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The Top 10 Issues Affecting The Toy Industry's

IMPORTS INTO THE U.S. AND CANADA

Presented to the Toy Industry Association

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QUESTIONS ?

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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 nearly seventeen years, Lindsay has provided **International Trade and Customs** advice at Venable where she heads Venable's 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, complex litigation, intellectual property and government affairs. Venable serves corporate, institutional, governmental, nonprofit and individual clients throughout 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 toy, 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.

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

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

Extensive Trade and Commodity Tax Experience. Rob's practice focuses on **Customs & Trade** matters, including Periodic Verification Audits concerning Valuation, Tariff Class Origin, or Marking issues, and including 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 MWK's practice include **Tax and Trade Litigation**, and Rob has acted as lead counsel in many cases before all courts, including the Canadian International Trade Tribunal, Tax Court of Canada, Federal Court of Appeal, Ontario Court of Justice, and the Ontario Court of Appeal.

Client Base. Millar Kreklewetz LLP has some of the best tax and trade files in Canada, and Rob advises a significant number of blue chip corporate clients, who are national and international leaders in manufacturing, wholesaling, retailing, financial services, information technology, medical testing and health services, chemicals and petrochemicals, oil and gas, and direct selling.

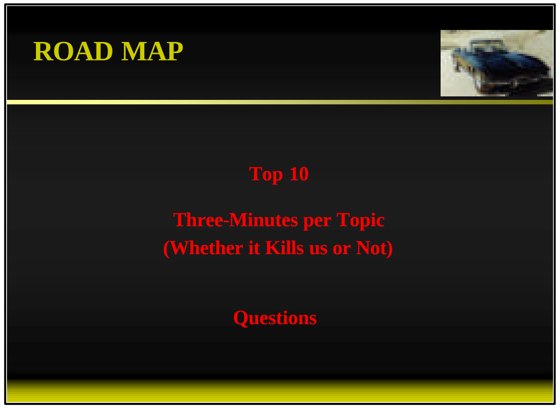
Speaking Engagements / Publications / Memberships. Rob continues to write and speak extensively in all of the above areas, regularly addressing the Canadian Associations of Importers & Exporters (CAIE), at its annual and semi-annual conferences, and various seminars, and regularly addressing other bodies like the Tax Executive Institute (TEI), Canadian Tax Foundation, Canadian Bar Association (CBA), Canadian Institute of Chartered Accountants (CICA), and Certified General Accountants (CGA), as well as speaking for many other professional conference developers.

MILLAR KREKLEWETZ LLP

Is the continuation of the customs, trade and commodity tax practices of W. Jack Millar and Robert G. Kreklewetz.

For the last three years in a row, their practices have contributed to the ranking of their former law firm as the top Canadian law firm in Commodity Taxes – "Indirect & State and Local Taxes"

(International Law Review, April 2004)



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THE ROAD MAP

General Focus of the Presentation

The toy industry is largely defined by goods sourced and imported from overseas, and predominantly from Asia.

In an age of diminished duty rates, and increased trade policy disputes, the current market presents challenges that are, in many ways, unique to this industry.

Although there are many similarities when importing into the U.S. and into Canada, there are some very subtle, but important differences of which you should be aware.

The Presentation today will provide a "Top 10" approach to current issues facing American companies as they seek to import their toys, dolls, and such goods into our North American markets.

The issues we raise are not meant to be comprehensive list of all the things you ought to know about import trade, but will be a summary of the points that we see, in our experience, as some of the more important issues facing U.S. toy businesses as they engage in import trade.

The Top 10 progresses from the general (e.g., Number 10, below), to the more specific (e.g., Number 1, below), and deal with various points to be considered by a company importing toys and like products into the U.S. and Canadian markets.

Navigating Through the Materials

While many readers will be familiar with trade with the process of importing into the U.S. (and some of you may even be familiar with the same processes in Canada and Mexico)., others will be less familiar.

Accordingly, these Materials are broken into several parts, including a very basic introduction to both the U.S. and Canadian trade systems, which will hopefully benefit most those readers who are less familiar with these matters, and a Part dealing with the more sophisticated issues and problems that we will be dealing with in our oral Presentation.

Specifically, the Materials are broken into the following parts:

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

Parts II 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 in these two North American countries.

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

And just to super-size our materials, we have added **Part V,** entitled *"What's New at CBP"*, and which reviews all the latest happenings at the U.S. Bureau of Customs and Border Protection.

“ 10 ”

Free Trade Agreements –

They’re everywhere, but will they help ?

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PART I

The TOP 10 Things Affecting the Toy Industry’s Imports – A U.S. and Canadian Perspective

No. 10 –

Free Trade Agreements – They’re everywhere, but will they help?

In today’s world, companies importing products in the toy industry face low or even duty-free customs rates for many of their products. That has allowed current sourcing trends to focus (often exclusively) in certain Asian countries, especially China.

This sourcing strategy, while providing opportunities for immediate short-term duty-free imports, also presents a longer-term risk in today’s environment, particularly given the proclivity of “trade policy disputes” between the U.S. and its trading partners, which can result in significant punitive duties charged against what would otherwise have been duty-free imports.

