Customs Compliance & Corporate Governance

What you and Upper Management need to Know !

Presented at I.E.Canada's 2006 Western Canada Conference

February 21, 2006: Calgary, AB

ROBERT G. KREKLEWETZ
LINDSAY B. MEYER

VENABLE LLP
MILLAR KREKLEWETZ LLP

Customs Compliance & Corporate Governance

What you and Upper Management need to Know !

Presented at I.E.Canada's 2006 Western Canada Conference

February 21, 2006: Calgary, AB

ROBERT G. KREKLEWETZ

LINDSAY B. MEYER

VENABLE LLP MILLAR KREKLEWETZ LLP

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 18 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 I.E.Canada at its Annual and Semi-Annual conferences, and various provincial Chapter meetings, and bodies like the Tax Executive Institute (TEI), Canadian Tax Foundation (CTF), 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.

ROAD MAP

U.S. Sarbanes Oxley Rules
Canadian Equivalents
What this Means FOR YOU
Audit Proofing

VENABLE LLP MILLAR KREKLEWETZ LLP

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

Recent world-wide corporate governance concerns have made "systems compliance" the new global standard for all businesses.

While "systems compliance" is a broad term, it applies with all of its breadth to the customs and logistics aspects of one's business, with both the Canada Border Services Agency ("CBSA")[1] and U.S. CBP increasingly paying attention to a business's "systems" and "processes", to ensure that they are reasonably capable of ensuring day-to-day customs compliance.

The focus of the Presentation today will be to review recent corporate governance standards like the SOX rules in the U.S., and Canada's own attempts at paralleling these rules, while relating that corporate governance standard back down to customs and logistics departments.

One will see that the new corporate governance standards effectively require a renewed focus on customs systems controls, at a time that "customs systems" continues to be a major focus of both CBSA and CBP.

The Presentation today, and the balance of these materials, will discuss the in's and the out's of corporate governance, and what it means for you (as the customs or logistics official), and your upper management.

While, by definition, much of the corporate governance legislation discussed in the Presentation and materials will related directly to U.S. or Canada public companies, the Presentation should also be of use to importers at private businesses, and any advisor or broker dealing with large corporate clients, as the controls and systems which this Presentation advocates would be helpful to any business, just purely from a error and cost minimization perspective.

Navigating Through the Materials

The Materials are broken into three parts, as follows.

Part I contains a comprehensive review and discussion of

(1) **Corporate Governance & Systems Compliance, the New Standard**, and includes a discussion of both the U.S. Sarbanes-Oxley Law, and the Canadian equivalents;

(2) **Self Help Remedies: Documenting & Assessing Your Systems**, which includes a discussion of the basis systems that any importer needs in place;

and

(3) **Audit-Proofing Your Company,** which focuses on a short discussion on strategies for ensuring that your business is not taken by surprise by any CBSA audit or verification.

As an added bonus, Part II contains a review of Canada's "mandatory correction" obligations in section 32.2 of the *Customs Act*, and Part III provides insight into the parallel U.S. provisions for those importing into the U.S.

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

Electronic Copy of These Materials

For readers interested in filing this Presentation on an electronic basis, a copy of it is available by typing the following into your web browser:

www.taxandtradelaw.com/1605.pdf

For other free customs and trade information, please visit either www.taxandtradelaw.com, or www.venable.com.

Why is Corporate Governance Important to Me ?

- Canadian & US Public Companies (& Subs)
- A New Disclosure Standard:
  - → If your customs department has material problems, your CEO and CFO need to know
  - → If your customs department lacks proper processes, your CEO and CFO need to know

VENABLE LLP MILLAR KREKLEWETZ LLP

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
CUSTOMS COMPLIANCE & CORPORATE GOVERNANCE: WHAT YOU & UPPER MANAGEMENT NEED TO KNOW

SECTION I - CORPORATE GOVERNANCE & SYSTEMS COMPLIANCE AS THE NEW GLOBAL STANDARD !

U.S. SARBANES-OXLEY LAW: THOSE DARNED SOX REQUIREMENTS !

Overview

In 2002 the U.S. Congress passed the "Sarbanes-Oxley Act" ("SOX"), which was in response to several corporate and accounting scandals involving companies that include Enron, WorldCom and Global Crossing.

As drafted, the SOX legislation impacts a wide range of businesses from publicly traded companies to certified accounting firms.

In particular, SOX seeks to tighten the standards for corporate financial disclosure, increase requirements for director independence, and increase penalties for corporate wrongdoing.

Does that then mean if I work with a private company or a company outside of the United States, that SOX does not impact me? The answer is: "no."

For one, foreign companies with securities listed on U.S. markets must also comply with SOX. In addition, non-U.S. entities whose financials "roll-up" into a U.S. entity may likewise be subject to this law. Even non-U.S., private companies may be affected by the restrictions of SOX if the company regularly trades with the U.S. As explained below, the disclosure requirements of SOX may take away the "voluntary" nature of many disclosures to the U.S. Government for companies with international trade operations.

While there are numerous provisions within the SOX legislation, two critical sections of SOX will be the focus of this presentation: Section 404, which requires management assessment of the company's internal controls, and Section 302, which directs certain certification requirements imposed on particular corporate officials.

These sections are addressed briefly below.

Section 404 Management Requirements

Section 404 of SOX requires management to specifically assess its company's internal controls. In particular, Section 404 states, as follows:

> (a) **Rules Required.** The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 to contain an internal control report, which shall …
>
> 1. state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
> 2. contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.
>
> (b) **Internal Control Evaluation and Reporting.** With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Section 302 Corporate Responsibility for Financial Reports

Under Section 302 of SOX, both the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO") are required to certify in their quarterly and annual reports that: (1) they have reviewed the report being filed; (2) the report does not contain any untrue statements of material fact or omit any material facts; and (3) the financial statements fairly present the financial condition of the company.

