

# ARTICLE

## The Customs Treatment of Royalties and License Fees with Regard to Imported Goods

Michael Lux, Dan Cannistra & Miguel A. Rodriguez Cuadros\*

*A commentary issued by the International Chamber of GATT Customs Valuation Code states with regard to royalties and license fees:<sup>1</sup> 'there is no part of the Code where so much is left to interpretation and implementation, and so little can be derived from a literal reading of the words used. Some critics have thought the authors of the Code did not explore the subject sufficiently, and it is true that the subject was only reached rather late in the Geneva negotiations and revealed considerable differences between governments (often as to what problems required attention, rather how they should be resolved)'.<sup>2</sup>*

*This article serves as a legal analysis of a variety of royalty payment scenarios and the resulting impact on final duty payments taking into account the legislation and practices in the Andean Community and Peru, the European Union (EU), and the United States. As a general matter, the term 'royalties' simply refers to a means by which consideration is paid for the right to use an intangible property. As such, royalty payments themselves are not inherently dutiable or not dutiable. Instead, one must look in particular to the nature of the intangible property that is being conveyed and the issue of whether it relates to the goods being valued and whether it must be paid, either directly or indirectly, as a condition of the sale.*

### I INTRODUCTION

Article II(1)(a) of the General Agreement on Tariffs and Trade (GATT), which is the basis of the modern trade framework, obliges GATT members to accord to imports from other GATT members treatment no less favourable (this is called 'most favoured nation treatment') than that provided for in the schedule of concessions that lays down the customs duty rates for the different types of goods. Most import duties are expressed in relation to the value of the goods (i.e., an *ad valorem* tax). For example, if the value of a good is USD 1,000, and the tariff rate negotiated with a country is 10%, then the importer can expect an amount of import duty of USD 100 (to this amount internal taxes, such as value-added tax (VAT) and/or excise duty, may have to be added, and those taxes may also be based on the value of the good). However, the term 'value' – as opposed to 'cost' or 'price' of the good – is open to different interpretations.

The current valuation framework, the Implementation of Article VII of the GATT, better known as the World Trade Organization (WTO) Customs Valuation

Agreement (CVA) promotes trade fairness, neutrality, and uniformity in customs duties assessment. However, the CVA came into force in the late 1970s, and since then, companies have evolved in how they conduct cross-border business, expanded international trade, supply chains, and distribution networks, and diversified how multinational corporations interact internally to create global efficiencies, centres of excellence, and allocation of revenue. With the increasing global nature of business, companies have developed a multitude of situations such as royalties and license fees that can impact the transaction value (paid price or payable price of imported goods).

As a general matter, the term 'royalties' simply refers to a means by which consideration is paid for the right to use an intangible property. As such, royalty payments themselves are not inherently dutiable or not dutiable. Instead, one must look to the nature of the intangible property that is being conveyed and the mechanism for paying for that intangible property before determining the dutiability of a specific payment for intangible property within the parameters set forth by the WTO CVA and its

### Notes

\* Michael Lux is the author of the book *Guide to Community Customs Legislation* (2002). After working in the German and EU customs administration, he is now a lawyer at the Brussels office of Graf von Westphalen, E-mail: m.lux@gvw.com. Dan Cannistra is a counsel within the International Trade Practice of Crowell & Moring LLP in Washington, DC. The authors also express their gratitude to Jini Koh, an associate at Crowell & Moring. Ms Koh provided invaluable insight and expertise in the development of this article. Miguel A. Rodriguez Cuadros is a lawyer from the University of Lima. He is Magister Legum (LL.M.) in International Taxation from the Freie Universität Berlin, Germany with post-graduate studies in Free Trade Agreements and in Wholesale Management and Foreign Trade. He is a candidate to obtain in 2012 the title of Master of International Trade Law and Economics from the World Trade Institute, University Bern, Switzerland, E-mail: marc@aloe.ulima.edu.pe.

<sup>1</sup> In the Customs Valuation Code (and in EU legislation), the terms 'royalties' and 'licence fees' are not differentiated from each other and are always used together; see Saul Sherman & Hinrich Glashoff, 'Customs Valuation: Commentary on the GATT Customs Valuation Code' (1988), 123 (hereinafter 'ICC Commentary').

<sup>2</sup> Sherman & Glashoff, 'Commentary on the GATT Customs Valuation Code' (1988), 123.

implementation in local law. Customs authorities in different countries, however, have increasingly construed royalties as a catch-all under which virtually any and all payments, such as those associated with distribution rights, cost-sharing agreements, licenses, trademarks, patents, royalties, and so on, may be considered an addition to the price under which the goods were sold (transaction value).

The purpose of this article is to explain how the customs valuation provisions from the European Union (EU), the United States, the Andean Community, and Peru treat royalties and licensee fees. Furthermore, case law from Germany, the United States, Peru, Spain, and other countries will be surveyed to have a better understanding of how royalties and licensee fees are addressed in various WTO jurisdictions.

## 2 WTO CVA: BACKGROUND

The basis of the modern customs valuation framework, within which royalty and license fees are considered as dutiable components of value or non-dutiable, begins with the GATT Valuation Provisions. Article II(3) of the GATT states that *no contracting party shall alter its method of determining dutiable value (. . .) so as to impair the value of any [tariff] concessions*. In other words, an importing country cannot change its customs valuation method to circumvent the effects of the bound tariff rate, but this rule alone does not preclude arbitrary methods for the determination of the customs value.<sup>3</sup> Article VII GATT attempts to lay down a common framework for the determination of the customs value. Article VII(2)(a) GATT stipulates that the value for customs purposes of imported merchandise should be based on the actual value of the imported merchandise on which duty is assessed, or of like merchandise, and should not be based on the value of merchandise of national origin or on arbitrary or fictitious values. A note to this provision clarifies that ‘actual value’ may be represented by the invoice price, plus any non-included charges for legitimate costs that are proper elements of ‘actual value’ and plus any abnormal discount or other reduction from the ordinary competitive price.

Article VII GATT allows thus for determination of the customs value for both a system based on the actual invoice price (which can also be called the transaction value) and a system based on the ordinary competitive price (which can also be called the normal value). This is

confirmed by Note 4 to Article VII GATT that concluded that GATT members may base the customs value either on the exporter’s price for the imported merchandise or on the general price level of the merchandise.

Pursuant to Article VII, GATT members implemented different appraisement interpretations to determine customs value. Until 1980, the members of the European Economic Community (what is now the EU) and many other countries used the CVA elaborated under the auspices of the Customs Cooperation Council (CCC) in Brussels (now known as the World Customs Organization – WCO). Under the CCC CVA, the customs value for the purpose of applying the customs tariff shall be the normal price, that is, the price that the goods would fetch, at the time of the declaration for home use, on a sale in the open market between a buyer and a seller independent of each other.<sup>4</sup> When the goods to be valued were (1) manufactured in accordance with any patented invention or are goods to which any protected design has been applied; (2) imported under a trademark; or (3) imported for sale, other disposal, or under a foreign trademark, the normal price shall be determined on the assumption that it includes the value of the right to use the patent, design, or trademark in respect of the goods; this provision also applies in the case of copyright or any other intellectual or industrial property right.<sup>5</sup>

Other countries, such as the United States, based the customs value on the export price or price at which the goods were sold for export to the United States. Other criteria included the actual price paid, the post-importation resale price in imported market, the constructed value, or cost of production. In order to end these divergences, during the Tokyo Round Negotiations (1973–1979), the GATT members negotiated a common customs valuation system. As a result, the members concluded the Agreement on Implementation of Article VII of the GATT, better known as the GATT CVA.<sup>6</sup> In the subsequent Uruguay Round (1986–1994), the CVA, with minor changes, was included as an annex to the Marrakesh Agreement establishing the World Trade Organization as the WTO CVA, with the effect that all WTO members must apply this agreement.<sup>7</sup>

## 3 WTO CVA: PROVISIONS

According to Article 1 of the Agreement, the primary basis for customs value is the *transaction value*, that is, the price actually paid or payable for the goods when sold for

### Notes

<sup>3</sup> World Trade Organization, *A Handbook on WTO Customs Valuation Agreement* (2011), 4.

<sup>4</sup> Article 1 Regulation (EEC) No. 803/68, OJ 1968 No. L 148, 6.

<sup>5</sup> Article 3 Regulation (EEC) No. 803/68.

<sup>6</sup> OJ 1980 No. L 71, 107.

<sup>7</sup> OJ 1994 No. L 336, 119.

export to the country of importation. The transaction value can be adjusted upwards or downwards in accordance with the provisions of Article 8 of the Agreement. Therefore, the customs value for the importation of goods is determined mainly by the following formula: [Paid or payable selling price] +/- [Adjustments of Article 8 of the Agreement].

Royalties and license fees are referred to in Article 8.1(c) of the Agreement as upward adjustments. The royalties and license fees must be added to the transaction value if the following main conditions are met:

- The royalties and license fees should be related to the goods being valued.
- The royalties and license fees should be paid by the buyer, either directly or indirectly.
- The royalties and license fee should be paid as a condition of sale of the goods being valued.
- The royalties and license fees are not included in the price actually paid or payable.
- The adjustment should be done on the basis of objective and quantifiable data.<sup>8</sup>

Included as part of the Agreement are also the notes in an Annex; two notes refer specifically to Article 8.1(c). As supplementary guidance to the Agreement, the Technical Committee on Customs Valuation of the WCO<sup>9</sup> has published Advisory Opinions and Commentaries. Those particular to royalties and licensee fees include: Advisory Opinions 4.1, 4.2, 4.3, 4.4, 4.5, 4.6, 4.7, 4.8, 4.9, 4.10, 4.11, 4.12, and 4.13 (Advisory Opinions) and Commentaries 19.1 and 25.1.

According to Note 1 to Article 8.1(c), charges for the right to reproduce the imported goods in the country of importation should not be added to the transaction value. This Note should be read in accordance with Commentary 19.1, which explains the meaning of the expression 'right to reproduce the imported goods' to include not only physical reproduction but also the right to reproduce or an idea incorporated into the imported good. Commentary 19.1 also notes that acquisition of goods covered by a right did not, in itself, confer the right to reproduce (i.e., the intellectual property rights).

In regard with the condition of sale requirement of Article 8.1(c), Note 2 to this Article outlines that the payments made by the buyer for the right to distribute or resell the imported goods shall not be added to the transaction value if such payments are not a condition of the sale for export to the importing country. However, the Note does not provide a meaning of the expression 'condition of sale' within the context of Article 8.1(c) of the Agreement. In this sense, it is necessary to look for other provisions that might provide a definition of the term 'condition of sale' or examples when the royalty and license fee payments for the resell or distribution of licensed products are not a condition of sale of the imported goods.

Commentary 25.1, issued by the WCO Valuation Committee in April 2011, addresses royalty and license fees when they are paid to a third-party licensor unrelated to the seller. In focusing on the purpose of Article 8.1(c), this Commentary states that the analysis requires a case-by-case determination focusing strongly on the terms of the licensing or royalty agreement and related transaction documents. Generally, however, it is unlikely that a fee paid to a third-party licensor would be included in the price paid or payable, but what must be analysed is how the fee is related to the imported good and if the fee is a condition of sale. A royalty or license fee may be considered to 'relate to the goods being valued' when the imported goods incorporate the intellectual property and/or are manufactured using the intellectual property covered by the license. With regard to the question of whether a royalty payment is a 'condition of the sale', the determining factor is whether the buyer is unable to purchase the imported goods without paying the royalty or license fee. Indicators for this are:

- there is a reference to the royalty in the sales agreement or related documents;
- there is a reference to the sale in the royalty agreement;
- the sales or license agreement can be terminated as a consequence of breaching the royalty agreement;
- the royalty agreement prohibits the production and sale of the goods incorporating the intellectual property if the royalties are not paid;

## Notes

<sup>8</sup> Article 8.3 CVA.