At this time, however, the U.S. is vigorously pursuing multilateral trade agreements with other countries at a pace not seen in quite some time.

Accordingly, it is often worth stepping back to consider whether other countries may begin to serve as alternative sources for the desired goods. An alternative source may alleviate any strain if a a company finds themselves in the midst of a trade war with their current source of supply.

Our presentation will review the current status of the various bilateral and multilateral treaties currently under review and recently enacted by the United States. These will include a review of the Free Trade Area of the Americas (“FTAA”), Andean Countries (Bolivia, Colombia, Ecuador and Peru), Australia, Bahrain, Central American Free Trade Agreement (“CAFTA”), Dominican Republic, Morocco, Panama, South African Customs Union (“SACU”), and Thailand; and will briefly discuss the tenth anniversary of the implementation of the North American Free Trade Agreement (“NAFTA”).

Canada’s efforts will be touched on in contrast.

No. 9 –

Global Customs Rules *are* harmonized, but only to a degree…

In attempting to understand the differences between what you know from your U.S. customs experience, and how other country’s rules apply to the same concepts, it is important to realize that the customs rules in most industrialized countries are in fact meant to be harmonized, albeit to a certain degrees.

The reason for this harmonization is the joint commitment that many countries (including the U.S. and Canada) have made to both the World Trade Organization (“WTO”), and the World Customs Organization (“WCO”), on matters like tariff simplification and reduction, and customs valuation. Joint commitments under other bilateral or trilateral trade agreements – such as the North American Free Trade Agreement (“NAFTA”) – have also lead to harmonization on things like duty rates, and origin.

Tariff Classification. Harmonization on tariff classification issues is accomplished through joint commitments under the WTO, to adhere to the internationally accepted Harmonized Commodity Description and Coding System (the "Harmonized System").

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

The Harmonized System is said to be harmonized to the six-digit (or Subheading) level, meaning that goods imported to the various countries using the Harmonized System should be all identically coded to the Subheading level.

Thus, for example, a “toy doll” would be expected to be classified under subheading 9502.10 (“Dolls, whether or not dressed”) in both the U.S. and Canada, and in every other WTO nation. The subsequent “statistical” classification (i.e., the 7^{th}, 8^{th}, 9^{th}, and 10^{th} digits in the tariff classification number) may be different, as may be the ultimate rates of duty, but the first six digits in this “subheading” are meant to be harmonized.

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Global customs laws
***are* Harmonized,**
But only to a degree …

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In terms of the methodology that is used to actually determine a tariff classification number for a particular good, 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.

Please contact the authors for further reference materials on tariff classification.

Valuation. Our rules for valuing goods are also generally harmonized through commitments under the WTO to adopt what was formerly referred to as the GATT Valuation Code.[1]

The General Agreement on Tariffs and Trade (the "GATT") was first drafted in 1947, and has long been the cornerstone of trade in the Western world.

The GATT set out a framework of fundamental principles designed to promote free trade among the GATT's member nations, and eliminate restrictive trade practices. One of the GATT's basic objectives was to harmonize Customs Valuation rules across its member nations, since differences in valuations rules had proven to be formidable barriers to trade in and of themselves.

The GATT's current valuations rules (*i.e.*, the GATT Code) were negotiated during the so-called Tokyo round of GATT negotiations conducted from 1973 to 1979.[2] These rules established an international valuations standard based primarily on the *price actually paid for goods* by the parties involved. (This is generally referred to as the “price paid or payable” requirements, or simply, “transaction value”.)

Thus, the chief innovation of the GATT Code was its explicit emphasis on this "positive standard" – the price of the transaction in question – as the basis for valuation.

Today, the GATT Code (and the WTO) has been adopted by virtually all of the industrialized nations, including, of course, the U.S. and Canada. Also included as WTO member countries are the members of the European Union, Japan and Australia. Each of the 125 member nations signing the WTO have bound themselves to enact the domestic legislation required to incorporate the valuations rules in the GATT Code.

Origin & Duty Rates. The current trend in Most Favored Nation (or General) duty rates is for diminishing rates. Also, for goods of interest to domestic industries, the increase in multilateral agreements (such as NAFTA), has resulted in more and more trade becoming been duty free between qualifying countries. However, it is important to bear in mind that, in many instances, there are particular requirements in order to obtain the preferential rates. Such duty benefit is a privilege that is afforded only based on compliance with strict rules of origin and other requirements.

Compliance with, and qualification for, the beneficial duty rates of various preferential duty programs, is a subject that could take a complete course to cover. A full discussion is beyond the scope of these materials.

Please contact the authors for further reference materials on valuation.

No. 8 –

Customs Penalties are the New Revenue Source !

Overview. With ever-shrinking duty rates, customs agencies are implementing more aggressive penalty systems on an increasing basis.

Companies importing into the U.S. are all too familiar with the imposition of penalties that may be assessed since the Mod Act imposed standards of “informed compliance” and “reasonable care.” Now, a similar penalty system exists north of our border. In our presentation, we will compare and contrast the penalty system in the U.S. with that in Canada, to familiarize the companies more fully. Here, we will discuss Canada’s new penalty system. It’s called the ***Administrative Monetary Penalty System*** – or “AMPS” for short.

