Voluntary Disclosures & Mandatory Corrections

Canadian & U.S. Approaches – The In's and the Out's

Presented at IE Canada's 2005 Western Canada Conference

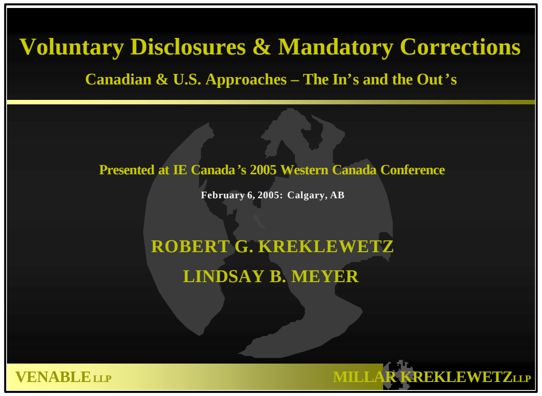
February 6, 2005: Calgary, AB

ROBERT G. KREKLEWETZ

LINDSAY B. MEYER

VENABLE LLP

MILLAR KREKLEWETZ LLP



ROBERT G. KREKLEWETZ, LL.B., M.B.A.

Rob is a partner at MILLAR KREKLEWETZ LLP, with an LL.B. from Osgoode Hall Law School, and a M.B.A. from York University.

Extensive Customs, Trade & Commodity Tax Experience. Rob's practice focuses on **Customs & Trade** matters, including Periodic Verification Audits and Voluntary Disclosures concerning Valuation, Tariff Class Origin, or Marking issues, and NAFTA Origin Verification Reviews, Forfeitures, Seizures, and other NAFTA & WTO issues. Rob's practice area also focuses on **Commodity Taxes**, which encompasses all issues involving Canada's Goods and Services Tax (GST) and Harmonized Sales Tax (HST), as well the various other provincial sales taxes, including Ontario RST and Quebec QST. All elements of Millar Kreklewetz's practice include **Tax and Trade Litigation**, and Rob has acted as lead counsel in the CITT, Tax Court of Canada, Federal Court of Appeal, Ontario Court of Justice, and the Ontario Court of Appeal.

Speaking Engagements / Publications. Rob has 17 years of experience, published over **325 articles & papers**, and spoken at over **125 conferences** in each of the areas described above. He continues to write and speak extensively, regularly addressing the Canadian Association of Importers & Exporters (IE Canada), at its annual and semi-annual conferences, and various seminars, and bodies like the Tax Executive Institute (TEI), Canadian Tax Foundation, Canadian Bar Association (CBA), and Canadian Institute of Chartered Accountants (CICA), as well as speaking at many other professional conferences.

Client Base. MILLAR KREKLEWETZ LLP has some of the best tax and trade files in Canada, and Rob advises blue chip corporate clients who are international leaders in:

- Airlines, Avionics & Aerospace
- Oil & Gas
- Chemicals & Petrochemicals
- Forestry Products
- Steel
- Drugs & Pharmaceuticals
- Medical Testing & Health Services
- Computer Hardware & Software
- Information Technology
- IT & Internet Solutions
- Banking
- Financial Services
- Leasing
- Publishing
- Public Sector
- Manufacturing
- Wholesaling
- Retailing
- Direct Mail
- Direct Selling

We are proud to announce that the International Tax Review has ranked us as the top Canadian law firm in our field for three consecutive years – "Indirect & State and Local Taxes".

LINDSAY B. MEYER, J.D.

Lindsay is a partner at Venable LLP, with an J.D. from George Washington University, National Law Center and a licensed U.S. Customs Broker.

Extensive Trade, Customs and Export Control Experience. For over sixteen years, Lindsay has provided **International Trade and Customs** advice at Venable where she heads its International Practice, located in Washington, D.C., concentrating on **Customs & International Trade** matters, including representation during U.S. Customs Focused Assessments, NAFTA Audits, C-TPAT, ISA Programs, Detentions, Forfeitures, Seizures, other Customs-related matters. She regularly provides strategic customs and trade counseling to Fortune 100 clients, by conducting Pre-Assessment Compliance Reviews including corporate-wide, multi-location assessments and training programs, and by representing companies before the U.S. Bureau of Customs and Border Protection, the Court of International Trade, and U.S. Court of Appeals for the Federal Circuit. Lindsay has extensive experience counseling companies on compliance with export controls regulated by the Departments of Commerce, State and Treasury and performing Export Control Assessments. Lindsay has also successfully represented companies in antidumping duty investigations and reviews before the U.S. Department of Commerce and International Trade Commission and on appeal. Lindsay also advises clients on **International Transactional** matters, where she counsels on strategic sourcing, sales and distribution arrangements in the U.S. and abroad; the use of foreign agents, affiliated offices, and joint ventures.

Venable LLP's Client Base. As one of *The American Lawyer's* top 100 law firms, Venable LLP has lawyers practicing in all areas of corporate and business law, litigation, intellectual property and government affairs. Venable serves corporate, institutional, governmental, nonprofit and individual clients in the U.S. and around the world from its base of operations in and around Washington, DC. Likewise, Lindsay's clients range from multinational manufacturers to start-up enterprises from a wide variety of industries including high technology, chemical, petrochemical, pharmaceutical, automotive, avionics, space control equipment, steel, and retail industries.

Speaking Engagements / Publications / Memberships. Lindsay is also very active in business and trade associations related to her profession, and in her fourth term as Chair of the International Trade and Customs Committee for the ABA's Section of Administrative Law and Regulatory Practice, is a member of the American Association of Exporters and Importers, and was appointed by the U.S. Secretary of Commerce to the Maryland-Washington District Export Council.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

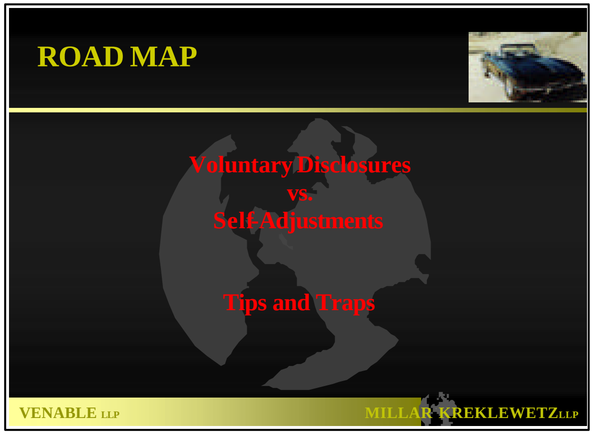
Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

THE ROAD MAP

General Focus of the Presentation

An area which does not receive enough attention is the effective use of the "voluntary disclosure" process (or the "prior disclosure" process in the United States) to deal with customs compliance gone-wrong. In both jurisdictions, a "voluntary" or "prior" disclosure can be an effective means of disclosing liability for customs purposes and, after paying the relevant duties/GST and interest owing, of moving forward with a clean slate, free of penalties or possible criminal sanctions.

Voluntary Disclosures are also often confused with post-entry adjustments, like those effective through a B2 Adjustment in Canada, or a Post Entry Amendment in the U.S. The former offer protection from penalties and possible criminal prosecution. The latter do not.

Another area that had not yet received enough attention in Canada, but is now *de rigueur* in the U.S., is the notion of "mandatory corrections" for certain fundamental customs entry information. In both jurisdictions, corrections are required wherever an importer develops the "reason to believe" that it has committed errors involving tariff classification, valuation or origin. In Canada the basis for the requirement is section 32.2 of the *Customs Act.* In the U.S., the requirement is found in section 284 of the *Tariff Act* (19 USC 1484).

The Presentation today, and the balance of these materials, will discuss the in's and the out's of both the Voluntary Disclosure and Mandatory Correction processes in Canada and the U.S., comparing and contrasting the two approaches, and discussing tips for effectively understanding and using both approaches to best advance an importer's interests.

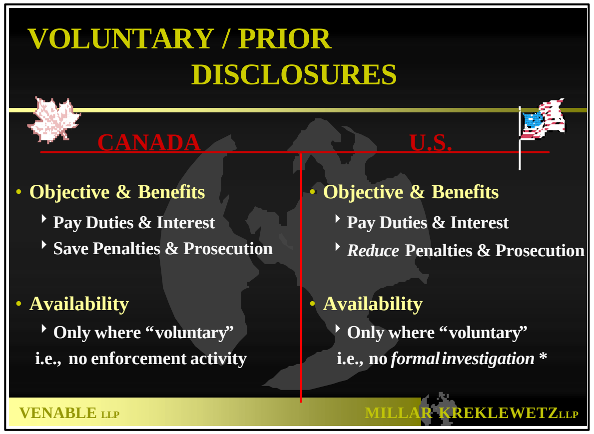
Navigating Through the Materials

The Materials are broken into * parts, as follows.

Part I contains a comprehensive review of (1) the Canadian "voluntary disclosure" and U.S. "prior disclosures" programs, in the customs context, (2) an equally comprehensive review of the Canadian and U.S. "mandatory correction" processes, and (3) a "compare and contrast" section aimed at drawing out the more important and practical points from these sections, both in Canada and the U.S..

As an added bonus, Part II contains general overviews of the Canadian customs, trade and commodity tax system, while Part III contains a general overview of the U.S. customs and trade law regime. Each of these Parts are designed to ensure that all readers operate from a level playing field.

The audience is encouraged to participate !
So feel free to ask questions at any time.



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

PART I

VOLUNTARY DISCLOSURES & MANDATORY CORRECTIONS

INTRODUCTION

In Canada and the U.S. alike, compliance obligations and responsibilities under various taxing and customs legislation like the Canadian *Customs Act* or the U.S. Code, Title 19, are premised on the principle of **voluntary self-compliance**.

In this context, and in order to deter persons from simply ignoring their compliance responsibilities under domestic legislation, enforcement authorities like Canada's Canada Border Services Agency (the "CBSA"), and the U.S.'s Bureau of Customs and Border Protection ("CBP") have been afforded a multitude of audit and enforcement powers, all aimed at detecting contravention.

Many commentators on both sides of the border have pointed out,[1] that there will never be enough money or resources available for customs authorities to achieve perfect compliance through audit and enforcement activities.

Accordingly, customs authorities like CBSA and CBP, and other authorities, have turned to promoting compliance, through other means.

There are two age-old theories towards promoting compliance.

On the one hand, you have the "carrot" approach; on the other, the "stick" approach.

The carrot approach is used in both Canada and the U.S., and comes in the form of "voluntary disclosure programs" ("VDP") aimed at encouraging persons in non-compliance to come forward and become compliant, all in the interests of avoiding penalties.

The stick approach might be likened to the mandatory correction requirements ("Self-Adjustments") that each of Canada and the U.S. have in their domestic legislation, aimed at forcing compliance in an "or else" environment.

With the adoption of both VDP and Self-Adjustment programs in Canada and the U.S., an importer faced with recognized non-compliance now has three alternatives, depending on the situation that is being faced:

1. A "do nothing" option, which sees the person keep a "heads down" approach, hoping that no assessment is ever raised in respect of the non-compliance; notably, this option exists whether or not the non-compliance relates to program areas in which Self-Adjustments exist (e.g., tariff classification, valuation, origin);
2. A "comply" through Self-Adjustment option, which sees the person faced with an error involving tariff class, valuation or origin, takes the steps required under the legislation to make the correction; and
3. A "comply" through VDP option, which sees the person, attempt to voluntarily correct his or her past mistakes through a VDP program.

The balance of this part will examine comprehensively both the VDP and the Self-Adjustment systems in Canada and the U.S.

CANADA [2]

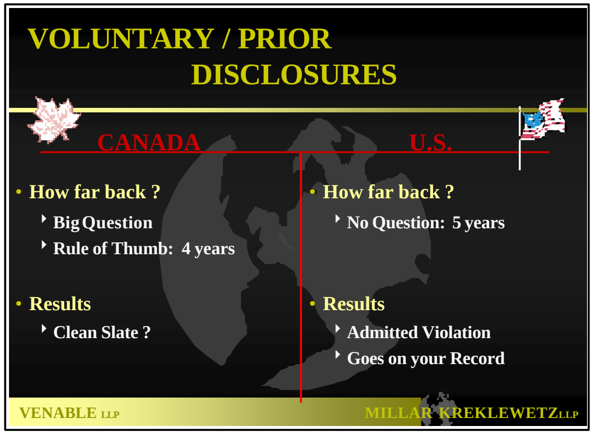
VOLUNTARY DISCLOSURES

Overview

The Customs Voluntary Disclosures Program ("VDP") is part of the CBSA's Fairness Initiative and is focused on encouraging voluntary compliance with customs laws and regulations by encouraging persons to come forward and correct errors or disclose information not previously reported, in order to be in compliance with customs laws.[3]

A voluntary disclosure ("VD") can be contrasted with a Self-Adjustment.

Under the VDP, *there are no mandatory requirements for persons to come forward and correct their mistakes*. This is not the case for Self-Adjustments – which are statutorily mandated in certain instances (see below). Rather, persons seeking to address non-compliance under the VDP have the choice to come forward and correct past errors, or do nothing, facing the risks of a possible assessment, as discussed in below.



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Second, a VDP is not limited to just errors in accounting declarations involving "tariff class", "value", or "origin", as Self-Adjustments are. Rather, a person can initiate a VD for any customs non-compliance, even the prior smuggling of goods to Canada!

Benefits of Initiating a Voluntary Disclosure

Where a VD is accepted, persons making the VD will only have to pay what duties may be owing, plus interest at the prescribed rate (and not at the higher specified rate).[4] Persons making a valid VD will be relieved from all other monetary penalties and, significantly, from possible criminal prosecution relating to their customs non-compliance.[5]

Conditions for a Valid Disclosure

Unlike the situation with Self-Adjustments, which are statutorily required with the legislative conditions are met, the conditions for a valid VD are as follows:[6]

1. The CBSA determines that the disclosure is **voluntary**.

   The disclosure must be voluntary and must be initiated by the client. A disclosure may not qualify as a voluntary disclosure if it is found to have been made with the knowledge of an audit, investigation, or other enforcement action that has been initiated by the CBSA or a related administration, such as other federal and provincial departments.

> **TIP: Computer Generated Notices**
>
> *Voluntariness.* Computer-generated notices requesting filing, remittance or other compliance action are register in respect of income tax are considered to be an enforcement action by the CBSA. However, if a sufficient amount of time has elapsed between the date of the last notice and the date of the VD (suggesting that CSA has abandoned the enforcement action), then the notice maybe considered *not* to be an enforcement action.
>
> *Beware of innocuous interaction with CBSA !*

2. The CBSA determines that the disclosure is **complete**.

   The disclosing client is expected to provide full and accurate reporting of all previously inaccurate, incomplete, or unreported information. While the information provided in a disclosure must be substantially complete, it will not be disqualified simply because it contains minor errors or omissions. However, if a disclosure is found to contain material errors or omissions, it will not qualify as a voluntary disclosure, and the disclosed information may be processed, and interest and penalties can be applied to the entire amount.

> **TIP: Disclosed & Undisclosed Transactions Still Subject to Audit**
>
> *Completeness.* Remember that where a VD is *not* complete the importer or owner risks the VD being ruled to be ineligible. Even if CBSA does not rule it to be ineligible, it still reserves the right to include transactions that have been previously disclosed by way of VD in CBSA's normal verification process. Where CBSA discovers non-compliant transactions (activities / trade data) that were not part of the original VD, those transactions could give rise to applicable duties, interest, penalties, and/or prosecution.
>
> *It pays to be complete !*

3. The disclosure involves a **monetary penalty**.

   A disclosure must involve at least one monetary penalty. If no monetary penalties apply to the information being disclosed, the client does not need to seek penalty relief through the VDP. This information must still be provided to the CBSA and will be processed, as would any other request for adjustment.

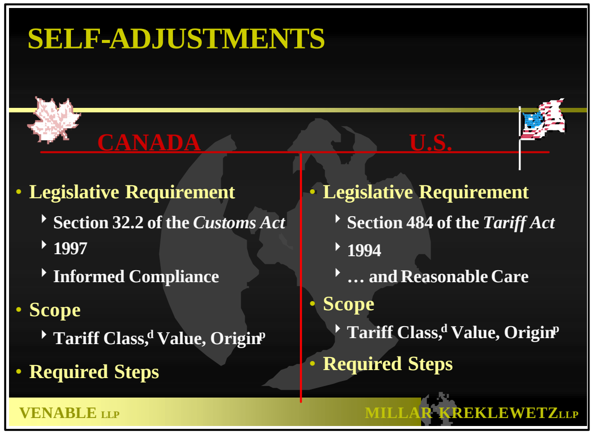
4. The disclosure involves information from a **prior accounting period**.

   The information being disclosed must include information that involves a prior accounting period, which is essentially a requirement that the information be dated, such that it was not required to be disclosed during the current accounting period.[7]

How *far back* does a VD have to go ?

A common question for anyone considering a VD to deal with non-compliance is "just how far back do I have to disclose, and pay?"

This is often a very relevant question given that subsection 59(1) of the *Customs Act* imposes a general four year assessment window on the CBSA for re-determining origin, tariff classification or value for duty.[8]



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

The answer is made a bit more difficult by a real lack of commitment on behalf of CRA and CBSA as to fixed guidelines. In fact, the general guidelines that the former Canada Customs and Revenue Agency ("CCRA") enforced – i.e., for income tax, GST, and customs purposes – required 6 year minimum for *disclosure* and *payment* of related taxes and interest, which corresponds to most statutory record-keeping requirements. In internally issued guidelines, the CCRA advised that "[w]hen omissions occur in any of the most current 6 years due, the VDP officer should include these years in the disclosure".

In our experience, however, *a person making a VD for Customs purposes will only have to disclose their errors, back four years*. Furthermore, and notwithstanding how far back the error and/or disclosure of the error goes, a person making a valid VD for customs purposes will only be held liable to pay back for duties and interest for the same four year period.

This CBSA-specific policy appears to be based on CBSA's own interpretation of the reassessment powers.

Again, and in other contexts, like the GST and income tax, there continue to be real issues as to how far back a taxpayer is required to go, albeit with the CRA's current "6 year" guidelines being moderated in practice.

> **TIP: Rule of Thumb is 4 Years**
>
> *How Far back?* CBSA and CRA generally require all non-compliance in "non-statute barred periods" (i.e., those period in which a CBSA or CRA auditor would be entitled to audit) to be periods which must be included in a VD in order for it to be complete. This translates into a "four year" back rule, which is a good rule of thumb.
>
> While CBSA and CRA then take the position that the facts and circumstances of the case will determine whether to require disclosure of years 5 and 6 (or for years beyond the normal 6 year record keeping requirement), a good rule of thumb going into a VD is that 4 years of disclosure will be required.
>
> *Anything less than 4 years means*
> *your advisor did a good job negotiating!*

The Process for Initiating a VD

A VD is made by contacting the CBSA in writing, setting out the details of the disclosure and establishing that the conditions for making a valid disclosure, set out above, have been met.

Once the information has been provided to the CBSA, it will review and verify the information and determine the validity of the VD.

Where a VD is accepted, a Detailed Adjustment Statement ("DAS") is generally issued.

No-Names Disclosure

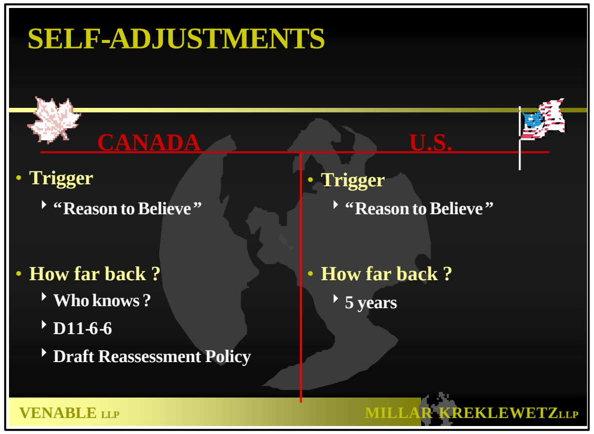
Process and Reasons For. As the discussion above suggests, there can often be a number of unanswered questions in the minds of importers or owners considering a VD. Will my VD be considered "voluntary"? What does "complete" really mean? How far back will I be required to go?

