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EUROPESE FISCALE STUDIES

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Dutiability of Royalty payments and License fees

Extending the concept of "condition of sale" in the EU

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Contents

1. Objective of the paper and build-up

Underlying paper treats dutiability of royalties and license fees upon importation of consignments into the European Union.

The objective of underlying paper is to describe how old GATT valuation rules – drafted in an era where supply chains and group structures were simple and straightforward – are currently being given a broad interpretation by legislators in order to capture today's complex reality and tax what – in their view – should always have been taxed. The provisions for the implementation of the GATT valuation rules as laid down by the EU legislator back in the early eighties, are no longer perceived as effective means for the taxation of royalties and license fees. Especially the freedom of source concept for trademark related royalties are causing many royalties to remain untaxed. Although, several guidelines have been published by the EU Customs Code Committee in the meantime in order to provide a broad interpretation of the condition of sale concept, it is only during the most recent years that the EU legislator got determined to implement new test criteria for the dutiability of royalties and license fees. By reviewing the latest version of the suggested modified test criteria, the ambition of the EU legislator becomes very clear, however it also makes me wonder whether these new test criteria are still in line with the WTO Valuation Agreement.
In concreto, I will attempt to demonstrate that the EU Commission's interpretation of the condition of sale rule has been broadened over time, and based on recent proposed EU legislation further extending the condition of sale, may be regarded no longer in line with the WTO Valuation Agreement. In addition, Advisory Opinions and recent published Commentary 25.1 of the WTO Technical Committee on Customs Valuation will be compaired with one another giving evidence that the interpretation of the condition of sale concept by the WTO is equally so extending.

Second objective aims at informing the reader of the concerned EU customs regulations and rules as well as some related advises published by the WTO Technical Committee on Customs Valuation, by making a journey through time starting in 1979 (completion of the GATT Tokyo Round Negotiations).

To start with, Chapter two will highlight general principles in respect to GATT valuation rules and dutiability of royalties and license fees. Next, the EU rules concerning dutiability are explained in detail, by means of providing examples and references to WTO Advisory Opinions. Also, guidelines published by the EU Customs Code Committee enlarging the scope for the taxation of royalties and license fees will be discussed. At the end of Chapter two, attention is given to explicit and implicit conditions of sale as well as to control factors resulting in many royalty and license fees being taxed.

Through-out Chapter three a comparison of the proposed EU revised taxation rules for royalty payments and license fees against the current rules of the Community Customs Code is conducted. It is clear that the intention of the EU Customs Code Committee is to drastically extend the condition of sale rule. Also a review of WTO Commentary 25.1 (2011) against older GATT Advisory Opinions 4.3 (1981) and 4.8 (1993) will be conducted.

In Chapter four, the current and revised condition of sale test criteria have been applied to a series of successive sales.

Chapter five summarizes the main conclusions in view of the revised EU condition of sale rule and provides comments in regards of the alignment thereof with WTO interpretations.

2. GATT and EU valuation rules

2.1 Introduction

Current European customs valuation rules are to a large extent based on the outcome of the multilateral Tokyo Round negotiations (1973-1979). During the seventies GATT contracting parties negotiated a common valuation system based on the "actual price" concept, abandoning the "notional price" concept.

As such arbitrary customs values, often dictated by Authorities in the countries of import under influence of economical and political motives, were no longer supported by the GATT contracting parties that accepted the GATT Valuation Code[1]. Out of the seventeen contracting parties[2] accepting the GATT Valuation Code, only seven contracting parties were developing countries. Many of the developing countries opposed to the Tokyo Round Agreement and its Valuation Code because it would negatively impact the power and competence of Authorities to reject customs values, in comparison to valuation systems build around 'notional prices'. This adversively impacting a country's income.

Late 1979, the Council of the European Economic Community decided to implement article VII of the General Agreement on Tariffs and Trade[3] and published mid 1980 its Valuation Code[4], introducing the "actual value" of the imported good as being the customs value. As such the "normal price" of the imported good[5] was abandonded by the EEC countries and a more uniform and neutral set of valuation rules was introduced. See also appendix 1.

In 1984, Commission Regulation (EEC) No. 3158/83 of 10 November 1983 on the incidence of royalties and license fees in customs value entered into force, providing implementing provisions on the dutiability of royalty and license fees.

Mid eighties, the GATT Uruguay Round negotiations were initiated. Less-developped countries and developed countries jointly accepted the concept of "actual value" instead of "normal value", agreeing that one set of uniform rules would be key for expanding international trade. By the end of the negotiations (1994) increased participation, especially amongst less-developped countries, in the GATT Valuation Code was achieved by the overall succes of the Urugauy Round negotiations. In comparison to the Tokyo Round agreement, where GATT contracting parties chose which parts of the multilateral agreements they accepted and which parts they did not accept, the Uruguay Round agreement (1994) constituted a "single undertaking". This is referred to as the Final Act (Marrakech, 1994) containing the Agreement establishing the World Trade Organization (WTO Agreement). The WTO Agreement stipulates[6] that multilateral agreements annexed to the WTO Agreement, are an integral part of the WTO Agreement, and therefore binding on all Members. It concerns multilateral agreements on Trade in Goods, General Agreement on Trade in Services (GATS) and Trade-Related aspects of Intellectual Property rightS (TRIPS) [7]. Because the "Agreement on Implementation of Article VII of the GATT 1994", also known as the WTO Customs Valuation Agreement, is one of the annexed multilateral agreements on Trade in Goods, it is binding on all WTO Members.

By that time, the European Council and Commission already published a consolidated Community Customs Code and Implementing Provisions (Council regulation 2913/92 and Commission Regulation 2454/93), including customs valuation rules based on Article VII of the GATT 1979 as previously included in European regulations 1224/80 and 3158/83.

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[1] *The Tokyo Round Agreement entered into force 1 January 1981*
[2] *The European Economic Community being one of them*
[3] *Council Decision 80/271/EEC, dd. 10 December 1979, Official Journal L 071 (p.1-2), 17 March 1980*
[4] *Council Regulation 1224/80, dd. 28 May 1980, Official Journal L134 (p.1-9), 31 May 1980*
[5] *Council Regulation 803/68, dd. 27 June 1968, Official Journal L148 (p. 6), 28 June 1968*
[6] *Article II §2 of the WTO Agreement, 15 April 1994, Marrakech*
[7] *Do note that plurilateral agreements (also annexed to the WTO Agreement), such as the agreement on trade in civil aircrafts, are only binding to the GATT contracting parties that accepted them*

The aforementioned Community Customs Code 2913/92 (hereafter referred to as "CCC") and Implementing Provisions 2454/93 (hereafter referred to as "CCCIP") are still in force today.