Importantly, the officers must also certify that they are responsible for establishing, maintaining and evaluating internal controls for the company, such as those provided for in Section 404.

Why is Corporate Governance Important to My Private Company ?

- Generally speaking, same process requirements expected by Canada Customs and U.S. CBP.
  - New global focus on "systems"
  - Enforcement re-focused on processes, systemic errors & self-correction requirements
- Effectively: Same disclosure & Correction obligations

VENABLE LLP MILLAR KREKLEWETZ LLP

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 this way, the CEO and CFO are held ultimately responsible for designing corporate-wide disclosure controls and procedures to ensure that material information is made known to them.

Significantly, this provision reflects that lack of knowledge is not a defense in the absence of an effective compliance system.

The Strong Smell of SOX Enforcement

Under SOX, penalties for false certification of financial reports are substantially increased. Now, fines of up to U.S. $5 million dollars and prison terms of up to 20 years are authorized by this statute. Further, if a company restates its financial statements as a result of material misconduct, the CEO and CFO may face forfeiture of their bonuses and profits.

The strong smell of SOX enforcement was recently demonstrated in the settlement of a case against a U.S. software company, McAfee, Inc. ("McAfee"). In the case against McAfee, the U.S. Securities and Exchange Commission ("SEC") alleged that the company misled investors when it engaged in a fraudulent scheme to overstate its revenue and earnings by hundreds of millions of U.S. dollars in violation of U.S. securities laws. Specifically, McAfee engaged in "channel stuffing" whereby it aggressively oversold its products to distributors in amounts that far exceeded demand and then offered distributors secret payments to hold the excess inventory rather than have the goods returned to McAfee for a refund.

McAfee consented to the entry of a Court order enjoining it from violating antifraud, books and records, internal controls, and periodic reporting provisions of the laws and agreed to pay a U.S. $50 million dollar civil penalty. The company also agreed to appoint an independent consultant to examine and recommend improvements to its internal accounting controls, a common provision in recent consent agreements.

On January 4, 2006, and in conjunction with the filing of charges and settlements against McAfee, the SEC issued a policy statement outlining its approach to financial penalties.

In particular, the SEC said that there are two primary factors that it will consider when determining penalties for companies that violate the securities laws. Namely, the SEC will consider: (1) the presence or absence of a direct benefit to the company, and (2) the degree to which the penalty will repay or further harm the injured shareholders.

The Commission then noted seven additional factors for consideration, which included:

- The need to deter the particular type of offense;
- The extent of the injury to innocent parties;
- Whether complicity in the violation is widespread throughout the corporation;
- The level of intent on the part of the perpetrators;
- The degree of difficulty in detecting the particular type of offense;
- Presence of lack of remedial steps by the corporation; and
- Extent of cooperation with the Commission and other law enforcement.

The SEC noted that even though it might not seek financial penalties against a particular business, it could still pursue actions against the individuals responsible at those firms when the violations occurred.

What Implications for Companies Involved in International Trade with the U.S.?

Because potential liability may arise from violations of trade laws and regulations, such violations may directly affect a company's financial well-being. Therefore, a CEO and CFO of a publicly-traded company may have an obligation under SOX to disclose any material import, export, and trade issues. This very disclosure may be inconsistent with the voluntary nature of reporting trade violations that had traditionally existed.

Enforcement cases brought by various U.S. agencies are on the rise, largely due to SOX, and these cases can clearly have an effect outside of the U.S. The case law based on the 2002 SOX legislation is only beginning to develop. That said, a review of recent trade law cases that could now fall within the those darned SOX rules, merits attention.

LINDSAY B. MEYER
ROBERT G. KREKLEWETZ

What is Corporate Governance ?

- New rules for disclosing material problems & maintaining proper systems and controls
- U.S. Sarbanes-Oxley Law
- Canadian Equivalents

VENABLE LLP MILLAR KREKLEWETZ LLP

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

FCPA Issues Lead to Hot SOX

Penalties in the amount of U.S. $500,000 appears to be a trend.

The first example is one where the activities by the foreign subsidiary of a U.S. corporation led to a substantial civil penalty. In 2004, the SEC charged **Schering-Plough Corporation** ("S-P") with violating the books and records and internal control provisions of the U.S. Foreign Corrupt Practices Act ("FCPA") in connection with payments that its Polish subsidiary, Schering-Plough Poland, made to a legitimate charity affiliated with the Polish Government. The SEC determined that the U.S. $76,000 in payments the company made to influence the health authority's purchase of P-S products were improperly recorded. Also, the company's system of internal controls did not detect or prevent the improper payments, supported the finding of a separate FCPA violation. The company was assessed a $500,000 fine and required to undertake an independent evaluation of its internal controls along with a report to the Government.

In another recent case, the SEC settled two enforcement proceedings against **Monsanto Company**, a U.S. producer of agricultural products, with the payment of a U.S. $500,000 penalty. In a related proceeding, the U.S. Department of Justice ("DOJ") filed a criminal information charging Monsanto under the FCPA. Monsanto agreed to pay an additional U.S. $1 million associated with those charges. Like the S-P case, the case against Monsanto also involved overseas activities. Specifically, the SEC charged that a U.S.-based manager directed the payment by an Indonesian consulting firm to make an illegal payment of U.S.$50,000 to an Indonesian Minister seeking the repeal of an unfavorable decree. Even though the decree was not repealed, the SEC looked to the fact that, nevertheless, the bribe was paid. The SEC determined that the company violated the antibribery provisions of the law and, among other things, also failed to maintain proper internal accounting controls.

