Nine Things for Corporate Counsel to Know about

Indirect Taxes

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ROBERT G. KREKLEWETZ

MILLAR KREKLEWETZ LLP

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

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

Extensive Commodity Tax, Customs & Trade Experience. Rob's practice 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. Rob's practice area also 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.

Tax & Trade Litigation. Tax & Trade Litigation is an integral element of Rob's practice, and Rob litigates tax and trade matters before all relevant bodies, tribunals and courts, including the Tax Court of Canada, Canadian International Trade Tribunal, Federal Court, Federal Court of Appeal, and Canada's various provincial Superior Courts and Courts of Appeal, and the Supreme Court of Canada. At MILLAR KREKLEWETZ LLP, we believe our "hands-on" tax and trade knowledge, combined with our litigation skill, gives us a competitive advantage. Rob's practice also includes planning and representation work before all government levels.

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

Speaking Engagements / Publications / Memberships. Rob has published over **350 articles and papers**, and spoken at over **125 conferences**.

Accordingly, Rob regularly addresses the Tax Executive Institute (TEI) – at its Annual Canadian and International Conferences, and at various provincial Chapter Meetings – and also speaks frequently before other organizations on like the Canadian Tax Foundation (CTF), Canadian & Ontario Bar Associations (CBA/OBA), Canadian Institute of Chartered Accountants (CICA), Certified General Accountants Association (CGA).

Rob also regularly addresses industry-specific associations like the Canadian Corporate Counsel Association (CCCA), Canadian Association of Importers & Exporters (CAIE), American Petroleum Institute (API), American Toy Industry Association (TIA), Canadian Finance and Leasing Association (CFLA), and the Canadian and U.S. Direct Sellers Associations (DSA). Rob is also a frequent speaker at other professional conferences held by organizations like the Strategy Institute, Infonex, IIR and Federated Press.

Rob is a regular contributor to the Tax Foundation's Tax Highlights publication, writing exclusively on commodity tax, customs & trade matters, and also contributes regularly to a number of other publications like Carswell's GST and Commodity Tax Reporter, the OBA's Tax Newsletter, Federated Press's Sales and Commodity Tax Journal, and the CAIE's Tradeweek publication.

Rob is a member of the OBA's Tax and International Law Executives, a member of the CFLA's Tax Committee, and Chair of the DSA's Taxation Committee. Rob is also a member of several federal and provincial consultation groups, consulting both with the federal Department of Finance, and the Ontario Ministry of Finance.

The Real Important Stuff – Unfortunately Left to the Bottom. Rob is married to Franceen, has a beautiful 8 year-old boy named William (the "Conqueror"), who has a 3 year-old little brother named Richard (the "Lion-Hearted").

While Rob concedes that Commodity Tax, Customs & Trade is truly scintillating, what he really enjoys is spending time with his family, playing golf with his boys, and attempting to finish at least one woodworking project he starts.

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".

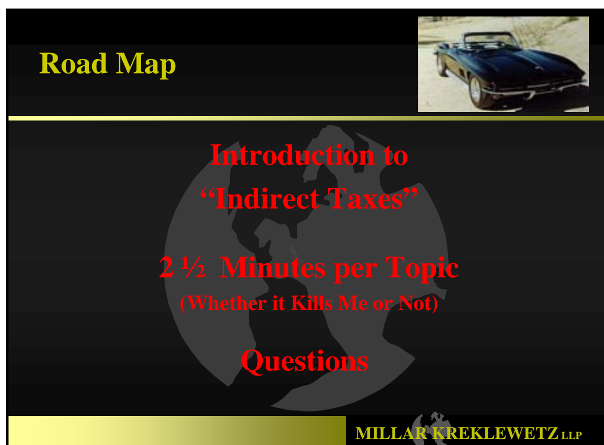
QUESTIONS ?

Please reach me 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



THE ROAD MAP

General Focus of the Presentation

Corporate Counsel by definition are often required to have a multi-disciplined approach to what they do. While some have the luxury of an expertise in a particular corner of the law, most will not count themselves as having any particular expertise (or even much practical experience) in the world of indirect taxes.

The presentation will focus on two things, as follows:

(1) Providing an overview (and good basic introductory written materials) to the world of commodity taxes (GST, provincial sales taxes), customs, and trade. To that end, Parts II and III of these written materials may prove to be a useful background resource for understanding each of Canada's GST, Retail Sales Tax, and Customs & Trade systems.

(2) Providing nine (i.e., by the time I sat down to commit all of this to paper and PowerPoint presentation, I gave up looking for ten topics, and settled for nine) practical points for Corporate Counsel to keep in mind when attempting to oversee or manage an indirect tax issue.

Accordingly, these "9 issues" are not meant to be comprehensive list of all the things you ought to know about indirect taxes, they will be a useful summary of the points that I see, in my experience, as some of the more important for Corporate Counsel to keep in mind.

Navigating Through the Materials

On the assumption that most Corporate Counsel will have only a rudimentary understanding of Indirect Taxes, these Materials are broken into several parts, as follows.

Part I is a narrative outline of the basic "nine" points to be made during the Presentation, and summarizes some of the points made.

Part II of the Materials is a comprehensive introduction to Canada's Commodity Tax Systems, including introductions to the GST, and the provincial sales tax systems in place in Ontario, British Columbia, Saskatchewan, Manitoba and PEI.

Part III of the Materials is a comprehensive introduction to Canada's customs and trade regime, including a review of the basic customs rules governing the importation of goods to Canada.

Questions ?

Questions are welcomed at any point during the presentation.

If you would like to discuss your question in private, please see me after the session, or contact me at the telephone or e-mail set out in the bottom left-hand corner.

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

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Web: www.taxandtradelaw.com

What the *&%% are "Indirect Taxes" ?

MILLAR KREKLEWETZ LLP

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Part I

Nine Things to Know about Indirect Taxes

What are Indirect Taxes

The first few slides of this presentation are meant to summarize the information in Part II (Introduction to Canada's Commodity Tax System) and in Part III (Introduction to Canada's Customs & Trade System).

Accordingly, please see the narrative in Parts II and III for the further detail on these few slides.

The materials will effectively begin, with Point No. 1.

1. The GST Rate Reduction Increased GST Exposure

As all readers will know, the GST was reduced to 6% effective July 1, 2006.

That is the good news for Canadian taxpayers, and was a highly publicized part of the May 2, 2006 Federal Budget. Less welcomed news, entailing other technical changes to the *Excise Tax Act* ("ETA") did not make as much news in the Canadian media, and will dramatically increase the cost of GST non-compliance, all as follows.

Currently, subsection 280(1) of the ETA imposes interest and penalty where a person fails to remit or pay an amount on time, as required under the ETA. The penalty is calculated at a rate of 6 % per year, and interest is imposed at the prescribed rate, on the amount not remitted. Beginning April 1, 2007, the interest and penalty provisions in subsection 280(1) will be replaced with a provision that only imposes interest-only, at a new prescribed rate, for the failure to remit or pay an amount on time. The prescribed rate of interest will be higher than the current prescribed rate, and will effectively include a 4% "penalty" bump up from the interest rate normally charged.

Currently, the payment of interest at a prescribed rate on late and deficient payments of GST and on GST refunds is determined by reference to the rate charged on 90-day Treasury Bills and adjusted quarterly (for the third quarter of 2006, this prescribed interest rate is 3.57 %). With the change on April 1, 2007, the new prescribed rate of interest will be as follows.

- For amounts payable to the Minister, interest will be calculated at the Treasury bill rate, rounded up to the nearest whole percentage, plus 4 %.
- For amounts payable to the taxpayer, interest will be calculated at the Treasury bill rate, rounded up to the nearest whole percentage, plus 2 %.

These changes will harmonize the interest rates that taxpayers will be paid, and will pay, on overdue amounts pursuant to the ETA, Excise Act, 2001, and the Income Tax Act.

While the change described above might be viewed as a positive change (i.e., elimination of the 6% penalty for a 4% increase in interest payable), the devil lies in the further details. Those details include changes, again effective April 1, 2007, which will make interest payable under the GST legislation (including interest payable under subsection 280(1)) non-deductible. (This interest has historically been deductible for income tax purposes.)

While the new rules will eliminate the automatic 6% penalty, other changes will see new section 280.1 added to the ETA to levy a penalty for late-filed returns, equal to 1 % of the outstanding balance, plus an additional 0.25 % per month for each complete month that the return is outstanding, to a maximum of 12 months. (These changes will apply to GST Returns required to be filed on or after April 1, 2007.)

Finally, the Minister's discretion to waive or cancel interest and penalties under section 280 (and new section 280.1) of the ETA will be limited to amounts that became payable in any of the preceding ten calendar years, with the changes again effective April 1, 2007. The Minister's current discretion to waive or cancel interest and penalties is unlimited in these respects.

By way of commentary, these changes will obviously increase the cost of non-compliance with the ETA, perhaps off-setting the ameliorative effects of the 1% reduction in the GST rate.

