Overview of

Canada's Customs Regime

With A Specific Discussion on Bill S-23 S.C. 2001, C. 25

MILLAR
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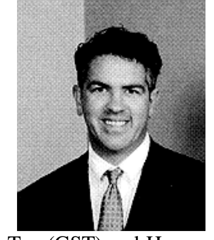
PROFESSIONAL PROFILE



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

Rob is a partner at Millar Wyslobicky Kreklewetz LLP (MWK) – a boutique tax law firm specializing in all Commodity Tax, Customs & Trade matters, and in Tax Litigation. Rob has a LL.B. from Osgoode Hall Law School, and a M.B.A. from York University.

Specialized Practice Area

Rob'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 PST and Quebec QST. Rob 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.

Rob also focuses on all issues involving Canada's Customs & Trade laws, including Valuation, Tariff Classification, Origin, and Marking issues, NAFTA Origin Verification Reviews, Forfeitures, Seizures, and other NAFTA & WTO matters.

Finally, Rob 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 establishing Canadian business operations (or gaining entry into Canada of business persons), providing Transfer Pricing advice, advising on the application of Canadian federal and provincial pay-roll source deduction taxes (e.g., Ontario EHT, CPP, EI) and any and all tax or licensing law issues affecting the Canadian Direct Selling Industry.

Extensive Tax Litigation Experience

All elements of Rob's practice include **Tax Litigation**, and Rob has acted as lead counsel in a significant number of cases before the Tax Court of Canada, Canadian International Trade Tribunal, Federal Court (Trial Division), Federal Court of Appeal, Ontario Court of Justice, and Ontario Court of Appeal. Rob also provides **Planning** and **Representation** services in these areas as well.

Blue Chip Client Base

MWK has some of the best tax files in Canada, and Rob advises a significant number of Fortune 500 and blue chip corporate clients, who are national and international leaders in the manufacturing, wholesaling, retailing, financial services, information technology, direct selling and consumer products industries. MWK also provides cost effective solutions for small and medium sized businesses, and individual entrepreneurs.

Speaking Engagements / Publications / Memberships

Rob continues to speak and write 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 Association of Importers & Exporters (CAIE), Certified General Accountants (CGA), and Direct Sellers (DSA). He also speaks frequently at Conferences held by the Strategy Institute, Infonex, IIR and Federated Press.

Rob is the regular commodity tax contributor to the Tax Foundation's *Tax Highlights* publication, and a regular contributor to a number of other tax publications, including Carswell's *GST and Commodity Tax Reporter* and Federated Press's *Sales and Commodity Tax Journal*.

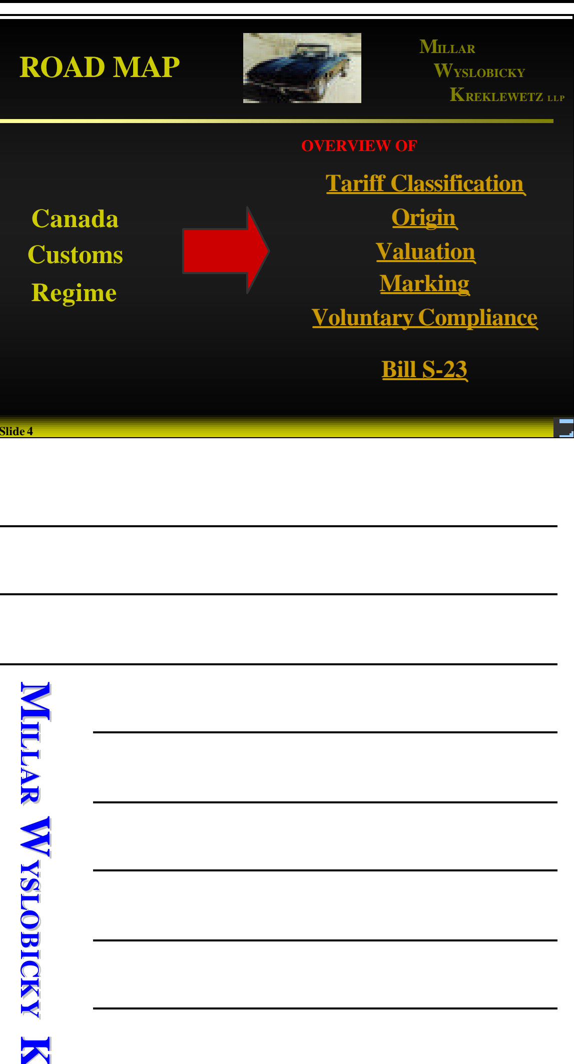
Rob is a member of the CBAO Tax Executive, a member of the CFLA's Tax Committee, and the DSA's Government Affairs Committee. Rob was a member of the CBA-CICA working group on the 1993 GST amendments, and consulted with the Department of Finance on the more recent HST.

The Real Important Stuff – Unfortunately Left to the Bottom

Rob is married to Franceen, and has a beautiful 4 year-old "pre-schooler" named William (who is *not* a baby, and should not be referred to as such!). When not working, Rob enjoys spending as much time with them as he can – with the only exception being the odd round of golf with William.

Jack, Dennis and Rob are proud to announce that as recently described in the L'Expert Magazine, MWK has become Canada's "brand name for Commodity Tax and International Trade work …".

Hard name. Simple solution.