Both of these cases demonstrate the vigor with which the U.S. Government is seeking to pursue charges based upon violations of the FCPA. They also show how the requirements for internal controls under SOX have been designed to detect such potential issues, and how the absence of controls can be a basis for SOX violations.

Acquiring or Being Acquired? Remember to Check your SOX

Thanks to SOX, due diligence has undertaken new importance in the world of mergers and acquisitions. Companies seeking to acquire a business are more concerned than ever regarding the potential liability that they might be inheriting.

This was certainly the case when General Electric sought to acquire **InVision Technologies**, Inc. ("InVision"), a manufacturer of explosive detection machines used in airports. There, a DOJ investigation into alleged violations of FCPA by InVision nearly thwarted the acquisition. InVision was under investigation From 2002 to 2004, InVision employees, sales agents and distributors pursued transactions to sell the company's detection equipment to airports in China, the Philippines and Thailand. And, importantly, it was alleged that the company was aware of a high probability that its foreign sales agents or distributors made or offered to make improper payments to foreign government officials related to the sales. InVision agreed to disgorge U.S. $589,000 in profits plus U.S. $28,700 in interest, and pay a U.S. $500,000 civil penalty before the acquisition by GE would conclude.

So why the increase in FCPA cases? Simply, the implementation of SOX and its new-founded requirements to identify and timely report any "material weaknesses" that affect a company's internal controls. As these cases demonstrate, the activities of U.S. companies, as well as of their non-U.S. subsidiaries and affiliates, are subject to the reach of SOX.

Are your Customers Caught up in the Threads of SOX?

The U.S. trade policies that form the basis of export control laws and regulations can also subject a company to SOX violations.

For example, in 2005, the U.S. Department of Commerce reached a settlement agreement with **E.D. Bullard Company** in the amount of U.S. $330,000 for various export control violations. Included in the violations were certain unauthorized re-exports from another country to a party not authorized under the export declaration and making false statements on its export documents. In the absence of internal controls, these violations may well have been material to this company thereby triggering the reporting requirements under SOX.

US Sarbanes-Oxley Law

- Section 404 – Internal Controls & Systems
- Section 302 – CEO and CFO Certification/Liability
- History
- Practical Implications

VENABLE LLP MILLAR KREKLEWETZ LLP

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

Likewise, **Mobil International Petroleum Corporation** and its related subsidiaries also found themselves settling with the U.S. Government for numerous unauthorized re-exports to third countries under similar facts. One can see how violations due to unauthorized re-exports can easily occur if a U.S. company ships a product to its Canadian affiliate, who in turn, sends the item on to a customer in another country and fails to properly obtain any U.S. export authorization before doing so.

There are also numerous cases where the U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC") seek penalties against companies that violate U.S. "trading with the enemy" laws. For example, OFAC recently reached a settlement with a U.S. company that provided unlicensed travel-related services to Cuba.

While there was no Canadian involvement in that particular case, prior OFAC cases have been pursued against Canadian citizens whose activities are undertaken from the U.S.

Therefore, from a SOX perspective, if your company is affiliated with a U.S. entity or trades with the U.S., it is advisable to assess whether the proper export control licensing or screening requirements are being observed. Likewise, you should ensure you're your transactions do not involve any prohibited end users or uses as identified within those U.S. laws.

Customs Violations can also Show a Hole in your SOX Compliance

Consider too, the case before the U.S. District Court for the Northern District of California, which recently denied a motion by **Nature's Farm Products** ("NFP") to dismiss a false claims action brought for fraudulent declarations of country of origin on Customs documents. There, certain Chilean mushrooms were subject to anti-dumping duties of 148.1%. Therefore, NFP undertook to circumvent the dumping duties my shipping large volumes of "brined" mushrooms to Canada, where they were "de-brined", repackaged for retail sale, and labeled as products of Canada. About 150 shipments of the mushrooms were made to the U.S. totaling approximately U.S. $4.8 million dollars in value.

Under this scheme, NFP evaded paying approximately U.S. $7.8million in antidumping duties. Perhaps most interesting is the fact that the case was originally brought under the Qui Tam laws by a competitor of NFP who discovered the scheme. While the competitor was dropped from the suit, the action continued on in the name of the U.S. Government under the False Claims Act charging that NFP defrauded the Government. Interestingly, in the U.S., funds recovered under the False Claims Act are shared between the private citizen who brings the suit and the Government in the three times the loss of revenue which results from the false claim. Clearly, an incentive for companies to keep a watchful eye on their competition.

Therefore, while a company may not be strictly subject to SOX, it may nevertheless find itself facing the internal control requirements as an importer into the U.S. Under the new importer compliance program of the U.S. Customs and Border Protection ("CBP"), Importer Self Assessment, a company also finds that it must meet near identical internal control and reporting requirements as found under SOX. Both ISA and SOX are based upon the internal control framework enunciated by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Both the ISA program and the SOX contain requirements for "internal control over financial reporting." Section 404, like the ISA program, is premised upon the five factors of: control environment; risk assessment; control activities; information and communication; and monitoring. Thus, whether through a related U.S. company or directly through your own U.S. trade activities, you may find your company under these heightened internal control requirements. Are you and your management ready?

What ifs …

Let's review the example of a Canadian company, which is a wholly-owned subsidiary of a U.S. parent company and whose financials are "rolled up" into those of the public U.S. parent.

… Under NAFTA?

What if the Canadian company determines that it may have exported to the U.S. a significant number of products that were improperly marked with the country of origin and also determined that the goods were then not eligible for preferential duty rates under the North American Free Trade Agreement ("NAFTA")?