To reduce some of the apprehensions that persons may have in coming forward to initiate a VD, a preliminary disclosure can be made on a **"no-names" basis**, usually with the assistance of counsel, who will be entitled to protect the name of the client should be VD not be accepted, and through the use of **Solicitor-Client Privilege,** and negotiate the terms of the VD prior to critical information being disclosed.

In this fashion, most of the information relevant to the VD can be disclosed to the CBSA on a no-names basis and the CBSA will confirm whether it appears that a formal VD, based on those facts, would be accepted.

Accordingly, the no-names disclosure can provide insight into the implications of making a VD, clarify any unanswered questions, and protect the name and ultimate interests of the importer or owner if CBSA does not see it your way.

Acceptance of a No-names Disclosure. Upon acceptance of a "no-names" VD, the CBSA will provide an opinion, which it will be bound to for 60 days, based on the facts presented, as to whether it falls within the VDP.



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Where a person makes a no-names VD and decides not to initiate a VD, the CBSA has indicated that it will not use any of the information provided in the no-names disclosure for assessment purposes.

Appeal Rights

Contesting a Denial of a VD. In some instances, CBSA may provide notice of intent to deny the VD.

For commercial importers, a "second review" is generally available if requested within 30 days of the notice of intention to deny. Through this process, the person will be afforded 30 days to request a review of the decision, and a second review of the Minister's exercise of discretion to waive or cancel interest is available.

The CBSA's ultimate decision to accept or deny a VD is discretionary, however, and there is no statutory right to appeal a denial of a VD, other than a possible "judicial review" application.

Judicial Review – Minister's Discretion. While there is no statutory right to appeal the denial of a VD, judicial review to the Federal Court is probably available, albeit on a fairly extraordinary basis.

That is because the Federal Court's powers on a "judicial review" are limited to ordering the CBSA to reconsider the file (rather than ordering it to accept the VD), and those powers will only be exercised if very clear legal or jurisdictional errors are shown to have occurred.

Benefits to Initiating a Voluntary Disclosure

As discussed above, there can be significant interest rate repercussions for non-compliance where duties are owing. While interest is still payable on amounts owing in respect of a VDV, the VDP provides relief from the higher specified rate.

Costs of Initiating a VD

Before initiating a VD, the taxpayer must be made aware of his or her potential liability for non-disclosure. If errors are detected on investigation, the taxpayer will be required to pay any duties owing plus interest at the specified rate (extra 6%) and may be assessed additional penalties (AMPS, ascertained forfeiture or criminal prosecution).

On the other hand, where a VD is denied by the CBSA (e.g., where it is discovered that the disclosure is not complete), the CBSA will generally use the information disclosed to issue an assessment for any duties and taxes owing, interest at the specified rate, as well as applicable penalties. The CBSA will also be able to initiate a criminal prosecution in the appropriate case.

Exceptions

While an accepted and successful VD will shield an importer or owner from anything other than duties and prescribed interest, there are two general exceptions worth keeping in mind.

Seizure or Export of Prohibited Goods. It ought to be noted that where a VD involves a prohibited or controlled goods, the VD may still well lead to the seizure of the particular good. In some instances, CBSA will allow for the export of the particular good in lieu of seizure.

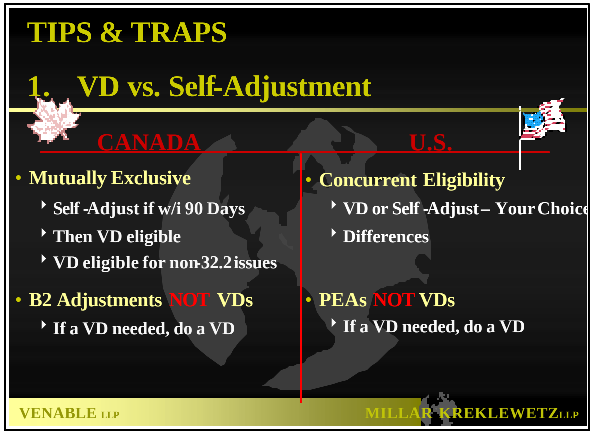
Contraventions of other Enactments. It is also important to understand that while the Customs VDP will offer an importer or owner the ability to avoid civil and/or criminal prosecution for *Customs Act* offences, CBSA also administers a number of other programs for other government departments, like Immigration, Health, and Food Safety. Where a VDP gives rise to information that indicates possible non-compliance or contravention of enactments *other than* the *Customs Act*, it will be important to determine <u>before-hand</u> whether there is potential liability for prosecution under those enactments, or available VDPs. Legal assistance will generally be required.

MANDATORY CORRECTIONS

Overview

The mandatory correction requirement, or Self-Adjustments as we will refer to them, is a fairly recent addition to the Canadian *Customs Act*, and effective since only January 1, 1997. The Self-Adjustment system is really an "informed compliance" initiative, which was brought into the *Customs Act* and patterned on a similar approach in the U.S., under the U.S.'s 1994 *Customs Modernization Act* (the "Mod Act").

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Informed Compliance requires importers to continually monitor whether they are in compliance with their customs' obligations, and where non-compliance is detected – in certain defined program areas – take the positive steps necessary to rectify the non-compliance, on both a go-forward and a go-backward basis.

The Self-Adjustment process is the process by which importers and owners are required to correct for compliance, and pay applicable duties and interest, and is set out in section 32.2 of the *Customs Act*.

Previously, where an importer discovered an error in the way in which goods were imported, the focus was more on the go-forward, since the onus was often on the CBSA to bring the prior problems to the importers attention, and to issue appropriate assessments.

There was no independent obligation on the importer or owner to do anything, which usually gave rise to a "hide the ball" strategy regarding past non-compliance. Under this approach, it was hoped that with the passage of time (and the operation of the general limitations periods for go-backward assessments), the hidden problems of the past would go unnoticed and eventually disappear.

That strategy has, to a great extent, been made obsolete by the new informed compliance approach in the *Customs Act*, and the Self-Adjustment process.

Legislative Authority & Scope – Section 32.2 of the *Customs Act*

Legislative Authority. The legislative authority for Self-Adjustments is found in section 32.2 of the *Customs Act*, which sets out the mandatory obligation on importers and owners to monitor, disclose and self-adjust for certain specific errors made in respect of accounting declarations, where a person has "reason to believe" that their declaration was incorrect, as follows:

> 32.2(1) **Correction to declaration of origin** — An importer or owner of goods for which preferential tariff treatment under a free trade agreement has been claimed or any person authorized to account for those goods under paragraph 32(6)(a) or subsection 32(7) shall, within ninety days after the importer, owner or person has reason to believe that a declaration of origin for those goods made under this Act is incorrect,
>
> (a) make a correction to the declaration of origin in the prescribed manner and in the prescribed form containing the prescribed information; and
>
> (b) pay any amount owing as duties as a result of the correction to the declaration of origin and any interest owing or that may become owing on that amount.
>
> (2) **Corrections to other declarations** — Subject to regulations made under subsection (7), an importer or owner of goods or a person who is within a prescribed class of persons in relation to goods or is authorized under paragraph 32(6)(a) or subsection 32(7) to account for goods shall, within ninety days after the importer, owner or person has reason to believe that the declaration of origin (other than a declaration of origin referred to in subsection (1)), declaration of tariff classification or declaration of value for duty made under this Act for any of those goods is incorrect,
>
> (a) make a correction to the declaration in the prescribed form and manner, with the prescribed information; and
>
> (b) pay any amount owing as duties as a result of the correction to the declaration and any interest owing or that may become owing on that amount.

Scope. The requirements above yield an important observations. Section 32.2 specifies only **three basic types of** errors that must be corrected for (which is one of the stark differences between the Self-Adjustment and VD processes, where all "errors" can be disclosed through VD).

Specifically, the Self-Adjustment process applies *only* to errors involving **tariff classification**, **valuation** and **origin.**

Reason to Believe. Further, it is also apparent that the requirement for a Self-Adjustment occurs only once an importer (or owner) has "reason to believe" that there is an error with respect to one of these program areas (i.e., origin, value for duty, tariff classification[10] or diversion[11]).

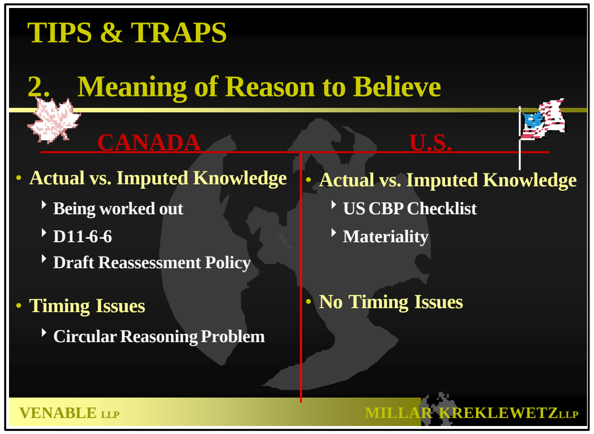
Once a "reason to believe" exists, however, the importer/owner comes under a positive duty to correct the error, within 90 days, and pay any additional duties owing, plus interest.

Duties Owing as a Result of a Section 32.2 Correction

It is noteworthy that the obligations in section 32.2 only apply where the Self-Adjustment would either result in **duties (or GST) owing**, or is "**revenue neutral**".

Where a self correction results in a refund, a refund application may be filed under section 74 of the *Customs Act*, *but no mandatory correction* is required.

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

GST Owing as a Result of an Section 32.2 Correction

Changes to GST Status to be Self-Adjusted under Customs Act. An exceptional situation involves corrections for GST owing as result of a Self-Adjustment.

Section 214 of the *Excise Tax Act* (the "ETA") provides that Division III GST payable on importations is paid and collected under the *Customs Act* and interest and penalties are imposed, calculated, paid and collected under the *Customs Act* as well, as if the GST payable were in fact customs duty levied on the goods.

In turn, subsections 216(2) and (3) provide that any changes to the GST status of imported goods are treated as if they were a determination, re-determination, or further re-determination of the tariff classification or an appraisal, re-appraisal, or further re-appraisal of the value for duty of the goods.

What that means is that corrections that affect the GST status of imported goods must always be dealt with under the Self-Adjustment process in section 32.2 of the *Customs Act*, and that any GST amounts owing will be subject to the interest and penalty provisions in the Custom Act.

Overvalued Goods. Moreover, there is an additional exception for goods that have been over-valued for GST purposes. Subsection 32.2(5) of the *Customs Act* (which does not require or allow a Self-Adjustment where the result would be a *claim for a refund of duties* – Self-Adjustments generally applying only where duties payable, or *revenue neutral* situations arise) does not apply to GST-registrant importers of duty-free goods. Thus importers who are GST registrants and who import duty-free and GST taxable goods are technically required to make a correction to a declaration pursuant to section 32.2 when they have reason to believe that the value for duty of the goods has been overvalued.

In practice, this means that any "overvaluation" of goods (which would generally always be subject to GST on importation, with certain limited exceptions) will give rise to a technical Self-Adjustment obligation.

EXAMPLE: Corrections Required for Over-Valued Goods

Facts. A GST-registrant importer imported duty-free and taxable (GST) goods with a value for duty of $1,500.

Two months following the importation of the goods, the importer has reason to believe that the declared value for duty was overvalued and should have been $1,000.

Analysis. Technically, the importer is required to make a correction to the value for duty under section 32.2 of the *Customs Act* even if it would result in a decrease in the GST assessed on the classification line.

Benefits of an Mandatory Disclosure

As indicated above, making a Self-Adjustment does not relieve an importer from paying any duties or interest owing; accordingly, when an importer makes the correction required under the Self-Adjustment process, any duties owing as well as interest must be paid from the first day after the person became liable to pay the amount, to the date that the amount is paid in full.

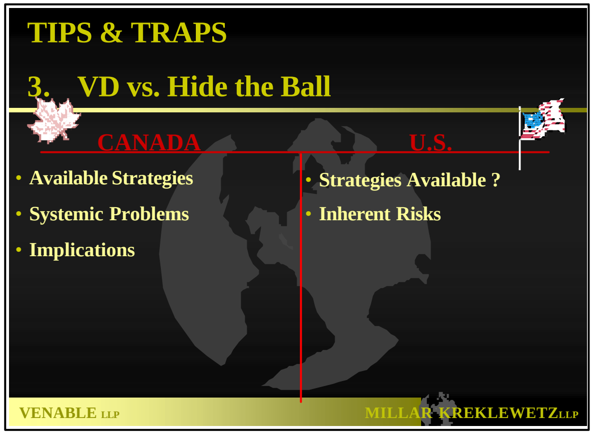
Like the situation under the VDP, there is some relief provided in the interest factor charged, as Self-Adjustments will only give rise to interest calculated at the prescribed rate (rather than the specified rate) on the amounts payable.

Unlike the VDP process, however, a Self-Adjustment will not shield an importer or owner from possible criminal prosecution, should the circumstances of the case warrant it.

"Reason to Believe"

As indicated, the positive obligation to make a correction under section 32.2 is premised – as it is in the U.S. – on the importer having the "reason to believe" that a declaration was incorrect.

To date, Canadian Courts have not yet considered what constitutes "reason to believe". However, based on non-customs jurisprudence and the ordinary dictionary definition of "believe", it appears that "reasonable belief" would generally require a person to have some level of information (actual knowledge versus imputed knowledge) so that he or she can have an opinion on the matter and not be simply guessing or hoping.[12]



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

While the CBSA initially took the view that departmental decisions, published directives or policies would constitute a "reason to believe", the CBSA has recently revised its position, clarifying that an importer (or owner) is required to have "specific information" that their declarations are incorrect, in order for them to have a "reason to believe".

Memorandum D11-6-6, entitled *Self-Adjustments to Declarations of Origin, Tariff Classification, Value for Duty and Diversion of Goods* ("D11-6-6"), now provides the following views as to what will constitute "reason to believe" – at least from the CBSA's perspective:

WHAT IS "REASON TO BELIEVE"

21. In regards to the provision of section 32.2 of the Act, "Reason to believe" occurs when the importer has specific information regarding the origin, tariff classification, value for duty, or diversion of the imported goods that gives them reason to believe that a declaration is in correct. This information can be found in:

(a) legislative provisions that are evident (obvious, apparent) and transparent (clear, self-explanatory), such as specific tariff provision, specific valuation provision, specific origin provision, etc.;

(b) formal assessment documents issued by the CCRA [ed.: now "CBSA"] to the importer, relating to the imported goods, such as determinations (not "deemed determinations"), re-determinations, further re-determinations, etc.;

(c) tribunal or court decisions issued to the Appellant [e.g., Canadian International Trade Tribunal (CITT), Federal Court, etc.];

(d) information received from exporters, suppliers, etc. [e.g., cancellation of certificates of origin or corrections to the value for duty];

(e) written communication addressed directly to the importer or his/her agent by the CCRA [CBSA] such as a ruling (e.g., National Customs Ruling), an Advance Ruling under section 43.1 of the Customs Act, a post-release verification report, or an official notification as a result of an exporter origin verification;

(f) a final report from an importer-initiated internal audit or review, or, from an external company conducting an audit or review of an importer company; or

(g) knowledge of the goods being diverted to a non-qualified end-use or end-user.

The CBSA also adds the following regarding "written communications" from CBSA, and post-release "audit" information:

22. Written communications from the CCRA, such as National Customs Rulings, Advance Rulings, or verification reports, will apply exclusively to: the same goods that were the subject of the communication (e.g., tariff classification for particular goods); the same valuation issue (e.g., the manner of calculating royalties on particular goods); or the same origin issue (e.g., a determination that specific goods do not qualify for preferential treatment).

23. A CCRA post-release verification may determine that a report from an importer-initiated internal audit or review, or, from an external company conducting an audit or review, as described in paragraph 21(f) above, is incorrect. In this case, the results of the CCRA post-release verification report will take precedence over the internal importer-initiated or external audit report and will become the importer's new "reason to believe".

TIP: USING SOLICITOR-CLIENT PRIVILEGE …

The CBSA has tipped its hand in paragraph 23 of D 11-6-6, indicating its intent on focusing its own audit activities on "importer-initiated" internal audits or reviews, or documentation prepared by "external companies] conducting an audit or review".

Use "Solicitor-Client Privilege" to your advantage by lawfully keeping the existence and substantive contents of such reports confidential, and out of the hands of the CBSA. Solicitor-Client Privilege will attach to any communications with a trade lawyer or other attorney, and may attach to certain documentation performed by non-lawyer consultants **if** requested by the lawyer, and if the work performed is as agent for the lawyer, and in furtherance of obtaining legal advice.

The availability of Solicitor-Client Privilege should be an important factor in any decision to self-audit, or embark on any internal audit process.

Perhaps the most conceptually troublesome of the criteria above is the notion that there exist evident or obvious and apparent legislative provisions!

In the authors experience, interpreting tariff classification, origin and valuation rules are generally complex and involved exercises, not often involving "evident or obvious and apparent legislative provisions".

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

TIP: EVIDENT & TRANSPARENT LEGISLATION

Buried in Appendix "D" to D-11-6-6 is the CBSA's current views on what "evident and transparent legislative provisions" mean.

A casual review of the examples suggests that the CBSA expects that the complex legislation and regulations underlying the Customs Act and the Customs Tariff (including special legal notes to the latter) be observed "to the t".

In effect, CBSA seems to be saying that "reason to believe" can include what an importer or owner **ought to have known**, and not just what they did, in fact, know.

There is great debate on whether CBSA is correct in imputing this additional meaning to the words "reason to believe", and only time will tell whether the Courts will accept this additional gloss.

D11-6-6 also goes on to state that where there is conflicting information, there will not be a "reason to believe".[13]

When Does "Reason to Believe" First Occur?

Paragraph 24 of D11-6-6 also addresses the CBSA's view on just "when" reason to believe occurs. We paraphrase this paragraph below:

24. The self-adjustment process is activated when the importer has "reason to believe" that the declaration of origin, tariff classification, or value for duty is incorrect. An importer is deemed to have "reason to believe" on:

    (1) The date of the written communication from the CCRA, such as a National Customs Ruling or post-release verification report;

    (2) The date of the CITT or Federal Court decision; or the date of the determination (but not deemed determination), re-determination, or further re-determination, for example; and

    (3) In the case of <u>evident and transparent legislative provisions not requiring further interpretation</u>, such as explicit tariff provisions, the date that the importer will have "reason to believe" will be from the <u>effective date of the legislation</u>, which originally gave rise to the existing provision.

Remember that when a person is "deemed" to have "reason to believe" (i.e., such as a previous ruling, previous CCRA verification or audit findings, or clear legislative provisions), the importer is required to correct the declarations, within 90 days, back to the earliest date of the specific information, to a maximum of four years.

TIP: CBSA's FLAWED APPROACH

Do you see the flaw in the CBSA's approach in the two sections just above ?

In the first section, CBSA suggests that where there are "evident and transparent legislative provisions", an importer will effectively be deemed to have the specific information that triggers "reason to believe" – thus invoking an "ought to have known" standard.

In the second section, the CBSA opines that the "reason to believe" Self-Adjustment obligation is "activated" on the "effective date" of the legislation.

See the problem?

The problem is that the section 32.2 requirement is correct and pay duties *within 90 days* of having "reason to believe". Accordingly, if the CBSA is correct in its approach, and its reliance on the "ought to have known" standard, that will mean that most importers caught in these requirements will actually have <u>missed</u> the 90 day window for making the correction, and will not be able to make that correction under section 32.2 in the first place. Their option, likely, would be to make a correction under a VDP.