One remaining issue will be whether the introduction of a higher (punitive?) interest amount will allow taxpayers to claim a due diligence defence in respect of that higher interest. This defence of due diligence has been upheld by the courts to restrict penalties under subsection 280(1), provided certain criteria are met (Consolidated Canadian Contractors Inc. v. Canada, [1998] GSTC 91 (FCA).).

Indirect Taxes

- Essentially non-income taxes, including value added (GST) and retail sales taxes (PST), as well as custom & excise duties, and other similar charges.
- Practice Area essentially focuses on all of these.
- Focus Today: GST, PST, Customs & Trade

MILLAR KREKLEWETZ LLP

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Web: www.taxandtradelaw.com

However, this due diligence defence has only been upheld with respect to the penalty in subsection 280(1), and not for any interest imposed under that subsection. Nevertheless, if this higher interest amount is found to be "punitive" and in fact a penalty, it could plausibly be open for taxpayers to claim that the due diligence defence still applies under the principles in Sault Ste. Marie v. Canada, [1978] 2 S.C.R. 1299 (SCC).

2. The GST Actually Applies in 3 Different Ways

Please see Part II (Introduction to Canada's Commodity Tax System) of these Presentation Materials for the technical information underlying this point.

3. U.S. Has Difficulty Understanding GST

Please see Part II (Introduction to Canada's Commodity Tax System) of these Presentation Materials for the technical information underlying this point.

4. The RST remains the Wild Wild West

Please see Part II (Introduction to Canada's Commodity Tax System) of these Presentation Materials for the technical information underlying this point.

5. There's no such thing as "exempt custom software"

Ontario's Rules. Since computer programs are specifically defined to be "tangible personal property" they, as a general rule, fall to be taxed when sold in Ontario to a purchaser, pursuant to the general taxing provision in subsection 2(1) of the *Ontario Retail Sales Tax Act* (the "RSTA").

RST applies to the sale of taxable computer programs which includes leases, licences and right to use agreements.

Custom software is exempt pursuant to subsection 7(1)(62) of the RSTA, however, it is narrowly defined as software that has been "designed and developed to meet the specific requirements of the initial purchaser" and only in the circumstances prescribed in section 14.2 of Regulation 1012.

Subsection 7(1)(62) provides as follows:62. Computer programs designed and developed to meet the specific requirements of the initial purchaser, but only in such circumstances as the Minister may prescribe. A detailed review of section 14.2 of Regulation 1012 is recommended.

The September 2004 *Computer Programs & Related Services Backgrounder* indicates that a computer program will not qualify as custom if:

- the program is designed and developed for the use of more than one person;
- it is created using pre-written modules, unless the source code of the program is extensively modified;
- the intent at the time of development is to resell the computer program to others (e.g., the developer retains the rights to the new program for subsequent resale purposes);
- it is designed for a specific industry and sold to several purchasers;
- the same core program is used to develop a program for each customer, and only minor modifications are made to that program; or
- the program is developed for the use of several related subsidiaries (separate legal entities).

Where software is taxable, related services also become taxable (e.g., installation, configuration, etc.). Most taxable computer services are specifically defined in Regulation 1012 under the RSTA.

Where computer software is properly exempt, related services will be exempt as well.

Certain other services remain non-taxable in Ontario notwithstanding whether related to "taxable" or "exempt" software – all pursuant to subsection 1.1(3) of Regulation 1012:

(a) training with respect to the use of a computer program;

(b) advising users of a computer program;

(c) performing activities relating to the management of data;

Whirl Wind Tour of

GST

- In place Since 1991
- Vast improvement over Former Situation
- Comprehensive
  - Everything taxable unless exempt or zero-rated
  - Most transactions taxable (e.g., domestic, imported)
- Still Predominantly a Vendor Liability Tax

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(d) project planning, including the analysis of specifications, determination and verification of hardware and software prerequisites, scheduling, the preparation of reports, review of documentation and discussions of any kind; and

(e) testing a computer program, unless the testing is done in connection with a taxable service described in subsection (1) and the value of the taxable service exceeds 10 per cent of the value of the testing.

However, Ontario's position is that in order for these services to be non-taxable, they must be

- the only service provided, or
- provided only with non-taxable services, or
- not required in order to supply a taxable service.

Modifications. Note that Only modifications to source code will fall within the exemption for modifications in Ontario. This is quite a narrow definition given that most services provider do not actually make changes to source code. In practice, therefore, the modification rules in Ontario are of very limited application, and charges for configuring or installing software are generally all taxable.

On the other hand, Ontario does allow for the accumulation of modifications (occurring after June 19, 2002) in determining whether or not software has been transformed into custom software, including in-house modifications. Where there are in-house modifications, companies are required to maintain documentation regarding the original price paid for the software, the price of any third party and the cost of staff wages for in-house modifications, as well as documentation regarding the sequence of modifications that were performed by third parties and in-house.

De Minimus Rules & Bundled Sales. As another relieving mechanism, Ontario's regulations allow taxable and non-taxable services sold together for a single price to be treated as non-taxable if the taxable portion is equal to or less than 10 per cent of the non-taxable portion. Where, however, the taxable portion is more than 10 per cent of the non-taxable portion, then the charge for both is taxable.

Accordingly, when taxable and non-taxable services are sold together and the taxable portion is greater than 10 per cent of the non-taxable portion, the amounts must be unbundled (i.e., separated on the invoice) otherwise, PST will apply to the total selling price.

Transfers of Software. The resale of custom software is generally considered to be taxable unless sold as part of a business. Paragraph 14.2(2)(f) of Regulation 1012 provides for relief of PST for custom software (including off the shelf software that has been modified to become custom software) that is used in a business, where it is sold in a transaction in which the purchaser acquires all or substantially all of the business assets and will continue to carry on the business.

Otherwise, Ontario views subsequent sales of custom software as taxable, as it does the transfer of non-custom software.

It is worth noting, however, that pursuant to the related party transfer rules in section 13 of Regulation 1013, it appears that software (which is defined for purposes of the RSTA as tangible personal property) may be transferred between related parties on an exempt basis, provided that the conditions of section 13 are otherwise met.

6. No one Knows Nothing about Customs

Please see Part III (Introduction to Canada's Customs & Trade Systems) of these Presentation Materials for the technical information underlying this point.

7. If you discover customs deficiencies, you may be legally obligated to let Customs know !

Please see Part III (Introduction to Canada's Customs & Trade Systems) of these Presentation Materials for the technical information underlying this point.

8. Duty-free trade with the U.S. Comes at a price.

Please see Part III (Introduction to Canada's Customs & Trade Systems) of these Presentation Materials for the technical information underlying this point.

9. No one knows nothing about NAFTA

Please see Part III (Introduction to Canada's Customs & Trade Systems) of these Presentation Materials for the technical information underlying this point.

Whirl Wind Tour of
PST

- Traditional Means of Provincial Commodity Taxation
- Significantly Different Systems
- Tax Base:
  - "Tangible Personal Property"
  - Limited Defined Services
  - But an expanding Tax Bases

MILLAR KREKLEWETZ LLP

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ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

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

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

PART II

CANADA'S COMMODITY TAX SYSTEMS

OVERVIEW OF CANADA'S GST SYSTEM

Introduction

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

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

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

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

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

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

Division II & "Taxable Supplies Made in Canada"

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

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

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

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

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

Whirl Wind Tour of

Customs & Trade

- Customs: Regulation of import & export of goods
- The Big Three:
  - Tariff Classification
  - Origin
  - Valuation
- Trade: Other Cross-Border Issues & Remedies

MILLAR KREKLEWETZ LLP

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

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

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

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

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

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

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

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

CRA has recently released its new interpretation on the meaning of permanent establishment in GST Policy P-208R, *Meaning of Permanent Establishment in Subsection 123(1) of the Excise Tax Act (the Act),* (March 23, 2005).

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

Ten Things about Indirect Taxes

MILLAR KREKLEWETZ LLP

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

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

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

The CRA has recently re-vamped its interpretation of the phrase "carrying on business", and the attendant registration requirements in the ETA, effectively discarding any reliance on the traditional jurisprudential position referred to above, and imposing multi-faceted tests of its own. Readers are accordingly cautioned to approach the meaning of "carrying on business" with caution, and seek professional advice. The CRA's views are set out in GST Policy P-051R2, *Carrying on Business in Canada.*

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

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

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

Division III & "Imported Goods"

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

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

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

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

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

Newly proposed rules in s. 178.8 of the ETA (proposed by Notice of Ways and Means Motion on October 3, 2003) will significantly change the manner in which importers of goods to Canada will be entitled to claim ITCs for the GST paid under Division III of the ETA and, accordingly, importers are cautioned to seek professional advice on this question.

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

1

The GST rate reduction actually increased your GST exposure !