<sup>9</sup> Article 18 of the Agreement establishes a Technical Committee on Customs Valuation ('Technical Committee') under the auspices of the WCO to ensure technical uniformity in interpretation and application of the Agreement. The responsibilities of the Technical Committee include advising on specific technical matters as requested by members or by a panel in a dispute. The Technical Committee also issues advisory opinions, which are technical instruments that analyse and answer questions raised by WTO members with regard to a specific set of facts.

- according to the royalty agreement, the licensor is allowed to manage the production or sale between the manufacturer and importer beyond quality control.

#### 4 IMPLEMENTATION OF THE CVA IN THE EU

The EU has implemented Articles 1 and 8 CVA in its Customs Code (CC)<sup>10</sup> and the implementing provisions thereto (CCIP).<sup>11</sup> Guidance on the use of the EU Customs Valuation Provisions is given in the Customs Valuation Compendium (CVC) of the Customs Code Committee.<sup>12</sup> Consequently, the customs value of imported goods is, in principle, based on the price actually paid or payable for goods when sold for export for the EU customs territory; this price is, in certain cases, to be adjusted upwards or downwards.<sup>13</sup> The ‘price actually paid or payable’ is defined as ‘the total payment made or to be made by the buyer to or for the benefit of the seller for the imported goods and includes all payments made or to be made as a condition of sale of imported goods by the buyer to the seller or by the buyer to a third party to satisfy an obligation of the seller’.<sup>14</sup>

Additions to the price actually paid or payable shall be made on the basis of objective and quantifiable data.<sup>15</sup> In cases where royalties and license fees related to the goods are not included in the price actually paid or payable, they shall be added to the price actually paid or payable for the purposes of determining the customs value.<sup>16</sup> Whereas the CVA mentions only *among other things, payments in respect to patents, trademarks and copyrights* and excludes *charges for the right to reproduce the imported goods in the country of importation*,<sup>17</sup> the EU provisions are more specific. Royalties and license fees are only included in the customs value when they relate to the goods being valued and constitute a condition of sale of those goods.<sup>18</sup> Accordingly, the term ‘royalties and license fees’ covers in particular payment for the use of rights relating to:

- the manufacture of imported goods, such as patents, designs, models, and manufacturing know-how;
- the sale for exportation of imported goods, such as trademarks and registered designs;
- the use or resale of imported goods, such as copyright and manufacturing processes inseparably embodied in the imported goods.<sup>19</sup>

However, no royalties or license fees shall be added for:

- charges for the right to reproduce the imported goods in the EU;
- payments made by the buyer for the right to distribute or resell the imported goods if such payments are not a condition of the sale for export of the goods to the EU.<sup>20</sup>

With regard to ‘know-how’, the following guidance is provided:<sup>21</sup>

- Where know-how (not divulged technical information necessary for the industrial reproduction of a product or process) provided under a license agreement applies to the imported goods, the inclusion of any royalty or license fee depends on the type of know-how provided.
- Where, under a franchising agreement, the supply of services, such as training of the licensee’s staff in the manufacture of the licensed product or in the use of machinery/plant is covered, such services are not to be included in the customs value.
- Where, under a license agreement and contract of sale, only a part of the royalty payment is dutiable and there is no clear separation between dutiable and non-dutiable elements, customs may include the whole royalty or license fee in the customs value.<sup>22</sup>

When the buyer pays royalties or license fees to a third party, they are added to the price actually paid or payable only where the seller or a person related to him requires

#### Notes

<sup>10</sup> Regulation (EEC) No. 2913/92, OJ 1992 No. L302, 1.

<sup>11</sup> Regulation (EEC) No. 2454/93, OJ 1993 No. L 253, 1.

<sup>12</sup> <[http://ec.europa.eu/taxation\\_customs/customs/customs\\_duties/declared\\_goods/european/index\\_en.htm](http://ec.europa.eu/taxation_customs/customs/customs_duties/declared_goods/european/index_en.htm)>.

<sup>13</sup> Article 29(1) CC; Art. 1 CVA.

<sup>14</sup> Article 29(3)(a) CC, Note to Art. 1 CVA.

<sup>15</sup> Article 32(2) CC, Art. 8(3) CVA.

<sup>16</sup> Article 32(1)(c) CC, Art. 8(1)(c) CVA.

<sup>17</sup> Note to Art. 8(1)(c) CVA.

<sup>18</sup> Article 157(2) CCIP.

<sup>19</sup> Article 157(1) CCIP; the latter condition is also laid down in Art. 32(1)(c) CC.

<sup>20</sup> Article 32(5) CC, Note to Art. 1 CVA.

<sup>21</sup> Commentary No. 3 CVC (5–10).

<sup>22</sup> This statement contradicts somewhat Art. 32(2) CC, Art. 8(3) CVA, and the Note to this provision, which stipulate that additions to the price actually paid or payable shall be made only on the basis of objective and quantifiable data. It is therefore advisable to separate in the license agreement the dutiable from the non-dutiable elements.

the buyer to make that payment (i.e., as a condition of sale).<sup>23</sup> The country of residence (within or outside the EU) of the recipient of the royalty or license fee is irrelevant in this context.<sup>24</sup>

It should be noted that in certain cases where the producer of the export goods receives inputs/assists free of charge or at reduced cost (the value of which includes royalties) it is those rules that are applied in practice and not those on royalties. These rules foresee that the value of materials and components, parts, and similar items incorporated in the imported goods that are supplied directly or indirectly by the buyer free of charge or at reduced cost for use in the production and sale for export of the imported goods are to be included in the customs value.<sup>25</sup> The same applies to engineering, development, artwork, design work, plans, and sketches undertaken elsewhere than in the EU and necessary for the production of the imported goods.<sup>26</sup>

## 5 IMPLEMENTATION OF THE CVA IN THE UNITED STATES

The CVA was adopted into US domestic law in the Trade Agreements Act of 1979 (the 'Act'), codified at 19 U.S.C. section 1401a and implemented through corresponding regulations contained in 19 C.F.R. section 152.100 and others. Transaction value is the preferred method of appraisal and is defined as 'the price actually paid or payable for the merchandise when sold for exportation to the United States' plus certain enumerated additions. Among others, these additions include 'any royalty or license fee related to the imported merchandise that the buyer is required to pay, directly or indirectly, as a condition of the sale of the imported merchandise for exportation to the United States' or 'the proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue, directly or indirectly, to the seller'.<sup>27, 28</sup> When passing the Trade Agreements Act of 1979, which includes 19 U.S.C. section 1401a(b)(1), Congress stated:

Additions for royalties and license fees will be limited to those that the buyer is required to pay, directly or

indirectly, as a condition of the sale of the imported merchandise for exportation to the United States. In this regard, royalties and license fees for patents covering processes to manufacture the imported merchandise will generally be dutiable, whereas royalties and license fees paid to third parties for use, in the United States, of copyrights and trademarks related to the imported merchandise, will generally be considered as selling expenses of the buyer and therefore will not be dutiable. However, the dutiable status of royalties and license fees paid by the buyer must be *determined on a case-by-case basis* and will ultimately depend on: (i) whether the buyer was required to pay them as a condition of sale of the imported merchandise for exportation to the United States; and (ii) to whom and under what circumstances they were paid. For example, if the buyer pays a third party for the right to use, in the United States, a trademark or copyright relating to the imported merchandise, and such payment was not a condition of the sale of the merchandise for exportation to the United States, such payment will not be added to the price actually paid or payable. However, if such payment was made by the buyer as a condition of the sale of the merchandise for exportation to the United States, an addition will be made. As a further example, an addition will be made for any royalty or license fee paid by the buyer to the seller, unless the buyer can establish that such payment is distinct from the price actually paid or payable for the imported merchandise, and was not a condition of the sale of the imported merchandise for exportation to the United States.

US Customs and Border Protection (CBP) has established a three-part test<sup>29</sup> to establish whether royalty payments meet the WTO standard:

- (1) *Was the imported merchandise manufactured under patent:*  
CBP differentiates between royalties paid for patents to help produce the imported merchandise and royalties paid for other licenses. Specifically, 'royalties paid for patents covering processes to manufacture the imported merchandise will generally be dutiable, and

### Notes

<sup>23</sup> Article 160 CCIP.

<sup>24</sup> Article 162 CCIP.

<sup>25</sup> Article 32(1)(b)(i) CC, Art. 8(1)(b)(i) CVA.

<sup>26</sup> Article 32(1)(b)(iv) CC, Art. 8(1)(b)(iv) CVA.

<sup>27</sup> See 19 U.S.C. ss 1401a(b)(1)(D) and (E) (emphasis added).

<sup>28</sup> As an initial note, CBP is entitled to presume that all payments made by the buyer to the seller or to a party related to the seller are part of the price actually paid or payable for imported merchandise. See *Generra Sportswear Co. v. United States*, 905 F.2d 377 (Fed. Cir. 1990). However, the *Generra* presumption may be rebutted provided the importer can establish that the payments at issue are unrelated to the imported merchandise. See *Generra*, 905 F.2d at 380. Beyond the initial *Generra* presumption, there is a specific test for royalties and license fees.

<sup>29</sup> Commonly known as the 'Hasbro II' factors and published in a CBP General Notice titled as Dutiability of Royalty Payments, vol. 27, No. 6 Cust. B. & Dec., 1 (10 Feb. 1993).

royalty fees paid to third parties for use, in the United States, of copyrights and trademarks related to the imported merchandise will not be dutiable'.<sup>30</sup>

- (2) *Was the royalty involved in the production or sale of the imported merchandise:* This analysis expands upon the analysis in the first question. In evaluating this question, CBP has looked at whether the 'licensed fee is linked to individual sales agreements or orders', and whether the royalty is paid for 'rights arising under a separate contractual arrangement'.<sup>31</sup>
- (3) *Could the importer buy the product without paying the fee?:*<sup>32</sup> This question 'goes to the heart' of whether a royalty is a condition of sale. CBP will ask whether royalties 'are paid on each and every importation and are inextricably intertwined with the imported merchandise'; if the payments are optional or if they are 'paid solely for the exclusive right to manufacture and sell in a designated area', then they do not constitute dutiable additions.<sup>33</sup> CBP has found that when it is 'clear from the license agreements that royalty payments' are only 'due upon the sale of imported merchandise in the United States', then 'if the imported goods are never sold in the United States, the license fees are never paid, thus, making the payments of license fees optional'.<sup>34</sup>

While CBP has held that positive responses to the first two questions and a negative response to the third would indicate that the payments were a condition of sale and, therefore, dutiable as royalty payments,<sup>35</sup> its rulings have tended to be less black and white. In effect, the rulings apply a 'totality of the circumstances' test that analyses several factors in each of the three prongs of its test, including:

- (i) [T]he type of intellectual property rights at issue (e.g., patents covering processes to manufacture the imported merchandise generally will be dutiable);
- (ii) [T]o whom the royalty was paid (e.g., payments to the seller or a party related to the seller are more likely to be dutiable than are payments to an unrelated third party);

- (iii) [W]hether the purchase of the imported merchandise and the payment of the royalties are inextricably intertwined (e.g., provisions in the same agreement for the purchase of the imported merchandise and the payment of the royalties; license agreements which refer to or provide for the sale of the imported merchandise, or require the buyer's purchase of the merchandise from the seller/licensor; termination of either the purchase or license agreement upon termination of the other, or termination of the purchase agreement due to the failure to pay the royalties); and,
- (iv) [Whether] there was payment of the royalties on each and every importation.<sup>36</sup>

Under the second factor, CBP has established a rebuttable presumption that payments made by the buyer to, or on behalf of, the seller are included in the price actually paid or payable.<sup>37</sup> CBP has tended to collapse related party transactions, holding that the presumption applies to payments made to parties related to the seller.<sup>38</sup> Finally, under 19 U.S.C. section 1401a(b)(1)(E), payments could be an addition to the price paid or payable if it is the 'proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue, directly or indirectly, to the seller'.<sup>39</sup>

## 6 IMPLEMENTATION OF THE CVA IN THE ANDEAN COMMUNITY AND PERU

The Andean Community comprises of four Andean countries: Colombia, Ecuador, Peru, and Bolivia. Currently, the Andean Community is a Free Trade Area where the importation of goods produced from any of the other Andean countries is duty free. The Andean countries have undertaken some efforts to become a Customs Union with an External Common Tariff. The Andean countries have already harmonized their Customs Valuation System and have implemented Community Rules regarding to the transaction value adjustments and the application of the Customs Valuation Methods.