LINDSAY B. MEYER
ROBERT G. KREKLEWETZ

Canadian Equivalents

- Multi-Lateral Instrument 52-109
- Adopted as Securities Requirements for Public Co's
- Mirroring US SOX Rules
- Expected Implications

VENABLE LLP MILLAR KREKLEWETZ LLP

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 marking violation may subject the company to a 10% *ad valorem* marking duty penalty and the non-eligibility under NAFTA may likewise result in substantial additional duties; with both errors subjecting the company to significant potential penalties. Under many laws and regulations, the company would normally have discretion as to whether it should make a voluntary prior disclosure. However, under SOX -- and the violations of laws and regulations enforced by the CBP -- because the company has discovered a material contingent financial obligation which would affect the U.S. parent company, the U.S. CEO and CFO may well have a duty to disclose this information in the company's financial reports. Additionally, this disclosure could then likely lead to liability under the U.S. Customs laws.

… You're Exporting Controlled Goods?

The same would be true for U.S. "outbound" transactions. If, for example, a U.S. company sent items to its affiliated entity in Canada where the goods are then transshipped without the proper authorization under the U.S. export control regulations, this activity may likewise reach to the level of a SOX violation. Therefore, if an audit committee performs an audit of the multinational entity and uncovers unauthorized exports, the potential liability can become ripe. As such, the pressure of SOX may require an internal analysis and ultimately a disclosure of the violation, which may result in penalties and fines on the company.

… You Want to go Public?

While any potential burden under SOX is less direct, private companies may also not escape the scrutiny. If, for example, the company has in interest at some point in going public, the company should fully expect that any potential acquirer would require full internal review and due diligence will often require the internal compliance controls seen under SOX. This is largely so because the cost of a mistake is significant.

Accordingly, given the widespread press on current scandals and the interest in SOX cases, a substantial number of private companies have made an affirmative decision to implement internal controls; not because it's required, but because they believe it's the right thing to do (and, if they don't they might trip across a big and costly mistake).

Global Trade and SOX – What to do?

As discussed above, non-compliance with trade laws can result in significant fines and even the revocation of trade privileges. These have the clear potential to adversely affect a company's financial position. Non-compliance can also result in SOX penalties if the company's internal controls are inadequate or non-existent. There is no margin of error when facing a material weakness or error.

Enforcement is Up and Controls are Needed

In today's environment, businesses must demonstrate their commitment to trade compliance by implementing solid procedures for: Tariff Classification; Valuation; Export Control authorization; Restricted and Denied Party Screening; and Preferential Trade Agreements (such as NAFTA). The U.S. Government is more carefully investigating and auditing the activities of companies in an effort to protect shareholder interests.

At the same time, the US CBP has stated a clear intent to increase commercial enforcement and importers who violate trade laws will no longer get a "pass" by paying merely unpaid duties plus interest. As the Regional Field Director for Regulatory Audit in Long Beach, California recently stated "We're going after penalties rather than just saying we'll take the loss of revenue." He emphasized the importance of compliance programs and training by noting "internal controls are your first line of defense."

Likewise, the U.S. Government agencies charged with enforcing export control laws are also operating in a new age of enforcement, largely in response to SOX. The bottom line is that companies need to implement systems that can detect and prevent material errors in compliance. This is especially true regarding potential issues that can have severe consequences to your company's bottom line.

And, in addition to being in place, those processes must:

- Establish the proper control environment,
- Ensure proper risk assessment,
- Include control activities,
- Have adequate information and communication
- Include supporting documentation, and
- Involve regular monitoring.

It's a tall order, but virtually a necessity in today's trade environment.

Practical Implications

- The Down Hill Principle
- Requires YOUR renewed focus on
  - Systems
  - Controls
  - Disclosure Requirements
- Is your Customs Department Ready ?

VENABLE LLP MILLAR KREKLEWETZ LLP

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

CANADIAN SOX – PARALLELING THE U.S. AGAIN

Canadian Securities Regulators' Response to Sarbanes-Oxley

For Canadian public companies, there are – surprise surprise – also new corporate governance obligations paralleling the U.S. *Sarbanes-Oxley Act* ("SOX").

Specifically, and in response to the U.S. SOX initiative, all Canadian provincial and territorial securities regulators have adopted *Multilateral Instrument 52-109 Certification of Issuers' Annual and Interim Filings* (the "Instrument") into their own particular rules or regulations.

The Instrument essentially parallels the SOX disclosure requirements for annual report certification, which for Canadian purposes we review in the following section.

Review of SOX Annual Report Certification

As indicated, the SOX requires both the CEO and CFO of a publicly-trade company to certify that:

1. they have reviewed the report being filed;
2. their quarterly and annual reports do not contain any untrue statements or material facts, or omit any material facts, and
3. the financial statements fairly present the financial condition of the company.

From the perspective of customs obligations, these SOX requirements are relevant because trade violations may directly affect a company's financial well-being.

Thus the conclusion that where material, a CEO and CFO of a publicly-trade company will be required under SOX to disclose any material import, export, and trade issues in the company's financial reports, even though, historically, disclosure has been of a voluntary nature.

Under the Instrument, the concern is that the same disclosure obligations would arise, as discussed below.

Canadian Certification of Filing Rules

The Instrument took effect March 30, 2004 and has since been adopted by various of the Canadian Securities Administrators as either a rule or regulation.

One sees that the Instrument requires the CEO and CFO of an "issuer" to file annual and interim certificates certifying that:

1. They have reviewed the filing;
2. The filing does not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement that is not misleading;
3. The financial statements and other financial information included in the filing fairly present in all material respects the financial condition, results of operations and cash flows of the issuer; and
4. That certain requirements with respect to disclosure controls and internal controls over financial reporting are met.

(Note that there is an exemption under the Instrument for issuers who have already complied with the annual report certification requirements under SOX.)

Disclosure Requirements

The companion policy to the Instrument (the "Policy") elaborates on the disclosure obligations with regard to financial statements and other financial information.

