Ten Things You Absolutely Need to Know About

NAFTA Trade with Canada

Presented at the 2007 FTA Certificate Series

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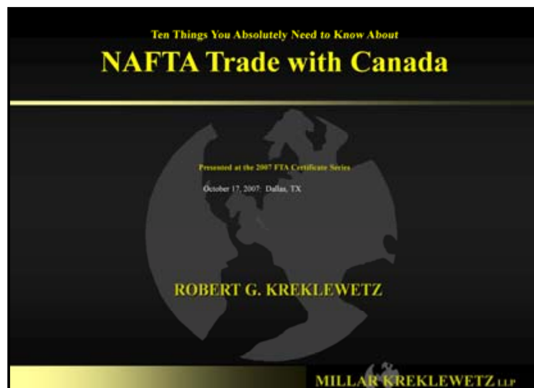
ROBERT G. KREKLEWETZ

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

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

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

Extensive Customs, Trade and Tax Experience. Rob's practice focuses on **Customs, Trade & Tax** matters involved in moving goods, services and intangibles across Canada's border.

Rob's *Customs and Trade* practice includes planning and representation work on all customs and trade issues, including assisting with Periodic Verification Audits and Voluntary Disclosures concerning Valuation, Tariff Class Origin, or Marking issues, and NAFTA Origin Verification Reviews, Forfeitures, Seizures, Administrative Monetary Penalties (AMPS) and other NAFTA & WTO issues, as well as Import and Export Controls and Licensing issues.

Rob's *Tax* practise includes comprehensive planning and advocacy services related to all Canada **income** and c**ommodity taxes**, including the application of Canada's federal *Income Tax Act,* and Canada's Goods and Services Tax (GST) legislation, as well as all indirect tax issues, like those involving provincial sales taxes, like the Ontario retail sales tax (RST) and Quebec Sales Tax (QST).

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 **450 articles and papers**, and spoken at over **150 conferences and seminars**.

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 Canadian 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 the Chair of the Ontario Bar Association's Taxation Executive, and a member of the OBA's International Law Executives, a member of the CFLA's Tax Committee, and past 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 three wonderful sons, 9 year-old boy named William (the "Conqueror"), 4 year-old Richard (the "Lion-Hearted"), and 2 month old Raine (the "Storm") – he named the first two after English kings, and Franceen named the last one after a weather pattern. While Rob concedes that Tax & 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 household project he starts.

Millar Kreklewetz LLP is proud to be recognized as a leading Canadian law firm, in World Tax 2008, and by the International Tax Review as the top Canadian law firm in indirect taxes for three consecutive years.

Rob is also proud to be recognized by L'Expert as one of Canada's the Top 500 lawyers – likely between 495 and 499!

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THE ROAD MAP

General Focus of the Presentation

Global trade is lucrative for U.S. businesses. On the other hand, moving goods to and from other countries like Canada – those countries being separate nations from the U.S. – can often raise tax and trade issues not otherwise present in the U.S. domestic sales context.

The Presentation today will provide 9 points worth considering when trading with Canada under the NAFTA. (The Presentation is styled as "10" points, but when it came down to it, I could not think of the tenth !)

The list is not a comprehensive list of all the things you ought to know about Canadian or global trade, but is meant to be both an interesting introduction to the nuances of global trade in the Canadian context, and a compilation of some important tips for that trade.

They are drawn from our collective experience in dealing with Canadian and U.S. businesses in these situations, and represent the more troubling issues facing U.S. businesses engaging in cross-border trade with Canada, and abroad.

The 9 points are presented in a "top 10" basis, and progress from the general (e.g., Number 9, below), to the more specific (e.g., Number 1, below).

Navigating Through the Materials

While many readers will be familiar with trade with Canada, or global trade issues, some will not be so familiar.

Accordingly, these Materials comprise both the very basic introduction to Canada and its trade (that persons unfamiliar with those matters would benefit from), and the more sophisticated issues, problems and areas of concern, that we will be dealing with in the main Presentation.

The Materials are broken into the following parts:

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

Parts II contains a fairly comprehensive review of the Canadian customs regime, and is designed to allow readers not completely familiar with Canada to more fully understand the customs systems in place there.

As an added bonus, **Part III** provides an overview of Canada's GST value-added taxing system, which will help explain to the reader how this unique tax system (unique, at least in the North American context, as the U.S. does not have a value-added federal sales tax system) works in Canada, and will help underpin some of the discussion in Part I, dealing with GST challenges in cross-border trade.

Audience participation is welcomed,
and questions will be entertained at any time.

Time for Questions will also be available
at the end of the presentation.

Electronic Copy of these Materials

For readers interested in keeping an electronic copy of this presentation, it can be downloaded free of charge by typing the following into your web browser:

http://taxandtradelaw.com/easy/1616.pdf

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www.taxandtradelaw.com

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PART I

The TOP 10 Things You Should Know About Your Cross-Border Trade with Canada

No. 9 –

Canada is Not the 51st State !

In our experience, many non-resident clients often fail to recognize the separate issues that face them when shipping, or selling, into Canada.

These issues generally rise, in the specific context, when the U.S. seller takes on transportation and importation responsibilities, and becomes responsible, according to Canada's customs laws, for the reporting and accounting for of the imported goods. (*See* Part II below for an introduction to Canada's customs laws). In these cases, the non-resident will be known as a "Non-Resident Importer" to Canada, and will be directly liable for Canada Customs enforcement if problems arise with the importations, or if the importation of the goods is not conducted properly or accurately. A number of other positive obligations may attach to this status.[1]

Problems are also exacerbated when goods are shipped for export from multiple plants in multiple locations – some of which may be more or less familiar with customs rules and process.

