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Miller Thomson's Customs Practice

This issue of Tax Notes profiles **Edward Lebow,** who assists clients with U.S. customs issues from Miller Thomson's Washington, D.C. office, and **Daniel Kiselbach,** who assists clients with Canadian customs issues from our Vancouver office.

Daniel L. Kiselbach provides advice and representation to governments, corporations and individuals in Canadian customs and international trade law. His customs practice includes forfeitures, civil monetary penalties and criminal penalties arising from contraventions of the Customs Act, brokerage licensing issues, duty free matters and appeals respecting the reclassification of goods. Mr. Kiselbach has acted in customs cases in the Federal Court of Canada, the British Columbia Supreme Court and Court of Appeal and the Supreme Court of Canada.

Edward M. Lebow advises a wide range of clients in U.S. customs, international trade, NAFTA and WTO law. In 1996 he represented the victorious U.S. petitioner in the first investigation under the Uruguay Round amendments to the U.S. antidumping law. Mr. Lebow was Assistant General Counsel at the U.S. International Trade Commission, where he was responsible for defending the agency in courts throughout the United States. Prior to this he headed the unfair trade practices investigation group. His experience at the ITC also included the investigation of predatory pricing by the Japanese color television industry, the investigation of import injury to the U.S. automotive industry, and antidumping investigations of steel products from the European Community.

U.S. Customs Enforcement Increases as NAFTA Duties Decrease

The phase-out under NAFTA of U.S. tariffs on many Canadian products is nearing its end-stage: increasing numbers of Canadian-origin products are now able to enter the United States duty-free. Nevertheless, Canadian producers and exporters need be aware that duty-free is not synonymous with paperwork-free or risk-free.

To take advantage of the preferential U.S. tariff treatment available to Canadian-origin products, a U.S. importer must be prepared to demonstrate that the goods originate in a NAFTA country. Every import above the de minimis level of US $2500 must be supported by an individual or multiple entry Certificate of Origin. False declarations can subject both the exporter and the importer to penalties in their respective jurisdictions.

The exporting producer, or a third-party exporter with knowledge of the goods and reliance on representations of the producer, usually prepares the Certificate of Origin. The certifying party is required to make a choice from among a number of preference criteria applicable to the subject merchandise. There are different criteria for finished goods and constituent materials. NAFTA-origin qualification depends in large measure on a change in tariff classification or achieving a certain level of regional value, or both.

The Certificate of Origin need not be filed with the import documents. However, for five years after the date of the certificate both the exporter and the importer must retain a complete set of records that includes transaction documents, cost data, and, of course, the Certificate of Origin itself.

The U.S. Customs Service is becoming more aggressive in requesting exporters and importers to produce these documents. After several years in which importers who were unable to produce a requested Certificate of Origin were given time to find or prepare them, U.S. Customs is now moving to impose penalties immediately for non-compliance if a certificate is not produced upon request. Fines of $10,000 per violation for negligence all the way up to $100,000 per violation for fraud are not uncommon.

An excellent way to be certain to avoid such problems is to establish rigorous corporate record keeping requirements for exports and ensure that all necessary personnel are aware of and are following these requirements. From time to time a qualified third party could be asked to review corporate compliance with U.S. Customs rules, including those relating to NAFTA origin and record keeping.

If specific questions arise with respect to the NAFTA origin issues, Miller Thomson, through its Washington, D.C. office, is available to provide guidance. In addition to NAFTA issues, our Washington, D.C. office provides advice with respect to country-of-origin declaration and marking, valuation, informed compliance procedures, seizures and penalties, prior disclosures, standards of reasonable care and binding rulings.

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Canadian Administrative Monetary Penalty System ("AMPS")

Introduction

In 1999, the Canada Customs and Revenue Agency announced new laws to enforce the Customs Act and Regulations, the Administrative Monetary Penalty System (“AMPS”).

AMPS is a positive alternative to the existing customs enforcement regime. Current sanctions for customs violations take the form of draconian remedies of seizure, ascertained forfeiture and criminal prosecution. AMPS on the other hand will provide a system of graduated fines that is meant to be more flexible and fair.

How will AMPS work?

The following outlines the AMPS process.

1. An officer detects a customs violation.
2. The violator’s compliance history is checked. Records of violations will be automatically erased within set time periods.
3. Regulations are checked to determine the appropriate penalty. A range of penalties from a warning to heavy fines may be imposed.
4. The penalty level will be set, taking into account factors such as the compliance history of the party and the seriousness of the contravention.
5. A Notice of Violation including notice of the penalty is issued.
6. A correction request may be made to a designated officer at the local or regional level. This officer can overturn or amend the penalty if any errors in the assessment have occurred.
7. The violator may then request an administrative review of the penalty within 90 days from the Adjudications Branch. At this stage mitigating and aggravating circumstances will be considered. A penalty reduction agreement may be negotiated with Customs Canada, by which a penalty may be reduced or waived if the party agrees to take steps within a certain time period to ensure future compliance.
8. The violator may appeal the decision of the Adjudication's Branch to the Federal Court.