THE ROAD MAP

GENERAL FOCUS OF THE PRESENTATION

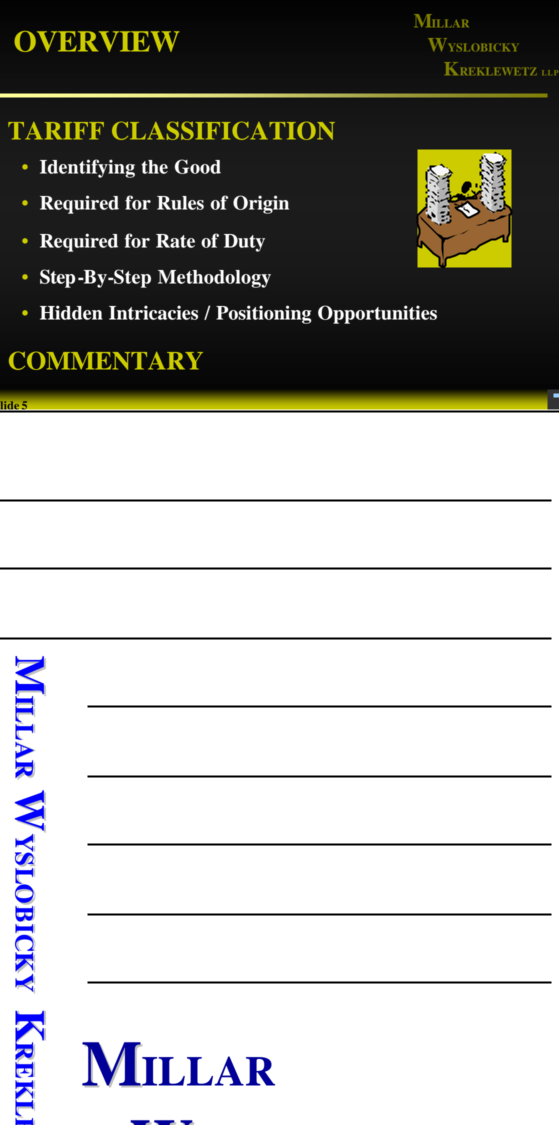
Customs and International Trade continues to be a vibrant and dynamic part of Canada's legal system. Customs and Trade issues continue to be high-focus items for Canadian taxpayers, often adversely impacting profitability, especially when the level of planning (or awareness) required to minimize their impact is not sufficient.

The Presentation / Materials will focus on providing a general backdrop and overview of Canada Customs Law regime, with a view to providing participants/readers with a solid basis for understanding the sessions that follow.

Where relevant, the presentation will include a discussion of the implications of Bill S23, recently enacted into Canadian law, and amending certain portions of the *Customs Act.*[1]

The audience is encouraged to participate !

So feel free to ask questions <u>at any time</u>.



BUILDING BLOCKS [2]

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.[3]

Tariff Classification. After being reported, an imported good must be classified under the provisions of the Customs Tariff .[4] 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.

Truly, understanding the manner in which goods are classified when imported under the Harmonized System requires a good degree of knowledge and understanding beforehand.

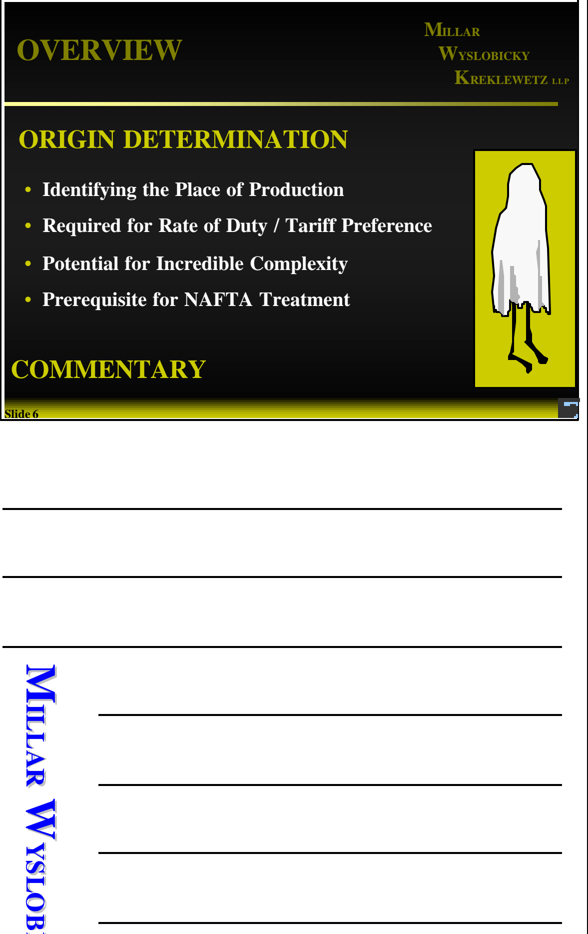
Articles further delineating the manner in which the Harmonized System is to be interpreted are also worthwhile exploring. Revenue Canada's *Customs Commercial System*, published with Canada's move to the Harmonized System in January of 1988, is also an excellent resource.

Tip: When it comes to classifying goods, one often encounters very difficult situations. It is always a good practice to resort to "first principles" when dealing with a potentially difficult classification. Start at the top. Finish at the bottom. And follow the rules. The temptation to classify immediately at a six, eight or ten-digit level must be avoided !

Tip: Importers should always 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.

Did you Know ? Did you know that when it comes to subheadings, there are two levels of subheadings, identified either by the (1) numbering system within the classification number, **or** by the (2) *corresponding number of dashes in front of the text of the subheadings.* Accordingly, all of those dashes in the HS do actually mean something, and when it comes to comparing possible classification as the subheading level, dashes can make the difference. (The first level of subheading occurs when the fifth digit is a number from one to nine, and the sixth digit is a zero. The first level of subheading can also be identified because the wording of the subheading is preceded by one dash).



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Origin Determination. Once the basic tariff classification for an imported good is determined, the next required step is – at least currently, under NAFTA – determining whether that good "qualifies" for NAFTA treatment, or any other favourable tariff treatment (e.g., Most Favoured Nation treatment, or "MFN").