2.2 Building Blocks provided by the WTO

Price actually paid or payable

The WTO Customs Valuation Agreement (hereafter referred to as "the Valuation Agreement") consists of introductory comments, twenty four articles and three annexes. In accordance to article 14 of the Valuation Agreement, the twenty four articles but also the three annexes form an integral part of the Valuation Agreement. Note that annex I includes Interpretative Notes to ten out of the twenty four articles. See also appendix 2.

According to article 18 and annex II of the Valuation Agreement, the Technical Committee on Customs Valuation[8] publishes advise in the form of commentaries, explanatory notes or advisory opinions; said advise is not binding on the WTO Agreement Members.

As is stipulated in the general introductory commentary, the Valuation Agreement works with a transaction value as primary basis for the customs value, to be adjusted with

- specific elements which are considered to form a part of the customs value and which are incurred by the buyer but not yet included in the transaction value
- certain considerations (in the form of goods and services) passing from the buyer to the seller.

Art. 1.1 of the Valuation Agreement:

"The customs value of imported goods shall be the transaction value, that is the price actually paid or payable for the goods when sold for export to the country of importation adjusted in accordance with the provisions of Article 8, provided […]"

Since the Valuation Agreement is based on the concept of 'actual price', in comparison to the concept of 'notional' or 'normal' price, the price is being determined by the buyer and the seller and therefore, it is common that identical goods in different transactions have different customs values (supply and demand mechanism[9]). The price actually paid or payable should be read as the total payment made or to be made by the buyer to or for the benefit of the seller for the imported goods[10] . Also "the price actually paid or payable includes all payments made or to be made as a condition of sale to the imported goods, by the buyer to the seller or by the buyer to a third party to satisfy an obligation of the seller"[11]. Therefore the price has to be paid by the buyer, but does not have to be paid directly to the seller; moreover, the buyer could also pay to a related party of the seller or to a third party to the seller, as long as it concerns a payment for the benefit of the seller. Note that no reference is being made to the importer of record but merely to the buyer as party to the sales transaction.

In order for a payment to be dutiable under article 1.1 of the Valuation Agreement, it shall be paid 'for' the concerned goods. The term 'for the concerned goods' is not clearly defined by the Valuation Agreement, however some examples of payments not to be regarded 'for the concerned goods' are provided for in Valuation Committee Decisions and interpretative notes

[8] *Established under the auspices of the World Customs Organization (formerly 'Customs Co-operation Council')*
[9] *For intra-group sales, the transfer price is accepted for Customs purposes upon condition that the price has an at arm's length character. This at arm's length character may be challenged by Customs and a comparison of the transfer price with test values may be requested. See for example article 29.2 (b) of the CCC*
[10] *Note to article 1, Annex I – interpretative notes to the WTO Customs Valuation Agreement, 1994*
[11] *Article 7, Annex III to the WTO Customs Valuation Agreement*

to the Valuation Agreement. Examples concern interest charges[12], payments for post-clearance services such as technical assistance, assembly services[13], etc.

Of course, one should be able to distinguish such payments from other payments 'for the concerned goods', in order to achieve exclusion from art. 1.1 of the Valuation Agreement. In practice separate invoicing, separate descriptions on a consolidated invoice etc. may suffice[14].

Do note that the term 'sale' is not defined by the Valuation Agreement and therefore it is feasible to verify national regulations. As guidance however, the Technical Committee on Customs Valuation indicates that it is the intention of the Valuation Agreement to apply the transactional value method to the greatest extent possible and that the term sale should be used in the widest sense[15]. On the other hand, imports of free goods (gifts, samples …), goods under consignment contract, goods under hire contract, goods under leasing contract, goods transferred by a company to its branch etc. are situations that do not resort under the term 'sale'.

In case the price is not established prior to the valuation of the imported goods, however buyer and seller did agree on a pricing formula or method (prior to or upon importation) so that post clearance a price can be established based on objective and quantifiable data, the transaction value method remains applicable.

Royalty payments and other add-on elements

Article 8 of the Valuation Agreement contains an exhaustive list of elements to be added to the customs value determined under the provisions of article 1 of the Valuation Agreement. In case article 8 value elements cannot be calculated on the basis of objective and quantifiable data, the transaction value method of article 1 of the Valuation Agreement cannot be applied.

Art. 8.1 of the Valuation Agreement:

"In determining the customs value under the provisions of Article 1, there shall be added to the price actually paid or payable for the imported goods: […]

(b) the value, apportioned as appropriate, of the following goods and services where supplied directly or indirectly by the buyer free of charge or at reduced cost for use in connection with the production and sale for export of the imported goods, to the extent that such value has not been included in the price actually paid or payable: […]

(iv) engineering, development, artwork, design work, and plans and sketches undertaken elsewhere than in the country of importation and necessary for the production of the imported goods;

(c) royalties and licence fees related to the goods being valued that the buyer must pay, either directly or indirectly, as a condition of sale of the goods being valued, to the extent that such royalties and fees are not included in the price actually paid or payable;

(d) the value of any part of the proceeds of any subsequent resale, disposal or use of the imported goods that accrues directly or indirectly to the seller."

[12] *Decision 3.1 on the treatment of interest charges in the customs value of imported goods, Tokyo Round Valuation Committee, 26 April 1984 (adopted by the WTO Valuation Committee on 12 May 1995)*
[13] *Note to article 1, Annex I – interpretative notes to the WTO Customs Valuation Agreement, 1994*
[14] *See Advisory Opinion 3.1, WTO Technical Committee on Customs Valuation, 1981*
[15] *See Advisory Opinion 1.1, WTO Technical Committee on Customs Valuation, 1981*

Since royalties and license fees are sometimes dutiable based on their qualification as assists[16], underlying paper also focuses on some of these add-on elements.

Article 8.1(b) of the Valuation Agreement focuses on dutiability of assists (such as materials, moulds, technical papers, drawings, know-how etc.) being provided by the buyer at a nil or reduced cost in relation to the production and sale of the goods being imported.

Assists as defined in article 8.1(b)(iv) are only dutiable in case the work required to generate such assist was undertaken elsewhere than in the country of import.

