# Customs Valuation Issues

## A SPIRITED DISCUSSION WITH THE CCRA

MILLAR WYSLOBICKY KREKLEWETZ LLP

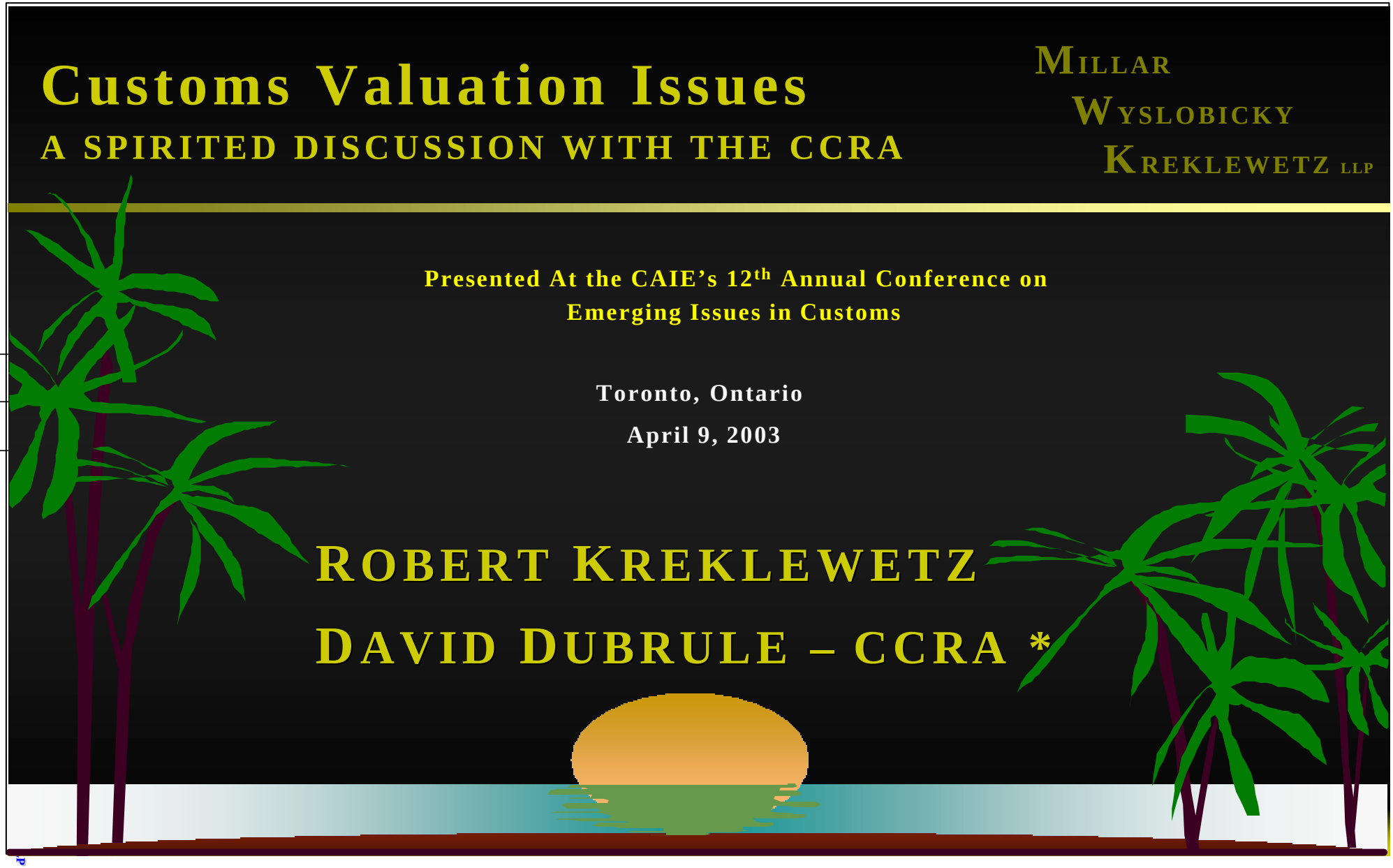
**Presented At the CAIE's 12th Annual Conference on Emerging Issues in Customs**