AMPS came into effect on October 7, 2002,[3] and there is every indication that in Canada, the CBSA will be aggressive in the administration of AMPS. Even on the trial implementation of the system, there were 649 AMPS-related penalties issued in just over the first month of the system. And for the first full year of operations, there were over 15,000, with 58% of those being issued as against importers.[4]

Limited Global

HARMONIZATION OF RULES

Areas of Harmonization:

- **Tariff Classification → To the 6 Digit Level**
- **Valuation → Common Valuation Code**
- **Origin & Duty Rates → Preferential Programs**

Conclusion: Some Rules Should be the Same

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Other statistics suggest that the CBSA is earning an average of $700,000 a month in AMPs, and the average AMP costs an importer about $700.[5] Not enough to put anyone out of business, by just enough to negatively impact the profit margin on sales to Canada.

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

Example No. 1: Xco sells Sony PS2s by Cargo Container to Canada, on a "delivered" basis, for U.S. $250,000. The value for duty, for Canadian purposes, is Cdn, $300,000.

Unbeknownst to the U.S. non-resident importer, the employee charged with exports, fields a telephone inquiry from CBSA and provides incomplete information.

AMPS Implication: There is an AMP payable on the provision of incorrect information (AMP 025), equal to $2,000 or 20% of the value for duty of the shipment, which ever is greater.

Result: An ill-informed employee just cost the company Cdn $60,000.

Example No. 2: Later, same employee, informed of problem with value of the shipment, files the information under "to do", and does nothing. The employee does not know about Canada's mandatory correction rules for, among other things, errors in value (*i.e.*, section 32.2 of *Customs Act*).

AMPS Implications: There is an AMP payable on the failure to correct past and subsequent shipments (AMP 350), equal to the *greater* of $100 or 5% of the value of the shipment.

Result: An untrained employee may be about to cost the company Cdn $15,000 on this shipment, and additional penalties on each and every other shipment involved in the valuation problem.

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.[6]

In that sense, AMPS seeks to secure compliance of Canadian customs legislation through the imposition of monetary penalties.[7]

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

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

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

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

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

<u>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</u>.

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

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

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

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Penalties are the *New* Revenue Source.

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

Graduated Penalties. In most instances, AMPS imposes a graduated type of penalty for specific infractions. That is, the monetary penalties will be imposed in proportion to the type, frequency and severity of the infraction. errors.[8]

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

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

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

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 ?

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

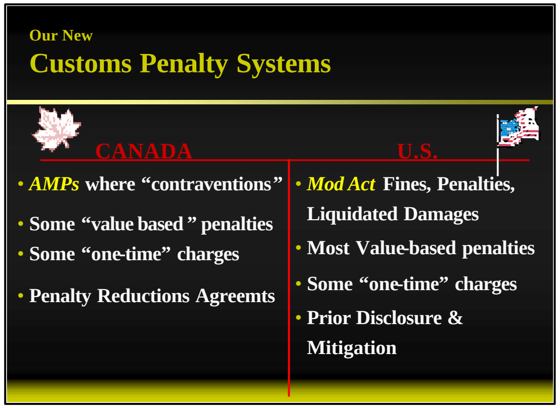
Types of Penalties. Just as under the U.S. penalty system, AMPS will apply to a wide variety of "customs infractions". Just what will be penalized, however, still appears to be under some dynamic revision. For example, even in the last few months Customs has been busy defining and redefining what infractions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

Prior to September 2002, it has been published that mere "errors" on B3[9] forms would result in flat rate $100 penalties for each infraction. Thus a simple error in one of the origin fields in the B3, or in the overall value of the good, or the statistical suffix required for tariff classification, was to lead to a $100 charge on the B3. More problematically, it appeared where so-called "systemic errors" existed (e.g., in the valuation methodology), resulting in the same sort of error being made in multiple importations, the $100 penalty would apply again and again, to each of the multiple importations. The current AMP for this infraction appears to be AMP Contravention C005.

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

Also of significance are the Minister's collection powers, which include the ability to detain goods or a conveyance in respect of which an AMP penalty was assessed, until the penalty is paid. Thus CBSA has given itself a fairly big stick in which to enforce its AMPS powers.[10]

Notice of Penalty Assessment. Once assessed an AMP, a person receives a Notice of Penalty Assessment, pursuant to section 109.3 setting out the penalty number, the amount of the penalty, the penalty calculation as well as the 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*.



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

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

Appealing an AMP Penalty. Once an AMP is assessed, a person has four options (which are not mutually exclusive): (1) pay the assessment;[11] (2) request corrective measures; (3) appeal the assessment; or (4) enter into a Penalty Reduction Agreement.[12]

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

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

In terms of the "formal" appeals process, a person has 90 days from the service of the notice of assessment to request reconsideration of the decision by the Minister, under section 131 of the *Customs Act*.[13] 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"[14] on the trading community, however, to the extent that a trader can demonstrate that they did exercise "reasonable care", they will not be subject to a penalty.

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

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

A Penalty Reduction Agreement ("PRA") is another interesting development, and may be used to reduce or eliminate the penalty assessed where a person has been assessed an AMPS penalty totaling $5,000 or more, as a result of their Customs Information System.[15] 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."[16]

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.