Notably, "fair presentation" is not limited to compliance with the issuer's GAAP.

According to the Policy, fair presentation includes:

- disclosure of financial information that is informative and reasonably reflects the underlying transaction; and
- inclusion of additional disclosure necessary to provide investors with a materially accurate and complete picture of financial condition, results of operations and cash flows.

The financial condition of the issuer encompasses a number of factors, including current and future considerations, events, risks or uncertainties that might impact the financial health of the issuer's business.

What Can You Do ?

Insist On:

- Proper Systems and Controls
- Proper Policies & Procedures Documents
- Sufficient Resources for External Assessment & Assistance

VENABLE LLP MILLAR KREKLEWETZ LLP

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 customs obligations are known (e.g., past errors and future mandatory correction obligations per section 32.2 of the *Customs Act*), they must be disclosed.

Similarly, and as the situation under SOX, it would appear that a company would be required by the Instrument to disclose in its filings material information regarding material import, export, and trade issues.

EXAMPLE:

Facts. A Canadian gas company ships natural gas from Western Canada to Eastern Canada via the U.S. Great Lakes Pipeline, and determines, in light of recent industry audit activity, that it has been getting its reporting wrong at the Canadian border point in St. Clair, Ontario. The value of the year's exports and imports is $200 M, and the situation has been on-going for 5 years.

Situation A: Assume there is a positive correction obligation (because they have incorrectly used "Canadian goods returned" as the appropriate tariff class.

Analysis: Corrections are required within 30 days, and would require payment of GST (duty rate is nil), plus requisite interest on the GST, for each of the past four (4) years. While the GST is refundable, the interest cost alone could reach $5 million. Even if corrections are made it is uncertain whether the interest would be waived on a "GST wash" transaction policy.

If no corrections are made, an AMPS penalty for failure to make the correction is potentially applicable, and an AMPS penalty for failure to remit the duties, GST and interest, is potentially applicable. The AMPs penalties can reach 5% of the value for duty of the goods, per shipment, not to exceed a total of $25,000 per shipment.

Situation B: Assume the goods were not reported in the first place, such that section 32.2 does not technically apply.

Analysis: CBSA takes the position that the goods are subject to ascertained forfeiture,[1] putting at risk the entire value of the non-reported goods, plus GST, plus interest (which may be reduced, but only on payment of still significant penalties, sometimes equal to 3 times the duties, GST, and interest evaded, or in the best case, at least the interest value of the duties and GST evaded).

In either situation, one can see the potential materiality of the situation, and the practical requirement that the situation be dealt with head on. Otherwise the company officials that sign the annual reports will be liable under the applicable U.S. or Canadian corporate governance requirements.

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

Controls and Systems

Regarding the "disclosure controls and internal controls" requirement referred to above, the requirement is more specifically for the CEO and CFO to certify that they are responsible for establishing and maintaining "disclosure controls and procedures" and "internal controls over financial reporting", and that they have:

Audit-Proofing

- Your "hole card" for all of this ?

Importers and Exporters that follow this approach WILL have audit-proofed their businesses

VENABLE LLP MILLAR KREKLEWETZ LLP

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

1. Designed such "disclosure controls and procedures" to provide "reasonable assurance that material information relating to the issuer, including its consolidated subsidiaries," is made known to them by others within those entities;
2. Evaluated the effectiveness of these disclosure controls and procedures (and disclosed their conclusion regarding the effectiveness in the annual MD&A); and
3. Designed such "internal controls over financial reporting" to provide "reasonable assurance regarding the reliability of financial reporting" and the preparation of financial statements for external purposes.

For these purposes, "**disclosure controls and procedures**" is defined to mean controls and other procedures designed to provide reasonable assurance that information required to be disclosed in filings is recorded, summarized and reported within the time limits specified by securities legislation. (This includes controls and procedures to ensure that information required to be disclosed is "accumulated and communicated" to the issuer's management, as appropriate to allow timely decisions regarding required disclosure).

Similarly, "**internal controls over financial reporting**" is defined to include polices and procedures that pertain to the maintenance of records that accurately and fairly reflect the transactions and dispositions of the assets of the issuer, and provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with the issuer's GAAP.

Note that Instrument also requires that the certifying officers certify that they have caused their issuer to disclose in the issuer's MD&A any change in the issuer's internal control over financial reporting that occurred during the issuer's most recent interim period that materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

Finally, and as a **transitional measure,** the certification requirements in regard to internal controls over financial reporting do not apply to annual and interim certificates filed for financial years ending on or before June 29, 2006.

Enforcement

There does not appear to be anything in the Instrument itself regarding penalties for failing to comply with the Certification requirements.

Rather, and as indicated in the Companion Policy, it appears that the CEO/CFO liability for false certificates (or omitted certifications) would come under quasi-criminal, administrative or civil proceedings under the particular Securities Act for the particular province.

Officers providing false certification could also potentially be subject to private right of actions for damages at common law (or civil law in Quebec). In addition, some Securities Acts (Ontario being the best notable example), include similar private rights of action in their own Securities Acts.

Enforcement provisions relative to the Instrument for each of British Columbia and Alberta are reviewed in the respective sections below.[2]

British Columbia

B.C. adopted the Instrument on September 19, 2005, after all the other provinces had done so.

The Instrument was adopted and effectively remade for B.C. enforcement purposes under the authority of section 184 of the British Columba *Securities Act* (the "BCSA"), which permits the B.C. Securities Commission to make rules for the purpose of regulating trading in securities or exchange contracts, or regulating the securities industry or exchange contracts industry.

(Under the BCSA, commission rules are generally considered to be regulations under the Act.)

