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Canada Seeks to Impose Customs Duties on Management Fees and R&D Payments

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On July 8, 2009, the Valuation Division of the Canada Border Services Agency (“CBSA”) issued a major new policy document that targets for inclusion in the value for duty of imported goods virtually all payments made between related parties. The document is published as Customs Memorandum D13-4-13, “*Post-Importation Payments or Fees – Subsequent Proceeds (Customs Act, Section 48)*”¹. It is the official announcement of a policy that has been gaining ground for several years among customs auditors that have sought to characterize various related party payments as part of the price paid or payable for imported goods and, therefore, subject to duty.

The starting point for CBSA is the notion of “subsequent proceeds”. The WTO *Customs Valuation Code*, and national legislation in signatory countries require that in calculating the price paid or payable for imported goods, you must include “the value of any part of the proceeds of any

subsequent resale, disposal or use of the goods (...) that accrues or is to accrue directly or indirectly, to the vendor”. Given that customs duty is calculated as a percentage of the price paid or payable for the goods, “subsequent proceeds” are dutiable.

What is novel in the new Canadian policy is the broad interpretation of the notion of subsequent proceeds that captures most inter-company transfers, no matter how they are described. Under the new policy, the following payments may be considered part of the price paid or payable for the imported goods and, therefore, dutiable:

- (i) payments based on the resale of the goods that cannot be tied to services received;
- (ii) management or administration fees paid by the importer, directly or indirectly to the vendor;
- (iii) contributions to the parent’s or an affiliate’s research and development efforts;
- (iv) contributions for worldwide marketing or promotion;

¹ CANADA BORDER SERVICES AGENCY, *Post-Importation Payments or Fees – Subsequent Proceeds (Customs Act, Section 48)*, Customs Memorandum D13-4-13, Ottawa, Public Safety Canada, July 8, 2009, <http://cbsa-asfc.gc.ca/publications/dm-md/d13/d13-4-13-eng.html>.

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- v) overhead expenses relating to the manufacture of the goods but not captured in the selling price;
- vi) interest on deferred payments.

In case there was any misunderstanding about the scope of the new policy, the D-Memorandum states:

“Nowhere in the *Customs Act* or the World Trade Organization (WTO) International Valuation Agreement, (*sic*) is there a requirement that these subsequent proceeds must be a “condition of sale of the goods or be “in respect of the goods” being imported. Rather, the mere fact that such payments exist requires they be added to the price paid or payable.”²

In other words, payments that are wholly unconnected to imported goods may still be considered part of the price paid for those goods.

Much of the D-Memorandum is devoted to discussing how management and administrative fees will be treated. However, separate Appendices are devoted to the treatment of research and development fees, marketing and promotional fees and various other inter-company payments

Management and Administration Fees

From now on, CBSA will consider management or administration fees paid between related parties to be part of the price paid or payable for imported goods (and therefore part of the value for duty) unless three conditions are met:

- 1) the services must have been rendered for the operation of the business in Canada;
- 2) the amount of the charge must be comparable to an arms-length charge; and

² *Id.*, Guidelines and General Information, s. 9.

- 3) the services provided are justified for the operation of the business in Canada.

The first requirement is that management or administration fees must be paid in respect of services actually rendered and the importer is responsible for keeping “sufficient and appropriate evidence, which establishes the nature of the services and proves that they were truly provided for the operation of the business in Canada”. Without such evidence, the fees will be considered part of the value for duty of the goods.³

CBSA will also subject the management fees to a two-part arms-length test that requires (i) that the amounts paid be comparable to the price that would be charged by an unrelated party and (ii) that the method of allocation of costs to the Canadian company must be reasonable and appropriate to the circumstances of the importer’s business. Again, the burden is on the importer to substantiate that the amount of the charge in question is reasonable. The D-Memo advises that management fees and/or administration fees determined after the provision of the service are more likely to be challenged by CBSA.⁴

The final condition is that the services must be justified, in the sense that an unrelated Canadian business would be willing to pay for the management and/or administrative services because the services are needed and deliver some kind of benefit. As an example of an unjustifiable service, the D-Memorandum notes that a Canadian corporation would not normally bear the costs of a shareholders meeting of its parent corporation or pay for promotional services that did not take place in Canada for a product not sold in Canada.⁵

³ *Id.*, s. 17-18.

⁴ *Id.*, s. 23.