**Toronto, Ontario**

**April 9, 2003**

ROBERT KREKLEWETZ

DAVID DUBRULE – CCRA *



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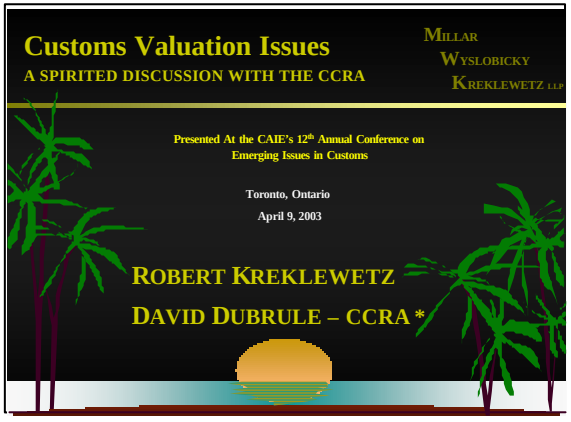


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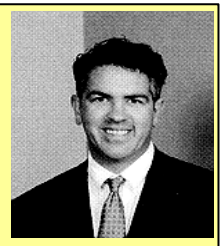
## PROFESSIONAL PROFILES



## 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 & Trade 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 is an area that encompasses Canada's federal Goods and Services Tax (GST/HST), as well the provincial sales taxes like the Ontario PST, BC SSTA, and Quebec QST. It also includes advising on the application of other "excise" taxes and duties, like those applying to tobacco, alcohol, jewellery, gasoline and other motive fuels.

Rob practice area focuses equally on Canada's **Customs & Trade** laws, including issues relating to Valuation, Tariff Classification, Origin, and Marking. It also includes advising on NAFTA Origin Verification Reviews, Ascertained Forfeitures, Seizures, and other NAFTA & WTO matters.

Finally, Rob advises on a number of other **Tax-Related Matters**, involving the domestic or international movement of goods, services and labour. Examples include advising non-residents on properly establishing Canadian business operations in Canada, including the provision of transfer pricing advice; advising on the application of Canadian pay-roll source deduction taxes (e.g., Ontario EHT, and federal CPP or EI); and any and all tax or licensing law issues affecting the Canadian Direct Selling Industry.

***Extensive Tax & Trade Litigation Experience***

All elements of Rob's practice include **Tax & Trade Litigation**, and Rob has acted as lead counsel in many cases before the Tax Court of Canada, CITT, Federal Court (Trial Division), Federal Court of Appeal, Ontario Court of Justice, and Ontario Court of Appeal.

***The Real Important Stuff – Unfortunately Left to the Bottom***

Rob is married to Franceen, has a beautiful five year-old boy named William, and expecting another child shortly. While Rob concedes that Commodity Tax and Customs & Trade is truly a scintillating area of the law (!), what he really enjoys is spending time with his family, playing golf with William, and trying to finish at least one woodworking project he starts.

## DAVID DUBRULE

Dave Dubrule is Senior Policy Analyst with the CCRA's Customs Branch (Origin & Valuation Policy Division).

***** The slides in the Presentation herein, and reproduced in the following pages, were prepared jointly by Mr. Dubrule and Mr. Kreklewetz. However, the views and impressions in the notes are those of Mr. Kreklewetz only. Mr. Dubrule will provide the views of Canada Customs and Revenue Agency ("CCRA") through independent hand-outs, and the answers provided to the various questions posed to him during the oral presentation.

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## THE ROAD MAP

The session will consider several current Customs Valuation issues – albeit, at a fairly high level of focus.

Each of the topics will be briefly introduced, and then questions will be directed to Mr. Dubrule to further elucidate Canada Customs' position on the various issues raised.