LINDSAY B. MEYER
ROBERT G. KREKLEWETZ

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

Liability for False or Misleading Statements

Accordingly, and pursuant to section 168.1, false or misleading statements – including those in any record required to be filed – are prohibited (subject to due diligence and lack of knowledge):

> **False or misleading statements prohibited**
>
> 168.1 (1) A person must not…
>
> (b) make a statement or provide information in any record required to be filed, provided, delivered or sent under this Act or the regulations that, in a material respect and at the time and in light of circumstances under which it is made, is false or misleading, or omit facts from the statement or information necessary to make that statement or information not false or misleading.

Note that annual or interim certificates are considered records required to be filed under the regulations.

Under section 155, it is an offence to contravene certain provisions, including section 168.1, above. Therefore, making a statement or providing information in a certificate which is false, or misleading, or omit facts from the statement or information necessary to make that statement or information not false or misleading is an offence.

Penalties for misleading statements are as follows: for a company, a a fine of not more than $1 million; for an individual, a fine of not more than $1 million, or imprisonment for not more than 3 years, or both.

Note that if a company commits an offence, any employee, officer, director or agent of that company who authorizes, permits or acquiesces in the offence is regarded as having committed the same offence (whether or not that company is convicted of the offence), and liable for prosecution as an individual.

Administrative Penalties

The Securities Commission may also levy administrative monetary penalties (also "AMPs") of up to $500,000 (company) or $250,000 (individual) for contravention of the Act or it regulations or failure to comply with a decision made under the Act (the Commission may also apply to Court for certain orders under section 157).

Such AMPs are civil fines in nature, and do not require the same level of criminal culpability as would a prosecution for a misleading statement; in effect, they are easier to levy, and harder to avoid.

Private Rights of Action

Finally, note that the BCSA does not presently provide for a statutory civil right of action in respect of continuous disclosure obligations (such as annual and interim filings or annual and interim certificates). There is, however, potential civil liability (damages or rescission) for misrepresentation made in a prospectus, offering memorandum, or circular (sections 131 – 132.1) (subject to certain defences).

Alberta

The Instrument was adopted by the Alberta Securities Commission as a rule, although given that the Alberta *Securities Act* (the "ASA") defines "regulations" as including "rules", the Instrument has the legal status of a "regulation" in Alberta, and part of Alberta's securities laws.[3]

General Liability for Contraventions of the ASA

Pursuant to subsection 194(1) of the ASA, a person or company who contravenes "Alberta security laws" is guilty of an offence.

The penalty for offences under the Act is $5,000,000, or to imprisonment for a term of not more than 5 years less a day, or both.

Directors and officers who authorize, permit or acquiesce in the commission of the offence are also liable to the same penalty (subsection 194 (3)). The Alberta Securities Commission may also levy AMPs of $1,000,000 for each contravention or failure to comply with securities law (the Commission may also apply to Court for certain orders).

Liability for False or Misleading Statements

The ASA does not otherwise appear to address public filings as specifically as the BCSA does although it might be generally concluded that given that the ASA prohibits the making of misleading or untrue statements, which would arguably include the filing of a certificate that is misleading or untrue, coverage is obtained through the ASA's misleading statements provisions as well:

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

92 (4.1) No person or company shall make a statement that the person or company knows or reasonably ought to know

(a) in any material respect and at the time and in the light of the circumstances in which it is made,

(i) is misleading or untrue, or

(ii) does not state a fact that is required to be stated or that is necessary to make the statement not misleading, and

(b) would reasonably be expected to have a significant effect on the market price or value of a security or an exchange contract.

Note that this offence is subject to a due diligence defence under subsection 194(2). Also note that section 146 requires that an issuer disclose material changes as provided under the regulations.

Private Rights of Action

The Act also provides for civil liability (damages or rescission) for misrepresentations in a prospectus, offering memorandum, or circular. Again, there does not appear to express civil liability for misrepresentations in Certificates or annual or interim filings, although common law remedies would presumably be available.

SOX Implications & The Modern Customs Act

Whether intended or not, the recent attention to corporate governance obligations has a direct effect on customs professionals, and the customs department of any public organization.

The *Customs Act*'s "mandatory disclosure" provisions (see Part II of the Presentation for a Review of the Canadian Requirements, and Part III of the Presentation for a Review of the U.S. Requirements), coupled with potential AMPs penalties for non-compliance, have put customs obligations front and centre for all to see.

Whether the source of the potential customs exposure is the application of the Mandatory Disclosure requirements, the potential imposition of AMPs penalties, or the potential imposition of more serious enforcement action like Ascertained Forfeitures – or similar exposure and sanctions emanating from South of the border – the fact remains that the existence of the exposure may be material, and may be required to be specifically disclosed per corporate governance requirements.

This imposes an independent primary obligation on importers or exporters to deal with and disclose obligations.

Keeping this information hidden, or accepting internal pressures to adopt a "do nothing, heads down" approach is not legally permissible.

SECTION II -
SELF HELP REMEDIES:
DOCUMENTING & ASSESSING YOUR SYSTEMS

What to Do ?

Fortunately the answer to the quandary that many customs officials will find themselves, is the development of internal monitoring and reporting procedures, which will help police customs compliance (on a pro-active rather than reactive basis), and ensure that material errors and omissions are brought to the attention of the appropriate up-the-chain officials.

The Basics of Systems Controls

While most readers will have familiarity with at least some control structures in their own businesses, be they computerized programs dealing with all aspect of export or import controls, or a combination of electronic and manual processes, some documented, others not, the key to basis systems controls is, in our view, proper planning, structural implementation, and internal documentation.

Like the situation that importers (or exporters to Canada) face on a CBSA multi-program verification or in the U.S. under a Focused Assessment, primary attention ought to be paid to major program areas like origin, tariff classification, valuation, and in the U.S., country of origin marking.