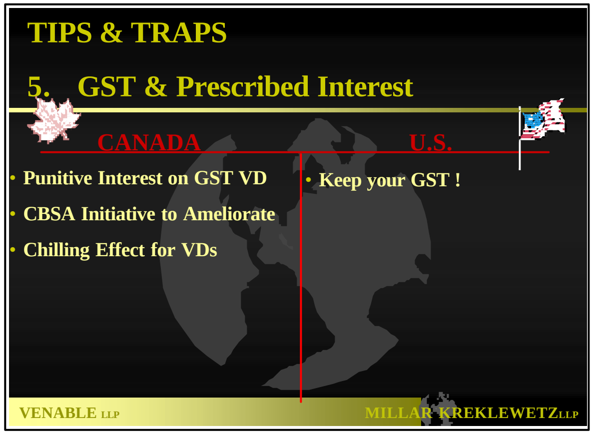
In all likelihood, the CBSA's approach here is wrong-headed, and we understand that CBSA is currently considering restating its policies in these areas.

No "Reason to Believe"

This discussion above should make the following obvious: where a person does not have a "reason to believe", there is no obligation under section 32.2 to disclose or correct.

If, in such a case (i.e., where there is no reason to believe) the CBSA subsequently discovers the error on audit or verification, the CBSA's policy is to assess for the current year and back one (the "one plus one" policy).

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Accordingly, where an error in origin, tariff classification or value for duty is determined as a result of a CBSA verification or audit, and there was no "reason to believe" that there was an error, the importer will be required to self correct for its previous 12-month fiscal period from the date of notification of the verification, up to and including the end of the verification.

In the case of an exporter origin verification, however, the CBSA will require the importer to correct for the verification period identified in the notification.

The importer will also be required to correctly account for the goods, for all future importations.

How Far Back Must the Correction Go

As in the case of "voluntary disclosures" under the VDP, a pressing question is how far back must the correct go, when an importer or owner develops a "reason to believe" that an error exists.

If one were to apply the technical provisions of the *Customs Act*, one would see that where discovered, errors correctible under section 32.2 would be required to be corrected for back as far as 4 (and sometimes 5 years).

Fortunately, CBSA has provided some administrative tolerance in D-11-6-6, and specifies the following corrections policy:

> **WHAT IS THE REASSESSMENT PERIOD**
>
> **TO CORRECT DECLARATIONS?**
>
> 27. When an importer has prior "reason to believe," such as a previous ruling, previous CCRA verification or audit findings, or clear legislative provisions, the importer shall correct the declarations back <u>to the earliest date of the specific information</u>, to a maximum of four years as provided for in the Act.
>
> 28. Rulings (e.g., National Customs Rulings, Advance Rulings) or decisions made by customs officials under sections 58, 59, 60, or 61 of the Act, for example, which may be erroneous, will be honoured by the CCRA until they are modified (and, thereby, superseded) or revoked. When it is determined that a ruling or decision is erroneous and must be modified, an effective date of the replacement ruling or decision will be established (e.g., within 90 days from the date that the error comes to the attention of the CCRA) and the client will be notified.
>
> 29. In all other cases, <u>as a result of a CCRA verification or audit, the importer shall correct for its previous 12-month fiscal period from the date of notification of the verification, up to and including the end of the verification</u>. However, in the case of an exporter origin verification, the importer shall correct for the verification period identified in the notification. For any future importations, the importer shall correctly account for the goods.
>
> 30. In the case of an importer-initiated internal audit or review, or in the case of an external company conducting an audit or review of an importer company, <u>the importer shall correctly account for the goods from the date of the report resulting from that audit or review</u>. This can be done provided there was no previous information available to give the importer reason to believe that a declaration was incorrect. Therefore, the importer will not be required to correct any declarations for goods accounted for prior to the date of the report.
>
> (emphasis added)

Over and above the provisions of D11-6-6, we also understand that the CBSA is currently in the process of drafting a further reassessment policy that clarifies that persons making corrections under section 33.2 are only required to correct <u>from the date that they had "reason to believe" that the declaration was incorrect, rather than back to the date of the error</u>.

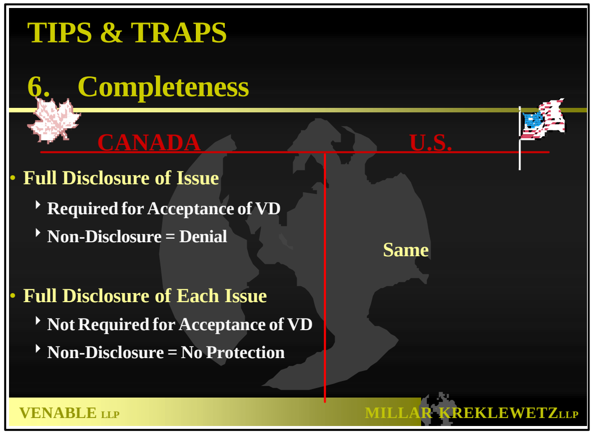
If formalized, that will be a helpful policy position to importers and owners.

Limitations Periods

Obligation to Disclose Within 90 Days. As indicated above, the obligation to correct under section 32.2 is limited to within 90 days of the importer having "reason to believe". Accordingly, if an importer has had "reason to believe" that there is an error and more than 90 days has elapsed, there is no longer an obligation to make a section 32.2 correction.

In such a scenario, the importer will be faced with two options: (1) doing nothing, in the hopes that the CBSA does not assess or, (2) come forward with a voluntary disclosure, which is discussed in further detail below.

To the extent the importer's failure to correct under section 32.2 is discovered, an AMP, in the least, will be assessable.



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Four Year Limit. Pursuant to subsection 32.2(4) of the *Customs Act,*[14] there is a general four year limitation period with respect to how far back a section 32.2 correction must go.

That is, an importer is only obligated to correct errors within four years after the goods have been accounted for. Accordingly, where a mistake is found more than four years after the original importation, there is no obligation to make a correction.

For mistakes found within the four year window, however, the above rules apply.

The four year window is meant to parallel the CBSA's assessment powers, which now allows the CBSA to automatically back assess four years, paralleling the situation for GST and income tax audits. (Previously, the CBSA generally regarded itself as limited to two years.)

Making a Mandatory Disclosure

B2 Adjustment Request. Self corrections made under section 32.2 are made by filing a B2, Canada Customs Adjustment Request ("B2"). Any money owing, as a result of the correction, should accompany the correction request.

The B2 may be filed by registered mail, courier or hand delivered to a customs office. The day that the B2 is sent (by registered mail, courier or delivered) to the customs office is deemed to be the date of filing for meeting the 90 day time limit under section 32.2.

Section 32.2 Correction Treated as Re-determination. Once a section 32.2 correction is made, pursuant to section 32.2, the correction will be treated as a re-determination under subparagraph 59(1)(a).

Further Assessment

As indicated above, a section 32.2 correction is treated as a re-determination, accordingly, the CBSA has four years, from the date of the section 32.2 correction, to reassess or review the correction.

There is also an added "twist" here, however. Not only has the CBSA reserved the right to use information gleaned from section 32.2 correction's to support further assessments up to four years, it has also added a special rule which extends the assessment window to five years where the self-correction is made in made in the last year of a limitations period.

This would seem to allow the CBSA an additional year's worth of duties in those instances where the four year limitation period actually provides some benefit to the importer.[15]

Appeal Rights

Finally, since section 32.2 correction's are treated like a usual re-determination, the importer always has the right to file a B2 appeal, and get Adjudications' views on whether the correction was necessary.

Ultimately, and unlike the situation with the VDP process, the importer would be able to appeal this decision to the Courts (e.g., the Canadian International Trade Tribunal ("CITT") and the Federal Court of Appeal), to the extent its objections were not dealt with satisfactorily.

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

THE UNITED STATES

VOLUNTARY PRIOR DISCLOSURES

Overview

In the U.S., the Voluntary Prior Disclosures Program ("VDP") was implemented as part of the Customs Modernization or "Mod Act".[20] The Customs Mod Act implemented two new concepts of "informed compliance" and "shared responsibility", which are premised on the notion that the trade community needs to be clearly and completely informed of its legal obligations in order to maximize compliance.

Therefore, the Mod Act imposes a greater obligation on CBP to provide the public with improved information regarding an importer's rights and responsibilities under the applicable laws and regulations.

This obligation is "shared" in the sense that the importer of record is responsible for using reasonable care to enter, classify and determine the value of imported merchandise and to provide other information necessary to enable CBP to properly assess duties, collect accurate statistics, and determine whether all additional requirements for importation have been met.[21] CBP is then responsible to fixing the final classification and value of the merchandise. Finally, an importer's failure to exercise such reasonable care could delay release of the goods and may lead to the assessment of penalties.

The U.S. voluntary Prior Disclosure program permits an importer to address its non-compliance by admitting to an error and correcting such errors. On the other hand, the importer can simply do nothing and take the risk of a possible assessment, as discussed in below.

As in Canada, the U.S. VDP is not limited to errors in accounting declarations, but also can apply to any customs non-compliance, which may have been by means of a erroneous statement or materials omission, provided it is associated with an importation.

What is a Prior Disclosure?

A valid prior disclosure is the admission of a statutory violation of 19 U.S.C. 1592,[22] which authorizes CBP to assess monetary penalties against parties who make material false statements, acts or omissions in connection with their importations. The material false statements, acts or omissions must result from the parties' negligence, gross negligence or fraudulent conduct.

Importers are not required to make a prior disclosure. Rather, they choose to submit a disclosure. Yet, it must be done <u>before</u> or <u>without knowledge of</u> a formal Customs investigation of the violation.

Benefits under the U.S. Voluntary Prior Disclosure Program

While a prior disclosure is an admission of an error or omission, the benefits of making a valid prior disclosure are, as follows:

The penalty is zero if the importations involve unliquidated (that is "open") Customs entries and no fraud is involved.

If the entries are liquidated (i.e., "closed" or finalized) and no fraud is involved, the penalty is the interest on the loss of duties, which simply makes CBP "whole". [23]

However, if a fraudulent violation is disclosed, the penalty is reduced from the normal assessment of the domestic value of the goods to 1 times the duty loss, or if the violation involves <u>no</u> duty loss, the penalty is reduced to 10 percent of the dutiable value of the merchandise.[24]

For those instances where liquidated entries are involved for duty loss violations, the importer <u>must</u> tender the duty loss to CBP and CBP will then notify the disclosure applicant whether the disclosure was valid and accepted.

Requirements for a Valid Disclosure

There is no requirement per se for an importer to make a prior disclosure. Nevertheless, if an importer seeks to make a disclosure, they must follow the regulatory requirements in order for it to be valid. The requirements, which are set forth in the CBP regulations at 19 C.F.R. 162.74, are as follows:[25]

1. The importer has the burden of proving that they have **no knowledge** of a formal investigation.

   While any interested party may submit a voluntary prior disclosure, the person asserting lack of knowledge of the commencement of a formal investigation has the burden of proof in establishing such lack of knowledge. Importantly, a "formal investigation" is considered to be the commencement with regard to the disclosing party and the disclosed information on the date recorded in writing by CBP as the date on which facts and circumstances were discovered or information was received which caused CBP to believe that a possibility of such a violation existed.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

2. The importer must **disclose the circumstances of a violation**.

   The disclosing client is required to disclose to CBP, either orally or in writing, a full and accurate reporting of all previously inaccurate, incomplete, or unreported information. It must: (1) identify the class or kind of merchandise involved; (2) identify the importation or drawback claim by entry number or by ports and approximate dates of entry; (3) specify the material false statements, omissions or acts including an explanation as to how and when they occurred, and (4) set forth, to the best of their knowledge, the true and accurate data, or, if unknown at the time of the VPD, that such data will be provided within 30 days or as otherwise agreed by CBP.

3. The actual loss of duties, taxes and fees or actual loss of revenue must be **tendered**.

   If the disclosure involves a loss of duties, taxes or fees, the disclosing party may either tender the monies due at the time of the claimed prior disclosure, or within 30 days after CBP notifies the person in writing of CBP's calculation of the actual loss of duties, taxes and fees or loss of revenue. And, when more than $100,000 is owing, the calculation may be reviewed by CBP Headquarters, upon request. Importantly, the failure to timely tender the monies due once finally calculated by CBP shall result in a denial of the prior disclosure.[26]

4. The **disclosure is verified** by a Fines, Penalties and Forfeitures Officer from the Office of Regulatory Rulings.

   The Fines, Penalties and Forfeitures Officer responsible for the port where the admitted violation took place will decide whether the disclosure is valid (*see* 19 C.F.R. 162.74(a)(2)). If the violations involve more than one port, the prior disclosure will be consolidated to one port for handling.

Prior Disclosure of NAFTA Claims

In the U.S., the statute also allows for prior disclosure of NAFTA claims. (See 19 U.S.C. 1592(c)(5) and (f)). Specifically, the statute provides that an importer shall not be subject to penalties under Section 592(a) for making an incorrect claim for preferential tariff treatment provided it:

(A) has reason to believe that the NAFTA Certificate of Origin on which the claim was based contains incorrect information; and

(B) in accordance with the regulations, voluntarily and promptly makes a corrected declaration and pays any duties owing.

Therefore, if an importer follows the proscribed voluntary prior disclosure rules, the benefits of Section 592 penalty avoidance will also accrue.

Additionally, a company doing business in North America should understand that Section 592(f) deals with false certifications for exports to NAFTA countries. Specifically, it can be unlawful for any person to certify falsely, by fraud, gross negligence, or negligence, in a NAFTA Certificate of Origin that a good to be exported to a NAFTA country qualifies under the rules of origin.

The U.S. sought to include the Section 592 penalties for violations stemming from false NAFTA Certifications. And, importantly, the prior disclosure treatment will only attach if the person voluntarily and promptly provides to all persons to whom the person provided the NAFTA Certificate of Origin, written notice of the falsity of the Certificate.

Exception for NAFTA Claims

U.S. CBP will not assess a Section 592 violation for a NAFTA Certificate of Origin if:

(A) The information was correct at the time it was provided in the NAFTA Certificate, but was later rendered incorrect due to a change in circumstances; and

(B) The person voluntarily and promptly provides written notice of the change to all persons to whom the person provided the Certificate of Origin.

US CBP interprets "promptly" to be notice within 30 days.

How Far Back Should You Disclose ?

If you have just discovered non-compliance, you will quickly want to know just how far back the VPD must extend. In the U.S., the statutory period is one year longer than in Canada, namely, five (5) years. For fraud, it is five years from the date of discovery and, for non-fraudulent violations, it is five years from the date of occurrence (typically, the date of entry).

The disclosure period often presents common problems for importers. First, it is critical to understand that the scope of the disclosure (in both time and substance) rests with the importer. That is, the importer decides precisely what it discloses.

For example, if you make a valid prior disclosure of 2004 violations and CBP discovers violations in 2003, you only get disclosure treatment for the 2004 violations.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Therefore, notwithstanding how far back the error actually occurred, a person making a valid VPD will only be liable back for duties, taxes, fees, and interest to a maximum of five years.

The Process for Initiating a Voluntary Prior Disclosure

A VPD can be made either orally or in writing by contacting CBP. It is recommended that the disclosure be in writing, to avoid obvious problems. If, however, the disclosure is initially made orally, it should be followed up in writing within 10 days of the discussion with Customs. The importer must provide the details of the disclosure and establish that the requirements for a valid disclosure, as set out above, have been met.

Once the information has been provided to the CBP, the data will be reviewed and verified, and, if accepted, a Pre-Penalty Notice , which will provide the reduced penalty treatment in the notice, will be issued.

Using Privilege Before Making a Disclosure

It is important to bear in mind that VPDs are not automatically accepted. Moreover, if the VPD is rejected, the substantial penalties in addition to back duties plus importer can face interest.

Therefore, importers will often consult with a U.S. attorney under the **Attorney-Client Privilege** prior to initiating a VPD. Similar to the process in Canada, counsel can assess the scope and potential liability and may even discuss, anonymously, the nature of the circumstances with CBP to obtain a better understanding of likely exposure. If the importer decides not to submit the VPD, there is no risk that the information will be used against it by CBP.

Appeal Rights

Contesting a Denial of a VPD. In the U.S., CBP's decision to accept a VD is discretionary. A disclosing party may request that the basis for determining Customs asserted actual loss of duties, taxes and fees be reviewed by Headquarters, such a review is within the discretion of CBP and shall be limited to determining issues correct tariff classification, correct rate of duty, elements of dutiable value and correct application of any special rules (e.g., GSP, HTS 9802, etc.). Appeals regarding the denial of VPD treatment are made to the U.S. Court of International Trade.

Judicial Review at the Court of International Trade. Judicial review to the U.S. Court of International Trade of any denial is available and expressly authorized by 19 U.S.C. 1592(e). An importer may seek to recover any monetary penalty claimed under Section 592 and <u>all issues</u>, including the amount of the penalty, are tried *de novo*.

If the penalty is based on fraud, the U.S. has the burden of proof to establish the alleged violation by "clear and convincing evidence." Id. If based on gross negligence, the U.S. has the burden to establish all elements of the alleged violation. And, if based on negligence, the U.S. has the burden to establish the act or omission constituting the violation, and the alleged violator shall have the burden of proof that the act or omission did not occur as a result of negligence.

Benefits to Initiating a Voluntary Disclosure

As discussed above, there can be significant interest rate repercussions for non-compliance where duties are owing. While interest is still payable on amounts owing in respect of a VPD, the amounts due are essentially those to make CBP "whole" as if they had been timely paid.

Costs Associated with a VPD

Before filing a VPD with US CBP, the importer must assess their potential liability for non-disclosure. In the absence of a VPD where CBP detects the errors, the taxpayer will be required to pay any duties owing plus interest at the published CBP rate and may be assessed additional penalties (Section 592 penalties, seizure and forfeiture of the goods or even criminal prosecution).

Conversely, where a VPD is denied by US CBP such as when the disclosure is incomplete in scope, the information provided can be used by CBP to assess any duties, taxes and fees owing (with interest) as well as applicable penalties, and may be liable to prosecution. Therefore, while there is typically a monetary expense associated with a VPD, there is always a business risk and expense associated if CBP determines a violation has been made in the absence of a valid disclosure.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

MANDATORY CORRECTIONS IN THE U.S.

Overview

In the United States, one of the most significant effects of the Customs Mod Act was the establishment of the clear requirement that parties exercise reasonable care in importing into the United States.

Section 484 of the Tariff Act, as amended, requires an importer of record using reasonable care <u>to make entry</u> by filing such information as is necessary to enable U.S. CBP to determine whether the merchandise may be released from Customs custody, and using reasonable care, <u>complete the entry</u> by filing with CBP the declared value, classification and rate of duty and such other documentation or information as is necessary to enable CBP to properly assess duties, collect accurate statistics, and determine whether all other relevant legal requirements have been satisfied.

This "informed compliance" initiative, has more recently found its way into the Canadian *Customs Act*. Informed Compliance requires importers to continually monitor and ensure that their import activities comply with US customs' obligations. And, more importantly, where non-compliance is detected, the importer must take affirmative action to correct the non-compliance for prior activities as well as to implement corrective actions prospectively.

Under these new rules, an importer is no longer permitted to simply prospectively correct an issue and wait for the statute of limitations to run on old problems. Rather, they now must correct for prior errors as well as implement changes to avoid future mistakes.

Mandatory Corrections due to Reasonable Care

In the U.S., the implementation of this "reasonable care" standard was thought to be balanced through the use of a new "informed compliance" era, where prior disclosures were encouraged by CBP policy. CBP was deliberately trying to move away from the "gotcha" mentality that had previously prevailed.

As discussed, the requirement for Mandatory Disclosure does not relieve an importer from paying any duties or interest owing; rather, it simply sets forth the affirmative burden on the importer, who can then either choose to correct and disclose, or ignore and take the risk that CBP will find the error.

