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Customs Valuation and Transfer Pricing in Canada

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INTRODUCTION

Canadian customs duties are calculated at the applicable *ad valorem* rate on the value for duty ("VFD") of goods imported into Canada.

In recent years, customs valuation has become a battleground between importers and the Canada Customs and Revenue Agency (the "Agency"). The Agency has adopted one-sided administrative interpretations into their Canadian customs valuation policies. Importers have not stood idly by and accepted the Agency's one-sided view of the world. They do not accept the Agency's administrative policies at face value (as they shouldn't) and lay down before the alter of the Agency's fiats.

Using the administrative channels available to them, importers vigorously dispute proposed and actual assessments, raised as a result of the Agency's competing views on the appropriate customs valuation (methods). Once importers have exhausted these channels, without any success or without sufficient success, they have moved relentlessly to the public forum to litigate customs valuation cases before the Canadian International Trade Tribunal (the "Tribunal") and the federal courts.

Nowhere was this relentlessness more clearly demonstrated than in the *Mattel Canada* case, *infra*, where Mattel Canada Inc. ("Mattel Canada") took their case all the way up to the Supreme Court of Canada last year. After years of dispute and litigation, Mattel Canada ultimately resoundingly defeated the Agency's strict position to include virtually all royalty payments in respect of imported goods in the VFD. It was a unanimous decision made by all nine members of the highest court in Canada.

This contentiousness is directly linked to the uncertainty in the application of the law arising from the revolutionary changes made to the customs valuation law in the 1980's by the world's organized trading partners. In 1979, they agreed to a new customs valuation code, found today in the *World Trade Organization's Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994* (the "Customs Valuation Code"). Before Canada adopted the Customs Valuation Code into its *Customs Act* in 1985, the Canadian *Customs Act* used fair market value as the basis for determining the VFD of imported goods.[1]

As required by the Customs Valuation Code, the primary method of customs valuation found in the *Customs Act*[2] is the transaction value method. This paper will focus on many of the contentious issues surrounding the transaction value method of customs valuation. As the result of the many points of dispute and confrontation between importers and the Agency, the Canadian law of customs valuation, particularly concerning the transaction value method, has undergone significant flux since the adoption of the Customs Valuation Code into the law, continuing throughout the 1990's and into the new millennium. As we will see, the Agency's administrative policies have not kept pace with the flurry of changes.

Finally, we will take a look at transfer pricing issues and the interaction of transfer pricing with customs valuation.

[1] *Customs Act*, RSC 1970, c. C-40, section 36(1). The amendments to the *Customs Act* are effective January 1, 1985 and found in S.C. 1984, c. 47.

[2] RSC 1985, c.1 (2d Supp.), as amended.

CUSTOMS VALUATION

I. Methods of Customs Valuation

In accordance with the Customs Valuation Code, the *Customs Act* sets out six methods for determining the VFD of imported goods:

(1) **The transaction value** - the price paid or payable for goods in a sale for export to Canada to a purchaser in Canada, subject to certain adjustments (section 48 of the *Customs Act*);

(2) **The transaction value of identical goods** – sold for export to Canada to a different purchaser than the purchaser of the goods being appraised when sold and exported in substantially the same conditions as the goods being appraised, or with appropriate adjustments made to compensate for any difference(s) in those conditions (section 49 of the *Customs Act*);

(3) **The transaction value of similar goods** – parallels the definition above in (2) (section 50 of the *Customs Act*);

(4) **The deductive value** – is based on the resale price in Canada of the imported goods, identical goods or similar goods, with deductions allowed for commissions or profits earned in Canada and general expenses incurred in Canada (section 51 of the *Customs Act*);

(5) **The computed value** – the cost of the imported goods, plus amounts to account for profits earned by, and general expenses incurred by, the supplier or producer in the country of export (section 52 of the *Customs Act*); and

(6) **Residual value** – a flexible method of valuation derived from among the methods and principles of valuation set out in (1) to (5) above, so as to most appropriately determine the customs valuation in accordance with these principles (section 53 of the *Customs Act*).

An importer must choose among the valuation methods by selecting the first listed method which is available to the importer. So, for example, the importer begins with the transaction value method and, if available, chooses that one, but if unavailable, determines whether the next method in descending order, the transaction value of identical goods, is available, and so on. The *Customs Act* allows the importer the flexibility to reverse the order of (4) and (5) above and choose (5) the computed valuation method over (4) the deductive valuation method even though the deductive valuation method is available. As previously stated, these rules mirror the rules set out in the Customs Valuation Code.

II. Transaction Value Method

As mentioned above, the transaction value is "the price paid or payable for the goods" (the "import price") when "sold for export to Canada to a purchaser in Canada", subject to certain adjustments as set out in sections 48(4) and (5) of the *Customs Act*. For an importer to use the transaction value method, the import transaction must meet certain conditions.

1. No Restrictions as to Disposition or Use

For the transaction value method to apply, there must be no restrictions imposed on the purchaser of the imported goods as to the disposition or use of the goods, other than restrictions:

(i) imposed by law,

(ii) limiting the geographical area in which the goods may be resold, or

(iii) not substantially affecting the value of the goods.

(Section 48(1)(a) of the *Customs Act*).

2. Import Price Can Be Determined at the Time of Import

The sale or import price cannot be subject to some condition or consideration for which a value cannot be determined (section 48(1)(b) of the *Customs Act*). The Interpretative Notes found in Annex I of the Customs Valuation Code give the following examples of such conditions or considerations, which would render the transaction value inapplicable:

"(a) the seller establishes the price of the imported goods on condition that the buyer will also buy other goods in specified quantities;

(b) the price of the imported goods is dependent upon the price or prices at which the buyer of the imported goods sells other goods to the seller of the imported goods;

(c) the price is established on the basis of a form of payment extraneous to the imported goods, such as where the imported goods are semi-finished goods which have been provided by the seller on condition that the seller will receive a specified quantity of the finished goods."

Section 48(4) of the *Customs Act* specifically requires that the import price be ascertainable and determined at the time of import of the goods into Canada.

In *Toyota Canada Inc. v. The Deputy Minister of National Revenue*,[3] Toyota Canada Inc. ("TCI") purchased vehicles from Mitsui & Co. in Japan and imported the vehicles into Canada.

Using the transaction value method, TCI had declared provisional prices as the import price for the vehicles when "sold for export to Canada". TCI negotiated the actual final purchase price of the vehicles after the import of the vehicles into Canada; in fact in certain cases as much as two months after the importation. To reflect the adjustments to the provisional prices that resulted from the negotiation of the final prices, TCI requested re-appraisals of the VFD (the transaction value) from the Agency.

Where TCI requested reductions in the transaction value to reflect downward adjustments, the Agency chose to disregard those downward adjustments for the purpose of determining the transaction value, in accordance with section 48(5)(c) of the *Customs Act*. The Deputy Minister of National Revenue affirmed the decisions of the Agency.

The Tribunal allowed TCI's appeal. The Tribunal agreed that the provisional price did not reflect the import price for the vehicles when sold for export to Canada. The actual import price is often higher or lower than the provisional price depending on the result of negotiations between the parties. In the Tribunal's view, the final negotiated selling price reflected the actual import price payable by TCI for the vehicles.

The Federal Court of Appeal[4] allowed the Deputy Minister's appeal and restored the decisions of the Agency. Under section 48(4) of the *Customs Act*, the import price had to be ascertainable at the time of import of the vehicles. If not, then TCI had to resort to an alternative method of customs valuation. If the import price is ascertainable at the time of import of the vehicles, then any rebate of, or decrease in, the import price after the goods are imported should be ignored for the purpose of determining the transaction value in accordance with section 48(5)(c).

The Federal Court of Appeal sent the case back to the Tribunal to decide in accordance with the legal considerations and principles articulated by the Federal Court of Appeal. On the consent of the parties, the Tribunal upheld the Agency's decision to disregard any rebates or price decreases negotiated after the import of the vehicles into Canada, adopting the provisional prices as the import prices.[5]

Similarly, in an earlier decision in *Quadra Chemicals Ltd. v. The Deputy Minister of National Revenue*,[6] Quadra Chemicals Ltd. ("Quadra") imported nickel sulphate into Canada.

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[3] [1996] 4551 ETC (CITT).

[4] *The Deputy Minister of National Revenue v. Toyota Canada Inc.*, [1999] 2912 ETC (FCA).

[5] Appeal No. AP-99-043 (September 12, 2000).

[6] [1994] 4619 ETC (CITT).

Its foreign supplier agreed to provide price reductions for which the purchase orders did not provide. The supplier agreed to grant these concessions to render the re-sale price of the imported nickel sulphate competitive in the Canadian market. The price reductions were negotiated after the import of the nickel sulphate into Canada. The Tribunal found that these after-import price reductions had no bearing on the import price and the transaction value and so should be ignored in accordance with section 48(5)(c) of the *Customs Act*.

