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The Latest Canadian

Customs & Cross Border Issues

Presented at the TEI's 57th Annual Conference

Toronto, Ontario: October 22, 2002

ROBERT G. KREKLEWETZ

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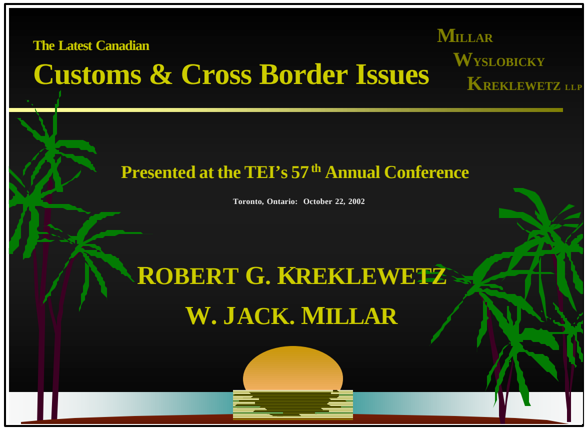

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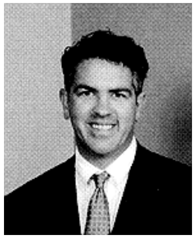
PROFESSIONAL PROFILES

Jack and Rob are partners at Millar Wyslobicky Kreklewetz (MWK) – a boutique tax law firm specializing in all **Commodity Taxes**, **Customs & Trade**, and **Tax Litigation**, and further described below.

W. JACK MILLAR, LL.B., LL.M.

Jack has an LL.M. from Osgoode Hall Law School, and is a member of the Board of Governors of the Canadian Tax Foundation.



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

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

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Specialized Practice Area
MWK's practice area focuses on **Commodity Taxes**, which encompasses all issues involving Canada's Goods and Services Tax (GST) and Harmonized Sales Tax (HST), as well the various other provincial sales taxes, including Ontario RST and Quebec QST. MWK also advises on the application of all other excise taxes, applying to a wide range of goods like tobacco, alcohol, jewellery, gasoline and other motive fuels.

MWK's also focuses on **Customs & Trade** matters, including Periodic Verification Audits concerning Valuation, Tariff Classification, Origin, or Marking issues, and including NAFTA Origin Verification Reviews, Forfeitures, Seizures, and other NAFTA & WTO issues.

Finally, MWK advises on a number of other **Tax-Related Matters,** wherever involving the domestic or international movement of goods, services and labour. These would include advising non-residents on properly structuring Canadian business operations (or on the entry into Canada of business persons), providing Transfer Pricing opinions, advising on the application of the Ontario EHT (and other pay-roll source deduction taxes), and any and all tax or licensing law issues affecting the Canadian Direct Selling Industry.

Extensive Tax Litigation Experience
All elements of MWK's practice include **Tax Litigation**, and Jack and Rob have acted as lead counsel in a significant number of cases before all courts, including the Tax Court of Canada, Canadian International Trade Tribunal, Federal Court (Trial Division), Federal Court of Appeal, Ontario Court of Justice, Ontario Court of Appeal, and the Supreme Court of Canada.

Speaking Engagements / Publications / Memberships
Both Jack and Rob continue to write and speak extensively in all of the above areas, regularly addressing the Tax Executive Institute (TEI) – both at its Annual Conference and Chapter Meetings – and other tax organizations like the Canadian Tax Foundation, Canadian Bar Association (CBA), Canadian Institute of Chartered Accountants (CICA), Canadian Finance and Leasing Association (CFLA), as well as the Canadian Associations of Importers & Exporters (CAIE), Certified General Accountants (CGA), and Direct Sellers (DSA). They also speak frequently at Conferences held by the Strategy Institute, Infonex, Federated Press, and at the Institute for International Research.

Jack, Dennis and Rob are proud to announce that the International Law Review has ranked them as the top Canadian law firm in the commodity tax area.

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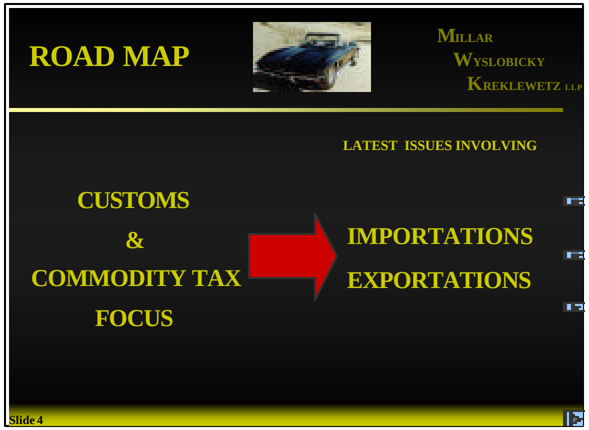

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THE ROAD MAP

General Focus of the Presentation

Customs and Commodity Tax issues continue to be high-focus items for persons doing business in Canada, on the provincial, national and international levels – often adversely impacting profitability, especially given the level of planning (or awareness) needed to adequately address and minimize these charges.

The Presentation / Materials will focus on the latest Customs and Commodity Tax issues facing persons involved in cross-border transactions, including issues involving Canada's Customs regime, as well as issues developing under Canada's GST[1] and RST[2] systems.

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

Navigating Through the Materials

The Materials are broken into two main parts.

Part I is a sampling of the latest Canadian customs and cross-border commodity tax issues, and begins just below.

Part II, which begins at page * of the Materials is a fairly comprehensive review of the particular customs and commodity tax regimes that are covered in Part I.

This part is thus designed to allow readers not completely familiar with these systems to more fully understand the customs and commodity tax systems in which these issues arise, providing a fuller understanding of some of the "current issues" discussed earlier on. Part II is styled, then, as a "*Building Block*" discussion, and that is what it is.

Obviously many readers will already have a very sophisticated understanding of Canada's GST, RST, and Customs system, and therefore for you, there may be little or no benefit in reading Part II.

PART I – CURRENT ISSUES

---------------- *CUSTOMS* ---------------

The following discussion addresses some of the latest Canadian customs issues affecting people doing business in Canada.

The Administrative Monetary Penalty System ("AMPS")

Overview. The biggest news in Canada's Customs law regime is the recently implemented *Administrative Monetary Penalty System* – or "AMPS" for short.

AMPS came into effect on October 7, 2002.[1] There is every indication that Customs will be aggressive in the administration of AMPS, as even on the partial implementation of the system last fall (i.e., CSA), there were 649 AMPS- related penalties issued in a bit over the first month of the system. And for the period December 3, 2001 to August 31, 2002, Customs reportedly issued over 11,500 AMPS warnings.

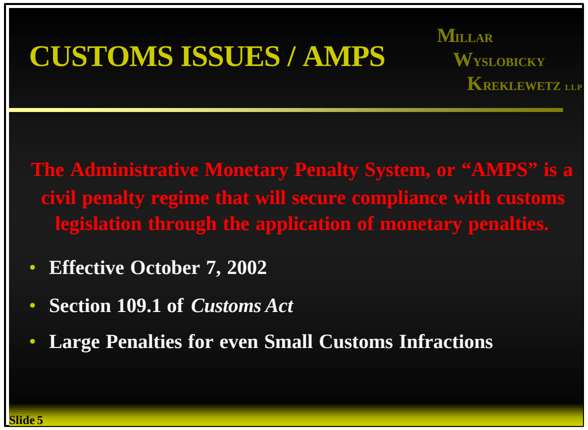
The Mechanics of AMPS. For Canada, AMPS is an unprecedented and comprehensive sanctions regime, aimed at providing Canada with a graduated civil monetary penalty system instead of the "all of nothing" approach under the former regime, which usually entailed quite draconian penalties (e.g., seizure of goods, or penalties amounting to the full value of the goods) for even the most minor of customs errors.[2]

In that sense, AMPS seeks to secure compliance of customs legislation through the imposition of monetary penalties.[3]

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 will 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 mis-classification of goods, to non-revenue related statistical errors.