LINDSAY B. MEYER
ROBERT G. KREKLEWETZ

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

Key Considerations

Consider the following issues in the following program areas:

For Origin Compliance

- Process for monitoring and determining when Certificates of Origin or Manufacturers Affidavits are required from vendors, or being issued by the business.
- *Where Certificate being relied on:* processes for ensuring contractual liability on the issuer for misrepresentations or errors; processes for ensuring requisite certificates on hand at time of importation, and kept as part of businesses record keeping obligations; processes for cursory review of each Certificate to ensure no obvious errors; processes for requesting and monitoring updates or error-fixes from issuers; processes for first level substantive sampling of key certificates obtained.
- *Where Certificate being issued:* processes for monitoring and controlling issuances of Certificates; processes for undertaking requisite origin analysis for all new goods; processes for re-determining (or double-checking) origin analysis for current inventory of goods, on periodic basis; other quality control issues.
- Processes for monitoring external legal changes to origin requirements.

For Country of Origin Marking Compliance

- Processes for determining the proper marking of an article and consistency with origin determination
- Processes for compliance with any repackaging certifications or notifications
- Processes for monitoring changes to country of origin determinations and effect on proper marking

For Tariff Classification Compliance

- Processes for determining responsible person, department or supplier for tariff rating.
- Process for monitoring and external assessment of tariff rating process by independent customs counsel.
- Process for monitoring application of appropriate rating guidelines to existing and new product.
- Processes for dealing with "one-off" situations.
- Processes for monitoring external legal changes to tariff classification requirements.

For Valuation Compliance

- Processes for vendor relationships (related parties? Consignments?)
- Process for determining applicable valuation methodology with each vendor relationship / product acquisition situation (i.e., transaction value may not always apply).
- Processes for determining existence of indirect payments for goods (royalties ? Subsequent proceeds ?)
- Process for determining existence of pre or post sale adjustments to pricing, and implications thereof.
- Process for reconciling invoicing quantum to final payment quantum, and monitoring of same.
- Processes for monitoring external legal changes to valuation requirements.

For GST Compliance

- Processes for obtaining requisite GST advice on import or export situation, and implementing appropriate GST systems.

For All Program Areas

- Processes for documenting all processes.
- Processes for communication and training on all processes
- Process for record-keeping and indexing all relevant supporting documents, and processes.
- Processes for periodic assessment of process requirements (and substantive requirements) by external customs counsel (subject to Solicitor-Client Privilege).

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

Additional Systems for CSA:

For CSA participants (and CSA Applicants), the notion of "systems controls" obviously extends beyond major program areas like Valuation, Origin, Tariff Classification, and GST Compliance, and to controls over the actual receipt, reporting and accounting function (that CSA moves from the border, to the importers back-room-staff, on an after-the-fact basis).

Accordingly, under CSA two additional systems controls must be established:

For border processing:

- The importer is required to identify all imported goods eligible for CSA clearance, and differentiate them from non-eligible goods, and communicate that to vendors, shippers, and carriers to ensure that non-eligible goods are reported and accounted for at the border.

For accounting, adjustment, revenue reporting, and payment:

- The importer requires a process to identify the date of release for eligible goods delivered to their own place of business and the place of business of the owner or consignee.
- A fundamental requirement is a process to ensure that imported goods are accounted to customs (i.e. a business system trigger for customs accounting), including transmission of B3 trade information to customs by EDI (CADEX/CUSDEC).
- Monthly reporting systems (to replace the K84 billing process), summarizing amounts payable on Revenue Summary Form (RSF).
- Monthly payment processes for the actual amounts due.
- Self-Adjustment processes through usually EDI transmissions, and maintenance of an audit trail between the accounting for and adjustment of goods.
- Other systems for special situations, as for example, drawback situations, information changes situations, etc.

External Assessment Reviews

An integral part of any systems based approach to customs compliance, are controls systems on the actual customs compliance.

Control systems would include, in addition to the development and implementation of the processes referred to above, the periodic self-audit and verification of the systems to uncover potentially disclosable errors, and deal with them accordingly.

We have attached to these materials copies of Millar Kreklewetz LLP's and Venable LLP's self-assessment methodologies, each entitled "Pre-Assessment Review".

These approaches would be viewed as bare minimum requirements for any self-assessed control system.

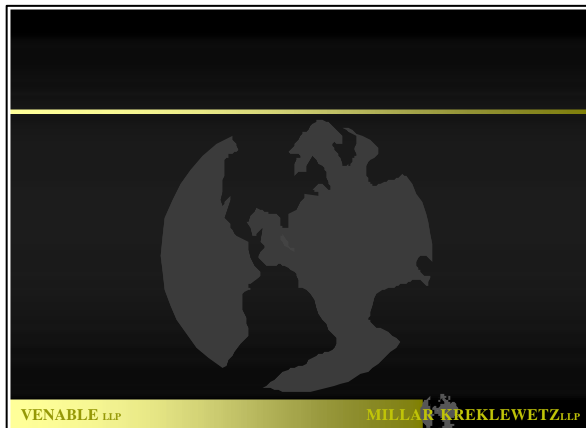
SECTION III - AUDIT-PROOFING YOUR COMPANY

CBSA'S AUDIT PRACTICE & USE OF MANDATORY CORRECTIONS

The implementation of Canada's mandatory correction system has changed the way in which Canada Customs does business, and has changed the focus of the CBSA audit.

Once a pure verification of import treatments for all past entries in the audit range (or at least a detailed sampling for that purpose, from every available audit year), the CBSA audit has transformed itself into a much more focused audit, in terms of sampling, and a focus on customs "compliance systems".