**While a number of set questions have been prepared and will be addressed during the session, the audience encouraged to participate, and ask questions at any time.**

The topics to be considered are all related to recent developments in the jurisprudence, and in the CCRA's policy positions, as regards the following areas:

1. The Royalties Aftermath: What Will Customs Think of Next ?

   – Simms - Sigal

   (Alternative Title: "Hey guys, do you think we can jam this into "Price Paid or Payable" ? How about "Subsequent proceeds" ?)

2. Its really is a Royalty After all: Living with Your Pre-Mattel Customs Planning !

   – Les Chaussures Brown Inc.

3. Purchaser in Canada: What will it take to convince Customs there has been a valid sale ?

   – FosterGrant

4. Canada's Sale for Export Position – Contrasting the U.S. & E.U. Experiences

5. AMPs & Valuation: What are the Implications ?

## The Royalties Aftermath – The *Simms Sigal* Case

***Royalties Inclusion.*** Subparagraph 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, ... .

***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.[1]

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.*[2]

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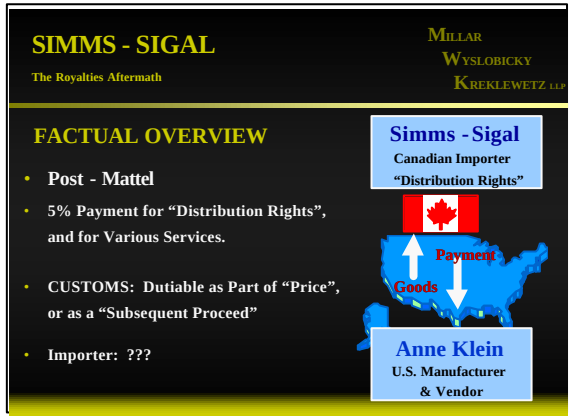


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***The Mattel Decision.*** The Supreme Court's decision was handed down on June 7, 2001, after a hearing on February 20, 2001, and the decision set out the law on "royalties", which is now as follows:[3]

> 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. 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, subparagraph 48(5)(a)(iv) is inapplicable.

Simply put, unless the sales contract required the royalties to be paid "as a condition" of the goods being sold, the royalties will not be subject to Canadian customs duties.

***Reebok Decision.*** 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 –handed down by the Federal Court of Appeal last year, from the bench, and again rejecting Canada Customs approach.

There the issue in Reebok appeared to rest in the fact that unlike the Mattel situation, there was no fixed "sales agreement", and the fact that also unlike Mattel, the Reebok vendor and licensor were one in the same person. This all lead Customs to argue that in reality, even though there was nothing formal or written that connects the roy alty agreement to the purchase order, the vendor would refuse to sell to the purchaser if royalties were not paid. And – so went Customs' logic – because the vendor could, and would, refuse to sell if royalties were not paid, the payment of royalties must be a condition of the sale of the goods and, therefore, royalties must be added to the purchase price of the goods for the purposes of calculating duty.

The FCA quickly rejected that idea, finding that the "contract of sale between the vendor and purchaser was a purchase order", and that since Customs had been forced to concede that it was not an express condition in the purchase order that royalties be paid, and there being nothing in the contract that otherwise provided such a condition, the royalties were NOT subject to duty.

So, as if the word of the Supreme Court was not enough, the final nail in the "royalties" coffin appears to have been hammered home by the lower, Federal Court of Appeal.

***The Aftermath.*** The *Simms – Sigal* case was heard by the CITT on December 2, 2002, and a decision is expected shortly.

In *Simms – Sigal*, the importer was the Canadian distributor of Anne Klein women's fashions, and was engaged through a "Distribution Agreement". Under the Distribution Agreement, the importer paid Anne Klein an undisclosed percentage of its sales, and was otherwise required to meet certain sales targets. The importer's position was the the distribution payment was the distribution rights, as well as various "services rendered", including the provision of samples, use of New York show rooms and models, and certain printed materials and sales aids.

The importer took the position that the fees paid had nothing to do with the purchase price of the goods – although it was not entirely clear what the importer's ultimate strategy in the appeal was.