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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 CCRA has stated that AMPS is designed to be corrective rather than punitive (and that its purpose is to secure compliance of 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 CCRA has maintained that AMPS will be administered in a manner that is consistent with the CCRA'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 will impose 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:

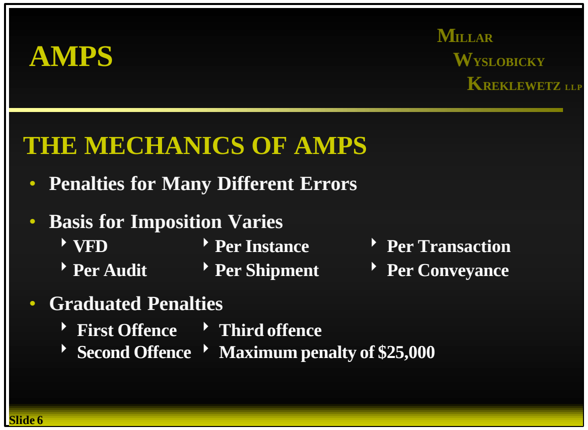
1st Time Offence	$ 1,000
2nd Offence	$ 5,000
3rd Offence	$10,000
4th Offence Plus	$25,000 [5]

The CCRA has indicated that 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.

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 ?

Types of Penalties. It is noteworthy that AMPS will apply to a wide variation 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. Prior to September, it has been published that mere "errors" on B3 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. With the newest Master Penalty Document, however, this flat rate penalty appears to have been eliminated – although one wonders if it has somehow been buried or addressed elsewhere.

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 Customs has given itself a fairly big stick in which to enforce its AMPS powers.[6]

Notice of Penalty Assessment. Once assessed an AMP, a person will receive 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 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.*

Finally, it is expected that 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.

It will be interesting to see how long it takes Canada Customs to implement this system, as experience indicates that when it comes to expediting electronic innovations, the CCRA is not well known for its speed.

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;[7] (2) request corrective measures; (3) appeal the assessment; or (4) enter into a Penalty Reduction Agreement.[8]

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 APM 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.

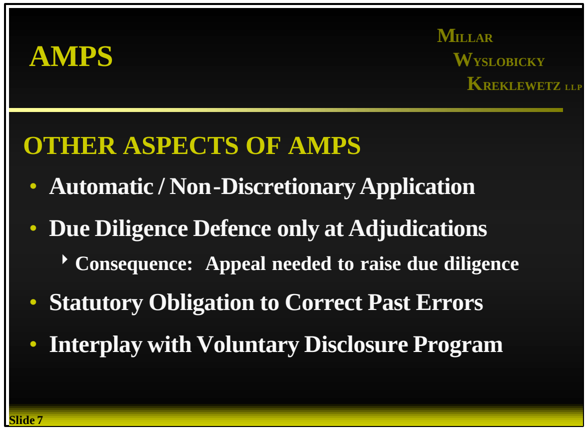
In the past, the Minister had no formal power to correct errors after an assessment was made, other than through the formal appeal process, and this is a welcomed "pre-appeal" addition. It remains to be seen, however, just how far the CCRA will go towards correcting wrong-headed AMPS assessments, and 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*.[9] 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"[10] 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 CCRA has indicated, however, that a "due diligence" defence will be considered albeit, only at the <u>Adjudications</u> 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.[11]

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."[12]



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.

Recent Grace Period. While there was an extended grace period since the partial implementation of AMPS, and multiple warnings issued for contraventions, the CCRA has indicated that with the recently full implementation of AMPS, there will be no penalties applied retroactively to infractions that occurred prior to October 7, 2002, and that all warnings received during the transition period will be wiped clean from a trader's compliance history.

AMPs Penalties for Violations of "Informed Compliance" Provisions. AMPS ought to be distinguished from another of Customs' programs, which can be loosely referred to as "informed compliance". 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.

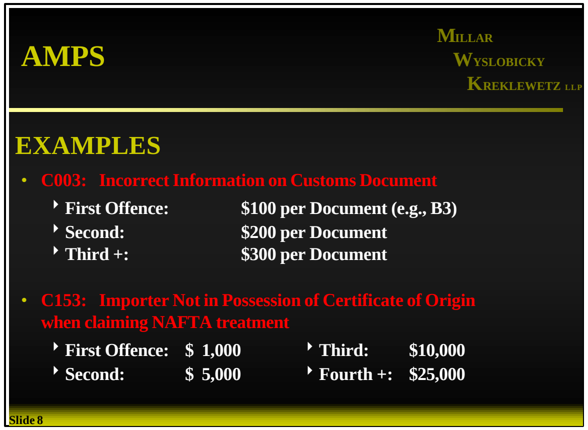
Significantly, with the introduction of AMPs, the penalties associated with non-compliance with the "informed compliance" provisions in section 32.2 have been repealed, and replaced by a special category of AMPS penalties. Where there is a failure to make the required corrections to a declaration of 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.

The Latest "Substantive" Customs Issues

The Last Word on the Royalties Inclusion. Section 48(5)(a)(iv) of the *Customs Act* requires the price paid or payable for imported goods to be specifically increased by the value of certain royalties and licence fees paid in respect of the imported goods, as a condition of their sale.

The relevant inclusion provision in the Customs Valuation Code is as follows:

> ***Customs Act***
>
> 48(5) *Adjustment of price paid or payable* — The price paid or payable in the sale of goods for export to Canada shall be adjusted …
>
> (a) by adding thereto amounts, to the extent that each such amount is not already included in the price paid or payable for the goods, equal to …
>
> (iv) royalties and licence fees, including payments for patents, trade-marks and copyrights, in respect of the goods that the purchaser of the goods must pay, directly or indirectly, as a condition of the sale of the goods for export to Canada, exclusive of charges for the right to reproduce the goods in Canada, ...



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Requirements. The rule requires three things before making a payment dutiable. The payment must be: (1) a "royalty" or "licence fee", (2) "in respect of" imported goods, and (3) a "condition of the sale" of the imported goods.

Despite the simple words, a number of considerations come into play when trying to understand apply the royalties provision, some of which have been dealt with by the Canadian jurisprudence on the subject.[13]

Accordingly, the meaning of this provision has undergone a fair amount of judicial scrutiny, at all levels of Canada's federal court system, culminating with the Supreme Court of Canada's decision, in mid-2001, in the *Mattel case.*[14]

Facts of the Case. On the facts of the case, Mattel Canada purchased goods from its U.S. parent corporation, Mattel Inc., for sale in Canada. Mattel Inc. sourced those goods from off-shore manufacturers, through a series of related companies, and Mattel Canada paid *a royalty to a licensor completely unrelated to either Mattel or the manufacturers.*

The royalty was for the right to sell products in Canada, with certain trade-marks affixed to them.

The real issue in the case, as it regarded "third-party" royalties, was the meaning and application of the (iii) "condition of sale" requirement. The problem was a difficult one, because the transaction was structured so that the Canadian importer had little to do with the Licensor of the goods.

The Supreme Court's decision was handed down on June 7, 2001, after a hearing on February 20, 2001, and the decision set out the law on "royalties" as follows:[15]

> The royalties paid by Mattel Canada to Licensor X were not royalties within the meaning of subparagraph 48(5)(a)(iv) of the *Customs Act*. The Court interpreted subparagraph 48(5)(a)(iv) to require that royalties and licence fees be paid as a "condition of the sale of goods for export to Canada." The words "condition of sale" are clear and unambiguous. <u>Unless a vendor is entitled to refuse to sell licensed goods to the purchaser or repudiate the contract of sale where the purchaser fails to pay the royalties or licence fees</u>, subparagraph 48(5)(a)(iv) is inapplicable.

One would have thought that would have been the end of the matter, but Canada Customs still proceeded with some cases that had been in the wings waiting for the *Mattel* decision.

First and foremost was the *Reebok* decision – recently handed down by the Federal Court of Appeal, from the bench, and again rejecting Canada Customs approach.

For now, then, it appears that with proper structuring, many Canadian royalties will not be subject to Customs duties.

What are the Purchaser in Canada Rules ?