In order for article 1.1 of the Valuation Agreement to be applicable, the value of any related assist should also be based on objective and quantifiable data. In case no purchase price of the assist is at hand, a manufacturing cost could be defended (based on Generally Accepted Accounting Principles). Objective is to capture the total cost of the assist in the customs value, including hidden indirect costs[17]. Do note that some general research can be excluded – depending on the situation at hand and upon condition that it is not part of the total price paid or payable.

Let us now focus on article 8.1(c) of the Valuation Agreement concerning dutiability of royalties and license fees. Said payments are to be interpreted in a wide sense and no distinction is made between royalty payments for the use of rights which are protected and those which are not. Interpretative Note to article 8 of the Valuation Agreement[18] indicates that it may concern, amongst others, payments in respect to patents, trademarks and copyrights. The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), also annexed to the WTO Agreement and binding on WTO Members, may give some further guidance on 'intellectual property rights'[19]. It concerns amongst others copyright and related rights such as rental rights and broadcasting rights, trademarks, geographical indications (interlinked with a certain reputation etc.), protected industrial design, patents and layout designs of integrated circuits.

Article 8.1(c) of the Valuation Agreement emphasizes that royalties and license fees are only dutiable to the extent that the buyer is the payer and that the payments do relate to the goods being valued and that the payments are a condition of sale of the goods being valued. Note that the buyer is making the payment direct or indirect. An indirect payment in relation to royalty payments is not explained in the Valuation Agreement or in its Interpretative Notes.

In terms of royalty payments relating to the goods, one should carefully consider whether the royalty payment is not in relation to another product or service. For example, royalty payments made in relation to finished products that are being manufactured within the EU are in principle not related to the imported ingredient under valuation, and therefore not dutiable upon import of the aforementioned ingredient.

The concept "condition of sale", although vital for a correct understanding of article 8.1(c), is not explained in the Valuation Agreement or in its interpretative notes (annex 1 of the Valuation Agreement). In principle, in case the buyer has a choice to purchase the goods without being required to pay the royalty (in the broadest sense) – than the royalty payment is not to be considered a condition of sale. In other words, the key question is whether the seller would or could sell the tangible to the buyer in case the latter is not purchasing the right to use the intangible. For example, a royalty payment is being made by the buyer to a licensor unrelated to the seller and in relation to the right to use a patented manufacturing process.

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[16] *See Case C-116/89, BayWa AG v. Hauptzollamt Weiden, 1991, European Court of Justice (First Chamber) where intellectual know-how, for which a license fee is paid by the buyer within the EU to a licensor, is incorporated in the assist provided by the buyer to the seller free of charge.*
A second example: design works incorporating trademarks provided free of charge to the seller, should also be assessed in view of qualification as assists.
[17] *See Commentary 24.1, WTO Technical Committee on Customs Valuation, 2010*
[18] *Annex I to the Valuation Agreement, WTO, 1994*
[19] *See section II to VII of Annex 1C (TRIPS) to the WTO Agreement*

When the machine equipped for that purpose is being purchased by the buyer from the seller and put under valuation upon import, than the royalty is not regarded dutiable[20].

Note that dutiability of royalty payments and license fees is not co-determined by the country of residence of the licensor holding the intellectual property rights or the country where the intellectual property was created in the first place (in comparison to the situation of assists treated in article 8.1(b)(iv)). Double inclusion of the royalty and license fee payments is avoided in case of payments already being included in actual price paid or payable.

Proceeds of resale, disposal or use of the imported goods accruing to the seller (article 8.1(d)) are dutiable, without a condition of sale. The reason therefore is that proceeds are linked to the goods being valued and could be considered as an article 1 type of payment (actual price paid or to be paid in the future). On the other hand, "charges for the right to reproduce the imported goods in the country of importation shall not be added to the price actually paid or payable for the imported goods […]"[21] since these charges do not relate to the goods being valued but rather to the goods being created (reproduced) in the country of importation. The right to reproduce may also be linked with an idea, creation or invention that is incorporated into the goods being valued. For example, the import of a transparency embodying a cartoon character that is to be reproduced on post cards[22].

Payments made by the buyer for the right to distribute or resell are of course 'related to the goods', but are only dutiable in case the payment is a condition of sale. Focus lies with (contractual) obligations and conditions making the royalty payments a condition of the sale or not.

Let us now focus on royalty and license fees in relation to the use of trademarks. The use of trademarks is applied to increase the attractiveness of a product in a specific market, they as such impact the market value of the concerned product. A royalty payment for the use of a trademark, just like any other royalty payment, is made dutiable in case it is related to the goods and is being paid as a condition of the sale. The Valuation Agreement makes no distinction in treatment between trademark related royalties and others.

In case the seller and the licensor are the same party, the likelihood increases that the royalty payment for the use of the trademark is made a condition of sale; in other words, in case the seller will not sell without the payer also paying for the use of the trademark, than the royalty is dutiable (if not already part of the total consideration). However, in case the seller, being the licensor, allows the buyer to market the imported goods with or without the use of the trademark, than the Technical Committee on Customs Valuation stipulates that for those volumes marketed with the trademark, the royalty payment is to be added and for those volumes marketed without the use of the brand, no addition is required to the actual price paid or payable[23]. Therefore, and according to the Technical Committee on Customs Valuation, in case the buyer has the right to opt for commercialization of the goods with use of the brand or not, the royalty payment becomes a condition of sale for those quantities that are taken to market with use of the brand. Do note that one could conclude the opposite, meaning that the royalty payment for the trademark should in no circumstances be regarded dutiable, because the seller is willing to sell without knowing upfront whether the buyer will apply the trademark or not. Therefore, in case the buyer decides on the quantities to commercialize with use of the brand, after the moment of sale between the seller and the buyer, and in case the sales contract stipulates that the royalty payments are triggered at the moment of re-sale (the buyer decides independently to apply the trademark or not for each of his sales transactions to his customers), than the condition of sale is likely not to be met.

[20] *See Advisory Opinion 4.3, WTO Technical Committee on Customs Valuation, 1981*
[21] *Note to article 8, Annex I – interpretative notes to the WTO Customs Valuation Agreement, 1994*
[22] *See Commentary 19.1, WTO Technical Committee on Customs Valuation, 1994*
[23] *See Advisory Opinion 4.6, WTO Technical Committee on Customs Valuation, 1983*

In the situation of a third party[24] licensor and buyer, seller and licensor being unrelated from one another, the royalty payment for the use of the trademark made by the buyer to the licensor can be excluded from the dutiable value in case the royalty payment is made under a license agreement not related to the sales agreement of the goods (separate contractual agreements)[25]. In other words, in case the buyer is allowed to make use of the right without any restrictions imposed by the licensor (for example in terms of sourcing), than the royalty payment made by the buyer to the licensor does not constitute a condition of the sale.

