DEALING WITH NAFTA VERIFICATION

& Other Customs Audits in the Current Compliance Environment

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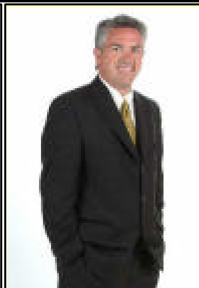

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Rob is a partner at MILLAR KREKLEWETZ LLP, with an LL.B. from Osgoode Hall Law School, and a M.B.A. from York University.

Extensive Customs, Trade & Commodity Tax Experience. Rob's practice focuses on **Customs & Trade** matters, including Periodic Verification Audits and Voluntary Disclosures concerning Valuation, Tariff Class Origin, or Marking issues, and NAFTA Origin Verification Reviews, Forfeitures, Seizures, and other NAFTA & WTO issues. Rob's practice area also focuses on **Commodity Taxes**, which encompasses all issues involving Canada's Goods and Services Tax (GST) and Harmonized Sales Tax (HST), as well the various other provincial sales taxes, including Ontario RST and Quebec QST. All elements of Millar Kreklewetz's practice include **Tax and Trade Litigation**, and Rob has acted as lead counsel in the CITT, Tax Court of Canada, Federal Court of Appeal, Ontario Court of Justice, and the Ontario Court of Appeal.

Speaking Engagements / Publications. Rob has almost 20 years of experience, has published over **325 articles & papers**, and has spoken at over **125 conferences** in each of the areas described above. He continues to write and speak extensively, regularly addressing the Canadian Association of Importers & Exporters (IE Canada), at its annual and semi-annual conferences, and various seminars, and bodies like the Tax Executive Institute (TEI), Canadian Tax Foundation, Canadian Bar Association (CBA), and Canadian Institute of Chartered Accountants (CICA), as well as speaking at many other professional conferences.

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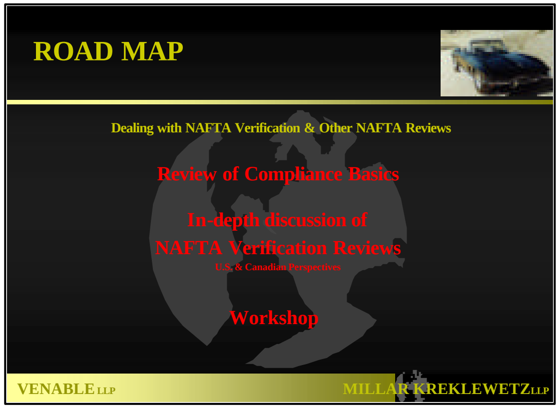
LINDSAY B. MEYER, J.D.

Lindsay is a partner at Venable LLP, with an J.D. from George Washington University, National Law Center and a licensed U.S. Customs Broker.

Extensive Trade, Customs and Export Control Experience. For over sixteen years, Lindsay has provided **International Trade and Customs** advice at Venable where she heads its International Practice, located in Washington, D.C., concentrating on **Customs & International Trade** matters, including representation during U.S. Customs Focused Assessments, NAFTA Audits, C-TPAT, ISA Programs, Detentions, Forfeitures, Seizures, other Customs-related matters. She regularly provides strategic customs and trade counseling to Fortune 100 clients, by conducting Pre-Assessment Compliance Reviews including corporate-wide, multi-location assessments and training programs, and by representing companies before the U.S. Bureau of Customs and Border Protection, the Court of International Trade, and U.S. Court of Appeals for the Federal Circuit. Lindsay has extensive experience counseling companies on compliance with export controls regulated by the Departments of Commerce, State and Treasury and performing Export Control Assessments. Lindsay has also successfully represented companies in antidumping duty investigations and reviews before the U.S. Department of Commerce and International Trade Commission and on appeal. Lindsay also advises clients on **International Transactional** matters, where she counsels on strategic sourcing, sales and distribution arrangements in the U.S. and abroad; the use of foreign agents, affiliated offices, and joint ventures.

Venable LLP's Client Base. As one of *The American Lawyer*'s top 100 law firms, Venable LLP has lawyers practicing in all areas of corporate and business law, litigation, intellectual property and government affairs. Venable serves corporate, institutional, governmental, nonprofit and individual clients in the U.S. and around the world from its base of operations in and around Washington, DC. Likewise, Lindsay's clients range from multinational manufacturers to start-up enterprises from a wide variety of industries including high technology, chemical, petrochemical, pharmaceutical, automotive, avionics, space control equipment, steel, and retail industries.

Speaking Engagements / Publications / Memberships. Lindsay is also very active in business and trade associations related to her profession, and in her fourth term as Chair of the International Trade and Customs Committee for the ABA's Section of Administrative Law and Regulatory Practice, is a member of the American Association of Exporters and Importers, and was appointed by the U.S. Secretary of Commerce to the Maryland-Washington District Export Council.



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THE ROAD MAP

General Focus of the Presentation

While many readers will now be aware of their general obligations regarding the North American Free Trade Agreement ("NAFTA"), many will not yet have had the pleasure of dealing "first-hand" with a NAFTA verification review, or indeed, other more detailed "Customs reviews" that can come in the form of a "Periodic Verification" or the "multi-program" reviews (in Canada), or a "focussed assessment" (in the U.S.).

Persons likely to experience a "first-hand" NAFTA verification review are persons that sign and distribute NAFTA Certificates of Origin ("Certificates"), attesting to the fact that the goods they produce or export, qualify for NAFTA treatment.

Persons likely to experience a "first-hand" "multi-program" review may be any domestic importer of goods to Canada, anyone importing from abroad (i.e., a "non-resident" importer).

Where NAFTA is relied upon for duty free trade, however, NAFTA Certificates are being signed by producers/exporters, and accepted by importers, and are being to enter goods into NAFTA territories on a reduced (and usually free) basis. The Certificates, and the manner in which the certified goods produced, are subject to periodic verification by the NAFTA Customs Administration in the territory to which the goods are exported, as our other import practices, including the tariff classes chosen for the imported goods, the values attributed to them, and other issues like marking etc.

For NAFTA Verification, these procedures are essentially provided for in Chapter Five of the NAFTA, which details the Customs Procedures to which each NAFTA party is required to adhere. These procedures also have the force of law, being enshrined into the domestic legislation of Canada, the U.S., and Mexico – and will be discussed further below. That is not to say, however, that the NAFTA's origin requirements are only the worry of the producer or exporter of the goods. Far from it.

Both Canada and the U.S. now have very similar legislation requiring any *importer* who develops the reason to believe that their NAFTA certified goods are *not* in fact NAFTA qualifying, to take positive steps to correct the declared origin of the goods on historic importation records, and to pay the requisite duties on the goods, under the normal applicable tariffs – in Canada, usually the Most Favoured Nation rate applies, and in the U.S., the General Rate of duty applies. And both countries have domestic legislation – following again from the NAFTA – which requires producers and exporters who are found to have incorrectly certified their goods as NAFTA "originating," to give timely notice to all of the importers who may have relied on those Certificates – thus giving the importers the "reason to believe" that leads to their own corrective action requirements.

Thus, a NAFTA verification review is a matter that is equally important to both exporters (and producers) and importers, and it becomes increasingly important to understand just what should be done when Canada or U.S. Customs comes knocking.

It should also be noted that while errors in tariff classification or valuation need not be reported to one's exporter / producer, each jurisdiction now has the same sort of "mandatory correction" provisions applying to require importers to correct substantive errors in tariff classification, and in valuation.

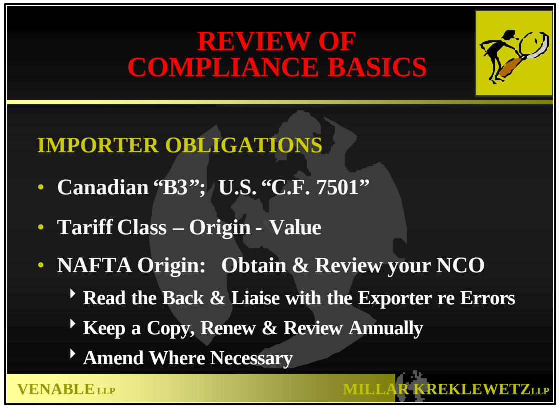
This Presentation will focus on first providing a brief overview of the basic NAFTA requirements for claiming duty-free treatment for U.S. or Canadian goods, including common errors and pitfalls, and then proceed to a discussion of the strategies and overall approach to be taken when Canada or the U.S. inevitably initiates an origin verification review. Finally a workshop will be conducted to give the attendee a first-hand understanding of how to determine NAFTA qualification under the Rules of Origin, and some of the issues that crop up in specific situations.

Navigating Through the Materials

The Materials are broken into the following parts:

Part I is a narrative outline of the basic points to be made during the Presentation, and focuses primarily on origin issues. **Parts II** and **III** of the Materials contain fairly comprehensive reviews, respectively, of the Canadian and U.S. Customs regimes, and are designed to allow readers not completely familiar with these systems to more fully understand the customs systems in place between our two countries. As an added bonus, Parts **IV** and **V** of the Materials contain a summary of the more recent customs issues facing, respectively, Canadian and U.S. importers.

Accompanying the Materials are detailed Appendices, and the Workshop Materials that will be referred to during the workshop



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PART I – DEALING WITH NAFTA

Overview

In many senses, the duty-free trade that comes with the NAFTA comes with strings attached. Those strings are the "NAFTA origin" requirement placed on the goods being imported which, in short, requires that the goods originate in the NAFTA territory in accordance with very specific rules, and that written certificates be provided by the producer or exporter of the goods to the importer of the goods, and kept on hand at all times during and after the importation process.

Origin is, therefore, 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.[1]

That being said, the next question is when and how is origin verified.

Many will recall the zest with which Canada Customs undertook "valuation" audits in the early 1990s. Such audits were plentiful in the U.S. during that time, as well. The gradual decline in duty rates under the NAFTA resulted in many practitioners from both countries forecasting a demise for the valuation audit, while at the same time predicting an increase in NAFTA verification of origin activity. Those forecasts have ultimately proved to be correct.

In the present decade, NAFTA Verification of Origin audits are becoming the source of work (and heartache) that valuation audits were in the 1990s.

And for Canadians and U.S. persons alike, they are resulting in the same sort of challenges that a "snap" valuation audit represented some 10 years ago.