Although it was not essential to the decision made by the Tribunal, the Tribunal approved of the Agency allowing duty refund claims in the case of certain other downward price adjustments where the Agency did not apply section 48(5)(c). Quadra had used an estimated sale price to determine the import price under the transaction value method. The purchase orders had indicated that the sale prices were subject to the London Metal Exchange commodity price for nickel sulphate on a specified date. The Agency allowed duty refunds claimed by Quadra for two orders for which the prices were adjusted downward to reflect the London Metal Exchange commodity sale prices, which prices the parties had negotiated before import. Quadra paid additional customs duties on the resulting upward adjustments. Although the refunds allowed by the Agency were not the subject of the appeal to the Tribunal, the Tribunal appeared to want to explain why these particular duty refunds were allowed, but not the ones claimed for the price reductions negotiated after import:

> "…[A] contractual arrangement providing that the final price is to be determined on the basis of a commodity market price at a certain date is not a rebate of the kind encompassed by paragraph 48(5)(c) of the *Act*…"

In another decision in *Nordic Laboratories Inc. v. The Deputy Minister of National Revenue for Customs and Excise*[7], the foreign supplier agreed that if generic forms of supplied products became introduced to the Canadian market, the supplier would apply a reduced price to the patented product sold by the supplier to Nordic Laboratories back to the date of the introduction of the generic product and give Nordic a credit. Some months after the importation occurred, the supplier recognized the availability of the generic products in Canada and therefore granted a credit adjustment. The Tribunal ignored the downward price adjustments on the basis of section 48(5)(c) of the *Customs Act*.

The Federal Court – Trial Division allowed the appeal of Nordic Laboratories. The Federal Court found that the Tribunal had erred in concluding that the credit granted to Nordic Laboratories constituted a rebate in the price within the meaning of section 48(5)(c). The Federal Court found that:

- When the products entered Canada, the pre-condition for the lower price, the presence of the generic products in Canada, already existed so the credit did not constitute a rebate or decrease in the import price;

- Even if the credit amounted to a rebate or price decrease, the credit did not take effect after the importation of the products. The parties had negotiated a lower sale price of the products before the importation of the products based on an event, when a generic product first circulated in Canada, which had occurred before the importation.

[7] Appeal No. AP-91-189 (July 20, 1992), Rev'd 113 F.T.R. 168 (FCTD) (February 26, 1996).

The Federal Court's finding was consistent with the Agency's own administrative position found in paragraph 3 of the Agency's **Memorandum D13-4-10 – "Transaction Value, Discounts"**, dated June 1, 1986:

> "3. If a discount is effected – that is, the obligation or condition to which a discount relates is fulfilled or met – prior to importation, the amount of that discount should be considered when calculating the price paid or payable for the imported goods."

When the Agency subsequently amended this Memorandum for release on March 20, 2001, the Agency left paragraph 3 unchanged from the June 1, 1986 version.

Based on the above cases, if the downward price adjustment is negotiated prior to importation and dependant upon some sort of objective criterion, a downward adjustment to the import price in determining the transaction value should be allowed. If, however, the downward price adjustment is negotiated between the parties after importation, then the downward adjustment should be ignored for the purpose of determining the transaction value, in accordance with section 48(5)(c) of the *Customs Act*.

3. Related Persons

Where the foreign supplier and "purchaser in Canada" are related to each other, the importer must be able to demonstrate that:

(i) the relationship did not influence the import price, or

(ii) the transaction value closely approximates one of the test values set out in section 48(3) of the *Customs Act*.

(Section 48(1)(d) of the *Customs Act*).

Under section 45(3) of the *Customs Act*, "persons are related to each other if

(a) they are individuals connected by blood relationship, marriage or adoption within the meaning of subsection 251(6) of the *Income Tax Act*;

(b) one is an officer or director of the other;

(c) each such person is an officer or director of the same two corporations, associations, partnerships or other organizations;

(d) they are partners;

(e) one is the employer of the other;

(f) they directly or indirectly control or are controlled by the same person;

(g) one directly or indirectly controls or is controlled by the other;

(h) any other person directly or indirectly owns, holds or controls five per cent or more of the outstanding voting stock or share of each such person; or

(i) one directly or indirectly owns, holds or controls five per cent or more of the outstanding voting stocks or shares of the other. S.C. 1995, c.41, s.17."

Note the low threshold for "related" in paragraphs (h) and (i) above.

The Agency's inclination is to accept the transaction value for sales between related persons and believes, it is easier, in most cases, to demonstrate that the relationship did not influence the import price than to demonstrate that the import price closely approximates one of the test values. See the Agency's **Memorandum D13-4-5, "Transaction Value Method for Related Persons"** (April 9, 2001).

Memorandum D13-4-5 gives examples of how related parties may demonstrate that their relationship does not influence the import price. Benchmarking against sales to unrelated purchasers under basically the same conditions or different conditions (where appropriate adjustments are made) is appropriate to demonstrate that the import price was uninfluenced. Evidence of genuine bargaining, including the ability of the purchaser to freely acquire the same products from independent suppliers, is another way to demonstrate that the relationship did not influence the import price.

The Interpretative Notes in the Customs Valuation Code give further examples:

> "(I)f the price had been settled in a manner consistent with the normal pricing practices of the industry in question or with the way the seller settles prices for sales to buyers who are not related to the seller, this would demonstrate that the price had not been influenced by the relationship. As a further example, where it is shown that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time in sales of goods of the same class or kind, this would demonstrate that the price had not been influenced."

As an alternative to demonstrating that the relationship between the related supplier and purchaser did not influence the import price, the importer needs to show that the import price closely approximates one of the test values. Where identical or similar goods are exported at the same or substantially the same time as the imported goods, then any one of the following values used to determine the VFD of those identical or similar goods may be used as the test value:

"(a) the transaction value of identical goods or similar goods in a sale of those goods for export to Canada between a vendor and purchaser who are not related to each other at the time of the sale;

(b) the deductive value of identical goods or similar goods; or

(c) the computed value of identical goods or similar goods."

(Section 48(3) of the *Customs Act*).

4. Sale of Goods

Transaction value applies to a sale of goods for export to Canada. In *Brunswick International Canada Limited v. The Deputy Minister of National Revenue,*[8] the Tribunal found that, based on its review of the relevant jurisprudence, the following three elements characterize a sale transaction:

"(a) there must be two parties, standing in relation of buyer and seller to one another;
(b) both parties must agree to the same proposition; and
(c) there must be a passage of title and consideration."

Where a foreign branch of a corporation transfers goods to its Canadian branch, no sale can occur between them. A corporation (or any other type of entity or person) cannot sell goods to itself.[9] The central issue in *Brunswick International*, which we will explore later in this paper, was whether Brunswick International Canada Limited actually purchased the goods from a foreign affiliate or only acted as legal selling agent on behalf of the foreign affiliate.

5. Sale of Goods "for Export to Canada"

In the *Mattel Canada* case, Mattel Canada acquired the goods imported into Canada through a three-tier distribution system:

- A Hong Kong manufacturer, related or unrelated to Mattel Canada, sold to an intermediary Mattel company in Hong Kong.

[8] [2000] 4507 ETC (CITT) ("*Brunswick International*").

[9] See *Tootsie Roll of Canada Ltd.* v *The Deputy Minister of National Revenue,* [1997] 4627 ETC (CITT*); Armstrong Brothers Tool Co*. v *The Deputy Minister of National Revenue,* [1997] 4603 ETC (CITT), leave to appeal to the FCA denied in an unreported decision; and the Agency's Memorandum D13-4-2, "*Sold for Export to Canada"* (May 14, 2001).

- The intermediary sold to Mattel Inc. in the United States ("US").

- Mattel Inc. sold to Mattel Canada in Canada.

Each sale occurred at a progressively higher price. Before Mattel Canada took legal title to the imported goods, the intermediary company and Mattel Inc. took legal title. Mattel Canada held legal title when it imported the goods into Canada.

Mattel Canada argued that "the sale between the manufacturer and intermediary constituted a sale for export to Canada". That sale price, Mattel Canada argued, should be the relevant one in determining the transaction value.

The Supreme Court ruled against Mattel Canada.[10] The court expressed concern that importers would establish multi-tiered arrangements for the purpose of establishing a sale at the first trade level in the chain as the "sale for export to Canada", thereby enabling the importer to use a lower sale price in calculating the transaction value. To address that concern, the Supreme Court established the legal principle that "the relevant sale for export is the sale by which title to the goods passes to the importer". The Supreme Court found that the sale from Mattel Inc. to Mattel Canada constituted "the sale for export to Canada", and that sale price should form the basis of the transaction value.

The Agency's policies found in **Memorandum D13-4-2 "Sold for Export to Canada"** (May 14, 2001) pre-date the *Mattel Canada* Supreme Court decision (June 7, 2001).

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[10] *Deputy Minister of National Revenue v. Mattel Canada Inc.*, 2001 SCC 36.

The *Mattel Canada* case involved import transactions that occurred before the "purchaser in Canada" amendments took effect.

6. Sale of Goods for Export to Canada "to a Purchaser in Canada"

Since September 17, 1997, the *Customs Act* has required that a sale for export to Canada be "to a purchaser in Canada".[11] The *Valuation for Duty Regulations* under the *Customs Act* define a "purchaser in Canada" to be:

- a person who qualifies as a resident in Canada, which, in the case of a corporation, means a corporation carrying on business in Canada and having central management and control in Canada;
- a non-resident person who has a permanent establishment in Canada;
- a non-resident person who imports goods into Canada for its own consumption, use, or enjoyment in Canada, but not for sale; and
- a non-resident person who imports goods into Canada for sale in Canada and who has not entered into an agreement to sell the goods to a Canadian resident before purchasing the goods.[12]

Those amendments to the *Customs Act* and the *Valuation for Duty Regulations* intended to address the same concern that the Supreme Court addressed in *Mattel Canada* - that importers would establish multi-tiered arrangements to use the sale at the first trade level in the

[11] Section 48(1) of the *Customs Act*.