Related Parties definition

Do note that persons or parties are deemed to be related in case they meet any of the criteria of article 15 of the Valuation Agreement[26]. In particular, in case one person has direct or indirect control over the other, meaning that the former is legally or operationally in a position to exercise restraint or direction over the latter[27], both persons are considered as related. The concept of "exercising restraint or direction" is subject to interpretation. In addition, the simple fact that parties to an agreement can enforce one another to act in accordance to the legally enforceable obligations of the agreement (e.g. selling at the agreed price etc.) does not constitute a relationship under article 15.1(e) of the Valuation Agreement.

By now the basic GATT rules on valuation and dutiability of royalty and license fees have been explained. Let us now focus on the interpretation of these rules from a perspective of the EU legislator and the EU Customs Code Committee.

2.3 European Customs Valuation and dutiability of Royalties and License fees

Following the GATT **1979**, the European Council implemented in 1980 the GATT valuation rules opting for a Cost Insurance and Freight-based valuation system. Current European customs regulations almost literally reproduce the valuation rules from the Valuation Agreement. In addition, several Interpretative Notes to the Valuation Agreement have been translated into European customs regulations.

Similar to the Valuation Agreement, the CCC stipulates that - in relation to the transaction value method - royalties and license fees related to the goods that the buyer must pay as a condition of sale of the goods being valued, are to be added to the price paid or payable (article 32.1(c) of the CCC). Moreover, and again in line with the Valuation Agreement, royalties and license fees for the right to reproduce (in the Community) are not dutiable, to the extent that they are not included in the total price paid or payable.

Furthermore, royalties and license fees for the right to distribute or resell are only payable in case they are related to the imported goods and constitute a condition of sale. Let us take the example of ingredients or components being imported and royalty payments being made for distribution rights of finished products. Even in case the royalty payments are being made as

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[24] *A third party is a party different from the seller*
[25] *Advisory Opinion 4.8, WTO Technical Committee on Customs Valuation, 1993*
[26] *Article 15 of the Valuation Agreement stipulates " For the purposes of this Agreement, persons shall be deemed to be related only if:*
- *(a) they are officers or directors of one another's businesses;*
- *(b) they are legally recognized partners in business;*
- *(c) they are employer and employee;*
- *(d) any person directly or indirectly owns, controls or holds 5 per cent or more of the outstanding voting stock or shares of both of them;*
- *(e) one of them directly or indirectly controls the other;*
- *(f) both of them are directly or indirectly controlled by a third person;*
- *(g) together they directly or indirectly control a third person; or*
- *(h) they are members of the same family.*

[27] *Annex I to the Valuation Agreement, Interpretative note to article 15, WTO, 1994*

a condition of sale of the ingredients or components, they will not be considered related to the imported goods being valued, and as such regarded not dutiable (to the extent that the payment is not part of the total price paid or payable).

On the other hand, the value of any part of the proceeds of any subsequent resale, disposal or use of the imported goods that accrues directly or indirectly to the seller, is made dutiable[28] in line with the Valuation Agreement, and this without the requirement of a condition of sale being met).

Royalties and license fees – definition

The CCCIP indicates that royalties and license fees in relation to article 32.1(c) of the CCC "shall be taken to mean in particular payments for the use of rights relating to the manufacture of imported goods (in particular, patents, designs, models and manufacturing know-how), the sale for exportation of imported goods (in particular, trademarks, registered designs), or the use or resale of imported goods (in particular, copyright, manufacturing processes inseparably embodied in the imported goods)"[29].

Safeguarding that the definition of royalties and license fees should be able to capture more situations, annex 23 of the CCCIP stipulates that royalties and license fees may include, amongst other payments, payments in respect to patents, trademarks and copyrights (non-exhaustive definition). Do remark that in case a payment is considered to be a royalty or license fee payment in accordance with article 32.1(c) of the CCC, it cannot be reclassified as part of the proceeds of resale, disposal or use accruing to the seller[30]. However, situations may arise whereby a royalty payment to a third party is non-dutiable because the payment is not considered to be a condition of sale, however intellectual property related costs (e.g. for designs capturing the trademark logo etc.) may become dutiable anyhow under the umbrella of assists provided by the buyer to the seller/manufacturer.

According to article 157.2 of the CCCIP, a royalty or license fee shall be added to the price actually paid or payable only when this payment is related to the goods being valued and constitutes a condition of sale of those goods.

Test criterion for dutiability – 'related to the goods'

Whether a royalty payment relates to the goods is depending to a great extent on what (right) is being obtained by the licensee and what product is being imported and put under valuation. How the royalty payment as such is being calculated, for example as a percentage of the re-sale price of the licensed product, is not decisive but rather indicative.

In case royalties or license fees relate to goods that have been subject to minor processing post-importation (such as diluting or packing), than the royalties or license fees may still be considered related to the imported goods under valuation (article 158 of the CCCIP). Or looked at from another perspective, minor processing only is insufficient in order to claim that the royalty or license fee, paid in relation to the processed goods, is considered to be unrelated to the unprocessed goods being valued upon importation; indeed the intellectual property is considered to be incorporated in the good already prior to the minor processing. Minor processing is not defined as such in the CCCIP however annex 72 to the aforementioned CCCIP may give an indication (usual handlings[31]). Important here is that the CCCIP extends the concept of 'related to the goods' so it captures goods under valuation but

[28] *Article 32.1(d) of Council Regulation 1992/2913*
[29] *Article 157 of Commission Regulation 1993/2454*
[30] *Para 20, Commentary N° 3, Compendium of Customs Valuation texts of the Customs Code Committee, XXI/1229/96-EN Rev. 3, 12/05/1997*
[31] *Generally speaking, it concerns minor activities to improve the appearance or the marketable quality as well as activities for making the goods ready for distribution or resale*

also goods resembling very well to the goods under valuation. Advisory Opinion 4.4 of the WTO Technical Committee on Customs Valuation focuses on the example of a royalty paid, as condition of sale, for the right to incorporate an imported patented concentrate in the end product (made after importation by diluting the imported concentrate with water). Regardless of the royalty amount being calculated based on the sales price of the end product, the royalty payment is considered to be related to the goods under valuation.