The Legal Requirements for Duty-Free Trade

Certificates. The basis for NAFTA verification is found in Chapter Five of the NAFTA, which sets out the basic legal requirement for claiming NAFTA preferential status. (A sample Certificate of Origin is included in your materials.)

These provisions – which have all been more-or-less enshrined in Canadian and U.S. legislation – provide as follows:

Article 501: Certificate of Origin

1. The Parties shall establish by January 1, 1994 a Certificate of Origin for the purpose of certifying that a good being exported from the territory of a Party into the territory of another Party qualifies as an originating good, and may thereafter revise the Certificate by agreement.

2. Each Party may require that a Certificate of Origin for a good imported into its territory be completed in a language required under its law.

3. Each Party shall:

   (a) require an exporter in its territory to complete and sign a Certificate of Origin for any exportation of a good for which an importer may claim preferential tariff treatment on importation of the good into the territory of another Party; and

   (b) provide that where an exporter in its territory is not the producer of the good, the exporter may complete and sign a Certificate on the basis of

      (i) its knowledge of whether the good qualifies as an originating good,

      (ii) its reasonable reliance on the producer's written representation that the good qualifies as an originating good, or

      (iii) a completed and signed Certificate for the good voluntarily provided to the exporter by the producer.

4. Nothing in paragraph 3 shall be construed to require a producer to provide a Certificate of Origin to an exporter.

5. Each Party shall provide that a Certificate of Origin that has been completed and signed by an exporter or a producer in the territory of another Party that is applicable to:

   (a) a single importation of a good into the Party's territory, or

   (b) multiple importations of identical goods into the Party's territory that occur within a specified period, not exceeding 12 months, set out therein by the exporter or producer,

   shall be accepted by its customs administration for four years after the date on which the Certificate was signed.

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For further Canadian information, see Customs Memorandum D11-4-2 (*Proof of Origin*, June 30, 1998), which outlines the relevant provisions of the *Customs Act*, and the *Proof of Origin of Imported Goods Regulations.*

For additional U.S. information, see Customs Directive No. 099 3810 (June 28, 1999), which sets forth the guidelines in completing a Certificate for use in the U.S. under the *NAFTA Rules of Origin Regulations*.

Certificates Must be On Hand. Thus, the basic rule is that where NAFTA preferential status is claimed, an importer must have in its possession, a valid NAFTA Certificate of Origin (as above, the "Certificate").

A very simple rule, it is: no Certificate, no NAFTA.[2] But having the Certificate in one's possession is supposed to be the easy part.

The more difficult situation is actually ensuring the that person providing you with the Certificate has provided it and prepared it properly. Under the NAFTA, after all, the ultimate responsibility for importing goods is on the *importer*. That means that where there are problems with the Certificate, the ultimate liability falls on the importer.

How is Origin Determined? Determining "origin", like the situation for determining appropriate tariff classification (as discussed below), 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. Likewise, the U.S. *NAFTA Rules of Origin Regulations* (at 19 C.F.R. § 181.131) and application of the Harmonized Tariff Schedule of the U.S. ("HTS") require a similar analysis for imports into the U.S. under NAFTA.[3]

A full understanding of the bill of materials (or "BOM"), which identifies the raw materials and components making up the imported finished goods, is often required.

Furthermore, 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).

Indeed, a full day (or week's course) could be structured around understanding how the Rules of Origin work, and in attempting to determining "origin" of NAFTA goods. For present purposes, we will assume that readers either have created customs expertise "in-house", or will obtain the requisite assistance from an outside customs and trade lawyer.

NAFTA Verifications

What is a NAFTA Verification? The tool that is used by both Canada Customs and U.S. Customs to police the NAFTA origin requirements is the NAFTA Verification review, which can entail site visits.[4]

NAFTA origin Verification reviews are provided for in Article 506 of the NAFTA, some of the more pertinent of provisions provide, as follows:

Article 506: Origin Verifications

1. For purposes of determining whether a good imported into its territory from the territory of another Party qualifies as an originating good, a Party may, through its customs administration, conduct a verification solely by means of:
   (a) written questionnaires to an exporter or a producer in the territory of another Party;
   (b) visits to the premises of an exporter or a producer in the territory of another Party to review the records referred to in Article 505(a) and observe the facilities used in the production of the good; or
   (c) such other procedure as the Parties may agree.
2. Prior to conducting a verification visit pursuant to paragraph (1)(b), a Party shall, through its customs administration:
   (a) deliver a written notification of its intention to conduct the visit … and
   (b) obtain the written consent of the exporter or producer whose premises are to be visited.

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3. The notification referred to in paragraph 2 shall include:
   (a) the identity of the customs administration issuing the notification;
   (b) the name of the exporter or producer whose premises are to be visited;
   (c) the date and place of the proposed verification visit;
   (d) the object and scope of the proposed verification visit, including specific reference to the good that is the subject of the verification;
   (e) the names and titles of the officials performing the verification visit; and
   (f) the legal authority for the verification visit.
4. Where an exporter or a producer has not given its written consent to a proposed verification visit within 30 days of receipt of notification pursuant to paragraph 2, the notifying Party may deny preferential tariff treatment to the good that would have been the subject of the visit.

…

9. The Party conducting a verification shall provide the exporter or producer whose good is the subject of the verification with a written determination of whether the good qualifies as an originating good, including findings of fact and the legal basis for the determination.
10. Where verifications by a Party indicate a pattern of conduct by an exporter or a producer of false or unsupported representations that a good imported into its territory qualifies as an originating good, the Party may withhold preferential tariff treatment to identical goods exported or produced by such person until that person establishes compliance with Chapter Four (Rules of Origin).

…

For further Canadian information, see Customs Memorandum D11-4-20 (*Free Trade Agreement Origin Verification Procedures*, May 14, 1999), which outlines the provisions of section 42.1 of the *Customs Act*, and the *Uniform Regulations of NAFTA*.

Additional U.S. information may be found at Customs Directives 3810-08 (*Notification of Proposed Verification Visits under NAFTA*) and 3810-10 (*Issuance of Origin Determinations under the NAFTA*), which outline the provisions of Subpart G, 19 C.F.R. §181.71 *et seq.*, *Origin Verifications and Determinations*, and Title 19, U.S. Code.

How NAFTA Verifications Get Started. In practice, NAFTA verification usually starts with a fairly innocuous inquiry on the importer side, with the particular Customs Administration contacting importers, asking about product information, and requesting copies of Certificates for their imported goods. The basis for the request is, again, found in the NAFTA, and in Article 502(1).

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

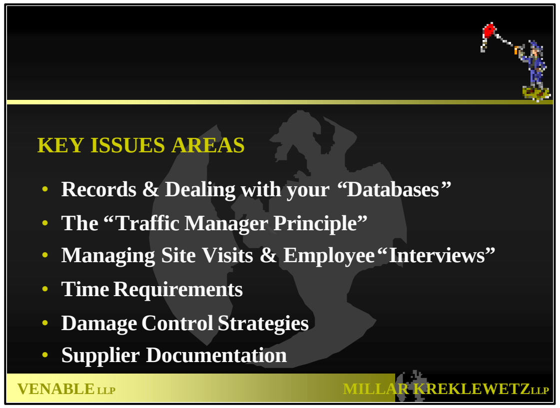
That is, unfortunately, an incorrect conclusion. For the importer, the process is simply delayed.

Re-focus on the Exporter. As alluded to just above, when armed with Certificate's issued by the exporter (or sometimes the producer of the goods), the particular Customs Administration will then turn its attention on the exporter of the goods, in an attempt to verify that the goods imported under the Certificate did actually meet the NAFTA "origin" requirements.

While there are a number of ways in which a Customs Administration is able to obtain information from NAFTA exporters (and a number of requirements Customs must satisfy before doing so – all as detailed in Article 506 above, and in domestic legislation), a typical approach is to seek the completion of *NAFTA Origin Verification Questionnaire* – copies of which are attached, as samples, in your materials.[5]

Once completed, a site visit is usually requested, and further verification steps taken. Among these, it is not uncommon for "supplier verification" steps to commence, whereby the Customs Administration issues verification questionnaires, or inquiry letters, to key suppliers in the manufacturing chain (i.e., aimed at ensuring the the raw materials those suppliers provide into the NAFTA manufacturing process are in fact "NAFTA" originating materials, as relied on by the present producer).

Pending completion of the audit and all related verification activities, and assuming the worst, the Customs Administration will provide the producer with written notice of its intent to deny NAFTA status, which while subject to representations and appeal, is a big problem.



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Assuming, at the end of the process, that the Customs Administration takes the view that an exporter has issued an improper Certificate, and that the imported goods do not in fact qualify for NAFTA treatment, then a number of very serious implications follow, each based in the so-called "informed compliance" initiatives now in Canadian, U.S. and Mexican trade laws.

These "reason to believe" requirements place positive obligations on both the exporter and importer (also as described in further detail in Parts II and III below).

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

Negative Determination ? Exporters' Obligations. For the exporters – who now have the "reason to believe" its Certificates are incorrect – a mandatory "reporting requirement" arises.

For example, Article 504(1) of the NAFTA provides as follows:

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

The Canadian rule is found in section 97.1(3) of the *Customs Act*, and Canada Customs takes the general view, in Customs Memorandum D11-4-14 (*Certification of Origin*, July 15, 1998) that an exporter or producer that has completed a Certificate "must immediately notify all persons to whom the certificate was given of any change identified subsequent to the initial completion of the certificate that may affect its accuracy or validity". This includes, in Canada Customs view, "amending [the Certificate] to reflect correct information when necessary", and with respect to both "the single certificate and the blanket certificate".

Furthermore, Canada Customs provides that the following must be done when a Canadian exporter is provided with a negative "determination" as to origin by U.S. or Mexican customs:

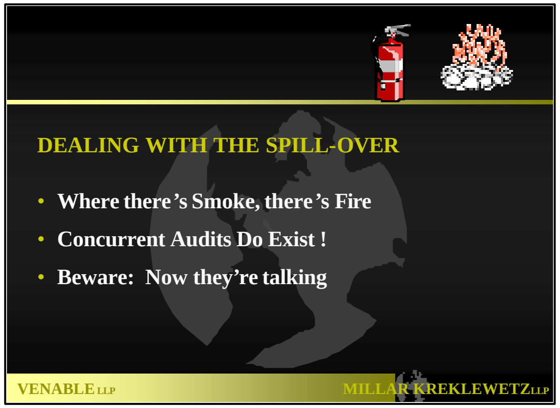
> 26. When a written determination of origin is given to an exporter or producer advising them that the goods under review are not originating, the exporter or producer shall at that time notify any person to whom a Certificate of Origin was given. The notification must advise the importer that the customs administration has issued a written determination on the goods stating that the goods do not qualify.