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Even where there are duties, they shouldn’t be on Royalties.

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

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

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

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

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

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

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

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

No. 7 –

You shouldn’t be paying Dutiable Royalties in the U.S or Canada on any dutiable goods

As noted above, most of the imports of toys and dolls are duty-free into both the U.S. and Canada.

However, depending on particular classification determinations (that we will be discussing in greater detail below), there are other products sold for the toy market that have a positive general duty rate. Accordingly, valuation and the treatment of royalties remains an important consideration for companies in this industry. Here we will review the treatment under both the Canadian and U.S. regimes.

The Canadian Royalties Inclusion. In Canada, when using “transaction value” (see Part II), section 48(5)(a)(iv) of the *Customs Act* requires the price paid or payable for imported goods to be specifically increased by the value of certain royalties and licence fees paid in respect of the imported goods, as a condition of their sale.

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

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

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

Despite the simple words, a number of considerations come into play when trying to understand apply the royalties provision, some of which have been dealt with by the Canadian jurisprudence on the subject.[17]

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*.[18]

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:[19]

> 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 CBSA still proceeded with some cases that had been in the wings waiting for the *Mattel* decision.

Reebok Decision. First and foremost was the *Reebok* decision – handed down by the Federal Court of Appeal ("FCA")last year, from the bench, and again rejecting Canada Customs approach.

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

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

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

To date, CBSA remains active in this area, challenging whether "royalties" are perhaps dutiable under various other provisions of the customs valuation code (*e.g.*, under the "price paid or payable provision").

Consistent with U.S. Interpretations. The same is true in the U.S., where several rulings examining the dutiability of "royalties" over the last few years and, specifically, the issue of whether the royalty payment is a "condition of the sale" for exportation to the United States.

“ 6 ”

Canada has some weirdo “Purchaser in Canada” rules.

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A recent ruling, published late last year (HQ 548373 (Nov. 24, 2003)), in response to a request for internal advice raised the issue of royalty payments in the oil industry. Here, the royalty was paid on a percentage of income from certain oil drilling operations that used particular equipment that had been purchased and imported. The importer was not related to either the licensor or to the seller of the imported merchandise, however the licensor and seller were related.

CBP held that the royalty payments are made to a party related to the seller, are “involved in the product or sale of the imported merchandise” and for the right to use the equipment, are related to the goods and are “a condition of sale” and result from a “subsequent resale, disposal or use of the imported merchandise.” As such, CBP held that the payments should be included in transaction value. In assessing how the amount of future royalty payments should be determined, CBP ruled that the payments should be apportioned to the subject entries in a reasonable manner in keeping with case precedence, Generally Accepted Accounting principles, and consistent with the methodology used to apportion assists.

No. 6 –

Canada has some weirdo “purchaser in Canada” rules.

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

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

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

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

At the same time, section 45 of the *Customs Act* – which provides the definitions for the various terms used in the Valuation Code – was also amended to allow the phrase "purchaser in Canada" <u>to be defined by regulations</u>. [20]

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

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

> **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).

“ 5 ”

What do you mean, it’s Counterfeit ?

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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 fact ors which will be considered, as business practices do vary; however, the list below is meant to illustrate the level of responsibility expected of the employees with the general authority to contract on behalf of the business entity, in Canada. The business entity must be able to show that the employees in Canada have the authority to, for instance:

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

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

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

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

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

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

    (b) whether purchase orders are solicited in Canada;

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

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

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

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

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

Management and Control in Canada

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

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

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

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

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

TIPS FOR

Intellectual Property Rights Protection

- **Record your Trademark, Trade Dress and Copyright**
  - ***Is your imported item recorded by someone else?***
- **Get Authorization to avoid *Detentions and Seizures***
- **Canadian Protections – Federal Court Application**
- **China & the practical reality of pirated imports**

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

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

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

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

To date the jurisprudence has focused on the banking arrangements in place, and other factors indicative of a arms' length relationship (see, for example, the *AAI FosterGrant* case).

No. 5 –

What do you mean, it's Counterfeit?

The importation of toys, dolls, and other products that appeal to the toy industry, present unique opportunities to capture the market for a new, innovative product that often needs to reach the marketplace in time for a holiday. Savvy companies will seek to protect their innovative product by means of obtaining registration of trademarks, trade dress, and copyrights associated with the item. The companies can seek further protection of their investment by recording their registered marks and copyrights with the U.S. CBP.

Intellectual Property Right ("IPR" holders worldwide have asked their respective government for assistance in protecting their IPRs from infringement.

Under international agreements, most particularly the NAFTA, and the WTO's Agreement on *Trade-Related Aspects of Intellectual Property Rights* ("TRIPS"), the U.S. and Canada have agreed to establish customs procedures at the border to assist IPR holders in protecting their rights in two areas: copyright and trade-mark.

Canadian Perspective. In Canada, there is also numerous domestic legislation available to the IPR holders to protect their rights i.e., the *Copyright Act, Industrial Design Act, Integrated Circuit Topography Act, Patent Act, Plant Breeders' Rights Act,* and *Trade-marks Act*. All of these Acts, with the exception of the Plant Breeders' Rights Act which is promulgated by Agriculture and Agri-Food Canada, are administered by Industry Canada.