⁵ *Id.*, s. 26.

The overall approach that CBSA intends to take is summarized in the D-Memorandum as follows:

“CBSA will initially presume that service fees are dutiable with the provision that this can be rebutted with evidence from the importer indicating that the fees are in accordance with the arms-length principle, and that they relate to justifiable services that were actually rendered for the Canadian operation. Importers must be able to provide “sufficient information” pursuant to subsection 45(1) to justify exclusion of the fees from the value for duty.”⁶

Research and Development Fees

In an appendix to the D-Memorandum, CBSA sets out its policy with respect to the treatment of Research and Development fees as follows:

“In general, payments to the vendor of goods by the purchaser in a sale for export to Canada for research and development are considered as an addition to the price paid or payable for the goods and are to be included in the value for duty as prescribed by subsection 48(5) of the *Customs Act*. These would include research expenditures that can be regarded as part of a continuing activity required to maintain an enterprise’s business and its competitive position and development activities normally undertaken with a reasonable expectation of commercial success and future benefits arising from increased revenue or from reduced costs.”⁷

CBSA considers that the typical activities that would be included in research are: (i) laboratory research and the discovery of new knowledge; (ii) searching for commercial applications for new research findings; and (iii) conceptual formulation and design of possible product or process alternatives. Similarly, typical examples of development activity are: (i)

testing in search for, or evaluation of, product or process alternatives; (ii) design, construction and testing of pre-production prototypes and models; and (iii) design of tools, jigs, moulds and dies involving new technology.⁸

Thus, a Canadian company’s contribution to the worldwide R&D efforts of its corporate group will be considered to form part of the price paid for imported goods, and will be subject to duty.

Marketing and Promotional Fees

The D-Memorandum distinguishes between two types of marketing and promotional fees that the parent corporation might charge to its subsidiaries. The first type of fee is in respect of marketing operations that are conducted on a global basis by multinationals to promote a particular product which is imported into Canada as well as distributed internationally. CBSA considers that these marketing fees are fees for services rendered (promotion in respect of a good that is imported into Canada).⁹

The second category relates to fees that are paid in respect of goods that are never imported into Canada and CBSA states that “if the marketing fee cannot be related to the specific product(s), which are imported and sold in Canada, then the fees cannot be identified as legitimate services the Canadian subsidiaries received”. Accordingly, this type of marketing or promotional fees would be found to be a “subsequent proceed” that must be added to the price paid or payable.¹⁰

Other Post-Importation Payments

The final appendix to the D-Memo brings together a number of specific examples of inter-company

⁶ *Id.*, s. 31.

⁷ *Id.*, Appendix A, para. 9.

⁸ *Id.*, Appendix A, para. 3-6.

⁹ *Id.*, Appendix B, para. 2.

¹⁰ *Id.*, Appendix B, para. 3.

payments that may be considered to be part of the price paid for the goods and, therefore, subject to customs duty. It confirms that dividend distributions are not considered to form part of the value for duty of the imported goods, but only if the importer can provide substantiation that the amounts were in fact paid as dividends.¹¹ If the importer cannot provide such proof, the payments will be treated as part of the value for duty of the goods. Payments made by the Canadian subsidiary to its parent to repay debts, even those amounts are calculated as a proportion of the selling price in Canada likewise are considered financial transactions that do not form part of the value for duty of the goods, providing the amounts are reasonable.¹²

Finally, the appendix provides several examples of management fees structures which may or may not be acceptable and confirms that payments for the installation of imported goods and setup and service charges are not part of the value for duty of the goods.¹³

Conclusion

The D-Memorandum leaves no doubt that CBSA is looking to develop the law in this area and will scrutinize virtually all inter-company transfers with a view to including those payments to the value of imported goods. CBSA will also operate on the assumption that such payments are dutiable unless the importer can provide evidence showing that the payments were in fact for services rendered, were justified and met an arms-length test.

Given the fact that CBSA can retroactively assess duty up to four years after goods were imported, the potential liability is significant. For that reason, related parties should re-examine all payment flows between its related entities to determine how best to structure and document such inter-company transactions to ensure that payments are not considered payments for imported goods and are not subject to duty.

For more information on the subject of this bulletin, please contact the author::

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¹¹. *Id.*, Appendix C, Situations A and B.

¹². *Id.*, Appendix C, Situation C.

¹³. *Id.*, Appendix C, Situations D and F.

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