Test criterion for dutiability – 'condition of sale'

Let us now take a look at some other two party and three party royalty scenarios. When the buyer is making a royalty or license fee payment to the seller, who is also the licensor, and the payment is related to the goods being valued, than it is likely that the seller will not sell in case the royalty payments are not made (although exceptions may occur; cfr. Advisory Opinion 4.6). In case the buyer is paying royalties or license fees to a third party, than these payments are to be added to the actual price paid or payable in case the seller or a party related to the seller requires the buyer to make the payment.

Article 160 of Commission Regulation 1993/2454:

"When the buyer pays royalties or licence fees to a third party, the conditions provided for in Article 157 (2)[32] *shall not be considered as met unless the seller or a person related to him requires the buyer to make that payment. "*

The CCCIP includes as such a straightforward approach to make third party royalties and license fees dutiable on the condition that the seller or a party 'related' to the seller requires the buyer to make the royalty payment. In case the licensor is a party related to the seller, for example because they both are sister companies within the same company group, than the royalty payment made by the buyer to the licensor is considered dutiable. Also, in case the licensor is in a position to operationally exercise restraints or direction over the seller, so that a relationship is met in accordance to article 15 of the Valuation Agreement (translated into article 143 of the CCCIP), than the royalty payment made by the buyer to the licensor is to be added to the actual price paid or payable. One can conclude that the CCCIP interprets the condition of sale as captured in the Valuation Agreement and reproduced in the CCC, from a standpoint of related parties. Remark that the Valuation Agreement does nowhere indicate that in case of seller and licensor being related, that the condition of sale is met per definition; it merely increases the likelihood of the condition of sale being met. It is important to note that the condition of sale can be met because there is an explicit requirement or an implicit requirement of payment of the royalty[33] (**1997**). In case the licensor and seller are companies in the same company group, it is likely that the seller may impose the royalty payment as contractual obligation onto the buyer or that the licensor vis-à-vis the buyer makes the royalty payment a condition of sale. The EU Commission is of the view that it is not important whether the condition is stipulated in a contract or otherwise; key factor in deciding whether a condition of sale is met will largely depend on parties being related in the sense that they are legally or operationally in a position to exercise constraint or direction over one another.

Trademarks

For royalty payments and license fees for the right to use trademarks, specific provisions are foreseen in the CCCIP giving guidance on how to interpret the standard test criteria of "related to the goods" and paid as "condition of sale" as included in the CCC (and Valuation Agreement)

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[32] *Under the transaction value method: a royalty or license fee shall be added to the price actually paid or payable only when this payment is related to the goods being valued, and constitutes a condition of sale of those goods.*

[33] *Commentary No. 3, Compendium of Customs Valuation texts of the Customs Code Committee, XXI/1229/96-EN Rev. 3, 12/05/1997*

Article 159 of Commission Regulation 1993/2454:

"A royalty or licence fee in respect of the right to use a trade mark is only to be added to the price actually paid or payable for the imported goods where:
— the royalty or licence fee refers to goods which are resold in the same state or which are subject only to minor processing after importation,
— the goods are marketed under the trade mark, affixed before or after importation, for which the royalty or licence fee is paid, and
— the buyer is not free to obtain such goods from other suppliers unrelated to the seller."

The first and second condition are both to be read in view of the criterion "related to the goods". Do note that – also in view of royalties for the use of trademarks – minor processing does not prevent the condition of 'related to the goods' being met. On the other hand, trademark related royalty payments for finished products whereas the buyer is importing ingredients or components, will not be considered as related to the goods; on condition that it takes more than minor processing to obtain the finished product from the ingredients or components of course. Also, trademark related royalty payments are only considered to be related to the imported goods upon condition that the trademark is used to commercialize and market the imported good under the trademark for which the royalty is paid. In other words, in case of an importer reselling the goods as generic (not marked), than the trademark royalty is not considered related to the imported goods.

The third condition is to be read in view of the criterion "condition of sale". Said condition is built around the concept of "freedom of source", not as such literally comprised in the Valuation Agreement. Whereas the WTO focuses on the broader concept of "condition of sale", the EU legislator has – specifically for trade mark royalty and license fee payments – narrowed down the condition of sale. There is no condition of sale in case the buyer has the right to source from suppliers unrelated to the seller. In view of UK Customs (HMRC) and other Customs authorities cross the EU, the buyer should only evidence that he is not obliged to exclusively source from the concerned seller[34]; he is not required to evidence that these goods were effectively supplied by other unrelated suppliers. Therefore, trademark related license agreements are often capturing freedom of source clauses in line with article 159 of the CCCIP resulting in non-dutiability. Since binding customs valuation rulings are not foreseen in the CCC nor CCCIP, importers of record are largely dependent on the discretion of national Customs Administrations to issue a national valuation ruling. It goes without saying that the Member State of application matters.

Control factors

During the early years 2000, the Customs Code Committee published Conclusion No. 24[35] in respect to a three party royalty case of imported goods protected by copyright. The case concerned a US licensor and its French subsidiary being licensed to use the trademarks and copyrights in France. The French subsidiary sub-licensed to the buyer, an unrelated EU based company, who paid in return royalties. The seller is a manufacturer, legally not related to the buyer, nor to the licensor. However, the French subsidiary (the sub-licensor) concluded a contractual agreement with the seller enabling him to perform quality checks and approvals in respect to production models, artistic design, packaging, presentation etc. including quality approvals in respect to changes to the finished products. The Customs Code Committee investigated whether the combination of the elements of control where sufficient to conclude that the seller and the sub-licensor were considered to be related in view of article 143 of the CCCIP resulting in the condition of sale being met (article 160 of the CCCIP). It was

[34] *p.25, E4-12 Guidance on the audit of Customs values, HMRC, http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_ShowContent&id=HMCE_PROD1_023450&propertyType=document*
[35] *Conclusion No. 24, Compendium of Customs Valuation texts of the Customs Code Committee, TAXUD/800/2002-EN, October 2003*

concluded that the royalty payments were not to be added to the actual price paid or payable mainly because quality related controls are not regarded sufficient in order to determine a relationship (according to article 143.1(e) of the CCCIP). In view of the control activities undertaken by the sub-licensor, the seller was able to sell even in case the buyer would no longer make the royalty payment to the licensor. Indeed, the seller was selected by the buyer and not by the sub-licensor; the latter could not intervene in nor block the production' operations, the seller did not apply technology which was owned by the sub-licensor etc.

Conclusion No. 24 is mainly important because the EU Customs Code Committee enlists several elements that may demonstrate that the licensor or sub-licensor is exercising direct or indirect control over the seller to an extent sufficient to consider the royalty payment being a condition of sale, and this without the seller and (sub-)licensor being legally related.