The CBSA's role is relegated, generally, to dealing with copyright or trade-mark goods, and it does not act upon any other IPR infringements such as patents or industrial designs.

Even then, the CBSA treats IPR as a private right and the actions of the CBSA in dealing with copyright or trade-mark infringing goods are initiated only by a private rights holder initiating action through the courts.

Although court orders generally apply only to commercial shipments, orders could be directed towards personal importations.

The general process for obtaining a Court order to through the Federal Court in Canada, with the application being made under either the *Copyright Act* or the *Trade-marks Act*. Here the owner of the registered trade-mark or exclusive licensee must apply to the court for an order directing the CBSAto take reasonable measures to detect and detain alleged infringing goods. The order will typically also direct the CBSA to notify the applicant and the importer of the detention of the goods and the reasons therefore.

For further information on prosecuting trade-mark or copyright infringement in Canada, please contact Rob Kreklewetz.

No. 4 –

If you're the "Importer" in Canada, GST might apply TWICE

For a detailed discussion on Canada's GST regime, see Part IV in these materials. The double-tax trap can occur where a person has registered for the GST, which would require the person to charge and collect GST on any sales made "in Canada" (e.g., a sale made to a Canadian customer, where the vendor is responsible for getting the product to the customer's doorsteps). In this situation, it is likely that the vendor would be responsible for importing the goods to Canada, and then on-delivering them to the customer. The GST applies as follows:

“ 4 ”

If you’re the “importer” into Canada, GST might apply TWICE !

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Tax Once: Under Division III of Part IX of the *Excise Tax Act* the vendor is required to pay GST, at the border, to the CBSA. (A GST input tax credit (“ITC”) is generally available to the vendor to recover the tax so paid).

Tax Twice: Under Division II of the Part IX of the *Excise Tax Act*, the vendor is required to charge and collect the GST from its Canadian customer, and remit that amount to the Canada Revenue Agency (“CRA”). (Note: The ITC generated by the tax being paid under Division III above could be used to off-set the tax remittance obligation).

The problem that many non-residents face is not understanding this mechanism, and making the assumption that all of the GST has been properly paid at the border (i.e., under Division III), making the second step of the transaction described above unnecessary. That leads to the incorrect omission to charge and collect the GST from the Canadian customer, or the failure to properly claim the ITC to off-set the amount owing.

Some non-residents get it all wrong, and fail to register for the GST, but still attempt to charge and collect the GST from their Canadian customers, to “reclaim” the GST they paid at the border.

There are also a myriad of other special rules to deal with other special situations (e.g., drop-shipments), and that does nothing further in terms of clarifying the situation for mystified non-residents.

No. 3 –

What “Special Marking Rules” and How can they Apply to your Imports?

In the United States, consumers are provided with information regarding the foreign origin of all imported goods.

The country of origin marking rules are required by the U.S. CBP regulations and call for each foreign-made product (or the outermost packaging that will reach the consumer) to be marked legibly, prominently, and indelibly with the phrase “Made in [Foreign Country of Origin]” or “Product of [Foreign Country of Origin]” or similar such marking.

These marking determinations require careful consideration of the country of origin of the product. And, when products such as toys are combined into “kits” the issue can become very complex if the component products are made in various countries. The U.S. CBP regulations provide for a 10% marking duty on the value of the product if the goods are found to be improperly marked. These marking penalties can easily shrink any profit that would otherwise be made on such an item.

In the U.S., there are certain “Special” marking rules that can be triggered on imported goods. That is, when an imported item includes a reference to a U.S. locality or states “America”, “USA”, “American” or the like on the foreign-made product, these “special” marking rules come into play. These rules protect the ultimate consumer from being misled or deceived as to the proper origin of the item. When such a non-origin locality is marked, the item (or container as the case may be) must include the “Made in [Country of Origin]” or “Product of [Country of Origin]” legibly, permanently, and in close proximity to the words and in at least comparable size. This can occur, for example, if a toy is imported and includes an instruction booklet that proclaims the name and address of the U.S. distributor or other copyrighted information which includes such a non-origin reference. Companies must be careful to ensure that their goods and any and all components to such goods are properly marked.

In addition to the U.S. CBP marking rules, there are instances when other agency marking requirements can apply. This is discussed below. Briefly, if a Halloween costume is imported into the U.S., the Federal Trade Commission “Care Label” marking requirements will apply to the item, even though this is not a garment intended for everyday use.

TIPS FOR IMPROVED

GST COMPLIANCE

- Read Part IV
- Tax at Border is "Division III Tax"
- Tax Paid by Customer is "Division II"
- Designate the Responsible Person & Get Her Trained.

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No. 2 –

Dealing with Other Agency Rules on your Imported Toys – Watch out !!

Companies that source goods from overseas and import them for sale in the North American markets are typically familiar with the need to meet CBP requirements, so that they can receive their imported goods and get them to market in the most efficient manner. What they often overlook, however, is the need to meet other U.S. agency requirements, which may not always be self-evident. At the border, the U.S. CBP is on the front line for inspecting products and processing the goods for entry into the Customs territory. CBP also serves as the conduit for other agency review and inspection.