Again, this administrative position effectively mirrors the Canadian legislative requirements, found in section 97.1(3) of the *Customs Act*.

In the United States, the policy statement is provided in U.S. Customs Directive No. 099 3810-014 (June 28, 1999). It instructs that an exporter or producer who completes and signs a Certificate of Origin, and who has reason to believe that the Certificate contains information that is not correct "shall promptly notify in writing all persons to whom he or she gave the Certificate of any change that could affect the accuracy or validity of the Certificate." For goods covered by a blanket certification, U.S. Customs states that "it is the exporter's responsibility to advise the importer of any significant changes in, for example, sourcing materials or production methods that may affect the NAFTA claim and furnish the importer with a new Certificate." Producers who provide a Certificate to an exporter are also required to notify the exporter of any such changes.

This reflects the regulatory provision set forth in subpart C, *Filing of Claim for Preferential Tariff Treatment Upon Importation*, 19 C.F.R. §181.21(b), which states:

> If, after making a declaration required [in connection with a claim for preferential tariff treatment under NAFTA], the U.S. importer has reason to believe that a Certificate of Origin on which a declaration was based contains information that is not correct, the importer shall within 30 calendar days after the date of discovery of the error make a corrected declaration and pay any duties that may be due," which shall be submitted to the Customs office where the original declaration was filed.



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The U.S. exporter (or producer) who provided the Certificate to importers, likewise has an obligation to "notify in writing all persons to whom the Certificate was given" when theyhave "reason to believe" that the Certificate contains inaccurate data which "could affect the accuracy or validity of the Certificate" and must do so within 30 calendar days. *See* Exporter Requirements, Subpart B, *Notification of Errors in Certificate*, at 19 C.F.R. §181.11(d). Further guidance is provided in Customs Directive No. 099 3810-014 (June 28, 1999).

Corresponding Correction Obligations on Importers. For the importers, the obligations are even more painful. In Canada, as in the U.S., there is a contemporaneous obligation on an importer receiving the bad news, in the form of a mandatory correction obligation.

This obligation follows from the obligations under Article 502 of the NAFTA, which provide as follows:

Article 502: Obligations Regarding Importations

1. Except as otherwise provided in this Chapter, each Party shall require an importer in its territory that claims preferential tariff treatment for a good imported into its territory from the territory of another Party to:

   (a) make a written declaration, based on a valid Certificate of Origin, that the good qualifies as an originating good;

   (b) have the Certificate in its possession at the time the declaration is made;

   (c) provide, on the request of that Party's customs administration, a copy of the Certificate; and

   (d) <u>promptly make a corrected declaration and pay any duties owing where the importer has reason to believe that a Certificate on which a declaration was based contains information that is not correct</u>.

2. Each Party shall provide that, where an importer in its territory claims preferential tariff treatment for a good imported into its territory from the territory of another Party:

   (a) the Party may deny preferential tariff treatment to the good if the importer fails to comply with any requirement under this Chapter; and

   (b) the importer shall not be subject to penalties for the making of an incorrect declaration, if it voluntarily makes a corrected declaration pursuant to paragraph 1(d).

3. Each Party shall provide that, where a good would have qualified as an originating good when it was imported into the territory of that Party but no claim for preferential tariff treatment was made at that time, the importer of the good may, no later than one year after the date on which the good was imported, apply for a refund of any excess duties paid as the result of the good not having been accorded preferential tariff treatment, on presentation of:

   (a) a written declaration that the good qualified as an originating good at the time of importation;

   (b) a copy of the Certificate of Origin; and

   (c) such other documentation relating to the importation of the good as that Party may require.

For Canadian importers, this mandatory correction obligation arises under section 32.2 of the *Customs Act*, which provides as follows:

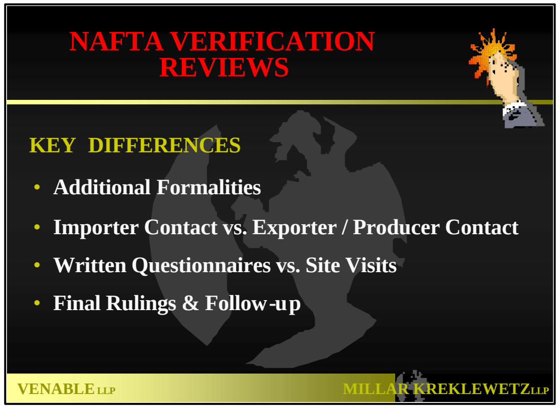
32.2(1) Correction to declaration of origin — An importer or owner of goods for which preferential tariff treatment under a free trade agreement has been claimed or any person authorized to account for those goods under paragraph 32(6)(a) or subsection 32(7) shall, within ninety days after the importer, owner or person has reason to believe that a declaration of origin for those goods made under this Act is incorrect,

(a) make a correction to the declaration of origin in the prescribed manner and in the prescribed form containing the prescribed information; and

(b) pay any amount owing as duties as a result of the correction to the declaration of origin and any interest owing or that may become owing on that amount.

Thus a Canadian importer that has reason to believe that a declaration of origin is incorrect, has 90 days to make a correction to the original declaration (i.e., by filing a B2 Adjustment Request), and to pay any duties (and GST) owing as a result of such a correction.

Canada Customs has detailed information on how these corrections can be made in Customs Memorandum D11-6-6 (*Self-Adjustments to Declarations of Origin, Tariff Classification, Value for Duty, and Diversion of Goods*, Feb. 11, 1998).



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A similar provision exists in the U.S. regulations, however, the time requirements are even *more* stringent. An importer in the U.S. who receives information that a Certificate is inaccurate or invalid "must make a corrected declaration of origin within 30 days of discovery, and pay any applicable duties, ..." See Customs Directive No. 099 3810 (June 28, 1999), wherein U.S. Customs expressly notes that the "failure to correct a declaration that is known to contain inaccurate information may result in the assessment of penalties." These are in addition to the payment of any back duties (plus interest) that are owing.

And that is about the point the NAFTA Verification audit concludes – often on a quite unhappy basis for both exporters and importers.

Commentary

It can be seen that under the NAFTA, the "importer" is the one left "holding the bag" in terms of possible duty and interest consequences for invalid Certificates. On the other hand, the attendant business and commercial implications of having made and passed on an incorrect Certificate can be very difficult for the producers and exporters too.

This means that NAFTA compliance is in everyone's overall interests. But therein lies the problem.

In our experience, Canadian, U.S. and Mexican exporters do not often pay the attention required of them when issuing Certificates. That results in errors on the face of Certificates, and in the worst case, entirely invalid Certificates. Even in situations were simple errors exist, but the goods are ultimately of NAFTA origin, the errors tend to act as the "big red flag" that Canada or U.S. Customs is looking for, perhaps inviting greater scrutiny, and a overall customs audit.

And in our experience, most Certificates will have at least one or two errors on them. And some of them can be real deuzies,[6] which put into question (at least in the mind of the Customs Administration requesting and reviewing the Certificate) whether there is any NAFTA compliance occurring at all, and whether anyone at your business has any idea about overall customs compliance.

Remember: where there is smoke, there is usually fire.

What all of this means for Canadian and U.S. importers, is that like it or not, they are the persons with the vested interest in reviewing Certificates obtained from their NAFTA exporters and producers. The importers, after all, will have to be the persons who will have to act as the "first line of defence" in scrutinizing the accuracy of Certificates they are provided.

Accordingly, Canadian and U.S. importers should take some basic steps towards ensuring the accuracy of the Certificates that they will be relying upon, perhaps taking a cursory review of the Certificates if only to ensure that there are no problems immediately apparent on their face.

What this also means, however, is that if you are the exporter (or producer) supplying the Certificate, you too may become embroiled in an audit, either directly – under the scrutiny of the Customs Administration in which the goods were shipped, or indirectly – by providing data (and possibly a corrected Certificate) to your customer. In this instance, you may find yourself facing the business consequence of an unhappy customer.

When Canada or U.S. Customs becomes involved, importers can also help their long-term positions by taking a lead role in both alerting the exporters to the on-coming review, the implications of what is about to occur, and perhaps guiding them to a source of Canadian or U.S. customs advice necessary to adequately meet the audit. It is in the importer's best interest to have an exporter knowledgeable on the NAFTA rules.

Generally speaking, that means a customs and trade lawyer, familiar with the NAFTA rules, and Canadian and U.S. administrative practices. In some cases, that may also mean getting more than one person on-board. This may become increasingly important as the Canadian and U.S. Customs authorities begin to share NAFTA origin audit information.

After that, however, our best advice is to keep your fingers crossed, buckle-up, and hang on for the ride.

Conclusions

As can plainly be seen, determining "origin" can be one of the most difficult processes in customs or tax law.

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Complicating matters, since the Certificate of Origin must be signed by the exporter or producer, based on its knowledge or pre-existing documentation, much work must technically be done by the exporter prior to any export / import of the goods taking place.

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 stops 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 or General rates instead of NAFTA rates, which sometimes means applying positive rates of duty to historic importations, and paying those duties to the Customs Administration, plus interest.[7]

Reverse Audits – Proactively Ensuring Compliance

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

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

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

At MWK, we call this process our "Multi-Program Review", while at Venable it is referred to as a "Pre-Assessment Review."

Under either label, what is performed is simply a "reverse-audit" approach aimed at verifying a business's compliance at the border, and focuses on analyzing the information provided by your company in past importations (generally from a series of 20 to 35 sample importations over the last calendar year), in order to ascertain your level of overall customs compliance.

This process emulates the approach that Canada Customs takes under its Program Compliance initiative and the approach that U.S. Customs now takes under its "Focused Assessment" program. Such reviews are also aimed at conducting an overall assessment of your company's ability to import and accurately report and account for goods – emulating the approach that Canada Customs takes under its System Review initiative and that U.S. Customs routinely includes as part of its Focused Assessments.