### Notes

<sup>30</sup> CBP Headquarters Ruling Letter (HQ) H089759 (28 Dec. 2010).

<sup>31</sup> *Ibid.*

<sup>32</sup> See *supra* n. 29.

<sup>33</sup> *Ibid.*

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*

<sup>36</sup> HQ H089790 (28 Dec. 2010).

<sup>37</sup> HQ W563354 (27 Oct. 2010) (citing *Generra Sportswear Co. v. U.S.*, 905 F.2d 377 (Fed. Cir. 1990) and *Chrysler Corp. v. U.S.*, 17 CIT 1049 (CIT 1993)).

<sup>38</sup> See *Generra*; see, e.g., HQ 548560 (3 Sep. 2004).

<sup>39</sup> See 19 U.S.C. s. 1401a(b)(1)(E).

The Customs Valuation Provisions of the Andean Community are regulated by Decision<sup>40</sup> No. 571 and Resolution<sup>41</sup> No. 846. According to Article 1 of Decision 571, the Andean countries are ruled by the WTO CVA and the Andean Community Customs Valuation By-law – Resolution 846. Pursuant to Decision 571, the Andean Community Commission has adopted the WTO CVA and it has also incorporated this Agreement as part of its Andean legal body. In this sense and as part of their obligations, the Andean Member States should lodge a Customs Value Andean Declaration for customs valuation purposes that contains the transaction conditions for the importation of goods in the Andean Customs Territory.

According to Article 26 of Resolution 846 (the Resolution), royalties and license fees are considered as general property right payments in order to:

- Produce or sell products or goods using or incorporating patents, trademarks or drawings, models and expertise manufacturing, manufacturing processes, or any other property right industry regulated in Andean Decision 486 that implements the Common Regime Property Industry for the Andean Community.
- Use, manufacture, or resell product with the right to use copyright or related rights that are regulated in Andean Decision 351. This Decision implements the Common Copyrights Andean Community Regime.
- Produce or sell products or goods with the right to use of breeders' plant varieties covered by Andean Decision 345. This Decision regulates the Protection of New Varieties of Plants within the Andean Community.
- Produce or sell products or goods with the right to use and to access to genetic resources regulated by Andean Decision 391.

While the Resolution provides a general list of royalties and license fees that are considered part of the price actually paid or payable, Article 26 of the Resolution should be read and applied along with other important Andean Decisions that regulate on detail the Copyrights Common Regime, the Industrial Property, the Protection of New Varieties of Plants, and the Access to Genetic Resources.

Peru formally joined the WTO in 2000 and has since modified many of its domestic customs rules to be in accordance with the WTO multilateral agreements and the provisions of the Andean Community. The WTO

multilateral agreements, particularly the CVA and the Andean Community Decisions, are part of the Peruvian customs statutes and, therefore, are binding upon Peruvian importers and the Peruvian Customs Authority. Along with the WTO CVA and the Andean Community Regulations, the customs valuation statute in Peru is currently ruled by Decree Supreme No. 186-99-EF<sup>42</sup> (the By-law) and Customs Valuation Procedure No. 038-2010 (the Procedure).<sup>43</sup> Article 7 of the By-law enumerates the upward adjustments to the transaction value, such as sales commissions, packing and packaging costs, some services rendered by the buyer, international freight and insurance, and finally the royalties and license fees. Unlike the Customs Valuation Provisions of the Andean Community, the By-law and the Procedure do not specify *what* royalties or license fees should be added to the customs value. The By-law and the Procedure only indicate that the royalty and license fee adjustments should be done upon the base of an objective and quantifiable information. However, this legal loophole might be covered by the provisions of Resolution 846 of the Andean Community and the WTO CVA. Therefore, it is necessary to read and interpret the By-law and Procedure in accordance with other legal sources, like the WTO CVA, the Advisory Opinions, and the Andean Community Customs Valuation Rules.

## 7 ROYALTIES AND LICENSE FEES OFTEN INCLUDED IN THE CUSTOMS VALUE

In considering whether royalties or license fees relate to the goods being valued,<sup>44</sup> the key considerations are:

- why the fees were paid, that is, what in fact the payee receives in return for the payment;
- how the activity covered by the fees relate to the imported goods;
- from and to whom the fees were paid; and
- the terms surrounding the fees and where the activity associated with the fees takes place.

Thus, in the case of an imported component or ingredient of the licensed product, or in the case of imported production machinery or plant, a royalty payment based on the realization on sale of the licensed product may relate wholly, partially, or not at all to the imported

### Notes

<sup>40</sup> Published on 15 Dec. 2003 in the Andean Community Official Gazette but in force since 2004; <[www.comunidadandina.org/aduanas/valoracion.htm](http://www.comunidadandina.org/aduanas/valoracion.htm)>.

<sup>41</sup> Resolution 846 was published on 9 Aug. 2004 in the Andean Community Official Gazette but in forced since 2004; <[www.comunidadandina.org/aduanas/valoracion.htm](http://www.comunidadandina.org/aduanas/valoracion.htm)>.

<sup>42</sup> Published on 29 Dec. 1999 but in force since January 2000.

<sup>43</sup> Published on 2 Feb. 2010 but in force since 23 Aug. 2010.

<sup>44</sup> As required under Art. 8(1)(c) CVA, Art. 157(2) CCIP, 19 U.S.C. s. 1401a(b)(1), and Decision 571.

goods.<sup>45</sup> Below are examples of activities or intellectual property rights that are the subject of royalties or license fees and factual circumstances under which they can be considered as an element to the price actually paid or payable. These examples are from the WCO Valuation Committee, EU, US, Andean, and Peruvian matters.

The analysis of the facts and the economic relationship of the parties is important to interpret the WCO Advisory Opinions. Table 1 below gives a summary of cases that are discussed in both the dutiable and non-dutiable sections.

Table 1 WCO Advisory Options: Conditions of Sale

<i>Advisory Opinions</i>	<i>Are Royalties and Licenses a Condition of Sale?</i>	<i>Main Reasons</i>
4.5	No	The royalties are paid irrespective of whether the importer uses ingredients provided by the foreign manufacturer or bought from local suppliers. [Royalties are only related to the manufacture and sale of finished goods.]
4.6	Yes/No	Yes, if the goods are resold with the trademark (and the owner of the trademark is also the manufacturer of the finished goods); no, if the goods are resold without the trademark that contains the licensed trademark.
4.8	No	Royalties are an obligation from a different contract than the sales good agreement. Manufacturer, Importer, and Licensor are unrelated parties.
4.9	No	The royalty payment is made for the right to manufacture the licensed preparation and to use the trademark for the licensed preparation. The imported product is a standard, non-patented ingredient available from different manufacturers.

<i>Advisory Opinions</i>	<i>Are Royalties and Licenses a Condition of Sale?</i>	<i>Main Reasons</i>
4.10	Yes	The owner of the trademark is also the manufacturer of the finished goods that contain the trademark and comic strip characters. The license agreement establishes that the finished goods are sold with the trademark and the comic strip characters.
4.11	Yes	Importer, Manufacturer, and Licensor are related parties, and the parent company obliges the importer to pay the royalty as a result of buying the goods from the manufacturer.
4.13	No	Importer and Manufacturer are unrelated parties, and there is a separate agreement between the importer and the licensor unrelated to the sale of export.

### 7.1 Intellectual Property Necessary for Production

Perhaps one of the clearest ways a royalty or license fee is considered related to the goods is when the fees are paid for patents, copyrights, trademarks, engineering, know-how, artwork, research and development, design, or other types of intellectual property that is necessary for production of the imported good.<sup>46</sup> That is, the relationship between the fees and the imported good is clear in that the intellectual property licensed is used within, consumed during, or affixed on the good during the manufacturing process.

Utility patents are considered patents for ‘any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof’.<sup>47</sup> Royalties paid for the use of such patents that protect the manufacturing process of an imported good are the quintessential dutiable royalty. The payment does relate to a product protected by a patent under CBP’s first prong,

**Notes**

<sup>45</sup> Commentary No. 3(11) CVC.

<sup>46</sup> See Art. 157(1) CCIP; 19 U.S.C. s. 1401a; Decision 571.

<sup>47</sup> 35 U.S.C. s. 101.

also, the patent relates to the manufacture and sale for exportation under the second prong, and the importer could not have purchased the product – because the product could never have been produced – without having paid the royalty under the third prong.<sup>48</sup> Therefore, royalty payments associated with utility patent rights are dutiable. When the imported article is a component of the finished goods manufactured in the EU or United States, an adjustment to the price actually paid or payable for the imported goods shall only be made when the royalty or license fee relates to the imported articles – and not the finished goods manufactured in the EU or United States.<sup>49</sup> Likewise, utility patents or license fees remitted for technical assistance or intellectual property incorporated in post-importation/domestic manufacturing is not considered related to the imported goods.<sup>50</sup> Where goods are imported in an unassembled state or only have to undergo minor processing before resale (such as diluting or packing), a royalty or license fee may, nevertheless, be considered related to the imported goods.<sup>51</sup>

Similarly, royalties and license fees related to the right to use a trademark are also often considered dutiable. The EU has delineated specific parameters for trademark usage as a dutiable addition to the price actually paid where:<sup>52</sup>

- the fees refer to goods that are resold in the same state as imported or are subject only to minor processing after importation;
- the goods are marketed under trademark, affixed either before or after importation; and
- the buyer is not free to obtain such goods from other suppliers unrelated to the seller.

However, in the United States, when the payment for use of the trademark in the United States is made to third parties (i.e., not the seller or a party related to the seller), such payments are typically considered selling expenses of the buyer and not dutiable.<sup>53</sup>

Unlike the EU and US Customs Valuation Regulations, the Andean Community Rules do not provide detailed examples of when royalties and license fees are considered

related to the imported goods. However, Article 26(2) of the Resolution provides some general guidelines. According to this Article, royalties and license fees are considered related to the imported goods only when the seller or an entity related to the seller explicitly demands that the buyer pays the royalty. Additionally, Article 26(2) considers fees that are related to other components, such as goods or services incorporated into the goods post-importation,<sup>54</sup> as being related to the imported goods. Any adjustments should be done upon the basis of objective and quantifiable information, in accordance with Interpretative Note 8 of Article 8 of WTO CVA and Article 60 of the Resolution.

## 7.2 Royalty or License Fees Calculated on Import Value or Resale Price

Another perspective under which customs authorities determine whether a royalty or license fee relates to the imported goods is to examine how the fees are calculated and remitted to the licensor. The calculation and delivery method of the payment will be a separate factor in consideration than to what activity the fees are related.