Couple these new "customs requirements" with some additional "GST requirements" (*e.g., see* point No. 3 in our Top 10), and U.S. traders with Canada will often find their experience with Canada totally mystifying.

The way in which to tackle this problem is to recognize, and inform everyone in your organization, that shipments to Canada are in fact different than domestic shipments, and may have to be treated differently. Therefore, even though you may be accustomed to more relaxed recordkeeping requirements when shipping to Canada – U.S. Shipper's Export Declarations ("SEDs") are not typically required except on items requiring a license under the U.S. export control regulations – the shipment is, nonetheless, an "export" from U.S. territory.

Education and training are often then necessary, and it is often advisable, if not mandatory, to create a completely separate function for "export compliance", to clearly identify the person in your organization that will be responsible for overseeing compliance with Canadian customs laws, and the responsibility for at least recognizing the issues that may befall the organization.

The last thing that your organization wants is a notice of intention to audit – from the Canada Customs and Border Services Agency ("CBSA") – to land somewhere in your organization, and not be recognized for what it is.

No. 8 –

Getting Goods into Canada is Harder than you Think !

Please refer to the information provided during the presentation, and call us for assistance, if you would like help setting up your Canadian trade operations.

No. 7 –

U.S. and Canadian Customs Rules *are* harmonized, but only to a degree…

In attempting to understand the differences between what you know from your U.S. customs experience, and how Canada's rules apply to the same concepts, or how international rules apply, it is important to realize that the U.S., Canadian, and most international rules are in fact meant to be harmonized to certain degrees.

The reason for this harmonization is the joint commitment that U.S., Canada and other nations have made to both the World Trade Organization ("WTO"), and the World Customs Organization ("WCO"), on matters like tariff simplification and reduction, and customs valuation.

Joint commitments under other bilateral or trilateral trade agreements – most notably the North American Free Trade Agreement ("NAFTA") – have also lead to harmonization on things like duty rates, and origin.

Tariff Classification. Harmonization on tariff classification issues is accomplished through joint commitments under the WTO, to adhere to 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 or more 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.

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.

Valuation. The U.S., Canadian and international rules for valuing goods are generally harmonized through commitments under the WTO to adopt what was formerly referred to as the GATT Valuation Code.[2]

The General Agreement on Tariffs and Trade (the "GATT") was first drafted in 1947, and has long been the cornerstone of trade in the Western world. The GATT set out a framework of fundamental principles designed to promote free trade among the GATT's member nations, and eliminate restrictive trade practices. One of the GATT's basic objectives was to harmonize Customs Valuation rules across its member nations, since differences in valuations rules had proven to be formidable barriers to trade in and of themselves.

The GATT's current valuations rules (*i.e.,* the GATT Code) were negotiated during the so-called Tokyo round of GATT negotiations conducted from 1973 to 1979. These rules established an international valuations standard based primarily on the *price actually paid for goods* by the parties involved. (This is generally referred to as the "price paid or payable" requirements, or simply, "transaction value".) Thus, the chief innovation of the GATT Code was its explicit emphasis on this "positive standard" – the price of the transaction in question – as the basis for valuation.

Today, the GATT Code (and the WTO) has been adopted by virtually all of the industrialized nations, including, of course, the U.S. and Canada. Also included as WTO member countries are the members of the European Union, Japan and Australia. Each of the 150 member nations signing the WTO have bound themselves to enact the domestic legislation required to incorporate the valuations rules in the GATT Code.[3]

Origin & Duty Rates. Thanks to the NAFTA, most trade between the U.S. and Canada has been duty free since January 1, 1998. Yet, that duty benefit is a privilege that is afforded only based on compliance with strict NAFTA rules of origin.

Compliance with NAFTA, and qualification for the preferential duty rates it can afford imports from NAFTA partners, is a subject that could take a complete course to cover. A full discussion is beyond the scope of these materials.

Readers interested in further information can refer to *Dealing With NAFTA Verification & Other Customs Audits in the Current Compliance Environment,* recently presented by the authors at national seminar of the Canada Association of Importers and Exporters. A revised copy of that presentation may be obtained by typing the following into your web browser:

http://taxandtradelaw.com/easy/easy0001.pdf

No. 6 –

Some of Canada's rules
are really different.

The "Purchaser in Canada" Requirement

A troubling customs valuation issue has been the application of the so-called "purchaser in Canada" rules, which are unique to Canada, and part of our section 48 requirement that in order to qualify for "transaction value", not only must goods be "sold for export to Canada", but they must now also be sold to a "purchaser in Canada".

QUESTIONS ?

Please reach me as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

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Facsimile: (416) 864 - 6201

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Web: www.taxandtradelaw.com

Basic Strategies for
Getting Goods into Canada

Three Basic Ways to Get Goods Into Canada:

(1) Canadian Resident Business
- Established subsidiary or branch operation
- Import as of Right
- Full Cdn Compliance Obligations (I/T, GST, Customs, Other)

(2) Non-Resident Importer
- Special Canadian Program
- Import based on Agreement with CBSA

MILLAR KREKLEWETZ LLP

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The Purchaser in Canada Rules. The "purchaser in Canada" rules are really regulations (which I will refer to as the "Purchaser in Canada Regulations"), and were first put in place in light of 1997 changes to sections 45 and 48 of the *Customs Act* – all effective September 17, 1997.

Those changes added the following phrase to the "sold for export" language in the Transaction Value section of Canada's Valuation Code:

48(1) Transaction Value as primary basis of Appraisal - ... the value for duty of goods is the transaction value of the goods if the goods are sold for export to Canada to a purchaser in Canada and the price paid or payable for the goods can be determined and if ...