This step 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.[4.1]

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.[5] Further, even if an imported goods proper qualities under NAFTA, a "Certificate of Origin" is must be obtained from the exporter or producer of the imported good, and be in the importer's hands *before* the goods are entered.

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).

Where goods (or inputs) are fungible, and held in a mixed inventory, determining origin can involve accounting methodologies aimed at dealing with fungible goods.

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 *before* 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.

Ensuring On-Going Compliance with NAFTA. 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 involved in transfer pricing analyses are well-served by taking a moment, to consider the proper "tariff classification" and "origin" of their imported goods.

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.[6]

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.[7] 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.

OVERVIEW

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VALUATION

1+1=3

- Identifying the Value of the Good
- Required for Duty, GST, Trade Statistics
- Potential for Incredible Complexity / "Absurd" Results
- New D-Memos on Royalties, Subsequent Proceeds
- Purchaser in Canada Issues

COMMENTARY

Slide 7

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Where Transaction Value is not available, a series of other meth ods 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;[8] (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,[9] 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.[10] In "parent-subsidiary" relationships, an issue will also arise as to whether the parent and subsidiary are in true "vendor-purchaser" relationships, or whether the parent controls the subsidiary to such an extent that the latter can be viewed as the mere agent of the former, negating a "buy-sell".

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

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

The change obviously makes the application of Transaction Value a bit more complicated, and requires some additional consideration of whether the sale for export to Canada has been made to what the CCRA considers a proper Canadian "purchaser".

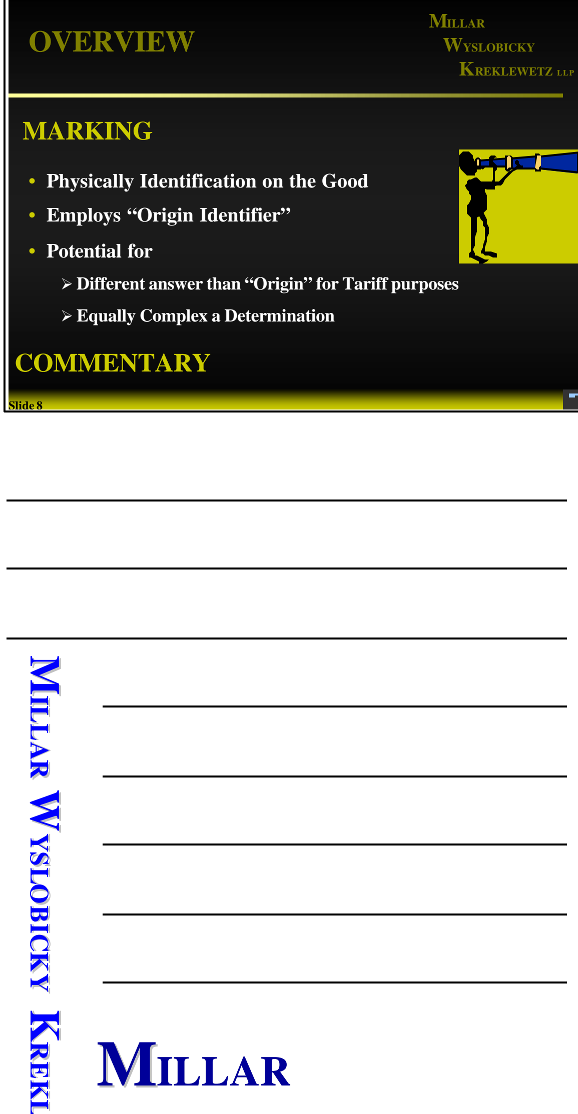
The meaning of "purchaser in Canada" – and the general rules described above – can be found in the *Purchaser in Canada Regulations*,[11] and Canada Customs' D-Memo 13-1-3, *Customs Valuation Purchaser in Canada Regulations* (December 11, 1998).

Understanding Canada Customs' view on "purchasers in Canada" could also be the subject of a whole separate presentation,[12] 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.[13]

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. To that extent, the newly enacted "Administrative Monetary Penalty (AMPS)" system will go a long way toward ensuring that proper valuation is made of imported goods, regardless of the ultimate duties payable on that valuation.

Statutory Additions and Deductions. Assuming Transaction Value is available, and once the "price paid or payable" for the goods can be determined,[14] the final transaction value (i.e., the amount which will represent the VFD of the imported goods) is determined by adding certain amounts to the price paid or payable, and by deducting certain other amounts, in accordance with the rules in section 48(5) of the *Customs Act*.

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

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

Again, a full discussion of the ramifications of the statutory additions and deductions required under section 48(5) of the *Customs Act* is beyond the scope of this presentation, and readers are directed to secondary sources, and other presenters.[15]