This was implemented in the time when U.S. Customs was moving away from the practice of auditing goods as they were entered, in favor of utilizing a post-entry audit process. Therefore, importers could plan to undergo a "compliance assessment" (now known as a "Focused Assessment") every few years.

What does "Reasonable Care" Require?

Despite the simple phrase, "reasonable care" imparts explicit responsibility on importers, yet CBP has noted that it defies easy explanation. CBP reasons that each import transaction sets forth different and unique factors that depend upon the experience of the importer and the nature of the imported goods. As such, CBP has not developed a "foolproof" reasonable care checklist to cover every import transaction.

Nevertheless, in order to meet the policy of the Mod Act for informed compliance, U.S. CBP has published a checklist governing reasonable care. (The checklists are included for your convenience as Appendix "C" to these materials.)

In CBP's opinion, the list of questions may prompt or suggest a program, framework or methodology for importers to use in order to avoid compliance problems and meet their reasonable care responsibilities.

Entry of Merchandise & Statutory Reasonable Care Rule

The reasonable care requirement was included into U.S. law as part of 19 U.S.C. 1484(1). In particular, Section 484(a) provided the following "requirement and time" provisions:

> (a)(1) [O]ne of the parties qualifying as 'importer of record' … either in person or by an agent authorized by the party in writing, shall, using reasonable care –
>
> (A) make entry therefor by filing with the Customs Service–
>
> (i) such documentation or, pursuant to an electronic data interchange system, such information as is necessary to enable the Customs Service to determine whether the merchandise may be released from customs custody, and
>
> (ii) notification whether an import activity summary statement will be filed; and

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

(B) complete the entry by filing with the Customs Service the declared value, classification and rate of duty applicable to the merchandise, and such other documentation or, pursuant to an electronic data interchange system, such other information as is necessary to enable the Customs Service to –

(i) Properly assess duties on the merchandise,

(ii) Collect accurate statistics with respect to the merchandise, and

(iii) Determine whether any other applicable requirement of law (other than a requirement relating to release from customs custody) is met.

Additionally, Section 484(a)(2)(C) states:

> The Secretary, in prescribing regulations to carry out this subsection, shall establish procedures which insure the accuracy and timeliness of import statistics, particularly statistics relevant to the classification and valuation of imports. Corrections of errors in such statistical data shall be transmitted immediately to the Director of the Bureau of the Census, who shall make such corrections in the statistics maintained by the Bureau. <u>The Secretary shall also provide, to the maximum extent practicable, for the protection of the revenue, the enforcement of laws governing the importation and exportation of merchandise</u>, the facilitation of the commerce of the United States, and the equal treatment of all importers of record of imported merchandise.
>
> (emphasis added)

This set the legal precedent for US CBP to affirmatively address instances of non-compliance (i.e., where there is an absence of reasonable care). For example, dutiable merchandise is introduced into the United States "contrary to law" whenever steps are taken to avoid the payment of a customs duty and, such evasion can occur even if the goods are not declared, or if declared, are undervalued. By statute, CBP is directed to enforce such laws "to the maximum extent practicable, for the protection of the revenue."

The Penalty Process in the U.S.

In the U.S., CBP has several tools to enforce these laws. The Administrative process for monetary penalties is used when a violation of Customs laws or laws enforced by Customs is discovered, in addition to, or in lieu of, seizure and/or referral for criminal prosecution. CBP usually has the option of assessing a personal penalty against the alleged violator.

While the penalty process generally begins with the issuance of the Penalty Notice, some U.S. statutes require the issuance of a prepenalty notice and opportunity for response before CBP makes its penalty claim by issuing a penalty notice.

A prepenalty notice is a written notice that Customs is "contemplating" issuance of a penalty against a named person and/or entity. At this preliminary stage, the person or entity is given information regarding the alleged violation and provided an opportunity to present reasons why CBP either should not issue the penalty claim at all, or should not issue the penalty claim in the contemplated amount.

When Pre-penalty Notices are Required

Penalties requiring the issuance of a prepenalty notice before issuance of a penalty notice include:[27]

- commercial fraud and negligence (19 U.S.C. 1592);
- drawback penalties (19 U.S.C. 1593a);
- customs broker penalties (19 U.S.C.1641);
- recordkeeping penalties (19 U.S.C. 1509);
- falsity or lack of manifest (19 U.S.C.1584(a)(1)); and
- equipment and vessel repairs (19 U.S.C. 1466).

Generally, the alleged violator has thirty (30) days from the date of mailing of the pre-penalty notice for response.

The Response or Petition to the Alleged Penalty in the U.S.

Upon receipt of a prepenalty response, CBP, through the Fines, Penalties and Forfeitures Officer, either will proceed to issue a penalty claim if the violation is substantiated or issue a written statement that CBP has chosen not to assess a penalty.

If a penalty is assessed, generally, the importer has sixty (60) days from the date of mailing to file a petition for relief. If, however, there is no response, CBP usually will refer the case for collection action.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Most penalties are assessed at the **statutory maximums** associated with the alleged violation. For example, most Section 1592 fraud penalties are assessed at the maximum domestic value amount. However, in most cases, petitions for mitigation are filed under 19 U.S.C. 1618. In some instances, the importer may be permitted to make an oral presentation to CBP if the law and regulations permit.

For instance, when the penalty incurred is for a violation of 19 U.S.C. 1592 or 1593a, the importer has a legal right to make an oral presentation. In all other violations, an oral presentation is within the discretion of the official authorized to act on the petition or supplemental petition.

There are guidelines for each penalty statute discussing authority to grant or deny mitigation of penalties. For instance, guidelines for Section 1592 penalties are set forth as Appendix B to Part 171 of the U.S. Customs Regulations. The importer may file a supplemental petition for further relief from the penalty. Generally, the office unit that decided the initial petition may grant further relief, but a request for further review by Headquarters can also be made.

Finally, if the assessed or mitigated penalty is not paid within the notice period or otherwise agreed time period, CBP will commence collection efforts.

As we will see, the penalties of non-compliance can be significant.

> **Tip:** In the U.S., some importers and their brokers mistakenly believe that a Post Entry Amendment ("PEA") is the initiation of a Voluntary Prior Disclosure. That, however, is not true unless all of the requirements for prior disclosure have been met. If you intend to seek prior disclosure treatment, the submission should be clearly labeled as such. Don't leave it to chance. The protections afforded under a voluntary prior disclosure are not afforded through the submission of a routine post entry adjustment.

Standard for a Section 592 Violation:

The "basic" penalty statute (19 U.S.C. 1592) authorizes that penalties may be assessed against any person who:

- by **fraud** (i.e., voluntarily and intentionally), **gross negligence** (i.e., with actual knowledge or wanton disregard), or **negligence** (i.e., fails to exercise reasonable care),
- **enters or introduces** (or attempts to enter or introduce) any merchandise into the commerce of the U.S.,
- **by means of any document or electronically transmitted data** or information, written or oral statement, **or act** which is **material** and **false,** or **any omission which is material** (i.e., the falsity has the potential to alter the classification, appraisement, or admissibility of merchandise, or the liability for duty or if it tends to conceal an unfair trade practice under the antidumping, countervailing duty or similar statute, or an unfair act involving patent or copyright infringement).

Maximum Section 592 Penalties:

Penalties against alleged violators may be assessed at a maximum of:

- **Fraud**: Domestic value of the merchandise;
- **Gross Negligence** : 4 times the loss of lawful duties, taxes, and fees deprived the government, or the domestic value OR, if the violation did not affect the assessment of duties 40% of the dutiable value if the violation did not affect the assessment of duties (but in no case to exceed the domestic value of the merchandise); and
- **Negligence** : 2 times the loss of lawful duties, taxes, and fees deprived the government OR 20% of the dutiable value if the violation did not affect the assessment of duties (but in no case to exceed the domestic value of the merchandise).

As discussed above, petitions for relief from may be filed pursuant to 19 U.S.C. 1618.

> **Tip:** CBP considers various mitigating and aggravating factors throughout the petition stage. Any disclosure or petition should underscore any applicable mitigating factors.
>
> - **Mitigating factors** justifying further relief include: contributory Customs error, cooperation with the investigation, immediate remedial action, inexperience in importing, and prior good record.
> - **Extraordinary mitigating factors** justifying further relief include: inability to obtain jurisdiction or to enforce a judgment against the violator, inability to pay the mitigated penalty, extraordinary expenses for the alleged violator, and Customs knowledge of the violation.
> - **Aggravating factors** include: obstructing the investigation, withholding evidence, providing misleading information concerning the violation, textile transshipment, and prior substantive 1592 violations with a final administrative finding of culpability.

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Reduced Penalties under Valid Voluntary Prior Disclosure

As discussed above, an importer who validly discloses a Section 1592 violation, before or without knowledge of the commencement of a formal investigation can receive substantially reduced penalties.

REMEMBER:

- In the case of **negligence or gross negligence** violations, if there is an **actual** revenue loss (i.e., loss of duties, taxes or fees after Customs already has liquidated the entries as final), the reduced penalty is an amount equal to interest from the date of liquidation until the duties are paid.
- In the case of **negligence or gross negligence violations**, if there is a **potential** revenue loss (i.e., loss of duties, taxes or fees prior to Customs liquidation of the entries as final), the penalty is remitted in full.
- In the case of **fraud** violations, the reduced penalty always equals one times the actual and potential revenue loss (or 10% of the dutiable value, if the violation did not affect the assessment of duties).

So, When is a Correction Required?

The affirmative obligation to correct an error or omission under Section 484 is based upon reasonable cause to believe that there has been a violation of 19 U.S.C. 1592 (or another authorizing statute). That is to say, if an importer has reason to believe that one of its statements to CBP was materially incorrect or if it made a material omission, the reasonable care standard requires it to disclose this to CBP.

CBP has stated that its own "reasonable care" checklist was designed to promote enhanced compliance with the Customs laws and regulations, CBP quickly notes that it has no legal, binding or precedential effect on U.S. CBP or the importing community. Further, CBP has stated that the checklist "is not an attempt to create a presumption of negligence, but rather, an attempt to educate, inform and provide guidance to the importing community." *See CBP's Reasonable Care Checklist* at 3.

That said, how do you "know" when you need to correct an error? If an importer has specific information regarding any material statement (that is, for example, concerning, origin, tariff classification, valuation, or any special tariff program) or omission that gives the importer reasonable cause to believe that its declarations are inaccurate or in error, it has an affirmative obligation to correct the error or omission.

CBP also works off the "reason to believe" standard. For example, if any auditor, import specialist, or inspector with CBP has reason to believe that an importer may have committed a violation, he or she will create a writing memorializing their concern, which may lead to a formal investigation.

A Formal Investigation and the "Reason to Believe" Standard

What is a formal investigation and how does it affect an importer's ability to make a voluntary prior disclosure? The law provides that when any Customs officer has "reason to believe" that a possibility of a violation of Section 1592 has taken place, and the Customs officer records such belief in writing, a formal investigation has commenced. This has been codified in the Customs regulations at 19 C.F.R. 162.74(g).

Therefore, if the Customs officer asks you specific questions regarding the issue, you may be charged with having knowledge that a formal investigation has commenced. And, if you then try to make a prior disclosure, it may be denied.

Generally, receipt of a Request for Information (Customs Form 28) or even a Notice of Action (including a Rate advance) (Customs Form 29) is <u>not</u> construed to be "notice of a formal investigation" for purposes of precluding a prior disclosure.

On the other hand, if an importer provides information to a Customs officer and that information would cause the officer to believe that you have committed a violation (namely, that you did not act with reasonable care), the officer may commence a formal investigation.

Should you Make a Disclosure if Under Customs Investigation?

This requires a judgment call dictated by the particular facts at hand. Some importers choose to voluntarily disclose where they have knowledge of the commencement of a formal investigation in order to obtain any additional mitigation for a subsequent Section 592 penalty proceeding. And, in certain very limited instances (usually due to extraordinary cooperation), will an importer obtain mitigation of reduced penalties even though they technically do not qualify for valid prior disclosure treatment. In other instances, mitigation may approach the amount that is typically afforded to an importer who makes a valid prior disclosure. When faced with non-compliance, it is advisable to consult with an attorney under the protections of privilege, to assess whether a prior disclosure is advisable, even in the face of knowledge.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

COMPARING AND CONTRASTING

Interrelationship Between the VDP vs. Self-Adjustment

Canada.. In Canada, the VDP and the Self-Adjustment processes are mutually exclusive. That is, if one applies, the other does not.

According to the CBSA, the VDP is *not* intended to be used as a substitute for existing corrective mechanisms, and this means that a VD will only be available where **no other corrective provisions apply** or where the time limits for the corrective mechanisms (e.g., the Self-Adjustment) have since expired.

TIP: B2 ADJUSTMENT WILL *NOT* SUBSTITUTE FOR A VD

Some importers and some brokers incorrectly believe that an adjustment via B2 Adjustment form is the initiation of a Voluntary Disclosure.

That is not the case, and the CBSA cautions that if a VD is to be initiated, it ought to be initiated as set out above.

Only then will the importer or owner to shielded from any further penalties or criminal prosecution. In the right set of facts, the difference between the two can be important.

Don't let your broker make a B2 Adjustment when a Voluntary Disclosure is called for!

Thus where an importer has a "reason to believe" that there is an error with their declarations that is subject to a section 32.2 correction, they are required to correct, within 90 days.

However, once the 90 day time limit has expired, or in instances where the error is not related to tariff class, origin, or valuation, there is no further obligation to correct, and section 32.2 is not strictly applicable.

Corrective measures could then be made under the VDP.

Accordingly, on the 91st day of having "reason to believe" that there is an error, an importer could technically initiate a VD, if it so chose.

On the other hand, where there is "reason to believe" within the 90 days, a VD would not be available.

Where the choice is between disclosing pursuant to the VDP or a plain B2 Adjustment (for situations either not covered by the scope of section 32.2, or where the 90 days has past), the VPD may sometimes be the better course of action.

United States. In the U.S., the voluntary prior disclosure program is not mutually exclusive from the obligation for mandatory correction.

Rather, in the U.S. the mandatory correction requirements exist and penalties for non-compliance will ensue.

If, however, the importer has availed itself of a valid prior disclosure in the absence of knowledge of a Customs investigation, the added benefits for further reduced penalties can apply.

Reason to Believe vs. Date of Error

Canada. Where an error is discovered and disclosed under the Self-Adjustment, the CBSA's Draft Reassessment Policy (an as of yet unpublished document, and under review only internally at the CBSA) that the importer will only be required to go back to the date of the "reason to believe".

This suggests that the Self-Adjustment may actually provide some advantages to the VDP, where the importer would be required to go back to the start of the beginning of the error, to a maximum of four years.

The details of this Reassessment Policy are sketchy at this point in time, and just how this new reassessment policy will work with the five year requirement set out in the *Determination, Re-determination and Further Re-determination of Origin, Tariff Classification, and Value for Duty Regulations*, also remains to be seen.

As it currently stands, when an importer makes a correction under section 32.2 during the last year of the adjustment period (i.e., 37th to 48th month from the declaration), the CBSA will have five years, from the date of accounting, to further re-determine the goods.

Accordingly, where such is the case, the VDP would appear to be the better option, given that it would be limited to four years.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

United States. In the United States, the mandatory correction requirement covers a five year period based on the statute of limitations authorizing CBP. The voluntary disclosure program in the U.S. does not prescribe the scope (in either time or substance) for the disclosure, so importers will typically disclose (and only disclose) back the five year period for which CBP may assess Section 592 penalties.

Right of Appeal

Another advantage that the Self-Adjustment process would appear to have over the VDP is the existence of a substantive right of appeal.

For example, where a self correction is required to be filed as a result of a CBSA audit or verification and the importer disputes that there is an error in its original declaration, the importer would have the right to appeal the CBSA's determination to the CITT.

Currently there is some uncertainty in the VDP as to whether the CBSA will issue a Detailed Adjustment Statement capable of being appealed.

In the U.S., an importer can have an adverse decision regarding, among other things, "charges or exactions of whatever character" (to include the assessment of penalties and the accrual of interest) reviewed by CBP by filing a protest under 19 C.F.R. 174 et seq. Then, pending an adverse decision on the importer's protest, the decision may be appealed U.S. Court of International Trade under 28 U.S.C. 1581, which statute authorizes jurisdiction to appeal a denial of a protest of a Customs decision.

Avoidance of Penalties Where Disclosures Made

Where a person discovers that they have not complied with the applicable customs legislation, they may be faced with three possible choices: (1) do nothing in hopes that they are not subsequently assessed (within the four year assessment window); (2) initiate a VD; or (3) initiate a section 32.2 correction.

The CBSA's reassessment powers are limited to four years.

When a person has "reason to believe" that their origin, tariff classification or value for duty is incorrect and they fail to come forward, with either a VD or section 32.2 correction, the CBSA will assess back four years (and apply any applicable penalties and specified interest).

However, an ascertained forfeiture can occur at any time within six years from date the infraction. Accordingly, where a disclosure is not made (which would be limited to four years), there is a risk that a non-compliant person may be held liable for six years.

Both of the disclosure options limit liability to a maximum of four years and provide relief from the application of specified interest and penalties, which are discussed in further detail below.

Canadian Ramifications of Failing to Self-Correct

Specified Interest & Penalties. Where an importer fails to meet its corrective obligations under section 32.2 (i.e., where there is a failure to make a self correction within 90 days of having "reason to believe" that an error exists), and an assessment is subsequently issued and the CBSA determines that the importer failed to comply with section 32.2, interest, on any amounts owing, will be calculated at the specified rate (i.e., the prescribed rate plus 6%).

AMPS Penalties. In addition to specified interest being applied, penalties may also be imposed under section 109.1[16] under the CBSA's Administrative Monetary Penalty System ("AMPS"), for the entire four year period.

Section 109.1 provides as follows:

> 109.1 (1) Designated provisions — Every person who fails to comply with any provision of an Act or a regulation designated by the regulations made under subsection (3) is liable to a penalty of not more than twenty-five thousand dollars, as the Minister may direct.

EXAMPLE: AMPS CONTRAVENTION C352

AMPS Contravention C352 provides that where a person fails to pay duties as a result failing to make the required corrections to a declaration of tariff classification within 90 days after having "reason to believe" that the declaration was incorrect, the person may be subject to the following penalty.

1st Infraction:	\$100 or 5% of VFD, whichever is greater;
2nd Infraction:	\$200 or 10% of VFD, whichever is greater;
3rd and Subsequent:	\$400 or 20% of VFD, whichever is greater.

With dutiable high value goods, one can appreciate that AMPS penalties can be significant incentives for proper compliance with section 32.2.

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Section 32.2 is a "designated provision", and that means that AMPS penalties for failing to make a section 32.2 correction under section 32.2 will be applied. Those penalties can, in some instances, be quite substantial and will vary depending on the amount of the duties ultimately owing due to the correction.

IN DEPTH FOCUS – AMPS

Where a person **fails to make a correction under section 32.2**, within 90 days of having a reason to believe that their declarations are incorrect, they may be subject to the following AMPS penalties:

> **Contraventions C080, C081, C082, C083**: Authorized person failed to make the required corrections to a declaration of, respectively, origin of imported goods subject to a free trade agreement, other origin, tariff classification, or value for duty, within 90 days after having reason to believe that the declaration was incorrect.
>
> Penalties for each of the above infractions are as follows:

1st:	$100
2nd:	$200
3rd and Subsequent:	$400

Significantly, **failure to pay the duties** required also carries separate AMPS, as follows:

> **Contravention C350, C351, C352, C353:** Authorized person failed to pay duties as a result of required corrections to a declaration of, respectively, origin of imported goods subject to a free trade agreement, other origin, tariff classification, or value for duty, within 90 days after having reason to believe that the declaration was incorrect.
>
> Penalties for each of the above infractions are as follows:

1st:	$100 or 5% of VFD, whichever greater
2nd:	$200 or 10% of VFD, whichever greater
3rd & Subsequent:	$400 or 20% of VFD, whichever greater

Seizures & Forfeitures.