Customs sought to assess duty on the basis that either the payments were part of "price paid or payable" for the imported fashions, or properly subject to duty as "subsequent proceeds" – which was put forward as an alternative argument.

***Price Paid or Payable Provision.*** The "price paid or payable" provision is found in the definition of that term in subsection 45(1) of the *Customs Act*, which provides as follows:

> "price paid or payable", in respect of the sale of goods for exp ort to Canada, means the aggregate of all payments made or to be made, directly or indirectly, in respect of the goods by the purchaser to or for the benefit of the vendor;

***Subsequent Proceeds Provision.*** The Subsequent Proceeds provision is actually a mandatory "inclusion" in the "price paid or payable" for goods, and is provided for in subparagraph 48(5)(a)(v) of the *Customs Act*, which provides for the following inclusion:

> (v) the value of any part of the proceeds of any subsequent resale, disposal or use of the goods by the purchaser thereof that accrues or is to accrue, directly or indirectly, to the vendor … .

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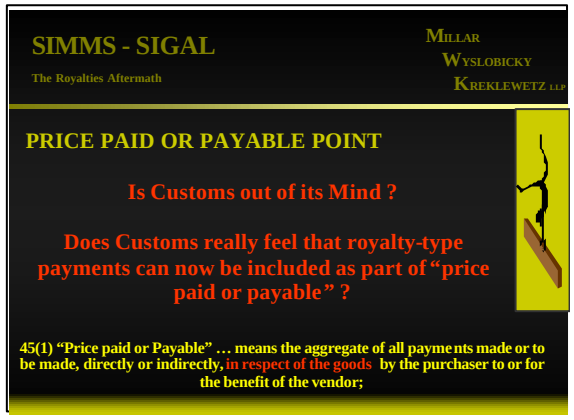


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While not as contentious as "royalties" and "license fees", the treatment of "subsequent proceeds" and other "post-importation fees" has also been the subject of angst at Customs. The provision clearly requires the price paid or payable for imported goods to be specifically increased by the value of any part of the proceeds of any subsequent resale, disposal or use of the goods by the purchaser thereof that accrues or is to accrue to the vendor. The question that Customs has been wrestling with, however, is just when that provision applies, and apparently, whether it can be applied when the royalties provision cannot.

Some additional history here involves Customs' attempts – about 5 years ago – to resurrect Subsequent Proceeds by publishing a draft Memorandum D13-4-13, entitled *Post-Importation Payments and Fees* (January 22, 1996) – and then reissuing that draft on November 2001 (the "Proceeds Memorandum").

The draft was supposed to have been finalize some time ago, but has not been finalized to date.

This, and the *Simms – Sigal* case, raises a number of questions.

## Living with Your Pre-Mattel Customs Planning – The *Chaussures Browns* Case

Hot on the heels, it seems, of *Simms – Sigal*, is another "near-royalty" case, called *Chaussures Browns*.

Although Customs assessed the importer duty on the "buying commission" it was paying its overseas "agent", I refer to this case as a "near-royalty" case since the inescapable conclusion is that what the case really involves is an importer, that had planned around Canada Customs royalties provision – when royalties were being held to be dutiable – but now had a change of heart.

***The Facts.*** The importer, Chaussures Browns, imported Aquatqalia shoes from Italy, using a putative "buying agent" called 621 South. The buying commission was nicely set out in a "Buying Agency Agreement", which provided for a buying commission of 10% of the invoiced cost of products shipped to and accepted by Chaussures Browns.

Customs, in assessing, took the position that a the 10% buying commission paid by the importer was in fact subject to duty, because under the prevailing tests for "true agency", the importer's overseas agent just did not cut it.

Customs problems with the putative "agent" appeared to be numerous, and included the fact the agent, "621 South", was really the same person as the licensor of the goods, Krasnow.(In fact, this appears to be the as even the importer acknowledges that 621 South is "a division of Krasnow" – making the two, as a matter of law, one in the same person)

While Krasnow did not appear to have any connection with the manufacturers of the shoes, Customs took the view that it was actually "buying and reselling" the goods to the importer, indicating that "the so-called agent [Krasnow] does not act in the Appellant's best interests and is in fact the vendor of the goods since it owns the "Aquatalia" trademark, causes the goods to come into existence and sources their production through various factories according to its own criteria.