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

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

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

Division IV & "Imported Taxable Supplies"

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

Zero-Rating Provisions

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

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

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

> **Section 1: Exported Goods**. A supply of tangible personal property (other than an excisable good) made by a person to a recipient (other than a consumer) who intends to export the property where ...
>
> (b) upon delivery of the TPP to the recipient, the TPP is exported "as soon as is reasonable" having regard to the "circumstances surrounding the exportation", and having regard to the "normal business practice of the recipient",
>
> (c) the TPP is not acquired by the recipient for consumption, use or supply in Canada before the exportation,
>
> (d) after the supply is made, the TPP is not further processed, transformed or altered in Canada, "except to the extent reasonably necessary or incidental to its transportation".
>
> (e) the supplier of the TPP maintains evidence satisfactory to the Minster of the exportation by the recipient (or the recipient issues the supplier with a special s. 221.1 export certificate – see *infra*) indicating that all the conditions above have been met.
>
> **Section 12: Supply via Common Carrier.** A supply of tangible personal property where the supplier delivers the property to a common carrier, or mails the property, for export.

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

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

> **Section 5: Agents' and Manufacturers' Rep Services.** Agents' services are zero-rated when provided to a non-resident under s. 5 of the Export Schedule. Also zero-rated are services "of arranging for, procuring or soliciting orders for supplies by or to the person" -- which would seem to cover the "manufacturers' representatives" situation. In both instances, however, the services must be in respect of "a zero-rated supply to the non-resident", or a "supply made outside Canada by or to the non-resident".
>
> **Section 7: General Services.** A supply of a service is zero-rated when made to a non-resident person, but not in the case of the following services:
>
> (a) a service made to an individual who is in Canada at any time when the individual has contact with the supplier in relation to the supply;
>
> (a.1) a service that is rendered to an individual while that individual is in Canada;
>
> (b) an advisory, consulting or professional service

GST

Rate Reduction Increases Exposure

- **Public Image: Reduction in GST**
- **Reality: Suppliers more Fully Exposed**
- **As of April 2007:**
  - **"6% Penalty" changed to "super-interest" at plus 4%**
  - **New Late Filing Penalty: 1.25% of tax due/mth**
  - **Most Significant Change: Non-deductible interest**
  - **Other implications: No More Due Diligence ?**

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

(c) a postal service;

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

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

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

(g) a transportation service; or

(h) a telecommunication service.

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

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

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

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

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

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

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

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

OVERVIEW OF CANADA'S RST SYSTEMS

Introduction

Who Still Has Them. Only 5 of Canada's provinces still levy a stand-alone provincial RST (i.e., BC, SK, MB, ON and PEI).[10] Québec ("QB") has a system (the "QST") which is partially harmonized to the GST, while the Atlantic provinces of Nova Scotia ("NS"), New Brunswick ("NB"), and Newfoundland & Labrador ("NF") have a fully harmonized system, incorporated into the *ETA* (the "HST").

Alberta ("AB") and Canada's two territories do not presently employ retail sales taxing systems.

Broad Comparisons. If broad comparisons can be drawn, these RST systems are "old generation" systems, and ancestors of the more recent attempts by Québec and the Atlantic Provinces (NS, NB, and NF) – to implement partially and fully harmonized systems. To understand how the "old generation" RST systems work, it is useful to consider both where they came from, and why they evolved the way they did.

Where did they Came From ? – The Historical Background. Retail sales taxes grew out of the economic depression of the 1930s, and were a product of the needs for greater tax revenues to fund increasing need for social programmes.

Interestingly enough, the first RST system was neither federal or even provincial: it was a municipal sales tax initiative, implemented by the City of Montreal, on May 1, 1935, which applied a 2% tax on tangible personal property ("TPP"). Within the year, however, Canada's provinces followed suit, with Alberta being the first to enact a provincial system, on May 1, 1936. (Unfortunately for Alberta, its RST system proved so unpopular, it was repealed less than two years later, and never replaced). Other provincial initiatives were somewhat more successful, with Saskatchewan implementing a system on August 2, 1937, Québec imposing a 4% tax on July 1, 1940, BC imposing a tax on July 1, 1948, New Brunswick on June 1, 1950, and Newfoundland by November 15, 1950. PEI and Nova Scotia waited until January 1, 1959 and July 1, 1960, respectively. Ontario and Manitoba became the last provinces to implement RST systems, with Ontario's tax applying on September 1, 1961, and Manitoba's applying on June 1, 1967.

2

The GST actually applies in 3 Different Ways – and sometimes TWICE.

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

Why Did They Evolve the Way They Did ? – Some Constitutional Limitations. In understanding how current RST systems operate, it is useful to observe that each system evolved within constitutional limitations imposed on the provinces by s. 92(2) of the *Constitution Act, 1867* – formerly the *British North American Act.*

Constitutionally, provinces are limited to "Direct Taxation within the Province in order to the raising of the Revenue for Provincial Purposes".

Understanding the scope of the limitation is useful. "Direct taxation" is generally accepted as a tax imposed on the person who will ultimately bear it, and was set out by the economist John Stuart Mill's as follows:

> Taxes are either direct or indirect. A direct tax is one which is demanded from the very persons who, it is intended or desired, should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another: such as the excise or customs ... Direct taxes are either on income or on expenditure ...

While a number of constitutional decisions were taken on a number of provincial attempts to tax such things as fuel and tobacco, one of the more important was the Privy Council's decision in *Atlantic Smoke Shops Ltd. v Conlon*, (1943) A.C. 550. The Court had to consider the constitutionality of New Brunswick's tax on purchasers of tobacco, and then set out the following standard for assessing an indirect or direct tax:

> It is a tax which is to be paid by the last purchaser of the article, and, since there is no question of further resale, the tax cannot be passed on to any other person by subsequent dealing. The money for tax is found by the individual who finally bears the burden of it. It is unnecessary to consider the refinement which might arise if the taxpayer who has purchased the tobacco for his own consumption subsequently changes his mind and in fact re-sells it. If so, he would, for one thing, require a retail vendor's licence. But the instance is exceptional and far-fetched, while for the purpose of classifying the tax, it is the general tendency of the impost which has to be considered.

Thus the crux of the matter fell to determining whether the "general tendency" of the tax was such that it would be borne by the person on whom it was imposed. Not surprisingly, the constitutional validity of a "retail sales tax" was eventually upheld by the Supreme Court of Canada ("SCC").[11]

> **Example.** A simple example of a "indirect tax" would be one imposed on a good that was purchased *for resale*. Since the initial purchaser (e.g., a wholesaler) would be taxed, but would also be generally expected to resell the TPP, and recover that tax in its purchase price, there could be seen to be a general tendency that the tax imposed on the wholesaler would be passed and borne by a another person (i.e., the retail purchaser). That fact makes the tax an "indirect" one – and one which none of the Provinces are constitutionally capable of levying.[12] It was probably with this concern in mind that Quebec – when making the transition from its *Retail Sales Tax Act* to its now partially harmonized QST – decided to employ the concept of "non-taxable supplies" for the purpose of recognizing instances where a provincial tax ought not be the charged on purchases acquired by businesses for purposes of resale. The concern was likely that if the QST were imposed on these purchases, it might well be considered a indirect tax – even though businesses would be entitled to a refund of the tax paid on most of their inputs.

Inter-Jurisdictional Comparisons

The following description discusses in general how the existing RST systems operate. While an attempt has been made to canvass all existing RST systems at every stage, there is an obvious focus on the RST system currently in place in Ontario.

What are their Common Concepts ? It was only with reference to this base constitutional jurisprudence that Canada's "old generation" RST systems were formulated. Accordingly, it is not surprising that each of the remaining five RST systems have a number of very common elements – many of which can be directly related to their constitutional antecedents. What are some of the common elements ?

First and foremost, one sees that all of the RST systems are (1) aimed at imposing taxes on *the final consumer or user* of the property or services being taxed. Thus while there may well be significant differences between the structures of the taxing systems,[13] or the tax bases or the tax rates, each RST system can be seen to apply a tax at the "consumer" and "user" level .[14]

GST

U.S. Has Difficulty Understanding GST

- Division II – Domestic Transactions
- Division III – Imports
- Division IV – Special Situations

- Allows for Double-Tax Situations
- Special Rules for Special Situations

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

If other generalizations can be made, most RST systems also (2) apply only if the TPP or taxable services are acquired within the province for "consumption" or "use" within the province, or acquired elsewhere, but brought into the province for consumption or use therein; (3) levy the tax directly on the retail purchaser/consumer, but require "collection" of the tax by vendors, as "agent" of the province, and under threat of "penalty" for non-collection; (4) contain either special exemptions for purchases for "resale", or leave these untaxed in the first place; and (5) contain special rules for determining other applicable exemptions.

How do they differ from the QST & GST/HST ? – Some Principal Differences. While the RST systems have some commonality, there are two main differences between these systems and their QST or GST/HST counterparts: the *comparatively narrow* tax base used by the RST systems, in comparison to their QST or the GST/HST counterparts; and over-all focus of the tax and provisions made for universal credits for business inputs.