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

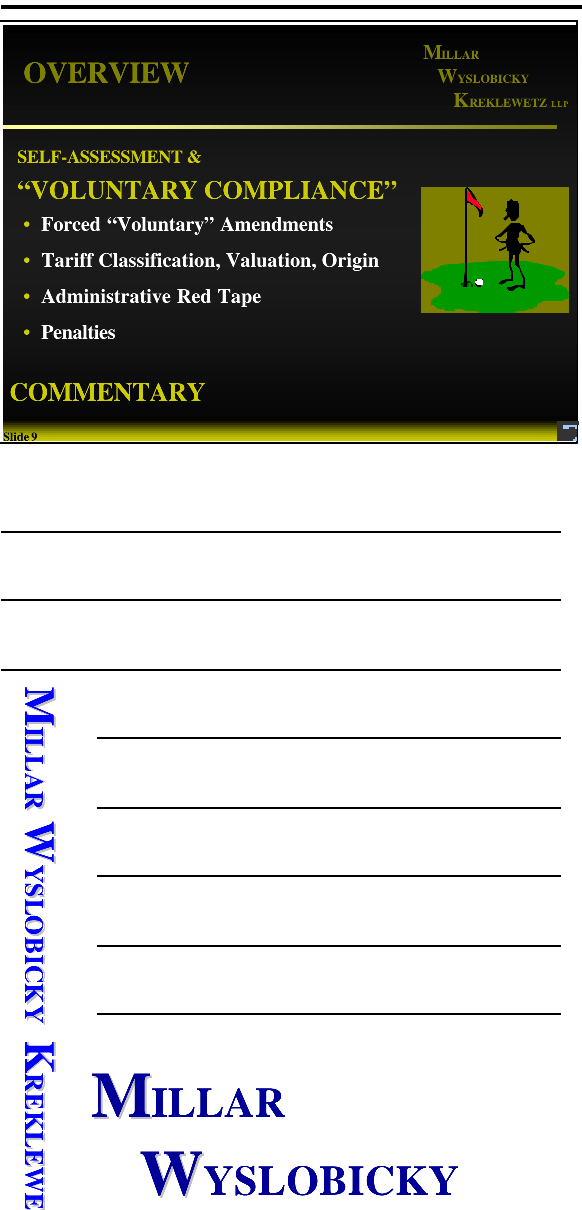
> 225. The methods for determining value for duty under the current provisions of the Customs Act resemble those outlined in this circular. However, differences do remain. The Department is not obliged to accept the value reported for duty when considering the income tax implications of a non-arm's length 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.[16] Unfortunately, these rules do not function to absolutely preclude asymmetry, and the U.S. is still far away from a perfectly symmetrical environment.



Marking. Certain goods imported to Canada are required to be marked to indicate clearly the country in which the goods were made.[16.1] Section 35.01 of the *Customs Act* makes this a mandatory prohibition, and prohibits every person from importing goods that are "required to be marked by any regulations made under section 19 of the *Customs Tariff* unless the goods are marked in accordance with those regulations".

While not all goods imported to Canada require "marking", a good number do. While the foreign exporter or producer usually applies the country of origin marking, Canadian importers are responsible for ensuring that imported goods comply with marking requirements at the time they import the goods.

Generally speaking, the purpose of the marking program is to inform the ultimate purchaser of the country of origin of the goods. (For NAFTA purposes, the ultimate purchaser is the last person in Canada who purchases the goods in the form in which they are imported, whether or not that purchaser is the last person to use the goods in Canada.)

Bill S-23 Implications: Bill S-23 includes a house-keeping amendment to add back into the *Customs Act* the authority to re-determine "marking" decisions. This was necessitated by the mistaken deletion of this authority the last time the *Customs Act* was amended (i.e., under "Tariff Simplification").

Bill S-23 also removes the historical penalty for failing to properly mark (I.e., previously provided for in section 35.02(1), and levying a $250 penalty for each failure to comply), in favour of treating this under AMPs. As As currently published, the penalties will be equal to:

- 1st - nil
- 2nd - $100 or 5% of the value for duty, whichever is greater
- 3rd - $200 or 10% of the value for duty, whichever is greater
- 4th + - $400 or 20% of the value for duty, whichever is greater

Did You Know ? Did you know that there are instances where the "rules of origin" for tariff purposes (i.e., for determining, for example, if the good qualifies for NAFTA treatment), might yield a different answer than the "rules of origin" for marking purposes (i.e., for determining what "made in" country is required to be marked on the goods). For example, an ergonomically handled fork could be imported under NAFTA, but marked "Made in Korea" ! Be aware of these situations, and always consult the "marking rules" (not the "tariff rules") when making a marking decision.

Customs Voluntary Compliance & Mandatory Correction Obligations. With the 1998 changes to the *Customs Act* have come a very marked change to the way in which importers must deal with tariff class, valuation, and origin mistakes. The change is really an "informed compliance" initiative, which Canada Customs imboarded into the *Customs Act*, and patterned on a 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.* (The requirements are set out in sections 32.2(1) & (2) of the *Customs Act*).

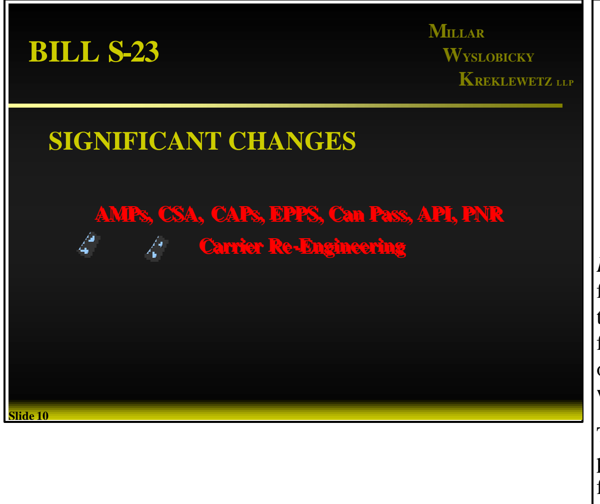
Previously, where an importer discovered an error in the way in which goods were imported, the focus was more on the go-forward, since the onus was often on Canada Customs to bring the prior problems to the importers attention, and to issue appropriate assessments. (With the effluxation of time, hidden 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.)

The new provisions are found in section 32.2 of the Act, the following of which applies to mistakes involving tariff class and valuation:

> 32.2(2) **Corrections to other declarations** — … [A]n importer or owner of goods … shall, within ninety days after the importer [or] owner … has reason to believe that the … declaration of tariff classification or declaration of value for duty made under this Act for any of those goods is incorrect,
>
> (a) make a correction to the declaration in the prescribed form and manner, with the prescribed information; and
>
> (b) pay any amount owing as duties as a result of the correction to the declaration and any interest owing or that may become owing on that amount.