[12] *Valuation for Duty Regulations*, SOR/86-792, as amended by SOR/97-443, section 2, effective September 17, 1997, and currently found in sections 2 and 2.1 of the *Valuation for Duty Regulations*.

chain as the “sale for export to Canada”, thereby “artificially” lowering the sale price used in determining the transaction value.

The Canadian government introduced these amendments to specifically respond to the decisions of the Tribunal and the Federal Court in *Harbour Sales (Windsor)* v *The Deputy Minister of National Revenue.*[13] In that case, both the Tribunal and the Federal Court looked to the sale at the first trade level in the chain as the “sale for export to Canada”. Harbour Sales (Windsor) Limited (“HSW”) purchased tiles and park benches from Taiwan manufacturers and imported the products into Canada. Although incorporated in Ontario, HSW had a very limited business operation or presence in Canada. Harbour Sales Company (“HSCUS”) provided the necessary administrative support for HSW’s activities in Troy, Michigan. A Canadian customer would place an order with HSW through HSCUS in Michigan who, in turn, would immediately thereafter place an order with a manufacturer in Taiwan for shipment directly from Taiwan to Canada on a through bill of lading.

HSW asserted that the sale from the Taiwan manufacturers to HSW was the “sale for export to Canada”. In accordance with its longstanding administrative policy, as set out in its **Memorandum D13-4-2 “Sold for Export to Canada”** (August 21, 1989),[14] the Agency argued that the sale from HSW to the Canadian customer was the relevant sale for export as the first sale, the one that sets off the chain of events leading to the export of the product to Canada. The Agency specifically argued that the sale for export must be “to a purchaser in Canada”. In its view, HSW had insufficient presence in Canada to be considered a purchaser resident in Canada.

[13] Appeal No. AP-93-322, (November 4, 1994, CITT). The Deputy Minister’s request for leave to appeal to the Federal Court Trial Division subsequently denied in *The Deputy Minister of National Revenue* v *Harbour Sales (Windsor) Inc.,* [1995] 2824 ETC. (“*Harbour Sales*”).

[14] Subsequently amended May 14, 2001 to its current version.

Both the Tribunal and Federal Court rejected this assertion, finding nothing in the law to support the view that a "sale for export to Canada" must be "to a purchaser in Canada". The Tribunal found a number of factors to indicate that the sales from the Taiwan manufacturers to HSW constituted the relevant sales for export to Canada. The bills of lading, manufacturers' invoices and Canada Customs documentation confirmed the direct shipment and export of the goods from Taiwan to Canada. HSW took legal title to the goods in Taiwan and assumed the risk for the goods, if lost or damaged while in transit during their direct shipment from Taiwan to Canada. HSW imported the goods into Canada and then transferred legal title to the imported goods in Canada to HSW's customers.

The Customs Valuation Code sets out the basic principles by which World Trade Organization ("WTO") members must determine customs valuation. The Custom Valuation Code says nothing about the "sale for export" having to be to a particular person. Under Article 19 of the Customs Valuation Code, a WTO member could challenge through the WTO's Dispute Settlement Mechanism the "purchaser in Canada" requirement in Canadian domestic law as a violation of Canada's international treaty obligations under the Customs Valuation Code. The US and Mexico might also challenge the legality of the "purchaser in Canada" requirement under Section B of Chapter 20 of the *North American Free Trade Agreement* (NAFTA). Indeed, the US has accepted the sale at the first trade level, the one with the lowest sale price, as the relevant sale for export to the US.[15]

What happens when a non-resident company ("non-resident seller" or "exporter") uses a related company ("distributor") to sell products into the Canadian market to an arm's length Canadian purchaser? A number of Tribunal decisions have focused on whether the Canadian customers purchase the products:

- directly from the exporter, or
- from the distributor, who has purchased them from the exporter.

In other words, does the distributor act as the legal selling agent on behalf of the non-resident seller, or as the purchaser and reseller of the imported goods? The Agency has argued in favour of the former relationship, assessing Canadian customs duties based on the purported "sale price" between the non-resident seller and the Canadian customer. The distributor has argued that the sale for export occurs between the non-resident seller as exporter and the distributor as importer, in which case the lower sale price between non-resident seller and distributor should form the basis of the transaction value.

Recent Tribunal decisions have been inconsistent. *Jewelway International Canada Inc. et al* v *Deputy Minister of National Revenue*[16] and *Patagonia International Inc.* v *Deputy Minister of National Revenue*[17] found a principal-agency relationship existed. In *Moda Imports Inc.* v *Deputy Minister of National Revenue*[18] and *Brunswick International,* the Tribunal ruled in favour of the distributor (the importer), finding that a vendor-purchaser relationship existed.

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[15] See for example *E.C. McAfee Co.* v *United States*, 842 F.2d 314 (1988) (US Court of Appeals, Federal Circuit) and *Nissho Iwai American Corp. v United States*, 982 F.2d 505 (1992) (US Court of Appeals, Federal Circuit).

[16] [1996] 4521 ETC (CITT).

[17] [2000] 4601 ETC (CITT).

[18] [1997] 4617 ETC (CITT).

The first Tribunal case to consider this issue in the context of the "purchaser in Canada" amendments was *Brunswick International.* That case concerned whether the transaction value of certain bowling equipment should be based on:

(i) the sale price at which Brunswick Bowling & Billiards Corporation ("BB&B"), a Delaware corporation located in Muskegon, Michigan and Bristol, Wisconsin allegedly sold goods to Brunswick International (Canada) Limited ("BIC"), as declared by BIC, or

(ii) the price at which BB&B allegedly sold goods to the Canadian end user, as claimed by the Agency.

BB&B either sourced products by manufacturing them or by purchasing them from other vendors. The majority decision (2 to 1) confirmed (i) above, with one member offering a vigorous dissent.

The majority did not consider the issue of whether BIC had central management and control in Canada and thus was "resident" in Canada under the *Valuation for Duty Regulations*. They found it unnecessary to consider the central control and management[19] issue because BIC had a permanent establishment in Canada. Section 2 of the *Valuation for Duty Regulations* defines a "permanent establishment" of a person as a fixed place of business of the person, including a place of management, a branch, an office, a factory or a workshop, through

[19] In the leading case in *DeBeers Consolidated Mines Ltd. v Howe* [1906] A.C. 455, the House of Lords determined that ". . . a company resides . . . where its real business is carried on . . . and the real business is carried on where the central management and control actually abides." Both the English and Canadian courts have subsequently adopted the "central control and management" test confirmed in *DeBeers Consolidated Mines.* Generally speaking, a company exercises the central control and management where the directors hold their meetings. A corporation could reside other than where its board of directors meet if, in fact, the shareholders maintain central control and management over the affairs of the corporation in a different jurisdiction. See *Unit Construction Co. Ltd. v Bullock,* [1960] A.C. 351 (House of Lords).

which the person carries on business. The Tribunal found that BIC had a number of fixed places of business in Canada including its warehouse, main sales office in Mississauga and three other sales locations throughout Canada. The Tribunal also found that BIC carried on business in Canada from those locations.

In its **Memorandum D13-1-3, "Purchaser in Canada Regulations"** (April 9, 2001), paragraphs 10 to 13, the Agency has outlined a number of the factors that the Agency would consider relevant in determining whether a purchaser carries on business in Canada. The Tribunal relied on a number of these factors in reaching its decision. With all due respect to the Agency and the Tribunal, with the benefit over 100 years of judicial experience in interpreting the meaning of "carrying on business within a jurisdiction", they should have looked to general legal principles established in those cases for determining whether a person "carries on business in Canada". As we will later see when discussing royalties, the Supreme Court in *Mattel Canada* made it clear that legal terms should be defined, to the extent possible, in accordance with their established meaning in jurisprudence (cases) and commercial law.

The majority decision found that BIC was not acting as the legal agent of BB&B, but, in fact, purchased the bowling capital equipment from BB&B, and then resold the equipment to the Canadian customers. The majority relied primarily on the following factors in reaching this conclusion:

(i) BIC's employees solicit sales from Canadian customers, negotiate the terms of the contract (including product mix and price) and engage in ongoing consultations with the customer throughout the delivery and installation process,

(ii) the invoice to the Canadian end user customer is in BIC's name, and BIC receives all payments from the Canadian customer,

(iii) BIC takes legal title to the goods upon shipment and bears the risk of non-payment by the Canadian customer,

(iv) the Canadian customer deals with BIC in respect of warranty claims, and

(v) BIC is not accountable to BB&B for profits earned on BIC's sales.

Although the majority of the Tribunal found certain other factors which could point to an agency arrangement, on balance they found that no agency relationship existed. Among these other factors noted, one contract appeared to be between BB&B and the customer, contracts between BIC and its Canadian customers made reference to BB&B's facilities and in one case, BB&B issued a letter of purchase acceptance to a Canadian customer. The majority acknowledged "mistakes" in the documentation, but attributed them to carelessness. On balance, despite the sloppiness in the documentation, a reasonable argument could be made that the documentation, consistent with their accounting for the transactions, pointed to a seller-purchaser relationship.

Based on the evidence as presented, the minority opinion offered a strong dissent as to the nature of the relationship between BB&B and BIC. The dissent asserted that the following factors strongly indicated evidence of an agency relationship:

(i) Where the Canadian customer uses an 800 number to order small bowling goods directly from BB&B, BB&B issues an invoice in BIC's name to the Canadian customer even though BIC has had no contact with the Canadian customer.

(ii) All sales contracts with Canadian customers indicate the address of BB&B to make payment. In practice, Canadian customers may have directed payment to BIC's lock box and bank account, to which BB&B's employees, but not BIC's employees, had access.