Narrower Tax Bases. The most obvious is the differences in the respective tax bases. While the QST and GST/HST are all-encompassing taxes, the RST systems are aimed at comparatively narrow tax bases. For example, the GST/HST is levied on virtually all tangible personal property ("TPP"), intangible personal property ("IPP"), real property, and services.

On the other hand, the various RST systems are usually aimed at levying tax on transactions involving only TPP, and certain specially defined "taxable services". (Saskatchewan's recent expansion of its tax base to include a large number of specifically defined "taxable services" has now become the exception to this general rule).

Having said that, these provinces generally employ an all encompassing definition of TPP (see *infra*) which is capable of not only capturing virtually all TPP, but what might otherwise be conceived of as a service, and even some IPP.

For example, each RST system now attempts to tax computer software. In terms of the specially defined "taxable services", most provinces attempt to tax services related to TPP (e.g., like services to install, assemble, dismantle, repair, adjust, restore, recondition, refinish, or maintain TPP), as well as certain other special-nature services.

Focus of the Tax & Treatment of Inputs. The second difference between the QST/GST/HST model and the various RST systems lies in the overall focus of the taxes, and the consequent treatment of business "inputs".

While the GST/HST, for example, is a multi-stage value-added tax, with a comprehensive system for taxing the value-added at each stage of the production process, and crediting tax paid at earlier stages of that process (e.g., through ITCs), the RST systems are aimed at (theoretically) imposing the RST only on the ultimate consumer of the taxable good or service. In other words, these systems attempt to create a "single incidence" tax. This poses a problem for business inputs, since situations arise where a business may be paying the RST on its business inputs, and then charging and collecting the RST again on the value of its production. Absent rules to "remove" this cascading of tax, the final manufactured product may well bear double and triple layers of tax.

While each RST system has some rudimentary rules providing for some limited exemptions (e.g., an exemption where TPP is purchased for "resale"), these rules are nothing like the "universal" ITC system available for commercial businesses paying the GST. Thus while the GST system ensures that every Canadian consumed good, service or intangible bears, at the most, a 7% GST component, the effective rate of RST imposed on fully manufactured Canadian TPP may be much higher than the stated provincial rate. Even more troubling, to the extent there is RST imbedded in manufactured TPP, the TPP will carry that RST even when exported from Canada.

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Your parents have great difficulty understanding the GST

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Example of Cascading RST. Consider Kco, an Ontario woodworking business, which builds and sells custom-made children's beds – miniature four-posters, in fact. Assume 10 beds are produced each year and sold for $1000 each, ultimately yielding $800 in Ontario RST (8% times $10,000).

To manufacture the beds, Co purchases a number of raw materials, which can be purchased exempt of Ontario RST, as well as a taxable desk and computer for $5,000, paying an additional $400 in Ontario RST. Assuming that the RST paid on the inputs is reflected in the final selling price of the beds, the effective rate of Ontario RST on the beds is much higher than 8%, perhaps approaching 12% in this simplistic example. One effect of this "cascading" of tax is to make Kco susceptible to competition from manufactures in other jurisdictions (e.g., the Harmonized Provinces) who might be entitled to ITCs for the RST paid on their business inputs, enabling them to sell their beds on a cheaper basis.

While all the taxes are at least theoretically aimed at imposing the tax burden on the ultimate consumer of a taxable item, the manner in which that is accomplished is much different across the various systems. This is markedly different than the GST/HST system – and, for that matter, the QST system – which generally affords universal input tax credits/refunds for most business inputs.

Imposition of the Tax – The "Charging Provisions". RST is generally imposed by virtue of an all-encompassing "charging provision", like that found in s. 2(1) of the Ontario Act:

> 2.(1) *Tax on Purchaser, of [TPP]* — Every *purchaser* of *tangible personal property*, except the classes thereof referred to in subsection (2), shall pay to Her Majesty in right of Ontario a tax in respect of the *consumption* or *use* thereof, computed at the rate of 8 per cent of the *fair value* thereof.
>
> *Charging provisions in the other RST systems are found in ss. 5 and 6 of the BC Act; s. 5 of the SK Act; s. 2 of the MB Act; and s. 4 of the PEI Act.*

While not entirely obvious, the addition of specially defined words, like those in *italics* above, make such charging provisions incredibly encompassing. In Ontario, s. 1 of the Ontario Act defines, among others, the following words:

> *TPP*, to mean just about anything that can be touched: "personal property that can be seen, weighed, measured, felt or touched or that is in any way perceptible to the senses and includes computer programs, natural gas and manufactured gas".
>
> *Purchaser,* to mean not only (a) a "consumer or person who acquires [TPP] anywhere", but also persons (b) acquiring TPP for the benefit of some other person, and (c) certain persons acquiring TPP for purposes of promotional distribution. Until recently, "purchaser" also included persons acquiring a taxable service at a sale in Ontario in order to fulfil warranty or guarantees or other contract for the service, maintenance or warranty of TPP.
>
> *Consumption* and *use,* to include all concepts of use, and the incorporation of something into another thing.
>
> *Fair Value,* to capture virtually every type of payment that could be expected to pass from a purchaser of TPP or services to the person from whom the TPP or services were acquired.

Sometimes definitions of certain words are contained in regulations underlying the particular legislation. Thus, for example, Ontario's Reg. 1013(1) helps define TPP by excluding things like gold and silver in their primary forms. Ontario is particularly notorious for hiding important definitions in regulations, and one can also find special definitions for "manufacturer", "contractor", "food products", and a number of other important terms.

Treatment of Certain "Taxable Services" & Specially Taxed Items. Each RST system taxes more than simply TPP. Some define a whole host of "taxable services", which in Ontario include, for example, most (i) telecommunication services, (ii) labour provided to install, assemble, dismantle, adjust, repair or maintain TPP, (iii) contracts for the service, maintenance or warranty of TPP. These are taxed at a rate of 8%, while "transient accommodation" is also defined as a "taxable service", but taxed at a special rate of 5%.

There are a number of other "specially taxed" items as well, with tax rates often much higher than the general 8% rate.

QUESTIONS ?

Please reach me 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

GST

U.S. Has Difficulty Understanding GST

- **Most U.S. persons have had little exposure to comprehensive value-added taxes.**
- **CRA "Carrying on Business" Concept capturing many Non-Resident Transactions**
- **Compartmentalize your Business**

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

For example, each of the following is subject to a special Ontario RST: liquor, beer and wine – s. 2(2); places of amusement – s. 2(5); "insurance premiums" – s. 2.1; "brew-your-own" beer and wine – s. 3.1; "new passenger vehicles or sport utility vehicles" – s. 4.1; "used motor vehicles" – s. 4.2; and the acquisition of a taxable service for the purpose of repairing, replacing, servicing or maintaining TPP under a warranty or guarantee or similar contract – s. 2.0.1. Like the case in BC and Manitoba, Ontario has now legislated a mandatory collections system for the RST exigible on items of non-commercial TPP accompanying returning residents to Ontario, as they cross the Canada-U.S. border.

In terms of the other RST systems, virtually all tax things like wine, spirits, and beer, telecommunications, and transient accommodation, but there are still some significant differences. BC and PEI tax "legal" and "professional" services, respectively, and Manitoba taxes certain types of "electricity".

As mentioned previously, Saskatchewan has recently taken this approach to an extreme, and now applies its RST against a wide variety of professional services.

Timing of the Tax. A pre-requisite of every valid tax is some indication as to when a validly imposed tax is *payable*. The general rule in most RST systems is that the tax is payable at the time of the sale, and Ontario's rule is found in s. 2(6) of the *RSTA*:

> 2(6) *When Tax Payable* — A purchaser shall pay the tax imposed by this Act at the time of the *sale*, or the promotional distribution of an admission.
>
> *Timing provisions in other RST systems are s. 5 of the BC Act; s. 5 of the SK Act; s. 2(2) of the MB Act; and s. 7(1) of the PEI Act.*

Sale is, like the other terms defined in s. 1 of the Ontario Act, defined in the broadest sense, and includes, in the case of TPP, "any transfer of title or possession, exchange, barter, lease or rental, conditional or otherwise, including a sale on credit or where the price is payable by instalments, or any other contract whereby at a price or other consideration a person delivers to another person [TPP]".

In the case of a "taxable service", *sale* is the "provision of any charge or billing, including periodic payments, upon rendering or providing or upon any undertaking to render or provide to another person a taxable service". Thus the general rule becomes as follows: tax is usually payable up-front.

Timing of RST on Leases. A special "timing" rule is usually found for leases of TPP which, by their very nature, do not involve the up-front acquisition of property. In most RST systems, the rule is like that found in s. 2(7) of the Ontario Act, with tax payable at the time of the rental payment, or other consideration paid under the lease as, for example again in Ontario, the payment on the exercise of a "purchase option".

Amounts Included in the Tax Base. The existing RST systems use one of three measures for determining what amounts are taxed: the "fair value" standard in MB, ON, PEI; "value" in Saskatchewan; and "purchase price" in BC.