While the calculation method of the royalty or license fee is not explicitly noted as being a factor relating the payment to the goods or as a condition of sale, several WCO Advisory Opinions include factual circumstances where the royalty or license fee is calculated on the sale price/import value or post-importation resale price and to whom the payment is made,<sup>55</sup> which supports consideration of this factor in determining whether the payment should be included in the price actually paid or payable.

In the EU, certain presumptions are placed on the royalty or license fees depending on the method or calculation of the fee, as follows:

- Where the method or calculation of the amount of a royalty or license fee derives from the price of the imported goods, it is assumed, in the absence of

### Notes

<sup>48</sup> See 19 C.F.R. s. 152.103(f).

<sup>49</sup> Article 158(1) CCIP; HQ 548692 (2 Mar. 2007).

<sup>50</sup> See, e.g., HQ 545419 (30 Nov. 1995); HQ W563404 (3 Mar. 2006); Art. 33(b) CC.

<sup>51</sup> Article 158(2) CCIP.

<sup>52</sup> Article 159 CCIP.

<sup>53</sup> 19 C.F.R. s. 152.103(f).

<sup>54</sup> According to the Andean Community Rules, the goods are imported once they are designated to a Customs Regime, for example, Temporary Importation or Bonded Warehouse Customs Regime.

<sup>55</sup> See, e.g., WCO Advisory Opinions 4.2 (royalty based on post-importation sale remitted to third party not included in price actually paid or payable), 4.4 (royalty based on post-importation sale of domestically finished goods to seller is included in price actually paid or payable), 4.5 (trademark fee based on annual gross sales of domestically finished goods to seller is not included in price actually paid or payable), 4.6 (trademark fee based on per unit sales to seller is included in price actually paid or payable), 4.7 (royalty based on % of retail selling price to seller is included in price actually paid or payable), 4.8 (trademark fee based on quantity sold to unrelated license holder is not included in price actually paid or payable).

evidence to the contrary, that the payment of that royalty or license fee is related to the imported goods.<sup>56</sup>

- Where the amount of a royalty or license fee is calculated regardless of the price of the imported goods, the payment of that royalty or license fee may, nevertheless, be related to the imported goods.<sup>57</sup>

While in the first case the burden of proof lies on the person declaring the goods, in the second case (lump sum royalty or license fee) the customs authorities need to justify why they assume that the royalty or license fee is related to the imported goods (given that further imports may follow). The other condition, namely that the royalty or license fee constitutes a condition of the sale,<sup>58</sup> must, of course, also be fulfilled.

In the United States, while the method of calculating the royalty, for example, based on the resale price, is not relevant in determining its dutiable status, there is a separate provision stating that payments could be an addition to the price paid or payable if it is the 'proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue, directly or indirectly, to the seller'.<sup>59</sup> Royalty or license fee payments based on the resale of imported merchandise or are obligated upon the resale of imported merchandise may be added to the price actually paid or payable. The proceeds of the subsequent resale inure directly to the seller or indirectly to the benefit of the seller (i.e., a party related to the seller). CBP notes a distinction, however, when payments are based on the resale of a finished product that is made, in part, from the imported merchandise and has determined that such payments are not dutiable as proceeds of a subsequent resale.<sup>60</sup>

In the Andean Community, when the calculation of the royalties or license fees is based on the import price, they are presumed to be related to the imported goods, unless the importer can prove the contrary. For example, if the importer pays the royalties or license fees upon an Free on Board (FOB) or Cost, Insurance and Freight (CIF) import value basis, the royalties or license fees are related to the imported goods declared according to their FOB or CIF values.

### 7.3 Royalties or License Fees When Considered as an Implicit or Explicit Condition of Sale

With regard to the question of whether a royalty or license fee constitutes 'a condition of the sale',<sup>61</sup> the answer depends on whether the seller would be prepared to sell the goods without the payment of a royalty or license fee or, conversely, whether the buyer could purchase the goods without paying the royalty or license fee. It is not necessary that the condition is explicitly stipulated in a license agreement or the contract of sale.<sup>62</sup> Such agreements, purchase contracts, and other transaction documentation should be reviewed, however, for language that may implicitly link or require the royalty or license fee to the imported merchandise.<sup>63</sup>

As expressed in WCO Advisory Opinions 4.6 and 4.10, the royalty or license fee can easily be considered as a condition of sale when the owner of the licensed right (and thus payee of the fees) is also the manufacturer and seller of the licensed goods. Thus, while refutable, there is a link between the imported goods and any royalty or licensed right that is attached to the goods.

When the buyer pays royalties or license fees to a third party, they are added to the price actually paid or payable only where the seller or a person related to him requires the buyer to make that payment.<sup>64</sup> Where a royalty or license fee is paid to a third party, the seller or a person related to him may be regarded as requiring the payment when, for example, in a multinational group goods are bought from one member of the group and the royalty is required to be paid to another member of the same group.<sup>65</sup> The same would apply when the seller is a licensee of the recipient of the royalty and the latter controls the conditions of the sale.<sup>66</sup> The payments are 'a condition of sale' if the buyer was not able to buy the goods from the seller, and the seller would not be prepared to sell the goods to the buyer, without the buyer paying a royalty to the license holder.

When royalties are paid to a party that exercises control over the manufacturer, such payments are regarded as

#### Notes

<sup>56</sup> Article 161(1) CCIP.

<sup>57</sup> Article 161(2) CCIP.

<sup>58</sup> Article 157(2) CCIP.

<sup>59</sup> 19 U.S.C. s. 1401a(b)(1)(E) (which is separate and distinct from royalty payments addressed under 19 U.S.C. s. 1401a(b)(1)(D)).

<sup>60</sup> See, e.g., HQ 546660 (June 1999); HQ 545951 (February 1998); HQ 545770 (June 1995); HQ 544656 (June 1991).

<sup>61</sup> As required under Art. 8(1)(c) CVA, Art. 32(1)(c) CC and Art. 157(2) CCIP, 19 U.S.C. s. 1401a(b)(1)(D), Art. 26(2) of the Resolution, and the Peruvian By-law and Procedure.

<sup>62</sup> Commentary No. 3(12) CVC.

<sup>63</sup> See, e.g., HQ 544991 (13 Sep. 1995); HQ 545379 (7 Jul. 1995).

<sup>64</sup> Article 160 CCIP.

<sup>65</sup> WCO Advisory Opinion 4.11.

<sup>66</sup> Commentary No. 3(13) CVC.

a condition of sale. The following elements outlined in the EU CVC help to determine if there is control, which also are similarly expressed in CBP rulings:<sup>67</sup>

- the licensor selects the manufacturer and specifies it for the buyer;
- there is a direct contract of manufacture between the licensor and the seller;
- the licensor exercises actual control either directly or indirectly over the manufacture (as regards centres of production and/or methods of production);
- the licensor exercises actual direct or indirect control over the logistics and the dispatch of the goods to the buyer;
- the licensor nominates/restricts who the producer can sell their goods to;
- the licensor sets conditions relating to the price at which the manufacturer/seller should sell their goods or the price at which the importer/buyer should resell the goods;
- the licensor has the right to examine the manufacturer's or the buyer's accounting records;
- the licensor designates the methods of production to be used/provides designs, and so on;
- the licensor designates/restricts the sourcing of material/components;
- the licensor restricts the quantities that the manufacturer may produce;
- the licensor does not allow the buyer to buy directly from the manufacturer but through the trademark owner (licensor) who could as well act as the importer's buying agent;
- the manufacturer is not allowed to produce competitive products (non-licensed) without the consent of the licensor;
- the goods produced are specific to the licensor (i.e., in their conceptualization/design and with regard to the trademark);
- the characteristics of the goods and the technology employed are laid down by the licensor.

While the totality of the circumstances must be considered, a combination of such indicators, which go

beyond purely quality control checks by the licensor, demonstrates that a relationship exists and hence the payment of the royalty would be a condition of the sale. In individual cases, other kinds of indicators may also exist. Certain indicators carry more weight and show more strongly than others that the licensor exercises restraint or direction over the manufacturer/seller, which therefore could, in themselves, constitute a condition of the sale.<sup>68</sup> Additionally, WCO Advisory Opinions 4.8, 4.11, and 4.13 indicate that the economical relationship of the parties plays an important role for the adjustments of royalties to the transaction value.

#### **7.4 Presumption Attached to Related Party Transactions**

Traditionally, customs authorities have been more willing to determine that license payments made to a licensor are a condition of sale of the importation, when the seller of the goods is related to the importer. For example, in WCO Advisory Opinion 4.11, royalties for a trademark affixed to imported goods paid to a parent company by an importer for goods purchased from a manufacturer equally related to the parent company are considered a condition of sale even where no contract provisions state this as such. In the United States, there is a presumption that all payments made by the buyer to the seller or to a party related to the seller are part of the price actually paid or payable for imported merchandise.<sup>69</sup> However, this presumption may be rebutted provided the importer can establish that the payments at issue are unrelated to the imported merchandise. A similar rebuttable standard is present in the EU as well;<sup>70</sup> however, for trademarks, the additional condition that the buyer is not free to obtain such goods from other suppliers unrelated to the seller must be fulfilled.<sup>71</sup>

### **8 ROYALTIES AND LICENSE FEES OFTEN NOT INCLUDED IN CUSTOMS VALUE**

Perhaps equally useful are royalties and license fees that are often not included in customs value. Below are examples of activities or intellectual property rights that are the subject of royalties or license fees and factual circumstances under which they are not generally considered an element to the price actually paid or payable. These examples are also from the WCO Valuation Committee, EU, US, Andean, and Peruvian matters.

#### **Notes**

<sup>67</sup> Commentary No. 13 CVC.

<sup>68</sup> *Ibid.*

<sup>69</sup> See *Generra Sportswear Co. v. United States*, 905 F.2d 377 (Fed. Cir. 1990).

<sup>70</sup> Article 157(2) CCIP.

<sup>71</sup> Article 159 CCIP.

## 8.1 Royalties or License Fees for Post-importation Manufacturing, Distribution, or Resale Rights

Royalty or license fees that are remitted for know-how utilized in post-importation (i.e., domestic) manufacturing are not generally considered additions to the price paid or payable of imported goods that may be used in the manufacturing process.<sup>72</sup> Similarly, reproduction rights of licensed goods within the importing country jurisdiction should also not be added to customs value.<sup>73</sup> Additionally, royalty or licensing payments for the importer's right to distribute and resell goods within a specific jurisdiction are also not dutiable if such payments are not a condition of the sale for export to the country of importation of the imported goods.<sup>74</sup>

The International Chamber of Commerce's commentary on the Valuation Agreement concurs, counselling importers to 'unbundle' payments for distribution rights from payments made for the underlying goods; when an exporter grants distribution rights to an importer, 'any remuneration paid to the exporter for granting this right should not be included in the price of the goods but rather should be the subject of a separate payment (normally a 'royalty' or 'license fee')'.<sup>75</sup> According to the CVA, payments made by a buyer or the right to distribute or resell the imported merchandise will not be added to the price actually paid or payable for the imported merchandise if the payments are not a condition of the sale of the merchandise for exportation to the country of importation.<sup>76</sup>

Under CBP's three-part framework outlined *supra*, distribution royalties would not be dutiable. Under prong one, these royalties are unrelated to the imported product's manufacturing process. The royalties are for the resale and distribution of the already manufactured products. Further, they are not involved in the production or the sale for exportation, under prong two. The royalty relates solely to the right to sell the products domestically *after* they have been successfully imported. Finally, under prong

three, these royalties are not 'inextricably intertwined' with the imported products. The royalties are paid for the right to sell within a certain geographic market and not on the basis of any specific products. Under any analysis therefore, royalty payments for exclusive distribution rights should not be dutiable.