In addition to the possible application of AMPS penalties, the *Customs Act* contains a regime of civil and criminal penalties for contraventions. The civil penalties take the form of seizures and ascertained forfeitures and can be triggered on simple non-compliance.

There is no requirement for willful default or neglect on the part of the taxpayer. Unlike the four-year limitation period for informed compliance, ascertained forfeitures can be conducted at any time up to six years after default.

Seizures. The CBSA's 's authority to seize goods is contained in section 110[17] and is premised on an officer's belief that the Act or the regulations "have been contravened".

Similarly, in the U.S. CBP is authorized to detain and seize imported merchandise that contravenes U.S. law. *See* 19 C.F.R. 162.1 *et seq*.

Ascertained Forfeitures. Ascertained forfeiture is used as an alternative to seizure where the goods cannot be found or if seizure would be impractical, and allow the Minister to demand payment of up to the value of the goods plus applicable duties.

The authority to conduct an ascertained forfeiture is contained in section 124.[18]

Administratively, under an ascertained forfeiture, the CBSA will only demand payment equal to three times the applicable duties and will not seek payment equal to the good's full value plus duties.

U.S. law also provides extensive tools by which CBP may undertake forfeiture proceedings both at the administrative level and with the cooperation of the U.S. Attorney's office when imported goods violate U.S. law. *See* 19 C.F.R. 162.1 *et seq*.

Criminal Sanctions. The Customs Act also imposes hefty fines and possible imprisonment for certain offences.[19] Criminal prosecution may be initiated under section 160 usually within three years. Where the CBSA commences criminal prosecution by way of "summary conviction", they are limited to offences committed within the last three years. Where criminal prosecution is initiated by way of an indictment, there is no limitation period.

As in Canada, the U.S. laws and regulations allow for criminal prosecution, which are typically pursued if the disposition of proceedings at the administrative level fail. Again, a five year statute of limitations period applies.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: **(416) 864 - 6200**
Facsimile: **(416) 864 - 6201**

E-Mail: **rgk@taxandtradelaw.com**
Web: **www.taxandtradelaw.com**

LINDSAY B. MEYER
Venable LLP

Telephone: **(202) 344 - 4829**
Facsimile: **(202) 344 - 8300**

E-Mail: **LBMeyer@Venable.com**
Web: **www.venable.com**

Penalties in the U.S. In the United States, the failure to correct a violation of Section 592 associated with an importation, can lead to the imposition of additional duties, plus interest at the CBP reported rate applicable to the relevant time period, as well as penalties. Depending upon whether or not a valid prior disclosure is filed, any back duties, fees and taxes plus interest will be assessed, however, the level of the penalty may be mitigated, but typically to a lesser degree than if a VPD were filed.

GST and Interest Difficulties

A recent issue for the CBSA has been the automatic application of "prescribe rate" interest to VDs involving only GST (i.e., the goods were duty free, and all that was owing was GST, which could have been fully recoverable in the first place – a so-called "wash transaction"). The automatic application of GST, to the date of the original non-compliance, has been a major headache for importers, and the CBSA is currently working towards expanding their VDP to automatically waive the prescribed interest in these punitive situations.

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

PART II a

CANADA'S CUSTOMS SYSTEM [1]

Introduction

Recent trade statistics suggest that the vast majority of Canadian trade is between Canada and the United States. With NAFTA now going strong, there has now been essentially a full elimination of Canada-U.S. customs duties since January 1, 1998.

This leads to the legitimate question of whether or not Canada's customs law regime is still a relevant consideration for businesses dealing in the international trade of goods, especially when the bulk of their trade is in the Canada-U.S. corridor. Certainly, that has been an issue in dealing with some clients in the midst of "downsizing", as the first to go is often the company's in-house customs expertise.

The short answer to the question is an "of course Custom is still important" – and that should be more-or-less obvious for most readers, especially given your background as either importer or an exporter. But understanding why customs is still relevant requires some understanding of how Canada's Customs rules work.

Overview of Canada's Customs Rules

Goods imported to Canada must be reported at the border, be properly *classified* under Canada's Customs Tariff, be identified in terms of their proper *origin*, be properly *valued*, and clearly and legibly *marked* in accordance with Canada's marking rules. Each of these steps is must be carried out, or penalties and other equally nasty things will ensue. Other ramifications will also arise if the steps are not taken properly as, for example, the possible denial of NAFTA preferential status if each of the first 2 steps (*e.g.*, classification and origin) are not taken properly.[2]

Tariff Classification

After being reported, an imported good must be classified under the provisions of the *Customs Tariff*.[3] To determine the proper tariff classification, reference must be made to Schedule I of Canada's Customs Tariff, which is a list of possible tariff classifications based on the internationally accepted *Harmonized Commodity Description and Coding System* (the "Harmonized System").

As its name indicates, the Harmonized System is a coding system used by virtually all of the world's major trading nations, and it is broken into Sections, Chapters, Headings and Subheadings. Chapters contain two-digits, Headings contain four-digits, and Subheadings contain six-digits.

The Harmonized System is said to be harmonized to the six-digit (or Subheading) level, meaning that goods imported to the various countries using the Harmonized System should be all identically coded to the Subheading level, and 6 digits are all that are generally required on NAFTA Certificates of Origin. (See *infra*).

The most important concept to be borne in mind when classifying goods under the Harmonized System, is that the System is hierarchical in nature, with classification required to be performed using a step-by-step methodology.

While the wording of each Heading and Subheading is relevant, so are specific Section and Chapter notes located at the beginning of the Chapter or Section. To complement this legal core of materials, there are also Explanatory Notes which, while not forming part of the legal Harmonized System, must also be reviewed in interpreting the Headings and Subheadings.

> **Note:** In many instances, there will be only one possible tariff classification for an imported good.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Origin Determination

Once the basic tariff classification for an imported good is determined, the next required step is determining whether that good "qualifies" for NAFTA treatment. That generally requires determining if the good "originated" in a NAFTA country under "specific rules of origin" found in the NAFTA, and reproduced in Canadian (U.S. and Mexican) domestic law.

As can plainly be seen, determining "origin" can be one of the most difficult processes in customs or tax law. Complicating matters, since the Certificate of Origin must be signed by the exporter or producer, based on its knowledge or pre-existing documentation, much work must technically be done by the exporter prior to any export / import of the goods taking place.

> **Tip**: Importers may be unpleasantly surprised by the lack of understanding on the part of exporters and producers as to their obligations under NAFTA in issuing proper NAFTA Certificates. Unfortunately, in too many cases, the exporter or producer's processes are lacking, making it difficult for the exporter or producer to substantiate the NAFTA Certificates issued when audited by the importing country's customs administration (called a "NAFTA Verification Audit"). Where errors are found, NAFTA preferential status can be denied, on a go-backward basis, with the obligation on the exporter to simply notify its importers of that fact.

Perhaps more significantly, the ultimate problem really ends up in the *importer's* lap, with the importer effectively left "holding the bag." The reason is that while the exporter's obligation stops with simply notifying the importer that NAFTA preferential rates never really applied, the voluntary compliance models in place in Canada and the U.S., require the importer to take subsequent positive steps to correct for the importations. Corrections usually mean claiming MFN rates instead of NAFTA rates, which sometimes means applying positive rates of duty to historic importations, and paying those duties to Canada Customs, plus interest.

Reverse Audits – Proactively Ensuring Compliance. Appendix "A" contains a copy of Millar Kreklewetz LLP's Pre-Assessment Review methodology, and includes the general program areas on which we would be expected to touch.

Valuation

Once the "tariff classification" and "origin" of imported goods can be determined, and the duty rate identified, it is then necessary to consider the proper "value for duty" (or "VFD") of the imported goods.[4] A casual reference to the *Customs Tariff* indicates that duties are generally applied on an *ad valorem* basis, expressed as a percentage and applied to the value of the imported goods. The product of these two factors determines the duties actually payable.[5] Accordingly, a sound basis for "valuing" imported goods is at the heart of Canada's customs regime.

Canada's rules for valuing imported goods are found in sections 44 through 53 of the *Customs Act*, which parallel the rules in place in most other member-nations of the WTO (e.g., they are virtually identical to rules in both the U.S. and E.U.).

Transaction Value Primary Method. The primary method of customs valuation is the so-called Transaction Value method, which applies where goods have been "sold for export to Canada to a purchaser in Canada", and a number of other conditions are met. If applicable, the focus of the Transaction Value method is the "price paid or payable" for the imported goods, with certain statutory additions, and certain statutory deductions.

Where Transaction Value is not available, a series of other methods must be considered, one after the other, with (generally) the first available method that works being the required method, as follows:

- Transaction Value of Identical Goods (§ 49)
- Transaction Value of Similar Goods (§ 50)
- Deductive Value (§ 51)
- Computed Value (§ 52)
- Residual Value (§ 53)

Transaction Value Conditions. While meant to be the "primary" method of valuation, most importers and exporters will already realize that there are some strict conditions regarding the application of Transaction Value.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

The legislative wording, for example, requires at a minimum that the goods be "sold for export to Canada to a purchaser in Canada". Additional restrictions are imposed if the "price paid or payable" cannot be determined, or where, for example, there are (1) restrictions respecting the disposition or use of the goods;[6] (2) the sale of the goods or the price paid or payable for the goods is subject to some condition or consideration of which a value cannot be determined; or (3) the purchaser and the vendor of the goods are related, and their relationship can be seen to have influenced the price paid or payable for the goods – unless certain other conditions can be met.

The "Sold for Export" Requirement. Just what transactions constitute valid "sales for export" has been a bone of contention with Canada Customs for some time. Generally speaking, a "sale" contemplates the *transfer of title* in goods, from a vendor to purchaser, for a price or other consideration,[7] and the CBSA's own policy generally reflects that: see D-Memorandum 13-4-1. The requirement that a "sale" occurs has some obvious ramifications. For example, Transaction Value would not be available where "leased goods" are imported, nor would it be available for transfers of goods between a foreign company and an international branch.[8] In "parent-subsidiary" relationships, an issue will also arise as to whether the parent and subsidiary are in true "vendor-purchaser" relationships, or whether the parent controls the subsidiary to such an extent that the latter can be viewed as the mere agent of the former, negating a "buy-sell".

The Sold for Export "to a Purchaser in Canada" Requirement. As most readers will be aware, Canada Customs recently had the "to a purchaser in Canada" language added to the section 48 "sold for export" requirement. The amendment was in response to the much written about *Harbour Sales* case, and has attempted to maintain Canada Customs' view that Transaction Value is only available in two general cases:

1. The Importer is a Resident, and both (a) carries on business in Canada (i.e.,with a general authority to contract, plus other factors), and (b) is managed and controlled by persons in Canada; or
2. The Importer is a Non-Resident, but with a Permanent Establishment in Canada (as above), and both (a) carries on business in Canada, and maintains a (b) physical permanent establishment in Canada.

The change obviously makes the application of Transaction Value a bit more complicated, and requires some additional consideration of whether the sale for export to Canada has been made to what Canada Customs considers a proper Canadian "purchaser". The meaning of "purchaser in Canada" – and the general rules described above – can be found in the *Purchaser in Canada Regulations*, and Canada Customs' D-Memo 13-1-3, *Customs Valuation Purchaser in Canada Regulations* (December 11, 1998). Understanding Canada Customs' view on "purchasers in Canada" could also be the subject of a whole separate presentation,[9] and will not be dealt with here in any further detail. Suffice it to say that while the *Purchaser in Canada Regulations* do create a fair degree of certainty where the purchaser is a Canadian incorporated entity, with mind and management in Canada, there are a number of difficult issues currently emerging with respect to their application, especially in the context of non-resident importers.[10]

Statutory Additions and Deductions. Assuming Transaction Value is available, and once the "price paid or payable" for the goods can be determined,[11] the final transaction value (i.e., the amount which will represent the VFD of the imported goods) is determined by adding certain amounts to the price paid or payable, and by deducting certain other amounts, in accordance with the rules in section 48(5) of the *Customs Act*.

Amounts which must be *added* to the price under section 48(5)(a) of the Customs Act include, for example, commissions and brokerage fees in respect of the goods incurred by the purchaser, packing costs, the value of any "assists" in respect of the goods, certain royalties and licence fees, and certain freight costs incurred in moving the goods to (and at) the point of direct shipment to Canada.

Amounts which must be *deducted* from the price under section 48(5)(b) include amounts for "in-bound" transportation costs from the place of direct shipment, certain expenses incurred in respect of the imported goods after importation, and amounts for Canadian duties and taxes payable on importation.

Again, a full discussion of the ramifications of the statutory additions and deductions required under section 48(5) of the *Customs Act* is beyond the scope of this presentation, and readers are directed to secondary sources.[12]

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

The Customs Whipsaw: Transfer Pricing (Dis)Connect

Perhaps a necessary implication of the statutory addition and deduction process described above is a necessary disconnect between the "transfer price" of a good for income tax purposes – described above as generally equal to the "price paid or payable" for the good for Customs purposes – and the VFD of the goods for customs purposes, and on which duties and GST are payable.

Importers must therefore be cognizant of the fact that while international transfer pricing rules required related parties to establish supportable transfer pricing procedures for Taxation purposes, the "valuation" amount that is used for Customs purposes may be a markedly different number.

As the very last paragraph of the Canada Revenue Agency's ("CRA" - formerly the "Canada Customs and Revenue Agency", or CCRA) Information Circular 87-2R (September 27, 1999) makes clear:

> **Part 12 – Customs Valuations**
>
> 225. The methods for determining value for duty under the current provisions of the Customs Act resemble those outlined in this circular. However, differences do remain. The Department is not obliged to accept the value reported for duty when considering the income tax implications of a non-arm's length importation.

Thus, even though the CRA was, at the time this circular was written, then integrated as between its Customs, Excise and Taxation functions, it took the position that two potentially different valuation bases can occur for Taxation and Customs purposes, and that there is no necessary symmetry between the transfer pricing rules used by Taxation, and the valuation methods used by Customs. Now that the CBSA has formally split from the CCRA (now CRA), there is every reason to believe that the potential dichotomy will continue to exist.

While somewhat anomalous, this approach is generally consistent with CBSA's historical position, and is indicative of the problems facing taxpayers involved in Customs' valuation reviews: they are faced with a "whipsaw", with high customs values being assessed by Canada Customs, but no ability to translate those assessments into positive income tax implications.

> **Tip**: Importers carrying out transfer pricing analyses must underst and that the "transfer price" they determine for Canadian income tax purposes – which the CRA will have a vested interest in ensuring is "low" enough to accommodate reasonable Canadian corporate income tax revenues – will usually be a different amount than the "VFD" figures used to import the goods. That is largely due to the requisite statutory additions and deductions described above.

The situation in the U.S. may differ somewhat, as the Internal Revenue Code has rules (e.g., section 1059A) aimed directly at ensuring that a valuation for U.S. Customs purposes be the same, subject to certain limitations, as an acceptable transfer price for U.S. Taxation purposes.[13] Unfortunately, these rules do not function to absolutely preclude asymmetry, and the U.S. is still far away from a perfectly symmetrical environment, as discussed in Part III below.

On-Going Significance of Valuation. Since tariff classification and origin determination may well lead to the conclusion that a particular good is "duty-free" under NAFTA, or perhaps an MFN duty concession negotiated under the WTO, many importers assume that "valuation" is not that important to the importing process. Unfortunately, Canada Customs has not adopted that view. In fact, and despite the rather pre-mature reports of its death, "Customs Valuation" continues to remain a significant part of Canada Customs' post-entry assessment process, and an active player in special investigations as well.

There are a number of reasons why Customs wishes to ensure that Canada's valuation rules continue to be complied with. First, despite the bold steps Canada has taken under NAFTA, and at the WTO, a significant portion of Canadian trade still remains subject to duty and excise, demanding a proper valuation of goods imported to Canada, and exported abroad.

Second, and irrespective of whether particular goods are subject to customs duties when imported, the GST usually always applies at the border, and the GST rules run off the value for duty of the imported goods, as determined for Customs purposes.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

While the GST paid at the border is generally recoverable by commercial importers, the GST rules still require a proper accounting of the GST payable in the first instance, and where mistakes are made (usually non-deductible) interest and penalties will apply. In the worst-case scenario, ascertained forfeitures can be levied, imposing – non-deductible, and non-creditable – penalties as high as "3 times" the GST short-paid. The 15% Harmonized Sales Tax in place in Canada's Atlantic provinces only serves to magnify this result.

Finally, Customs is interested in ensuring that Canada's trade statistics are properly recorded, and in ensuring that the value of the goods entering Canada is consistently and properly declared.

All of this has thus led Canada Customs to ensure that Canada's new "Administrative Monetary Penalty" system (see Part IV) continues to apply to valuation declarations, specifically requiring that incorrect valuation declarations be corrected under section 32.2 of the *Customs Act* – under the pain of potential AMPs if the corrections are not made.

PART II b

CANADA'S GST SYSTEM

Overview of the GST System

Canada's federal value-added taxation system is called the Goods and Services Tax (the "GST") and is provided for in Part IX of the *Excise Tax Act* (the "*ETA*"). The GST, while commonly considered to be a single tax, is actually imposed under three separate taxing divisions, on three distinct types of transactions. Together, the three taxing divisions create a comprehensive web of taxation.

Its basic design is aimed at taxing virtually all (1) supplies of *domestic* goods, services, and intangibles,[1] all (2) supplies of *imported* goods, services, and intangibles, and (3) relieving from tax a number of *exported* goods, services, and intangibles.

Under Division II of the *ETA*, for example, GST is imposed on domestic supplies, or "taxable supplies made in Canada". In turn, Division III imposes GST on most "importations" of "goods", while Division IV imposes tax on "imported taxable supplies", which amount to certain services and intangibles acquired outside of Canada, but consumed, used or enjoyed in Canada. The "zero-rating" of exports from Canada (both goods, services, and intangibles) is facilitated through various enumerated categories in Part V of Schedule VI of the *ETA*.

What this means is that taxpayers engaged in cross-border transactions can find themselves subject to GST under any one of Divisions II, III or IV (and, in some instances, subject to a "double-tax" under more than one division).

Not surprisingly, then, determining how the GST applies to a particular transaction, and determining how the impact of the GST can be minimized, requires an understanding of how each of these taxing divisions operates, as well as an appreciation of a number of other special rules in the *ETA*. That includes the rules regarding "zero-rated exports" in Part V of Schedule VI of the *ETA* (the "Export Schedule"), and the rules regarding "non-taxable importations" found in Schedule VII of the *ETA*.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

With the fairly recent addition of an 8% "harmonized sales tax" ("HST") to transactions involving Canada's Atlantic provinces, businesses with exposure in those areas will see that what was once a 7% risk, is now a 15% risk – all usually measured on gross revenues (i.e., the "consideration" for the supplies).

Division II & "Taxable Supplies Made in Canada"

When Canadians speak of the GST, they are most often referring to the GST that is imposed under Division II of the *ETA*. Division II is entitled *Goods and Services Tax*, and imposes tax on "every recipient of a taxable supply made in Canada": s. 165(1).

While applying only to domestic supplies (e.g., taxable supplies "made in Canada"), Division II affects a large number of cross-border transactions, including supplies made in Canada by registered non-residents,[2] unregistered non-residents who carry on business in Canada, and supplies which are drop-shipped in Canada on behalf of unregistered non-residents. Division II can also affect certain goods exported from Canada. Having said all of this, there are a number of general rules governing when a "taxable supply" will be regarded as having been made "in Canada", and forcing a supplier to register and begin charging and collecting GST.