It is noteworthy that interest will be calculated at the prescribed rate[17] from the "first day after the day the person became liable to pay the amount and ending on the day the amount has been paid if full, calculated on the outstanding balance of the amount that would have otherwise been payable" – which will have a significant effect on the amount a person making a "voluntary" correction is required to pay.

Penalties where Corrective Action Not Taken. If corrective action is not taken within the 90 day period, the importer is liable for penalties. While one possible penalty was initially the $100 fine provided for failing to properly account for goods (in section 33.1), Customs traditionally took the position that while technically feasible, the $100 fine would not be resorted to for infractions involving the Informed Compliance rules. Bill S-23 legislatively makes that reality, but eliminating the section 33.1 penalty – and most other penalty provisions in the *Customs Act* – in favour of a new broad regulatory power to impose penalties (new section 109.1), and the AMPS system referred to further below.



Bill S-23 Implications: Under AMPS, Customs intends to rely on a new set of penalty provisions put in place especially for Informed Compliance infractions. As currently published, the penalties will be equal to:

1st -	$100 or 5% of the value for duty, whichever is greater
2nd -	$200 or 10% of the value for duty, whichever is greater
3rd + -	$400 or 20% of the value for duty, whichever is greater

Limitations Periods & Possibility of Further Assessment. There is also a four year limitation period on self-corrections which must be made under the Informed Compliance initiative. This means that where a mistake is found *more than* four years after the original importation, there is no obligation to make a correction. For mistakes found within the 4 year window, however, the above rules apply.

The four year window is meant to parallel Customs new assessment powers, which now allow Customs to automatically assess backwards, for four years of importations, paralleling the situation for GST and income tax audits. Previously, Customs generally regarded itself as limited to two years.

There is also an added "twist" here, however. Not only has Customs reserved the right to use information gleaned from self-corrections to support further assessments under its (new) 4 year window, it has also added a special rule which *extends* the assessment window to *5 years* where the self-correction is made in made in the last year of a limitations period. This would seem to allow Customs 1 additional year's worth of duties in those instances where the 4 year limitation period actually provides some benefit to the importer.

Commentary. Like it or not, the corrective actions required under section 32.2 are here to stay. And unfortunately, the Informed Compliance initiative is an "order in magnitude" shift from the situation that existed prior to January 1, 1998. Now even simple errors could result in an automatic assessment of penalties, perhaps regardless of the level of due diligence which occurred at the time of the original accounting.

Even more ominous is one school of thought, at Canada Customs, which seems to hold to the notion that a "reason to believe" includes importers who "should have known" that they were accounting improperly for their goods (e.g., because the information was publicly available, and perhaps a matter of Departmental policy, spelled out in a D-Memorandum or Customs Notice).

My recent understanding is that Customs may be backing off that approach, and holding importers liable for this type of "constructive notice" only in the clearest of cases (e.g., a D-Memo includes a recent CITT case which spells out the new "tariff class" for particular goods). Only time (and possibly a few court challenges) will tell whether this "constructive notice" concept will carry beyond a few hopefuls at Canada Customs.

In practical terms, one of the biggest issues in attempting to comply with these requirements is the difficulty in making corrections, including the unworkability of Blanket B2 Adjustment Forms.

Canada Customs' Memorandum D11-6-6 outlines the manner in which section 32.2(2) corrections ought to be made. The requirements include the filing of a properly completed Form B2, *Canada Customs Adjustment Request,* and payment of any monies (e.g., duties, GST, interest) owing to Canada Customs. Canada Customs allows, with permission, "Blanket B2 Forms"[18] to be filed, on a quarterly basis, and sets out the relevant procedures and requirements are set out in Customs' Memorandum D17-2-1. Although not specifically stated in the Memorandum, our experience is that written permission must be obtained from the Client Services Director in the Customs Region where the goods were imported.

It is also our experience, that when it comes to processing "voluntary corrections", the bureaucratic red-tape involved can be unbelievable – especially where the errors found are systemic.

BILL S-23 AND CUSTOMS ACTION PLAN.

Bill S-23 and Customs Action Plan. The CCRA announced the "Customs Action Plan" on April 7, 2000, in a document entitled Investing in the Future: The Customs Action Plan 2000-2004 ("CAPs").19 CAPs was aimed at bringing Canada at least a bit further into the 21st century, in terms of the management of border and trade policy. In practical terms, CAPs calls for a change in Customs' focus, from a "transaction-by-transaction" methodology, towards a "self-assessment" and "voluntary compliance" type of system.

CAPs thus focuses on a "risk-management system", supported by a greater use of technology, and proposes to use these risk-based processes to streamline trade and business travel. The guiding principles are (1) pre-approval, (2) advance information, and (3) self-assessment.

Bill S-23. When first announced, Bill S-23 was touted by the CCRA as the "first step in modernizing Canada's border program". The Bill, in general terms, proposed to amend the Customs Act and other related legislation to allow the CCRA to implement the initiatives previously announced in CAPs.