Under the EU rules, the result is, in principle, the same, as long as the royalties are not included, or are shown separately, in the invoice<sup>77</sup> and provided such payments are not a condition of the sale for export to the EU.<sup>78</sup>

## 8.2 Royalties or License Fees Related to Importations from Unaffiliated Manufacturers

In cases where royalties are paid to unrelated third parties, according to the WCO Advisory Opinions (see Table 1), the first question to be answered is whether the seller has requested the importer to pay to a third party or whether the importer, seller, and third party are related entities.<sup>79</sup> If the seller has requested the importer to pay an unrelated third party, then the payment is viewed as a condition of the sale and the payment is to be included in the customs value,<sup>80</sup> unless an exception applies, for example, the right to reproduce the imported goods in the country of importation.<sup>81</sup> Examples for royalties that are not a condition of the sale are the following cases:

- a manufacturer sells music records and the importer is required, under the law of the country of importation, to pay a copyright royalty to the author of the music;<sup>82</sup>
- an importer acquires the right to use a patented process and agrees to pay the patent holder a royalty on the basis of the number of articles produced using that process; in a separate contract, the importer designs and purchases from a foreign manufacturer a machine that is specially intended to perform the patented process;<sup>83</sup>

### Notes

<sup>72</sup> See WCO Advisory Opinion 4.9 (where fees were related to proprietary preparation manufactured post-importation and for sale of the licensed preparations in the country of importation).

<sup>73</sup> Note 1 to Art. 8.1(c) CVA.

<sup>74</sup> Note 2 to Art. 8.1(c) CVA, Art. 32(5)(b) CC.

<sup>75</sup> ICC Commentary, *supra* n. 1, para. 930.

<sup>76</sup> Note 2 to Art. 8.1(c) CVA, likewise 19 C.F.R. s. 152.103(f), and Arts 32(5)(a) and 33(1)(d) CC.

<sup>77</sup> Article 33(1)(d) CC.

<sup>78</sup> Article 32(5)(b) CC.

<sup>79</sup> See s. 7.4 *supra*.

<sup>80</sup> Advisory Opinions 4.1, 4.4, 4.6, 4.7, and 4.11.

<sup>81</sup> Note 1 to Art. 8.1(c) CVA.

<sup>82</sup> Advisory Opinion 4.2.

<sup>83</sup> Advisory Opinion 4.3.

- a foreign manufacturer owns a trademark in the country of importation and the importer sells under this trademark various types of cosmetics; the importer has to pay a royalty of 5% of all sales under this trademark; however, all the ingredients are obtained in the country of importation, with the exception of one which is bought from the foreign manufacturer;<sup>84</sup>
- the importer pays a royalty to the holder of a trademark for shoes bearing that trademark; the importer concludes another agreement with the manufacturer of the shoes and supplies him with the art and design work provided by another person to whom the importer pays a royalty, too;<sup>85</sup> however, it must be noted that the Advisory Opinion leaves open the question of whether the art and design work would qualify as dutiable under Article 8.1(b) CVA (as an assist);
- a manufacturer/trademark holder grants the importer the exclusive right to manufacture, use, and sell a licensed preparation in the country of importation; the royalty rate is dependent on the amount of sales of the preparation per year; the imported product is a standard, non-patented product;<sup>86</sup>
- the importer buys sports bags from different foreign manufacturers and supplies them with trademark labels that are affixed to the sports bags before the importation; the importer pays a royalty to the trademark holder.<sup>87</sup>

While both the EU and US legislation and practice largely follows these Advisory Opinions, the US regulations also explicitly provides that if a buyer paid a royalty to a third party for use in the United States of trademarks or copyrights relating to the imported goods, that payment will generally be considered selling expenses of the buyer and therefore not dutiable unless the payments were a condition of the sale for importation.<sup>88</sup> CBP has found that when the purchase orders, vendor agreement, and entry documents contain no reference to a royalty, these third-party royalty payments are non-dutiable, particularly when the payment is for US patent or licensed

rights.<sup>89</sup> Thus, importers' royalty payments to a party other than an unrelated contract manufacturer should not automatically be included in the value of its imports from unaffiliated manufacturers. The payments are not made to the seller of the imports but to an unrelated third party. Without an inextricable linkage between the payment and the imported goods (e.g., patented technology necessary for production of the goods), in the import agreements, the invoices, and the purchase orders that flow between the importer and the unaffiliated manufacturers, the payments would not be considered dutiable. In fact, the importer's obligation to make these payments arises out of a separate agreement with the licensee. As a result, in the United States, no third-party royalties should be added to the customs valuation of finished products imported from unaffiliated contract manufacturers.

### 8.3 Royalties or License Fees for Ornamental Designs

A design patent covers the ornamental designs of functional items, for example, the distinctive packaging on a Digital Video Disc (DVD) box set. Design patents do not cover the composition of an item.<sup>90</sup> In contrast, as outlined *supra*, a utility patent is 'any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof'.<sup>91</sup>

The US statute's Statement of Administrative Action noted that 'royalties and license fees for patents covering processes to manufacture imported merchandise generally will be dutiable'.<sup>92</sup> Design patents, in contrast, 'protect the ornamental design of the [item] rather than the process by which the article itself is manufactured'.<sup>93</sup> Thus, CBP has recognized that design patents are more 'akin to royalties and license fees paid for the right to use copyrights and trademarks' and are typically not dutiable.<sup>94</sup> CBP has held that a patent does not cover a product's 'ornamental design' if the product's 'aesthetic features' are not visible during the product's 'normal

## Notes

<sup>84</sup> Advisory Opinion 4.5.

<sup>85</sup> Advisory Opinion 4.8.

<sup>86</sup> Advisory Opinion 4.9.

<sup>87</sup> Advisory Opinion 4.13.

<sup>88</sup> Statement of Administrative Action, H.R. Doc. No. 153, 96 Cong., 1st Sess. (1979) (hereinafter 'SAA'); see also 19 C.F.R. s. 152.103(f).

<sup>89</sup> HQ H024979 (6 May 2009) ('we find that the license fees paid by Licensee to a third-party unrelated Licensor pursuant to the above-referenced License Agreement are not a condition of sale of the imported merchandise. . .').

<sup>90</sup> See HQ H004991 (2 Apr. 2007) (rejecting an argument that the patents were design patents because they covered the items composition); HQ 545998 (13 Nov. 1996) (same).

<sup>91</sup> 35 U.S.C. s. 101.

<sup>92</sup> SAA, *supra* n. 88.

<sup>93</sup> HQ 545379 (7 Jul. 1995).

<sup>94</sup> See *ibid.* (finding that a design patent for a hairband is unrelated to its manufacture). See also HQ H024979 (6 May 2009) (citing the license's relation to 'trademarks or design patents' as one factor for not finding the royalty to be dutiable).

course of use'.<sup>95</sup> In Headquarters Ruling (HQ) 545379, CBP analysed the dutiability of royalties paid for design patents on imported hairbands. CBP found that the royalties met the first prong as the hairbands were 'protected by the licensor's design patent'.<sup>96</sup> However, CBP found that the royalties failed to meet the second prong. The 'licensor's patent protects the ornamental design of the hairband, rather than the process by which the article itself is manufactured'.<sup>97</sup> The design is 'associated with the appearance of the hairband, specifically, its ornamental qualities and attributes' and is therefore not dutiable. This case is distinguishable as it reviewed payments by an importer to an unrelated third party. If an importer demonstrates that some of the patents in question were for a product's ornamental design and did not relate to a product's production or physical composition, then those products should be excluded from valuation as they do not pertain to the production and sale for import of the finished goods.

In the EU, design work is normally included in the customs value, either as the provision of assists<sup>98</sup> or as a royalty payment.<sup>99</sup>

#### 8.4 Royalties or License Fees for Marketing Rights or Usage of Corporate Names

The importer's royalty for the right to use a particular name as part of its corporate name and in its marketing materials is unrelated to the design, manufacture, production, or sale of the imported goods. The use of the trade name helps increase domestic business, but is unrelated to any import transaction or any imported goods.

In the United States under CBP's three-part test, royalty payments for these licenses should not be added to customs value. The royalties are not involved in the production of any product under prong one, nor are they involved in any product's sale for exportation under prong two. The licenses may relate to the domestic sales within the importing country but that is irrelevant under the WTO; the analysis focuses on the sale for exportation between the exporting country and importing country and not on the downstream resale of imported products. CBP has analysed royalty payments made by an importer for

'non-manufacturing rights' including the right to use 'certain trademarks, service marks, *trade names*, trade dress, copyrights, designs, patterns, trade secrets, know-how, and other proprietary rights, in connection with the manufacture, promotion, distribution and sale of the imported merchandise in the U.S.'.<sup>100</sup> CBP found these royalties to be non-dutiable. While the royalty payments at issue were paid to unrelated third parties, CBP's analysis did not rest on that fact. Instead, they held that 'based on the statement in your submission, that is, that "the type of intellectual property is limited to non-manufacturing rights only", it is our position that the royalty payments are not included in transaction value'.<sup>101</sup> In HQ 547968, CBP found marketing royalties to be non-dutiable; '[t]he licensed rights for which the license fees were paid relate solely to the distribution and sale of the merchandise in the United States – not the sale for exportation'.<sup>102</sup>

Therefore, royalty payments for the use of a corporate name in the importer's corporate name as well as in its marketing materials is unrelated to the imported products under the WTO and would be excluded from valuation under CBP precedent. The royalties for these two licenses should, therefore, not be dutiable.

In the EU, the result is the same if the trade name is unrelated to the design, manufacture, production, or sale of the imported goods; however, if the payment is made as a condition of the sale for export to the EU by the buyer for the right to distribute or resell the imported goods, such payment is dutiable.<sup>103</sup>

#### 8.5 Royalties or License Fees for Trademarks

A trademark license allows the licensed trademarks to be affixed to the finished products prior to importation. The trademarks are probably therefore 'related to' the imported goods. In the United States, however, CBP regulations indicate that royalties or license payments paid for the use of 'copyrights or trademarks related to the imported merchandise generally will be considered selling expenses of the buyer and not dutiable'.<sup>104</sup> As discussed, CBP's three-prong analysis focuses on the manufacturing process. Under the first prong, the trademarks do not relate to any patented process for producing the finished goods. The

#### Notes

<sup>95</sup> HQ H004991 (2 Apr. 2007).

<sup>96</sup> HQ 545379 (7 Jul. 1995).

<sup>97</sup> *Ibid.*

<sup>98</sup> Article 32(1)(b)(iv) CC.

<sup>99</sup> Article 157(1) CCIP.

<sup>100</sup> HQ 548520 (13 Jan. 2004) (emphasis added).

<sup>101</sup> *Ibid.*

<sup>102</sup> HQ 547968 (7 May 2002).

<sup>103</sup> Article 32(5)(b) CC.

<sup>104</sup> 19 C.F.R. s.152.103(f).

trademarks are affixed after importation and are used simply to identify the brand. Under the second prong, the trademarks are not related to the manufacture or sale for export of the finished products. As discussed, the products are both manufactured and sold without trademarks.