There are also some other special rules applying to unregistered non-residents who do not carry on business in Canada, all of which will be touched on further below.

What is a "Taxable Supply". Before engaging in a consideration of whether a supply is made "in Canada" or "outside Canada", it is usually a good "first step" to assess whether the supply is "taxable" or "exempt". (This is because the Division II GST only applies to "taxable" supplies made "in Canada".) A "taxable supply" is defined in subsection 123(1) of the *ETA* to be a supply that is made in the course of a "commercial activity". Since "commercial activity" is quite broadly defined, a taxable supply would generally include most supplies made in the course of a business, or in an adventure or concern in the nature of trade.

Significantly, however, a "taxable supply" specifically excludes the making of "exempt" supplies enumerated in Schedule V of the *ETA*.[3]

Supplies Made "in Canada". If a supply is "taxable", one can then proceed on with the issue of whether that supply is made "in Canada", such that the taxing provisions in Division II impose the GST on it. As indicated, the *ETA* contains a number of general rules for determining when a supply is made "in Canada",[4] and these are found in s. 142. For example, if the supply under consideration is a "sale" of "goods", the applicable rule is that the goods will be supplied "in Canada" if "delivered or made available" in Canada. Other rules apply for other types of supplies (e.g., a supply of leased goods, a supply of services, intangibles or real property like land). Understandably, some of these rules can be quite complex, and require some detailed consideration.

Special Non-Residents Rule. The general "place of supply rules" found in s. 142 of the *ETA* must always be read in context with a number of other rules which affect the determination of whether a particular supply is made "in Canada" for purposes of the Division II GST.

For non-residents, the most important of these rules is found in s. 143 of the *ETA*, which deems all supplies of property and services made in Canada by non-residents to be made outside Canada, unless:

(a) the supply is made in the course of a business carried on in Canada; or

(b) at the time the supply is made, the person is registered.

What this means is that for most unregistered non-residents, the general "place of supply" rules found in s. 142 of the *ETA* are unimportant: as long as the unregistered non-resident is not "carrying on business" in Canada, it is kept outside the GST system; accordingly, it is neither required to register for the GST, nor charge, collect and remit GST on its supplies to Canadians.[5] The significance of that rule obviously brings up the meaning of terms like "non-resident", "registered", and "carrying on business in Canada".

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Residents & Non-Residents. While a complete discussion is outside the scope of this presentation, the *ETA* does have some complex rules regarding the meaning of "non-resident" and "resident".[6] For example, s. 132 of the *ETA* provides that a corporation will be considered a "resident" of Canada if it has been "incorporated" or "continued" in Canada, and not continued elsewhere. While this might suggest that all corporations incorporated or continued outside of Canada would qualify as "non-residents" of Canada, there are other rules which may impact like, for example, the *ETA*'s "permanent establishment" rules.

Permanent Establishments. A special rule in s. 132(2) of the *ETA* provides that where a person who is otherwise a "non-resident" (e.g., a corporation incorporated in the U.S.) has a "permanent establishment in Canada, the person shall be deemed to be resident in Canada in respect of, but only in respect of, activities of the person carried on through that establishment". The effect of this rule, of course, would be to deem the non-resident to be a "resident" in respect of any activities carried on through a Canadian permanent establishment, which has the ancillary effect of *excluding* the 'non-resident' from use of the special "non-resident's rule" referred to above. Accordingly, a non-resident with a Canadian permanent establishment might (unhappily) find that its activities in Canada have effectively brought itself *into* the GST system, requiring it to take positive steps to register for the GST, and to begin charging, collecting, and remitting the GST to the Canada Revenue Agency ("CRA" – formerly the "Canada Customs and Revenue Agency", or "CCRA").

Carrying on Business. As we saw, the other main requirement for use of the "non-residents rule" in s. 143 was that the non-resident not "carry on business" in Canada. The concept of "carrying on business" is not defined in the *ETA*, and falls to be determined by the facts of the situation, and a number of tests developed largely from income tax jurisprudence. That jurisprudence suggests that to "carry on" a business is a factual-based analysis, focused on a couple of primary factors, and an inexhaustive set of secondary factors. The two primary factors are:

(a) the place where the contract for the supply was made; and

(b) the place where the operations producing profits take place.

In terms of the "place where a contract is made", the jurisprudence generally accepts that the important elements of the contract are its offer, and its subsequent acceptance, and that the place the contract is "accepted" is the place it was made.

Significantly, the CRA (Excise), in its GST Memoranda Series 2.5 (*Non-Resident Registration*, June 1995) has confirmed that the concept of "carrying on business" ought to focus on the two primary factors above, with the place a contract is concluded being the "place where the offer is accepted".

Summary of Application of Division II Tax. For non-residents, most will want to ensure that they are "unregistered" and "not carrying on business" in Canada – so as to ensure the proper application of the "non-residents rule" in s. 143. The application of that rule will "exonerate" non-residents from charging, collecting and remitting the GST in respect of transactions with Canadian residents.

On the other hand, for most readers, the Division II tax will usually be payable (e.g., you will be a resident Canada, or a non-resident carrying on business in Canada) – which raises a contemporaneous requirement to register for the GST.

Even where Division II tax is payable, that is not usually the end of the "GST story". Depending on your business activities, there may be additional GST imposed on your business under either Division III or Division IV, as discussed below.

Division III & "Imported Goods"

Division III is entitled *Tax on Importation of Goods* and imposes tax on "every person who is liable under the *Customs Act* to pay duty on imported goods, or who would be so liable if the goods were subject to duty": s. 212.[7]

Accordingly, the Division III GST applies to most goods imported into Canada. Here, the supplier is under no obligation to charge or collect tax. Rather, the importer of the goods is required to pay the tax when clearing them with Canada Customs.

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

As indicated above, even if a person (like an unregistered non-resident, not carrying on business in Canada) has successfully shielded itself from any Division II GST obligations (i.e., because of the special non-residents rule in s. 143), the Division III tax can still apply to any goods imported by the non-resident. And many other taxpayers and consumers now fully know, from their personal cross-border shopping experiences, the GST also applies to imported goods.

The surprising element here, however, is that since there is no provision in the *ETA* creating a mutual exclusivity between Division II and Division III taxes, "double-taxation" can happened in many cross-border transactions. In those situations, *both* the Division II and Division III tax will apply to a particular movement of goods from outside of Canada, to inside of Canada.

The key to minimizing tax in these situations, then, is to understand when and how this can occur, and how to either avoid it, or how to unlock one or both of the taxes that have been paid.

Interplay of Division III Tax with Customs Valuation Rules. As mentioned, the GST's Division III tax is payable on the "duty paid value" of the imported goods, as determined under the *Customs Act*. Significantly, then, the provisions in the *Customs Act* and *Customs Tariff* which affect the "value for duty" of imported goods are still important for GST purposes – even if the goods being imported are otherwise "duty free". This means that even those duties on imported goods may have long-since been removed, the CRA will still be interested in a proper valuation of the imported goods, for GST purposes, and will continue to focus on issues like whether dutiable royalty payments, assists, "subsequent proceeds", and "buying commissions" have been included in the "value for duty" of goods. Where these additions are left out, GST will be regarded as having been short-paid, and customs assessments (or other positive "voluntary correction" obligations – see *infra*) will arise.

This effectively means that when combined with its "customs cousins", Division III can have the effect of taxing more than simply goods, but also certain payments for intellectual property or services.

While GST registrants carrying on commercial activities will only experience cash-flow strain (e.g., between the time GST paid and the time it is recovered via ITC), persons involved in partially or wholly exempt activities (e.g., financial institutions, municipalities, universities, schools, and hospitals) would find these amounts to be "hard costs", and not all recoverable.[8]

Division IV & "Imported Taxable Supplies"

The third taxing division under which GST might be payable is Division IV, which is entitled *Tax on Imported Taxable Supplies Other than Goods,* and which imposes tax on "every recipient of an imported taxable supply": s. 218(1). Since an "imported taxable supply" is defined quite broadly, Division IV captures most transactions not otherwise taxable under Divisions II or III and, as indicated above, can catch a number of international transactions involving services or intangibles. The rules defining "imported taxable supplies" are remarkably complex, and to the extent taxpayers are again involved in somewhat less than "exclusive" commercial activities, special attention should be paid to these rules: they will create a self-assessment obligation equal to the 7% GST, multiplied by the amounts paid abroad for the ultimate use, in Canada, of intellectual property, other intangibles or services.

Zero-Rating Provisions

Even if Division II tax somehow applies to a transaction involving a good, service or intangible (i.e., because the supply was made "in Canada"), there is a general intention in the *ETA* that if the supply is for consumption, use or enjoyment *outside* of Canada, it should be free of GST.[9]

This intention is manifested in Part V of Schedule VI of the *ETA*, which sets out a number of zero-rating rules for *export situations*, some of the more important ones of which are as follows.

Zero-Rated Goods. Some of the rules for zero-rating exported goods are provided for as follows:

> **Section 1: Exported Goods**. A supply of tangible personal property (other than an excisable good) made by a person to a recipient (other than a consumer) who intends to export the property where ...

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

(b) upon delivery of the TPP to the recipient, the TPP is exported "as soon as is reasonable" having regard to the "circumstances surrounding the exportation", and having regard to the "normal business practice of the recipient",

(c) the TPP is not acquired by the recipient for consumption, use or supply in Canada before the exportation,

(d) after the supply is made, the TPP is not further processed, transformed or altered in Canada, "except to the extent reasonably necessary or incidental to its transportation".

(e) the supplier of the TPP maintains evidence satisfactory to the Minster of the exportation by the recipient (or the recipient issues the supplier with a special s. 221.1 export certificate – see *infra*) indicating that all the conditions above have been met.

Section 12: Supply via Common Carrier. A supply of tangible personal property where the supplier delivers the property to a common carrier, or mails the property, for export.

Dovetailing with these rules are special "Export Certificate" rules aimed at certain registered persons whose business consists of export trading activities. These persons would include 'export trading houses' who export goods which are not manufactured by them. The bulk of their business activity is purchasing domestic goods for export (e.g., a transaction likely subject to GST), warehousing them, and then exporting them.

Zero-Rated Services. Some of the rules for zero-rating exported services are provided for as follows:

Section 5: Agents' and Manufacturers' Rep Services. Agents' services are zero-rated when provided to a non-resident under s. 5 of the Export Schedule. Also zero-rated are services "of arranging for, procuring or soliciting orders for supplies by or to the person" – which would seem to cover the "manufacturers' representatives" situation. In both instances, however, the services must be in respect of "a zero-rated supply to the non-resident", or a "supply made outside Canada by or to the non-resident".

Section 7: General Services. A supply of a service is zero-rated when made to a non-resident person, but not in the case of the following services:

(a) a service made to an individual who is in Canada at any time when the individual has contact with the supplier in relation to the supply;

(a.1) a service that is rendered to an individual while that individual is in Canada;

(b) an advisory, consulting or professional service

(c) a postal service;

(d) a service in respect of real property situated in Canada;

(e) a service in respect of tangible personal property that is situated in Canada at the time the service is performed;

(f) a service of acting as an agent of the non-resident person or of arranging for, procuring or soliciting orders for supplies by or to the person;

(g) a transportation service; or

(h) a telecommunication service.

Section 8: Advertising Services. The supply of advertising services is zero-rated if meeting the following conditions: a supply of a service of advertising made to a non-resident person who is not registered under Subdivision d of Division V of Part IX of the *ETA* at the time the service is performed.

Section 23: Advisory, Professional or Consulting Services. A supply of the following services is also zero-rated, A supply of an advisory, professional or consulting service, made to a non-resident person, but not including a supply of

(a) a service rendered to an individual in connection with criminal, civil or administrative litigation in Canada, other than a service rendered before the commencement of such litigation;

(b) a service in respect of real property situated in Canada;

(c) a service in respect of tangible personal property that is situated in Canada at the time the service is performed; or

(d) a service of acting as an agent of the non-resident person or of arranging for, procuring or soliciting orders for supplies by or to the person.

Zero-Rated IPP. Zero-rated IPP is currently limited to the following supplies of *intellectual* property – which is notably a smaller subset of IPP, and which would be expected to exclude things like "contractual rights":

Section 10: Intellectual Property. A supply of an invention, patent, trade secret, trade-mark, trade-name, copyright, industrial design or other intellectual property or any right, licence or privilege to use any such property, where the recipient is a non-resident person who is not registered under Subdivision d of Division V of Part IX of the *ETA* at the time the supply is made.

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

PART III

THE U.S. CUSTOMS SYSTEM

Introduction

Canada has consistently remained as the most significant trading partner for the U.S., with shipments to and from Canada surpassing those of other countries. With the implementation of the U.S. - Canada Free Trade Agreement and, subsequently the NAFTA, customs duties between our two countries have been virtually eliminated. That does not mean, however, that the U.S. Bureau of Customs and Border Protection (formerly U.S. Customs Service ("U.S. Customs" or "CBP")), will focus alone on border security at the cost of examining customs matters from the trade that flows into the U.S. from Canada.

In fact, the opposite is true. The examination of our bilateral trade has just reached new levels of scrutiny. On April 23, 2003, Commissioners Rob Wright of Canada Customs and Revenue Authority and Robert Bonner of U.S. Customs signed a Memorandum of Understanding ("MOU") regarding the exchange of NAFTA-related information. The very purpose of the MOU is "to simultaneously ensure and enhance compliance with the NAFTA rules of origin governing our cross-border trade." As Commissioner Wright stated, the MOU is "yet another example of the strong partnership between our Customs agencies <u>and our cooperation in enforcing our respective customs-related laws and regulations</u>."

Simply put, customs enforcement is live and well in the U.S.

And accordingly, it will pay well for Canadian importers and exporters to understand the additional nuances of the U.S. system.

Overview of the U.S. Customs Rules

When seeking to import goods into the United States, the importer (which may be a non-U.S. resident) must provide certain information to CBP before it will be admitted for entry. The process is nearly identical to that in Canada. Specifically, the goods must be properly *classified* under the Harmonized Tariff Schedule of the United States, be identified as to their proper *origin*, be properly *valued*, and clearly and legibly *marked* in accordance with U.S. laws and regulations (which, practically speaking, include U.S. Customs rulings and interpretations).

When importing products from Canada, an importer may seek to import its goods under the preferential trade program of the NAFTA and its set of rules. Imports that are not brought in under a preferential trade program, like NAFTA, are subject to yet *another* set of rules.[1]

"Informed Compliance" & "Reasonable Care"

Since 1994, and the implementation of the U.S. Customs Modernization Act (the "Mod Act"), U.S. Customs has applied new standards of "informed compliance" and "reasonable care" on companies doing business in the U.S. Essentially, this means that the burden of compliance in determining and reporting accurate data, and of interpreting how the laws and regulations apply to those facts, now falls squarely on the companies importing into the U.S.

Along with this enhanced responsibility, U.S. Customs also instituted a new penalty structure (not dissimilar from the AMPS program recently initiated in Canada), subjecting importers to potential fines and penalties of up to the domestic value of the imported goods.

New Approach to Compliance. The Mod Act also brought about a new strategy in the U.S. agency's approach to compliance. Rather than assess products on an entry-by-entry basis, CBP has sought to apply its resources in a more strategic manner. It determined that the top 1000 U.S. importers accounted for approximately 60% of the value of imports into the United States. So began an audit program that examined U.S. importers starting with those who accounted for the bulk of in-bound trade. The audits[2] included a cradle-to-grave review of sampled transactions as well as an in-depth review of the company's customs compliance policies and procedures.

Today, and a few program generations later, CBP continues this approach in determining which companies importing goods into the United States are compliant, and which ones are not. A poor assessment may result in increased inspections of your goods at the border; further scrutiny of your compliance with preferential programs, (such as claims for NAFTA treatment), and the denial of duty-free benefits. As well, possible penalties and fines may arise, in addition to back duties (plus interest) owing if non-compliance is found.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

And, simply, an importer will suffer the increased business costs associated with being under the microscope in all aspects of your customs activities. One significant impact for companies, both large and small, was the adoption of the severe penalty provisions which may be sought in the event of non-compliance. Clearly, for U.S. Customs compliance, the buck stops with the companies importing into the U.S.

Tariff Classification for Entries into the United States

At the time of entry, an imported good must be classified within the Harmonized Tariff Schedule of the United States ("HTS"), in keeping with the General Rules of Interpretation that instruct an importer in determining which particular 10-digit provision applies. The U.S., like Canada, follows the "harmonized" system for classifying imported goods.[3] That is, the same general hierarchical coding system applies to U.S. imports under the HTS and its corresponding Sections, Chapters, Headings and Subheading provisions, as was described above. While the classification codes are "harmonized" among WTO countries to the six-digit level, an import in the United States must be reported in a subheading provision with ten digits. The breakout in the U.S. provisions of the 9th and 10th digit are for U.S. statistical purposes.

CBP treats the harmonized "Explanatory Notes," which accompany the HTS, as "guidance" but not strictly binding.[4] Instead, CBP typically applies the principles for classification that have been found in Customs Rulings for similar goods. Any importer or potential importer may request a ruling with U.S. Customs as to the proper treatment of its goods, including a request as to the proper classification provision for a product.

> **Tip**: Importers should periodically review existing U.S. Customs rulings on similar products to determine if CBP has concluded that a subheading, which differs from your intended provision, applies. While rulings are binding on the particular product and company making the formal request, Customs will routinely review existing decisions to see if other importers are seeking to evade a particular provision (typically with its corresponding higher duty) or if, in fact, a distinction from a ruling may validly be made. Then, if your goods are detained for examination, having a ruling on comparable goods upon which to refer in support of your classification subheading, will typically satisfy CBP.

> **Note**: When requesting a ruling, which will then bind the importer, a company should use the services of a customs and trade lawyer so that the request for the desired classification subheading is crafted in the most persuasive manner.

As determinations on proper classification impact the rate of the duty which applies,[5] it is important to make the effort to regularly review the classification headings that apply to your goods, and to do so as changes in product make-up or raw material sourcing occur. This is especially true for goods that are imported under the NAFTA. Also, bear in mind that classification provisions, themselves, are not static, so they should be regularly reviewed. What may have been an appropriate subheading in the past, may have become inaccurate.

Origin Determination under the U.S. Rules

Having determined that a product has been properly classified, the importer must determine the *origin* of the imported good in order to report the same to CBP at the time of entry. The classification decision is critical for a company seeking to determine origin under the NAFTA.

> **Note**: In the U.S., non-NAFTA entries (and those that are not made under another preferential trade program) are subject to a "substantial transformation" test. This standard for determining origin is <u>not</u> based upon the "tariff shift" rules of the NAFTA. Rather, the general rule under this test is that the country of origin of an imported product is the country in which the raw materials where last "substantially transformed" into a new article of commerce. *See* 19 C.F.R. 134 *et seq*. Importantly, a product may have an origin as determined under the NAFTA Rules of Origin, which may differ from the origin determined by the general U.S. rules of origin.

Under NAFTA, determining a good's "origin" can be particularly complex. Often an importer does not possess perfect information as to the origin and classification of all of the raw materials that make up the finished product; this serves to further complicate the process in determining origin. For example, although a raw material is purchased from a company *located* in the U.S., that raw material may not necessarily be of "U.S." origin.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

Therefore, it is advisable to obtain origin certificates or statements from all suppliers of raw materials before determining the origin of the finished products that your company produces. As a practical matter, it may be difficult to obtain statements for all raw material inputs; nevertheless, the effort should be made.

As discussed above, the liability for reporting the proper origin rests with the importer. Under the existing Customs standards, if an importer has "reason to know" that its origin declarations under NAFTA are incorrect, it has an affirmative obligation to correct what was reported. This means a review of all prior entries (on an entry-by-entry basis) for which the origin declaration, and typically the corresponding duty-free treatment, was incorrect over the last five years,[6] along with a reporting within 30 days to CBP.