At the same time, section 45 of the *Customs Act* – which provides the definitions for the various terms used in the Valuation Code – was also amended to allow the phrase "purchaser in Canada" to be defined by regulations.[4]

The relevant regulations been in place for several years now, and are set out in some detail in Customs D-Memo D13-1-3.[5]

Effectively they require a valid purchaser in Canada to have "substance" in Canada, which Canada Customs describes in the following terms:

Business Entities (Incorporated and Unincorporated)

8. As stated in paragraph 5, in order for an incorporated or unincorporated business entity to meet the residency requirement of section 2.1 of the Regulations, it must be carrying on business in Canada and the management and control of the business entity must be maintained in Canada. The mere fact that a business entity is incorporated in Canada is not sufficient to meet the residency definition.

9. Therefore, in order to determine if a business entity is a resident in Canada, the two following concepts must be closely examined:

   (a) whether it is carrying on business in Canada (see the Note below and paragraphs 10 to 13); and

   (b) whether it is managed and controlled in Canada (see paragraphs 14 and 15).

Carrying on Business in Canada

10. Generally, determining whether or not a business entity is carrying on business in Canada involves weighing a number of factors which indicate that the business entity has a significant presence in Canada.

11. In reviewing the business entity's activities undertaken in Canada, the business entity must be able to demonstrate that these activities include the authority to buy and sell goods and services, to support the day-to-day regular and continuous operation of the business entity in Canada. The business entity must be able to demonstrate that one or more employees in Canada have been granted the general authority to contract on behalf of the business entity, without the approval of another person outside of Canada.

12. It is not possible to develop an exhaustive list of the factors which will be considered, as business practices do vary; however, the list below is meant to illustrate the level of responsibility expected of the employees with the general authority to contract on behalf of the business entity, in Canada. The business entity must be able to show that the employees in Canada have the authority to, for instance:

    (a) negotiate the resale terms of the goods sold in the Canadian market (selling price, trade volume discounts, delivery conditions, etc.), without seeking the confirmation from another person outside of Canada;

    (b) contract purchases of goods and services inside and outside Canada, including sales for export to Canada (supplies, office equipment, goods for resale market, inputs for assembly or production, lease agreements, retaining accountants, lawyers, etc.);

    (c) negotiate human resource issues for the business entity in Canada; and

    (d) make necessary withdrawals, issue cheques, and other such activities to process payment of goods and services acquired or used by the business entity in Canada.

13. In addition to demonstrating that the business entity's activities in Canada include the authority to buy and sell goods and services, other factors, such as those listed below, will be analyzed collectively to determine the extent to which the business entity's activities and functions are conducted in Canada. The following will be of interest:

Basic Strategies for
Getting Goods into Canada

(3) Non-Resident Exporter
- Customer is the Legal Importer
- Business issues

Another Way ?

- Commercial Shipments to Canada by Courier
  - What legal relationship has been created ?
  - Caution: What are your legal obligations ?

MILLAR KREKLEWETZ LLP

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(a) whether payment for the goods is made in Canada;

(b) whether purchase orders are solicited in Canada;

(c) whether inventory (if applicable) is maintained in Canada;

(d) whether the Canadian operation is responsible for the provision and costs of after-sale services, repairs, and/or warranties

(e) whether the business entity in Canada files Canadian income tax returns

(f) whether there exists a branch or office located in Canada; a

(g) whether bank accounts for the business entity are maintained in Canada.

Management and Control in Canada

14. In establishing whether or not a business entity is a resident in Canada for customs valuation purposes, the extent of management and control exercised by the business entity over its business affairs, or day-to-day operations, is to be considered. The extent of management and control will vary from one business entity to another and therefore must be determined on a case by case basis. Generally, for customs valuation purposes, management and control pertain to the Canadian business entity's ability to make decisions and issue instructions necessary to run its business.

15. The history of the business entity's entire activities must be examined and a thorough analysis of all facts must be performed before a conclusion can be reached as to the degree of management and control that exists in Canada. It must be noted that no one factor is determinative. Nor will it be concluded that management and control do not exist simply because one or several factors are not present in a particular case. Factors will be reviewed on a case by case basis and must always be reviewed in their entirety. The following are some of the factors that will be examined and considered to establish whether management and control are, in fact, exercised by the Canadian business entity:

(a) the Canadian business entity has the general authority to conduct business in Canada beyond that of simply finding buyers for imported goods and collecting payment on behalf of another party;

(b) the Canadian business entity has a board of directors that meets and exercises its authority in Canada;

(c) the Canadian business entity is not influenced or controlled by another party located outside Canada (i.e., the control over the day-to-day activities and functions of the Canadian business entity remains with the Canadian entity), for instance:

(1) the Canadian business entity exercises control over day-to-day functions necessary to maintain the continuous operation of the Canadian business entity;

(2) the Canadian business entity makes decisions on the allocation of profits earned in Canada;

(3) the Canadian business entity maintains control over its bank accounts (i.e., signing authorities will be examined and questioned); and

(d) the Canadian business entity maintains separate books and records in relation to the Canadian business operations, and prepares separate financial statements.

To date the jurisprudence has focused on the banking arrangements in place, and other factors indicative of a arms' length relationship (see, for example, the AAI FosterGrant case), although the judicial threshold for "purchaser in Canada" appears to be substantially lower than that set out by the CBSA in their administrative D-Memorandum..

No Comparable Requirement in the U.S. In the U.S., in order to apply the Customs preferred "Transaction Value", the regulations state that the goods must be imported as a result of a "sale for export" to the United States. However, there is no requirement such as in Canada, that there be a sale to a purchaser in the U.S.