For its part, the importer – of all things – mustered up the following primary argument:

> It is respectfully submitted that the payment as made by the [importer] to 621 South is to be viewed as a royalty payment which falls within [sic] the scope of paragraph 48(5)(a)(iv) of the Act and, as such, is to be treated as a non-dutiable royalty payment.

(Do you see the *non sequitur* ? )

Despite the poor choice of wording, the importer's intent here, is obviously to seek to have the payment characterized as a "royalty", then dealt with under the royalty provisions in subparagraph 48(5)(a)(iv) of the Act, and then presumably found to be non-dutiable per the *Mattel* case above.[4]

By way of "alternative argument" – which is legal speak for 'if you don't think my first argument is good enough, try this other one on for size' – the importer asserted that even if the payment was a "buying commission", then the agent was a true agent, and the payment was non-dutiable.

*The Buying Agency Provision.* The Buying Agency provision is found in the "addition" in subparagraph 48(5)(a)(i) of the Act, which provides for the following addition to "price paid or payable":

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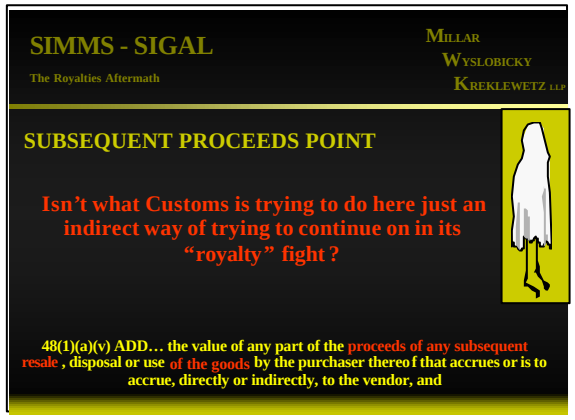


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(i) commissions and brokerage in respect of the goods incurred by the purchaser thereof, other than fees paid or payable by the purchaser to his agent for the service of representing the purchaser abroad in respect of the sale .. .

The provision has been interpreted as permitting the deduction (or, more properly, the non-addition) of payments made to "buying agents", provided that the putative agents are in fact "true agents".

Thus, the focus of most buying agent cases is attempting to establish whether a true agency arrangement exists.

*Analysis & Recent Jurisprudence.* A useful definition of agent can be taken from Fridman's Law of Agency:

> Agency is the relationship that exists between two persons when one, called the agent, is considered in law to represent the other, called the principal, in such a way as to be able to affect the principal's legal position in respect of strangers to the relationship by the making of contracts or the disposition of property.

Generally speaking, a number of indicia will be required to exist in order to obtain a true "agent" and "principal" relationship, with the buying agent expected to perform some of the following functions for its Canadian principal:

- assisting in the finding of manufacturers/vendors
- negotiating the prices for the goods with the foreign entity
- processing orders from the Canadian principal
- engaging in quality control functions on behalf of the principal
- conducting periodic factory inspections

And among all things, the "principal" must be seen to "control" the so-called "agent", and the "agent" must be seen to act always in the "best interests" of the principal.

***Jurisprudence on the Subject.*** Buying commissions have been canvassed by the CITT in the *Sherson Marketing*[5] line of cases, and by the Federal Court of Appeal (FCA) in the *Utex* case.[6]

The bottom-line seems to be that minor "conflicts of interest" and other irregularities may be overlooked – which was essentially the position taken by the FCA in *Utex* – but that the ultimate test is "a question of fact", which will take a number of factors into account – not unlike those set out above.

The *Chaussures Browns* case raises a number of questions.

