TA 2013-25 – Top 10 cross-border GST and customs issues

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The recent increase in audit activity and denials of input tax credits (ITCs) in cross-border transactions serves as a reminder that there are many goods and services tax (GST) and customs tips and traps involved when importing and exporting goods. Failure to plan appropriately can result in unforeseen — and potentially costly — consequences.

Cross-border GST and customs issues become particularly relevant when a company is re-engineering its supply chain. Often the focus is on reducing effective corporate income tax rates, but failure to plan for GST or customs issues that can arise with supply chain adjustments can result in non-recoverable costs that may outweigh the income tax benefits.

We recently hosted a webcast on this important subject. In this alert, we identify the top 10 issues you should consider when reengineering a supply chain.

1. **GST paid on importation should be recoverable and should not become a sunk cost. But recovery of the tax is not a given and careful planning is required.** If an ITC is not available to the taxpayer, a flow-through method of recovery or drop shipment rules may be used to avoid adverse tax consequences.

2. **In the case of exports, GST should not be applicable,** but an exporter should nevertheless pay close attention to whether or not its export meets the necessary requirements to be "zero rated."

3. **Identifying the best party to act as the importer of record is crucial.** In Canada, various parties in a trade chain can act as the importer of record if they obtain an importer account number from the Canada Revenue Agency (CRA). However, companies sometimes fail to understand potential consequences of selecting one party over another. For instance, both the importer of record and the "actual" importer are liable for taxes, but only the actual importer can obtain an ITC for the GST paid on the importation.

4. **Non-resident companies face particular challenges when planning to import goods into Canada in their own name.** Typically, a company will carefully consider whether or not its planned commercial activities (selling to Canadian customers, importing and delivering goods, maintaining inventory) will create a permanent establishment (PE) in Canada for income tax purposes. However, that same company may not invest as much time and energy in determining what indirect tax consequences might be triggered by the same commercial activities. The threshold is lower than having a PE and usually turns on the ephemeral concept of "carrying on business." The decision of whether or not to register for GST/HST should be made with a clear understanding of its impact.

5. **Many trade chain structures involving non-resident companies will trigger an application of the Canadian drop shipment rules.** These rules arise where a non-resident vendor does not keep goods in inventory, but instead transfers customer orders and shipment details to either a manufacturer or a wholesaler, who then ships the goods directly to the customer in Canada. Rules exist to relieve the GST burden where appropriate, but the interpretation of the rules can be less than obvious and many companies will unknowingly misapply the rules, creating a risk that goes unnoticed until a GST audit is conducted on one of the companies involved in the supply chain. It is crucial to understand the requirements surrounding who needs to issue a drop shipment certificate to whom, and the ensuing GST implications. These rules can be a trap for the unwary.

6. **Attention should be paid to standard terms of trade (e.g., INCOTERMS), as they can have significant implications on the payment of GST and duties.** Establishing who takes title to the imported goods and when and where is critical for resident and non-resident importers alike. Such details are relevant when determining who should be charging GST or other taxes on which transactions and also who can claim an ITC. A common pitfall is that companies rely on INCOTERMS without considering their implications, which can result in a higher-than-necessary dutiable customs value or unanticipated risks and expenses borne by the purchaser/importer.

7. **Under a penalty regime known as the Administrative Monetary Penalty System (AMPS), the Canada Border Services Agency (CBSA) will issue monetary penalties for instances of non compliance with customs obligations.** For more serious offences, an importer can face criminal charges and shipments can be seized. All imported goods must be reported to the CBSA, the proper customs value must be determined and any applicable duties and taxes (e.g., import GST) must be calculated and paid. Typically, companies will appoint a licensed customs broker to represent them and assist them in the process of having their goods customs cleared at the border and also accounted for. The importer, not the customs broker, is responsible for the

importation and all customs compliance obligations surrounding the import, so it's important to ensure the broker receives the correct information and to verify that the declaration was done correctly.

8. **Determining the customs value of imported goods, or their value for duty (VFD), requires the application of a prescribed valuation method.** The primary method in Canada is the transaction value method. To use the transaction value method, a sale for export to Canada must have taken place, and there must be a price paid or payable for the goods. The purchaser of the imported merchandise must also qualify as a "purchaser in Canada," a unique Canadian customs valuation requirement. Also, where not already included in the price paid or payable of the goods, certain statutory additions (e.g., assists or some royalty payments) to the price paid or payable may need to be added to the VFD, thus increasing the value on which import duties and import taxes are calculated. It is obligatory to determine the VFD of the imported goods correctly, whether the goods are subject to import duties or not. Failure to do so can lead to miscalculations in the duties and taxes owing, and therefore potential reassessments, punitive interest charges and non-compliance penalties if discovered by the CBSA.

9. **Importers involved in related-party transactions need to understand that there are additional complications to arrive at the VFD when the seller and the buyer are related.** The CBSA will accept a transfer price (intercompany price) as the basis for customs valuation in certain circumstances if based on an OECD-approved method, and also that the price paid or payable is arm's length and all intercompany charges that might constitute statutory additions to the VFD have been included. Quite often a Canadian company may pay a parent company for finished goods that it imports and also a management and administrative services fee on a separate transaction. There's a high risk that the intercompany services fee will be considered part of the VFD of the goods themselves.

10. **Although Canada is known as a favourable jurisdiction when it comes to using transfer prices for purposes of determining the VFD on related-party transactions, income tax rules that govern transfer pricing and the customs valuation rules are not the same.** The methodologies differ and the "tax" objectives in transfer pricing and customs planning are not identical. Transfer pricing considers overall results and activities over a lengthy period of time, and focuses on annual net income for tax purposes. Customs valuation is transactional in nature (specific transaction on a specific date) and zeroes in on a specific item's value and corresponding duty exposure. Multinational enterprises sometimes increase the price paid or payable by the Canadian company for transfer pricing purposes without appreciating that raising the VFD means raising the import duty liability on the goods. If the goods happen to be garments with duty rates of approx 18%, the impact could be considerable. Importers in this situation need to exercise caution and to make sure that both income tax and customs planning objectives are considered simultaneously. It is also important to recognize that periodic (e.g., year-end) adjustments to transfer prices for income tax purposes may need to be reported to the CBSA. If the price paid or payable is effectively going up, even post-importation, then the new VFD on each import transaction impacted by the adjustment needs to be reported to the CBSA.

In conclusion, importing and exporting goods into and out of Canada is complex and requires a good understanding of multiple laws and regulations. Many companies fail to appreciate just how complicated and multifaceted the legal and compliance requirements surrounding these commercial activities actually are. There are many potential "traps" and there can be costly consequences for the misinformed and unprepared.

Learn more

For more information, view our webcast, and contact your Ernst & Young advisor or one of the following Indirect Tax professionals.

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