What one now receives is a "Final Verification Report" listing errors during the limited period under review, and a corresponding Detailed Adjustment Statement for any duty or GST implications, with the importer advised that the errors discovered constitute "reason to believe" that prior entries for prior periods are incorrect – requiring in CBSA's view, self-correction for prior periods, in accordance with section 32.2 obligations.



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
CANADIAN
MANDATORY CORRECTIONS SYSTEM

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").

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.

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

Scope. The requirements above yield an important observation. 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[1] or diversion).[2]

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.

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.

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

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.[3]

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 incorrect. 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.

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 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".

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".

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.

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.

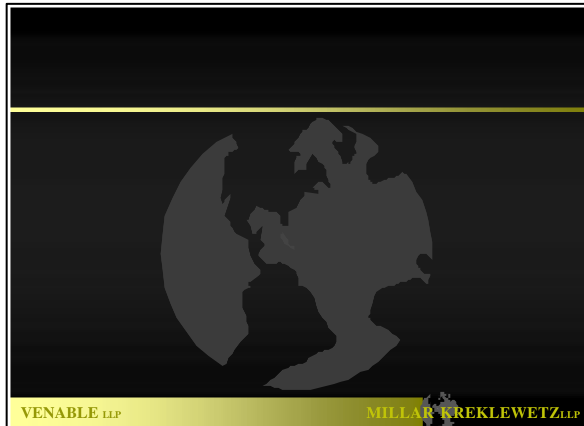
There is great debate on whether CBSA is correct in imputing this additional meaning to the words "reason to believe", and only time will tell whether the Courts will accept this additional gloss.

D11-6-6 also goes on to state that where there is conflicting information, there will not be a "reason to believe".[4]

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



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

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).

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.

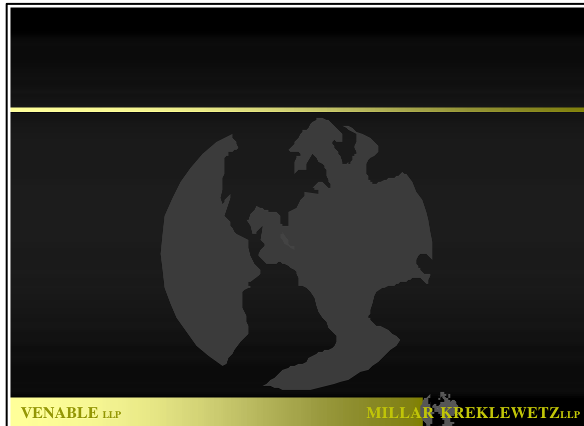
How Far Back Must the Correction Go

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.



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

29. In all other cases, 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. 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, the importer shall correctly account for the goods from the date of the report resulting from that audit or review. 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 from the date that they had "reason to believe" that the declaration was incorrect, rather than back to the date of the error.

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.

Four Year Limit. Pursuant to subsection 32.2(4) of the *Customs Act,*[5] 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).

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

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.[6]

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 and the Federal Court of Appeal), to the extent its objections were not dealt with satisfactorily.

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
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 to make entry 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, complete the entry 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

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. 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, 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:[1]

- 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.

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).

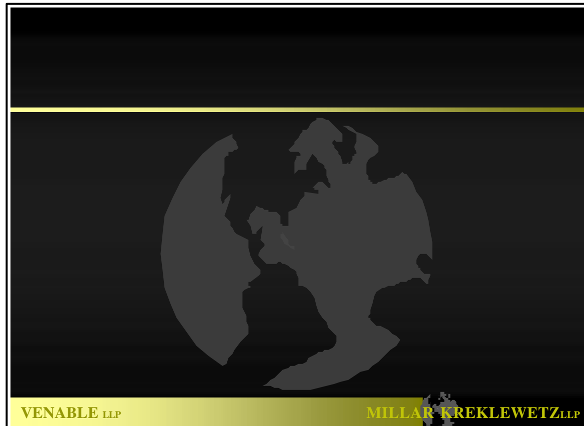
Therefore, if the Customs officer asks you specific questions regarding the issue, you may be charged with having knowledge that a formal investigation has commenced. And, if you then try to make a prior disclosure, it may be denied.

Generally, receipt of a Request for Information (Customs Form 28) or even a Notice of Action (including a Rate advance) (Customs Form 29) is not 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

ENDNOTES TO INTRODUCTION:

1. The CBSA, while operating for some time by prime ministerial order, received legislative authority for its creation on the Royal Assent of Bill C-26, *An Act to establish the Canada Border Services Agency (CBSA)* on November 3, 2005, and came into effect (by Order of the Governor in Council) on Decemb er 12, 2005.

   Under this enactment, the CBSA has now been officially established, joining the former border services functions of the Canada Customs and Revenue Agency (CCRA) with the same border functions formerly performed at each of the Canadian Food Inspection Agency and Citizenship and Immigration Canada.

ENDNOTES TO PART I :

1. 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. Note that the discussion that follows is a general discussion of securities requirements, and not meant to be relied on other than as background for this Presentation. If you have questions regarding B.C. or Alberta Securities Law, please consult an advisor that would specialize in these areas.

3. Moreover, pursuant to section 224, a rule made by the Commission under section 224 has the same force and effect as a regulation made by the Lieutenant Governor in Council. "Alberta securities laws" is defined to include the Act, the regulations and any decisions made by the Commission or the Executive Director. Therefore, it appears that the Instrument would be considered to be "Alberta securities laws."

ENDNOTES TO PART II:

1. See subsection 32.2(2) of the *Customs Act*.
2. On this point, see subsection 32.2(6) of the *Customs Act*.
3. See for example, *Aumann v. McKenzie* [1928] 3 W.W.R. 233.
4. 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.

5. 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).

6. 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*.

ENDNOTES TO PART II:

1. 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).