Part of the reporting includes a requirement for the payment of any back-duties owed, plus interest to make U.S. Customs Service "whole" (as if the duties had been timely paid). It is also recommended to consider any such reporting under CBP's voluntary prior disclosure program, in order to minimize and, hopefully avoid altogether, any corresponding fines or duties that may be assessed by Customs.

Pre-Assessment Reviews to Ensure Compliance. Venable routinely conducts Pre-Assessment Reviews of a company's customs activities to determine if any "origin", or other Customs, issues exist. While it is preferable to do so *before* the company has received any audit notice from Customs, we have also conducted reviews "post-notice," but in advance of CBP's commencement of a formal investigation. See Appendix "B", for the areas typically covered in our Pre-Assessment Reviews.

Valuation in the United States

Following the determinations of the imported goods' "tariff classification," "origin", and corresponding duty rates, next the importer must consider the proper value that will be declared to CBP. Goods imported into the United States are appraised in under the statutory authority of section 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 ("TAA").[7]

In the U.S., most duties are applied on an *ad valorem* basis, expressed as a percentage, and applied to the value of the imported goods. As with most countries, the proper valuation of imported goods remains of high importance to ensure that valid trade statistics are gathered.

This remains true even though there has been a significant decline in the "General Duty" rates applied in the U.S., along with an increase in the number of preferential duty programs, such as the multilateral NAFTA Agreement and the more recent U.S. bilateral agreements with Israel, Jordan, Vietnam, Chile and Singapore, where reduced and duty-free rates abound.

In the U.S., the rules for valuing imported goods are found in Part 152, Subpart E, *Valuation of Merchandise* of the U.S. Code of Federal Regulations. These rules are consistent with the rules in place in most other WTO member-nations, and parallel the rules in Canada.

> **Note**: In addition to the rules pronounced in the regulations, U.S. Customs also relies upon the World Customs Organization's *Valuation* handbook for guidance. Also, U.S. importers should review the existing CBP rulings and its Informed Compliance publications on valuation (including its 450-page *Valuation Encyclopedia*) for further information on Customs' interpretation of such rules to particular facts. Importers should periodically review existing U.S. Customs rulings and interpretations often change or are further retired over time.

Transaction Value Preferred Method. The "Transaction Value" will typically be found to apply when products have been "sold for export to the U.S.", and several additional conditions are met.

The Transaction Value is defined as the "price actually paid or payable" for the imported goods when sold for exportation to the United States[8] (or secondarily for identical or similar goods), with certain regulatory additions and deductions.

The valuation rules, like the classification rules, are hierarchical in nature in the U.S. Therefore, if the Transaction Value does not apply, other methods must be considered, in the following order:

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

- Transaction Value of Identical Goods (19 C.F.R. §152.104);
- Transaction Value of Similar Goods (19 C.F.R. §152.104);
- Deductive Value* (19 C.F.R. §152.105);
- Computed Value* (19 C.F.R. §152.106); and
- "Fallback" Value (19 C.F.R. §152.107).

* At the importer's discretion, the Computed Value method may be applied before the Deductive Value method, provided the request has been made to Customs when the entry summary is filed.

Transaction Value Conditions. Consistent with the treatment in Canada, the "primary" Transaction Value method applied in the U.S. includes certain strict conditions that many importers have difficulty meeting.

The regulations provide that Transaction Value does not apply unless the goods are imported as a result on a "sale for export" to the United States.[9]

Additional limitations of the use of Transaction Value apply when the "price paid or payable" cannot be determined, such as when the total payment (whether made directly or indirectly) is not made or will not be made for the imported goods by the buyer to, or for the benefit of the seller. [10]

Also, it will not apply where:[11] (1) there are restrictions regarding the disposition or use of the goods; (2) the sale of the goods or the price paid or payable for the goods is subject to some condition or consideration for which a value cannot be determined; (3) proceeds of any subsequent resale, disposal or use of the imported goods, will accrue to the seller, and the appropriate value adjustment has not been made; or (4) the buyer and the seller of the goods are related, and their relationship influenced the price paid or payable for the goods, unless the importer can meet certain defined "test values." [12]

The "Sale for Export" Requirement. As with concerns raised by CBSA, CBP has also placed interpretative restrictions on which transactions constitute valid "sales for export" as the extensive body of rulings and cases on the subject reflect.

Typically, a "sale" contemplates the *transfer of ownership in the property*, from a seller to buyer, whether directly or indirectly, for a price or other consideration. *See* CBP's Informed Compliance Publication, *Bona Fide Sales and Sales for Exportation*.

Because a "sale" must occur, there are numerous scenarios which prohibit the use of Transaction Value. For example, the "presumption" of CBP is that merchandise shipped to a foreign party and location prior to reaching the U.S., is not "sold for export" to the United States.

CBP has also held that Transaction Value is inapplicable when goods are imported under a "lease" and hence, no "sale" occurs. Also, Transaction Value would not typically apply when goods are transferred between unincorporated related parties, such as when a U.S. branch or division receives a transfer of goods in inventory from its related overseas office. Likewise, when goods are transferred, but not sold, from overseas to a subsidiary in the U.S., which, in turn, sells the goods to an unrelated U.S. purchaser, CBP has typically ruled that Transaction Value does not apply. [13]

Multi-Tiered Transactions and the Nissho Iwai Line of Cases. The application of Transaction Value in related party transactions has consistently been scrutinized, and historically rejected, by CBP. This trend began to change, however, with the final pronouncement in the *Nissho Iwai* decision.[14] When all was said and done, the U.S. Court of Appeals for the Federal Circuit examined whether the proper value to be applied was the contract price between the unrelated U.S. purchaser and the U.S. subsidiary, or the price paid by the U.S. subsidiary's foreign parent (the "middleman") to the foreign manufacturer of the goods, and held the latter was the proper transaction value given the presence of certain enumerated conditions.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

In the subsequent case, *Synergy Sport International, Ltd. v. United States*, 17 CIT 18 (1993), the U.S. Court of International Trade, addressed the methodology for determining the transaction value of merchandise imported pursuant to a three-tiered transaction and held that the price paid by the middleman *could* serve as the basis for transaction value for the shipments in question. However, in keeping with the statute it was stated that for the transaction to be viable, the sale must be negotiated at arm's length, free from non-market influences, and involve goods clearly destined for the U.S.

Since then, many importers have sought a similar decision through rulings by CBP. While this is a viable approach, importers must take care to ensure that their transaction is properly structured prior to the initial importation, in order to obtain the benefit of the reporting lower, pre-markup value.

Statutory Additions and Deductions. After an importer determines that Transaction Value properly applies and the "actual price paid or payable" for the goods is determined, the "reportable" transaction value must be calculated and declared to U.S. CBP. This requires consideration of certain "additions" to and "deductions" from the price paid or payable, in keeping with the U.S. Customs rules. Amounts which must be *added* to the declared value include the following: packing costs, selling (but not buying) commissions incurred by the buyer for the imported goods, the value of any "assists" associated with the goods, certain royalties and license fees, and the proceeds of any subsequent resale, disposal, or use of the imported goods that accrue to the seller.[15] There have been several U.S. CBP rulings over the past year addressing whether royalties and service fees are included within the dutiable value of goods. (*See* Part I above.)

The following amounts shall be *deducted* from the declared value, provided they are identified separately from the price paid or payable and from any other cost reported as an "addition" to value. Permissible deductions include: any reasonable cost or charge for the construction, erection, assembly, or maintenance of, or technical assistance provided with respect to the goods after their importation into the U.S.; transportation costs incurred after importation, [16] and amounts for customs duties and certain Federal taxes.[17]

Because the determination as to which amounts qualify as statutory "additions" and "deductions" under the U.S. Customs laws and regulations can be quite complex, the discussion here on this subject is very limited and general. Readers are recommended to consult with a Customs expert to ensure that their particular facts do not conflict with existing CBP decisions.

The U.S. Transfer Pricing "Disconnect" may be Re-connected

U.S. companies have similarly faced a "disconnect" between the "transfer price" of a good reportable for U.S. income tax purposes and the value declared for the same good for customs purposes, but seemingly to a lesser extent that that experienced in Canada. U.S. Internal Revenue Code rules (e.g., section 1059A) provide that, when a U.S. taxpayer acquires imported goods from a related party, the taxpayer's basis in the goods may not be less than the dutiable value declared to U.S. Customs. As such, the rules should be the same, subject to certain limitations, as both are to demonstrate acceptable, arm's length transfer prices.

Nevertheless, CBP's approach to related-party transfer pricing has traditionally differed from that of the Internal Revenue Service. This lack of perfect consistency may be faced, for example, by a Canadian affiliated of a U.S. company.

Accordingly, U.S. companies trading with Canadian affiliates must recognize the fact that while international transfer pricing rules require related parties to relied upon supportable transfer pricing procedures for taxation purposes, the "valuation" amount that applies for U.S. Customs purposes may differ.

Recent CBP Headquarters rulings, however, have taken steps to re-connect the disparity for U.S. Customs purposes. For example, in HQ 547382 (Feb. 14, 2002), CBP relied upon an independent economic analysis applying the U.S. Internal Revenue Service's ("IRS") Comparable Profits Methodology to demonstrate that a transfer price between related entities is settled in an acceptable, arm's-length manner and, importantly, may be used as the basis for transaction value.

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

In that ruling, CBP stated:

> As we explained in a recent ruling, HRL 546979 dated August 30, 2000, Customs' approach to related party transactions differs from that of the IRS. Specifically, the method {described} reviews profitability on an aggregate basis, where as Customs' examines profitability on a product by product basis. Nonetheless, Customs' accepts that the IRS methodologies may be used as evidence to substantiate the circumstances of sale test in some instances where the method is actually used by the parties, and where any adjustments required by the method are accurately reported to Customs.

In the earlier ruling, HQ 546979 (Aug. 30, 2000), CBP stated that while the goal of both the Customs legislation and section 482 of the U.S. Tax Code is to ensure that the transactions between related parties are at arm's length, the method of making that determination is different under each law.

There, CBP concluded that the transfer pricing agreement applicable to the importer is a bilateral agreement, in which both countries have reviewed the submission and negotiated a fair result for both taxing authorities.

CBP's review of the information, including attending the Advance Pricing Agreement prefiling conference and review of information submitted to the U.S. tax authority, allowed CBP to conclude that the relevant aspects of the transaction had been examined, including the way in which the importer and its related suppliers organize their commercial relations, as well as the way in which the price in question was arrived at between the parties. Thus, Customs held that the importer demonstrated that the price has not been influenced by the relationship and that transaction value was the proper basis of appraisement.

Today, the potential "re-connection" of the transfer pricing value appears to be possible for U.S. Customs purposes. However, companies exporting to the U.S. should be aware that this possibility is not yet widespread and there are substantial hurdles to overcome before they may be accepted for a company importing into the U.S.

Continuing Significance of Valuation in the U.S.

Despite the fact that a substantial portion of U.S.-Canadian trade is duty-free under the NAFTA, proper valuation remains a significant focus of CBP. Many importers improperly believe that because an importation has no revenue implication, CBP will not be "bothered" evaluating the shipment. Actually, the opposite appears to be true.

CBP closely reviews NAFTA transactions – as recently reaffirmed with the MOU to exchange information on NAFTA origin audits – in order to determine whether the goods, in fact, qualified for the claimed duty-free treatment. Accordingly, it is fully expected that the assessment of declared value along with NAFTA Origin Verification Audits, remain a clear priority of CBP.

Even beyond an examination of NAFTA transactions, CBP has an interest in continuing to examine the value declared in its imports and ensuring their accuracy. After all, once a revenue agency, always a revenue agency.

Why would CBP continue to examine value? There are several reasons. First, the U.S., like Canada, has a considerable part of its in-bound trade that remains subject to duty and it seeks accurate accounting to ensure the complete collection of revenue.

Additionally, other fees are paid to CBP at the time of importation, such as Merchandise Processing Fees ("MPF") and Harbor Maintenance Taxes, which are assessed based upon the declared value. (For example, MPF will apply if entry is not made under the benefit of NAFTA.)

Finally, as with most industrialized countries, the U.S. seeks to have a proper accounting of its inbound and outbound trade[18] in order to confirm that the value and volume of trade are accurately reflected in its trade statistics.

Accordingly, an integral part of most audits or examinations performed by CBP is a review of the declared value. This is true for large-scale audits of preferential trade programs, such as under the NAFTA, as well as for even informal border examinations of entry shipments performed by U.S. Customs Import Specialists. Importantly, with the decline in duty rates, the introduction in 1994, of CBP's penalty provisions under the Mod Act, when the possibility of collecting additional monies (up to the value of the imported goods in the case of fraud) became widely recognized, CBP has continued to audit valuation. There is no incentive or likelihood that this will change in the coming years.

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

ENDNOTES TO PART I:

1. See Malcolm Sparrow, *Imposing Duties: Government's Changing Approach to Compliance* (Westport, Conn.: Praeger, 1994).

2. The authors would like to express their thanks to Wendy A. Brousseau, of Millar Kreklewetz LLP, who assisted in the preparation of this section of the Materials.

3. It is important to note that the VDP does not apply to penalties imposed under legislation that is administered by the CBSA on behalf of other government departments and agencies nor does it apply to penalties that are imposed for contraventions that are not related to accounting and payment provisions of custom legislation (e.g., broken seals).

4. Note that the concession under the VDP that only interest at the "prescribed rate" apply is, in itself, relief from penalties. That is because the ordinary interest that would apply to most customs non-compliance would be interest as the "specified rate"– pursuant to subsection 33.4, which applies interest at the specified rate to any duties which are owing. Specified interest is statutorily defined to be "interest, expressed as a percentage per year, equal to 6% per year plus the prescribed rate" – effectively adding a 6% penalty on top of prescribed rate interest.

5. In Canada the legislative authority to waive or cancel *penalties* and *interest* otherwise payable is provided for in subsection 3.3(1) of the *Customs Act* and the authority to waive or cancel *specified interest* is found in subsection 126 of the *Customs Tariff.*

6. For further information see Customs Notice N-332, "Voluntary Disclosures Program.

7. There is some uncertainty as to just what the nature of this requirement is. According to paragraph 151 of Customs D-Memo 17-1-5, "[a]ccounting information must be presented or transmitted and accepted by the customs automated system within five business days of the date customs releases the goods", and at paragraph 106, "[t]he accounting period includes the business day during which the goods were released (day 0) and the following five full business days (days 1 to 5)."

   That seems to suggest that the VDP requirement is simply this: if the information can be correctly presently during normal guidelines, it should not be presented through the VDP.

8. Subsection 59 of the Customs Act provides as follows:

   59.(1) Re-determination or further re-determination — An officer, or any officer within a class of officers, designated by the Minister for the purposes of this section may

   (a) in the case of a determination under section 57.01 or 58, re-determine the origin, tariff classification, value for duty or marking determination of any imported goods at any time within:

   (i) four years after the date of the determination, on the basis of an audit or examination under section 42, a verification under section 42.01 or a verification of origin under section 42.1, or

   (ii) four years after the date of the determination, if the Minister considers it advisable to make the re-determination; and

   (b)further re-determine the origin, tariff classification or value for duty of imported goods, within four years after the date of the determination or, if the Minister deems it advisable, within such further time as may be prescribed, on the basis of an audit or examination under section 42, a verification under section 42.01 or a verification of origin under section 42.1 that is conducted after the granting of a refund under paragraphs 74(1)(c.1), (c.11), (e), (f) or (g) that is treated by subsection 74(1.1) as a re-determination under paragraph (a) or the making of a correction under section 32.2 that is treated by subsection 32.2(3) as a re-determination under paragraph (a).

9. Judicial review is be available pursuant to section 18.1 of the Federal Courts Act which provides as follows:

   18.1 (1) An application for judicial review may be made by the Attorney General of Canada or by anyone directly affected by the matter in respect of which relief is sought.

   (2) An application for judicial review in respect of a decision or an order of a federal board, commission or other tribunal shall be made within 30 days after the time the decision or order was first communicated by the federal board, commission or other tribunal to the office of the Deputy Attorney General of Canada or to the party directly affected by it, or within any further time that a judge of the Federal Court may fix or allow before or after the end of those 30 days.

   (3) On an application for judicial review, the Federal Court may

   (a) order a federal board, commission or other tribunal to do any act or thing it has unlawfully failed or refused to do or has unreasonably delayed in doing; or

   (b) declare invalid or unlawful, or quash, set aside or set aside and refer back for determination in accordance with such directions as it considers to be appropriate, prohibit or restrain, a decision, order, act or proceeding of a federal board, commission or other tribunal.

   (4) The Federal Court may grant relief under subsection (3) if it is satisfied that the federal board, commission or other tribunal

   (a) acted without jurisdiction, acted beyond its jurisdiction or refused to exercise its jurisdiction;

   (b) failed to observe a principle of natural justice, procedural fairness or other procedure that it was required by law to observe;

   (c) erred in law in making a decision or an order, whether or not the error appears on the face of the record;

   (d) based its decision or order on an erroneous finding of fact that it made in a perverse or capricious manner or without regard for the material before it;

   (e) acted, or failed to act, by reason of fraud or perjured evidence; or

   (f) acted in any other way that was contrary to law.

10. See subsection 32.2(2) of the *Customs Act*.

11. On this point, see subsection 32.2(6) of the *Customs Act*.

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

12. See for example, *Aumann v. McKenzie* [1928] 3 W.W.R. 233.

13. Paragraph 26 of D11-6-6 provides states as follows:

> 26. "Reason to believe" does not occur if, all things being equal, there is conflicting information, such as rulings, issued by the CCRA. If there is conflicting or unclear information, importers are encouraged to contact their regional client services office. If an officer determines that the information is conflicting or provides some uncertainty to the importer, the officer will provide corrective action, in the form of a new ruling, for example. The date of the new ruling will then constitute the date of "reason to believe" for purposes of self-adjustment.

14. Subsection 32.2(4) provides as follows:

> (4) **Four-year limit on correction obligation** — The obligation under this section to make a correction in respect of imported goods ends four years after the goods are accounted for under subsection 32(1), (3) or (5).

15. However, when an importer has filed a correction during the last year of the adjustment period (i.e., 37th to 48th monthfrom the declaration), the CBSA will have five years, from the date of accounting, to further re-determine the goods: see section 2 of the *Determination, Re-determination and Further Re-determination of Origin, Tariff Classification, and Value for Duty Regulations*.

16. For contraventions of section 32.2 during the period from January 1, 1998, to November 29, 2001 (i.e., prior to Bill S-23 coming into force), penalties that were in existence under the former section 109.11 may apply.

    From November 30, 2001, to the implementation date of the Administrative Monetary Penalty System (AMPS) (i.e., the designated transitional period), there are no penalties in effect.

    From the date of AMPS implementation forward, AMPS penalties pertaining to section 32.2 may apply.

17. Section 110 of the *Customs Act* provides as follows:

> 110.(1) **Seizure of goods or conveyances** — An officer may, where he believes on reasonable grounds that this Act or the regulations have been contravened in respect of goods, seize as forfeit the goods; or any conveyance that the officer believes on reasonable grounds was made use of in respect of the goods, whether at or after the time of the contravention.
>
> (2) **Seizure of conveyances** — An officer may, where he believes on reasonable grounds that this Act or the regulations have been contravened in respect of a conveyance or in respect of persons transported by a conveyance, seize as forfeit the conveyance.