## 9 CALCULATION OF ROYALTY OR LICENSE FEES ADDED TO CUSTOMS VALUE, APPORTIONMENT AND SIMPLIFICATIONS THEREOF

### 9.1 Calculation of Royalty or License Fees Added to Customs Value, Including Apportionment Methods

Upon determination that a royalty or license fee should be added to the price actually paid or payable, Article 8.1(c) of the CVA states that the adjustment should be done on the basis of objective and quantifiable data. Permissible within this criterion are adjustments to the royalty or license fee limited to the dutiable portion of the fee. For example, if royalties or license fees relate partly to the imported goods and partly to the other ingredients or component parts added to the goods after their importation, or to post-importation activities or services, an appropriate apportionment shall be made.<sup>105</sup> Apportionment refers to the allocation of a royalty payment to individual rights embedded within the agreement. If no objective and quantifiable date are available, the customs value cannot be determined on the basis of the transaction value.<sup>106</sup>

The basis for apportionment of the total payment into dutiable and non-dutiable elements can or should be found in the license agreement itself. When, for example, a 7% total royalty is specified as representing 3% for patent rights, 2% for marketing know-how, and 2% for trademark usage, the know-how element can be deducted. The respective values of rights and know-how can, at time, be established by evaluating the extent to which know-how is transferred or availed of and deducting that sum from the total royalty paid or payable.<sup>107</sup> It could then identify which of these payments were related to the imported products and add the appropriate percentage to the import's customs valuation.

The United States has recognized that royalties can be apportioned when the royalty relates to multiple licenses. CBP has accepted that 'apportionment may be appropriate in cases' like the example above 'where it is clear that a portion of the royalty payment does not relate to the imported product'.<sup>108</sup> Furthermore, CBP allows an importer to apportion the value of the royalty or license fee to imported merchandise when the apportionment is made in a reasonable manner appropriate to the circumstances and in accordance with generally accepted accounting principles.<sup>109</sup> If the importer cannot provide support of a reasonable apportionment, then it is likely that CBP will conclude that the entire amount is an assist. The EU has gone further, providing apportionment guidelines. Customs authorities should first look to the agreement to determine if it apportions payments. If not, the officials should try to determine if 'the respective values of rights and know-how can . . . be established by evaluating the extent to which know-how is transferred or availed of and deducting that sum from the total royalty paid or payable'.<sup>110</sup> Any such apportionment must be based on an 'economic justification for the division of the royalty or license fee between its several elements'.<sup>111</sup>

CBP has more experience apportioning assists, covered under the same Article of the Valuation Agreement; '[i]f the anticipated production is only partially for exportation to the United States, or if the assist is used in several countries, the method of apportionment will depend upon the documentation submitted by the importer'.<sup>112</sup> By analogy, the importer's royalty payments should, therefore, be apportioned among the licenses granted and duties should only be assessed on those licenses that are related to the imported goods being valued.

To carry out an apportionment, the importer would need to provide with documentation supporting a proposed allocation of the royalty payments across licenses. Pre-existing internal analyses or transfer pricing studies would be sufficient for this purpose. In the absence of such information, the importer would need to provide some form of economic justification for any proposed allocations.

Within the Andean Community, the calculation of the royalty or license fee will depend mostly on each Andean country's domestic legislation. For example, Chapter No. 6.4 of the Peruvian Customs Valuation Rules establish a

## Notes

<sup>105</sup> Article 158(3) CCIP.

<sup>106</sup> Annex 23 CCIP, Interpretative Note to Art. 32(2) CC, Note to Art. 8(3) CVA.

<sup>107</sup> Commentary No. 3 CVC (16).

<sup>108</sup> HQ 545710 (30 Oct. 1998).

<sup>109</sup> See, e.g., HQ 548316 (16 Jul. 2003).

<sup>110</sup> Commentary No. 3 of the Customs Code Committee on the incidence of royalties and license fees in customs value (hereinafter 'Commentary No. 3'), para. 16.

<sup>111</sup> ICC Commentary, 143.

<sup>112</sup> 19 C.F.R. s. 152.103(E). See also ICC Commentary, 930 ('However, the importer should be able to furnish evidence for the adequacy of both the price for the goods and the payment for the intangible. The latter should not vary with the volume of goods imported.')

particular mechanism about how to calculate and add the royalties to the customs value. Nevertheless, there are some general guidelines established in the Resolution that the Andean countries should take into consideration such as adjustment for royalty or license fees that are applicable only to the imported goods separated from fees remitted for services and components can be incorporated with the imported goods post-importation. Similar to the EU and the United States, a proportional and correct adjustment should be made but only if the importer provides sufficient information that distinguishes the import price of the goods from the price of the components and value of the services. If not, the Customs Authority might consider the whole value as the final base for the royalty and licensee fee adjustments. With the regard to the calculation of the dutiable royalty, Article 26(4) of the Resolution states that the royalty and license fee adjustments apply regardless of the country payee's residence. In order words, the royalties and licensee fees should be calculated and added to the customs value, regardless if the licensor is located in or out of the Andean Community Customs Territory.

In comparison with the WTO CVA and the Andean Community Customs Valuation Rules, the Peruvian By-law regulates in detail how the royalties and license fees should be calculated and adjusted. For the upward adjustment of royalties and license fees, the Peruvian importers should consider the following apportionment procedure:

- Imported finished goods: The total amount of the paid or payable royalties and license fees of the imported finished goods should be apportioned among the FOB values declared on the customs declarations of the imported goods.
- Imported inputs: The share of the total amount of the paid or payable royalties and license fees of the imported inputs should be apportioned among the FOB values declared on the customs declaration of the imported goods.

When the royalties and license fees are paid and calculated upon the basis of domestic net sales of the imported goods, the importers cannot determine nor calculate the upward royalty adjustment during the customs clearance; therefore, the apportionment procedure allows them to declare upon a non-definitive customs value basis. Like the Andean Community Customs Valuation Rules, the Procedure establish that once the royalties have been calculated and paid to the licensor, the importers should declare a definitive value by adjusting the royalties according to a royalty apportionment procedure and paying the corresponding customs duties and import taxes. For a better understanding of how the royalties can be adjusted in regard with the FOB value of the imported goods, we provide the following example of an apportionment calculation.

Table 2 Royalty Upward Adjustment Calculation

Royalty for licensed imported finished goods	5%			
Net sales	12,500,000			
Total amount of royalty to be paid	625,000			
Ratio: Total royalties/ total FOB value	2.25			
<b>Import Declaration</b>	<b>Numbering Date</b>	<b>FOB Value</b>	<b>Royalty Apportioned Ratio 2.25</b>	<b>FOB Value Added with Royalties</b>
1	15 January 2010	10,000	22,523	32,523
2	10 February 2010	20,000	45,045	65,045
3	6 April 2010	35,000	78,829	113,829
4	18 June 2010	4,500	10,135	14,635
5	20 July 2010	76,000	171,171	247,171
6	15 August 2010	12,000	27,027	39,027
7	6 September 2010	15,000	33,784	48,784
8	25 October 2010	40,000	90,090	130,090
9	18 November 2010	45,000	101,351	146,351
10	22 December 2010	20,000	45,045	65,045
		<b>277,500</b>		<b>902,500</b>

In this example, a Peruvian company agrees to pay 5% royalties from its domestic net sales of trademark sport shoes. These sport shoes were definitively imported in Peru according to Customs Declarations described in the

table. The total import FOB value is USD 277,500. At the end of year, the importer's net sales are USD 12.5 million and the total amount of royalties paid to licensor is USD 625,000. In order to calculate the royalty adjustment for each Customs Declaration, we divide the total amount of the paid royalties by the total FOB import value. The result is the royalty ratio that is multiplied by each FOB import value. Finally, both values, the FOB value and the apportioned royalty, are summed up and the final result is the FOB value with the adjusted royalties.

When a part only of a royalty payment is includible in the customs value, consultation between the importer and the customs authorities should take place.<sup>113</sup> By presenting the facts and circumstances surrounding the royalty payment in advance to the authorities, an importer has the unique opportunity to advocate for his preferred interpretation as well as present his preferred method of apportionment and/or declaration method. The licensor may offer to indicate an appropriate apportionment based on his own calculation (i.e., if this is not specified in the license agreement).<sup>114</sup> Correspondence between licensor and licensee and negotiation reports may also provide a basis for apportionment.<sup>115</sup>

## 9.2 Provisional Declarations of Value/ Simplifications

Royalties and license fees may be calculated after importation of the goods to be valued. In the EU, the provisions on incomplete customs declarations<sup>116</sup> allow a provisional indication of the customs value. The missing details may be provided within four months or even later.<sup>117</sup> A general adjustment may be determined, between the importer and the customs authorities, based on results over a representative period and updated regularly.<sup>118</sup>

Furthermore, there is a general provision for simplifications that can be applied also with regard to royalties. It aims at resolving situations in which certain data (such as the exact amount of royalties) are not available at the time of acceptance of the customs declaration in order to avoid that an incomplete declaration must be lodged, with the consequence that import clearance is only finalized when the missing particulars are communicated, possibly several months

later, to the customs authorities. This provision<sup>119</sup> empowers the customs authorities to authorize, at the request of the person concerned, that certain elements, which are to be included in the customs value but which cannot be exactly quantified at the time of acceptance of the customs declaration, are determined on the basis of appropriate and specific criteria. If at a post-clearance audit it turns out that the criteria did not reflect exactly the amount of royalties, there will, nevertheless, be no post-clearance recovery or refund, but the criteria may be adjusted for the future if maintaining such authorization is still appropriate. This may have been the source of the misconception in the WTO dispute *EC-Selected Customs Matters* in which the United States claimed that some customs authorities in the EU were imposing some form of prior approval with regard to the customs value.<sup>120</sup> The criteria that may be fixed for future imports may be derived from the results of pre- or post-clearance audits covering a representative period and/or from evidence submitted by the person concerned covering a representative period and any arrangements for the future already available. If the arrangements change (e.g., a higher royalty), the holder of the authorization must inform the customs authorities so that the criteria can be adjusted.

In the United States, importers can register with CBP under the Reconciliation Program, which allows importers to file entry declarations with the best available information with the mutual understanding that certain elements, such as customs value, remain provisional. At a later date, the importer files a Reconciliation entry that provides the final and correct information and remits any additional duties, if applicable.

Similarly, Andean Community's Article 26(5) of the Resolution permits that royalty adjustments can be made by declaring a provisional customs value, when the amount of royalties and license fees cannot be calculated or is unknown at the time of customs clearance, provided that the importer regularizes this situation, as soon as the definitive amount of the royalties paid to the licensor is known. The provisional customs value declaration is a simplified mechanism that allows importers to declare a provisional value of the goods, when they cannot calculate or determine the amount of royalties during the customs clearance. This is the case when importers of licensed

---

### Notes

<sup>113</sup> Commentary No. 3 CVC (15).

<sup>114</sup> Commentary No. 3 CVC (17).

<sup>115</sup> Commentary No. 3 CVC (18).

<sup>116</sup> Articles 254 and 257(3) CCIP.

<sup>117</sup> Article 256(1) CCIP.

<sup>118</sup> Commentary No. 3 CVC (14).

<sup>119</sup> Article 156a CCIP.

<sup>120</sup> See, on this aspect of the WTO dispute, *Rovetta & Lux*, GTCJ (2007): 204.

goods must pay royalties according to a percentage of the domestic net sales of imported goods. Indeed, when the licensed goods have been sold domestically, the importer can calculate the net sales of the imported goods and he will know the exact amount to be paid to the licensor. Once the importer has paid the royalties, he must add them to the customs value and pay the additional customs duties and import taxes. Finally, the importers must prove before Customs Authority when the paid royalties are not related to the imported goods in order to avoid the royalty and license fee adjustments. Likewise, the importers need to prove that the condition of sale does not exist in their transactions, especially when the Customs Authority presumes that there is an implicit condition of sale.