No. 5 –

Duty Free Trade with Canada is a Privilege …

Please refer to the information provided during the presentation, and the main slides for the specifics of this point.

Further reference material on NAFTA origin requirements in general, may be found in Part II of these Materials.

No. 4 –

Dumb errors trigger NAFTA Verification Reviews …

Please refer to the information provided during the presentation, and the main slides for the specifics of this point.

Further reference material on NAFTA verification reviews may also be found in Part II of these Materials.

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Web: www.taxandtradelaw.com

No. 3 –

The GST is a Pain …

Please refer to the information provided during the presentation, and the main slides for the specifics of this point.

Further reference material on Canada's GST System may also be found in Part III of these Materials..

No. 2 –

Income Tax Considerations …

Please refer to the information provided during the presentation, and the main slides for the specifics of this point.

No. 1 –

If you screw up, you'll have to correct

INTRODUCTION

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

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

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

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

There are two age-old theories towards promoting compliance.

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

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

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

VOLUNTARY DISCLOSURES

Overview

The Customs Voluntary Disclosures Program ("VDP") is part of the CBSA's Fairness Initiative and is focused on encouraging voluntary compliance with customs laws and regulations by encouraging persons to come forward and correct errors or disclose information not previously reported, in order to be in compliance with customs laws.[6]

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

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

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

Limited Canada – U.S.
HARMONIZATION OF RULES

Areas of Harmonization:
- Tariff Classification → To the 6 Digit Level
- Valuation → Common Valuation Code
- Origin & Duty Rates → NAFTA

Conclusion: Some Rules Should be the Same

MILLAR KREKLEWETZ LLP

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Benefits of Initiating a Voluntary Disclosure

Where a VD is accepted, persons making the VD will only have to pay what duties may be owing, plus interest at the prescribed rate (and not at the higher specified rate).[7] Persons making a valid VD will be relieved from all other monetary penalties and, significantly, from possible criminal prosecution relating to their customs non-compliance.[8]

Conditions for a Valid Disclosure

Unlike the situation with Self-Adjustments, which are statutorily required with the legislative conditions are met, the conditions for a valid VD are as follows:[9]

1. The CBSA determines that the disclosure is voluntary.

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

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

2. The CBSA determines that the disclosure is complete.

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

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

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

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

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

The information being disclosed must include information that involves a prior accounting period, which is essentially a requirement that the information be dated, such that it was not required to be disclosed during the current accounting period.[10]

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

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

This is often a very relevant question given that subsection 59(1) of the *Customs Act* imposes a general four year assessment window on the CBSA for re-determining origin, tariff classification or value for duty.[11]

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Web: www.taxandtradelaw.com

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

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

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

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

TIP: Rule of Thumb is 4 Years

How Far back? CBSA and CRA generally require all non-compliance in “non-statute barred periods” (i.e., those period in which a CBSA or CRA auditor would be entitled to audit) to be periods which must be included in a VD in order for it to be complete. This translates into a “four year” back rule, which is a good rule of thumb.

While CBSA and CRA then take the position that the facts and circumstances of the case will determine whether to require disclosure of years 5 and 6 (or for years beyond the normal 6 year record keeping requirement), a good rule of thumb going into a VD is that 4 years of disclosure will be required.

Anything less than 4 years means
your advisor did a good job negotiating!

MANDATORY CORRECTIONS

Overview

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

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

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

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

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

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

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

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

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

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

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

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

Reason to Believe. Further, it is also apparent that the requirement for a Self-Adjustment occurs only once an importer (or owner) has "reason to believe" that there is an error with respect to one of these program areas (i.e., origin, value for duty, tariff classification[11] or diversion[12]).

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

Duties Owing as a Result of a Section 32.2 Correction

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

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

"Reason to Believe"

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

To date, Canadian Courts have not yet considered what constitutes "reason to believe". However, based on non-customs jurisprudence and the ordinary dictionary definition of "believe", it appears that "reasonable belief" would generally require a person to have some level of information (actual knowledge versus imputed knowledge) so that he or she can have an opinion on the matter and not be simply guessing or hoping.[13]

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

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

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

WHAT IS "REASON TO BELIEVE"

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

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

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

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

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

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

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

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

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

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

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

TIP: USING SOLICITOR-CLIENT PRIVILEGE …

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

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

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

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

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

CANADA NOW HAS "MOD ACT" PENALTIES !

Overview.

Companies importing into the U.S. are all too familiar with the imposition of penalties that may be assessed since the Mod Act imposed standards of "informed compliance" and "reasonable care." Now, a similar penalty system exists north of our border. It's called the ***Administrative Monetary Penalty System*** – or "AMPS" for short.

AMPS came into effect on October 7, 2002, and there is every indication that CBSA will be aggressive in the administration of AMPS. Even on the trial implementation of the system, there were 649 AMPS-related penalties issued in just over the first month of the system. And for the first full year of operations, there were over 15,000, with 58% of those being issued as against importers.[14]

Basic
NAFTA REQUIREMENTS

- Potential Duty Free Trade since 1998
- Requirements:
  - NAFTA Certificate at Time of Importation
  - Properly Completed & Substantively Correct

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

Other statistics suggest that the CBSA is earning an average of $700,000 a month in AMPs, and the average AMP costs an importer about $700.[15] Not enough to put anyone out of business, by just enough to negatively impact the profit margin on sales to Canada.

Pure statistics are deceiving, however, as AMPs are often based on a percentage of "value for duty" or duties payable. Thus, when the importer is involved in significantly valued goods, the average AMP for their particular industry can be significantly higher.