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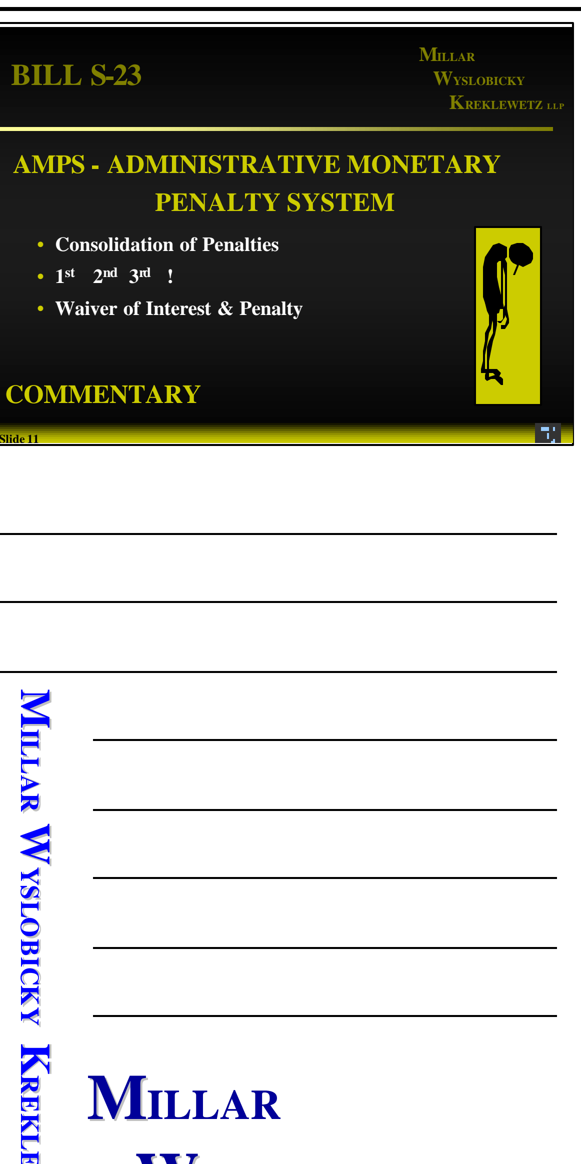


Generally speaking, the amendments were directed at the following initiatives.

Customs Self-Assessment. Customs Self-Assessment ("CSA") is a programme that proposes to offer commercial importers a quicker (and in Customs' view, a "more dependable") way to get their goods across Canada's border. It proposes to allow the CCRA to focus its resources on "high- or unknown-risk" shipments by expediting the release of "low-risk" goods at the border when low-risk importers identify themselves. It will rely on profiling, audit, and border spot checks to enforce the law. Importers will use their own books and records to account for imported goods to the CCRA, rather than completing forms solely for CCRA purposes.

In these respects, CSA tends to move Customs focus from a "transaction-by-transaction" policing, to a more "after-the-fact" self-assessment, and voluntary compliance system.

Bill S-23 Implications: In terms of CSA, Bill S-23 makes a number of changes, including as follows:

- Allowing duties to be paid at a financial institution (Clause 6)
- Allowing CCRA to accept undertakings from importers and third-parties (Clause 5)
- Requirement information provided to Customs Officers to be "true, accurate, and complete" (Clause 6).
- Establishing the dates for determining "rates of duty", "value" and "release", and "accounting" (Clauses 14, 21, 37)
- Allowing for legislative electronic releases (Clause 16)
- Allowing "CSA approved importers" to off-set their Customs obligations by "refunds owning" (Clause 51).
- Requiring "voluntary compliance" corrections in the case of "diverted goods" (Clause 22).
- Broadening scope of "premises" for purposes of audit and record keeping requirements (Clause 32).

Carrier Re-engineering. Carrier Re-engineering is Customs proposal for arming itself with what will arguably be more effective tools for managing risk. For example, Bill S-23 included amendments to assist the CCRA in intercepting contraband shipments or shipments that pose health or safety risks, while allowing it to clear legitimate, low-risk shipments quickly. Under Carrier Re-engineering, shippers are required to electronically transmit pre-arrival data to the CCRA, allowing the CCRA to identify shipments of "high or unknown risk".

The Administrative Monetary Penalty System. The Administrative Monetary Penalty System ("AMPS") is probably one of the more publicized initiatives proposed under CAPs, and one of the more notable parts of Bill S-23. AMPs – for readers not already familiar with it – was designed to encourage businesses and travellers to comply with trade and border legislation. It allows the CCRA to respond to non-compliance in a variety of ways, ranging from warnings to fines. This program will allow the CCRA to respond to non-compliance fairly and consistently, with penalties proportional to the compliance history of travellers, importers, and service providers.

Bill S-23 Implications: In terms of AMPs, Bill S-23 makes a number of changes, including as follows:

- Repealing most of the *Customs Act's* penalty provisions, in favour of new section 109.1, and broad regulatory powers allowing for the implementation of AMPs (Clauses 24 – 30), while consolidating all other penalties (Clauses 62-64).
- Establishing the concept of "value for [exported] goods", allowing the CCRA to impose AMPs in respect of export transactions (Clause 67) and, where the value is too difficult to determine, to simply "determine" the the value itself (see proposed new section 124(4.3)).
- Changing the manner in which interest is calculated, and allowing for the cancellation, reduction or refund of penalties(or interest) in certain circumstances (Clauses 2, 3, 30, 68, 72-74).