Appendix "A-1" contains a copy of MWK's Multi-Program Review framework, and includes the general program areas on which we would be expected to touch.

Appendix "A-2" provides a copy of Venable's "Pre-Assessment Review" strategy, and sets forth the general areas which are typically covered.

Appendix "B-1" and "B-2" provide copies, respectively, of Canadian and U.S. issued NAFTA Certificates of Origin – remember to read the back page ! Appendices "C-1" to "C-3" contain sample NAFTA Verification inquiries, including questionnaires, from each of Canada, the U.S. and Mexico.

Some Final Notes

A Note on MFN or "General" Rates. Another note worth thinking about is that when faced with a NAFTA verification issue, don't forget to ask yourself what the MFN rate (in Canada) and General Rate (in the U.S.) is for a particular good – since these rates are often also duty-free – or whether the tariff classification for the subject goods (which of course drives the MFN or General Duty rate) is correct. We have both seen occasions where the NAFTA status of imported goods did not really matter, since the MFN or General rate was duty-free, in any event.

Record Keeping. It is also worth mentioning the respective "record keeping" requirements in the NAFTA territories. For both importers and exporters, the record keeping requirements in Canada, the U.S., and Mexico, are as follows (a) Canada, are for a period of not less than six years; (b) the United States, are for a period of not less than five years from the date of entry; and (c) Mexico, are for a period of not less than five years.

In the U.S., for example, separate penalties may apply to record keeping violations, in addition to other Customs' violations that may have occurred. *See* 19 C.F.R. § 163.6.

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PART II – *CANADA'S CUSTOMS SYSTEM* [1]

Introduction

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

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

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

Overview of Canada's Customs Rules

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

Tariff Classification

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

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

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

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

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

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

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

Origin Determination

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

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

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

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

Reverse Audits – Proactively Ensuring Compliance. Appendix "A-1" contains a copy of MWK's Multi-Program Review framework, and includes the general program areas on which we would be expected to touch.

Valuation

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

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

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

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

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

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

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

The "Sold for Export" Requirement. Just what transactions constitute valid "sales for export" has been a bone of contention with Canada Customs for some time. Generally speaking, a "sale" contemplates the *transfer of title* in goods, from a vendor to purchaser, for a price or other consideration,[7] and the 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.[8] In "parent-subsidiary" relationships, an issue will also arise as to whether the parent and subsidiary are in true "vendor-purchaser" relationships, or whether the parent controls the subsidiary to such an extent that the latter can be viewed as the mere agent of the former, negating a "buy-sell".

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

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

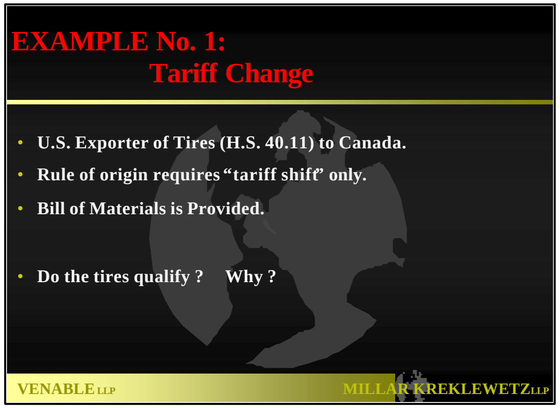
The change obviously makes the application of Transaction Value a bit more complicated, and requires some additional consideration of whether the sale for export to Canada has been made to what Canada Customs considers a proper Canadian "purchaser". The meaning of "purchaser in Canada" – and the general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

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

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

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

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



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The Customs Whipsaw: Transfer Pricing (Dis)Connect

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

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

As the very last paragraph of the 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.

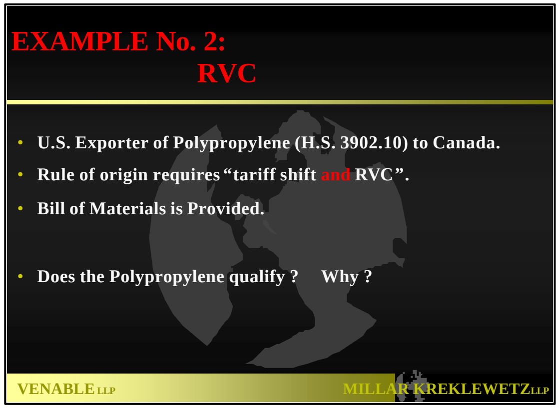
The situation in the U.S. may differ somewhat, as the Internal Revenue Code has rules (e.g., section 1059A) aimed directly at ensuring that a valuation for U.S. Customs purposes be the same, subject to certain limitations, as an acceptable transfer price for U.S. Taxation purposes.[13] Unfortunately,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

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

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

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

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



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

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

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

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PART III – *THE U.S. CUSTOMS SYSTEM*

Introduction

Canada has consistently remained as the most significant trading partner for the U.S., with shipments into the United States surpassing those of other countries. With the implementation of the U.S. - Canada Free Trade Agreement and, subsequently the NAFTA, customs duties between our two countries have been virtually eliminated. That does not mean, however, that the newly established U.S. Bureau of Customs and Border Protection (formerly U.S. Customs Service ("U.S. Customs")), will focus alone on border security at the cost of examining customs matters from the trade that flows into the U.S. from Canada.

In fact, the opposite is true. The examination of our bilateral trade has just reached new levels of scrutiny. On April 23, 2003, Commissioners Rob Wright of Canada Customs and Revenue Authority and Robert Bonner of U.S. Customs signed a Memorandum of Understanding ("MOU") regarding the exchange of NAFTA-related information. The very purpose of the MOU is "to simultaneously ensure and enhance compliance with the NAFTA rules of origin governing our cross-border trade." As Commissioner Wright stated, the MOU is "yet another example of the strong partnership between our Customs agencies <u>and our cooperation in enforcing our respective customs-related laws and regulations</u>."

Simply put, customs enforcement is live and well in the U.S.

And accordingly, it will pay well for Canadian importers and exporters to understand the additional nuances of the U.S. Customs System.

Overview of the U.S. Customs Rules

When seeking to import goods into the United States, the importer (which may be a non-U.S. resident) must provide certain information to U.S. Customs before it will be admitted for entry. The process is nearly identical to that in Canada. Specifically, the goods must be properly *classified* under the Harmonized Tariff Schedule of the United States, be identified as to their proper *origin*, be properly *valued*, and clearly and legibly *marked* in accordance with U.S. laws and regulations (which, practically speaking, include U.S. Customs rulings and interpretations).

When importing products from Canada, an importer may seek to import its goods under the preferential trade program of the NAFTA and its set of rules. Imports that are not brought in under a preferential trade program, like NAFTA, are subject to yet *another* set of rules.[1]

"Informed Compliance" & "Reasonable Care"

Since 1994, and the implementation of the U.S. Customs Modernization Act (the "Mod Act"), U.S. Customs has applied new standards of "informed compliance" and "reasonable care" on companies doing business in the U.S. Essentially, this means that the burden of compliance in determining and reporting accurate data, and of interpreting how the laws and regulations apply to those facts, now falls squarely on the companies importing into the U.S.

Along with this enhanced responsibility, U.S. Customs also instituted a new penalty structure (not dissimilar from the AMPS program recently initiated in Canada), subjecting importers to potential fines and penalties of up to the domestic value of the imported goods. (See further discussion in Part V.)

New Approach to Compliance. The Mod Act also brought about a new strategy in the U.S. agency's approach to compliance. Rather than assess products on an entry-by-entry basis, U.S. Customs sought to apply its resources in a more strategic manner. It determined that the top 1000 U.S. importers accounted for approximately 60% of the value of imports into the United States. So began an audit program that examined U.S. importers starting with those who accounted for the bulk of in-bound trade. The audits[2] included a cradle-to-grave review of sampled transactions as well as an indepth review of the company's customs compliance policies and procedures.

Today, and a few program generations later, U.S. Customs continues this approach in determining which companies importing goods into the United States are compliant, and which ones are not. A poor assessment may result in increased inspections of your goods at the border; further scrutiny of your compliance with preferential programs, (such as claims for NAFTA treatment), and the denial of duty-free benefits. As well, possible penalties and fines may arise, in addition to back duties (plus interest) owing if non-compliance is found.

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And, simply, an importer will suffer the increased business costs associated with being under the microscope in all aspects of your customs activities. One significant impact for companies, both large and small, was the adoption of the severe penalty provisions which may be sought in the event of non-compliance. Clearly, for U.S. Customs compliance, the buck stops with the companies importing into the U.S.

Tariff Classification for Entries into the United States

At the time of entry, an imported good must be classified within the Harmonized Tariff Schedule of the United States ("HTS"), in keeping with the General Rules of Interpretation that instruct an importer in determining which particular 10-digit provision applies. The U.S., like Canada, follows the "harmonized" system for classifying imported goods.[3] That is, the same general hierarchical coding system applies to U.S. imports under the HTS and its corresponding Sections, Chapters, Headings and Subheading provisions, as was described above. While the classification codes are "harmonized" among WTO countries to the six-digit level, an import in the United States must be reported in a subheading provision with ten digits. The breakout in the U.S. provisions of the 9th and 10th digit are for U.S. statistical purposes.

U.S. Customs treats the harmonized "Explanatory Notes," which accompany the HTS, as "guidance" but not strictly binding.[4] Instead, U.S. Customs typically applies the principles for classification that have been found in Customs Rulings for similar goods. Any importer or potential importer may request a ruling with U.S. Customs as to the proper treatment of its goods, including a request as to the proper classification provision for a product.

> **Tip**: Importers should periodically review existing U.S. Customs rulings on similar products to determine if Customs has concluded that a subheading, which differs from your intended provision, applies. While rulings are binding on the particular product and company making the formal request, Customs will routinely review existing decisions to see if other importers are seeking to evade a particular provision (typically with its corresponding higher duty) or if, in fact, a distinction from a ruling may validly be made. Then, if your goods are detained for examination, having a ruling on comparable goods upon which to refer in support of your classification subheading, will typically satisfy U.S. Customs.

> **Note**: When requesting a ruling, which will then bind the importer, a company should use the services of a customs and trade lawyer so that the request for the desired classification subheading is crafted in the most persuasive manner.