While there are a number of legislative "additions" to each of these terms (usually making it necessary to review each definition), some generalizations can be drawn.

GST. First, unlike the situation in Quebec – where GST is included in the QST tax base – GST is not generally included in any sales tax base in existing RST systems (the only exception being PEI). Each RST system does include all other federal customs or excise duty in its tax base, however.

Financing Charges. So long as financing charges are broken out (e.g., "unbundled") in the price or invoice for taxable TPP or services, they are not required to be included in the sales tax base in any of the existing RST systems. Where bundling of financing charges is occurring, tax will generally apply on the whole amount being charged for the taxable TPP or services, including the bundled financing charges.

4

The RST remains the Wild Wild West

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

Delivery Charges. The tax status of delivery charges across the RST systems is rather complex. Most other RST systems (e.g., BC, SK, MB) will require RST to be charged on any delivery charges made in respect of TPP sold on a "delivered basis" (i.e., "FOB purchaser"), but allow for some relief for delivery charges in respect of TPP sold on an "FOB vendor" basis. (In some cases, as in SK and MB, delivery charges for FOB "vendor" sales are taxed if the TPP originates from outside of the particular province). Ontario taxes virtually all types of delivery charges, whether or not broken out, and whether or not the sale is made FOB "purchaser" or "vendor".

Installation Charges. Most RST systems tax installation charges, whether bundled with contract prices for taxable TPP, or broken out separately. This is generally accomplished by defining such installation to be a "taxable service" in its own right. Saskatchewan, which was once the only province not to include installation as a "taxable service", recently moved to close that loop-hole, and now defines "repair and installation services" among the various "taxable services" that it began to tax as part of its 2000 budget.

Treatment of "Trade-ins". A number of RST systems, like that in Ontario, Manitoba and PEI allow "trade-ins" of TPP to reduce the tax base of the new TPP sold. BC and Saskatchewan do not allow for that treatment, although BC does allow limited "trade-in" treatment on purchases of "passenger vehicles." Where relief is available, some special rules and conditions would generally apply.

> *For SK's administrative prohibition for Trade-In see s. 8(14) of the SK Administrative Guides.*

Temporary Imports. Most RST systems have special rules for TPP that is temporarily imported to the province. Since the general importation rules would require a self-assessment of RST on the full value of the imported TPP (see *infra*), these "temporary import" rules are relieving in nature, and usually result in a partial taxation of the imported TPP.

While the rules may differ, each of the other RST systems offer this same type of relief, and generally tax the TPP by applying 1/36 of its value to the regular tax rate, for each month the TPP is employed in the province.

In Ontario, for example, if TPP is imported for less than 12 months, tax is payable on a tax base equal to the "net book value" of the TPP, divided by 36, and is payable each month the TPP is present in Ontario.

Where equipment is leased, the RST systems generally attempt to tax the equipment on the basis of the lease payments being made.

> *Temporary importation rules for other RST systems are in s. 11 of the BC Act and Reg. 2.38; s. 5(9.1) of the SK Act and Reg. 1(17.3); s. 17 of MB Reg. 75/88R; s.2(21) of the Ontario Act and Reg. 1012(15.4); and s. 37 of PEI Reg. EC262/60.*

Most of the RST systems also deal expressly with the temporary importation of "big ticket" items like aircraft, railway rolling stock, and inter-provincially used transportation equipment. (In some systems, some of these items are completely exempt).

Exemptions. Each RST system imposes its own distinct set of exemptions. There are some commonalties among the exemptions afforded by the various RST systems, with the two most important ones being for *TPP purchased for resale* and *TPP delivered outside of a province by a vendor.* These exemptions exist for obvious constitutional reasons since in the absence of a "resale" exemption, the general tendency of the RST might well be interpreted as an "indirect" one; and in the absence of an exemption for TPP delivered "outside" a province, there might be some issue as to whether the RST was a direct tax "within the province". Some other exemptions that are generally common across each of the existing RST systems are as follows: [16]

> Books; food and beverages for human consumption; children's clothing and footwear; most motive fuels (for reason only that they are taxed under separate provincial systems); fuel oil; wood; certain pharmaceuticals and medical supplies (usually if prescribed); agricultural feeds and certain purchases by farmers; raw materials and components for use in manufacturing; and catalysts and direct agents.

RST

The Wild Wild West

- RST issues and rules often esoteric; not obvious
- Jurisprudence still really "non-existent"
- Ontario has an impossible appeals process
- Higher premium on Planning & Audit Management

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

Some notable exemptions specific to particular provinces are:

> BC: human organs, tissue, and semen; portable buildings manufactured and sold in the province for non-residential use; prescribed energy conservation equipment and materials; prototypes; repossessed TPP on which tax has been paid; 2-wheel bicycles; vitamins and dietary supplements; and, since 2001, production and manufacturing equipment.
>
> SK: beer, wine, and spirits; mail order records, cassettes, and tapes when purchased by subscription; and prototypes for R&D purposes.
>
> MB: flood control sandbags; private purchases of used TPP (except snowmobiles, aircraft and registrable vehicles); used furniture valued at $100 or less; and prototype equipment for mining
>
> ON: Gifts of cars between family members; liquor, beer, or wine purchased for consumption at a special event; R&D TPP; and production and manufacturing equipment.
>
> PEI: anti-pollution TPP; electricity production equipment; equipment to produce telephone service by telephone utilities; and production and machinery equipment.

Notably present in Ontario and British Columbia is an exemption for "production machinery and equipment". While Ontario was historically the only province to have afforded such an exemption, British Columbia announced a similar exemption as part of its 2001 budget, which change was effective July 1, 2001.

Exemptions by Nature of the Purchaser. Most RST systems have special exemptions by nature of the purchaser, although these are diverse. For example, the federal government (or related departments) is RST exempt in Saskatchewan, but taxable elsewhere. Similarly, provincial and municipal governments (including all departments, boards, and commissions) are generally taxable in all RST systems.

Some provinces, like Ontario, have special exemptions for certain TPP purchased by certain hospitals, and certain additional exemptions for certain types of hospital equipment, when purchased by a hospital.

Exemption Permits. Most RST systems require "purchase exemption certificates" ("PECs") to be provided by purchasers seeking to claim an exemption, whether the exemption be for "resale" or otherwise. In Ontario, the PEC can be included in the purchase order, letter or on Ontario's prescribed form, but must be signed by the purchaser. A customer may submit a single or blanket PEC, with blanket PECs valid for up to four years from the date of issue. The purchaser would make reference to the blanket PEC when making subsequent purchases of items which it covers. The customer's vendor permit number should generally be shown on the PEC. (Ontario does have the concept of a "G" permit holder, who are not required to issue PECs; all that is required is the G Permit holder provide the vendor with the G Permit number, although it might well be advisable for the vendor to obtain a copy of the permit.)

Vendor Registration & Collection Requirements. Each RST system creates a vendor-registration and vendor-collection system. Under these systems, a vendor selling taxable TPP or taxable services in the province is usually required to register for the system (i.e., obtain a "RST licence", often called a "vendor permit"), and thereafter to begin charging, collecting and remitting RST in respect of its taxable supplies. In Ontario, for example, the relevant rule is found in s. 5 of the Ontario Act, which provides as follows:

> 5.(1) *Vendor Permits* — No vendor shall sell any taxable [TPP] or sell any taxable service or own or operate any place of amusement the price of admission to which is taxable unless the vendor has applied for, and the Minister has issued to the vendor, a permit to transact business in Ontario and the permit is in force at the time of such sale.
>
> *Collection requirements in other RST systems are s. 92 of the BC Act; s. 4 of the SK Act; s. 5 of the MB Act; and s. 13 of the PEI Act.*

Issues with Non-Resident Collection. The traditional issue relating to vendor collection requirements under RST systems is when and why a non-resident vendor, with little or no connection to a particular province, needs to register under that province's RST system. The answer comes, in part, from the definition of "vendor" employed in each RST system.

5

There's no such thing as "exempt custom software"

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

In BC, for example, the definition of "vendor" provides as follows:

> "*vendor*" means a person, including an assignee, liquidator, administrator, receiver, receiver manager, trustee or similar person, who, in the ordinary course of the person's business, in British Columbia, sells [TPP] to a purchaser at a retail sale in British Columbia.
>
> *"Vendor" is defined in s. 3(o) of the SK Act; s. 1 of the MB Act; s. 1 of the Ontario Act; and s. 1(t) of the PEI Act.*

With the exception of Ontario, all other RST systems contain a similar "carrying on business in the Province" wording. Ontario's provision does not require the vendor to be carrying on business "in Ontario", but that requirement is administered in practice – as it would probably have to be in order for Ontario's registration requirement to be within its constitutional authority. The Ontario Act defines "vendor" to mean, among other things, "a person who, in the ordinary course of business, (a) sells or licenses [TPP], [or] (b) sells or renders a taxable service ...".