Art. 2.2 of Conclusion 24 of the Customs Code Committee:

"[...] a) elements relating to the goods, for example:
- the goods produced are specific to the licensor (i.e., in their conceptualization and with regard to the trade mark);
- the characteristics of the goods and the technology employed are laid down by the licensor;
b) elements relating to the manufacturer, for example:
- the licensor selects the producer and specifies it for the buyer;
- there is a direct contract of manufacture between the licensor and the seller.
c) elements relating to the actual control exercised by the licensor, for example:
- the licensor exercises actual control either direct or indirect 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 seller. […]"

Around **2007**, the Customs Code Committee published Commentary No. 11[36], replacing and extending Conclusion No. 24, further building on direct and indirect controls exercised by the licensor over the seller/manufacturer in view of constituting a condition of sale based on the concept of related parties. Below elements (going beyond quality control) should be considered, amongst others, in determining control by the licensor over the seller that is being regarded sufficient in order to determine a relationship ("the control factor").

Section 1 of Commentary 11 of the Customs Code Committee:

"[...] - 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 themanufacture (as regards centres of production and /or methods of production);
- the licensor exercises actual direct or indirect control over the logistics and thedispatch 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 thegoods;
- 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 etc.
- the licensor designates/restricts the sourcing of materials/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 conceptualisation/design and with regard to the trade mark);
- the characteristics of the goods and the technology employed are laid down by the licensor. [...]"

[36] *Commentary No. 11, Compendium of Customs Valuation texts of the Customs Code Committee, TAXUD/800/2002-EN, January 2007*

The fact whether a licensor is legally or operationally in a position to exercise restraint or direction over a seller is a matter that should be carefully investigated on a case by case basis. Another example included in Commentary No. 11 concerns a licensor, owner of manufacturing know-how and technology being used in the production of the imported goods. The buyer is a subsidiary of the licensor and pays royalties to the licensor. The seller/manufacturer is not legally related to the licensor, nor to the buyer. Therefore, the seller may want to sell anyhow regardless of the fact whether the buyer pays the royalty to the licensor or not. In this case, it should again be verified whether there is some kind of control exercised by the licensor over the seller that may be regarded sufficient to meet article 143.1(e) of the CCCIP; in other words is the licensor from an operational perspective, positioned to exercise restraint or direction over the seller. Commentary No. 11 of the Customs Code Committee concludes that the royalty is dutiable based on the licensor designating the suppliers supplying raw materials to the seller, the licensor restricting the manufactured goods only for buyers appointed by the former, the licensor prohibiting production in excess to the orders placed etc.

Conclusion

We conclude that EU Customs law and EU Customs Code Committee guidelines are explaining the 'condition of sale' in terms of legal relationships and control factors. Especially "control factors going beyond normal quality control" often gives rise to practical issues[37] since there is no straightforward interpretation or approach to assess whether the control factors are regarded sufficient to establish direct or indirect control by the licensor over the seller/manufacturer. A case by case assessment remains required. Anyhow, for scenarios whereby the licensor and the seller are legally unrelated and the seller is not explicitly requiring the buyer to make the royalty payment to the licensor, a condition of sale can still be met. This broad interpretation of the condition of sale is an important element to take into account when opting for a tax efficient supply chain.

Concerning royalty payments for the use of trademarks, please remark that EU Customs law already back in 1983 did foresee the "freedom of source"-concept resulting in many trademark related royalties being excluded from the customs value.

Do note that the Valuation Agreement does not provide for an explanation of the concept of "condition of sale" in regards to articles 8.1(c) of the Valuation Agreement. Singapore Customs recently requested from the WTO Technical Committee on Customs Valuation to obtain such interpretation[38].

In view of Chapter three it is important to keep in mind that the EU legislator has until recently been interpreting the condition of sale from a perspective of the sale of goods transaction and the seller. In other words, the seller is requiring the royalty payment in some way, be it explicitly, be it implicitly due to the fact that the licensor has influence / impact on the seller (control factors). Put differently, the obligations to make the royalty payment to the licensor are emanating from the sales agreement seller - buyer.

3. Recent developments in the EU and WTO

Revised EU Customs legislation

[37] *Cfr. "Summary of conclusions reached during the meeting held on 12 and 13 February 2008", Customs Code Committee, TAXUD/2218/2008-EN, 7/05/2008*
[38] *WCO news n°66, p. 26, October 2011, www.wcoomd.org*

In **2008**, the EU Modernized Customs Code[39] (hereafter referred to as 'MCC') entered into force. However the MCC is not applicable since its implementing provisions (hereafter referred to as 'MCCIP') have not been published yet. The scheduled date of implementation of the MCCIP is likely to be postponed from mid 2013 to 2016[40], mainly due to concepts such as centralized clearance heavily relying on advanced IT capabilities. It remains unclear whether a selection of legislative articles of the MCC and draft MCCIP will be implemented earlier as amendments to the current CCC and CCCIP.

Underlying paper refers to version TAXUD/MCCIP/2010/100-3 of the MCCIP dd. 25 November **2011**.

Valuation articles in the MCC and MCCIP

It is remarkable that the MCC, in comparison to the current CCC, only withholds some conceptual articles in view of the transaction valuation and alternative valuation methodologies. The other valuation articles, for example in relation to assists and royalties, are being pushed to the implementing provisions in articles 230-01 to 230-22 of the MCCIP. Although several articles captured by the MCCIP are literally copy pasted from the Valuation Agreement and are therefore unlikely to be changed by the EU legislator, it is obvious that a Regulation of the Commission such as the MCCIP could in principle be modified easier and faster than a Regulation of the European Parliament and of the Council such as the MCC.

As example, article 230-09 of the MCCIP enlists the elements to be added to the price paid or payable and is focusing amongst others on assists (engineering, development etc.), royalties and license fees as well as proceeds accruing to the seller. The text is similar to the wordings in the Valuation Agreement and article 32 of the current CCC; however the text is being included in the Implementing Provisions and no longer in the basic Regulation.

We note that most of the implementing provisions of the CCCIP in view of valuation have not been withheld at all or have been tremendously modified in the MCCIP. One new consolidated article 230-11 has been introduced in the MCCIP covering the definition of royalty and license fees and focusing on general test criteria for assessing the condition of 'being related to the goods' and the 'condition of sale'.