As determinations on proper classification impact the rate of the duty which applies,[5] it is important to make the effort to regularly review the classification headings that apply to your goods, and to do so as changes in product make-up or raw material sourcing occur. This is especially true for goods that are imported under the NAFTA. Also, bear in mind that classification provisions, themselves, are not static, so they should be regularly reviewed. What may have been an appropriate subheading in the past, may have become inaccurate.

Origin Determination under the U.S. Rules

Having determined that a product has been properly classified, the importer must determine the *origin* of the imported good in order to report the same to U.S. Customs at the time of entry. The classification decision is critical for a company seeking to determine origin under the NAFTA.

> **Note**: In the U.S., non-NAFTA entries (and those that are not made under another preferential trade program) are subject to a "substantial transformation" test. This standard for determining origin is <u>not</u> based upon the "tariff shift" rules of the NAFTA. Rather, the general rule under this test is that the country of origin of an imported product is the country in which the raw materials where last "substantially transformed" into a new article of commerce. *See* 19 C.F.R. 134 *et seq*. Importantly, a product may have an origin as determined under the NAFTA Rules of Origin, which may differ from the origin determined by the general U.S. rules of origin.

Under NAFTA, determining a good's "origin" can be particularly complex. Often an importer does not possess perfect information as to the origin and classification of all of the raw materials that make up the finished product; this serves to further complicate the process in determining origin. For example, although a raw material is purchased from a company *located* in the U.S., that raw material may not necessarily be of "U.S." origin. Therefore, it is advisable to obtain origin certificates or statements from all suppliers of raw materials before determining the origin of the finished products that your company produces. As a practical matter, it may be difficult to obtain statements for <u>all</u> raw material inputs; nevertheless, the effort should be made.

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As discussed above, the liability for reporting the proper origin rests with the importer. Under the existing Customs standards, if an importer has "reason to know" that its origin declarations under NAFTA are incorrect, it has an affirmative obligation to correct what was reported. This means a review of all prior entries (on an entry-by-entry basis) for which the origin declaration, and typically the corresponding duty-free treatment, was incorrect over the last five years,[6] along with a reporting within 30 days to U.S. Customs.

Part of the reporting includes a requirement for the payment of any back-duties owed, plus interest to make U.S. Customs Service "whole" (as if the duties had been timely paid). It is also recommended to consider any such reporting under U.S. Customs voluntary prior disclosure program, in order to minimize and, hopefully avoid altogether, any corresponding fines or duties that may be assessed by Customs.

Pre-Assessment Reviews to Ensure Compliance. Venable routinely conducts Pre-Assessment Reviews of a company's customs activities to determine if any "origin", or other Customs, issues exist. While it is preferable to do so *before* the company has received any audit notice from Customs, we have also conducted reviews "post-notice," but in advance of Customs' commencement of a formal investigation. See Appendix A-2, for the areas typically covered in our Pre-Assessment Reviews.

Valuation in the United States

Following the determinations of the imported goods' "tariff classification," "origin", and corresponding duty rates, next the importer must consider the proper value that will be declared to U.S. Customs. Goods imported into the United States are appraised in under the statutory authority of section 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 ("TAA").[7]

As in Canada, most duties in the United States are applied on an *ad valorem* basis, expressed as a percentage, and applied to the value of the imported goods. As with most countries, the proper valuation of imported goods is of high importance to U.S. Customs.

This remains true even though there has been a significant decline in the "General Duty" rates applied in the U.S., along with an increase in the number of preferential duty programs, such as the multilateral NAFTA Agreement and the more recent U.S. bilateral agreements with Israel, Jordan, Vietnam, and those expected to be completed with Chile and Singapore, where reduced and duty-free rates abound.

In the U.S., the rules for valuing imported goods are found in Part 152, Subpart E, *Valuation of Merchandise* of the U.S. Code of Federal Regulations. These rules are consistent with the rules in place in most other WTO member-nations, and parallel the rules in Canada.

> **Note**: In addition to the rules pronounced in the regulations, U.S. Customs also relies upon the World Customs Organization's *Valuation* handbook for guidance. Also, U.S. importers should review the existing U.S. Customs rulings and its Informed Compliance publications on valuation (including its 450-page *Valuation Encyclopedia*) for further information on Customs' interpretation of such rules to particular facts. Importers should periodically review existing U.S. Customs rulings and interpretations often change or are further retired over time.

Transaction Value Preferred Method. The "Transaction Value" will typically be found to apply when products have been "sold for export to the U.S.", and several additional conditions are met.

The Transaction Value is defined as the "price actually paid or payable" for the imported goods when sold for exportation to the United States[8] (or secondarily for identical or similar goods), with certain regulatory additions and deductions.

The valuation rules, like the classification rules, are hierarchical in nature in the U.S. Therefore, if the Transaction Value does not apply, other methods must be considered, in the following order:

- Transaction Value of Identical Goods (19 C.F.R. §152.104);
- Transaction Value of Similar Goods (19 C.F.R. §152.104);
- Deductive Value* (19 C.F.R. §152.105);
- Computed Value* (19 C.F.R. §152.106); and
- "Fallback" Value (19 C.F.R. §152.107).

* At the importer's discretion, the Computed Value method may be applied before the Deductive Value method, provided the request has been made to Customs when the entry summary is filed.

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Transaction Value Conditions. Consistent with the treatment in Canada, the "primary" Transaction Value method applied in the U.S. includes certain strict conditions that many importers have difficulty meeting.

The regulations provide that Transaction Value does not apply unless the goods are imported as a result on a "sale for export" to the United States.[9]

Additional limitations of the use of Transaction Value apply when the "price paid or payable" cannot be determined, such as when the total payment (whether made directly or indirectly) is not made or will not be made for the imported goods by the buyer to, or for the benefit of the seller. [10]

Also, it will not apply where:[11] (1) there are restrictions regarding the disposition or use of the goods; (2) the sale of the goods or the price paid or payable for the goods is subject to some condition or consideration for which a value cannot be determined; (3) proceeds of any subsequent resale, disposal or use of the imported goods, will accrue to the seller, and the appropriate value adjustment has not been made; or (4) the buyer and the seller of the goods are related, and their relationship influenced the price paid or payable for the goods, unless the importer can meet certain defined "test values." [12]

The "Sale for Export" Requirement. As with concerns raised by Canada Customs, U.S. Customs has also placed interpretative restrictions on which transactions constitute valid "sales for export" as the extensive body of rulings and cases on the subject reflect.

Typically, a "sale" contemplates the *transfer of ownership in the property*, from a seller to buyer, whether directly or indirectly, for a price or other consideration. *See* U.S. Customs' Informed Compliance Publication, *Bona Fide Sales and Sales for Exportation*.

Because a "sale" must occur, there are numerous scenarios which prohibit the use of Transaction Value. For example, the "presumption" of U.S. Customs is that merchandise shipped to a foreign party and location prior to reaching the U.S., is not "sold for export" to the United States.

U.S. Customs has also held that Transaction Value is inapplicable when goods are imported under a "lease" and hence, no "sale" occurs. Also, Transaction Value would not typically apply when goods are transferred between unincorporated related parties, such as when a U.S. branch or division receives a transfer of goods in inventory from its related overseas office. Likewise, when goods are transferred, but not sold, from overseas to a subsidiary in the U.S., which, in turn, sells the goods to an unrelated U.S. purchaser, U.S. Customs has typically ruled that Transaction Value does not apply. [13]

Multi-Tiered Transactions and the Nissho Iwai Line of Cases. The application of Transaction Value in related party transactions has consistently been scrutinized, and historically rejected, by U.S. Customs. This trend changed, however, with the final pronouncement in the *Nissho Iwai* decision.[14] When all was said and done, the U.S. Court of Appeals for the Federal Circuit examined whether the proper value to be applied was the contract price between the unrelated U.S. purchaser and the U.S. subsidiary, or the price paid by the U.S. subsidiary's foreign parent (the "middleman") to the foreign manufacturer of the goods, and held the latter was the proper transaction value given the presence of certain enumerated conditions.

In the subsequent case, *Synergy Sport International, Ltd. v. United States*, 17 CIT 18 (1993), the U.S. Court of International Trade, addressed the methodology for determining the transaction value of merchandise imported pursuant to a three-tiered transaction and held that the price paid by the middleman *could* serve as the basis for transaction value for the shipments in question. However, in keeping with the statute it was stated that for the transaction to be viable, the sale must be negotiated at arm's length, free from non-market influences, and involve goods clearly destined for the U.S. (*See* Part V for further discussion on matter tiered transactions).

Since then, many importers have sought a similar decision through rulings by U.S. Customs. While this is a viable approach, importers must take care to ensure that their transaction is properly structured prior to the initial importation, in order to obtain the benefit of the reporting lower, pre-markup value.

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Statutory Additions and Deductions. After an importer determines that Transaction Value properly applies and the "actual price paid or payable" for the goods is determined, the "reportable" transaction value must be calculated and declared to U.S. Customs. This requires consideration of certain "additions" to and "deductions" from the price paid or payable, in keeping with the U.S. Customs rules. Amounts which must be *added* to the declared value include the following: packing costs, selling (but not buying) commissions incurred by the buyer for the imported goods, the value of any "assists" associated with the goods, certain royalties and license fees, and the proceeds of any subsequent resale, disposal, or use of the imported goods that accrue to the seller.[15]

The following amounts shall be *deducted* from the declared value, provided they are identified separately from the price paid or payable and from any other cost reported as an "addition" to value. Permissible deductions include: any reasonable cost or charge for the construction, erection, assembly, or maintenance of, or technical assistance provided with respect to the goods after their importation into the U.S.; transportation costs incurred after importation, [16] and amounts for customs duties and certain Federal taxes.[17]

Because the determination as to which amounts qualify as statutory "additions" and "deductions" under the U.S. Customs laws and regulations can be quite complex, the discussion here on this subject is very limited and general. Readers are recommended to consult with a Customs expert to ensure that their particular facts do not conflict with existing Customs decisions.

