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The FCA's FosterGrant Decision

Jamie M. Wilks, McMillan Binch, LLP

Federal Court of Appeal Overturns CITT *FosterGrant of Canada* Value for Duty Decision

The following article was written by Jamie M. Wilks of McMillan Binch LLP.

The footnotes cited in this article are available on our Web site at: www.iecanada.com/tradeweek/footnotes/04_vol.115.19_wilks_footnotes.pdf.

On July 14, 2004, the Federal Court of Appeal (FCA) released its decision in AAi.FosterGrant of Canada Co. v CCRA.[1] The Canadian International Trade Tribunal (CITT) had upheld the Canada Border Services Agency (CBSA) customs duty assessment, resulting from the CBSA's approximate 200 per cent increase in the value for duty (VFD) of the imported goods.[2] The FCA allowed the importer's appeal of the CITT decision and vacated the assessment.

VFD Issue

The broad issue considered in FosterGrant of Canada is as follows. A foreign entity (AAi.FosterGrant, Inc.) purportedly sells goods to its affiliated Canadian distributor (AAi.FosterGrant of Canada Co.) for resale to arm's length Canadian customers (Canadian retailers such as Zellers, Wal-Mart Canada and Sears

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Canada). CBSA took issue with whether AAi.FosterGrant of Canada Co. (AAi Canada) was really purchasing for resale or was, in fact, acting as a selling agent in Canada.

The issue was of fundamental importance for Canadian customs valuation purposes because it meant the difference between using the transfer price between the AAi.FosterGrant, Inc. (AAi U.S.) and AAi Canada, or the higher sales price to the ultimate arm's length customer in Canada, as the basis for the determination of the VFD under the transaction value method (TVM).

CITT Decision

To qualify as "a purchaser in Canada" under the TVM, AAi Canada would have to either:

(i) be a resident in Canada, such that "it carried on business in Canada and had its management and control in Canada, or"
(ii) have a permanent establishment in Canada, such that it "had a fixed place of business in Canada through which it carried on business."[3]

The CITT found that because of the control that AAi U.S. exercised over AAi Canada's activities, AAi Canada "did not carry on business in Canada during the period at issue." On that basis, AAi Canada could not be " a purchaser in Canada" under either of the above tests in (i) or (ii).

FCA Decision

The FCA applied two fundamental legal principles from the 2001 Supreme Court of Canada VFD case, *Canada v. Mattel Canada Inc.*[4] First, the standard of judicial review on questions of statutory/regulatory interpretation is legal correctness. In other words, on questions of statutory/regulatory interpretation involving the interpretation of terms with established legal meanings, the courts should not defer to any extent to the CITT's judgment and should determine on their own account the correct legal meanings of such terms. The courts should not hesitate to substitute their own legal interpretations and judgments in such circumstances. That is what courts are supposed to do. The courts, as opposed to the CITT, have specialized expertise in such matters.

Second, on a related point, the FCA found that the CITT's definition of "carries on business" did not accord with the meaning established by jurisprudence. The FCA found no legal authority for the proposition that AAi Canada could not carry on business in Canada if its parent corporation, AAi U.S., exercised significant *de facto* control over it. The FCA looked to the Supreme Court of Canada's decision in *Backman v. Canada*[5] for the legal meaning of "carries on business." Based on those legal principles, the FCA found that AAi Canada satisfied all the conditions for carrying on business in Canada, namely:

1) holding "one's self out to others as engaged in the selling of goods or services;"
2) "the occupation of time, attention and labour;"
3) "the incurring of liabilities to other persons; and"
4) engaging in those activities for "the purpose of a livelihood or profit."

In interpreting complex legislation, such as the *Customs Act* or the *Income Tax Act*, absent a legal sham, the FCA has a "duty to apply an unambiguous provision of the Act to a taxpayer's transaction." It is inappropriate for the FCA to inquire into the "economic realities" of a situation and "an unexpressed legislative intention" of Parliament in these circumstances.

The decision harmonized the results between Canadian customs valuation and income tax. There was no doubt whatsoever that AAi Canada carried on business through a permanent establishment in Canada for Canadian income tax purposes. While AAi Canada maintained no inventory in Canada, it employed approximately 100 full-time and part-time employees across Canada, including a full-time president and vice-president, who worked at its leased office premises and showroom in Toronto, Ontario, Canada. AAi Canada had the authority to enter into the lease for its Toronto premises, to enter into binding agreements of purchase and sale with its Canadian suppliers and customers, and to hire, terminate and manage its employees. AAi Canada earned profits from its re-sales of goods in Canada, for which it reported its sales profits on its Canadian income tax returns and paid Canadian income tax.

Important Implications for Customs Valuation

A note to CBSA's Memorandum D13-1-3 "Customs Valuation: *Purchaser in Canada Regulations*" states that the meanings of the terms "resident," "carrying on business," and "permanent establishment" for the purposes of the *Customs Act* may not necessarily correspond to the meanings of those terms for the purposes of the *Income Tax Act* or Part IX of the *Excise Tax Act* (GST Legislation).