Do note that the 'freedom of source' concept as condition of sale for royalties and license fees mainly in connection to the use of trademarks has been abolished. Also, the test criteria 'related to' and 'condition of sale' are now equal to all type of royalties and licenses envisaged by the MCC and MCCIP. It goes without saying that the condition of sale concept has been extended in the MCCIP.

Article 230-11[41] of draft Commission Regulation TAXUD/MCCIP/2010/100-3:

"1. For the purposes of point (c) of Article 230-09 (1), royalties and licence fees refers to payment for the use of rights relating to, inter alia, know-how, trade marks, copyright, patents, designs and models.
2. Royalties and licence fees are related to the imported goods where in particular, the rights transferred under the licence or royalties agreement are embodied in the goods. The method of calculation of the amount of the royalty or licence fee is not the decisive factor. However, where the method of calculation of the amount of a royalty or licence fee derives from the price of the imported goods, it may be assumed in the absence of evidence to the contrary that the payment of that royalty or licence fee is related to the goods to be valued.

[39] *Regulation of the European Parliament and of the Council N° 450 dd. 23 April 2008; to be recasted in view of the Lisbon Treaty and the new comitology Regulation of the European Parliament and of the Council N° 182 dd. 16 February 2011*
[40] *Para 23, European Parliament resolution of 1 December 2011 on modernisation of customs (2011/2083(INI)), adopted 5 December 2011*
[41] *Version 100-3 of article 230-11 dd. 25 November 2011 is identical to version 100-2 Rev.2 dd. 22 February 2011*

3. Payments made by the buyer for the right to distribute or resell the imported goods are not part of the customs value if such payments are not a condition of the sale of the goods for export to the Customs territory of the Community.
4. Royalties and licence fees are considered to be paid as a condition of sale for the imported goods when any of these conditions is met:
a) the seller or person related to the seller requires the buyer to make this payment;
b) the payment by the buyer is made to satisfy an obligation of the seller, in accordance with contractual obligations;
c) the goods cannot be sold to, or purchased by, the buyer without payment of the royalties or license fees to a licensor.
5. The country in which the recipient of the royalty or licence payment is established is not a material consideration."

Royalties and license fees – definition

The first paragraph of article 230-11 of the draft MCCIP provides a very short and general non-exhaustive definition of royalties and license fees, which is built on a combination of the current CCCIP definition and the additional wordings of annex 23 of the CCCIP in regards to royalties and license fees.

Test criterion for dutiability – 'related to the goods'

The second paragraph of article 230-11 of the draft MCCIP focuses on the payments being made 'related to the goods'. In case the royalty payments and license fees are paid for the use of rights that are 'embodied' in the concerned goods, than the payments are considered to be 'related to the goods'. This new interpretation of 'related to the goods' is now being embedded in the MCCIP, fully in line with the WTO Commentary 25.1 published in 2011, which elaborates amongst others on imported goods 'incorporating' the intellectual property and / or are being manufactured using the intellectual property covered by the license.

In terms of royalties for the right to use a trademark and the condition of 'related to the goods', WTO Commentary 25.1 focuses explicitly on trademarks being incorporated in the goods being valued, without providing further comments on a situation where trademarks are not incorporated upon the moment of valuation. Whereas the current CCCIP rules (article 159 of the CCCIP) consider a royalty payment for a trademark 'related to the goods' in case it refers to goods which are resold in a more or less identical state (regardless of the trademark being affixed to the goods prior or post custom clearances), it seems that the MCCIP rules, based on the WTO Commentary, may no longer envisage royalties paid for trademarks which are only embodied in the goods after importation. This is however subject of doubt since it is clear that the EU legislator is determined to increase the scope of taxation of intangibles. Secondly, older WTO Advisory Opinions, such as WTO Advisory Opinion 4.6 dated 1983, seem to indicate that royalty payments for trademarks applied – post customs clearance – to identical goods or goods having been subject to a minor process, are considered to be related to the goods under valuation. Anyhow, some further comments from the EU Customs Code Committee on the concept of 'embodied in the goods' are more than welcome. Also in view of discussions regarding unprocessed goods under valuation and royalties being paid for goods that have been subject to a minor versus a significant process post customs clearance.

Although the terms 'embodied in' or 'incorporated in' may seem very broad, it is still to be seen whether this specific notion would catch many royalty payment scenarios that are not in scope of today's CCCIP taxation rules.

For rights related to the manufacture of imported goods[42], patented manufacturing processes applied to manufacture the goods sold for export etc. the MCCIP is not likely to give a different outcome in comparison to current CCCIP regulation. Also, let us take another example of a royalty payment being made to a licensor for the right to manufacture in the

[42] *For example patented ingredients used in the manufacture of the goods sold for export*

country of import a specific licensed product and to obtain equally the right to commercialize this product with use of a licensed brand name. Assume that the manufacturing process makes use of some ingredients and components that are being valued upon importation. Under current CCCIP rules, the royalty payment is not considered to be related to the ingredients and components under valuation since the royalty payment is related to the product manufactured in the EU. Under the MCCIP, the conclusion would be identical given that the right transferred under the royalty agreement is not embodied in the ingredients or components.

The MCCIP mentions explicitly that the calculation method of the royalty amount is not the decisive factor to determine whether a royalty payment relates to the imported good or not. One should indeed verify which rights are obtained by making the royalty payment; the calculation can be based on several variables, amongst others the price of the imported good, the resale price after importation etc. Anyhow, in case the royalty amount is based on the price of the imported goods but the right is not embodied in the goods, than it is recommendable that the importer provides evidence to Customs prior to the establishment of the customs value. No change in comparison to the current CCCIP (article 161).

Note that the third and fifth paragraphs of article 230-11 of the draft MCCIP are in line with the current CCC and CCCIP.

Test criterion for dutiability – 'condition of sale'

The fourth paragraph elaborates on the condition of sale and stipulates three separate rules on how to interpret the condition of sale. From the moment that any of these three rules is met, the condition of sale is met.

