origin would not be fulfilling their purpose. This problem of assemblies and similar "pass-through" operations in the BDCs was a subject of concern in Congress when the GSP program was enacted.

With regard to the second question, the GSP related rulings concerning substantial transformation have become increasingly complex and as their number has grown the number of apparent contradictions between them has grown as well. We are creating a labyrinth which will simply generate ever more letter rulings. It would be more logical to devise a system that the parties interested in the GSP could understand by themselves.

Insofar as what is to be done is concerned, it is evident that the problems involved in separating and distinguishing the two successive substantial transformations will remain as long as that double requirement exists. Thus if the present double requirement is to be retained the obvious place to start is for Customs to admit the existence of the

197 UNCTAD, supra note 196, para. 64, at 17.
198 See, e.g., 119 CONG. REC. 40525, 40537, 40543 (Dec. 10, 1973). It was also Congress which added the provision to Title V of the Trade Act of 1974 excluding "import-sensitive electronic articles" from preference under GSP. 19 U.S.C. § 2463(c)(1)(C) (1976); 120 CONG. REC. S39771 (Dec. 13, 1974).
problems which it has caused. Customs should publicly clarify and explain the differences between the two substantial transformation tests being applied within the GSP program and the relationships between those tests and the substantial transformation tests being applied in other areas of customs law. Such a public clarification could also contain an explanation of the rationales behind these differences. Furthermore, since one of the major problems facing any person dealing with substantial transformation in the context of GSP has been that the rules and theories of which that concept is composed have thus far been spread point by point throughout the various rulings, Customs should at a minimum collect all these rulings and decisions in one place and make them easily available to the public. These two simple steps alone would go a long way towards helping to clear up the present confusion. As this article was going to press the 1978 bound volume of *Customs Bulletins and Decisions* became available. This volume contains a descriptive list of the 1978 unpublished Customs Decisions. This is a major step toward alleviating the above mentioned problem.\(^{199}\)

For the longer term, there is also the possibility of adopting a more easily applicable definition of substantial transformation for purposes of the GSP. This could possibly be done along one of the lines which have been suggested by UNCTAD.

UNCTAD has been calling for a harmonization of the GSP rules of origin world-wide.\(^{200}\) At present there are two types of substantial transformation tests being used by GSP preference-giving market economy countries throughout the world. UNCTAD has termed these the "process" test and the "percentage" test.\(^{201}\) The United States is one of a minority of countries using the latter.\(^{202}\) The "process" test defines a substantial transformation as, in general, an operation which results in a change in the Customs Cooperation Council Nomenclature (CCCN) tariff classification of the materials involved.\(^{203}\) The "percentage" test, on the other hand, requires that either a certain minimum percentage of the value of the eligible article be added in the BDC (a "domestic con-

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200 UNCTAD, supra note 196, at 4.
201 UNCTAD, Review and Evaluation of the Generalized System of Preferences, U.N. Doc. TD/232 at 12-13 (Jan. 9, 1979). It should be noted that UNCTAD uses the phrase "substantial transformation" in a much broader sense than does the United States. For UNCTAD the phrase seems to refer to almost any operation which meets any requirement which must be met to confer origin on an article.
202 Id. at 13.
203 UNCTAD, supra note 196, at 7-8. In addition to this general criterion, the donor countries employing the "process" test have also established two lists of exceptions to the general rule. List "A" attaches additional requirements in many specific instances where an operation resulting in a change in CCCN number would otherwise confer original status. Some of these additional requirements involve percentage value-added requirements. List "B", on the other hand, is comprised of operations which are deemed to confer the status of origin despite the fact that they do not result in a change in CCCN. See, e.g., 22 OFFICIAL JOURNAL OF THE EUROPEAN COMMUNITIES 1-54 (Jan. 31, 1979).
tent" rule) or that the import content of the eligible article not exceed a

certain maximum percentage of its value (an "import content" rule). The United States, of course, utilizes the "domestic content" approach. UNCTAD has been calling for a harmonization within each of the two