In another area of Customs valuation, the Purchaser in Canada rules are really regulations (the "Purchaser in Canada Regulations") that Canada put in place in light of 1997, to complement changes to sections 45 and 48 of the Customs Act. The new rules are effective on September 17, 1997, and add 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 <u>to a purchaser in Canada</u> and the price paid or payable for the goods can be determined and if ...

Thus section 48 of the *Customs Act* was amended to add the requirement that the "sale for export to Canada" be to "a purchaser in Canada."

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" <u>to be defined by regulations</u>.[16]

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

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.

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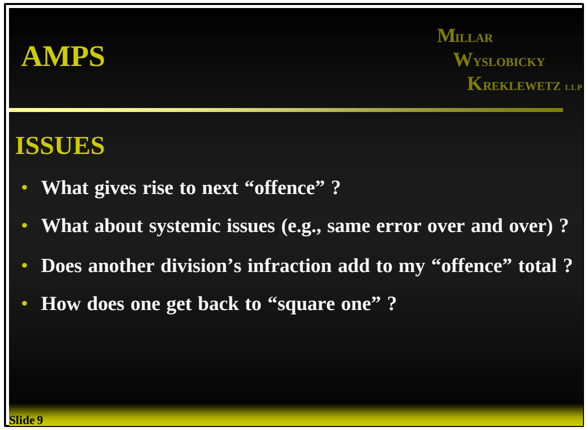

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9. Therefore, in order to determine if a business entity is a resident in Canada, the two following concepts must be closely examined:

(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:

(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; and

(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:

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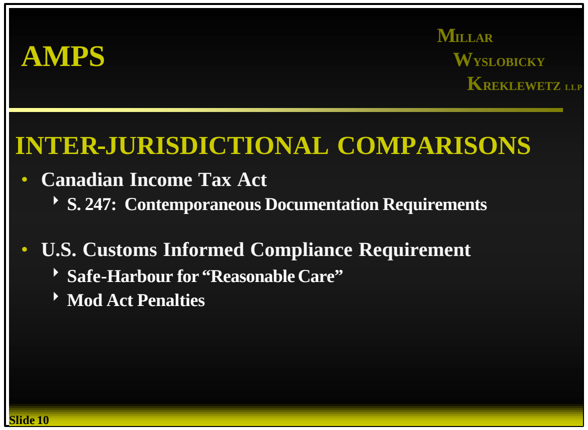

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(1) the Canadian business entity exercises control over day-to-day functions necessary to maintain the continuous operation of the Canadian business entity;

(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.

The regions have been quite aggressive in auditing these criteria, and that has required a new vigilance on Canadian importers, particularly where there are positive rates of duties associated with the products.

NAFTA Origin Issues

Origin is highly significant in that only when the origin of the goods can be determined can the preferential rates of duty applicable to the imported goods be determined.[17]

Many readers will recall the zest with which Canada Customs undertook "valuation" audits in the early 1990s. The decline of U.S. duties under NAFTA results in many practitioners forecasting a demise for the valuation audit, while at the same time predicting an increase in NAFTA verification activity. I guess those guys were right.

In the present decade, NAFTA Verification audits are becoming the source of work (and heartache) that valuation audits were in the 1990s. And for Canadian importers and U.S. exporters/producers, they are resulting in the same sort of disbelief, distress and disgust – all in that order – that a "snap" valuation audit represented some 10 years ago.

Overview. The basis for NAFTA verification is found in Chapter Five of the NAFTA which sets out the basic legal requirement for claiming NAFTA preferential status. The basic rule that where NAFTA preferential status is claimed, an importer must have in its possession, a valid NAFTA Certificate of Origin ("NCO"). So the first rule: no NCO, no NAFTA.

Having the NCO in one's possession is actually supposed to be the easy part. The more difficult situation is actually ensuring the that person providing you with the NCO has provided it and prepared it properly. Under the NAFTA, after all, the ultimate responsibility for importing goods is on the *importer*. That means that where there are problems with the NCO, the ultimate liability falls on the importer.

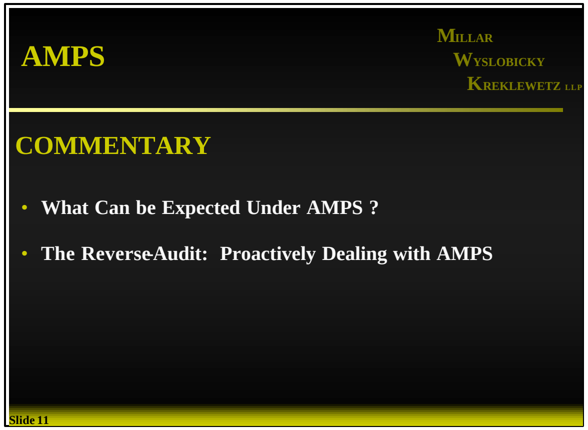
NAFTA Verifications. The tool that is used by both Canada Customs and U.S. Customs to police the NAFTA origin requirements is the NAFTA Verification review, which can entail site visits .[18] NAFTA Verification usually starts with a fairly innocuous inquiry, on the importer side, with the Customs Administration contacting importers, asking about product information, and requesting copies of NCOs. The basis for the request is, again, found in the NAFTA, and in Article 502(1).

Once an importer provides Customs with the information it is seeking, the importer can often be lulled into concluding that the process is over – particularly as Custom Administration re-focuses its attention to the NAFTA exporter, to perform further "origin verification".

Re-focus on the Exporter. Armed with NCO's issued by the exporter (or sometimes the producer of the goods), Customs will then turn its attention on the exporter of the goods., in an attempt to verify that the goods imported under the NCO's did actually meet the NAFTA "origin" requirements.

While there are a number of ways in which a Customs Administration is able to obtain information from NAFTA exporters (and a number of requirements Customs must satisfy before doing so), a typical approach is to seek the completion of *NAFTA Origin Verification Questionnaire*. Once completed, a site visit is usually requested. Pending completion of the audit, and assuming the worst, Customs will then provide the importer with written notice of its intent to deny NAFTA status, which while subject to representations and appeal, is a big problem.

)While I have summarized the process, it is often very involved, requiring the detailed attention of a Canadian customs lawyer, and internal time and resources.)



Closing out the Loop: Back to the Canadian Importer. Assuming, at the end of the process, that Customs takes the view that an exporter has issued improper NCOs, a number of very serious implications arise, each based in the so-called "informed compliance" initiatives now in Canadian (and U.S. and Mexican) trade laws. These "reason to believe" requirements place positive obligations on the exporter and importer, as described generally in Part II below.

For the exporter – who now has "reason to believe" its NCOs are incorrect – a mandatory "reporting requirement" arises. For example, Article 504(1) of the NAFTA provides as follows:

> 1. Each Party shall provide that: …
>
> (b) an exporter or a producer in its territory that has completed and signed a Certificate of Origin, and that has reason to believe that the Certificate contains information that is not correct, shall promptly notify in writing all persons to whom the Certificate was given by the exporter or producer of any change that could affect the accuracy or validity of the Certificate.

In Canada and the U.S. there is a contemporaneous obligation on an importer receiving the bad news, in the form of a mandatory correction obligation. In Canada this is found in section 32.2 of the *Customs Act*:

> 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 … 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.

And that is about the point the NAFTA Verification audit concludes – usually on a quite unhappy basis for the importers.

Commentary. It can be seen that under the NAFTA, the "importer" is the one left "holding the bag" in terms of possible duty and interest consequences for invalid NCOs. That is troublesome, but at least predictable and manageable given a reasonable degree of customs compliance in the U.S. and Mexico. But therein lies the problem.

In my experience, U.S. and Mexican exporters do not often pay the attention required of them when issuing NCOs. That results in errors on the face of NCOs, and in the worst case, entirely invalid NCO's. Even in situations were simple errors exist, but the goods are ultimately of NAFTA origin, the errors tend to act as the "big red flag" that Customs is looking for, perhaps inviting a greater scrutiny. And in my experience most NCOs will have at least one or two errors on them. Some of them can be real deuzies,[19] which put into question (at least in the mind of Customs) whether there is any NAFTA compliance occurring at all).