## 10 NOTABLE COURT CASES RELATED TO THE CUSTOMS VALUATION OF ROYALTIES AND LICENSE FEES

### 10.1 European Court of Justice (ECJ) and Other Judgments in the EU

#### 10.1.1 Bosch

In Case 1/77<sup>121</sup> (complemented by Case 135/77<sup>122</sup>), the dispute concerned the customs valuation of a cast-on strap machine protected by an invention patent called a product patent, as well as a so-called process patent concerning the process enabling the machine to be used for the manufacture of terminal bridges for lead-acid batteries. The ECJ had to answer the question of whether the value of a patented process embodied in an appliance is to be included in the customs value. The Court answered that, in principle, patented inventions that relate to the process of use of an article are to be disregarded for the purposes of customs valuation. However, this is not the case where a patented process, the carrying out of which constitutes the only economically viable use of the goods and which is only put into effect by the use of those goods, is regarded as embodied in the imported goods. Though this judgment concerns the legislation in force prior to the implementation of the GATT/WTO CVA, it is still being quoted in the context customs valuation for royalty payments.

#### 10.1.2 BayWa

In Case C-116/89,<sup>123</sup> the ECJ had to deal with the following situation – BayWa buys basic seed in the EU. As part of the contract, it will resell that seed to propagation undertakings outside the EU for the purpose of propagating the basic seed to produce harvest seed. The relationship between BayWa and the propagation undertakings is governed by separate contracts. In these contracts, it is agreed that BayWa may import harvest seed into the EU in order to market it there. Once the harvest seed has been imported and marketed, BayWa has to pay a license fee to the EU breeders in the year following the harvest at the latest. The issue before the Court was:

- whether the license fee forms part of the value of the basic seed that should be added to the transaction value; or
- whether the inclusion of the license fee in the customs value is contrary to the principle that an intellectual service provided within the EU enjoys freedom from customs duty.

Advocate General Lenz took the view that the license fee was not a condition of the sale between BayWa and the propagators outside the EU, so that the fee cannot be included in the customs duty.<sup>124</sup> Furthermore, the license fee is not paid in respect of the imported goods but in respect of their distribution, so that Article 32(5) CC applies according to which payments made by the buyer for the right to distribute or resell the imported goods shall not be included in the customs value, unless such payments are a condition of the sale for export to the EU (they are in fact a condition of the sale between the breeder in the EU and the importer).

The ECJ took the opposite view by basing its arguments on Article 32(1)(b) CC<sup>125</sup> according to which the value of materials incorporated in the imported goods supplied directly or indirectly by the buyer free of charge for use in connection with the production and sale for export of the imported goods must be included in the customs value.

It argued that the customs value of harvest seed comprises both the value of the basic seed and the cost of propagation incurred outside the EU. The license fees are a

## Notes

<sup>121</sup> Case 1/77, *Robert Bosch GmbH v. Hauptzollamt Hildesheim* [1977] ECR 1473.

<sup>122</sup> Case 135/77, *Robert Bosch GmbH v. Hauptzollamt Hildesheim* [1978] ECR 855.

<sup>123</sup> C-116/89, *BayWa AG v. Hauptzollamt Weiden* [1991] ECR I-1095; description of the case on I-1102 ff.

<sup>124</sup> See I-1109 ff.; legal references have been adjusted by the author to the current legislation.

<sup>125</sup> Article 8(1)(b) CVA.

payment for the breeders' service and provide them with a fair share of the profits resulting from the breeding of the basic seed. The license fees must, therefore, be attributed to the purchase of the basic seed and form part of the price payable for that seed. Since the basic seed is then incorporated in the imported goods, those fees must be added, pursuant to Article 32(1)(b)(i) CC, to the price actually paid or payable for the imported seed.

The intellectual service that led to the production of the basic seed (and which cannot be included in the customs value as it was undertaken in the EU)<sup>126</sup> had been completed and played no part in the propagation process. Consequently, the Court decided that license fees that BayWa has to pay to the breeders of the basic seed in respect of the propagation of that seed is to be added to the price paid or payable in accordance with Article 32(1)(b)(i) CC, even where the breeders' service has been performed within the EU.

This result has also been justified with the argument that the foreign sellers would not have received the harvest seed at the agreed price if the buyer – instead of the seller – had not paid the license fee to the breeder.<sup>127</sup> The consequence of this judgment for cases where goods subject to license fees are supplied directly or indirectly by the importer for use in the production by the foreign seller is that the importer cannot rely on the specific rules on royalties and license fees.

### 10.1.3 Compaq

A similar issue arose in Case C-306/04:<sup>128</sup> Compaq Computer International Corporation (CCIC), established in the Netherlands, is a subsidiary of the US-based Compaq Computer Company (CCC). Under a contract between CCC and Microsoft (United States), Compaq computers may be equipped with Microsoft operating systems and sold with these systems, in return for a payment of USD 31 to Microsoft for every computer equipped with those operating systems.

CCC bought computers from two Taiwanese computer manufacturers. As part of this sale, it was agreed that the operating systems would already be installed on the hard drives of the computers when they were delivered. To that end, CCC made these operating systems available free of charge to the manufacturers who installed them on those computers. CCC sold these computers to CCIC. When CCIC declared the computers for free circulation in the

EU, it did not include in the declared customs value the value of the operating systems. Dutch customs took the view that, in accordance with Article 32(1)(b) CC,<sup>129</sup> the value of the operating system should be added to the price actually paid to the seller. The ECJ had to decide whether the value of the operating systems

- is not to be included in the customs value because they do not fall within any of the categories of Article 32(1)(b) CC or because the transaction between CCIC and CCC is decisive for the establishment of the customs value; or
- is to be included in the customs value either as goods or services supplied by the buyer free of charge to the seller or as royalties or license fees related to the goods.

The Court argued as follows: The operating systems were made available to the Taiwanese manufacturers free of charge by CCC. As these systems had a unitary economic value of USD 31 that was not included either in the value of the transaction between the Taiwanese manufacturers and CCC or in that of the transaction between CCC and CCIC, the transaction value must be adjusted. The Court left open whether this result is to be based on:

- Article 32(1)(b)(i) CC (incorporated materials);
- Article 32(1)(b)(iv) CC (engineering, development work); or
- Article 32(1)(c) CC (royalties and license fees).

Insofar, the Opinion of Advocate General Stix-Hackl is helpful according to which pre-installed operating systems are to be considered as 'materials, components, parts and similar items incorporated in the imported goods' in accordance with Article 32(1)(b)(i) CC.<sup>130</sup> The result is then the same as in Case C-116/89, again with the consequence that the special rules on royalties and license fees cannot be applied.

### 10.1.4 Royalties for DVD

On 27 February 2007, the German Federal Finance Court (*Bundesfinanzhof*) decided on Case VII R 25/06<sup>131</sup> that has some similarities with Case C-306/04, *Compaq*: US film studios holding the copyrights give free of charge film copies to Company W in the United States who owns a patent for producing DVDs. W charges Company I in

## Notes

<sup>126</sup> See Art. 32(1)(b)(iv) CC and Art. 8(1)(b)(iv) CVA.

<sup>127</sup> Glashoff in Schwarz-Wockenfoth, Zollrecht, Commentary to Art. 32 CC, No. 105, Likewise *Bundesfinanzhof*, Case VII R 107/87, published in the same commentary under E 4535.

<sup>128</sup> C-306/04, *Compaq Computer International Corporation v. Inspecteur der Belastingdienst – Douanedistrict Arnhem* [2006] ECR I-10991.

<sup>129</sup> Article 8(1)(b) CVA.

<sup>130</sup> [2006] ECR I-11006; Krüger in Dorsch, Zollrecht, Commentary to Art. 32 CC, No. 29, considers Art. 32(1)(b)(iv) to be applicable.

<sup>131</sup> Published in *Zeitschrift für Zölle und Verbrauchsteuern* (2007): 125.

Taiwan with the production of the DVDs and provides it with the stampers necessary for the production. The EU importer, a subsidiary of Company I, buys the DVD's from Company W, checks and packs them in the EU, and delivers them to the European subsidiaries who pay license fees (EUR 8.50 per DVD) to the US film studios. The importer has no right to use or distribute the DVDs. The importer releases the DVDs for free circulation on the basis of the invoice from Company W (United States) to Company I (Taiwan) at a price of USD 1.45 per piece.

The Court came to the conclusion that the license fees paid to the European subsidiaries of the US film studios are to be added to the price actually paid in accordance with Article 32(1)(b) CC. The Court argued that the whole economic context that consists of making available to EU consumers US films on DVD and not only the contract submitted by the importer for the purposes of determining the customs value has to be assessed. Otherwise, the DVDs would not have been sold at a price representing only the value of the material but not the value of the license fee.

## 10.2 US Court of International Trade (CIT) Cases

### 10.2.1 *Tikal Distributing Corp. v. U.S.*

*Tikal Distributing Corp. v. U.S.*, 93 F. Supp. 2d 1269 (2000) is the most recent decision issued by the US Court of International Trade (CIT) addressing royalty or license fees. Most importers attempt to resolve matters with CBP at the administrative agency level. In *Tikal*, the importer remitted payments to the seller for exclusive distribution rights that were separate from payments for the imported merchandise. The exclusive distribution payment was calculated as 5% of the importer's retail sales. The CIT held that CBP had reasonably interpreted the transaction value statute and that the exclusive distribution payments were a dutiable addition to the price actually paid or payable as an 'integral part of the total price paid for the merchandise'.<sup>132</sup> The CIT noted the agreement between the seller and the importer, 'inextricably linking' the sale of the merchandise with the exclusive distribution payments as opposed to conferring specific contractual

rights.<sup>133</sup> The CIT also acknowledged that the determination is a fact-specific consideration.<sup>134</sup>

## 10.3 Peruvian Judgments and Customs Rulings

### 10.3.1 *Umbro Royalty and Procter & Gamble Cases*

In the *Umbro* case,<sup>135</sup> a Peruvian company imported during the years 2004 and 2005 trademark footwear and apparel from unrelated Chinese manufacturers. The importation of the goods was made by issuing direct purchase orders to the Chinese manufacturers and Letters of Credit to ensure the payment of the sale price and the dispatch of the goods. According to License Agreement signed with the owner of the footwear trademark (Licensor), the Peruvian importer must pay royalties at the rate of 5% to 6.5 % upon the base of the domestic net sales of the licensed goods. In this case, all the parties were unrelated.

After the analysis of the License Contract and by application of Advisory Opinion 4.11, the Peruvian Tax Court concluded that the royalties should be added to the customs value, because the payment of the royalties qualified as a condition of sale and the footwear and apparel cannot be purchased without the licensed trademark.

In the *Procter & Gamble* case,<sup>136</sup> Procter & Gamble Peru signed a Trademark License Agreement and a Technical Assistance Agreement with Procter & Gamble Company, Richardson Vicks Inc., Shulton Inc, and Procter & Gamble Interamericas Inc. to produce and develop products in Peru and to use exclusively the trademarks in Peru owned by the licensors. Procter & Gamble Peru purchased directly the licensed products from the licensor and imported them into Peru. According to the License Agreements, the Peruvian company must pay royalties to licensors upon the domestic net sales.

The Customs Authority requested the upward adjustment of the royalties and the Tax Court confirmed such a request under the same criteria described in the *Umbro* case, that is to say, the payment of royalties was a

---

## Notes

<sup>132</sup> 93 F. Supp. 2d at 1272.

<sup>133</sup> *Ibid.*, 1271.

<sup>134</sup> *Ibid.*, 1273.