Extra-territorial Registration Provisions. Some provinces (like BC, Manitoba and Quebec) have recently employed extra-territorial registration requirements, which effectively deem out-of-province vendors to be "vendors" required to be registered for local provincial sales taxes, on the basis of certain activities related to the province (e.g., soliciting goods for sale, and sending those goods into the province). As the constitutional (and practical) effects of these measures are uncertain, readers are cautioned to seek professional advice on these matters.

Carrying on Business. As indicated above, whether one "carries on business" in a particular jurisdiction falls to be determined by the facts of the situation. A number of legal tests have also been developed, largely from jurisprudence under the *Income Tax Act* ("*ITA*"), as reviewed above. As most readers will already appreciate, that jurisprudence suggests that to determine whether a person is "carrying on business" in Canada requires a factual-based analysis, focused on a couple of primary factors, and a inexhaustive set of secondary factors.[17]

The two primary factors are: (a) the place where the contract for the supply was made; and (b) the place where the operations producing profits take place. In terms of the "place where a contract is made", the jurisprudence generally accepts that the important elements of the contract are its offer, and its subsequent acceptance, and that the place the contract is "accepted" is the place where it was made.

Voluntary Registration. Each RST system allows non-residents selling TPP or taxable services into a province to *voluntarily* register, which sometimes, is the path of least resistance for persons wishing to carry on business on a national scale, although located in one particular province (or, indeed, located outside of Canada).

Collection Provisions. Once registered, each RST system imposes a *collections* obligation on vendors of the TPP or taxable services, always imposing this obligation as an "agent" of the Crown. In Ontario, this requirement is found in s. 10:

> 10. *Vendor to be Collector* — Every vendor is an agent of the Minister and as such shall levy and collect the taxes imposed by this Act upon the purchaser or consumer.
>
> *Vendor collections obligations are s. 93(1) of the BC Act; s. 8.1 of the SK Act; s. 9(2) of the MB Act; and s. 19 of the PEI Act.*

While constitutionally limited to imposing "direct taxes" on consumers, the RST systems generally enforce a vendor's obligations to collect tax by imposing penalties for non-compliance. Ontario's "vendor non-compliance" penalty is found in s. 20(3) of the Ontario Act, which provides as follows:

> 20(3) *Penalty for Non-Collection of Tax* — The Minister may assess against every vendor who has failed to collect tax that the vendor is responsible to collect under this Act a penalty equal to the amount of tax that the vendor failed to collect, but, where the Minister has assessed such tax against the purchaser from whom it should have been collected, the Minister shall not assess the vendor.
>
> *While sometimes only imposing a "deemed amount of tax collected by not remitted", similar provisions can be at s. 116(1) of the BC Act, s. 58 of the SK Revenue And Financial Services Act; and s. 22 of the PEI Revenue Administration Act.*

There is a general four year limitation on s. 20(3) penalties – see s. 20(5) – although there is no limitation period in cases where the vendor's non-compliance is attributable to neglect, carelessness, wilful default or fraud. (In such cases, an additional 25% penalty can also apply: see s. 20(4)).

There is currently some issue in my mind as to whether a penalty assessed against a vendor can be "recovered" as tax by a vendor from a purchaser.

There is also currently some issue whether such penalties lie where the vendor has been duly diligent.

RST

Exempt Custom Software

- Across all Provinces, "computer software" is taxable.
- Limited Exemption for "custom" software
- Rules Differ provincially for what is "custom"

- In Ontario: Virtually everything is Taxable
- What about inter-company charges for software use ?

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

Ontario generally takes the position that a vendor can pursue a purchaser for such recovery, but there are technical problems in the Ontario Act suggesting that anything collected from a purchaser on account of "tax" would have to be remitted to the Ontario Ministry of Finance in any event. Additionally, contract law principles would seem to make it difficult for a vendor to pursue a purchaser for a "penalty" imposed on it by statute. Accordingly, there have been occasions where I have suggested to purchasers that vendors seeking recourse for "penalties" levied under section 20(3) may be without valid claims against the purchasers.

Assessments & Appeals. Each RST system is based on voluntary compliance, as enforced by substantive audit activity. Assessments are, as would be expected, limited by statutory limitation periods, generally at least 4 years in length in Ontario and PEI, but up to 6 years in BC, Saskatchewan and Manitoba – although in some cases there is a 3 year limitation imposed on assessing vendors for failure to collect tax. In cases of wilful default or fraud, the statute of limitations is always extendable, and in some RST systems (most notably, Ontario), the limitations period can be extended to instances only of misrepresentation that is attributable to "neglect, carelessness or wilful default".

Statute of limitations rules are found at s. 115 of the BC Act; s. 18 of the Ontario Act; and s. 38 of Revenue Tax Act Regulations made under the PEI Act. While the SK and MB Act's do not specify a period of time after which a Notice of Estimate or Assessment for a particular year may not be issued, In SK, Estimates are generally assumed to be limited to a six-year period under SK Limitation of Actions Act. In MB, Assessments are generally limited by administrative practice to "two years" prior to the commencement of the audit, although the Assessments may be up to 6 years for "own use" situations.

Appeal Rights. All RST systems provide for appeal rights to assessments issued, both at the administrative level, and to the provincial superior courts.

Timing for the appeals ranges from 90 days in BC (s. 118(2)); 30 days in SK (s. 61 of the SK Revenue and Financial Services Act; 60 days in MB (s. 18(1)); 180 days in Ontario (s. 24); and 60 days in PEI (s. 9).

Generally speaking, RST assessed is payable on issuance of the Notice of Assessment, and must be paid irrespective of administrative or judicial appeals. Under some RST systems (e.g., SK), a notice must first be issued (i.e., after the appeal is commenced) before payment becomes mandatory. Where an appeal is won, the amounts paid are repaid, with interest.

Directors & Officers Liability. Each RST system contains a special provision by which a director (or sometimes officers or mere agents) can be made personally liable for a corporation's tax debts. In a number of instances, however, there are either limitations placed on the administration's ability to pursue directors (e.g., unsuccessful attempts must first be made to collect the tax liability from the corporation), and/or the director's are given the ability to make out complete "due diligence" defences.

Directors' Liability provisions are found at s. 48.1 of the SK Revenue and Financial Services Act; s. 22.1 of the MB Revenue Act and s. 24.1 of the MB Act; s. 43 of the Ontario Act; and s. 22.1 of the PEI Revenue Admin. Act.

Voluntary Disclosure Programmes. A number of RST systems have voluntary disclosure programmes, aimed at allowing taxpayers or vendors with RST exposure to come forward on a voluntary basis and, in return, to avoid civil penalties or criminal prosecutions in respect of the liability. In effect, then, all that would be payable would be the net tax owing, plus statutory interests charges. In all instances, the voluntary disclosure is required to be "voluntary" – in the sense that it is not in any way prompted by a contact by a particular provincial administration – and "full", with most systems requiring full payment of the tax and interest. Currently, all RST systems with the exception of PEI have some form of voluntary disclosure or another. Saskatchewan is currently the only jurisdiction which waives *both interest and penalty* on a voluntary disclosure.

Waiver of Interest and Penalty. Like the federal situation under the GST/HST legislation, some RST systems are beginning to be augmented with legislative provisions allowing for the waiver of interest and penalties. For example, s. 58.1 of the SK *Revenue and Financial Services Act* allows Saskatchewan to waive or cancel all or any part of any interest or penalty otherwise payable by a vendor or consumer. Absent these sorts of provisions, the only relief would be tax remission, which is generally done at the Executive Level of government, by Order of Council.

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No one knows nothing about Customs

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

GAAR. Currently Manitoba is the only RST system with any semblance of a "general anti-avoidance rule" (see s. 245 of the *ITA*).

Self-Assessment Obligations. A hallmark of each RST system is a series of rules regarding self-assessment obligations in certain instances. While many RST systems now incorporate international collections agreements for the collection of RST on non-commercial importations, the RST payable on commercial importations is generally left up to the importer, both in terms of TPP imported from another country, and TPP imported from another Canadian province or territory. Generally speaking, however, the self-assessment obligation is imposed only on persons who ordinarily reside in the particular province.

Self-assessment is also required in most cases where TPP is "manufactured" for "own use", or otherwise acquired on an exempt basis (e.g., for "resale"), but thereafter committed to a different use. When such TPP is permanently put to a taxable use, the user generally falls into the definition of "purchaser", and is required to self-assess and remit tax based on the fair value of the TPP at the time of the change in use. Accordingly, vendors who permanently withdraw TPP from inventory for business or personal use must account for tax on the fair value of the TPP at that time. Special valuation rules apply to printed matter and certain other TPP manufactured for own use.