In the toy industry, this may manifest itself in many different ways, with many different U.S. agencies. For example, as we noted above, imported costumes that are treated differently from everyday clothes by CBP, are not distinguished as such by the rules imposed by the FTC. Therefore, all of the labeling requirements for care and treatment, but be present and in compliance with this other agency's set of rules.

Another important area where U.S. CBP works cooperatively with another agency is safety. The U.S. Consumer Products Safety Commission is very active in monitoring toys, dolls and other products that are marketed to children for compliance with various safety standards. Just recently, the CPSC announced a recall involving 150 million pieces of imported toy jewelry that posed a risk of lead poisoning – one of the largest recalls in history. This recall occurred in the absence of any report of injury or illness, but simply as a result of the agency monitoring imported goods.

Another popular item for the toy industry is in the area of make-up that is marketed for children to "dress up." The make-up products are most often within the regulations of the U.S. Food and Drug Administration and must comply with that agency's requirements in addition to meeting those of CBP.

In Canada, Health Canada administers the *Hazardous Products Act*, and the more specific *Hazardous Products (Toys) Regulations*, all generally to the same effect.

No. 1 –

What Precisely is a "Toy" ?! (a.k.a. classification wonders)

Currently, the most contentious issue for purposes of compliance with Customs requirements, is the proper classification of goods. More specifically, the issue becomes: is this a "toy"? There is no definition of "toy" in the Customs regulations or the Harmonized Tariff Schedule. Rather, companies must rely on sifting through the most recent rulings and case law pronouncements to fully understand how the customs service is interpreting that term. The implications can be significant.

Currently, this is an issue as to whether the educational item that a company seeks to import should be classified by its value for "function" versus its value for "amusement." The former typically having a positive general customs duty rate and the latter having duty-free status. With each new upgraded model, providing ever greater "bells and whistles", the determination becomes a "slippery slope" for CBP. Therefore, these determinations are made bearing in mind not only the item currently at issue, but also the next product for which a ruling may be sought.

Other classification issues are presented when dealing with items that are brought to market as a set or kit. For example, the essential character of a bath set comprised of bubble bath, a sponge and a bucket, is found in the bubble bath. An item, that is marketed to children, but whose function overrides the "amusement" value as determined by CBP.

In our discussion, we will review additional significant recent decisions and areas identified to be of "ongoing concern" by CBP.

“ 3 ”

What “Special” Marking Rules and How can they Apply to Your Imports ??

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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.

> **Note:** In many instances, there will be only one possible tariff classification for an imported good.

“ 2 ”

Dealing with “Other Agency” Rules on your Imported Toys -- Watch out!

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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 Pre-Assessment Review methodology, 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.

“ 1 ”

What precisely is a “Toy” ? !
(a.k.a. classification wonders)

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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 CBSA’s own policy generally reflects that: see D-Memorandum 13-4-1. The requirement that a “sale” occurs has some obvious ramifications. For example, Transaction Value would not be available where “leased goods” are imported, nor would it be available for transfers of goods between a foreign company and an international branch.[8] In “parent-subsidiary” relationships, an issue will also arise as to whether the parent and subsidiary are in true “vendor-purchaser” relationships, or whether the parent controls the subsidiary to such an extent that the latter can be viewed as the mere agent of the former, negating a “buy-sell”.

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

1. The Importer is a Resident, and both (a) carries on business in Canada (i.e., with a general authority to contract, plus other factors), and (b) is managed and controlled by persons in Canada; or
2. The Importer is a Non-Resident, but with a Permanent Establishment in Canada (as above), and both (a) carries on business in Canada, and 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 Canada Revenue Agency's ("CRA" - formerly the "Canada Customs and Revenue Agency", or CCRA) Information Circular 87-2R (September 27, 1999) makes clear:

> **Part 12 – Customs Valuations**
>
> 225. The methods for determining value for duty under the current provisions of the Customs Act resemble those outlined in this circular. However, differences do remain. The Department is not obliged to accept the value reported for duty when considering the income tax implications of a non-arm's length importation.

Thus, even though the CRA was, at the time this circular was written, then integrated as between its Customs, Excise and Taxation functions, it took the position that two potentially different valuation bases can occur for Taxation and Customs purposes, and that there is no necessary symmetry between the transfer pricing rules used by Taxation, and the valuation methods used by Customs. Now that the CBSA has formally split from the CCRA (now CRA), there is every reason to believe that the potential dichotomy will continue to exist.

While somewhat anomalous, this approach is generally consistent with CBSA's historical position, and is indicative of the problems facing taxpayers involved in Customs' valuation reviews: they are faced with a "whipsaw", with high customs values being assessed by Canada Customs, but no ability to translate those assessments into positive income tax implications.

> **Tip**: Importers carrying out transfer pricing analyses must understand that the "transfer price" they determine for Canadian income tax purposes – which the CRA will have a vested interest in ensuring is "low" enough to accommodate reasonable Canadian corporate income tax revenues – will usually be a different amount than the "VFD" figures used to import the goods. That is largely due to the requisite statutory additions and deductions described above.