The U.S. Transfer Pricing "Disconnect" may be Re-connected

U.S. companies have similarly faced a "disconnect" between the "transfer price" of a good reportable for U.S. income tax purposes and the value declared for the same good for customs purposes, but seemingly to a lesser extent that that experienced in Canada. U.S. Internal Revenue Code rules (e.g., section 1059A) provide that, when a U.S. taxpayer acquires imported goods from a related party, the taxpayer's basis in the goods may not be less than the dutiable value declared to U.S. Customs. As such, the rules should be the same, subject to certain limitations, as both are to demonstrate acceptable, arm's length transfer prices.

Nevertheless, U.S. Customs' approach to related-party transfer pricing has traditionally differed from that of the Internal Revenue Service. This lack of perfect consistency may be faced, for example, by the U.S. affiliate of a Canadian company.

Accordingly, companies exporting from Canada to the U.S. must recognize the fact that while international transfer pricing rules require related parties to relied upon supportable transfer pricing procedures for taxation purposes, the "valuation" amount that applies for U.S. Customs purposes may differ.

Two recent U.S. Customs Headquarters rulings, however, have taken steps to re-connect the disparity for U.S. Customs purposes. Most recently, in HQ 547382 (Feb. 14, 2002), U.S. Customs relied upon an independent economic analysis applying the U.S. Internal Revenue Service's ("IRS") Comparable Profits Methodology to demonstrate that a transfer price between related entities is settled in an acceptable, arm's-length manner and, importantly, may be used as the basis for transaction value.

In that ruling, U.S. Customs stated:

> As we explained in a recent ruling, HRL 546979 dated August 30, 2000, Customs' approach to related party transactions differs from that of the IRS. Specifically, the method {described} reviews profitability on an aggregate basis, where as Customs' examines profitability on a product by product basis. Nonetheless, Customs' accepts that the IRS methodologies may be used as evidence to substantiate the circumstances of sale test in some instances where the method is actually used by the parties, and where any adjustments required by the method are accurately reported to Customs.

In the earlier ruling, HQ 546979 (Aug. 30, 2000), U.S. Customs stated that while the goal of both the Customs legislation and section 482 of the U.S. Tax Code is to ensure that the transactions between related parties are at arm's length, the method of making that determination is different under each law.

There, Customs concluded that the transfer pricing agreement applicable to the importer is a bilateral agreement, in which both countries have reviewed the submission and negotiated a fair result for both taxing authorities.

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U.S. Customs review of the information, including attending the Advance Pricing Agreement prefiling conference and review of information submitted to the U.S. tax authority, allowed Customs to conclude that the relevant aspects of the transaction had been examined, including the way in which the importer and its related suppliers organize their commercial relations, as well as the way in which the price in question was arrived at between the parties. Thus, Customs held that the importer demonstrated that the price has not been influenced by the relationship and that transaction value was the proper basis of appraisement.

Today, the potential "re-connection" of the transfer pricing value appears to be possible for U.S. Customs purposes. However, companies exporting to the U.S. should be aware that this possibility is not yet widespread and there are substantial hurdles to overcome before they may be accepted for a company importing into the U.S.

Continuing Significance of Valuation in the U.S.

Despite the fact that a substantial portion of U.S.-Canadian trade is duty-free under the NAFTA, proper valuation remains a significant focus of U.S. Customs. Many importers improperly believe that because an importation has no revenue implication, U.S. Customs will not be "bothered" evaluating the shipment. Actually, the opposite appears to be true. U.S. Customs closely reviews NAFTA transactions -- as recently reaffirmed with the MOU to exchange information on NAFTA origin audits -- in order to determine whether the goods, in fact, qualified for the claimed duty-free treatment. Accordingly, it is fully expected that the assessment of declared value along with NAFTA Origin Verification Audits, remain a clear priority of U.S. Customs.

Even beyond an examination of NAFTA transactions, U.S. Customs has an interest in continuing to examine the value declared in its imports and ensuring their accuracy. After all, once a revenue agency, always a revenue agency.

Why would U.S. Customs continue to examine value? There are several reasons. First, the U.S., like Canada, has a considerable part of its in-bound trade that remains subject to duty and it seeks accurate accounting to ensure the complete collection of revenue.

Additionally, other fees are paid to U.S. Customs at the time of importation, such as Merchandise Processing Fees and Harbor Maintenance Taxes, which are assessed based upon the declared value.

Finally, as with most industrialized countries, the U.S. seeks to have a proper accounting of its inbound and outbound trade[18] in order to confirm that the value and volume of trade are accurately reflected in its trade statistics.

Accordingly, an integral part of most audits or examinations performed by U.S. Customs is a review of the declared value. This is true for large-scale audits of preferential trade programs, such as under the NAFTA, as well as for even informal border examinations of entry shipments performed by U.S. Customs Import Specialists. Importantly, with the decline in duty rates, the introduction in 1994, of U.S. Customs' penalty provisions under the Mod Act, when the possibility of collecting additional monies (up to the value of the imported goods in the case of fraud) became widely recognized, Customs has continued to audit valuation. There is no incentive or likelihood that this will change in the coming years.

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PART IV –

THE LATEST CANADIAN CUSTOMS ISSUES

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

The Administrative Monetary Penalty System

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

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

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

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

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

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

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

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.

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

Penalty Amount:

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

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

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

Types of Penalties. It is noteworthy that AMPS will apply to a wide variation of "customs infractions". Just what will be penalized, however, still appears to be under some dynamic revision. For example, even in the last few months Customs has been busy defining and redefining what infractions will result in what penalties. Prior to September, it has been published that mere "errors" on B3 forms would result in flat rate $100 penalties for each infraction. Thus a simple error in one of the origin fields in the B3, or in the overall value of the good, or the statistical suffix required for tariff classification, was to lead to a $100 charge on the B3. More problematically, it appeared where so-called "systemic errors" existed (e.g., in the valuation methodology), resulting in the same sort of error being made in multiple importations, the $100 penalty would apply again and again, to each of the multiple importations. With the newest Master Penalty Document, however, this flat rate penalty appears to have been eliminated – although one wonders if it has somehow been buried or addressed elsewhere.

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

Also of significance are the Minister's collection powers, which include the ability to detain goods or a conveyance in respect of which an AMP penalty was assessed, until the penalty is paid. Thus Customs has given itself a fairly big stick in which to enforce its AMPS powers.[6]

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

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

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

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

Appealing an AMP Penalty. Once an AMP is assessed, a person has four options (which are not mutually exclusive): (1) pay the assessment;[7] (2) request corrective measures; (3) appeal the assessment; or (4) enter into a Penalty Reduction Agreement.[8]

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

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

In terms of the "formal" appeals process, a person has 90 days from the service of the notice of assessment to request reconsideration of the decision by the Minister, under section 131 of the *Customs Act*.[9] The Minister's decision is final and cannot be altered or changed except by appeal to the Federal Court, Trial Division, under section 135.

AMPS Defences. It is noteworthy that AMPS penalties are automatically imposed, despite "reasonable care" efforts to comply, unlike the situation in the U.S. under the Mod Act. The Mod Act imposes a duty of "reasonable care"[10] on the trading community, however, to the extent that a trader can demonstrate that they did exercise "reasonable care", they will not be subject to a penalty. Under the AMPS regime, even where a person has exercised reasonable care to comply with customs laws, they may still be subject to a penalty. The CCRA has indicated, however, that a "due diligence" defence will be considered albeit, only at the 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.[11]

The PRA also appears to be a viable alternative to appealing an AMPS penalty, in that it give a person assessed the ability to enter into a formal agreement with Customs to fix their systems to become compliant. The purpose of a PRA "is to facilitate the client's ability to comply through partnering them with Customs to correct a CIS problem that has resulted in a contravention, so that there will not be a repeat of the error."[12]

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

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

AMPs Penalties for Violations of "Informed Compliance" Provisions. AMPS ought to be distinguished from another of Customs' programs, which can be loosely referred to as "informed compliance". Under that program, and as set out in subsection 32.2(1) and 32.2(2) of the *Customs Act*, importers are required to monitor and control their importations of goods, and make mandatory corrections to their import documentation where errors in tariff classification, valuation and origin are found – and generally patterned on the similar approach in the U.S..

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

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

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

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Significantly, with the introduction of AMPs, the penalties associated with non-compliance with the "informed compliance" provisions in section 32.2 have been repealed, and replaced by a special category of AMPS penalties. Where there is a failure to make the required corrections to a declaration of origin, a tariff classification or a declaration of value for duty within 90 days after having a reason to believe the declaration was incorrect, a penalty will be imposed, per instance (that there is a failure to correct within 90 days) as follows: $100 for the first instance; $200 for the second instance; and $400 for the third and subsequent instances (*per* s. 32.2(2)(a) of the *Customs Act*). In addition, an AMP penalty will also apply where there is a failure to pay duties as a result of a failure to make the required corrections (to a declaration of origin, a tariff classification or a declaration of value for duty) within 90 days of having a reason to believe that the declarations were incorrect (*per* s. 32.2(2)(b) of the *Customs Act*). The AMPS penalties for failure to pay duties as a result of required corrections will be based on the value for duty as follows: 1st penalty - $100 or 5% of VFD; 2nd penalty - $200 or 10% of VFD; 3rd and subsequent - $400 or 20% of VFD.

The Last Word on the Royalties Inclusion

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

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

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

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

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

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

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

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

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

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

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

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

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

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

What are the Purchaser in Canada Rules ?

In another area of Customs valuation, the Purchaser in Canada rules are really regulations (the "Purchaser in Canada Regulations") that Canada put in place in light of 1997, to complement changes to sections 45 and 48 of the Customs Act. The new rules are effective on September 17, 1997, and add the following phrase to the "sold for export" language in the Transaction Value section of Canada's Valuation Code:

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

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

At the same time, section 45 of the *Customs Act* -- which provides the definitions for the various terms used in the Valuation Code -- was also amended to allow the phrase "purchaser in Canada" <u>to be defined by regulations</u>.[16]

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

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

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

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.