<sup>135</sup> Peruvian Tax Court Ruling No. 14845-A-2010.

<sup>136</sup> Peruvian Tax Court Ruling No. 13884-A-2008.

condition of sale of the imported goods, because the licensed products cannot be purchased without the licensed trademarks.

### 10.3.2 *Rip Curl and Mattel Royalty Cases*

Other cases like the *Rip Curl* case<sup>137</sup> and the *Mattel* case<sup>138</sup> confirmed the criteria that payment of royalties was a condition of sale of the imported licensed goods because of the application of Advisory Opinion 4.11. In the *Rip Curl* case, the Peruvian importer was related to the owner of the trademark, but it was not related to some suppliers, who were previously approved by the Licensor for technical standards purposes. Unlike the *Umbro* case, the Licensor provided the Peruvian Importer a list of approved suppliers to purchase from them the Rip Curl products. In the *Mattel* case, the manufacturer of the licensed products was authorized by Mattel Inc. to produce licensed products with the Trademark Barbie. These licensed products were sold to the Peruvian Importer, who paid royalties to Mattel Inc. for the distribution and resale of Barbie Products in Peru.

As we can see, the application of Advisory Opinion 4.11 has allowed the Peruvian Tax Court to determine that the payment of royalties was a condition of sale. Indeed, according to the Tax Court's interpretation of this Advisory Opinion, the royalties was related to the imported goods and they must be paid to the licensor regardless the manufacturer's ability to demand the payment of the royalties to the Peruvian Importer or the possibility to suspend the dispatch of the licensed products in case of unpaid royalties. This interpretation might seem to be contrary to the application, analysis, and interpretation of the Advisory Opinions made in Table 1.

### 10.3.3 *Henkel Royalty Case*

The Peruvian Superior Court of Justice (the Court of Justice) has recently confirmed in the *Henkel* case<sup>139</sup> the following criteria: According to the CVA of the WTO, the royalties should be added to the customs value if: (a) the royalties are related to the imported goods; (b) the payment of the royalties is a condition of sale; and (c) the royalties are not included in the paid or payable price of the goods. With regard to the condition of sale, the Court of Justice considers that, if the importer pays royalties to produce domestic goods and purchases inputs from any

supplier or even from the licensor, there will be no condition of sale, and consequently, no royalties should be added to the imported inputs.

Henkel Peru signed License Agreements with Schwarzkopf and Henkel Germany to produce and sell licensed products in Peru. Regardless the relationship of the parties, the Court of Justice concluded that there was a condition of sale, because the paid royalties were related to the imported licensed goods. In this case, the Court of Justice did not evaluate the correct application of the Advisory Opinions of the Technical Committee of WTO and neither makes a comprehensive analysis of the term condition of sale and the economical relationship between the parties.

### 10.3.4 *Telecommunication Equipments and Software Case*

Article 8(1)(b) of the WTO CVA provides that if the buyer has provided certain production inputs – generally known as 'assists' – free or at reduced cost, then the value of the assist should be included in the custom value. In this case,<sup>140</sup> known as the *Telecommunication-software* case, the Peruvian Customs Authority started a non-compliance customs procedure to a Private Telecommunication Company (the Company) in order to collect customs duties and import taxes that were not paid during the customs clearance of the telecommunication equipments.

The Customs Authority detected that the Company did not include the values of the software, engineering artwork, and design work in the customs value of the imported telecommunication equipments. The Company brought this case before the Tax Court who rejected partially the tax assessments of the Customs Authority. With regard to the software value, the Tax Court determined that the software acquired by the Company from a foreign IT supplier was necessary to run and operate the telecommunication equipments. Therefore, the software value should have been included in the import price of the equipments, although this software was downloaded from the Internet and installed in Peru by the IT staff of the foreign supplier.

Along with the software, some engineering artwork and design work were also needed to run and implement the telecommunication equipment in different parts of Peru. In this sense and according to the Customs Authority, these assists (engineering artwork and design work) were

## Notes

<sup>137</sup> Peruvian Tax Court Ruling No. 01871-A-2010.

<sup>138</sup> Peruvian Tax Court Ruling No. 02077-A-2010.

<sup>139</sup> Resolution No. 16, dated 16 Jun. 2010, Case 1023-2009, *Corte Superior de Justicia de Lima Cuarta Sala Especializada en lo Contencioso Administrativo*.

<sup>140</sup> Peruvian Tax Ruling No. 14040-A-2009 dated 30 Dec. 2009.

provided by the Company (the buyer), and therefore, their values should have been included in the import price of the telecommunication equipments. However, the Tax Court concluded that the Peruvian Customs Authority did not support sufficiently its arguments. Indeed, the Customs Authority did not determine upon an objective and quantifiable information base what good or right was directly or indirectly supplied free or at reduced cost by the Company to the seller.

Furthermore, the Peruvian Tax Court outlined that the Customs Authority did not comply with the formal procedure and conditions established in Article 8(1)(b) of the WTO CVA. According to the Tax Court, this procedure involves mainly the answer to two important questions: what service or product was provided by the buyer to the manufacturer in regard with the assists categories of Article 8 CVA and what amount or cost should be added to the invoice price to account for the assists.

## 10.4 Other International Court Judgments and Rulings

### 10.4.1 Mattel Canada Case

In the *Mattel Canada* decision,<sup>141</sup> released on June 2001, the Supreme Court of Canada concluded that some royalties were non-dutiable, because they were not paid as condition of the sale of the imported licensed goods into Canada. The Court by unanimous decision stated that the royalties shall only be dutiable where the sale contract for the exported goods allows the seller to terminate the sale contract, if the royalties are unpaid. According to the Supreme Court of Canada, the term *condition of the sale of goods* must be interpreted in accordance with its legal meaning under common law and relevant sale of goods and not by using several and complex tests. The Canadian Supreme Court stated the following:

Rather than create a complex series of test 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 license fees are paid as condition of sales of the goods for export to Canada (...).<sup>142</sup>

*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 [Canadian International Trade Tribunal] decision notes that some goods were purchased and imported into Canada without ever making a royalty payment in respect of the goods.*<sup>143</sup>

Following the same criteria of Advisory Opinions 4.8 and 4.13, the Supreme Court of Canada determined that the license agreements and the sales agreement were two different contracts, and therefore, the royalties were not paid as condition of the sale of the imported licensed goods.

### 10.4.2 Adidas Spain Case

In 2001, the Spanish Customs Authority started proceedings for non-compliance against Adidas Spain S.A. with regard to the import duty and VAT on imports for the fiscal period 1999. The Spanish Customs Authority considered that the fees paid to Adidas International B.V. of the Netherlands (subsidiary company owned 100% by the German Adidas AG) to sell and distribute product bearing the brand name Adidas should be included in the customs value of imported goods. These goods were manufactured in Asia and acquired from Adidas Asia Pacific Ltd. (ASPA), domiciled in Hong Kong (see

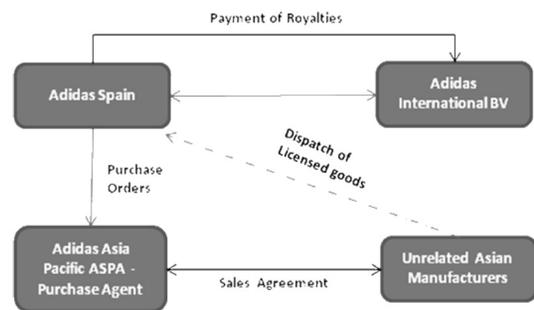


figure below).

In this case, the following arguments were filed by Adidas Spain in order to argue against the non-compliance customs procedure started by the Spanish Customs Authority:

- The royalties paid by Adidas Spain to Adidas International B.V. are not related to the goods imported. Royalties for distribution rights of goods

## Notes

<sup>141</sup> *Deputy Minister of National Revenue v. Mattel Canada Inc.*, 2001 SCC36.

<sup>142</sup> *Ibid.*, 29, para. 59.

<sup>143</sup> *Ibid.*, 120, para. 62.

bearing the Adidas brand are paid regardless whether they are imported or not.

- Neither ASPA, nor Adidas International B.V., nor Adidas Spain have any economical relation with the manufacturers in Asia.
- The manufacturers in Asia, who are the sellers of the imported goods, cannot demand payment of the royalty. Furthermore, they do not benefit from the royalty payments.
- The payment of royalties made by Adidas Spain to Adidas International B.V. corresponds to exclusive distribution rights, within the Spanish market of products bearing the Adidas brand. This is an independent payment different than the sales of the goods, and as such, it is not a condition of sale.

After almost twelve years of legal discussion between Adidas Spain and the Spanish Customs Authority, the Spanish Supreme Court in February 2011<sup>144</sup> upheld the Cassation Appeal filed by Adidas Spain against the Resolution of Customs Authority that confirmed that the royalties are condition of sale. The final arguments addressed by the Spanish Supreme Court were the following:

- The royalties agreed on and paid by Adidas Spain were for marketing rights and distribution rights of products bearing the Adidas brand, regardless the existence or non-existence of imports. Therefore, the royalties paid to Adidas International B.V. for royalties were not related to imported goods.<sup>145</sup>
- The royalty payment was not a condition of sale of the imported goods but a subsequent condition for the distribution of the licensed products.<sup>146</sup>
- The royalty payment was made solely and exclusively for the granting of rights to distribute products bearing the Adidas brand and not for their prior purchase. The consequences of not paying royalties could only imply the prohibition to continue distributing Adidas products in Spanish territory, regardless of whether they were or not EC origin.<sup>147</sup>

The Spanish Customs Authority did not prove that the transactions between the manufacturers and the Adidas

Buying Agent (ASPA) were empowered to include the royalties in the import price.<sup>148</sup>

## II CONCLUSION

This overview on the implementation of the WTO CVA with regard to royalties in three continents shows that divergent approaches exist. A number of explanations can be given for such divergences:

- (1) The text of the CVA may not be precise enough to cover all circumstances, so that divergent interpretations remain possible. In particular, the term 'condition of sale' is too vague to provide meaningful guidance to WTO signatories.
- (2) When an international agreement is concluded, Contracting Parties have the tendency, both in the negotiation and implementation phases, to maintain as many of the rules they applied before the conclusion of the agreement. The same is true for the Courts.
- (3) In the EU, there is a tendency to use the assists rules as a 'catch-all' clause; in the United States, the assists provisions are rarely used with regard to royalties. Examples in the Andean countries have reflected both the EU and US approaches, thus remaining open for interpretation.

Despite the disparity in practices, general principles may be applied in a variety of jurisdictions. First, even if a royalty payment is not made to the seller of the goods, it is still possible that it is dutiable. Second, royalties related to the production of a good are generally included in dutiable values. Third, royalties related to the distribution of a good in the importing country are generally not included in dutiable values unless they are a condition of the sale for export to the importing country. Finally, the intangible property that is the object of the royalty payment is critical in the determination of whether a particular payment should be included in dutiable values.

Going forward, future CVA negotiations should further refine the royalty provisions by relying on an analysis of specific intangible rights and the dutiability of payments for those rights.

## Notes

<sup>144</sup> Appeal No. 7460/2005; Court Supreme Resolution ROJ No. 641/2011 published on 15 Feb. 2011 in the Spanish Supreme Court's website, <[www.poderjudicial.es/search/index.jsp](http://www.poderjudicial.es/search/index.jsp)>.

<sup>145</sup> *Ibid.*, 123, seventh paragraph.

<sup>146</sup> *Ibid.*, 123, second paragraph.

<sup>147</sup> *Ibid.*, 123, third paragraph.

<sup>148</sup> *Ibid.*, 123, fourth paragraph.