(iii) Although invoices indicated that BIC took legal title to the goods in Michigan, sales contract clauses indicated otherwise.

(iv) BIC did not assume much, if any, risk concerning the sales of the goods. BIC's sales contracts were subject to approval by BB&B. BIC maintained no inventory. BIC did not place orders for goods until BIC had a purchaser for the goods and usually did not pay BB&B for the goods until the Canadian customer paid. If a prior credit check of the Canadian customer is not properly carried out by BB&B, then BB&B assumes the risk of the Canadian customer defaulting on payment. As evidence of this fact, BB&B assumed the credit risk for an unpaid liability by a Canadian customer in the only circumstance on record in which the Canadian customer defaulted on payment for a shipment of capital bowling equipment. Brunswick Corporation, a parent corporation of both BB&B and BIC, insured the goods in transit and was the person to whom the insurance company would make out a cheque in case of loss.

(v) BIC's profitability was determined by the transfer price handed down by corporate headquarters.

(vi) BB&B controlled the sale contract form with the Canadian customer. BB&B controlled the technical aspects of the sales orders, such as ensuring the customer has ordered the right products.

(vii) Although BIC signs the written customer contract, the contract states in effect that it does not become binding until approved by BB&B.

Given the strong difference of opinion and different twist on the facts between the majority and minority decisions in *Brunswick International*, we should examine both the majority and minority opinions carefully to weigh their relative merits. As a starting point, let's first consider the legal definition of "agency":

Over hundreds of years, common law jurisprudence has considered the meaning of agency. Black's Law Dictionary defines "agency" as:

> A relationship between two persons, by agreement or otherwise, where one (the agent) may act on behalf of the other (the principal) and bind the principal by words and actions…
>
> Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.

Black's Law Dictionary defines "agent" as:

> A person authorized by another (principal) to act for or in the place of him. One entrusted with another's business. *Humphries* v. *Going*, D.C.N.C. 59 F.R.D. 583, 587. One who represents and acts for another under the contract or relation of agency….

As the Tribunal noted, the Supreme Court has defined agency as:

> the relationship that exists between two persons when one, called the *agent*, is considered in law to represent the other, called the *principal*, in such a way as to be able to affect the principal's legal position in respect of strangers to the relationship by the making of contracts or the disposition of property. [Emphasis in original.][20]

A principal must authorize an agent to act on its behalf. The authorization may be either expressed or implied. A written agreement between the principal and agent may indicate the authorization of the principal and the consent of the principal and agent to act together in an agency relationship. The agreement would provide evidence of an agency relationship.

Despite the fact that no written agency agreement existed between BB&B and BIC, reasonable arguments could be made that a legal agency relationship existed. A legal agent may affect the legal position of the principal by binding the principal to certain legal obligations. The most typical example is where an agent enters into contracts with third parties on behalf of its principal. Arguably, BIC entered into sales contracts on behalf of, or negotiated sales terms for approval by, BB&B. This fundamental pillar and foundation of an agency relationship could, on a reasonable view of the facts, be said to have existed.

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[20] *R. v Kelly*, [1992] 2 S.C.R. 170, citing with approval G.H.L. Fridman, *The Law of Agency*, 5th ed. (London: Butterworths, 1983) at 9.

One key indicator of an agency relationship is that the principal assumes the risk for the transactions entered into by the agent. The agent does not accept any responsibility from any loss arising from a transaction with a third party.[21]

On this point, the case for agency in *Brunswick International* appears somewhat unclear. The dissenting member found that BIC did not assume much, if any, risk, citing a number of factors in this regard:

(i) BIC maintained no inventory;

(ii) BIC did not place orders for goods until BIC had a purchaser for the goods and usually did not pay BB&B for the goods until the Canadian customer paid;

(iii) BB&B assumed credit risk for customers; and

(iv) Brunswick Corporation, a parent corporation of both BB&B and BIC, insured the goods in transit and was the person to whom the insurance company would make out a cheque in case of loss.

In regard to the first two factors, the majority, rightly in our view, downplayed the importance of these two factors. The majority states: "In the circumstances, where bowling capital equipment is custom ordered and too large to inventory, the Tribunal does not find that this practice supports a finding that (BIC) is the agent of BB&B". To define their relationship, the Tribunal looked beyond the surface to the business reality of the situation. In the real world, it is not uncommon for exporters to drop-ship directly to distributors' customers. Good business reasons may exist for doing so, not the least of which involves the distributor saving on shipping and handling costs and the expenses of having a warehouse facility and personnel to maintain the

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[21] *Parkland Crane Services Ltd. v Canada*, [1994] G.S.T.C. 58 (TCC), *Glengarry Bingo Association v Canada* [1995] G.S.T.C. 41 (TCC); rev'd [1999] G.S.T.C. 15 (FCA); leave to appeal denied [2000] G.S.T.C. 9 (SCC).

inventory. The drop-shipment arrangement may very well best respond to customer demands for quick turn around of shipments to satisfy their orders.

Too often, in our view, without any further analysis, the Agency takes the easy route and concludes that an agency relationship exists based solely on the facts that the exporter drop-ships directly to Canadian customers and the distributor does not maintain a warehouse with inventory. The Agency often assumes that the direct physical shipment of goods from the exporter to the distributor's Canadian customer means that there is a sale from the exporter to the distributor's Canadian customer. The terms of the relationship between the exporter and distributor may have nothing to do with legal agency, but everything to do with the business reality between vendor and purchaser. Two parties, dealing with each other at arm's length, could very well operate in this manner while maintaining a *bona fide* vendor-purchaser relationship.

The last two factors cited in the dissent do, however, tend to undermine, and cause concern as to the existence of, an agency relationship. As the purchaser, BIC should generally have the credit risk in all circumstances. This factor is somewhat mitigated by the fact that BB&B takes responsibility for doing the credit check and only assumes the credit risk when it does not do a proper credit check. As the owner of the goods and importer of them into Canada, BIC should have the risk of loss for the goods while in transit into Canada. Brunswick Corporation, the parent corporation of both BB&B and BIC, insured the goods and was the loss payee. BIC could argue that Brunswick Corporation insured the goods on behalf of BIC. Together with the so-called "sloppy" documentation, BIC's weak evidence as to its risk for the goods, or at least the inherent ambiguity in such evidence, presented serious impediments for BIC to overcome in building its case in support of the vendor-purchaser relationship.

Finally, the principal must exercise a greater degree of control over an agent's action than a person would exercise over an ordinary independent contractor. BB&B appeared to exercise substantial control over BIC. BB&B controlled the form of sales contract with the Canadian customer, controlled technical aspects of the sales orders, performed credit checks on the customers and approved sales. BB&B appeared to exercise substantial control over BIC's actions in relation to the sales to the Canadian customer.

While the issue of an agency-principal relationship versus a vendor-purchaser relationship in *Brunswick International* was murky, at best, from the importer's perspective, exporters and importers can draw very clear lessons from this case study. Care and planning is required to properly give effect to a seller-purchaser relationship. The parties should properly account in their books and records for the transactions between them as sales and purchases. Sales invoices, purchase orders and sales agreements should all be consistent with, and substantiate, the vendor-purchaser relationship. The distributor's sales to third parties should be accounted for as sales. A written and signed agreement between the exporter and the distributor/importer should evidence the vendor-purchaser relationship. The distributor should have the authority to negotiate sales terms and enter into sales contracts in its own right, with freedom of interference from the exporter, and habitually do so. Even in the absence of a written agency agreement, the Tribunal or court will consider whether an agency relationship exists. In determining the nature of this relationship, the Tribunal or court will, as it deems appropriate in the circumstances, examine the relevant factors and attach the appropriate weight to each factor. Where an exporter and distributor wish to enter into a vendor-purchaser relationship, all doubts about the nature of the relationship should be removed by dotting all the "i's" and crossing all the "t's".

To our knowledge, the courts have yet to judicially review a Tribunal decision turning on the relationship of principal-agent versus seller-purchaser as between the exporter and the distributor. In light of *Mattel Canada*, the courts would not hesitate to weigh into the debate and, in the appropriate circumstances, substitute their judgement for that of the Tribunal. We will discuss later the *Utex Corporation* case where the Federal Court of Appeal had no hesitancy in finding that the Tribunal erred in law in its decision concerning buying agency. The Tribunal has no special expertise in agency and sale of goods law. Quite the opposite, it is the courts who do have the expertise in dealing with these fundamental legal principles in commercial law. It is certainly axiomatic to say that each case turns on its own particular facts and circumstances. Nonetheless, the courts may have an opportunity to provide clearer guidance as to the appropriate factors, and the appropriate weight to attach to each, in ascertaining the nature of the relationship between the exporter and distributor.

What would happen if the *Harbour Sales* were decided today by the Tribunal? Given its limited presence in Canada, HSC may very well not have residence in Canada, and as a non-resident of Canada, have no permanent establishment in Canada, for Canadian customs purposes. Assuming that HSC has no central management and control (residence) in Canada and no permanent establishment in Canada for Canadian customs purposes, then HSC would not qualify as a "purchaser in Canada". HSC would not otherwise qualify as a non-resident "purchaser in Canada". HSC pre-sold the goods to Canadian customers before entering into its agreement to purchase the goods from the Taiwan manufacturers.