What all of this means for Canadian importers is that like it or not, they are the persons with the vested interest in reviewing NCOs obtained from U.S. or Mexican exporters (or producers). And they will be the persons who will have to act as the "first line of defence" in scrutinizing the accuracy of NCOs they are provided with. Accordingly, Canadian importers should take some basic steps towards ensuring the accuracy of the NCOs that it will be relying upon, perhaps taking a cursory review of the NCOs if only to ensure that there are no problems immediately apparent on their face.

When Canada Customs becomes involved, importers can also help their long-term positions by taking a lead role in both alerting the exporters to the on-coming review, the implications of what is about to occur, and perhaps guiding them to a source of Canadian customs advice necessary to adequately meet the audit.

Generally speaking that means a Canadian-based practitioner, familiar with Canada Customs and its administrative practices. After that, however, my best advice for a Canadian importer is to keep its fingers crossed, buckle-up, and hang on for the ride.

Final Note. When faced with a NAFTA verification issue, don't forget to ask yourself what the MFN rates are for a particular good – since these rates are often also duty-free – or whether the tariff classification for the subject goods (which of course drives the MFN duty rate) is correct. I have seen occasions where the NAFTA status of imported goods did not really matter, since the MFN rates were duty-free in any event.

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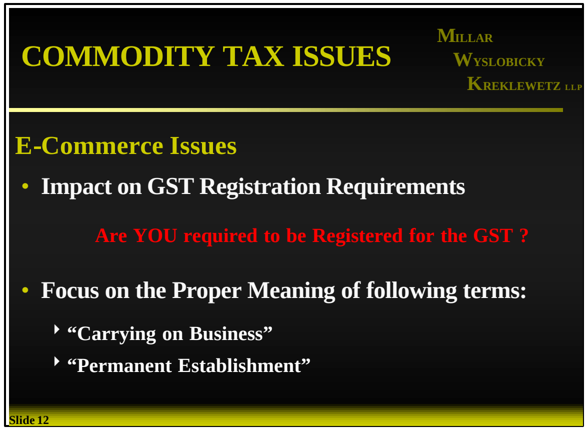

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As can plainly be seen, determining "origin" can be one of the most difficult processes in customs or tax law. Complicating matters, since the Certificate of Origin must be signed by the exporter or producer, based on its knowledge or pre-existing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

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

Perhaps more significantly, the ultimate problem really ends up in the *importer's* lap, with the importer effectively left 'holding the bag'. The reason is that while the export's obligation stop with simply notifying the importer that NAFTA preferential rates never really applied, the voluntary compliance models in place in countries like 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 the CCRA, plus interest.

Reverse Audits – Proactively Ensuring Compliance

To date, "origin determination" has been one of the most heavily focused areas in terms of Customs' post-entry verification review for NAFTA compliance. Certificates of Origin are also coming under increasing review, as is the origin and tariff classification analyses which underlie the Certificates.

Importers and exporters are well-served by taking a moment, to consider the proper treatment of their goods when imported to Canada, and not only from the perspective of "tariff classification", valuation" and "origin" of their imported goods.

Increasingly our clients are asking for assistance in developing a reverse-audit strategy, designed to parallel the approach that Customs itself takes in auditing customs compliance.

At MWK we call this process our "Multi-Program Review", and that is simply a "reverse-audit" approach aimed at verifying a business's compliance at the border, and focuses on analyzing the information provided by your company in past importations (generally from a series of 20 to 35 sample importations over the last calendar year), in order to ascertain your level of overall customs compliance – emulating the approach that Canada Customs takes under its Program Compliance initiative. It is also aimed at conducting an overall assessment of your companies' ability to import and accurately report and account for goods – emulating the approach that Canada Customs takes under its System Review initiative.

Appendix "A" contains a copy of MWK's Multi-Program Review framework, and includes the general program areas on which we would be expected to touch.

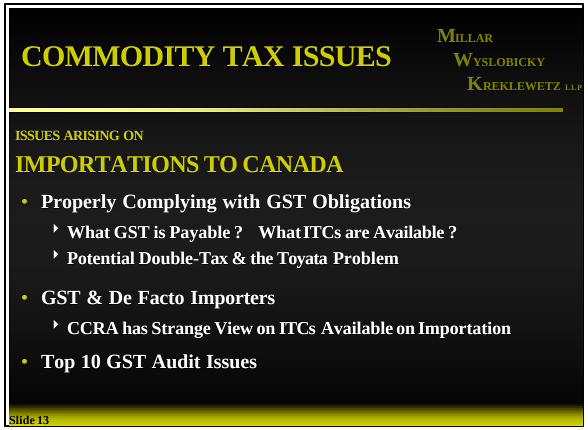
---------------- *COMMODITY TAXES* ---------------

The following discussion addresses some of the latest Canadian customs issues affecting people doing business in Canada.

E-Comm Issues

While some might legitimately suggest that despite the recent abundance of speakers and writers on "e-comm", there are really few real substantive issues involved in ecomm transactions – which, after all, would not seem to affect the traditional trade in goods, and perhaps only really affect the transfer or intellectual property or services via computers.[20]

Like it or not, however, the recent technological developments that have accompanied the internet, and the digitization of traditional brick and mortar products, has raised a number of fundamental tax issues. Key among these are as follows:



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1. What business activities will not make a business capable of "carrying on business in Canada" or constituting a "permanent establishment in Canada" ("PE") ?

and

2. How to characterize electronic supplies of (digitized) goods, services and intangible property?

Only after these fundamental questions are answered can one properly apply the commodity tax rules necessary to determine whether a particular supply is taxable or non-taxable.

Registration Requirements – COB & PE Issues. When one speaks of whether one is "carrying on business" in Canada, or has a "PE" in Canada, one is generally concerned with determining whether one is required to be registered as part of the Canadian tax system, and paying, charging, or collecting applicable taxes. The same is so in the GST context, where these same issues arise.

Whether one "carries on business" in Canada is important because of a special rule that applies to non-residents who are not registered for the GST (and who do not carry on business in Canada). That rule is found in s. 143 of the *ETA* (discussed in detail in Part II), and which deems supplies made by these persons to be made outside Canada, and therefore never subject to GST. (There are some exceptions).

As the development of e-commerce makes it increasingly easier for non-residents to conduct business with Canada, the issue of whether they are "carrying on business in Canada" becomes significantly important – as the meaning of the phrase effectively marshals just what non-resident businesses are required to comply with Canada's GST system. Additionally, as non-residents who have a "PE" in Canada are "deemed to be resident in Canada" for purposes of s. 143 (and the *ETA* as a whole), whether one's e-comm activities constitute a PE in Canada also become increasingly important.

Carrying on Business. Under the common law, the primary factors in determining whether some is carrying on business in Canada have always been (i) the place where the contract is concluded and (ii) the place where the operations from which profits arise take place (see Part II for a greater discussion on the traditional tests).

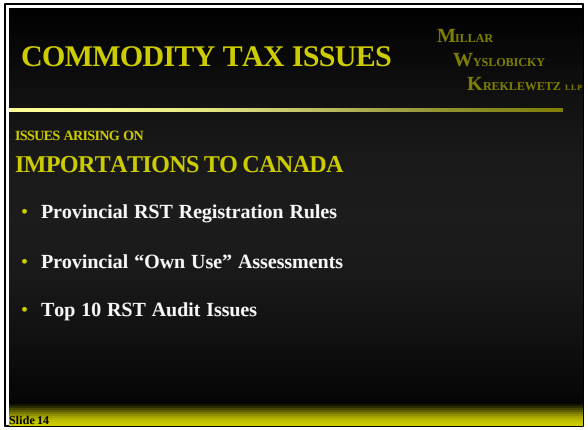
Thus the mere advertising of products for sale in Canada (invitations to treat and not formal "offers for sale") was not generally regarded as sufficient to "carry on business" in Canada.

In addition to the two primary factors indicated above, Courts also considered various "other factors" in assessing whether a non-resident is carrying of business in Canada, although it was clear that the pre-dominant among these was the place where the contract is concluded – allowing taxpayers wishing to remain "outside of Canada" to order their affairs by ensuring that contracts are all concluded 'off-shore'.