## Purchaser in Canada: What will it Take ? – The *FosterGrant* Case

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

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

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

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

At the same time, section 45 of the *Customs Act* – which provides the definitions for the various terms used in the Valuation Code – was also amended to allow the phrase "purchaser in Canada" to be defined by regulations.[7]

The relevant regulations been in place for several 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:

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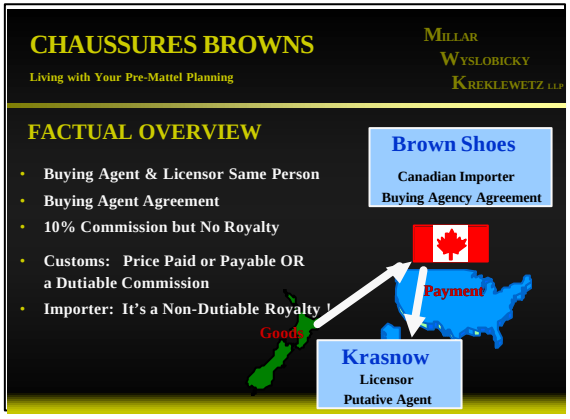


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**Business Entities (Incorporated and Unincorporated)**

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

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

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

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

**Carrying on Business in Canada**

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

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

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

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

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

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

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

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

   (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:

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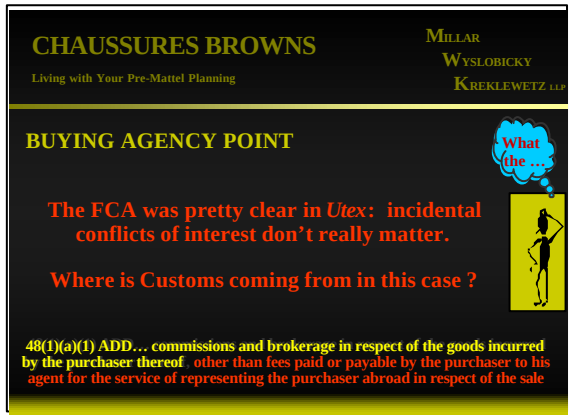


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(a) the Canadian business entity has the general authority to conduct business in Canada beyond that of simply finding buyers for imported goods and collecting payment on behalf of another party;

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

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

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

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

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

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

The regions have been quite aggressive in auditing these criteria, and some cases have begun to arise.

The most recent is the *AAI FosterGrant* case, now before the CITT.

*The Facts.* FosterGrant Canada was an importer, purchasing and importing from a related parent, AAI USA. (FosterGrant was, in fact, the wholly owned subsidiary of AAI).

According to the importer, its "principal place of business is in Toronto, Ontario", and during the relevant times, it "employed approximately 100 full and part-time employees across Canada" – with various degrees of responsibility. These included the negotiation of sales terms to Canadian customers, accepting purchase orders, and developing marketing programs and strategies for the imported goods.

Products were thereafter purchased from the U.S. parent, with the goods "direct shipped" to the ultimate Canadian customer by the parent. Canadian invoices were each included in the shipments to the importers customers, reflecting the fact that the Canadian company was the seller of the goods to the Canadian customer.

Payments received from the Canadian customers were deposited in the Canadian company's bank accounts. Various services were provided, however, by the U.S. parent, such as accounting, accounts receivable, MIS, and "cash management" – whatever that means.

According to Customs, however, the story was quite a bit different. Customs first noted that the "100 employees" amounted, in fact, to only to 2 full-time employees, and 38 contract "sales representatives". Customs then also questioned whether there was any Canadian management at FosterGrant Canada, pointing out that:

> 11. In attempting to contact a representative of the [importer], [Customs] … was advised in July 1997 that the Toronto location for Foster Grant Canada was only a showroom in Mississauga, Ontario. [It was also] advised that all questions or correspondence should be sent to B.J. Brockett, Corporate Traffic Manager, Foster Grant Group, Dallas, Texas.

Apparently, as well, the advice that Customs received was that there was no longer a branch office of FosterGrant operating in Canada, at the time of its inquiries. Perhaps some fairly damning evidence when it comes to establishing management and control in Canada.