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

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

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

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

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

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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 to and from Canada 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 U.S. Bureau of Customs and Border Protection (formerly U.S. Customs Service ("U.S. Customs" or "CBP")), 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 CBP before it will be admitted for entry. 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 into the U.S., an importer may seek to import its goods under a preferential trade program and its particular 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.

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, CBP has 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 in-depth review of the company's customs compliance policies and procedures.

Today, and a few program generations later, CBP 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, 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, <u>even if</u> there is no duty loss to the Government!

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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 most industrialized countries, 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.

CBP treats the harmonized "Explanatory Notes," which accompany the HTS, as "guidance" but not strictly binding.[4] Instead, CBP 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 CBP 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 CBP.

> **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. 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 CBP at the time of entry. The classification decision is critical for a company seeking to determine origin under any preferential program.

> **Note**: In the U.S., entries that are not made under a preferential trade program, are subject to a "substantial transformation" test. This standard for determining origin is <u>not</u> based upon the "tariff shift" or other special origin rules of a preferential program. 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 a preferential program, which may differ from the origin determined by the general U.S. rules of origin.

We caution that under a preferential program, 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 a particular country, that raw material may not necessarily be of that country's origin.

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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 all raw material inputs; nevertheless, the effort should be made.

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 a preferential program 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 CBP.

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 CBP's 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 CBP's commencement of a formal investigation.

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 CBP. 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]

In the U.S., most duties 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 remains of high importance to ensure that valid trade statistics are gathered.

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, 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 CBP 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:

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- 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 requesthas been made to Customs when the entry summary is filed.

Transaction Value Conditions. Under the valuation regime, 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. CBP 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* CBP's 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 CBP 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.

CBP 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, CBP 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 CBP. This trend began to change, 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.

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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.

Since then, many importers have sought a similar decision through rulings by CBP. 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.

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. CBP. 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] There have been several U.S. CBP rulings over the past year addressing whether royalties and service fees are included within the dutiable value of goods. (*See* Part I above.)

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 CBP 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, CBP's 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 a Canadian affiliate of a U.S. company.

Accordingly, U.S. companies trading with affiliates 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.

Recent CBP Headquarters rulings, however, have taken steps to re-connect the disparity for U.S. Customs purposes. For example, in HQ 547382 (Feb. 14, 2002), CBP 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.

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In that ruling, CBP 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), CBP 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, CBP 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.

CBP's review of the information, including attending the Advance Pricing Agreement prefiling conference and review of information submitted to the U.S. tax authority, allowed CBP 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 imports for the toy industry is duty-free, proper valuation remains a significant focus of CBP. Many importers improperly believe that because an importation has no revenue implication, CBP will not be "bothered" evaluating the shipment. Actually, the opposite appears to be true.

CBP closely reviews duty-free transactions 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 remain a priority of CBP.

CBP 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 CBP continue to examine value? There are several reasons. First, the U.S., 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 CBP at the time of importation, such as Merchandise Processing Fees ("MPF") and Harbor Maintenance Taxes, which are assessed based upon the declared value. (For example, MPF will apply if entry is not made under the benefit of NAFTA.)

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 CBP 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 CBP's 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, CBP 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

OVERVIEW OF CANADA'S GST SYSTEM

Overview of the GST System

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

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

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

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

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

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

Division II & "Taxable Supplies Made in Canada"

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

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

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

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

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

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

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

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

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

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

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

Residents & Non-Residents. While a complete discussion is outside the scope of this presentation, the *ETA* does have some complex rules regarding the meaning of "non-resident" and "resident".[6] For example, s. 132 of the *ETA* provides that a corporation will be considered a "resident" of Canada if it has been "incorporated" or "continued" in Canada, and not continued elsewhere. While this might suggest that all corporations incorporated or continued outside of Canada would qualify as "non-residents" of Canada, there are other rules which may impact like, for example, the *ETA*'s "permanent establishment" rules.

Permanent Establishments. A special rule in s. 132(2) of the *ETA* provides that where a person who is otherwise a "non-resident" (e.g., a corporation incorporated in the U.S.) has a "permanent establishment in Canada, the person shall be deemed to be resident in Canada in respect of, but only in respect of, activities of the person carried on through that establishment". The effect of this rule, of course, would be to deem the non-resident to be a "resident" in respect of any activities carried on through a Canadian permanent establishment, which has the ancillary effect of *excluding* the 'non-resident' from use of the special "non-resident's rule" referred to above. Accordingly, a non-resident with a Canadian permanent establishment might (unhappily) find that its activities in Canada have effectively brought itself *into* the GST system, requiring it to take positive steps to register for the GST, and to begin charging, collecting, and remitting the GST to the Canada Revenue Agency ("CRA" – formerly the "Canada Customs and Revenue Agency", or "CCRA").

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

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

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

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

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

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

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

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

Division III & "Imported Goods"

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

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

As indicated above, even if a person (like an unregistered non-resident, not carrying on business in Canada) has successfully shielded itself from any Division II GST obligations (i.e., because of the special non-residents rule in s. 143), the Division III tax can still apply to any goods imported by the non-resident. And many other taxpayers and consumers now fully know, from their personal cross-border shopping experiences, the GST also applies to imported goods.