The Mechanics of AMPS. For Canada, AMPS is an unprecedented and comprehensive sanctions regime, aimed at providing Canada with a graduated civil monetary penalty system instead of the "all of nothing" approach under the former regime, which usually entailed quite draconian penalties (*e.g.*, seizure of goods, or penalties amounting to the full value of the goods) for even the most minor of customs errors.[16]

In that sense, AMPS seeks to secure compliance of Canadian customs legislation through the imposition of monetary penalties.[17]

On the flip side, however, and as the experience in the U.S. appears to have been, AMPS is also expected to act like an indirect tax on importations, with AMPS penalties expected to form a significant cost of doing business in Canada.

Scope of AMPS. AMPS penalties apply to contraventions of Canada's customs laws (which are principally found in the *Customs Act*, the *Customs Tariff*, the *Special Import Measures Act,* and regulations thereunder).

Accordingly, AMPS penalties can be imposed for over 350 different "infractions", ranging from simple misclassification of goods, to non-revenue related statistical errors.

The infractions themselves are grouped into 22 categories, including errors relating to Forms, Late Accounting, Corrections - Trade Data, Exportation, Marking of Goods, Origin of Goods, Records, Release, Report of Goods and Conveyances, Brokers and Agents, SIMA, and Transportation.

AMPS penalties can be applied against owners or importers of goods, as well as exporters, travelers, carriers, customs brokers, and warehouse licensees.

Penalties may be assessed at a flat rate or on a graduated basis or as a percentage of the value for duty of the goods involved in the contravention.

The basis for imposing an AMPS penalty and penalties also varies and can be imposed on a per conveyance basis, a per instance basis, a per transaction basis, a per shipment basis, a value for duty basis or a per audit basis.

Principles of AMPS. While the CBSA has stated that AMPS is designed to be corrective rather than punitive (and that its purpose is to secure compliance with customs legislation), it is expected that the penalties provided for under AMPS will quickly begin to take their toll on larger importers to Canada.

In our experience, it is difficult if not impossible to ensure that all customs entries are completely error-free. For importers with a large number of importations per year, AMPS penalties may lead to a large business expenses.

Having said that, the CBSA has maintained that AMPS will be administered in a manner that is consistent with the CBSA's Fairness Policy and, accordingly, that the Customs Voluntary Disclosures Program will apply to AMPS contraventions. It remains to be seen, however, to what extent the Customs VD program will mesh and interact with AMPS, as at least initially, there are a number of possible concerns here.

Graduated Penalties. In most instances, AMPS imposes a graduated type of penalty for specific infractions. That is, the monetary penalties will be imposed in proportion to the type, frequency and severity of the infraction.

These graduated penalties will take the compliance history of the person into consideration.

> **Example.** AMPS Penalty "C 152" applies where *an importer fails to furnish the proof of origin on request*. The penalties provided for this "offence" are as follows, depending upon how many times in the past the importer has been found to be in non-compliance.

Penalty Amount:

1st Time Offence	$ 1,000
2nd Offence	$ 5,000
3rd Offence	$10,000
4th Offence Plus	$25,000 [18]

Penalties applied under AMPS will be removed from a person's profile after three years, except in the case of late accounting penalties, which will be removed after a year.

Basic
NAFTA REQUIREMENTS

- Case Study
- Common Certificate of Origin Errors
  - Did you know there are instructions ?
  - Are you really the Producer ? Field 1/3
  - What is the Canadian Sub-Heading Field 6
  - A is for Audit … and metal don't grow on trees! Field 7
  - Not Producer ? How'dya know ? Field 8

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

It is not entirely certain, at this point, however, how this will all work itself out. And it is also quite uncertain as to what will constitute a subsequent offence. For example, a company with multiple divisions with multiple customs reviews might be found to be in contravention 4 times in a month. Would that ramp it up to the 4th and Subsequent Offence category for penalties ?

In the U.S., CBP has traditionally taken the view that errors are attributable to a company at the company's IRS or EIN number. Thus, errors by divisions that are not separately incorporated, would be cumulated at the level of the EIN-reported entity.

Types of Penalties. Just as under the U.S. penalty system, AMPS will apply to a wide variety of "customs infractions". Just what will be penalized, however, still appears to be under some dynamic revision. For example, even in the last few months Customs has been busy defining and redefining what infractions will result in what penalties. (This is not dissimilar from the refinement undertaken over the years by CBP culminating in the most recent release of "Mitigation Guidelines: Fines, Penalties, Forfeitures and Liquidated Damages" in February 2004.)

Prior to September 2002, it has been published that mere "errors" on B3[19] forms would result in flat rate $100 penalties for each infraction. Thus a simple error in one of the origin fields in the B3, or in the overall value of the good, or the statistical suffix required for tariff classification, was to lead to a $100 charge on the B3. More problematically, it appeared where so-called "systemic errors" existed (e.g., in the valuation methodology), resulting in the same sort of error being made in multiple importations, the $100 penalty would apply again and again, to each of the multiple importations. The current AMP for this infraction appears to be AMP Contravention C005.

Applicability of Other Penalties. It is significant to note that an AMP may be assessed in addition to any other penalty (e.g., seizure), and in addition to any prosecution.

Also of significance are the Minister's collection powers, which include the ability to detain goods or a conveyance in respect of which an AMP penalty was assessed, until the penalty is paid. Thus CBSA has given itself a fairly big stick in which to enforce its AMPS powers.[20]

Notice of Penalty Assessment. Once assessed an AMP, a person receives a Notice of Penalty Assessment, pursuant to section 109.3 setting out the penalty number, the amount of the penalty, the penalty calculation as well as the contravention and the legislative authority. The AMP becomes payable on the day the notice of assessment is served on the person, under section 109.4 of *Customs Act*.