The "purchaser in Canada" amendments, read in conjunction with the definition of "sale of export" in the *Mattel Canada* Supreme Court decision, pose serious concerns and risks for exporters and distributors/importers. As previously noted above, the Supreme Court in

Mattel Canada has defined "the relevant sale for export" as "the sale by which title to the goods passes to the importer". This definition of "sale for export" proves problematic in the *Harbour Sales* scenario. HSC cannot use the transaction value for the "sale for export" from the Taiwan manufacturer to HSC, because HSC is not a "purchaser in Canada". By the same token, HSC, as importer, cannot use the sale from HSC to the Canadian customer to determine the transaction value because, although the customer could qualify as a "purchaser in Canada", the customer is not a "purchaser in Canada" in "the sale for export to Canada". The net result is that HSC cannot use the transaction value method to determine the VFD.

This result runs contrary to the very principles on which the Customs Valuation Code are founded. In the very first sentence of Section 1 in the General Introductory Commentary of the Customs Valuation Code, it is unequivocally asserted:

> The primary basis for customs value under this Agreement is "transaction value" as defined in Article 1.

The recitals in the Customs Valuation Code set out its purposes and objectives including:

> *Recognizing* that the basis for valuation of goods for customs purposes should, to the greatest extent possible, be the transaction value of the goods being valued.

Section 47(1) of the *Customs Act* affirms this basic principle – that transaction value should be the primary basis for determining the VFD. The anomaly of the "purchaser in Canada" requirement leads to an absurd result; the distributor/importer has to resort to an alternative valuation method to the transaction value even though it acquires the goods in a "sale for export to Canada".

One way around this problem could be to ensure that the distributor has sufficient presence in Canada, either through the residence test or a permanent establishment in Canada, to qualify as a "purchaser in Canada". Of course, the benefits of this structure from a customs valuation perspective may be outweighed by the costs of establishing and maintaining the structure and exposure to Canadian income tax. Even if this structure is feasible, the Canadian distributor should go to great lengths to support the vendor-purchaser relationship between the exporter and distributor and avoid the characterization of principal-agent, especially where goods are drop-shipped directly by the exporter to the Canadian customer. Another way around the "purchaser in Canada" impediment is for the distributor to enter into agreements to sell the goods to Canadian customers only after having purchased the goods from the exporter, but the distributor may want to avoid the commercial risk associated with such an arrangement.

7. Adjustments to the Import Price

In determining the transaction value, certain adjustments are made to the import price. These adjustments are set out in section 48(5) of the *Customs Act.* To the extent not already included in the import price, certain amounts are added to the import price (section 48(5)(a)). To the extent not already excluded from the import price, certain amounts are deducted from the import price (section 48(5)(b)). We will discuss a few of the adjustments set out in section 48(5)(a), those which in recent years have given rise to substantial litigation.

(a) Royalties and Subsequent Proceeds

Importers make payments of royalties and licence fees for the rights to distribute products with valuable trademarks, such as NIKE and Chaps Ralph Lauren, or to use certain copyrights, patents or other intellectual property rights in respect of their imported goods.

Throughout the 1980's and 1990's, the Agency became very aggressive in including these royalties in the transaction value, or VFD of the imported products to which the royalties related. The Agency would then, of course, assess duties on those royalties at the duty rates for the imported products. In the case in particularly of imported footwear, apparel and textile products, the duty rates and duties can be quite substantial. Duties are borne as direct costs of doing business and either have to be absorbed as costs by importers or passed on to their customers through higher sale prices.

So importers took issue with the Agency's broad application of assessing duties on royalties and contested those assessments, ultimately resulting in substantial litigation. In the landmark decision in *Mattel Canada*, released on June 7, 2001, the Supreme Court of Canada found that certain royalties were non-dutiable as they were not paid as a condition of the sale of the goods for export to Canada. It was a unanimous decision made by all 9 members of the highest court in Canada and a resounding defeat for the Agency. The Supreme Court severely restricted the circumstances in which royalties became dutiable. Royalties should only be dutiable where the sale contract for the exported goods allows the vendor to terminate the sale contract if the royalties are unpaid. Moreover, the Supreme Court slammed the door on the Agency trying to impose duties on royalties through the back door. The Supreme Court would not allow the Agency to impose duties on royalties through an alternative provision in the *Customs Act*, one which imposes duties on subsequent proceeds.

Royalties and Subsequent Proceeds Considered in *Mattel Canada*

Under section 48(5)(a)(iv) of the *Customs Act*, an importer must add "royalties and licence fees" to the import price where they are paid or payable "in respect of the goods" as a "condition of sale" of the goods for export to Canada. This provision specifically includes "payments for patents, trademarks and copyrights" and excludes "charges for the right to reproduce the goods in Canada."

In the *Mattel Canada* case, the importer, Mattel Canada, paid licence fees (the "direct royalty payments") to an unrelated third party for the right to manufacture, import, distribute, and sell in Canada products based on certain trademarks or licensed materials. The direct royalty payments were equal to a percentage of Mattel Canada's net invoiced billings for goods sold to Canadian customers. In addition, Mattel Canada periodically reimbursed its indirect US parent, Mattel Inc., for licence payments (the "indirect royalty payments") that Mattel Inc. made to various licensors (the "master licensors"). The master licensors granted Mattel Inc. and, ultimately, Mattel Canada certain licence rights in respect of various goods manufactured in Hong Kong.

Tribunal Decision

At the Tribunal level, it was held that Mattel Canada did not make the direct royalty payments "as a condition of the sale of goods for export to Canada" on the basis that there was not a sufficient nexus between the payments and the sales for export. The direct royalty payments were, therefore, non-dutiable. Specifically, the Tribunal concluded that

> the payments were more closely related to rights, in respect of the goods, exercised in Canada and quantified in reference to resales in Canada and other factors that bore little or no connection to the sales for export. Furthermore, the evidence was to the effect that some goods were purchased and imported into Canada without the appellant ever making a royalty payment in respect of the goods.[22]

The Tribunal also relied on a "control" test in reaching its decision, stating that

> the appellant was making payments to a third-party licensor, which was unrelated to the vendor of the goods. The evidence did not support a finding that the licensor actually exerted control or influence over the sales for export through ownership, contract or otherwise to the extent that sales were made conditional on royalty payments.[23]

For essentially the same reasons, the Tribunal reached a similar conclusion about the indirect royalty payments.

The Tribunal also considered whether section 48(5)(a)(v) of the *Customs Act* would capture the indirect royalty payments in the VFD. That provision requires an adjustment to the import price under the transaction value method for "the value of any part of proceeds of any subsequent resale, disposal or use of the goods by the purchaser thereof that accrues or is to accrue, directly or indirectly, to the vendor." The Tribunal found that Mattel Inc. did not receive "the economic benefit or value of the indirect royalty payments passed through Mattel [Inc.] and accrued to the master licensors."[24] Accordingly, these payments could not be added to the VFD.

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[22] *Mattel Canada v. D/MNR,* [1997] ETC 4506, at paragraph 30 (CITT).

[23] *Ibid*., at paragraph 31.

[24] *Ibid*., at paragraph 34.

Federal Court of Appeal Decision

The Federal Court of Appeal agreed with the Tribunal on the issue of the direct royalty payments and found them non-dutiable. In coming to this conclusion, the court relied on the "control" test. Under the control test, the licensor must have the ability to impede the goods' importation if the importer fails to pay the royalties. According to the court, if Mattel Canada failed to make the direct royalty payments, the licensor could not impede the goods' importation but could only terminate the licence agreement. The court found that the control exercised by the licensor was "not associated with an importation of the goods to Canada, but rather with their subsequent sale in Canada."[25]

The court, however, came to a quite different conclusion with respect to the indirect royalty payments. Overturning the Tribunal's decision on the indirect royalty payments, the court found that these payments were subsequent proceeds accruing for Mattel Inc.'s benefit and were therefore caught by section 48(5)(a)(v) of the *Customs Act*. The court observed, "Were it not for the reimbursement of such fees by the respondent [Mattel Canada], the income or assets of Mattel Inc. would necessarily have been reduced by that amount."[26]

Supreme Court Decision

Ultimately, the Supreme Court found in favour of Mattel Canada on both issues. Significantly, the court rejected both the sufficient nexus and control tests and applied a third test. The court found that the phrase "condition of the sale of goods" must be interpreted in accordance with its settled legal meaning under common law and relevant sale of goods

[25] [1999] 2817 ETC, at paragraphs 30 and 31 (FCA).

legislation. Explaining its use of this test, the court emphasized its desire to clarify the law by relying on time-honoured legal principles. The court noted:

> Rather than create a complex series of tests not strictly based on the settled legal meaning of words, it is preferable to rely on common law and sale of goods law to determine whether royalties and licence fees are paid "as a condition of sale of the goods for export to Canada" in accordance with s. 48(5)(a)(iv) of the Customs Act. The Court of Appeal erred when it concluded that "the word 'condition' is not used in the Act as a term of art which carries the meaning generally ascribed to it in the law of sales."[27]

The Supreme Court explains the well-established meaning of "condition of sale" and its application to the direct royalty payments:

> The royalties in the present appeal were not paid as a condition of sale. If Mattel Canada refused to pay royalties to Licensor X, Mattel U.S. could not refuse to sell the licensed goods to Mattel Canada or repudiate the contract of sale. The sale contract and the royalties were separate agreements between different parties. In fact, the CITT's decision notes that "some goods were purchased and imported into Canada without [Mattel Canada] ever making a royalty payment in respect of the goods."[28]

In the court's view, the control test was too broad because it captured virtually all royalties and licence fees, owing to the remedies that the *Trademarks Act* affords to trademark owners. Under that Act, a registered trademark owner may obtain an order directing the minister to take reasonable measures to detain trademarked goods where the court is satisfied that the goods are about to be imported into Canada and that the distribution of the goods in Canada

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[26] *Ibid*., at paragraph 39.