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

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

Interplay of Division III Tax with Customs Valuation Rules. As mentioned, the GST's Division III tax is payable on the "duty paid value" of the imported goods, <u>as determined under the *Customs Act*.</u> Significantly, then, the provisions in the *Customs Act* and *Customs Tariff* which affect the "value for duty" of imported goods are still important for GST purposes – even if the goods being imported are otherwise "duty free". This means that even those duties on imported goods may have long-since been removed, the CRA will still be interested in a proper valuation of the imported goods, for GST purposes, and will continue to focus on issues like whether dutiable royalty payments, assists, "subsequent proceeds", and "buying commissions" have been included in the "value for duty" of goods. Where these additions are left out, GST will be regarded as having been short-paid, and customs assessments (or other positive "voluntary correction" obligations – see *infra*) will arise.

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

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

Division IV & "Imported Taxable Supplies"

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

Zero-Rating Provisions

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

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

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

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

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

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

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

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(c) a postal service;

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

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

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

(g) a transportation service; or

(h) a telecommunication service.

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

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

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

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

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

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

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

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

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PART V – THE LATEST FROM CBP

New Security Initiatives

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 -- 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 exporting to and 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 CBP's 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 was designed as a paperless cargo release system. The next release system under the program is a Pre-Arrival Processing System (PAPS), which uses barcode technology for clearance and is implemented in a several border ports.

> **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) and was recently expanded to ports, marine terminal operators and certain foreign manufacturers. 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 (which is currently held up from distribution due to privacy/confidentiality concerns);
- 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 Your Company? Even companies which have no independent interest in becoming a C-TPAT partner, may find themselves 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 and may 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, CBP 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. (In fact, the petroleum industry was the first industry to enter into a specific MOU with CBP and jointly worked to create an ISA plan dedicated to the industry.) 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, CBP then determines which areas to further investigate and sample. As with most audit methods, CBP 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 CBP 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, CBP 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 CBP, 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 CBP, and provide an annual written notification reaffirming these commitments.

Some of the benefits touted include: CBP 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 generally 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.

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ENDNOTES TO PART I:

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

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

3. 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 AMP S. 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.

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

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

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

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

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

8. Please note that all discussion of AMPS contraventions or penalties is based on the CBSA's most recent (at the time of writing) AMPS Contraventions Master Penalty Document, dated February 1, 2004.

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

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

11. 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.

12. 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).

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

14. 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.

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15. 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.

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

17. 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).

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

19. 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.

20. 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.

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

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

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

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

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

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9. See, for example, the presentation on the "Purchaser in Canada Regulations" made by Robert G. Kreklewetz and Stuart MacDonald (CBSA), at the Canadian Importers Association's May 11, 1999 Emerging Issues in Customs Conference (Toronto, Ontario). Please contact the presenter if you would like copies of this presentation.

10. See, for example, the presentation on the "*Recent Customs Valuation Cases: A Spirited Discussion With the CCRA*", made by Robert G. Kreklewetz and David DuBrule (CBSA), at the Canadian Importers Association's April 6, 2000 Emerging Issues in Customs Conference (Toronto, Ontario). This presentation was also updated and presented at the same Canadian Association of Importers and Exporters conference on April 5, 2001. Please contact the presenter if you would like copies of this presentation.

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

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 a preferential program differ substantially from those that apply to non-preferential program 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 administrations.

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 CBP 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 CBP rulings interpreting the phrase "price paid or payable." Care should be taken to ensure that an importer's particular facts would be within CBP's 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 CBP 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. CBP 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.

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ENDNOTES TO PART IV:

1. 1.For "domestic" supplies, the principal exceptions are goods, services, or intangibles enumerated in Schedules V or VI of the *ETA*. For "imported" goods, the principal exception is goods enumerated in Schedules VII of the *ETA*.

2. "Registered" or "registered under the *ETA*" is used to refer to persons who are registered in accordance with subdivision d of Division V of the *ETA*, which establishes who must be registered for the GST, and how they must register.

3. Bear in mind that a "taxable" supply will include the sorts of "zero-rated" supplies that are enumerated in Schedule VI of the *ETA*. The difference between the two is that a simply "taxable" supply is taxed at a rate of 7%, while a zero-rated supply is taxed at a rate of 0% (effectively removing the GST from the zero-rated supply).

4. In reviewing the general and specific rules discussed below, and in determining whether a particular taxable supply is made "in Canada" or "outside Canada", remember the significance of these rules: (1) Where a taxable supply is made "inside" Canada it will be taxable under Division II, and not generally taxable under any other provision in the *ETA* (although there are some exceptional situations where double-tax can occur); (2) If, on the other hand, the taxable supply is made "outside Canada", it will be outside the purview of Division II tax, and would only be subject to GST, if at all, under Division III (imported goods) or Division IV (imported services and other intangibles).

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

   Many non-residents are confused in the application of the GST in these situations, increasing the likelihood that the GST rules are either not being fully complied with, or that some of this "double" GST is not being fully unlocked (see *infra*).

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

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

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

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