An automated penalty assessment process will be introduced to issue and record all penalty assessments. The automated system will link the contravention to the penalty level, calculate the penalty level and record the penalty in the person's compliance history, as well as recording any changes to the penalty assessment.

Interest. In addition to any AMPS penalties that might be imposed, it is worth reminding oneself that any applicable increased duties are also payable, plus interest at the prescribed rate, as well as interest on the AMPS penalty itself, which accrues from the date the assessment is served until the penalty has been paid in full. (Section 109.5(2) provides, however, that no interest is payable if the penalty is paid in full by the person, within 30 days after the notice of assessment.)

Appealing an AMP Penalty. Once an AMP is assessed, a person has four options (which are not mutually exclusive): (1) pay the assessment;[21] (2) request corrective measures; (3) appeal the assessment; or (4) enter into a Penalty Reduction Agreement.[22]

The "corrective measures" option is interesting, in that section 127.1 of the *Customs Act* allows the Minister (or more realistically, an officer designated by the Minister) to cancel or reduce an AMP penalty (or other penalty for that matter) within 30 days of the assessment, if there was "no contravention" or if there was an "obvious error" in the amount assessed.

In the past, the Minister had no formal power to correct errors after an assessment was made, other than through the formal appeal process, and this is a welcomed "pre-appeal" addition. It remains to be seen, however, just how far the CBSA will go towards correcting wrong-headed AMPS assessments, and how quickly they will be to simply punt the issue on to Adjudications.

In terms of the "formal" appeals process, a person has 90 days from the service of the notice of assessment to request reconsideration of the decision by the Minister, under section 131 of the *Customs Act*.[23]

Basic

NAFTA REQUIREMENTS

- Common Certificate of Origin Errors (Continued)
  - Not Producer ? Howdya know ?
  - Net Cost means "NC" or "NO" … Not Your Cost ! Field 9
  - Country or Origin: Taiwan Field 10
  - Authorized Signature Line – Not "Vera" in Shipping
  - Dates – Effective Dates vs. Back-dating Field 2

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 Minister's decision is final and cannot be altered or changed except by appeal to the Federal Court, Trial Division, under section 135.

AMPS Defences. It is noteworthy that AMPS penalties are automatically imposed, despite "reasonable care" efforts to comply, unlike the situation in the U.S. under the Mod Act. The Mod Act imposes a duty of "reasonable care"[24] on the trading community, however, to the extent that a trader can demonstrate that they did exercise "reasonable care", they will not be subject to a penalty.

Under the AMPS regime, even where a person has exercised reasonable care to comply with customs laws, they may still be subject to a penalty.

The CBSA has indicated, however, that a "due diligence" defence will be considered albeit, only at the Adjudications stage. Accordingly, and to the extent that a trader has been "duly diligent", in order to avail themselves of the defence, and to avoid second and third level penalties, an appeal must be instituted for first level offences, which would not appear to be economically feasible where the first level penalty is minimal.

A Penalty Reduction Agreement ("PRA") is another interesting development, and may be used to reduce or eliminate the penalty assessed where a person has been assessed an AMPS penalty totaling $5,000 or more, as a result of their Customs Information System.[25] The PRA also appears to be a viable alternative to appealing an AMPS penalty, in that it give a person assessed the ability to enter into a formal agreement with Customs to fix their systems to become compliant. The purpose of a PRA "is to facilitate the client's ability to comply through partnering them with Customs to correct a CIS problem that has resulted in a contravention, so that there will not be a repeat of the error."[26]

It appears that the degree of penalty reduction will also be governed in relation to the amounts traders pay to fix the problems in their systems, with the draft PRA statement indicating that the reduction of the penalty amounts assessed will be $1 for every $2 paid to fix a CIS problem, with the maximum reduction being the full amount of the penalty assessed.

AMPs Penalties for Violations of "Informed Compliance" Provisions. AMPS ought to be distinguished from mandatory correction obligations discussed above.

Under that program, and as set out in subsection 32.2(1) and 32.2(2) of the *Customs Act*, importers are required to monitor and control their importations of goods, and make mandatory corrections to their import documentation where errors in tariff classification, valuation and origin are found – and generally patterned on the similar approach in the U.S..

Informed Compliance requires importers to continually monitor whether they are in compliance with their customs' obligations, and where non-compliance is detected, take the *positive steps necessary to rectify the non-compliance, on both a go-forward and a go-backward basis.* Previously, where an importer discovered an error in the way in which goods were imported, the focus was more on the go-forward, since the onus was often on Canada Customs to bring the prior problems to the importers attention, and to issue appropriate assessments.

(With the effluxation of time, hidden problems in the past would generally disappear, since the applicable limitations period for the levying of Customs assessments – 2 years until recently – eventually ran out.)

That has changed, and importers not have a positive correction obligation, within 90 days of developing the "reason to believe" their entry documents were in error.

Significantly, with the introduction of AMPs, the penalties associated with non-compliance with the "informed compliance" provisions in section 32.2 have been repealed, and replaced by a special category of AMPS penalties.

Where there is a failure to make the required corrections to a declaration of origin, a tariff classification or a declaration of value for duty within 90 days after having a reason to believe the declaration was incorrect, a penalty will be imposed, per instance (that there is a failure to correct within 90 days) as follows: $100 for the first instance; $200 for the second instance; and $400 for the third and subsequent instances (*per* s. 32.2(2)(a) of the *Customs Act*).