major categories of rules and then for harmonization between them. Within the "percentage" category it has opted for the "import content" approach as being the most desirable from the point of view of the developing countries due, among other things, to its relative simplicity and the lesser burden of record-keeping which it imposes. The import content approach also seems to avoid the problem of determining what is a material produced in a BDC by simply adding up the "customs value of the material, parts and components at importation or, as regards materials etc. of undetermined origin, the earliest ascertainable price paid for such materials, etc. in the territory of the country where the manufacture takes place." Then, if this figure exceeds a certain percentage of the value of the ultimate eligible article that article will not qualify for GSP. Due to the U.S. experience with a similar import content rule in its trade relations with its insular possessions, however, it probably would not desire to adopt such a rule again, without modification, for purposes of its GSP. Such modification, however, could probably be made by simply adding in to the sum of the costs of the imported materials those expenses which in the present GSP scheme are not permitted to be included in the direct cost of processing. In effect, the legitimate domestic value-added would be defined negatively by determining what percentage of the final appraised value of the eligible article it is not. The single "product of" substantial transformation test could be used with this approach and the percentage requirement could be newly fixed to reflect the change in the method of calculation. The present problems resulting from the double substantial transformation test would be avoided.

Finally, a second long term possibility would be for the United States to adopt the "process" substantial transformation test. Although the United States would have problems moving quickly towards such a test because the U.S. Tariff Schedules are different from the CCCN schedules used by the process-test countries, such a solution may be possible eventually if the U.S. GSP program is extended beyond 1985. UNCTAD has not as yet taken a position as to whether it considers the process or the percentage approach preferable but the United States is

204 UNCTAD, supra note 196, at 8.
205 Id. at 4.
206 UNCTAD, supra note 84, at 6, 19-23.
207 Id. at 19 (footnote omitted). UNCTAD notes in this study that the varying methods of customs valuation in the different countries might be a problem with this approach which would have to be resolved. Id.
210 See, e.g., UNCTAD, supra note 196, at 4.
already engaged in a process of negotiation designed to lay the foundations for a harmonization of its tariff schedules with those of the CCCN countries by the date just mentioned.

Author's Postscript

Shortly after this article had been put in final form, the U.S. Court of Appeals for the Second Circuit handed down a non-GSP case containing language defining "substantial transformation" in the country of origin context as a fundamental change in the form, appearance, nature or character of an article which adds to that article a significant amount or percentage of its value. A petition for writ of certiorari in this case was pending before the Supreme Court when this article went to the printer. See United States v. Murray 621 F.2d 1163 (2d Cir. 1980). A recent Customs Service Decision also suggested that "value-added" may be a relevant factor in determining whether a substantial transformation has occurred. C.S.D. 80-111, 14 Cust. B. & Dec. No. 32, at 33 (weekly ed. 1980)
Appendix

I. Example of a case in which the country of origin requirement was held to have been satisfied.


*Facts:* Saw chain parts are imported into the BDC and assembled.

*Reasons Given for Decision:* "Eligible articles which are the growth, product, manufacture, or assembly of a [BDC] may qualify for duty-free entry under the GSP provided that all requirements for such treatment are satisfied. 19 C.F.R. 10.176 (1976). . . . [T]he saw chains satisfy the country of origin requirement as stated above. . . . [T]he 35 percent requirement must be satisfied by direct costs of processing alone."

II. Example of a case in which the country of origin requirement was held not to have been satisfied.


*Facts:* "[A] wire with 10 light sockets connected thereto, known as a harness, is . . . imported into [the BDC] where a fuse plug is attached. Then, a light bulb is inserted into each socket located on the harness. A plastic ornament is attached and the finished [Christmas] light set is placed on cardboard liner and inserted in a cardboard box with a cellophane window." It is then exported.

*Reasons Given for Decision:* "The addition of light bulbs, plastic ornaments, and the fuse plug changes the light set from an unfinished light set to a finished light set though it does not change the light set into a new and different article of commerce. The finished light set as imported is classified under item 688.10, TSUS, as the unfinished light set, the harness, is classifiable under item 688.10, TSUS. Therefore the harness has not undergone a substantial transformation in [the BDC] and would not be eligible for treatment under GSP."
III. Cases in which the cost or value of the imported materials qualified for inclusion in the sum to meet the 35% value-added requirement.


**Facts:** Imported asbestos lap is carded and combed into asbestos roving and the roving is then spun into eligible yarn which is woven into eligible asbestos cloth.

**Reasons Given for Decision:** "Roving is an assemblage of carded asbestos fibers condensed into a single strand without twist. It is used in the electric wire industry . . . as insulation." The imported lap is thus substantially transformed into roving which is "a new and different article of commerce." The roving is then further substantially transformed into eligible asbestos yarn and cloth. The cost or value of the lap may thus be included in computing the 35% criterion for both the yarn and the cloth.