The CCRA's new e-commerce policy is set out in a July 2002 Technical Information Bulletin B-090: *GST/HST and Electronic Commerce* (the "E-Comm Bulletin"). In assessing how Canada should approach its "carrying on business in Canada" requirement, the CCRA has indicated that the new focus ought to be the "place of operations", and will look to the following indicia to assess whether Canada is the "place of operations" for the business0:

- the place where agents or employees of the non-resident are located;
- the place of delivery;
- the place of payment;
- the place where purchases are made;
- the place from which transactions are solicited;
- the location of an inventory of goods;
- the place where the business contracts are made;
- the location of a bank account;
- the place where the non-resident's name and business are listed in a directory;
- the location of a branch or office;
- the place where the service is performed; and
- the place of manufacture or production.

Based on these various factors, the E-Comm Bulletin provides various examples including a business that supplies downloadable audio files. In this example, the CCRA has confirmed that the following factors are <u>not</u> sufficient to establish the carrying on of a business in Canada:



1. Advertising that is directed at the Canadian market through a U.S. based web-site;

2. Concluding contracts in Canada; and

3. Processing payment in Canada.

Permanent Establishment. As indicated, the definition of "permanent establishment" is also important for Canada's tax system, as if someone constitutes a PE, they will be drawn into both Canada's income tax and GST systems. Focusing on the commodity tax aspects of PE, the term is defined in s. 123 of the ETA as:

> (a) a fixed place of business of the particular person ... through which the particular person makes supplies, or
>
> (b) a fixed place of business of another person (other than a broker, general commission agent or other independent agent acting in the ordinary course of business) who is acting in Canada on behalf of the particular person and through whom the particular person makes supplies in the ordinary course of business;

In the E-Comm Bulletin, the CCRA has addressed various basic questions about what will and will not constitute a PE for Canadian GST purposes. For example, the E-Comm Bulletin confirms that the presence, alone, of a web-site in Canada will not constitute a PE, since it is merely software and electronic data (intangible property). The E-Comm Bulletin suggests, however, that if the server on which the web-site is stored is located in Canada, <u>then this may constitute a PE if the functions carried out through the server are "on their own, an essential and significant part of the business activity of the enterprise as a whole, or constitute other core functions of the enterprise"</u>.

Characterization of Supply & Place of Supply Rules. Other "e-comm" issues include Canada's attempts to determine just how e-comm transactions will affect its GST system. Two of the more fundamental areas of focus include the application of Canada's place of supply rules, and issues arising on the "characterization" of the particular supplies.

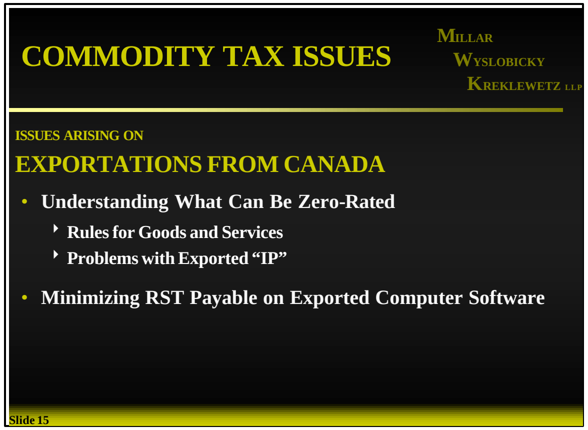
Regarding "place of supply", s. 142 of the ETA provides the primary "place of supply" rules, with s. 142(1) deeming the following supplies to be made in Canada and potentially subject to GST:

> 142.(1) For the purposes of this Part, subject to sections 143, 144 and 179, a supply shall be deemed to be made in Canada if
>
> (a) in the case of a supply by way of sale of tangible personal property, the property is, or is to be, delivered or made available in Canada to the recipient of the supply;
>
> (b) in the case of a supply of tangible personal property otherwise than by way of sale, possession or use of the property is given or made available in Canada to the recipient of the supply;
>
> (c) in the case of a supply of intangible personal property,
>
> (i) the property may be used in whole or in part in Canada, or
>
> (ii) the property relates to real property situated in Canada, to tangible personal property ordinarily situated in Canada or to a service to be performed in Canada;
>
> (d) in the case of a supply of real property or of a service in relation to real property, the real property is situated in Canada; …
>
> (f) the supply is a supply of a prescribed service; or
>
> (g) in the case of a supply of any other service, the service is, or is to be, performed in whole or in part in Canada.

Given the fact that the "place of supply" rules differ significantly depending on the nature of the supply (i.e., intangible personal property is supplied in Canada if it "may be used in whole or in part in Canada"; whereas, a service is generally only supplied in Canada if it is "performed in whole or in part in Canada"), the proper characterization of the supply is an essential starting point to any GST analysis. (Similar issues also arise in terms of applying the zero-rating exports and telecommunication services provisions.)

Characterization. The E-Comm Bulletin indicates that all supplies delivered in an electronic format are either supplies of intangible personal property ("IPP") or a service and not tangible personal property. In situations where a person obtains "rights", the supply is generally characterized as IPP, with the CCRA indicating that the following factors are consistent with a supply of IPP:

> 1. A right in a product or a right to use a product for personal or commercial purposes is provided, such as:
>
> - intellectual property or a right to use intellectual property (e.g., a copyright); or
> - rights of a temporary nature (e.g., a right to view, access or use a product while on-line);



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2. A product is provided that has already been created or developed, or is already in existence;
3. A product is created or developed for a specific customer, but the supplier retains ownership of the product; and
4. A right to make a copy of a digitized product is provided.

If, however, the supply involves the specialized or individual labour of the supplier, the supply is generally characterized as a service, with the CCRA focusing on the following factors:

1. The supply does not include the provision of rights (e.g., technical know-how), or if there is a provision of rights, the rights are incidental to the supply;
2. The supply involves specific work that is performed by a person for a specific customer; and
3. There is human involvement in making the supply.

Other "Place of Supply" Considerations. With electronic commerce, service providers can provide certain services from a remote location and, at first blush, it would appear that such services are being performed outside Canada if the person performing the service is located outside Canada. For example, a computer technician can access a customer's computer situated in Canada as opposed to showing up physically at the customer's location.

The E-Comm Bulletin has indicated that these types of "remote access" services will generally be considered made in Canada if the service involves operations performed by the supplier's computer equipment that is located in Canada or the "supply involves doing something to or with a recipient's equipment by accessing it from a remote location, and the recipient's equipment is located in Canada". The mere use of equipment in Canada to receive delivery of a service, however, will not result in the service being performed in whole or in part in Canada.

Commodity Tax Issues Affecting Persons Doing Business In Canada

GST & De Facto Importers

A current issue that focuses on the interplay between the Division III GST imposed under the *ETA* and the provisions of the *Customs Act* is the so-called "de facto" importer issue.

Overview. In a nut shell, the "de facto importer" involves a number of different possible situations, but essentially involves the CCRA's attempts to limit the persons who may claim ITCs for the GST paid on the importation of goods to Canada.

The CCRA's efforts have been aimed, in part, at certain "loop-holes" in the taxing system imposed by the *ETA* which seem to allow virtually anyone that pays the GST at the border, to claim the requisite ITC – if otherwise eligible to do so.[21]

One example involves the case of "leased goods", for the consumption and use in Canada of certain leased goods, with no application of the GST. Where the consumer or user is either not registered, or an exempt user (e.g., an Financial Institution), the situation can look quite inviting.

> Example: Asset is purchased outside of Canada by Canadian Lessor from third-party Vendor. Lessor gives possession of the Asset to the Lessee (a Financial Institution) outside of Canada, under a Lease Agreement. Lessee brings Asset into Canada, but Lessor reports it, and acts as importer of record, paying the GST at the border. Lessor claims the ITCs.
>
> Implications: No Division II GST applies to the Lease Payments as the possession of the Asset was given to the Lessee outside of Canada. (The Lease is deemed to have been made "outside of Canada" under the rules in sections 142 and 136.1(d) of the *ETA*, taking the lease transactions outside of the GST system altogether).

The CCRA has been moving to deny the claiming of the ITCs by the Lessors in these situations.