In addition, an AMP penalty will also apply where there is a failure to pay duties as a result of a failure to make the required corrections (to a declaration of origin, a tariff classification or a declaration of value for duty) within 90 days of having a reason to believe that the declarations were incorrect (*per* s. 32.2(2)(b) of the *Customs Act*). The AMPS penalties for failure to pay duties as a result of required corrections will be based on the value for duty as follows: 1st penalty - $100 or 5% of VFD; 2nd penalty - $200 or 10% of VFD; 3rd and subsequent - $400 or 20% of VFD.

Basic
NAFTA REQUIREMENTS

- Common Problems
  - Importer's Failure to Have Certificate "On-Hand"
  - Exporter's Failure to Understand Anything about NAFTA
  - Exporter's Misapprehension of the "Rules of Origin"

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 II

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 customs 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 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.

“ 4 ”

Dumb errors trigger NAFTA Verification Reviews … especially in Texas, during cold Canadian winters.

MILLAR KREKLEWETZ LLP

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’s 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. A copy of Millar Kreklewetz’s Pre-Assessment Review methodology is available upon request, and includes the general program areas on which we would be expected to touch.

Valuation

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

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

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

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

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

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

QUESTIONS ?

Please reach 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

Basics of a
NAFTA VERIFICATION

- Mandated & Authorized under NAFTA
- Allows Canada Customs to Audit YOU …
  - Starting Point: Your Own Certificates
  - Next: NAFTA Origin Questionnaire
  - Next: Site Visit
  - Then: Judgement Day

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 (b) maintains a 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 current 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.

Basics of a
NAFTA VERIFICATION

- Some Practical Realities …
  - CBSA is Unionized & Seniority Gets You the Plumb Jobs, even if you started as a Border Agent.
  - Training may be lacking.
  - Canada Has Cold Winters; CBSA Auditors Plan their own Audits
  - How would you justify a 2 week trip to Texas ?

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

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]

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.

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**

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 now 14% 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.

QUESTIONS ?

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Millar Kreklewetz LLP

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

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

PART III
CANADA'S GST TAX SYSTEM

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 6% risk, is now a 14% 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]

Basics of
GST Compliance

- GST System will Affect Traders with Canada
- Non-Resident Importers
  - Generally Required to be GST Registered
- Other Sellers into Canada
  - Have you ever voluntarily registered ?
  - Registration Requirements: Carrying on 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

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:

Basics of
GST Compliance

- Obligations on GST Registration
  - Periodic GST Returns
  - Division II GST: Charge & Collect from Canadian Customers
  - Division III GST: Pay at the Border
  - Most Non-Residents Screw it Up

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

(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 enacted rules in s. 178.8 of the ETA (proposed by Notice of Ways and Means Motion on October 3, 2003) 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.

“ 2 ”

If you think
the GST is a pain in the *SS,
try falling into Canada's
Income Tax System.

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 6% 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 … 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;

Basics of
Income Tax System for Non-Residents

- **Even Broader Test for "Carrying on Business"**
  253(1)(b): Extended meaning of "carrying on business"
  Solicits orders or offers anything for sale in Canada through an agent or servant, whether the contract … completed inside or outside Canada … .
- **CRA takes GST Registration as *Admission* of COB for Canadian Income Tax Purposes**

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

(b) an advisory, consulting or professional service

(c) a postal service;

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

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

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

(g) a transportation service; or

(h) a telecommunication service.

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

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

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

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

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

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

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

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

A newly proposed provision, section 10.1, will effectively zero-rate most supplies of web-based services.

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

Basics of
Income Tax System for Non-Residents

- Treaty Protection if no "Permanent Establishment"
- Filing Requirement – T2 Return with Schedule 91
  - Sch 91 - Information re Claims for Treaty-Based Exemptions
- Practical Problem: Have to file to get the Protection

MILLAR KREKLEWETZ LLP

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ENDNOTES TO PART I:

1. The term "non-resident importer" ("NRI") is a bit of term of art in Canada. Non-resident importers generally do not maintain an office in Canada but forward invoices and shipping documents to a licensed customs broker who, under authority of the importer, prepares accounting documents, pays duties, takes delivery of the goods, and forwards them or has delivery made to those designated in instructions from his client.

   In most instances, an NRI will ask the CBSA for permission to maintain records at locations outside of Canada. Permission is granted, but usually only on the basis of an agreement whereby the NRI agrees to accede to CBSA audits of their business records at their foreign (to Canada) addresses, and pay the reasonable costs of the same.

2. The 1979 GATT Code is properly referred to as the *Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade*, and was signed by member parties on April 12, 1979 in Geneva, Switzerland. Canada adopted the 1979 GATT Code (the "GATT Code") on July 1, 1985, putting the machinery in place to convert Canada's century fair market value standard into its present form, and marking a significant change in the way goods imported to Canada were valued: for the first time, Canada began applying an international, positive standard of valuation.

3. The former GATT Code is now enveloped in the WTO's valuations rules, and entitled the WTO's Agreement on Customs Valuation. Again, the member nations signing the WTO have bound themselves to this agreement, requiring each of them to enact domestic legislation that incorporates the WTO's valuations rules.

4. The ability to define a term by regulation is generally regarded as a more flexible means of giving meaning to a term since, if a term is defined in the underlying Act, only legislative amendment passed by Parliament can change it, whereas changing a Regulation is much easier than changing an Act.

5. At time of writing, a draft copy of this D-Memorandum had been publically distributed to customs and trade practitioners, however, the draft copy had not been finalized.