**Facts:** An imported zinc ingot is melted and diecast into a front housing. This housing is then assembled with other components into a front housing assembly which in turn is assembled into an eligible electric motor.

**Reasons Given for Decision:** The zinc ingot has been substantially transformed into a constituent material and therefore is includible in the costs of materials to meet the 35% value-added requirement.


**Facts:** Extension cord sets are manufactured in the BDC from imported materials in the following fashion. Imported copper wire is covered by an extrusion of an imported vinyl extrusion compound to form insulated wire which is wound onto 50,000 foot reels. The insulated wire is then cut to length; the ends are stripped; metal contacts and blades are crimped onto the exposed wire ends; vinyl pellets are then injection molded to form a cap on the blade and a connector service block on the other (female) end. A safety cap is then assembled into each connector service block to form the completed extension cord set.

**Reason Given for Decision:** "The vinyl-insulated wire, produced by extrusion of vinyl over wire, is a new and different article of commerce, and, if used in the manufacture of the extension cord sets, is a substantially transformed constituent material for purposes of the GSP. The other materials are not substantially transformed constituent materials because the processing of such materials does not result in intermediate products that are distinct from the materials as imported and that are subsequently used in the production of the eligible article."

IV. Cases in which the cost or value of the imported materials was held not to qualify for inclusion in the sum to meet the 35% value-added requirement.


**Facts:** Technical atrazine is produced in two steps from four imported raw materials A, B, C and D, as follows. As the first step, chemical A is reacted with chemical B to produce dichloro. Chemical D is added to produce a more complete reaction. As the second step, the dichloro is reacted with chemical C to produce eligible technical atrazine. Chemical D is again added to produce a more complete reaction.

**Reasons Given for Decision:** "On the basis of the information supplied concerning the nature of the manufacturing process [apparently a reference to an allegation that it was continuous in nature] and in the absence of any evidence of a market for
dichloro in unrefined form . . . the dichloro is not a substantially transformed constituent material . . . and [its] value cannot be included [to meet the 35% value-added requirement]."


Facts: Diuron wettable powder is produced in the BDC in two steps from imported materials. As the first step, DMA is reacted with DCPI to create the technical diuron. As the second step, the technical diuron is mixed with various agents (e.g. anti-caking, wetting and dispersing materials) and inert extenders to produce eligible diuron wettable powder.

Reasons Given for Decision: "Although the addition of various agents to the technical diuron causes a change in the diuron's physical composition, it does not result in any chemical change. The technical diuron has therefore not been substantially transformed into a new and different article of commerce, and its value may not be included [to meet the 35% requirement]."


Facts: Various electronic components and a bare but otherwise finished circuit board are imported into a BDC and there assembled by soldering into an assembled circuit board for an eligible computer which is exported to the U.S.

Reasons Given for Decision: "Although substantially transformed, the fabricated unit is not a substantially transformed constituent material of the computer . . . . Articles produced by the joining and fitting together of components are not considered substantially transformed constituent materials."


Facts: Brown kraft paper is imported into the BDC in jumbo rolls. In the BDC "[t]he paper is fed from the rolls directly into a machine which folds and pastes it into a tube, then cuts, pastes and folds it into a finished paper bag. The entire procedure is accomplished in one continuous process, on a single machine . . . ."

Reasons Given for Decision: "There is . . . no intermediate step at which a new and different article of commerce emerges . . . . Therefore, the brown draft paper does not become a substantially transformed constituent material . . . and its value or cost may not be used [to meet the 35% requirement]."


Facts: Potassium gold cyanide, nickel chloride and nickel anodes are imported into the BDC and used to electroplate an article which is eligible for duty-free treatment under the GSP. The electroplating process is carried out as follows: the eligible article is cleaned, rinsed twice with water, dipped in hydrochloric acid, rinsed twice more with water, electroplated with nickel, rinsed three times with water again, electroplated with gold, rinsed again and dried.

Reason Given for Decision: "The electroplating process by which metals contained in nickel chloride, potassium gold cyanide, and nickel anodes are plated out as free metals on a GSP-eligible article does not result in substantially transformed constituent materials. . . . The imported materials in question are deposited directly by the electroplating process onto the eligible article. They do not become intermediate products having a separate existence apart from their condition as materials imported into the BDC or as integral parts of the eligible article."