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The following will be of interest:

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

(b) whether purchase orders are solicited in Canada;

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

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

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

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

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

Management and Control in Canada

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

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

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

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

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

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

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

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

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

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

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PART V – THE LATEST FROM U.S. CUSTOMS

New Security Initiatives of U.S. Customs

Since the events of September 11, 2001, U.S. has sought ways in which to enhance the security of people and goods that are coming into the United States. There have been several significant changes that directly affect companies that seek to do business and import goods in the United States. Foremost among the change is the recent reorganization of the agency itself, from the U.S. Customs Service (operating under the U.S. Department of Treasury), to the newly formed U.S. Bureau of Customs and Border Protection (which is housed within the U.S. Department of Homeland Security), effective March 1, 2003. This new agency sought to "unify" the border agencies, combining employees from the Department of Agriculture, the Immigration and Naturalization Service, the Border Patrol, and the U.S. Customs Service. The stated Mission and Responsibility of the newly organized agency (referred as "CBP") is, as follows:

> The priority mission of CBP is to prevent terrorists and terrorist weapons from entering the United States. This important mission calls for improved security at America's borders and ports of entry as well as for extending our zone of security beyond our physical borders - so that American borders are the last line of defense, not the first.
>
> CBP also is responsible for apprehending individuals attempting to enter the United States illegally, stemming the flow of illegal drugs and other contraband; protecting our agricultural and economic interests from harmful pests and diseases; protecting American businesses from theft of their intellectual property; and regulating and facilitating international trade, collecting import duties, and enforcing U.S. trade laws.

From this, it is plain to see that, with security as a top priority, trade facilitation takes a lesser focus. In an effort to appease the trade community, Customs has therefore, specifically designed certain programs with the intent to assist the importing business community in its trade activities, while still supporting its goal of security.

Strategy of Customs and Border Protection. CBP's strategy to improve security and facilitate the flow of legitimate trade and travel includes:

- Improving targeting systems and expanding advance information regarding people and goods arriving in the U.S.;
- Pushing our "zone of security outward" by partnering with other governments as well as with the private sector;
- Deploying advanced inspection technology and equipment;
- Increasing staffing for border security; and
- Working in concert with other agencies to coordinate activities with respect to trade fraud, intellectual property rights violations, controlled deliveries of illegal drugs, and money laundering.

With these strategies in mind, several programs were developed. Two such programs that may be of interest to companies importing from Canada are described briefly below. (A day-long program could be dedicated to this subject, so it will only be described here in general detail.)

Free And Secure Trade (FAST) Program

The *FAST* program is a bilateral initiative between the U.S. and Canada. The program is designed to harmonize, as much as possible, the processes for clearance of commercial shipments at our shared border. The intent is for importers and carriers in U.S. Customs' Customs - Trade Partnership Against Terrorism (C-TPAT) program or Canada's Partners in Protection (PIP) program, to undergo the clearance process more efficiently by reducing Customs information requirements, providing greater resources for FAST participants, applying shared technology and minimizing physical inspections.

The program was implemented for U.S.-bound shipments at certain ports in December 2002. It is designed as a paperless cargo release system. The next release system under the program is a Pre-Arrival Processing System (PAPS), which will use barcode technology for clearance and is anticipated to be implemented later this year.

> **Note:** PAPS is for U.S. inbound shipments only and is not interchangeable with Canada's PARS system, which covers commercial shipments into Canada.

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In order to obtain the benefits designed within the FAST program, a company must be a member of either the C-TPAT (described below) or PIP programs.

Customs - Trade Partnership Against Terrorism (C-TPAT)

Through the C-TPAT program, U.S. Customs requires businesses to ensure the integrity of their security practices and to communicate their security guidelines to their business partners within the supply chain. In order to participate in C-TPAT, companies must sign an agreement that committing to:

- Conduct a comprehensive self-assessment of supply chain security using the C-TPAT security guidelines covering: Procedural Security, Physical Security, Personnel Security, Education and Training, Access Controls, Manifest Procedures, and Conveyance Security.
- Submit a supply chain security profile questionnaire response to Customs.
- Develop and implement a program to enhance security throughout its supply chain in keeping with C-TPAT guidelines.
- Communicate C-TPAT guidelines to other companies in the supply chain and work toward building the guidelines into relationships with these companies.

C-TPAT is currently open to all U.S. importers and carriers (air, rail, sea). As a participant in this supply chain security program, Customs has touted that the following potential benefits are available to C-TPAT members:

- A reduced number of inspections (reduced border times);
- An assigned account manager (if one is not already assigned);
- Access to the C-TPAT membership list;
- Eligibility for account-based processes (e.g., bimonthly/monthly payments); and
- An emphasis on self-policing, not Customs verifications.

In order to participate, applicants need to submit a signed agreement to Customs, stating their commitment to the C-TPAT security guidelines, and provide a supply chain security profile questionnaire when the signed agreements are submitted or within a specified time, and, finally, has its security procedures "validated."

What does it mean to be a C-TPAT "Partner" ? Once Customs fully evaluated the importer's C-TPAT application and questionnaire response it will then be considered a C-TPAT "partner". In effect, that is simply the status of a participant that has provided sufficient preliminary information, but whose security procedures have not yet been "validated."

The Customs-appointed Account Managers oversee the company's action plans, which are to reflect the C-TPAT commitments made. Through the Action Plans, Customs tracks participants' progress in: making security improvements, communicating C-TPAT guidelines to their business partners, and establishing improved security relationships with other companies. If the C-TPAT commitments are not upheld, the participant's C-TPAT "benefits" will be suspended, and only reinstated once identified deficiencies in compliance and/or security are corrected.

In joining C-TPAT, companies commit to following certain agreed upon actions which include: self-assessing security systems, submitting security questionnaires, developing security enhancement plans, and communicating C-TPAT guidelines to companies in the supply chain. As such, companies should not seek participation unless they are fully committed to this program, and for an extended period of time.

As mentioned above, each C-TPAT Partner must also successfully complete the "Validation" process. That is when Customs meets with the company representatives, and may perform an on-site review of the company's facilities, potentially both domestic and foreign, to verify that the procedures are in place and are followed.

> **Note**: Customs has stated that these "Validations" are not "audits", as they do not measure a company's adherence to existing government rules and regulations. Nevertheless, companies undergoing the process should be prepared to treat it as if it were. A negative determination can have a detrimental affect on a company's trade operations, especially if it had come to rely on the fact of fewer inspections and faster clearance of their imports.

How Might This Affect Canadian Companies? Even if a Canadian company has no interest in becoming a C-TPAT partner, it may find itself in the process nonetheless. For example, it may be within the supply chain of a C-TPAT member, a customer or perhaps a carrier, and suddenly have

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additional obligations and procedures "requested" of it in order to continue to do business. While new procedures may assist in enhancing security, the reality is that they may also further burden an established practice or add increased costs to the process.

Furthermore, no one should be lulled into believing that with all of the new security initiatives, like C-TPAT and FAST, Customs audits will become extinct. This is simply not true. Audits will continue to be used to assess trade compliance (as the Canadian - U.S. MOU on sharing NAFTA audit data demonstrates).

As mentioned previously, U.S. Customs has recently implemented "Focused Assessment" methodology to conduct its audits. While companies are not *required* to undergo a Focused Assessment in order to participate in C-TPAT, companies are wise to consider whether they are fully prepared to meet Customs' enhanced compliance procedure requirements, such as those reviewed in an assessment. However, to participate in Customs' Importer Self-Assessment (ISA) program, importers must be C-TPAT participants. What follows is a brief overview of these programs and some differences between them.

Focused Assessments versus Importer Self-Assessments. As noted in Part III above, Customs' Focused Assessments ("FA") have replace the "CAT" audits of the late 1990s, with perhaps a greater emphasis on a company's compliance *procedures* than on the transactional entry review (which is conducted to a lesser extent under an FA). An FA is a compliance audit of a company's overall customs operations. Companies must complete an Internal Control Questionnaire relating to its customs transactions in: its Control Environment (e.g., identifying the policies, procedures and assignment of responsibility for the compliance function); Risk Assessment (how the company identifies and manages its customs compliance risk); Control Procedures (procedures associated with reporting accurate valuation, classification, quantity, preferential trade program data), Information and Communication (staying current and disseminating relevant Customs information), and Monitoring (procedures for monitoring and oversight of the customs compliance function).

Armed with this information, Customs then determines which areas to further investigate and sample. As with most audit methods, Customs continues to meet with company personnel, interview key personnel, sample particular areas, and evaluate the results.

Under an FA, the company responds to the inquiries posed by Customs and hopes to successfully complete the audit within a reasonable time frame. (An objection of the former CAT audits was the extended length of time under which the audit was performed. As both a blessing and a curse, Customs seeks to hold companies to very strict time frames in an FA.) Importer Self Assessments, on the other hand, seeks to have the company perform more of the analysis, under the direction of Customs, but without as much oversight.

While this has appeal, in theory, there are substantial burdens placed upon a company that seeks to participate in this voluntary program. First, the company must be a validated member of C-TPAT with at least two years of importing experience. Next, the company must sign a MOU, complete a questionnaire (similar to that in the FA program), agree to maintain a system that demonstrates a particular level of accuracy in its customs transactions, agree to make appropriate disclosures to Customs, and provide an annual written notification reaffirming these commitments.

Some of the benefits touted include: Customs agrees to provide consultation and training and, importantly, a removal from an "audit pool" of any established comprehensive audit, such as FAs, and entry summary trade data with analysis support, and generally, less Customs intrusion. Also, participation is to be favorably considered in the event that civil penalties or liquidated damages are assessed against the importer. The a significant disadvantage, however, are that it requires an affirmative, ongoing commitment that lasts long past the likely conclusion of a FA. Not every company is in a position to make such a commitment of time or resources.

The reality is that participation in this new "voluntary" ISA program has been low. Most companies are trying to get their "house in order" in the event that they get added to the latest "audit pool list", at which time, they reassess where they are in terms of their formalized compliance procedures, the existing time and resources to dedicate to the effort, and the firm commitment of upper management to confirm and maintain the necessary support.

In our experience, and in most instances, it isn't until the Notice of a Focused Assessment is received by a company does it begin to give it its true consideration. Nevertheless, as audits are here to stay, companies would be wise to consider whether their customs' compliance procedures are sufficient to withstand the scrutiny, and to think about it *sooner* rather than later.

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ENDNOTES TO PART I:

1. 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.

2. Canada Customs' Memorandum D11-4-2 puts it this way: "To benefit from the preferential tariff treatment provided for under a given free trade agreement, the importer must provide to Revenue Canada, as proof of origin for the goods in question, <u>either a copy of the Certificate of Origin for the given agreement completed and signed by the exporter</u>, or <u>a declaration of origin indicating that the Certificate of Origin is in the importer's possession and will be presented upon request</u>.