In light of the FCA decision in *FosterGrant of Canada*, this administrative policy may be misguided and misleading. Subject to specific statutory or regulatory provisions defining these terms, the CITT and courts are obligated to look to jurisprudence for the established meanings of these terms. It is the only objective way to discern the intent of Parliament; otherwise, taxpayers and importers are subject to the discretionary whims of the administrative enforcement agency, the CITT and the courts in interpreting and applying the law.

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Of course, the CBSA's administrative policy guidelines for interpreting the law do not make law. In *Nowegijick v. The Queen,*[6] Mr. Justice Dickson of the Supreme Court of Canada said:

> Administrative policy and interpretations are not determinative but are entitled to weight and can be an "important factor" in case of doubt about the meaning of legislation ...

In *FosterGrant of Canada*, the FCA rightly attached little or no weight to the CBSA's policy in Memorandum D13-1-3. There is no reason to arbitrarily depart from the established meanings of "carries on business" and "permanent establishment" found in jurisprudence since the *Valuation for Duty Regulations* and *Customs Act* do not invite us to do so by providing their own unique definitions of those terms. In fact, quite the opposite, they suggest interpreting those terms in accordance with their established meanings. That is presumably why the Governor in Council chose those very specific terms in the *Valuation for Duty Regulations*. The law should promote certainty and consistency in their application. It may be time for CBSA to go back to the drawing board and rewrite its policies for interpreting "carries on business" and "permanent establishment" in the *Valuation for Duty Regulations*.[7]

The Joint Committee on Taxation of the Canadian Bar Association and The Canadian Institute of Chartered Accountants (The Joint Committee) made this suggestion to the CRA International Tax Directorate and CBSA in its November 24, 2003 correspondence, when commenting on the CRA/CBA draft policy memorandum on the compatibility of income tax transfer pricing and customs valuation (the Draft Memorandum). The Joint Committee commented on the Draft Memorandum's laudable goal of consistency between customs and income tax/transfer pricing to promote harmonization and certainty in results for importers and taxpayers.[8] It specifically recommended the following:

> Terms used in the *Valuation for Duty Regulations* should be interpreted and applied in the same manner for customs purposes as for income tax purposes, except where this is not possible because of legislated definitions or rules. The terms we particularly have in mind are "carries on business" and "permanent establishment."

The legal rules are complex enough without adding a second layer of arbitrary rules, which have no basis in law.

In our view, confusion has arisen because of the merging of two distinct and separate issues: whether the Canadian distributor is a selling agent, as opposed to a purchaser/re-seller and whether the Canadian distributor is a "purchaser in Canada." Rather than looking at the clearly delineated tests set out in the jurisprudence to determine the *bona fides* of whether a Canadian distributor is "a purchaser in Canada," CBSA wants to blur the lines and "muddy the waters" by delving into the "economic realities" of the transactions and nature of the relationship between the parties. As the FCA noted, the Supreme Court has repeatedly said, absent a sham, the legal transactions govern the terms of the relationship between the parties.

The first issue is whether the Canadian distributor is legally acting as a purchaser/re-seller or selling agent. Specific legal principles apply in making this determination. If it is a purchaser, then the next issue becomes whether it qualifies as "a purchaser in Canada" for Canadian customs purposes. A selling agent obviously cannot be "a purchaser in Canada." Once the courts and Tribunal determine that a Canadian distributor is a purchaser, they cannot revisit the issue by departing from the established meanings of the terms "carries on business" and "permanent establishment."

The CBSA may need to look at a wide range of factors in making their determination about the legal nature of the relationship, including whether a sales (distribution) agreement and a service agreement exist between the foreign affiliate and Canadian distributor, trade terms, credit risk, transfer of title, risk of ownership, sales invoices, where payment is made, and who enters into the sales contracts with Canadian customers (where sales contracts are concluded), among other factors. Good planning, as always, goes a long way to avoiding customs and income tax problems. It is particularly important where the Canadian distributor does not maintain any inventory in Canada and the imported goods are drop-shipped from a foreign country directly to the customer in Canada.

Finally, the FCA decision in *FosterGrant of Canada* removes a potentially powerful arbitrary hammer from the audit and assessment tools and arsenal of CBSA. The federal customs and taxing authorities cannot have it both ways; that is, enforce the existing law where it suits their purposes, but choose to ignore it when it does not. Had AAi Canada taken the position for Canadian income tax purposes that it did not carry on business through a permanent establishment in Canada, such that it had no obligation to pay Canadian income taxes, would CRA have seen any merit in that position? We all know the answer to that rhetorical question, and rightfully so. CBSA and CRA have obligations to enforce the law uniformly for all purposes, not to administer the law unevenly for their own revenue generating purposes.