Treatment of Business Organizations and Reorganizations. The treatment of business organizations and reorganizations is also particularly complex. Bear in mind here, that the focus is on the treatment of certain sales of TPP resulting from such transactions, since the transfer of 'shares' would never generally be expected to give rise to RST liability, since such a transaction would amount only to a transfer of an "intangible". The issue arises, then, in the context of TPP, usually situated in a province, and usually tax-paid, that is to be transferred to another corporation as a result of a business organization or reorganization. While I have summarized some of the treatments across RST systems below, there are often a number of exceptions and additional conditions and requirements to the "general" rules. Accordingly, the rules in each particular RST system ought to be consulted before considering the full RST treatment afforded to any of these transactions.

Amalgamations. As a general rule, the transfer of TPP by virtue of an *amalgamation* is generally either legislated to be exempt, or treated as exempt through administrative practice.

Wind-Ups. The transfer of TPP by virtue of a *wind-up* is generally either legislated to be exempt, or treated as exempt through administrative practice in every RST system other than Ontario. Ontario has a special rule which taxes the transfer unless the particular corporation being wound-up has previously paid tax in respect of its consumption or use of the TPP.

Related-Party Transfers. Each RST system has rules aimed at relieving tax from TPP transferred between related parties. The rules, however, can often be quite difficult to meet. For example, most RST systems require at least a 95% shareholding between corporations before they can be considered to be related.

Bulk Sales Transactions. Most RST systems have provisions aimed at ensuring that purchasers of TPP "in bulk" (e.g., a business being acquired through the acquisition of "assets") obtain a retail sales tax clearance certificate from the vendor indicating that all sales taxes have been paid by the vendor. The vendor is then required to obtain the same from the particular provincial tax administration, thereby ensuring that in the "sale by way of assets" situation, the particular province does not suffer tax leakage because a tax debtor divests itself of all its assets. (Normally, the only time a purchaser would acquire a vendor's liabilities – for taxes or otherwise – would be in the instance where it purchased a business by way of shares, thereby acquiring all assets and all liabilities). Where "bulk sales certificates" are not obtained, the purchaser is made personally liable for any sales taxes due. Currently, the RST systems in all of the RST Provinces have bulk sales requirements.

Bulk sales provisions can be found in s. 99 of the BC Act; s. 51(2) of the SK Revenue and Financial Services Act; s. 8 of the MB Act; s. 6 of the Ontario Act; and s. 56 of the PEI Act.

Government Structure & Resources. The last point in terms of the structures of the various RST systems is the structure of the bureaucratic agencies overseeing the systems, which can often play an important part in the informal resolution of assessment and appeal matters.

Customs

Customs Compliance Generally Lacking

- Customs often delegated to "traffic" / "logistics"
- Even HUGE multi-nationals have Deficiencies
- AMPS system is making people pay for inattention.

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In Ontario, for example, the Ontario Act falls under the auspices of the Ministry of Finance, and within that Ministry, the Retail Sales Tax Branch, administers retail sales tax policy set by the Ministry. Although the Retail Sales Tax Branch has input into legislation, largely through its Tax Advisory section (and in view of its practical experience), there is another body, called the Tax Design and Legislation Branch of the Office of the Budget and Taxation which has the primary input into the drafting of legislation and the wording of exemptions.

In terms of the day-to-day administration of the Ontario Act, the Audit Branch, Appeal Branch, and Collections Branches all have separate parts to play, as [does] the Special Investigations Branch. Separate from each of these branches, is the Office of Legal Services.

Needless to say, it can sometimes get quite involved determining just who in the Ministry of Finance has the "call" on even the most simple of audit, assessment or appeal issues.

Often times, in order to resolve matters at the Appeals or Court stage of the assessment process, consensus is need from up to 3 or 4 separate branches (e.g., the Office of Legal Services, Appeals, Tax Advisory, and possibly the first-line Audit Branch). When Branches disagree, the Deputy Minister and his ADM are often required to sign-off on the final decision.

Resources. While secondary resources for determining the application of RST systems are notoriously lacking, most RST administrations attempt to publish at least their view of how the particular legislation is to be administered. In Ontario, for example, this is done through separate series of *Sales Tax Guides* and *Information Bulletins* and through the limited public dissemination of a RST Handbook called *UOST* – short for the "Understanding Ontario Sales Tax" Handbook.

While *Sales Tax Guides* are published as needed, on a topic by topic basis (e.g., Ontario Sales Tax Guide No. 210: *Partnerships*), *Information Bulletins* are usually published after an Ontario budget, or on changes to regulations, outlining changes in the law and administrative practice. *UOST* is a handbook initially compiled by the Retail Sales Tax Branch as a training aid, and as an internal reference manual for the application of Ontario RST. In many respects, the manual is the most detailed piece of "general" information available in terms of specific Ontario administrative policies. While UOST was once available in electronic form, Ontario has since made it "unavailable", ostensibly on the basis that it was "out of date".

My understanding is that an electronic version continues to be updated and in use at the Retail Sales Tax Branch, and it may well be that an electronic version of UOST is available – albeit, only to those willing to avail themselves of Ontario's *Freedom of Information Act.*

Finally, Ontario's Retail Sales Tax Branch maintains what I understand to be a formidable collection of "unsanitized" written rulings, issued and catalogued on a number of subjects. Given that the rulings contain "confidential information", Ontario has traditionally resisted publishing them, even in a semi-sanitized form. While some rulings are now being published by Ontario, it is my understanding that they are not representative of all of the issued rulings to date. While these and some other rulings are commonly distributed amongst industry, caution should always be taken in relying on them, since the Ontario Ministry of Finance has no compunction in observing that a ruling letter issued to one person is not binding upon the Ministry in respect of the activities of another person – even if very closely related.

Other RST systems also have detailed governmental sources of information, although perhaps BC is the only system that comes close to Ontario in terms of the availability of that information. BC may well have more accessible information, since its own internal training manual ("TIM" - Tax Interpretation Manual) is widely available, and in electronic format.

QUESTIONS ?

Please reach me 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

7

If you discover customs deficiencies, you may be legally obligated to let Customs know !

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

PART III

CANADA'S CUSTOMS SYSTEM [1]

Introduction

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

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

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

Overview of Canada's Customs Rules

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

Tariff Classification

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

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

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

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

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

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

Customs

Section 32.2 of the Customs Act

- **Reason to believe you have an error in "tariff class", "origin", or "valuation" ?**
  - **90 Days to Correct**
  - **90 Days to Pay**
- **Significant Penalties for Non-Compliance**

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

Origin Determination

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

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

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

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

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

Valuation

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

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

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

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

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

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

8

Duty-free trade with the U.S., usually comes at a price.

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me 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

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

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

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

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

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

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

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

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

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

Trade

Prerequisites to U.S. Duty Free Trade

- What is required for NAFTA duty free trade ?
  - Properly completed Certificate of Origin
  - Problem: Often overlooked or obviously in error.
- Result: Possible dutiable rates on Imported Goods.
- The buck stops with you as importer !

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

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

E-Mail: rgk@taxandtradelaw.com
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The Customs Whipsaw: Transfer Pricing (Dis)Connect

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

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

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

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

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

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

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

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

On-Going Significance of Valuation. Since tariff classification and origin determination may well lead to the conclusion that a particular good is "duty-free" under NAFTA, or perhaps an MFN duty concession negotiated under the WTO, many importers assume that "valuation" is not that important to the importing process.

Unfortunately, Canada Customs has not adopted that view. In fact, and despite the rather pre-mature reports of its death, "Customs Valuation" continues to remain a significant part of Canada Customs' post-entry assessment process, and an active player in special investigations as well.

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

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

9

No one else knows nothing about NAFTA

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

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

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

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Web: www.taxandtradelaw.com

Trade

Prerequisites to U.S. Duty Free Trade

- Who is exporting goods to the U.S. ?
- Who in your organization is filling out these NAFTA Certificates of Origin ?
- Complex rules require specialized training in the person overseeing the Certification process.
- Exposure ? Limitation Clauses ?

MILLAR KREKLEWETZ LLP

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ENDNOTES

TO PART I1

1. For "domestic" supplies, the principal exceptions are goods, services, or intangibles enumerated in Schedules V or VI of the *ETA*. For "imported" goods, the principal exception is goods enumerated in Schedules VII of the *ETA*.
2. "Registered" or "registered under the *ETA*" is used to refer to persons who are registered in accordance with subdivision d of Division V of the *ETA*, which establishes who must be registered for the GST, and how they must register.
3. Bear in mind that a "taxable" supply will include the sorts of "zero-rated" supplies that are enumerated in Schedule VI of the *ETA*. The difference between the two is that a simply "taxable" supply is taxed at a rate of 7%, while a zero-rated supply is taxed at a rate of 0% (effectively removing the GST from the zero-rated supply).
4. In reviewing the general and specific rules discussed below, and in determining whether a particular taxable supply is made "in Canada" or "outside Canada", remember the significance of these rules: (1) Where a taxable supply is made "inside" Canada it will be taxable under Division II, and not generally taxable under any other provision in the *ETA* (although there are some exceptional situations where double-tax can occur); (2) If, on the other hand, the taxable supply is made "outside Canada", it will be outside the purview of Division II tax, and would only be subject to GST, if at all, under Division III (imported goods) or Division IV (imported services and other intangibles).
5. Note the distinction between charging, collecting and remitting the Division II GST on supplies made by the non-resident "in Canada", and the non-resident's obligation to pay GST at the border on goods imported to Canada under Division III. Many non-residents incorrectly assume that the "special non-residents rule" referred to just above somehow relates to the Division III obligations regarding imported goods. It does not. Accordingly, one could have a situation where, as a non-resident, one is entitled to deliver goods to Canadian customers *without* charging GST to the Canadian customer (i.e., because of the application of the non-residents rule in s. 143), but still required to pay the GST at the border because of the application of Division III.