Is AMPS more flexible than the existing enforcement regime?

The system of graduated penalties will provide customs officers with the ability to impose a greater range of penalties for customs violations without resorting to seizure and forfeiture of goods. Seizure and forfeiture will only be used in the case of serious offences.

On the other hand, it appears that customs officers will not have the discretion to address mitigating circumstances at the time the penalty is imposed nor will the designated officer at the regional level be able to consider the circumstances. Only if the penalty is appealed to the adjudication’s branch will mitigating circumstances be taken into account.

New penalties for brokers will be imposed under AMPS. At present when brokers fail to comply with the Act or Regulations the most important penalty is the power to withdraw the broker’s licence. However, this power is rarely used. Customs officers have indicated that they need more varied enforcement sanctions to ensure that brokers comply with their requirements imposed under the Brokers Licensing Regulations.

It will be interesting to see the extent to which compliance agreements are utilized under AMPS. Some importers may enter into compliance agreements with Canada Customs which will specify the operating conditions for those importers and the obligations and penalties for non-compliance. Presumably these agreements will be subject to regular monitoring by customs officials which will encourage voluntary compliance.

One might compare the Canadian AMPS initiative with current United States customs administration initiatives. According to the U.S. policy document entitled Customs Informed Compliance Strategy, U.S. customs is operating on the basis that they have already achieved extremely high levels of compliance among the importing and exporting communities. New compliance efforts are to be redirected not at enforcement but at voluntary compliance measures. Account managers will regularly track data for given client accounts and compliance reviews will be limited areas where non-compliance is likelier suspected.

The full implementation of AMPs and the corresponding legislative changes was delayed by the recent Federal election this past October 2000. However, it is expected that the Canada Customs and Revenue Agency will continue to prepare for the introduction of AMPs along with other programs such as the periodic verification program for 2001. The move towards periodic verification (i.e. periodic audits of importers to determine compliance) will move Canada Customs away from reliance on draconian enforcement measures.

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Is the Settlor of Your Trust a Trustee or a Beneficiary?

As the income taxation of trusts becomes more complex, more and more pitfalls have arisen for those who use them. This article examines one fairly commonplace pitfall.

One of the most time-honoured “attribution” rules in the Income Tax Act is in subsection 75(2). The subsection applies if, under the terms of the trust, one of the following three conditions is met:

- trust property (or property substituted for it) may revert to the person from whom the property was directly or indirectly received (the “settlor”);
- the settlor of the trust retains a power to pass the property to persons the settlor may determine at any time after the trust is created; or

- the trust indenture states that, during the settlor's lifetime, the property must not be disposed of except with the settlor's consent or in accordance with the settlor's direction.

If any one of these conditions is met, any income or loss from the property (or property substituted for it) and any gain or loss from its disposition is "attributed" to and taxed in the hands of the settlor. For example, even though the trust beneficiaries benefit from a cash distribution by the trustees, the resulting income inclusion is attributed to the settlor for income tax purposes.

In order to avoid attribution under this provision, non-income-producing property (like a gold coin) is often used to settle a trust. No settlor's good-night's sleep will be lost worrying about income or gains arising from a gold coin used to settle the trust.

But watch out for subsection 107(4.1) – a very nasty provision indeed. This provision applies where subsection 75(2) was applicable at any time to any property of a trust – even a gold coin. When subsection 107(4.1) applies, property distributed to a Canadian resident beneficiary in satisfaction of all or part of the beneficiary's capital interest will be treated as having been disposed of by the trust at fair market value. The general rule in subsection 107(2) which provides a "rollover" will not apply.

Ironically, the settlor per se and the settlor's spouse are excluded from the application of subsection 107(4.1). It is the other beneficiaries who are caught by it.

Here is a common situation in which subsection 107(4.1) applies. A mother settles a trust with a gold coin. She also acts as the initial trustee of the trust. Both the father and mother, and their children, are discretionary beneficiaries. In these circumstances, arguably all three conditions for the application of subsection 75(2) are met.

If subsection 107(4.1) applied only to deny a tax-free rollover by the trust to a beneficiary of the gold coin, it would be as innocuous as attribution under subsection 75(2). But it is clear that subsection 107(4.1) is not so restricted. Indeed, if the common shares of an operating company held by the trust appreciated by several million dollars, all the accrued gains would be subject to taxation on a distribution of that trust property to the beneficiaries (other than the settlor or spouse of the settlor).

A similar result could arise on a deemed disposition when a trust has its 21st anniversary.

Subsection 107(4.1) has been in the Income Tax Act since 1988. It was enacted without explanation, and took the tax community by surprise. The Canada Customs and Revenue Agency ("CCRA") has shown every indication that it will give full force and effect to the harsh results arising from the interplay between subsections 75(2) and 107(4.1).