18. Section 124 of the *Customs Act* provides as follows:

> 124.(1) **Ascertained forfeitures** — Where an officer believes on reasonable grounds that a person has contravened any of the provisions of this Act or the regulations in respect of any goods or conveyance, the officer may, if the goods or conveyance is not found or if the seizure thereof would be impractical, serve a written notice on that person demanding payment of an amount of money determined under subsection (2) or (3), as the case may be; or such lesser amount as the Minister may direct.
>
> (2) **Determination of amount of payment in respect of goods** — For the purpose of paragraph (1)(a), an officer may demand payment in respect of goods of an amount of money of a value equal to the aggregate of the value for duty of the goods and the amount of duties levied thereon, if any, calculated at the rates applicable thereto at the time the notice is served, if the goods have not been accounted for under subsection 32(1), (2) or (5) or if duties or additional duties have become due on the goods under paragraph 32.2(2)(b) in circumstances to which subsection 32.2(6) applies; or at the time the goods were accounted for under subsection 32(1), (2) or (5), in any other case.

19. For instance, section 161 of the *Customs Act* provides as follows:

> 161. **Summary conviction offence and punishment** — Every person who contravenes any of the provisions of this Act not otherwise provided for in section 160 is guilty of an offence punishable on summary conviction and liable to a fine of not more than twenty-five thousand dollars and not less than one thousand dollars or to imprisonment for a term not exceeding six months or to both fine and imprisonment.

20. Title VI of the North American Free Trade Agreement Implementation Act (Pub. L. 103-182, 107 Stat. 2057 (Dec. 8, 1993), which amended various sections of the Tariff Act of 1930 and related laws.

21. Section 484 of the Tariff Act, as amended (19 U.S.C. 1484), sets forth the requirement for importers to use reasonable care in their importations and reporting to CBP.

22. Section 592 of the Tariff Act of 1930 (19 U.S.C. 1592) authorizes CBP to assess penalties for acts and omissions involving fraud, gross negligence and negligence associated with an importation into the United States. These penalties are assessed "without regard to whether the United States is or may be deprived of all or a portion of any lawful duty, tax, or fee." *Id*. The statute notes that clerical errors or mistakes of fact are not violations unless they are part of a pattern of negligent conduct (but that the mere nonintentional repetition by an electronic system of an initial clerical error does not equate to such a pattern of negligent conduct). *Id*.

23. *See* 19 U.S.C. 1592(c)(4)(B).

24. *See* 19 U.S.C. 1592(c)(4)(A).

25. The regulatory provisions for voluntary prior disclosures of errors and omissions under Section 592 are provided at 19 C.F.R. 162.74. these provisions are different from Petitions for Relief, under 19 C.F.R. Part 171, which may be relied upon to seek mitigation or remission once a penalty or liquidated damages have already been assessed. The discussion of petitions for remission or mitigation are, however, beyond the scope of this presentation.

26. *See* 19 C.F.R. 162.74(c).

27. Penalties not requiring the issuance of a prepenalty notice include, but are not limited to:

    - penalties for aiding unlawful importation (19 U.S.C. 1595a(b));
    - drug related manifest penalties (19 U.S.C. 1584(a)(2));
    - counterfeit trademark penalties (19 U.S.C. 1526(f));
    - conveyance arrival, reporting, entry, and clearance violations (19 U.S.C. 1436);
    - coastwise trade (Jones Act) violations (46 U.S.C. App. 883).

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

ENDNOTES TO PART II a:

1. For readers less familiar with Canada's customs rules, secondary sources may be helpful, and this this regard, please consider *Customs Valuation: A Comparative Look at Current Canadian, U.S. & E.U. Issues*, Robert G. Kreklewetz, A Paper presented at the 1996 CICA Annual Symposium in Ottawa, Ontario (Sept. 29 - Oct. 2, 1996). That paper contains sections dealing in detail with Canada's customs rules, as well as providing a fairly recent review of the major issues facing Canadian importers, from a valuations perspective. If you would like a copy sent to you, please contact the presenter.

2. And as most importers and exporters will have already learned, while goods imported to Canada that are of "U.S. origin" are generally expected to be entitled to duty-free status under NAFTA, there is a complex process necessary to determine whether in fact the goods "qualify", as well as complex rules aimed at ensuring proper compliance. (See *infra*).

3. Practically speaking, goods are usually reported in a Form B3 (*Canada Customs Coding Form*), which at the same time lists a description of the goods, their applicable tariff classification, duty rates, values for duty.

4. Determining the "VFD" is technically required even where goods are not subject to a positive rate of duty. Among the substantive reasons are the fact that the federal GST is payable on imported goods, based on their VFD for customs purposes. Additionally, the CBSA has taken the view that a proper VFD for imported goods is required to maintain the integrity of industry Canada's trade statistics.

5. For example, assume that the rate of duty on golf clubs made and imported from the U.S. is 2.4%. A $100 golf club can be expected to bear customs duties of $2.40. Only rarely are duties imposed on a "goods-specific" basis, which would impose flat-dollar duty figures on the quantity or weight of the imported goods.

6. Restrictions that are (i) are imposed by law, (ii) limit the geographical area in which the goods may be resold, or (iii) do not substantially affect the value of the goods are allowable under Transaction Value: see section 48(1)(a) of the *Customs Act*.

7. Section 2(3) of the Ontario *Sale of Goods Act* provides that a sale occurs here, under a contract for sale, "the property in the goods is transferred from the seller to the buyer". Similarly, in *Anthes Equipment Ltd. v. MNR*, the Tax Court of Canada cited *Black's Law Dictionary* for the following definition of sale: "A contract between two parties, called, respectively, the 'seller' (or vendor) and the 'buyer' (or purchaser), by which the former, in consideration of the payment or promise of payment of a certain price in money, transfers to the latter the title and the possession of property. Transfer of property for consideration either in money or its equivalent." See also the recent CITT decision in *Brunswick International (Canada) Limited*, [2000] ETC 4507.

8. In the former example, a "lease" does not amount to a sale. In the latter, a corporation and branch office are not separate persons, meaning that no sales transaction could occur between the two (i.e., one cannot sell to oneself).

9. See, for example, the presentation on the "Purchaser in Canada Regulations" made by Robert G. Kreklewetz and Stuart MacDonald (CBSA), at the Canadian Importers Association's May 11, 1999 Emerging Issues in Customs Conference (Toronto, Ontario). Please contact the presenter if you would like copies of this presentation.

10. See, for example, the presentation on the "*Recent Customs Valuation Cases: A Spirited Discussion With the CCRA*", made by Robert G. Kreklewetz and David DuBrule (CBSA), at the Canadian Importers Association's April 6, 2000 Emerging Issues in Customs Conference (Toronto, Ontario). This presentation was also updated and presented at the same Canadian Association of Importers and Exporters conference on April 5, 2001. Please contact the presenter if you would like copies of this presentation.

11. The "price paid or payable" for the goods will generally start with the "transfer price" determined under the importer's requisite transfer pricing analysis.

12. See again: *Customs Valuation: a Comparative Look at Current Canadian, U.S. & E.U. Issues*, Robert G. Kreklewetz, A Paper presented at the 1996 CICA Annual Symposium in Ottawa, Ontario (Sep 29 - Oct 2, 1996).

13. While initially meant as a "sword" for use by the IRS in combating possible tax avoidance strategies amongst related parties (e.g., importing at a low price, but selling for income tax purposes at a much higher price), the rules may also be available to taxpayers as a "shield", preventing U.S. Customs and the IRS from arriving at similarly asymmetrical results.

ENDNOTES TO PART II b:

1. For "domestic" supplies, the principal exceptions are goods, services, or intangibles enumerated in Schedules V or VI of the *ETA*. For "imported" goods, the principal exception is goods enumerated in Schedules VII of the *ETA*.

2. "Registered" or "registered under the *ETA*" is used to refer to persons who are registered in accordance with subdivision d of Division V of the *ETA*, which establishes who must be registered for the GST, and how they must register.

3. Bear in mind that a "taxable" supply will include the sorts of "zero-rated" supplies that are enumerated in Schedule VI of the *ETA*. The difference between the two is that a simply "taxable" supply is taxed at a rate of 7%, while a zero-rated supply is taxed at a rate of 0% (effectively removing the GST from the zero-rated supply).

4. In reviewing the general and specific rules discussed below, and in determining whether a particular taxable supply is made "in Canada" or "outside Canada", remember the significance of these rules: (1) Where a taxable supply is made "inside" Canada it will be taxable under Division II, and not generally taxable under any other provision in the *ETA* (although there are some exceptional situations where double-tax can occur); (2) If, on the other hand, the taxable supply is made "outside Canada", it will be outside the purview of Division II tax, and would only be subject to GST, if at all, under Division III (imported goods) or Division IV (imported services and other intangibles).

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

5. Note the distinction between charging, collecting and remitting the Division II GST on supplies made by the non-resident "in Canada", and the non-resident's obligation to pay GST at the border on goods imported to Canada under Division III. Many non-residents incorrectly assume that the "special non-residents rule" referred to just above somehow relates to the Division III obligations regarding imported goods. It does not. Accordingly, one could have a situation where, as a non-resident, one is entitled to deliver goods to Canadian customers *without* charging GST to the Canadian customer (i.e., because of the application of the non-residents rule in s. 143), but still required to pay the GST at the border because of the application of Division III.

   Many non-residents are confused in the application of the GST in these situations, increasing the likelihood that the GST rules are either not being fully complied with, or that some of this "double" GST is not being fully unlocked (see *infra*).

6. Also outside the scope of this presentation is a full discussion regarding the "registration" requirements in the *ETA*. Suffice to say that s. 240 of the *ETA* requires every person making taxable supplies in Canada in the course of a commercial activity to register for GST. Limited exceptions exist, including exceptions for certain "small suppliers" making less that $30,000 of supplies annually, and for non-residents who do "not carry on any business in Canada" – which dovetails with the special rule in s. 143 discussed just above.

7. Section 214 provides that Division III tax shall be paid and collected under the *Customs Act* as if the tax were a customs duty levied on the goods. In turn, the *Customs Act* provides that the person who "reports" the goods in accordance with that Act (i.e., the importer of record), is jointly and severally liable, along with the owner, for the duties levied on the imported goods. Accordingly, Division III tax is often applied to persons not actually owning imported goods, but merely reporting them for customs purposes.

8. Persons engaged in "commercial activities" are generally entitled to claim full input tax credits ("ITCs") for the GST paid, under s. 169 of the *ETA*. As this can only be done on the regular GST return following the day on which the GST became payable, there is often only a cash-flow issue involved in the payment of the GST. On the other hand, persons engaged in "exempt activities" are generally precluded from claiming ITCs, making the GST they pay unrecoverable, and a "hard cost". (In certain instances, where the exempt person is also a "public service body", limited rebates may be available for the GST paid – these would include, for example, municipalities, universities, schools, hospitals and charities, but not financial institutions).

9. This is consistent with the general policy in the GST legislation of removing all taxes and artificial costs from the cost base of Canadian exports, in order to eliminate the competitive disadvantages that would face Canadian exporters in the international markets as a result of these artificial costs.

ENDNOTES TO PART III:

1. For example, the origin rules under the NAFTA differ substantially from those that apply to non-preferential proper imports.

2. Initially, these audits were under the U.S. Customs Compliance Assessment Testing ("CAT") program. The CAT audits have recently been replaced with "Focused Assessments." The all-encompassing audits have not, however, resulted in the elimination of other specialized audits focused on origin, value or classification. We have also represented companies as they faced concurrent audits by both U.S. and Canada Customs administrations.

3. The U.S. regulatory authority classifying imported goods under the HTS is found in section 152.11 of Subpart B, *Classification*, of the U.S. Code of Federal Regulations. Typically, importers report data on a Customs Form 7501 ("CF 7501"), which provides a description of the goods, the corresponding tariff classification, declared value and duty rate.

4. We have seen instances where CBP will not accept (and does not agree with) a subheading that is acceptable to another country's Customs Administration; so, in practice there are instances where the system is not perfectly "harmonized."

5. While most countries are "harmonized" to the 6th digit on classification, each country has independent authority to assess the duty rate which applies.

6. In the U.S., the statute of limitations (that is, the length of time for which legal actions may be pursued) is five years from the date of the statement of action.

7. A declared value is required to be reported even in instances where the imports are subject to a "0%" duty rate. As in Canada, there are other fees and taxes that apply to U.S. imports which are a factor of the declared value. Additionally, U.S. statistics require accurate data reporting of both dutiable and duty-free imports.

8. There are a significant number of CBP rulings interpreting the phrase "price paid or payable." Care should be taken to ensure that an importer's particular facts would be within CBP's interpretation (or have been previously included in a prior ruling of comparable facts).

9. *See* 19 C.F.R. §152.101(c). Again, "sale for export" has been carefully reviewed by CBP and the courts. *See, e.g.*, HQ 547607 (Feb. 14, 2002); ("*Nissho Iwai").*

10. For example, when imports are made by an agent who then sells the goods in the U.S., the imported goods will not be allowed under transaction value as no "bona fide" sale will have been deemed to have occurred. *See, e.g.*, HQ 547917 (Nov. 2, 2001); 19 C.F.R. §152.102(f) "Sale" means a transfer of ownership from one to another for consideration. *J.L. Wood v. United States*, 505 F.2d 1400, 1406 (1974).

11. These limitations on the use of Transaction Value are provided for in 19 C.F.R. §152.103(j) of the Customs regulations. On the other hand, restrictions that are imposed by law, limit the geographical area in which the goods may be resold, or those which do not substantially affect the value of the goods are permissible under Transaction Value. *See* 19 C.F.R. §152.103(j) and (k).

QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

12. Acceptable " test values" are shown when an examination of the " circumstances of the sale" demonstrates that the relationship did not influence the price or when the transaction value closely approximates that of identical or similar goods in sales to unrelated buyers in the U.S. *See* 19 U.S.C. §1401a(b)(2)(B).

13. *See, e.g.*, HQ 544775 (Apr. 3, 1992).

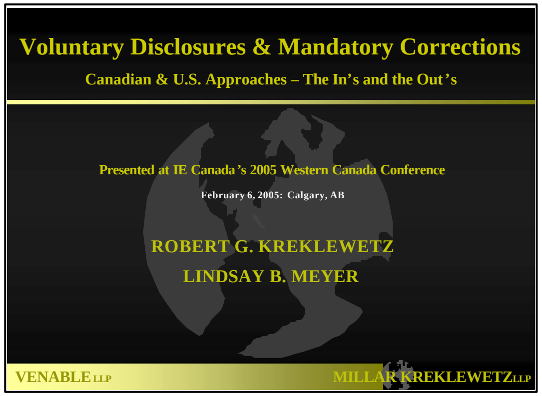
14. *Nissho Iwai American Corp. v. United States*, 786 F. Supp. 1002 (Ct. Int'l Trade 1992), *rev'd in part*, 982 F.2d 505 (Fed. Cir. 1992). *See also Synergy Sport International, Ltd. v. United States*, 17 CIT 18 (1993).

15. 19 C.F.R. §152.103(b).

16. Transportation and insurance costs that are incurred prior to the arrival at the U.S. port. These costs may be excluded from the entered value of the goods provided they are separately identified on the entry papers, such as the CF 7501, and are based on *actual*, not estimated rates. CBP has aggressively reviewed claimed exclusions for freight and insurance during its assessments.

17. 19 C.F.R. §152.103(i).

18. This is the reason behind the U.S. HTS provisions being reported to the tenth digit; a level of delineation far beyond that of most countries.



QUESTIONS ?

Please reach us as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
Facsimile: (416) 864 - 6201

E-Mail: rgk@taxandtradelaw.com
Web: www.taxandtradelaw.com

LINDSAY B. MEYER
Venable LLP

Telephone: (202) 344 - 4829
Facsimile: (202) 344 - 8300

E-Mail: LBMeyer@Venable.com
Web: www.venable.com

ROBERT G. KREKLEWETZ, LL.B., M.B.A.

Rob is a partner at MILLAR KREKLEWETZ LLP, with an LL.B. from Osgoode Hall Law School, and a M.B.A. from York University.

Extensive Customs, Trade & Commodity Tax Experience. Rob's practice focuses on **Customs & Trade** matters, including Periodic Verification Audits and Voluntary Disclosures concerning Valuation, Tariff Class Origin, or Marking issues, and NAFTA Origin Verification Reviews, Forfeitures, Seizures, and other NAFTA & WTO issues. Rob's practice area also focuses on **Commodity Taxes**, which encompasses all issues involving Canada's Goods and Services Tax (GST) and Harmonized Sales Tax (HST), as well the various other provincial sales taxes, including Ontario RST and Quebec QST. All elements of Millar Kreklewetz's practice include **Tax and Trade Litigation**, and Rob has acted as lead counsel in the CITT, Tax Court of Canada, Federal Court of Appeal, Ontario Court of Justice, and the Ontario Court of Appeal.

Speaking Engagements / Publications. Rob has 17 years of experience, published over **325 articles & papers**, and spoken at over **125 conferences** in each of the areas described above. He continues to write and speak extensively, regularly addressing the Canadian Association of Importers & Exporters (IE Canada), at its annual and semi-annual conferences, and various seminars, and bodies like the Tax Executive Institute (TEI), Canadian Tax Foundation, Canadian Bar Association (CBA), and Canadian Institute of Chartered Accountants (CICA), as well as speaking at many other professional conferences.

Client Base. MILLAR KREKLEWETZ LLP has some of the best tax and trade files in Canada, and Rob advises blue chip corporate clients who are international leaders in:

- Airlines, Avionics & Aerospace
- Oil & Gas
- Chemicals & Petrochemicals
- Forestry Products
- Steel
- Drugs & Pharmaceuticals
- Medical Testing & Health Services
- Computer Hardware & Software
- Information Technology
- IT & Internet Solutions
- Banking
- Financial Services
- Leasing
- Publishing
- Public Sector
- Manufacturing
- Wholesaling
- Retailing
- Direct Mail
- Direct Selling

We are proud to announce that the International Tax Review has ranked us as the top Canadian law firm in our field for three consecutive years – "Indirect & State and Local Taxes".

LINDSAY B. MEYER, J.D.

Lindsay is a partner at Venable LLP, with an J.D. from George Washington University, National Law Center and a licensed U.S. Customs Broker.

Extensive Trade, Customs and Export Control Experience. For over sixteen years, Lindsay has provided **International Trade and Customs** advice at Venable where she heads its International Practice, located in Washington, D.C., concentrating on **Customs & International Trade** matters, including representation during U.S. Customs Focused Assessments, NAFTA Audits, C-TPAT, ISA Programs, Detentions, Forfeitures, Seizures, other Customs-related matters. She regularly provides strategic customs and trade counseling to Fortune 100 clients, by conducting Pre-Assessment Compliance Reviews including corporate-wide, multi-location assessments and training programs, and by representing companies before the U.S. Bureau of Customs and Border Protection, the Court of International Trade, and U.S. Court of Appeals for the Federal Circuit. Lindsay has extensive experience counseling companies on compliance with export controls regulated by the Departments of Commerce, State and Treasury and performing Export Control Assessments. Lindsay has also successfully represented companies in antidumping duty investigations and reviews before the U.S. Department of Commerce and International Trade Commission and on appeal. Lindsay also advises clients on **International Transactional** matters, where she counsels on strategic sourcing, sales and distribution arrangements in the U.S. and abroad; the use of foreign agents, affiliated offices, and joint ventures.

Venable LLP's Client Base. As one of *The American Lawyer's* top 100 law firms, Venable LLP has lawyers practicing in all areas of corporate and business law, litigation, intellectual property and government affairs. Venable serves corporate, institutional, governmental, nonprofit and individual clients in the U.S. and around the world from its base of operations in and around Washington, DC. Likewise, Lindsay's clients range from multinational manufacturers to start-up enterprises from a wide variety of industries including high technology, chemical, petrochemical, pharmaceutical, automotive, avionics, space control equipment, steel, and retail industries.

Speaking Engagements / Publications / Memberships. Lindsay is also very active in business and trade associations related to her profession, and in her fourth term as Chair of the International Trade and Customs Committee for the ABA's Section of Administrative Law and Regulatory Practice, is a member of the American Association of Exporters and Importers, and was appointed by the U.S. Secretary of Commerce to the Maryland-Washington District Export Council.