[27] *Supra* at 10 at paragraph 59. This finding is consistent with the Supreme Court's decision in *Will-Kare Paving & Contracting Limited*, 2000 D.T.C. 6467, which also looked to the common law and sale of goods legislation to determine the meaning of "sale of goods" as found in the Canadian *Income Tax Act*.

[28] *Supra* at 10, at paragraph 62.

would be contrary to the *Trademarks Act*. According to the court, interpreting the phrase "condition of sale" by applying the control test would render the phrase "condition of sale" virtually meaningless.[29]

In allowing Mattel Canada's appeal in respect of the indirect royalty payments, the court found that since those payments were not paid as "a condition of sale" and did not come within the royalty provision in section 48(5)(a)(iv) of the *Customs Act*, it was not necessary to consider the subsequent proceeds provision in section 48(5)(a)(v) of that Act. To do otherwise would render the limiting language in section 48(5)(a)(iv) meaningless.

The Supreme Court's ruling on the indirect royalty payments directly contradicts the Court of Appeal's judgment on the issue. The latter court had found that since the indirect royalty payments fit within the scope of section 48(5)(a)(v) as subsequent proceeds, it was not necessary to consider the royalty provision in section 48(5)(a)(iv).

In *Mattel Canada*, the Supreme Court decided to apply the most exacting standard of judicial review of a Tribunal decision, "legal correctness". The issues in *Mattel Canada* did not require any special expertise in international economic relations and international trade relations, matters with which the Tribunal had special expertise. Rather, the *Mattel Canada* case involved "pure questions of law that require the application of principles of statutory interpretation and other concepts which are intrinsic to commercial law." These issues are traditionally the province of the courts, and the Tribunal did not have any particular expertise related to these issues. Accordingly, there was nothing to suggest that the court should defer to the Tribunal's decision in these matters.

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[29] *Ibid*., at paragraphs 60 and 61.

In *Mattel Canada*, the Supreme Court found that certain royalties and licence fees were non-dutiable as they were not paid as a condition of the sale of the goods for export to Canada. The *Mattel Canada* decision did not deal with a situation where the vendor and licensor were one and the same person or related to each other.

In *Customs Notice* no. 390, "Impact of Supreme Court Decision in Mattel Canada," released by the Agency on July 10, 2001, the Agency indicates that it may try to do an end-run around the *Mattel Canada* decision where the foreign vendor and the licensor are one and the same person (or are related to each other). According to the customs notice, the royalties or licence fees would be considered part of the import price, as defined in section 45(1) of the *Customs Act*, before any adjustments for royalties or other items set out in section 48(5). In our view, another provision, section 48(1), which details certain conditions for the transaction value to apply, suggests otherwise. It specifically refers to the import price as "the price paid or payable for the *goods* [emphasis added]."

Royalties Considered in Federal Court of Appeal Decision in *Reebok Canada*

On April 10, 2002, the Federal Court of Appeal faced this issue in *Reebok Canada, a division of Avrecan International Inc. and The Deputy Minister of National Revenue for Customs and Excise*.[30] The Federal Court of Appeal wasted little time dispensing with the case, hearing the arguments and delivering judgement from the Bench that day.

Reebok Canada appealed from decisions of the Tribunal and Federal Court, Trial Division, which both upheld the inclusion of royalty payments in the VFD of certain imported

[30] 2002 FCA 133.

goods and the assessment of duties on those royalties. The Federal Court of Appeal allowed Reebok Canada's appeal, overturning the assessments.

The case involved a situation where the vendor/exporter and licensor were one and the same person. The sale contract for the goods between the vendor/exporter and the purchaser/importer was a purchase order. Another agreement existed between the same vendor and purchaser for the payment of royalties in respect of the goods. Neither agreement made any express reference to the other. As a practical matter or as a matter of economic reality, the Federal Court of Appeal agreed that "the vendor in the present case would probably refuse to sell to the purchaser if the purchaser was not making royalty payments." The Federal Court of Appeal, however, found that the payments were not made as a legal condition of sale.

In *Mattel Canada*, the Supreme Court laid out the legal test for condition of sale in accordance with sale of goods law. Royalties would be payable as a condition of sale if the vendor would be entitled to refuse to sell to the purchaser if the royalties were not paid. The test "implies a prior obligation" (of the vendor to sell goods) "from which the vendor is entitled to be relieved." In the *Reebok Canada* case, each purchase order constituted a new sale contract. There was "no continuing obligation to sell to the purchaser". Each sale contract stood alone as an independent obligation. The sale agreements (purchase orders) did not contain any express condition of sale to the effect that the vendor could refuse to sell the goods subject to the purchase order if the royalties were unpaid. The payments of the royalties could only be conditions of sale for existing sale agreements and there were no agreements in place for future sales of goods between the vendor and purchaser.

We understand that the Deputy Minister of National Revenue has not appealed the *Reebok Canada* decision to the Supreme Court and that the deadline for filing such an appeal has passed.

It will be interesting to see how the Agency responds to *Reebok Canada* in future situations where the vendor and licensor are one and the same person or are related to each other. The Agency might try to limit *Reebok Canada* to its own particular facts. In particular, where the sale contract imposes on the purchaser/importer a continuing obligation to purchase from the seller/exporter, the Agency might read into the sale contract a requirement to pay royalties as an implied condition of sale. Where the vendor/exporter is also the licensor or is related to the licensor, the vendor/exporter and purchaser/importer would be wise, subject to competing business or legal considerations, to use one-off purchase orders as sales contracts with no express reference to the royalty payments made under a separate agreement. In fact, the purchase order/sales contract and royalty agreement should not cross-reference each other at all. Another planning point would be to make clear that goods could be purchased and imported into Canada without ever making a royalty payment in respect of the goods.

We note that Customs notice no. 390 pre-dates the *Reebok Canada* Federal Court of Appeal decision and that the Agency's **Memorandum D13-4-9 "Royalties and Licence Fees"** (March 28, 2001) pre-dates both the *Mattel Canada* Supreme Court decision and the *Reebok Canada* Federal Court of Appeal decision.

Based on recent communications with the Customs Valuation Division (Headquarters) of the Agency, we understand that the Agency will amend **Memorandum D13-4-9** to reflect those two decisions and supersede Customs notice no. 390. They have indicated that the revised D-Memorandum will explicitly state that where the vendor and licensor are one and the same person, or are related to each other, the royalties have to be paid as a true legal condition of sale to be dutiable. We can only hope that the Agency holds true to the spirit of those two decisions and does not take an overly strict interpretation of their application.

We have turned to a new page in the saga concerning the dutiable status of royalties and licence fees. Companies should continue to monitor the dutiable status of royalties and structure their affairs, with professional assistance, so as to minimize their duties payable, particularly in the situation in which the vendor and licensor are one and the same person or related to each other. To the extent that importers have previously paid duties in error on royalties, those importers have duty refund opportunities (subject to the 4-year statutory limitation period for making those claims).

(b) Buying Agent Commissions

Section 48(5)(a)(i) provides additional adjustments to “the import price in the sale of goods for export to Canada” for:

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

A number of Tribunal and Federal Court decisions have considered whether certain payments are excluded from the VFD, as determined under the transaction value method, based on the fact they were paid by the purchaser to a *bona fide* buying agent for services of representing the purchaser abroad in respect of the sale. These include: *Signature Plaza Sport*

Inc. v. The Queen,[31] *Chaps-Ralph Lauren v. The Deputy Minister of National Revenue,*[32] *Mexx Canada Inc. v. The Deputy Minister of National Revenue,*[33] *Superfine Import Co. v. The Deputy Minister of National Revenue,*[34] *Charley Originals Ltd., Division of Algo Group Inc. and Mr. Jump Inc., Division of Algo Group Inc. v. The Deputy Minister of National Revenue,*[35] *Utex Corporation v. The Deputy Minister of National Revenue,*[36] and *Sherson Marketing Corporation v. The Deputy Minister of National Revenue*.[37]

A *bona fide* buying agent representing the buyer abroad connects the purchaser with the foreign vendor. In his capacity as a *bona fide* buying agent, the agent may approve samples, negotiate prices on the purchaser's behalf, place orders for the purchaser, and advise as to delivery schedule, among other functions.

The Agency has, at times, challenged whether the alleged buying agent can, in reality, be a buying agent because of its presumed conflicting or compromised loyalties. A legal agent has a fiduciary duty to always act in the best interests of its principal or at least disclose any interest which may affect the agent's performance of its duty to its principal. The Tribunal has accepted that a person can act as a *bona fide* buying agent where the buying agent is a

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[31] Court File No. A-453-90, February 28, 1994 (Federal Court of Appeal).

[32] Appeal Nos. AP-94-190 and AP-94-191 (November 1, 1995, CITT).

[33] Appeal Nos. AP-94-035, AP-94-042, and AP-94-165 (February 16, 1995, CITT).

[34] Appeal No. AP-95-074 (December 3, 1996, CITT).

[35] Appeal Nos. AP-95-261 and AP-95-263 (April 29, 1997, CITT).

[36] Appeal No. AP-98-085, October 27, 1999 (CITT); Rev'd by [2001] 2856 ETC (FCA); Remanded to the Tribunal to set aside AP-98-085 in accordance with the Federal Court of Appeal reversal, Appeal No. AP-2000-060 (CITT).