Another situation involves a commercial seller of goods, that is GST registered, that sells the goods "f.o.b." U.S. (i.e., providing that title to the goods passes in the U.S.), but then acts as the importer of the goods into Canada, also paying the GST. The CCRA has been moving to deny the requisite ITC to the seller of those goods, again on the basis that certain avoidance situations could arise.

Commentary. Our view is that ITCs should usually be available since, under the rules in the *Customs Act*, the person importing the goods is generally required to pay the GST, and that seems to

be the only current requirement for the taking of the ITCs – and in most instances, it can be said that the GST is paid in the course of the person's consumption, use or supply of the goods in commercial activities.

Section 32 of the *Customs Act* permits either the "owner" or the "importer" of imported goods to account for them, and pay the required duties imposed on the goods. The *Customs Act* indicates no preference as to which of the importer or the owner – if in the circumstances of the importation, the two are different – accounts for the goods.[22]

Having said that, the *Customs Act* (and the CCRA's administrative policies) is replete with instances where either the importer or owner of the goods is able to account for the goods. And once a person accounts for the goods, certain implications follow: First, the person is considered the "importer" of the goods for customs purposes; second, a liability is created for further payment of duties and GST.

Accordingly, while there may be some "tax policy issues" with the manner in which the *ETA* fails to tax these situations, the ITCs seem to be available.

The matter is currently in the Tax Court on a number of fronts.

RST Registrations Requirements for Out of Province Vendor

With the advent of electronic commerce, Canadian and provincial borders are becoming less of an obstacle resulting in more and more businesses selling taxable goods to persons situated all across Canada.

In addition to the tax collection agreements that all PST taxing border provinces (namely, BC, SK, MB, ON and QB) have entered into with the Government of Canada to ensure that the tax bases are not eroded, a number of provinces have taken steps to arm themselves with legislation that forces non-resident with some connection to the province to register.

Notable examples of these are the provinces of British Columbia and Quebec.

BC's Approach. Section 93 (1.1) of British Columbia's *Social Services Tax Act* requires businesses, located outside BC, who in the ordinary course of business sell goods to persons in BC, to register for BC sales tax if they meet the following four conditions:

1. solicit sales in British Columbia through advertising or other means including mail, Internet, fax, telephone or newspaper advertisment if the solicitation is targeted to potential BC customers,
2. accept purchase orders originating in British Columbia,
3. sell goods to British Columbia purchasers, and
4. cause the goods to be delivered to a location in British Columbia. (either physically or electronically).

(See also Consumer Taxation Bulleting No. 74: *Out-of-Province Sellers*).

These rules serve to significantly broaden the registration requirements of non-resident Canadian businesses. Whether such a broad registration requirement amounts to a direct tax in the province and is constitutionally valid, however, remains to be seen.

Notably, and perhaps in recognition of the difficulties associated with enforcing these rules on non-residents of Canada, BC provides some administrative relief.

Since the CCRA already collects BC PST on non-commercial importations that enter Canada at the BC border, there is the potential for double tax with the expanded registration rules.

In these situations, BC generally relieves the non-resident from registering for BC sales tax, however, obtaining special permission is recommended.

In determining whether to grant administrative relief, BC will consider what percentage of sales will be covered by the border collection agreement (i.e., are the products entering Canada at the BC border or another province) and whether the purchaser is a British Columbia business or individual.

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Notably, the administrative relief does not appear aimed at situations involving something other than physical goods. Thus a U.S. non-resident selling computer software into BC (which is delivered by electronic means), might be the sort of entity that BC would want registered.

QST & Expanded Registration Requirements. Quebec's expanded registration rules are found in section 409.1 of the QST Act as follows:

> 409.1. Every person, other than a small supplier, who is not resident in Québec but is resident in Canada, who does not carry on a business in Québec and who, in the course of a business carried on by the person in Canada, solicits orders in Québec for the taxable supply, other than a zero-rated supply, by the person of corporeal movable property, other than prescribed property for the purposes of section 24.1, to be delivered in Québec to a consumer is required to be registered and shall apply to the Minister for registration before the day the person first makes such a supply.

Unlike the situation in BC, Quebec's expanded registration rule applies to all non-residents of Quebec that are at the same time "resident" in Canada.

Thus for the most part, U.S. non-residents would not have to worry about Quebec registration – that is, however, until such a time as their activities in Canada caused them to be regarded as "resident in Canada".

The Latest Canadian Customs and Cross-Border Issues

Presented at the TEI's 57th Annual Conference (October 22, 2002: Toronto, Ontario)

ROBERT G. KREKLEWETZ
W. JACK MILLAR

To 10 GST Audit Issues

1. Year End Adjustments
   - Adjustments for ITA not done for ETA
   - Meals and Entertainment 50%
   - Automobile Leases
   - Personal Expenses
   - Taxable Benefits
2. Self Assessment
   - Supplies from non-resident of services and intangible property, where < 100% commercial use
3. Bad Debts
4. Failure to Register
5. ITC Eligibility
6. Exports
7. Inter-company Transactions & 156 Election
8. Sale of business Assets & 167 Election
9. Sale of real property issues
10. Failure to add properly

Source: Based on information provided by representatives of the *Canada Customs and Revenue Agency*

(November 2001)

Toronto West Practitioners Consultation Group Meeting

Top 10 RST Audit Issues

1. Failure to Register
2. Incorrect Filing of Returns
3. Clerical Errors
4. Books & Records not properly kept
5. Exempt Sales not properly recorded /dealt with
6. Goods Acquired for Own Use not Self-Assessed
7. Manufactured Cost Calculations
8. Inter-Company Transactions Not Properly Accounted For
9. Real Property Transactions
10. Underground Economy

Source: Based on information provided by representatives *Ontario Ministry of Finance*

(November 2001)

Toronto West Practitioners Consultation Group Meeting

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Top Importer GST Compliance Issues

1. Place of Supply Issues - inside/outside Canada?
2. Accounting Systems – Foreign Currency problems.
3. HST not being charged on delivery to "Participating Province".
4. Duties frequently included when claiming ITC's.
5. Inadequate Documentation to support ITC's on Importation.
6. Improper Self-Assessments on Imported Taxable supplies.
7. Improper ITC claims on Importation.
8. Is registrant principal or agent on importation? Only principal can claim ITC.
9. Lack of compliance on fact determination of "de facto importer".
10. Improper company claiming ITC (in closely related Corps).
11. FI's and others not self-assessing for GST on imported taxable supplies (S.217 and S.218).
12. Non-residents, non-registrants not realizing they are required to register and charge tax.
13. Application of Div II and Div III tax on same supply (double taxation due to FOB destination).

Source: Based on information provided by representatives of the *CCRA's Compliance Programs Branch (Large Business Audit Division* - June 2002)

Top Exporter GST Compliance Issues

1. Proof of exports supported by inadequate documentation.
2. Billings in U.S. $ not converted to Canadian $.
3. Inadequate documentation to establish transaction is genuine export (see Memo 4.5.2).
4. Place of supply/delivery in Canada-Invoice to U.S. (no GST charged).
5. If supply is in part within Canada-entire supply is taxable even if 1%.
6. "Drop Shipment" problems.
7. E-Commerce problems.
8. Dropshipment Certificate unsigned; Goods not leaving country & customer entitled to ITC.
9. Export Documentation missing.
10. Application of S.180 flow-through provision for ITC's.
11. Tax status of exported services supplied to non-residents (exceptions).
12. Lack of availability of records in Canada causing undue delays.
13. Improper documentation per Part V, Schedule VI, Item 1.