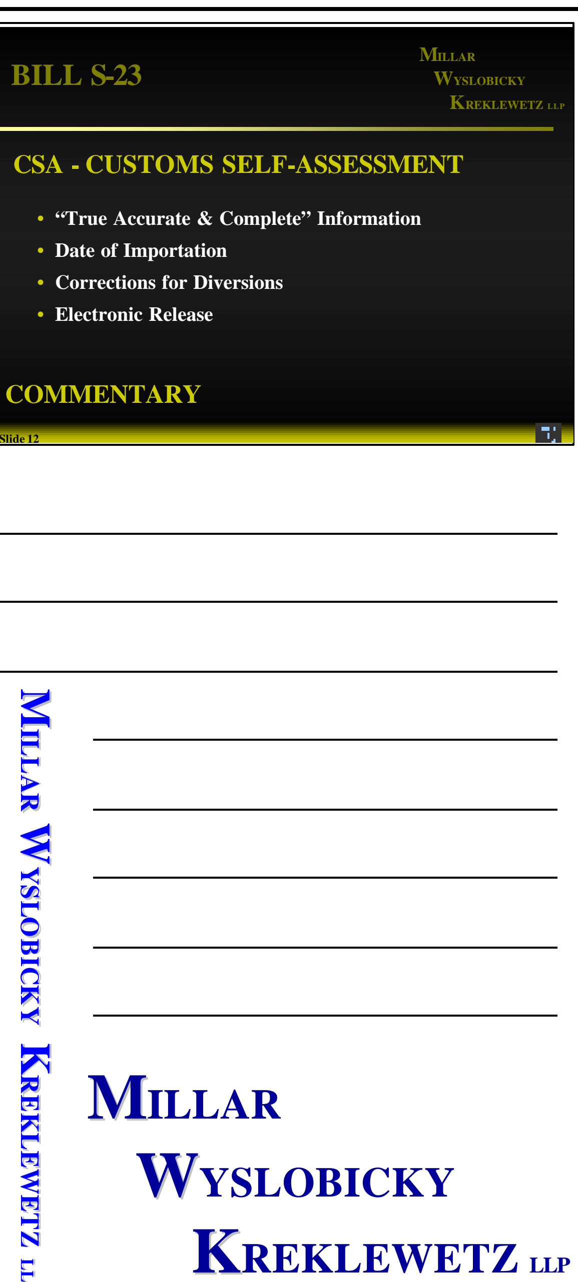
The Expedited Passenger Processing System. The Expedited Passenger Processing System ("EPPS") allows for pre-approved travellers to clear customs and immigration at airports quickly. They will use automated kiosks to confirm their identity and their membership in the program.

EPPS also entails an expansion of the so-called "CANPASS" family of permit-based programs, which will help pre-approved, low-risk travellers cross the Canada-U.S. border more quickly.

Other Administrative Clean-Up. Bill S-23 also included a host of other measures aimed at bringing the *Customs Act* into greater conformance with existing tax legislation (e.g., like that found in the *Income Tax Act,* or the GST provisions in the *Excise Tax Act.*) The more significant of these measures are summarized below.

Bill S-23 Implications: Some of the other administrative measures provided for in Bill S-23 include as follows:

- *Entry Into Canada of Individuals.* Prior to Bill S-23, an individual could technically enter Canada anywhere, and then proceed to Canada Customs to report the entry (i.e., giving rise to situations where, upon being apprehended by the RCMP for being in Canada 'illegally', the person apprehended would indicate "No, I am just on my way to report my entry to Canada Customs"). Bill S-23 has changed the rules and now requires that individuals enter Canada only at a customs office that is open for business, and must report to an officer "without delay". (Clause 10).



- *Dispute Resolution Deadlines.* The *Customs Act* contains numerous dispute resolution (i.e., appeals) deadlines. In some instances, Bill S-23 extends these deadlines to time limits more-or-less consistent with other appeals deadlines under the *Income Tax Act* and the *Excise Tax Act*. In other instances, Bill S-23 allows for the "extension" of time from these deadlines, in certain to be prescribed instances.
- *Rulings.* Prior to Bill S-23, administrative rulings on "tariff class" obtained from Customs were just that: of an administrative and non-legally binding nature (although Customs treated itself as bound by them). But there were no built-in appeals procedures, as there were for other rules (e.g., origin). Bill S-23 allows "tariff class" rulings to be added to Customs' "advance rulings program", thus allowing redress or appeal of a classification decision under sections 60 to 68 of the *Customs Act* prior to the actual importation of the good.
- *Record Keeping.* Bill S-23 contains a number of provisions dealing with records and record keeping, and generally designed to better keep the *Customs Act* in step with the electronic age in which we are now in.
- *Refunds Without Application.* Bill S-23 allows the Minister to provide refunds without any application therefore from an importer, in certain circumstances. (One wonder how often this new power will be used in practice !).
- *Harmonized Collection Procedures.* Bill S-23 amends the correct collections procedures in the *Customs Act* to make collection and restrictions for customs debts consistent with the structure and philosophy currently employed in the *Income Tax Act* and the *Excise Tax Act* (Clauses 1, 32, 35, 58, 78-80, 82-3).

Coming into Force Provisions. Section 112 of Bill S-23 provides the Bill's "Coming in Force" provisions. Unlike most bills, which come into force with Royal Assent, Bill S-23 expressly provides that its various provisions will come into force "on a day or days to be fixed by order of the Governor in Council". This means, in practical terms, that the provisions and rules in Bill S-23 are not yet in force, but will be coming into force at various times (likely) in the coming months. Customs most recent word on the subject was posted to their Website on October 26, 2001, and indicated that "we are currently reviewing our different initiatives for the "coming into force" of the various provisions."

Commentary. In Customs view, Bill S-23 will allow it to "target sectors of higher or unknown risk, thereby ensuring more effective protection for Canadians."

This was all, of course, prior to September 11th.

Since that time, and despite the laudable goals of Bill S-23, its effect, and the ultimate "lay of the land" may be a bit up in the air, particularly as Canada currently debates the "common border". In that respect, some of the changes enacted by Bill S-23 may well have a short shelf-life. But that remains to be seen over the next few months. In the meantime, CCRA Minister Cauchon appears to now be spinning Bill S-23 as providing Canada "with the legal framework to forge ahead with additional reforms to strengthen the security against terrorism, while streamlining legitimate low-risk people and goods" (describing October 11, 2001). The real proof, they say, lies in the pudding, and we will have to see how the new rules in Bill S-23 fare with the larger dynamic of the world-wide fight against Terrorism, and the current "Fortress North America" sentiments playing out on both sides of the Canada – U.S. border.