   Many non-residents are confused in the application of the GST in these situations, increasing the likelihood that the GST rules are either not being fully complied with, or that some of this "double" GST is not being fully unlocked (see *infra*).
6. Also outside the scope of this presentation is a full discussion regarding the"registration" requirements in the *ETA*. Suffice to say that s. 240 of the *ETA* requires every person making taxable supplies in Canada in the course of a commercial activity to register for GST. Limited exceptions exist, including exceptions for certain "small suppliers" making less that $30,000 of supplies annually, and for non-residents who do "not carry on any business in Canada" – which dovetails with the special rule in s. 143 discussed just above.
7. Section 214 provides that Division III tax shall be paid and collected under the *Customs Act* as if the tax were a customs duty levied on the goods. In turn, the *Customs Act* provides that the person who "reports" the goods in accordance with that Act (i.e., the importer of record), is jointly and severally liable, along with the owner, for the duties levied on the imported goods. Accordingly, Division III tax is often applied to persons not actually owning imported goods, but merely reporting them for customs purposes.
8. Persons engaged in "commercial activities" are generally entitled to claim full input tax credits ("ITCs") for the GST paid, under s. 169 of the *ETA*. As this can only be done on the regular GST return following the day on which the GST became payable, there is often only a cash-flow issue involved in the payment of the GST. On the other hand, persons engaged in "exempt activities" are generally precluded from claiming ITCs, making the GST they pay unrecoverable, and a "hard cost". (In certain instances, where the exempt person is also a "public service body", limited rebates may be available for the GST paid – these would include, for example, municipalities, universities, schools, hospitals and charities, but not financial institutions).
9. This is consistent with the general policy in the GST legislation of removing all taxes and artificial costs from the cost base of Canadian exports, in order to eliminate the competitive disadvantages that would face Canadian exporters in the international markets as a result of these artificial costs.
10. The existing RST systems are as follows: in BC, the *Social Services Tax Act* applies at a general rate of 7%; in SK, the *Provincial Sales Tax Act* applies at a rate of 6%; in MB the *Retail Sales Tax Act* applies at a rate of 7%; in ON the *Retail Sales Tax Act* applies at a rate of 8%; and in PEI, the *Revenue Tax Act*, 1988 applies at a rate of 10%.1

    The Ontario *Retail Sales Tax Act* will be referred to here as simply the Ontario Act. Other provincial legislation referred to above will be referred to in the same way (e.g., the BC Act, the SK Act, etc.).
11. See *Cairns Construction Ltd. v. Government of Saskatchewan,* [1960] S.C.R. 619.
12. The logical result of this is the creation of purchase exemptions in every RST systems which, one can see, are not so much a matter of provincial generosity as they are a constitutional imperative.
13. The structures of the taxing systems in ON, PEI and MB tend to be very similar perhaps due to the timing of their respective taxes (all enacted within about 7 years of each other in the early 1960s). BC and SK, with somewhat older systems, tend to be quite different in structure, although containing each of the (constitutionally required) elements described just above.
14. While QB's QST is a sales tax system levied on purchases at all levels of the production and distribution chain, business purchasers are usually afforded refunds on business inputs, helping confirm that the QST is intended to be borne by the ultimate consumer or purchaser.
15. The recent addition of a separate charging provision in section 2.0.1 of the Ontario Act has recently obviated the need for defining purchaser in this manner, and these words were removed from the definition: see s. 2.0.1 of the Ontario Act, as added by 2000, c. 10, s. 24, effective May 3, 2000.
16. Please note that a number of exceptions and conditions apply to some of these exemptions, meaning that in each case, the actual legislative rules ought to be consulted prior to determining if a particular supply is an exempt one.

Thank You !

MILLAR KREKLEWETZ LLP

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17. According to the jurisprudence, other factors could include: (a) the place where the TPP was delivered, (b) the place where the payment was made, (c) the place where the TPP in question was manufactured, (d) the place where the orders were solicited, (e) the place where the inventory of the TPP is maintained, (f) the place where the company maintains a branch or office, (g) the place where agents or employees, who are authorized to transact business on behalf of the non-resident person, are located, (h) the place where bank accounts are kept, (i) the place where back-up services are provided under the contract, and (j) the place in which the non-resident person is listed in a directory.

PART III:

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1. For readers less familiar with Canada's customs rules, secondary sources may be helpful, and this this regard, please consider *Customs Valuation: A Comparative Look at Current Canadian, U.S. & E.U. Issues,* Robert G. Kreklewetz, A Paper presented at the 1996 CICA Annual Symposium in Ottawa, Ontario (Sept. 29 - Oct. 2, 1996). That paper contains sections dealing in detail with Canada's customs rules, as well as providing a fairly recent review of the major issues facing Canadian importers, from a valuations perspective. If you would like a copy sent to you, please contact the presenter.
2. And as most importers and exporters will have already learned, while goods imported to Canada that are of "U.S. origin" are generally expected to be entitled to duty-free status under NAFTA, there is a complex process necessary to determine whether in fact the goods "qualify", as well as complex rules aimed at ensuring proper compliance. (See *infra*).
3. Practically speaking, goods are usually reported in a Form B3 (*Canada Customs Coding Form*), which at the same time lists a description of the goods, their applicable tariff classification, duty rates, values for duty.
4. Determining the "VFD" is technically required even where goods are not subject to a positive rate of duty. Among the substantive reasons are the fact that the federal GST is payable on imported goods, based on their VFD for customs purposes. Additionally, the CBSA has taken the view that a proper VFD for imported goods is required to maintain the integrity of industry Canada's trade statistics.
5. For example, assume that the rate of duty on golf clubs made and imported from the U.S. is 2.4%. A $100 golf club can be expected to bear customs duties of $2.40. Only rarely are duties imposed on a "goods-specific" basis, which would impose flat-dollar duty figures on the quantity or weight of the imported goods.
6. Restrictions that are (i) are imposed by law, (ii) limit the geographical area in which the goods may be resold, or (iii) do not substantially affect the value of the goods are allowable under Transaction Value: see section 48(1)(a) of the *Customs Act.*
7. Section 2(3) of the Ontario *Sale of Goods Act* provides that a sale occurs here, under a contract for sale, "the property in the goods is transferred from the seller to the buyer". Similarly, in *Anthes Equipment Ltd. v. MNR*, the Tax Court of Canada cited *Black's Law Dictionary* for the following definition of sale: "A contract between two parties, called, respectively, the 'seller' (or vendor) and the 'buyer' (or purchaser), by which the former, in consideration of the payment or promise of payment of a certain price in money, transfers to the latter the title and the possession of property. Transfer of property for consideration either in money or its equivalent." See also the recent CITT decision in *Brunswick International (Canada) Limited,* [2000] ETC 4507.
8. In the former example, a "lease" does not amount to a sale. In the latter, a corporation and branch office are not separate persons, meaning that no sales transaction could occur between the two (i.e., one cannot sell to oneself).
9. See, for example, the presentation on the "Purchaser in Canada Regulations" made by Robert G. Kreklewetz and Stuart MacDonald (CBSA), at the Canadian Importers Association's May 11, 1999 Emerging Issues in Customs Conference (Toronto, Ontario). Please contact the presenter if you would like copies of this presentation.
10. See, for example, the presentation on the "*Recent Customs Valuation Cases: A Spirited Discussion With the CCRA* ", made by Robert G. Kreklewetz and David DuBrule (CBSA), at the Canadian Importers Association's April 6, 2000 Emerging Issues in Customs Conference (Toronto, Ontario). This presentation was also updated and presented at the same Canadian Association of Importers and Exporters conference on April 5, 2001. Please contact the presenter if you would like copies of this presentation.
11. The "price paid or payable" for the goods will generally start with the "transfer price" determined under the importer's requisite transfer pricing analysis.
12. See again: *Customs Valuation: a Comparative Look at Current Canadian, U.S. & E.U. Issues*, Robert G. Kreklewetz, A Paper presented at the 1996 CICA Annual Symposium in Ottawa, Ontario (Sep 29 - Oct 2, 1996).
13. While initially meant as a "sword" for use by the IRS in combating possible tax avoidance strategies amongst related parties (e.g., importing at a low price, but selling for income tax purposes at a much higher price), the rules may also be available to taxpayers as a "shield", preventing U.S. Customs and the IRS from arriving at similarly asymmetrical results.