Source: Based on information provided by representatives of the *CCRA's Compliance Programs Branch (Large Business Audit Division* - June 2002)

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PART II – BUILDING BLOCKS

CANADA'S GST SYSTEM

Overview of the GST System

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

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

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

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

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

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

Division II & "Taxable Supplies Made in Canada"

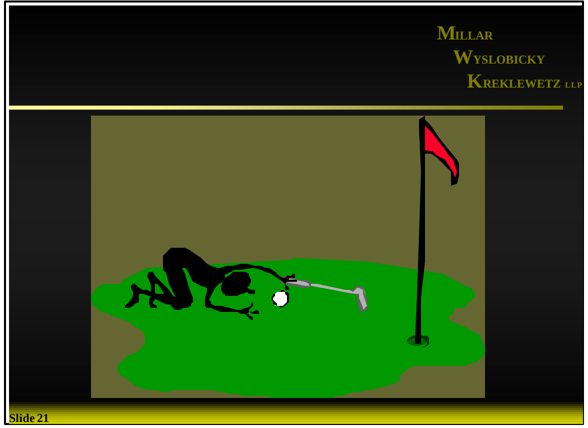
When Canadians speak of the GST, they are most often referring to the GST that is imposed under Division II of the *ETA*. Division II is entitled *Goods and Services Tax,* and imposes tax on "every recipient of a taxable supply made in Canada": s. 165(1).

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

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

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

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



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

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

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

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

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

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

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 CCRA.

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

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

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

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

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

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

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

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

Division III & "Imported Goods"

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

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

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

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

Interplay of Division III Tax with Customs Valuation Rules. As mentioned, the GST's Division III tax is payable on the "duty paid value" of the imported goods, <u>as determined under the *Customs Act*.</u> 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 CCRA will still be interested in a proper valuation of the imported goods, for GST purposes, and will continue to focus on issues like whether dutiable royalty payments, assists, "subsequent proceeds", and "buying commissions" have been included in the "value for duty" of goods. Where these additions are left out, GST will be regarded as having been short-paid, and customs assessments (or other positive "voluntary correction" obligations – see *infra*) will arise.

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

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

Division IV & "Imported Taxable Supplies"

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

Zero-Rating Provisions

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

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

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

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

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

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

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

CANADA'S RST SYSTEMS

Overview of a Typical RST System

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

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

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

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

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

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

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

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

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

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

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

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

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

Inter-Jurisdictional Comparisons

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> *TPP*, to mean just about anything that can be touched: "personal property that can be seen, weighed, measured, felt or touched or that is in any way perceptible to the senses and includes computer programs, natural gas and manufactured gas".
>
> *Purchaser,* to mean not only (a) a "consumer or person who acquires [TPP] anywhere", but also persons (b) acquiring TPP for the benefit of some other person, and (c) certain persons acquiring TPP for purposes of promotional distribution. Until recently, "purchaser" also included persons acquiring a taxable service at a sale in Ontario in order to fulfil warranty or guarantees or other contract for the service, maintenance or warranty of TPP.[15]
>
> *Consumption* and *use*, to include all concepts of use, and the incorporation of something into another thing.
>
> *Fair Value,* to capture virtually every type of payment that could be expected to pass from a purchaser of TPP or services to the person from whom the TPP or services were acquired.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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Some notable exemptions specific to particular provinces are:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Finally, Ontario's Retail Sales Tax Branch maintains what I understand to be a formidable collection of "unsanitized" written rulings, issued and catalogued on a number of subjects. Given that the rulings contain "confidential information", Ontario has traditionally resisted publishing them, even in a semi-sanitized form. My understanding is that – again ostensibly for resource reasons – these "headquarters" rulings will not be published in the near future. While some of these ruling are commonly distributed amongst industry, and TEI members, caution should always be taken in relying on them, since the Ontario Ministry of Finance has no compunction in observing that a ruling letter issued to one person is not binding upon the Ministry in respect of the activities of another person – even if very closely related.

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

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CANADA'S CUSTOMS SYSTEM[18]

Recent trade statistics suggest that the vast majority of Canadian trade is between Canada and the United States. With NAFTA now going strong, there has now been essentially a full elimination of Canada-U.S. customs duties since January 1, 1998. This leads to the legitimate question of whether or not Canada's customs law regime is still a relevant consideration for businesses dealing in the international trade of goods, especially when the bulk of their trade is in the Canada-U.S. corridor. Certainly, that has been an issue in dealing with some clients in the midst of "downsizing", as the first to go is often the company's in-house customs expertise. The short answer to the question is an "of course Custom is still important" – and that should be more-or-less obvious for most readers, especially given your background as either importer or an exporter. But understanding why customs is still relevant requires some understanding of how Canada's Customs rules work.

Overview of Canada's Customs Rules

Goods imported to Canada must be reported at the border, be properly *classified* under Canada's Customs Tariff, be identified in terms of their proper *origin*, be properly *valued*, and clearly and legibly *marked* in accordance with Canada's marking rules. Each of these steps is must be carried out, or penalties and other equally nasty things will ensue. Other ramifications will also arise if the steps are not taken properly as, for example, the possible denial of NAFTA preferential status if each of the first 2 steps (e.g., classification and origin) are not taken properly.[19]

Tariff Classification. After being reported, an imported good must be classified under the provisions of the *Customs Tariff*.[20] 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.

> **Tip**: Importers carrying out transfer pricing analyses should take the time to make inquiries as to the level of duties applying to the goods they import. If there are significant positive duties attaching to particular goods, efforts might be made to consider any other possible applicable tariff classifications, perhaps positioning the goods into duty free tariff classes – either under NAFTA preferential rates, or the increasingly falling Most Favoured Nation ("MFN") rates. In the past number of years, as MFN rates have continued to fall, there have even been instances where MFN rates would be preferable to certain NAFTA rates, on certain goods. Accordingly, the tariff classifications chosen for some goods, many years ago, may not be the best possible choices today.

> **Note:** In many instances, there will be only one possible tariff classification for an imported good. The above "tip" considers situations for complex goods, where there can often appear to be a number of possibly applicable tariff classifications, with a fair degree of uncertainty as to which is the appropriate.

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.

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Determining "origin", like the situation for determining appropriate tariff classification, is a complex process. Detailed rules exist for determining the "origin" of goods imported to Canada, usually involving Canada's *NAFTA Rules Of Origin Regulations*, and involving a further examination of the tariff classifications of each of the "inputs" in the imported good, effectively breaking down the imported goods into its basic components, and asking whether each of those components also "originated" in a NAFTA country.

A full understanding of the bill of materials (or "BOM") making up the imported goods is often required. Further, where the "specific rules" of origin require "regional value content" tests to be met in the absence of straight "tariff shifts", an understanding is required of the nature and relative costs of each and every input in the imported goods (including their classification under the Harmonized System, and an understanding of whether those inputs are "originating" or "non-originating" in nature).

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.[21] 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.[22] 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. 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;[23] (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,[24] and the CCRA'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.[25] 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".

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

1. The Importer is a Resident, and both (a) carries on business in Canada (i.e., with a general authority to contract, plus other factors), and (b) is managed and controlled by persons in Canada; or

2. The Importer is a Non-Resident, but with a Permanent Establishment in Canada (as above), and both (a) carries on business in Canada, and maintains a (b) physical permanent establishment in Canada.

The change obviously makes the application of Transaction Value a bit more complicated, and requires some additional consideration of whether the sale for export to Canada has been made to what the CCRA 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,[26] 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.[27]

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.

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

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

Statutory Additions and Deductions. Assuming Transaction Value is available, and once the "price paid or payable" for the goods can be determined,[28] 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.

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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.[29]

The Transfer Pricing (Dis)Connection (& Customs Whipsaw). 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 CCRA's 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 CCRA is now integrated as between its Customs, Excise and Taxation functions, it is taking 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.

While somewhat anomalous, this approach is generally consistent with Custom'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 CCRA 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.[30] Unfortunately, these rules do not function to absolutely preclude asymmetry, and the U.S. is still far away from a perfectly symmetrical environment.

ENDNOTES TO INTRODUCTION:

1. 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 entity that administers it is the Canada Customs and Revenue Agency ("CCRA"), which was formerly very well known as "Revenue Canada".

2. For these purposes, consider that there are only five Canadian provinces which still imposed stand-alone RST systems. These are: British Columbia ("BC"), Saskatchewan ("SK"), Manitoba ("MB"), Ontario ("ON") and Prince Edward Island ("PEI"). These provinces may sometimes be referred to in these materials as the "RST Provinces".