The *FosterGrant* case raises some interesting questions however, for Customs.

## AMPS & Valuation
## – What are the Implications ?

***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.[8] 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.

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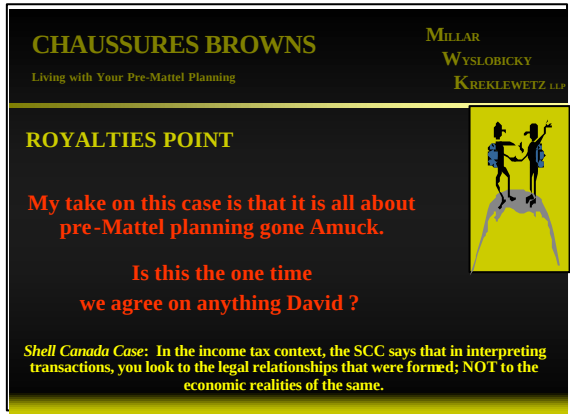


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***The Mechanics of AMPS.*** For Canada, AMPS is an unprecedented and comprehensive sanctions regime, aimed at providing Canada with a graduated civil monetary penalty system instead of the "all of nothing" approach under the former regime, which usually 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.[9]

In that sense, AMPS seeks to secure compliance of customs legislation through the imposition of monetary penalties.[10]

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.

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 [11] |

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.

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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[12] 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.[13]

***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;[14] (2) request corrective measures; (3) appeal the assessment; or (4) enter into a Penalty Reduction Agreement.[15]

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*.[16] 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"[17] 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 Adjudications stage. Accordingly, and to the extent that a trader has been "duly diligent", in order to avail themselves of the defence, and to avoid second and third level penalties, an appeal must be instituted for first level offences, which would not appear to be economically feasible where the first level penalty is minimal.

A Penalty Reduction Agreement ("PRA") is another interesting development, and may be used to reduce or eliminate the penalty assessed where a person has been assessed an AMPS penalty totaling $5,000 or more, as a result of their Customs Information System.[18]

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."[19]

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.

AMPS poses some interesting questions from a pure "valuation" perspective.

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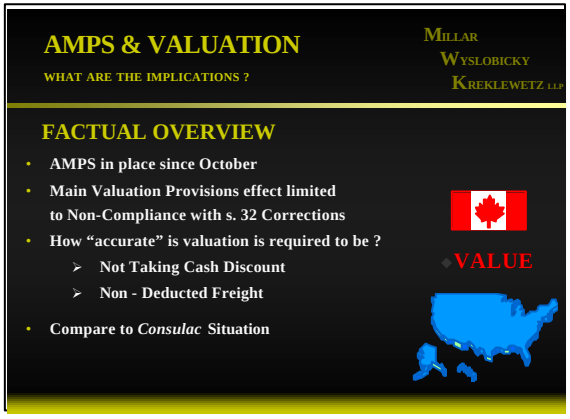


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## ENDNOTES

1. 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).

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

3. The two additional issue 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.

4. Note the difficulties the importer may have in light of the Supreme Court's income tax decision in the *Shell Canada* case: see *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622.

   In *Shell*, the Supreme Court essentially rejected, as an appropriate method of statutory interpretation, carte blanche reference to economic realities.

   Rather, the Court underlined that "the economic realities of a situation can be used to recharacterize a taxpayer's bona fide legal relationships."

   This may be a harbinger of bad things to come for the importer, especially when it comes to the argument that despite the Buying Agent Agreement" that was entered into, what was really happening in *Chaussures Browns* was the payment of a "royalty".

5. See, for example, *Sherson Marketing Corporation v. D/MNR* [2000] 4575 ETC (AP-98-002).

   In *Sherson*, Sherson Marketing was an importer and distributor of footwear. Sherson engaged buying agents abroad, to assist it in obtaining goods (and to provide other related services). The general issue in each of the cases was whether the fees paid by Sherson to its agents were non-dutiable as *bona* fide "buying commissions".