[37] The Tribunal rendered a series of decisions concerning Sherson Marketing Corporation reported as *Sherson Marketing Corporation* v *D/MNR* at [2000] 4575 ETC, [2000] 4576 ETC, [2000] 4577 ETC, and [2000] 4578 ETC.

trademark holder in relation to the imported goods as well as the designer and distributor of the goods in the US, acts for more than one purchaser, or is much larger than the purchaser.[38]

In *Utex Corporation v The Deputy Minister of National Revenue,*[39] the Federal Court of Appeal reversed the decision of the Tribunal. The Tribunal found that certain commissions payable to a representative of the purchaser abroad had to be added to the import price. The foreign representative, Fabco Trading Corp. ("Fabco"), relied on the activities of a related person, Corin International (HK) Ltd. ("Corin"), to represent the purchaser/importer Utex Corporation ("Utex") abroad while Corin received commissions from Chinese factories with which Utex was doing business. The Tribunal found that a person can only be a *bona fide* buying agent of a purchaser where it always acts in the best interests of the purchaser and has no conflicting duties or loyalties.

The Federal Court of Appeal found no evidence that Fabco failed in any respects to act in the best interest of Utex. Even if Fabco had failed in such respects, "that by itself would not be sufficient to establish that the fees paid to Fabco are outside the exception set out in subparagraph 48(5)(a)(i) of the *Act* as fees paid to the agent of a purchaser for the service of representing the purchaser abroad in respect of the sale."

The Agency has set out its policies in **Memorandum D13-4-12 "Commissions and Brokerage"** (March 28, 2001).

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[38] Ibid.

[39] *Supra* at 36.

(c) Assists

Under section 48(5)(a)(iii) of the *Customs Act*, the value of any of the following goods and services supplied, directly or indirectly, by the purchaser of the goods free of charge or at a reduced cost for use in connection with the production and sale for export of the imported goods, shall be added to the import price:

> "(A) materials, components, parts and other goods incorporated in the imported goods;
>
> (B) tools, dies, moulds and other goods utilized in the production of the imported goods;
>
> (C) any materials consumed in the production of the imported goods; and
>
> (D) engineering, development work, art work, design work, plans and sketches undertaken elsewhere than in Canada and necessary for the production of the imported goods."

Although "assist" is not a legally defined term in the *Customs Act* or Customs Valuation Code, goods and services provided in this manner, within the ambit of section 48(5)(a)(iii), are colloquially known as "assists". In *Capital Garment Co. Inc. v The Deputy Minister of National Revenue,*[40] the Tribunal considered whether graded patterns for garments produced by the purchaser's/importer's design facility in Canada were "assists" provided free of charge by the purchaser/importer to the foreign manufacturer within the meaning of section 48(5)(a)(iii)(B). Were the graded patterns "tools, dies, moulds and other goods utilized in the production of the imported goods" as contemplated by section 48(5)(a)(iii)(B), or, as the purchaser/importer argued, design work used in the production of the imported goods? If the

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[40] Appeal No. AP-96-002 (June 3, 1997, CITT).

latter, they would not be dutiable under section 48(5)(a)(iii)(D) as only design work undertaken outside Canada could be dutiable under this provision.

The Tribunal ruled that they qualified as design materials and were non-dutiable because they were one step removed from the actual production of the goods.

By contrast, in *Chaps-Ralph Lauren*, *A Division of 131384 Canada Inc. and Modes Alto-Regal Inc. v The Deputy Minister of National Revenue,*[41] an importer supplied design materials, where the design work was undertaken outside Canada, to the foreign manufacturers, and the Tribunal found that they were dutiable assists. In *Style-Kraft Sportswear Limited* v *The Deputy Minister of National Revenue*,[42] the importer acquired sample garments. The Tribunal found that the portion of the license fees paid to acquire the garments were not dutiable as design work under section 48(5)(a)(iii)(D) of the *Customs Act*. The evidence did not show that the importer passed on the design work to the third-party foreign manufacturers of the garments as required by section 48(5)(a)(iii)(D).

For more information, see the Agency's **Memorandum D13-4-8, "Assists"** (March 7, 2001) and **Memorandum D13-3-7, "Engineering, Development Work, etc. Undertaken Elsewhere Than in Canada"** (March 27, 2001).

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[41] Appeal Nos. AP-94-212 and AP-94-213 (December 22, 1997, CITT).

[42] [1998] 4545 ETC (July 28, 1998, CITT).

III. Sanctions

Penalty Regime before November 29, 2001

By way of amendments to the *Customs Act*[43] effective November 29, 2001, Bill S-23[44] repealed sections 109.1 and 109.11 of the *Customs Act*.[45] For a first offence (e.g., under declaration of VFD), the former subsection 109.11(2) imposed a penalty equal to:

- an amount of 5% of the unpaid duties, plus
- 1% of the unpaid duties for each complete month up to a maximum of 12 months (12%) for a maximum penalty of 17% of the unpaid duties.

The *Customs Act* defines "duties" to include GST payable on the import of goods into Canada. For repeat offences, the penalties could amount to up to 50% of the unpaid duties.

Administrative Monetary Penalty System (AMPS)

Effective November 29, 2001, Bill S-23 repealed sections 109.1 and 109.11 of the *Customs Act* and replaced them with a new section 109.1.[46] Section 109.1 introduces a regime of designated regulatory penalties for specific contraventions under the *Customs Act* and other customs legislation, known as the administrative monetary penalty system or AMPS. After

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[43] R.S.C. 1985, c. 1 (2nd Supp.), as amended.

[44] S.C. 2001, c. 25, An Act to amend the *Customs Act* and to make related amendments to other Acts, received Royal Assent on October 25, 2001 ("Bill S-23").

[45] Section 62 of Bill S-23. Under section 112 of Bill S-23, the provisions of Bill S-23 come into force on a day or days to be fixed by order of the Governor in Council. The Governor in Council proclaimed November 29, 2001 as the day this provision comes into force. P.C. 2001-2202, November 29, 2001, SI/2001-115, December 19, 2001, Canada Gazette Part II, Vol. 135, No. 26, p. 2896.

[46] Ibid.

numerous delays in implementation, the Agency announced that AMPS will come into effect on October 7, 2002 for commercial shipments to Canada.[47]

Under the proposed penalty regime under AMPS, scheduled for implementation on October 7, 2002 (but which the Agency has already extended a number of times), once the 90-day grace period expires for making a voluntary correction to an incorrectly declared VFD (see discussion below in a later section), the Agency can impose:

- for a first offence penalty, \$100 or 5% of any undeclared portion of the VFD, whichever is greater,
- for a second offence penalty for the same reason, \$200 or 10% of any undeclared portion of the VFD, whichever is greater, and
- for a third or subsequent offence for the same reason, \$400 or 20% of any undeclared portion of the VFD, whichever is greater.[48]

It is important to note that an "AMP" could result even in a situation where the Agency suffers no revenue loss (such as where imported goods are duty-free and GST payable on import is fully recoverable by way of input tax credit claims).

One alleged unlawful import entry could trigger multiple contraventions under customs law and multiple penalty sanctions under AMPS. In addition to the "AMP" noted above, an under declared VFD could trigger another "AMP" for the failure to pay "duties", including

[47] Agency's Customs Notice N-439 "Administrative Monetary Penalty System—AMPS" (April 11, 2002).

[48] Contravention #C083 of the Master Penalty Document released by the Agency on May 14, 2002.

GST, on imported goods accounted for under sections 32(2) and (3) of the *Customs Act*, the failure of which would give rise to:

- a first offence penalty of $100,
- a second offence penalty of $500, and
- a third and subsequent offence penalty of $1,000.[49]

Seizures and Ascertained Forfeitures

Despite the so-called grace period to allow importers and stakeholders to become familiar with the new penalty regime under AMPS, through the Agency issuing warnings and notifications without having any binding effect, the Agency appears more prone to resort to the onerous sanctions of seizures or ascertained forfeitures for customs valuation infractions during the current period between November 29, 2001 and October 7, 2002 in which there is a gap, or absence of, other available penalties.

Under section 117 of the *Customs Act*, the Agency may return seized goods for an amount of money equal to the aggregate of the VFD of the goods seized, plus the amount of duties, inclusive of GST, levied thereon, or such lesser amount as the Agency may direct.

Where imported goods cannot be found or the seizure thereof would be impractical, the Agency may resort to ascertained forfeiture. Under an ascertained forfeiture, the importer would, like in the case of a payment to have seized goods returned, pay an amount of money equal to the aggregate of the VFD of the goods seized, plus the amount of duties, inclusive of GST, levied thereon, or such lesser amount as the Agency may direct.

Until the implementation of AMPS, the Agency, based on our own experience, is more likely to resort to seizures and ascertained forfeitures to levy sanctions for under declared VFD, especially for repeat offences. Once the Agency implements AMPS, we anticipate (and hope) that the Agency would reserve seizures and ascertained forfeitures for egregious offences or ones involving significant risk of non-collection.

Voluntary Corrections Within 90 Days of "Having Reason to Believe" That Declarations Incorrect

Section 32.2 of the *Customs Act* requires that an importer correct any error in its declaration of VFD, other than one that would result in a refund of duties, within 90 days of having "reason to believe" that the declaration is incorrect. The importer pays any additional duties and GST owing, plus interest calculated at the prescribed rate. The prescribed rate of interest approximates the prevailing rate of interest on 3-month Government of Canada Treasury Bills.[50] If the importer does the correction and pays the unpaid duties and GST, plus interest at the prescribed rate, within the 90-day period, then AMPS will not apply.