   U.S. Customs' Directive states: "Import Specialists shall deny claims, and consider the assessment of penalties, if it is determined that an importer did not possess a valid Certificate of Origin at the time the claim for preferential NAFTA treatment was made." U.S. Customs Directive No. 099 3810-014 (June 28, 1999).

3. U.S. imports for which NAFTA treatment is not sought, are governed by a "substantial transformation" origin test rather than NAFTA's "tariff shift" analysis, which may, in certain limited instances, result in a different origin.

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

5. Please note that a variety of NAFTA Verification Questionnaires formats can be used, depending on the precise rules of origin applicable to the imported goods – and as specified in the relevant Certificate. Sample NAFTA Verification Questionnaires provided in your materials include both a Canada Customs and U.S. Customs document, issued for imported goods that meet the NAFTA rules of origin because of a tariff change only.

6. In copies of NAFTA Certificates reviewed, exporters have put "Taiwan" and "Europe" in the "Origin" column of the Certificate, likely mistaking the "Country of Export" (e.g., the U.S.) as the basis on which the NAFTA could be issued. To be clear, the "Origin" of goods subject to a NAFTA Certificate of Origin ought to be either Canada (CA), the U.S. (US), Mexico (MX) or, in certain limited instances "JNT" for joint production. In another situation, where the NAFTA Certificate of Origin sought whether the Net Cost method was used for purposes of a RVC (Regional Value Content) requirement, the exporter had actually inserted a numerical figure. What was required was a "NC" if RVC was calculated based on the net cost method; otherwise "NO."

7. In the U.S., the regulations also expressly provide for the application of U.S. criminal, civil and administrative penalties for violations of the laws and regulations relating to the NAFTA (Subpart H, Penalties, 19 C.F.R. §§ 181.81-82), although penalties can often be minimized or even avoided when promptly disclosed.

ENDNOTES TO PART II:

1. For readers less familiar with Canada's customs rules, secondary sources may be helpful, and this this regard, please consider *Customs Valuation: A Comparative Look at Current Canadian, U.S. & E.U. Issues*, Robert G. Kreklewetz, A Paper presented at the 1996 CICA Annual Symposium in Ottawa, Ontario (Sept. 29 - Oct. 2, 1996). That paper contains sections dealing in detail with Canada's customs rules, as well as providing a fairly recent review of the major issues facing Canadian importers, from a valuations perspective. If you would like a copy sent to you, please contact the presenter.

2. And as most importers and exporters will have already learned, while goods imported to Canada that are of "U.S. origin" are generally expected to be entitled to duty-free status under NAFTA, there is a complex process necessary to determine whether in fact the goods "qualify", as well as complex rules aimed at ensuring proper compliance. (See *infra*).

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

4. Determining the "VFD" is technically required even where goods are not subject to a positive rate of duty. Among the substantive reasons are the fact that the federal GST is payable on imported goods, based on their VFD for customs purposes. Additionally, the CCRA has taken the view that a proper VFD for imported goods is required to maintain the integrity of industry Canada's trade statistics.

5. For example, assume that the rate of duty on golf clubs made and imported from the U.S. is 2.4%. A $100 golf club can be expected to bear customs duties of $2.40. Only rarely are duties imposed on a "goods-specific" basis, which would impose flat-dollar duty figures on the quantity or weight of the imported goods.

6. Restrictions that are (i) are imposed by law, (ii) limit the geographical area in which the goods may be resold, or (iii) do not substantially affect the value of the goods are allowable under Transaction Value: see section 48(1)(a) of the *Customs Act*.

7. Section 2(3) of the Ontario *Sale of Goods Act* provides that a sale occurs here, under a contract for sale, "the property in the goods is transferred from the seller to the buyer". Similarly, in *Anthes Equipment Ltd. v. MNR*, the Tax Court of Canada cited *Black's Law Dictionary* for the following definition of sale: "A contract between two parties, called, respectively, the 'seller' (or vendor) and the 'buyer' (or purchaser), by which the former, in consideration of the payment or promise of payment of a certain price in money, transfers to the latter the title and the possession of property. Transfer of property for consideration either in money or its equivalent." See also the recent CITT decision in *Brunswick International (Canada) Limited*, [2000] ETC 4507.

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

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

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10. See, for example, the presentation on the "*Recent Customs Valuation Cases: A Spirited Discussion With the CCRA*", made by Robert G. Kreklewetz and David DuBrule (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.
11. The "price paid or payable" for the goods will generally start with the "transfer price" determined under the importer's requisite transfer pricing analysis.
12. See again: *Customs Valuation: a Comparative Look at Current Canadian, U.S. & E.U. Issues*, Robert G. Kreklewetz, A Paper presented at the 1996 CICA Annual Symposium in Ottawa, Ontario (Sep 29 - Oct 2, 1996).
13. While initially meant as a "sword" for use by the IRS in combating possible tax avoidance strategies amongst related parties (e.g., importing at a low price, but selling for income tax purposes at a much higher price), the rules may also be available to taxpayers as a "shield", preventing U.S. Customs and the IRS from arriving at similarly asymmetrical results.

ENDNOTES TO PART III:

1. For example, the origin rules under the NAFTA differ substantially from those that apply to non-preferential proper imports.
2. Initially, these audits were under the U.S. Customs Compliance Assessment Testing ("CAT") program. The CAT audits have recently been replaced with "Focused Assessments." The all-encompassing audits have not, however, resulted in the elimination of other specialized audits focused on origin, value or classification. We have also represented companies as they faced concurrent audits by both U.S. and Canada Customs.
3. The U.S. regulatory authority classifying imported goods under the HTS is found in section 152.11 of Subpart B, *Classification*, of the U.S. Code of Federal Regulations. Typically, importers report data on a Customs Form 7501 ("CF 7501"), which provides a description of the goods, the corresponding tariff classification, declared value and duty rate.
4. We have seen instances where U.S. Customs will not accept (and does not agree with) a subheading that is acceptable to another country's Customs Administration; so, in practice there are instances where the system is not perfectly "harmonized."
5. While most countries are "harmonized" to the 6th digit on classification, each country has independent authority to assess the duty rate which applies.
6. In the U.S., the statute of limitations (that is, the length of time for which legal actions may be pursued) is five years from the date of the statement of action.
7. A declared value is required to be reported even in instances where the imports are subject to a "0%" duty rate. As in Canada, there are other fees and taxes that apply to U.S. imports which are a factor of the declared value. Additionally, U.S. statistics require accurate data reporting of both dutiable and duty- free imports.
8. There are a significant number of U.S. Customs rulings interpreting the phrase "price paid or payable." Care should be taken to ensure that an importer's particular facts would be within U.S. Customs' interpretation (or have been previously included in a prior ruling of comparable facts).
9. *See* 19 C.F.R. §152.101(c). Again, "sale for export" has been carefully reviewed by U.S. Customs and the courts. *See, e.g.*, HQ 547607 (Feb. 14, 2002); ("*Nissho Iwai").*
10. For example, when imports are made by an agent who then sells the goods in the U.S., the imported goods will not be allowed under transaction value as no "bona fide" sale will have been deemed to have occurred. *See, e.g.*, HQ 547917 (Nov. 2, 2001); 19 C.F.R. §152.102(f) "Sale" means a transfer of ownership from one to another for consideration. *J.L. Wood v. United States*, 505 F.2d 1400, 1406 (1974).
11. These limitations on the use of Transaction Value are provided for in 19 C.F.R. §152.103(j) of the Customs regulations. On the other hand, restrictions that are imposed by law, limit the geographical area in which the goods may be resold, or those which do not substantially affect the value of the goods are permissible under Transaction Value. *See* 19 C.F.R. §152.103(j) and (k).
12. Acceptable "test values" are shown when an examination of the "circumstances of the sale" demonstrates that the relationship did not influence the price or when the transaction value closely approximates that of identical or similar goods in sales to unrelated buyers in the U.S. *See* 19 U.S.C. §1401a(b)(2)(B).
13. *See, e.g.*, HQ 544775 (Apr. 3, 1992).
14. *Nissho Iwai American Corp. v. United States*, 786 F. Supp. 1002 (Ct. Int'l Trade 1992), *rev'd in part*, 982 F.2d 505 (Fed. Cir. 1992). *See also Synergy Sport International, Ltd. v. United States*, 17 CIT 18 (1993).
15. 19 C.F.R. §152.103(b).
16. Transportation and insurance costs that are incurred prior to the arrival at the U.S. port. These costs may be excluded from the entered value of the goods provided they are separately identified on the entry papers, such as the CF 7501, and are based on *actual*, not estimated rates. U.S. Customs has aggressively reviewed claimed exclusions for freight and insurance during its assessments.
17. 19 C.F.R. §152.103(i).
18. This is the reason behind the U.S. HTS provisions being reported to the tenth digit; a level of delineation far beyond that of most countries.

ENDNOTES TO PART IV:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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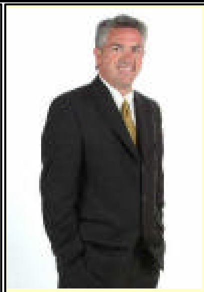

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Extensive Trade, Customs and Export Control Experience. For over sixteen years, Lindsay has provided **International Trade and Customs** advice at Venable where she heads its International Practice, located in Washington, D.C., concentrating on **Customs & International Trade** matters, including representation during U.S. Customs Focused Assessments, NAFTA Audits, C-TPAT, ISA Programs, Detentions, Forfeitures, Seizures, other Customs-related matters. She regularly provides strategic customs and trade counseling to Fortune 100 clients, by conducting Pre-Assessment Compliance Reviews including corporate-wide, multi-location assessments and training programs, and by representing companies before the U.S. Bureau of Customs and Border Protection, the Court of International Trade, and U.S. Court of Appeals for the Federal Circuit. Lindsay has extensive experience counseling companies on compliance with export controls regulated by the Departments of Commerce, State and Treasury and performing Export Control Assessments. Lindsay has also successfully represented companies in antidumping duty investigations and reviews before the U.S. Department of Commerce and International Trade Commission and on appeal. Lindsay also advises clients on **International Transactional** matters, where she counsels on strategic sourcing, sales and distribution arrangements in the U.S. and abroad; the use of foreign agents, affiliated offices, and joint ventures.

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