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

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

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

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

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

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

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

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

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

14. Statistics as provided by the CBSA, and relevant for the period from October 7, 2002 through September 30, 2003.

15. Statistics developed from CBSA materials. Sample month of August 2003; AMPs issued: 858; Value: $581, 783.

16. When first publicized in the Customs Action Plan 2000 – 2004, AMPS was recommended as an administrative monetary penalty regime necessary to ensure that Customs penalties were imposed according to the type and severity of the infraction as part of creating a fairer and more effective sanctions regime. In Customs' view (as in ours) the then-existing penalties were insufficient and too limited, with too much reliance on seizures and ascertained forfeitures. Accordingly, AMPS was intended to replace the use of seizures and ascertained forfeitures for technical infractions, and to relegate the use of seizure and forfeitures for the most serious offences. AMPS was also thought necessary to secure a level playing field for traders and ensure trade data integrity.

17. Section 109.1 of the *Customs Act* (the "Act") provides for the imposition of an AMPS penalty by providing that every person who fails to comply with any provision of an Act or regulations will be liable to a penalty of not more than $25,000. The *Designated Provisions (Customs) Regulations* designate certain provisions of the *Customs Act*, *Customs Tariff* and Regulations made under those Acts, to fall under the penalty provisions of section 109.1 of the *Customs Act*.

    Pursuant to section 109.1 the maximum penalty for a single contravention is $25,000, however, this does not mean that the total amount assessed cannot exceed $25,000. For instance it is possible to have more than one AMP penalty assessed with regards to the same conveyance or transaction, with a combined penalty amount for the same transaction exceeding $25,000. Similarly, the consolidation of identical contraventions involving multiple transactions might also result in a consolidated penalty assessment in excess of $25,000.

18. Please note that all discussion of AMPS contraventions or penalties is based on the CBSA's AMPS Contraventions Master Penalty Document, dated January 1 2007.

19. A Canada Customs Coding Form (Form B3) is the counterpart to the U.S. Customs Form CF 7501.

"1"

If you screw up, you'll have to correct, and that will be the biggest pain in the *SS !

Mandatory Corrections, Voluntary Disclosures & Administrative Monetary Penalties

MILLAR KREKLEWETZ LLP

QUESTIONS ?

Please reach me as follows:

ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
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20. Perhaps in an effort to down-play all of this, the CBSA has stated that, "As a rule, the goods of commercial importers and carriers who are penalized by the system will not be detained unless there has been a collection problem in the past, or the penalty exceeds $5,000". See: Canada Customs and Revenue Agency, "Administrative Monetary Penalty System" Fact Sheet, January 2002.

21. 21.Section 97.22(2) provides that an amount assessed under section 109.3 and any interest payable under section 109.5, is a debt due to Her Majesty and that person is in default unless the person pays the amount or requests a decision of the Minister within 90 days. Accordingly, Customs can commence collection proceedings after 90 days.

22. Prior to an AMP being assessed, and where there is a contravention of an AMP penalty provision, it is noteworthy that a person also has the option of being proactive, and entering into a "voluntary disclosure" process (see below). In some instances, however, as in the case of the "records requirements" on B3 entry documents, the person may also have the technical obligation to correct the error under *Customs Act*'s "reason to believe" provisions, which require correction of tariff classification, value for duty, and origin errors within 90 days of a person gaining the "reason to believe" an error exists (see below).

23. If no request is made within the 90 days provided for in section 129, a person can apply to the Minister for an extension of time for making the request, under section 129.1. A request for an extension of time must be made within one year after the expiry of time set out in section 129 and the applicant must demonstrate that they had a bona fide intention to appeal within the 90 day period, it would be just and equitable to grant the application and the application was made as soon as circumstances permitted.

24. In this regard, the U.S. Customs Service has published a guide entitled "Reasonable Care Checklist" to assist traders in meeting their "reasonable care" standard.

25. The PRA seems to follow from sections 3.3(1) and 3.3(1.1) of *Customs Act* which provide the Minister with statutory authority to reduce or waive any portion of a penalty or interest otherwise payable by the person under the *Customs Act.* However, the Minister may only do so after the time frame for correction (section 127.1) and redress (section 129) have expired.

26. Please note that at the time of writing, the CBSA's policy regarding PRAs had not yet been finalized. Accordingly, our comments are based on the CBSA's Penalty Reduction Agreement - External Guidelines, published in July 2003.

ENDNOTES TO PART II:

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 valuation's 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, and 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.

MANDATORY CORRECTIONS & VOLUNTARY DISCLOSURES

- Laws Impose New Obligations to Correct
- Significant penalties for Failure to Correct
- What does Voluntary Disclosure get you?
- Strategies for a "go forward" vs. "go back" correction
- Importance of Privilege in any Correction/Disclosure

MILLAR KREKLEWETZ LLP

QUESTIONS ?

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ROBERT G. KREKLEWETZ
Millar Kreklewetz LLP

Telephone: (416) 864 - 6200
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12. See again: Customs Valuation: a Comparative Look at Current Canadian, U.S. & E.U. Issues, Robert G. Kreklewetz, A Paper presented at the 1996 CICA Annual Symposium in Ottawa, Ontario (Sep 29 - Oct 2, 1996).

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

ENDNOTES TO PART III:

1. 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.

Canada's New
Administrative Monetary Penalty System

CANADA
- *AMPs* where "contraventions"
- Some "value based" penalties
- Some "one-time" charges
- Penalty Reductions Agreemts

U.S.
- Fines, Penalties, Liquidated Damages
- Most Value-based penalties
- Some "one-time" charges
- Prior Disclosure & Mitigation

MILLAR KREKLEWETZ LLP

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