ENDNOTES TO PART I:

1. Royal Assent was received for Bill S-23, *An Act to amend the Customs Act and to make related amendments to other Acts*, on October 25, 2001. That act introduced a series of amendments to the *Customs Act* designed to bring into effect several of the initiatives introduced in the *Customs Action Plan 2000-2004* ("CAP"). On November 29, 2001, an Order-in Council made pursuant to clause 112 of Bill S-23 brought into force all of the CAPs initiatives, including AMPS. While AMPS penalties had been partially implemented on December 3, 2001, difficulties underlying the full implementation of the AMPS system led to full implementation being delayed to October 7, 2002.

2. 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.

3. 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.

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

5. Please note that all discussion of AMPS contraventions or penalties is based on the CCRA's most recent (at the time of writing) AMPS Contraventions Draft, released in its *Master Penalty Document (Short Version)*, dated September 3, 2002.

6. Perhaps in an effort to down-play all of this, the CCRA 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.

7. 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.

8. 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).

9. 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.

10. 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.

11. 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.

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ENDNOTES (Continued)

12. Please note that at the time of writing, the CCRA's policy regarding PRAs had not yet been finalized. Accordingly, our comments are based on the CCRA's Draft Penalty Reduction Agreement document, dated July 7, 2000.

13. For a full discussion of the Canadian treatment of royalties, and a comparative treatment in other WTO nations, see *Customs Valuation: A comparative look at Current Canadian, U.S. & E.U. Issues*, Robert G. Kreklewetz, (1996) A Paper presented at the 1996 CICA Annual Symposium (Ottawa, Canada).

14. See *DMNR v Mattel Canada Inc.*, [2001] 2909 ETC (SCC).

15. The two additional issues before the Court in *Mattel* concerned the so-called "sale for export" issue, and an issue regarding the scope of the "subsequent proceeds" provision in subparagraph 48(5)(a)(v) of the *Customs Act*.

    The "sale for export" issue related to which sale, in a series of sales, was the relevant sale for transaction value purposes. The Supreme Court decided that issue in Canada Customs' favour, ruling that the "earlier sales that some importers had been arguing was the "relevant" sale for Customs purposes was not in fact relevant. The Supreme Court determined that for purposes of valuation under section 48 of the *Customs Act*, the only relevant sale for export was the sale by which title to the goods *passed to the importer* – the importer being considered to be the party who had title to the goods at the time the goods were transported into Canada, and may be the intermediary or the ultimate purchaser, depending on which party actually imported the goods into Canada. For the purpose of determining whether a sale is for export, the residency of the purchaser or of the party transporting the goods was held to be immaterial. (Note that the Supreme Court's decision did not have to take into account the legislative change to "sale for export to Canada" in subsection 48(1) of the *Customs Act*, which now requires valid "sales for export" to be to a "purchaser in Canada" – as defined in the regulations.)

    The "subsequent proceeds issue" related to periodic payments paid by Mattel Canada to the Master Licensors through Mattel U.S., and Canada Customs argument that even if the payments did not amount to dutiable "royalties", they amounted to dutiable subsequent proceeds. The Supreme Court rejected Customs' argument on that front, finding that if the royalties payments were not dutiable under the royalties provision, they could not be captured in a indirect manner through application of the subsequent proceeds provision.

16. 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.

17. A tariff contains the rates of duty applicable to the imported goods, with the duty rates usually "bound" to a common maximum rate - usually the rate applied to Most Favored Nations (the "MFN" rate), if the trading nations are members of the World Trade Organization ("WTO"). In some instances, however, the tariff rates can be higher or lower. Low rates exist, for example, under multi-lateral negotiated treaties like that in place under NAFTA. Under NAFTA, for example, most U.S. origin goods have been duty free when imported from the United States.

18. Generally speaking, NAFTA Verification audits find their basis in Chapter Five of the NAFTA, and are aimed at ensuring that the NCO's that Canadian importers are relying on are in fact *validly* executed. That really means ensuring that the imported goods meet the origin requirements provided for in the NAFTA. While having their basis in NAFTA, the origin requirements are reproduced in the domestic laws of Canada, the U.S. and Mexico.

19 In a copy of NCOs I saw, the exporter has actually put "Taiwan" in the "Origin" column of the NCO, likely mistaking the "Country of Export" (e.g., the U.S.) as the basis on which the NAFTA could be issued. To be clear, the "Origin" of goods subject to a NCO ought to be either Canada (CA), the U.S. (US) or Mexico (MX).

    In another situation, where the NCO asked for an indication as to whether the Net Cost method was used for purposes of a RVC (Regional Value Content) requirement, the exporter had actually inserted a numerical figure, where what was required was a "yes/no" answer.

20. The reason is that most of the "tax" issues related to goods are dealt with by traditional means (e.g., virtually all countries have devleoped customs regimes, aimed at catching goods at the border, and charging and collecting the applicable duties and taxes at that point, regardless of whether the goods were purchased and sold "over the net", or across a "brick and mortar" counter). Similarly, many services cannot be transmitted or performed via electronic means, and they too are left to be dealt, from a tax perspective, through the usual means and usual systems.

21. Basic eligibility requirements includebeing GST registered, and having expended the GST for "consumption, use, or supply" in the course of "commercial activities". While the phraseolgy appears plain, a number of issues have arisen in the context of goods imported to Canada.

22. This probably has to do with the fact that the *Customs* Act generally imposes *in* rem duties, which are charged on the goods, and is not aimed at charging a particular person with those duties – *in personem* – until that person reports the imported goods.

ENDNOTES TO PART II:

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 istaxed 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,

ENDNOTES (Continued)

under Division III (imported goods) or Division IV (imported services and other intangibles).

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

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

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

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

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

10. The existing RST systems are as follows: in BC, the *Social Services Tax Act* applies at a general rate of 7%; in SK, the *Provincial Sales Tax Act* applies at a rate of 6%; in MB the *Retail Sales Tax Act* applies at a rate of 7%; in ON the *Retail Sales Tax Act* applies at a rate of 8%; and in PEI, the *Revenue Tax Act*, 1988 applies at a rate of 10%.

The Ontario *Retail Sales Tax Act* will be referred to here as simply the Ontario Act. Other provincial legislation referred to above will be referred to in the same way (e.g., the BC Act, the SK Act, etc.).

11. See, for example, *Cairns Construction Ltd. v. Government of Saskatchewan*, [1960] S.C.R. 619.

12. The logical result of this is the creation of purchase exemptions in every RST systems which, one can see, are not so much a matter of provincial generosity as they are a constitutional imperative.

13. The structures of the taxing systems in ON, PEI and MB tend to be very similar perhaps due to the timing of their respective taxes (all enacted within about 7 years of each other in the early 1960s). BC and SK, with somewhat older systems, tend to be quite different in structure, although containing each of the (constitutionally required) elements described just above.

14. While QB's QST is a sales tax system levied on purchases at all levels of the production and distribution chain, business purchasers are usually afforded refunds on business inputs, helping confirm that the QST is intended to be borne by the ultimate consumer or purchaser.

15. The recent addition of a separate charging provision in section 2.0.1 of the Ontario Act has recently obviated the need for defining purchaser in this manner, and these words were removed from the definition: see s. 2.0.1 of the Ontario Act, as added by 2000, c. 10, s. 24, effective May 3, 2000.

16. Please note that a number of exceptions and conditions apply to some of these exemptions, meaning that in each case, the actual legislative rules ought to be consulted prior to determining if a particular supply is an exempt one.

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

18. 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 (September 29 - October 2, 1996). That paper contains sections dealing in detail with Canada's customs rules, as well as providing a fairly recent review of the major issues facing Canadian importers, from a valuations perspective. If you would like a copy sent to you, please leave your business card at the culmination of the presentation, or otherwise contact the presenter.

19. 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*).

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

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ENDNOTES (Continued)

21. 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 CCRA has taken the view that a proper VFD for imported goods is required to maintain the integrity of industry Canada's trade statistics.

22. 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.

23. 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*.

24. 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.

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

26. See for example the presentation on the "Purchaser in Canada Regulations" made by Robert G. Kreklewetz and Stuart MacDonald (CCRA), 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.

27. 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 (CCRA), 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.

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

29. 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).

30. 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.