   The complicating factors in *Sherson* were that (1) the so-called buying agent was sometimes paid a flat fee, from time-to-time – as opposed to the normal buying agent commission, (2) the buying agents sometimes had "conflicts of interest" with Sherson (e.g., acting on its own behalf, and as the trademark holder, designer, importer and distributor of the same goods to Canada, or otherwise acting as the "agent" for a number of other purchasers competitive to Sherson); and (3) some of the alleged "buying commissions" actually represented payments for some design work.

   *Flat-Fee Buying Commissions.* The CITT was not overly bothered by the Flat-Fee buying commission, although likely realizing that the remuneration structure was a bit out of the ordinary. In the Tribunal's words: "remuneration by way of lump sum payments at fixed intervals of time has not prevented courts from finding that an agency relationship exists", leaving it to the parties to "determine, between themselves, the appropriate remuneration, which may include lump sum or variable payments".

   *Conflict of Interest.* The CITT was also not overly bothered by the alleged "conflicts of interest", since the agents had made a full disclosure to Sherson and therefore, in the CITT's view, had met its their fiduciary obligations. (Apparently, once the disclosure was made, the CITT felt that Sherson was free to choose the agent to act on its behalf.)

   *Carve Out for Design Work.* The CITT also had to grapple with the fact that functions that really went beyond that of a buying agent were in cluded in the "buying commission" flat-fee arrangement paid to the buying agent. The CITT essentially said that if Customs wants to back that portion of the buying commission out (and subject it to duty), there had better be some evidence of the amounts paid for non-buying commission functions, and even where there was such evidence, permitted Sherson to carve out the offending amounts from the bona fide buying commission.

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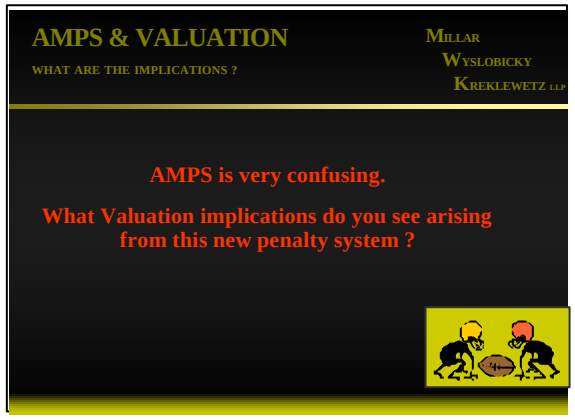


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## ENDNOTES

6. See *Utex Corporation v. D/MNR*, [1999] 4542 ETC (AP-98-085).

   In *Utex*, Utex engaged a buying agent ("Fco") to assist it in obtaining goods from China, and related "buying" services. The issue at the CITT was whether Fco was a bona fide buying agent, and the CITT quickly concluded that it was not, essentially because Fco failed to make complete disclosure to Utex of the transactions it undertook on Utex's behalf. (Utex also lacked a real degree of control over its agent, it seems, since it had little knowledge of how the buying agent (or their subagents) were operating.

   The CITT held that the determination of whether a buying agency relationship exists is "a question of fact", and indicated that it was simply not persuaded by the evidence that Fco always acted in the best interests of Utex, concluding therefore that the Fco was not a *bona fide* buying agent, and subjecting the buying commissions paid to Fco to duty.

   Utex appealed to the FCA, and in a 9 paragraph judgment the Court overturned the CITT, saying:

   > [7] We are all agreed that the Tribunal erred in law.
   >
   > [8] There is no evidence in the record that Fabco, in provided services to Utex Corporation, failed in some respect to act in the interest of the appellant but event if there were, that by itself would not be sufficient to establish that the fees paid to Fabco are outside the exception set out in subparagraph 48(5)(a)(i) of the *Act* as fees paid to the agent of a purchaser for the service of representing the purchaser abroad in respect of the sale.

7. 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.

8. 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.

9. 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.

10. 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.

11. 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.

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

13. 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.

14. 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.


15. 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).
16. 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.
17. 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.
18. 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.
19. 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.

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