Aside from the identity of settlor and trustee, and including the settlor as a discretionary beneficiary, here are other circumstances to watch out for:

1. *Replacement trustees.* It is important to consider these subsections in addressing replacement trustee provisions in a trust indenture. Typically, a mother may be settlor, and a father the sole trustee. If the mother is made a replacement trustee on the father's death, arguably a gold coin used to settle the trust may "pass to persons to be determined by [the mother] at a time subsequent to the creation of the trust" (i.e., meet the second condition in subsection 75(2)). Arguably, this concern would arise not only at a time when the mother became a replacement trustee, but also at the time the indenture was created (i.e., when her trusteeship was a mere possibility).
2. *"Wipeout" clauses.* Care should be taken in drafting "wipeout" clauses and provisions where a trustee is empowered to add beneficiaries after a trust indenture is created. Again, arguably if the settlor might conceivably become a beneficiary, subsection 75(2) might be considered to apply, not only at the time the settlor becomes a beneficiary, but also from the time the settlor's inclusion as a beneficiary was a possibility, however remote.
3. *"In-trust" accounts.* Bank accounts, securities portfolios and a host of other properties are often held in "in-trust" accounts, where the only evidence of a trust may be a telephone conversation with a broker or banker many years ago, and the use of the words "in trust" or "in trust for" (sometimes abbreviated to "itf") in standard form contracts or periodic account summaries. The CCRA will often view these arrangements as giving rise to an agency, rather than a trust, and place the onus on those alleging a trust to prove it. In these circumstances, the interplay between subsections 75(2) and 107(4.1) arises squarely, since there is often little or no evidence of the difference between the settlor and the trustee. In these circumstances, attribution in respect of all property of the "trust" might be subject to attribution under subsection 75(2), and incapable of a rollover to beneficiaries under subsection 107(4.1). For this and other reasons, "in trust" accounts should be avoided.

If you know or suspect that your trust may suffer from the evils identified in this article, we can help. Measures can often be taken to amend, replace or rectify it.

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Employee Stock Options

Draft legislation was released December 21, 2000 implementing, among other things, the tax deferral relief for employee stock option benefits from public company share options which was announced in the February 2000 federal budget. Where all requirements are met, the stock option benefit (i.e. the difference between the fair market value of the shares at the time of exercise and the exercise price) will not be taxed at the time of exercise (as required by the general rule), but will be taxed on the earliest of sale, death or becoming a non-resident of Canada. In addition, the stock option benefit will be taxed at capital gains rates. The deferral is subject to a $100,000 annual vesting limit.

The rules relating to this deferral will be the subject of a more comprehensive article at a later time. **The purpose of this brief note is to bring to your attention that an election must be filed by the employee to qualify for**

the deferral. For shares acquired in 2000, the election must be filed on or before February 15, 2001. The filing deadline will be January 15 in subsequent years. The election is to be filed with either the employer, the issuer of the shares or the grantor of the option (if different). A prescribed form must be used. However, as the prescribed form is not yet available, the election for shares acquired in 2000 may be a letter which requests that the deferral provisions apply, specifies the amount of stock option benefit to be deferred, confirms that the employee was a Canadian resident when the shares were acquired and confirms the $100,000 annual vesting limit is not exceeded.

Where an employee has made this election, the employer, the issuer of the shares and the grantor of the option (if different) are jointly responsible for reporting the deferred amount of stock option benefit as special item on the employee's T4 for 2000.

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Tax Treaty Status Report

Changes to Canada's tax treaties with Luxembourg, Austria and Japan take effect in early 2001. For Luxembourg and Japan, the effective date is January 1, 2001. For Austria, the effective date is March 1, 2001. Some of the significant changes are briefly summarized.

Luxembourg

- 5% withholding tax for dividends from Canada to certain significant corporate shareholders
- withholding tax exemption for certain dividends from Luxembourg to certain significant corporate shareholders
- withholding tax for interest reduced to 10%
- withholding tax exemption for software, patent and know-how royalties

Austria

- 5% withholding tax for dividends to certain significant corporate shareholders
- withholding tax for interest reduced to 10%
- withholding tax exemption for software, patent and know-how royalties
- a new mutual tax collection assistance provision

Japan

- 5% withholding tax for dividends to certain significant corporate shareholders
- a new mutual tax collection assistance provision

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Publications and Seminars

Gregory Shannon of our Calgary office spoke at the Calgary Chamber of Commerce conference on E-commerce Income Tax Issues on November 30, 2000.

Bill Fowlis of our Calgary office taught a course entitled "Advanced Tax Planning Techniques for the General Practitioner" for the Institute of Chartered Accountants of Alberta in Calgary and Edmonton in November, 2000.

Robert Hayhoe of our Toronto office is the author of a book entitled "Fundraising from Canada – The Complete Guide for Charitable Organisations Outside of Canada" published by Chapel and York of London, England, 2001.

Bill Fowlis will be teaching a course on "Advanced Tax Planning Techniques for the General Practitioner" for the Institute of Chartered Accountants of Alberta in Calgary and Edmonton in January, 2001.

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Note:

Miller Thomson's Tax Notes are provided as an information service to our clients and is a summary of current legal issues of concern to business persons and their advisors. These articles are not meant as legal opinions and readers are cautioned not to act on information provided in this newsletter without seeking specific legal advice with respect to their unique circumstances. Your comments and suggestions are most welcome and should be directed to:

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