In terms of the application of the various programmes themselves, and while the "coming into force" of most of the programmes is also up in the air at this point, the AMPs committee has slated AMPs for "coming into force" on December 3, 2001, for commercial operations". Confusing the situation, however, is the planned "grace period" before AMPs penalties really begin kicking it. In Customs' words:

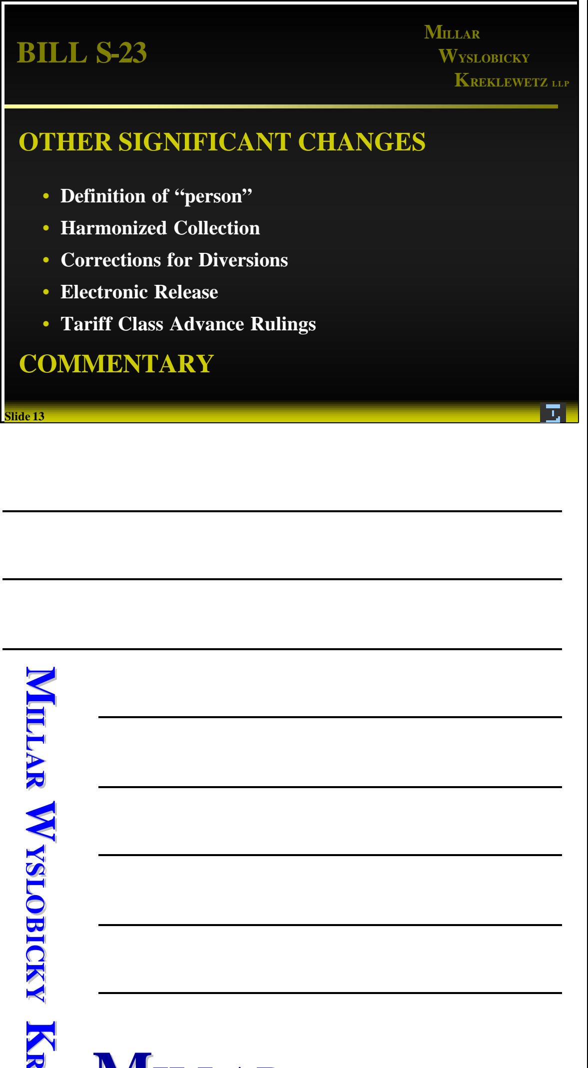
> In order to allow clients time to fully understand their obligations, an extended grace period will be provided until April 1, 2002, during which time the current system of penalties will be applicable. However, AMPS penalties will apply to certain aspects of the Customs Self Assessment program from the date of implementation.

To help better explain the AMPs programme, Customs has made available presentations on-line, at:

http://www.ccra-adrc.gc.ca/customs/general/amps/information-e.html

The AMPs Master Penalty Schedule is available at:

http://www.ccra-adrc.gc.ca/customs/general/amps/contraventions-e.html



ENDNOTES:

1. Bill s-23 received Royal Assent on October 25, 2001, and is now enacted into Canadian law as S.C. 2001, c. 25.

2. 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.

3. 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*).

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

4.1 The discussion in the presentation and here will focus on "origin determination" for purposes of the NAFTA. If any other equally preferable tariff treatment is being sought, the steps required will mirror those for NAFTA goods. Otherwise, where NAFTA is an equally favourable tariff treatment is not available, "origin determination" generally required determining if the good "originated" under the MFN rules – which is often generally assumed. Note, however, that while MFN "origin" is usually assumed, and MFN rates used, there are still specific requirements that have to be met in order to qualify for MFN status: see, for example, the *Most-Favoured-Nation Tariff Rules of Origin Regulations,* SOR/98-33.

5. 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.

6. 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.

7. 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.

8. 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.*

9. 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.

10. 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).

11. 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 terms is defined in the underlying Act, only legislative amendment passed by Parliament can change it. While not itself an entirely easy process, changing a Regulation is much easier than changing an Act.

12. 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.

13. 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.

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

15. 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).

16. 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.

16.1 The authority for application of Canada's marking program is contained in section 19 of the *Customs Tariff*, *which* enables regulations to be made which identify (a) what goods require country of origin marking; (b) the appropriate country to be marked on goods; (c) the proper method and manner of marking; and (d) the time when goods must be marked.

Readers therefore should note that the "marking" requirement referred to herein is a purely "customs" requirement, and ought not to be confused with *additional* labelling requirements of other government departments such as Agriculture and Agri-Food Canada, Industry Canada, or Health Canada.

17. The "prescribed rate" differs from the "specified rate" sometimes payable under the *Customs Act*, and is the lower of the two. Specified interest is an additional 6% points above the "prescribed rate", and is generally regarded as including a 6% "penalty component".

ENDNOTES (Continued)

18. Blanket B2s are generally used to request an adjustment to more than one B3 accounting document. In the absence of permission to use a Blanket B2, separate Form B2's would have to be filed for each and every B3 accounting entry made during the Period (e.g., over 800 separate B2s would have to be filed).

19. CAPs was really the first step in the process initially announced by Revenue Canada (now the CCRA) in its "Blueprint" discussion paper issued in the Fall of 1998. In that discussion paper, the CCRA committed itself to:

    - improving service;
    - ensuring that businesses and travellers play by the rules;
    - intensifying efforts to stop illegal activity and threats to health and safety; and
    - promoting certainty and consistency for travellers and traders alike. Extensive consultations showed widespread support in the business, trade, and tourism communities for the Blueprint's proposals.

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