Once the 90-day period expires, the Agency may assess duties, GST, interest at the specified rate, and AMPS (once implemented), or resort to a customs seizure or ascertained forfeiture. The specified rate of interest is equal to the prescribed rate of interest, plus 6% per year.

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[49] *Ibid.*, Contravention #C336.

[50] *Interest Rate for Customs Purposes Regulations*, Order in Council P.C. 1992-1863, August 27, 1992.

Voluntary Disclosure

An importer may be eligible for relief from penalties (imposed under AMPS) and other sanctions (i.e., seizures and ascertained forfeitures), as well as interest at the specified rate, by making a voluntary disclosure at any time (even if after the 90-day grace period noted above). The importer however, remains responsible for unpaid duties and GST, plus interest at the prescribed rate.[51]

[51] Section 3.3(1) of the *Customs Act*, as amended by section 3 of Bill S-23 effective November 29, 2001, and CCRA's Customs Notice N-332 "Voluntary Disclosures Program".

TRANSFER PRICING

In addition to the above, an importer must carefully consider the impact, if any, of Canadian transfer pricing rules on the valuation of an imported good and its associated payments. A Canadian taxpayer/importer may well have competing objectives between customs valuation and income tax transfer pricing. While an importer wishes to minimize the dutiable value of an imported good as much as possible, including possibly segregating out as large a portion as possible to a non-dutiable royalty, the non-arm's length exporter and importer (as taxpayers) wish to maximize the transfer price on the same good (to minimize the importer's Canadian profits and exposure to Canadian income tax) and to minimize or avoid any royalties or other payments subject to withholding tax. Where a royalty is segregated from its related products, the benefit of any reduced customs valuation of the goods may be reduced or eliminated by significant withholding taxes on the outbound royalty.

Since the introduction of the transfer pricing rules into the *Income Tax Act* (Canada)(the "Tax Act")[52] in 1998 which are effective for fiscal years starting after 1997, the Minister of National Revenue can adjust transactions between non-arm's length parties in accordance with the "arm's length principle". In addition, the Minister may, in certain circumstances, assess significant penalties in connection with the adjusted amount unless the taxpayer maintains contemporaneous documentation.

[52] R.S.C. 1985 (5th Supp.), c. 1, as amended to February 5, 2002.

1. "Related Persons" and Non-Arm's Length Parties

The Tax Act looks to differentiate a taxpayer[53] that is dealing independently or at "arm's length" with a non-resident exporter from the taxpayer who is not dealing at arm's length. Evidence of hard bargaining will not on its own satisfy the arm's length requirement. In the Tax Act, an individual and a corporation do not deal at arm's length where the individual, alone or as a member of a group of related persons, controls the corporation. Corporations do not deal at arm's length if they are both controlled by the same person or if they are controlled by persons or group of persons that are related to one another. In addition, corporations do not deal at arm's length where they are each controlled by a third corporation.[54]

2. Arm's Length Principle and Related Persons

The transfer pricing rules found at section 247 of the Tax Act apply only to a taxpayer and a non-resident person who do not deal with each other at arm's length. Section 247(2) impugns two types of transactions: (1) transactions in which the terms or conditions differ from those that would have been made between persons dealing at arm's length, and (2) transactions into which arm's length parties would not have entered and into which the parties did not enter primarily for *bona fide* purposes other than to obtain a tax benefit.[55] Subsection 247(2) provides that the terms and conditions or the nature of an offending transaction <u>shall be adjusted</u> to the quantum or nature to which arm's length parties would have agreed.[56]

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[53] For the purposes of this discussion on transfer pricing, the term "taxpayer" includes a partnership.

[54] See section 251 of the Tax Act to determine when individuals and entities are related to one another and thereby deemed to not deal at arm's length. In addition, an importer may have to consider whether in fact it is associated or related with the non-resident exporter or licensor under an applicable treaty.

[55] See section 247(2), paragraphs (a) and (b) of the Tax Act.

[56] See section 247(2), paragraphs (b) and (c).

The basis for the "arm's length principle" is found in the OECD's *Model Tax Convention On Income and On Capital* (the "Model Convention"). Paragraph 1 of Article 9 of the Model Convention reads:

> Where conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

3. Arm's Length Pricing Methods

The Agency will review a transaction under the transfer pricing rules with a view to establishing an arm's length price. In order to do so, the Agency has developed its policy relying primarily on methods adopted in the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (the "Guidelines").[57]

(a) Hierarchy of Pricing Methods

Unlike what the *Customs Act* does for customs valuation, the Tax Act does not establish a hierarchy of methods to be used for transfer pricing. However, the Agency's administrative practice endorses the hierarchy of methods adopted by the Guidelines. Paraphrasing the Guidelines, the Agency's Information Circular IC-87-2R, "International Transfer Pricing" ("IC 87-2R"),[58] states that "the traditional transaction methods are preferable to the transactional profit methods" and that "the transactional profit methods are used as methods of last resort, when the use of traditional transaction methods cannot be reliably applied

[57] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* (Paris: OECD, 1998) updated to February 1998.

or cannot be applied at all."[59] Like in the Guidelines, the Agency includes the following methods in each group

(i) "traditional transaction methods" include the comparable uncontrolled price (or CUP) method, the resale price method, and the cost plus method; and

(ii) "transactional profit methods" include the profit split method and the transactional net margin method.[60]

Yet, the Agency does recognize in IC 87-2R "that transfer pricing is not an exact science" and that the "application of the most appropriate transfer pricing methodology may produce a range of results".[61]

(b) Resemblance of Transfer Pricing Methods to Customs Valuation Methods

Where applicable, an importer may want to leverage off its customs valuation method to determine its transfer pricing method, or vice versa, in order to avoid duplication of efforts. An importer will likely need to make adjustments because the Agency views each valuation separately, as illustrated by its comments at the end of IC-87-2R:

> 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.[62]

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[58] Information Circular IC-87-2R "International Transfer Pricing" (September 27, 1999).

[59] *Ibid.*, at para. 52.

[60] Transitional profit methods can also include the residential profit split method.

[61] *Ibid.*, at para. 34.

[62] *Ibid.*, at para. 225.

However, it is useful to draw parallels and analogize transfer pricing methods with customs valuation methods, as in the table below.

Transfer Pricing Method	**Analogous Customs Valuation Method**
Comparable uncontrolled price (or CUP)	Uninfluenced transaction value
Resale price	Deductive value
Cost plus	Computed value
Transactional profit methods	Not used

4. Compliance Requirements and Consequences

(a) Contemporaneous Documentation

The transfer pricing rules impose penalties on an offending transaction unless a taxpayer has made "reasonable efforts" to determine an arm's length transfer price. For the purposes of imposing a penalty, the rules deem a taxpayer to not have made such "reasonable efforts" unless the taxpayer maintains records and documents ("contemporaneous documentation") that provide an accurate and complete description of the transaction. Contemporaneous documentation includes,[63] in addition to a complete description of the transaction, a description of:

(1) the terms and conditions of the transaction and its related transactions,

(2) the identity of the participants and their relationship to one another,

(3) the data and methods considered to determine the transfer price or allocation of profit or loss, and

[63] Please see s. 247(4) of the Tax Act for the exact requirements.

(4) the business reasons and context of the transfer price determination.

(b) Penalties

The penalty for an offending transaction is equal to 10% of the amount of the transfer pricing adjustment for which reasonable efforts were not made. However, a penalty is levied only if the adjusted amount exceeds a "safe harbour". The safe harbour is the lesser of 10% of the taxpayer's gross revenue for the year and $5,000,000. It must be noted that the penalty would be levied in addition to any increase in tax (and interest and other penalties thereon) resulting from the transfer pricing adjustment.

5. Royalties and Part XIII of the Tax Act

In considering the appropriate valuation of a royalty in respect of an imported good, an importer will want to assess the impact of withholding tax at paragraph 212(1)(d) of the Tax Act. With certain exceptions, paragraph 212(1)(d) of the Tax Act broadly subjects rent, royalty or similar payments to withholding tax. For example, a royalty received by an American parent for licensing a trademark in respect of imported goods to its Canadian subsidiary will be subject to a withholding tax of 10%, assuming the American parent benefits from the *Canada-United States Income Tax Convention (1980)*. In the absence of any treaty relief, the withholding tax would be 25% of the royalty payment. This withholding tax is unrecoverable except to the extent of any available foreign tax credits.

In addition to a classical royalty (on a trademark licence or similar agreement) and a "know-how" royalty, proceeds paid subsequent to a transaction may also be subject to withholding tax based on the broad language of paragraph 212(1)(d) of the Tax Act. The Agency could also conceivably argue that a portion of the purchase price of an imported good includes an embedded royalty which would be subject to withholding tax.

CONCLUSION

As we can all see, many opportunities exist to lower the VFD and avoid the payment of unrecoverable duties. To the extent that importers have previously paid duties in error on royalties or otherwise for customs valuation errors, those importers have duty refund opportunities (subject to the 4-year statutory limitation period for making those claims). Despite the Supreme Court's pronouncement on sale for export to Canada and the new purchaser in Canada requirement, opportunities remain for vigilant importers to use these rules to their advantage.

Poor planning can result in importers incurring additional duties and taxes. Worse yet, importers who are unaware of the current law may have assessments for not only duties and taxes, but also substantial interest and penalties and other sanctions for under declaring the VFD.

And finally, importers need to be cognizant of the competing concerns between customs valuation and transfer pricing.

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