The first rule (article 230-11.4(a)) describes royalty payments as being a condition of sale in case the seller or a person related to the seller requires such payment from the buyer. Similar to article 160 of the CCCIP, the MCCIP also explains the condition of sale in terms of the concept of related parties[43]; in case a party related to the seller, such as the licensor, requests the royalty payment, than that payment is de facto a condition of sale. Referring to Commentary 25.1, the WTO Technical Committee on Valuation only mentions, in case of a seller and licensor being related, that the likelihood increases for the royalty payment to be considered a condition of sale; certainly in comparison to a royalty payment made to a licensor not related to the seller. Assessing the 'condition of sale' criterion in view of 'related parties' is often difficult when it comes down to proving the direct or indirect control by the seller over the licensor or vice versa (exercising restraint or direction over the other party is a difficult concept to work with). We conclude that this interpretation of the MCCIP is already part of the current set of rules under the CCCIP, with the important exception for royalty and license fees for the right to use trademarks. Given that the freedom of source concept is abolished in the MCCIP, several royalty scenarios concerning trademarks may have a different outcome under the MCCIP rules. Let us take the example of a seller and a trademark licensor being part of the same group of companies. In case the buyer, paying the royalty for the trademark to the licensor, is given the freedom by the latter to equally source from sellers unrelated to its group of companies, than the royalty for the trademark under the CCCIP rules is not dutiable. Under MCCIP rules, the royalty is made dutiable since the payment is requested for by a party related to the seller.

The second rule (article 230-11.4(b)) indicates that the condition of sale is met in case the buyer is making the royalty payment to fulfil on obligation of the seller. E.g. the seller and the licensor have concluded a license agreement but it is the buyer who is making the royalty payment to the licensor, for example as condition of the sale agreement, satisfying the obligation of the seller towards the licensor under the license agreement. Although it is the

[43] *Related parties are captured in MCCIP article 230-01; similar to article 143.1 of the CCCIP.*

seller being contractually obliged to pay the licensor, the royalty payment will anyhow constitute a condition of sale because it is considered to be an indirect payment by the buyer. It is obvious that in case the buyer will not make that royalty payment, that the seller will no longer be willing to sell to the buyer.

This second rule is new in comparison to the current CCCIP condition of sale build around the concept of 'related parties'. However do note that article 32.1(c) of the CCC as well as article 230-09.1(c) of the MCCIP[44], both in line with article 8.1(c) of the Valuation Agreement, already define royalty payments so they include direct and indirect payments. Also, when reading the wordings of article 230-11.4(b) resemblances are found with the definition of the actual price paid or payable (article 1.1 of the Valuation Agreement) which equally includes payments to be made as a condition of sale by the buyer to satisfy an obligation of the seller.

Do note that the words "in accordance with contractual obligations" were only added in February 2011 when version 100-2 Rev. 2 of the MCCIP was prepared. During the meeting of the Customs Code Committee (valuation section) late February 2011 the notion "contractual obligations" was questioned by several Member States remarking that a more precise wording might be feasible; also it remains unclear why it is not pointed out what contracts are referred to (buyer-seller; seller-licensor, buyer-licensor). The benefit of the wordings "in accordance with contractual obligations" is unclear; it is expected that a buyer in principle makes a payment to satisfy an obligation of the seller because he is – by contractual agreement or similar – obliged to do so.

The third rule (article 230-11.4(c)) foresees a new broad interpretation for the condition of sale. Royalties and license fees are considered to be a condition of sale in case the goods cannot be sold to the buyer or in case the goods cannot be purchased by the buyer without the payment of the royalty or license fee to the licensor.

Please note that the previous draft text of article 230-11.4(c) of the MCCIP at some point contained specific descriptions of situations that were aimed at. These specific cases where included following consultations with the Trade Contact Group[45].

Article 230-11.4(c) of draft Commission Regulation TAXUD/MCCIP/2010/100-1 dd. 28 September 2010:

"the goods cannot be sold to, or purchased by, the buyer without payment of the royalties or license fees. [This condition is met in the following cases:
- the seller is required by contract to pay royalties or license fees to the licensor and the buyer pays the licensor to satisfy an obligation of the seller; and/or
-the seller may refuse to sell, or cancel the sale of the goods, if the buyer does not pay royalties or license fees to the licensor.]"

However, during the Customs Code Committee (valuation section) meeting dated 22 November 2010, the removal of the first indent was approved since it was considered to be related to article 230-11.4(b) rather than to article 230-11.4(c). Also, it was proposed – in respect to the last indent – to equally focus on obligations of the buyer, rather than on the power of the seller to refuse the sale. This could imply that the Customs Code Committee aims at taxing royalty payments not only because those payments are required by the seller (as an explicit or implicit condition) but because the buyer is obliged to make those payments as such (emanating from obligations not related to the sales of goods transaction). As of version 100-2 Rev.2 dated 22 February 2011, the text of article 230-11.4(c) got to the state it is in today (version 100-3).

[44] *"royalties and license fees related to the goods being valued that the buyer must pay, either directly or indirectly, as a condition of sale of the goods being valued" shall be added to the price paid or payable for the purposes of the determination of the customs value and in accordance with Article 41 and point (a) of Article 43 of the Code, if they have not been included already*
[45] *See Summary of Conclusions reached during the meeting held on 21 June 2010, EU Customs Code Committee, TAXUD/376343/2010-EN rev.1, 22 June 2010*

In order to cover all sorts of situations, both capturing the power of the seller to cancel the sale, as well as other factors resulting in the buyer not being allowed to purchase, the Customs Code Committee simply withheld the first sentence and got rid of all indents to the article. Therefore, it seems that in a scenario whereby buyer, seller and licensor are all unrelated, that a royalty paid by the buyer to a licensor could still become dutiable.
In addition, the article does nowhere indicate that, in order for the condition of sale to be met, it should be the buyer that is making the royalty payment (in comparison to articles 230-11.4(a) and (b) stipulating explicitly the buyer as the party making the royalty payment). Based on the current draft text, it seems like the condition of sale works with any party – not necessarily the buyer – making the royalty payment as condition of sale.
On the other hand, the Valuation Agreement, the CCC and the draft MCCIP imply that royalties can only be added to the actual price paid or payable to the extent that the buyer is making this payment directly or indirectly. Therefore, the definition of indirect payment, which is not defined, is vital. Interpretative Note to article 8.1(c) of the Valuation Agreement only indicates the buyer as the party making the royalty payment in view of assessing whether the royalty payment is indeed a condition of the sale for export to the country of importation, however the Interpretative note does not explain direct versus indirect payments.

Therefore, and in the absence of control factors or legal relationships between the seller and the licensor (article 230-11.4(a)), and in the absence of the buyer making the royalty payment to satisfy a condition of the seller (article 230-11.4(b)), the condition of sale can still be met simply because the buyer cannot obtain the goods without paying the royalty (even regardless of who is paying the royalty). This seems like a catch all clause.

Given that most intellectual property rights are protected by law and given that the licensee is allowed by the intellectual property owner to use such right only when he lives up to certain conditions (e.g. making use of the right for a limited period in time, making a royalty payment etc.), it is likely that the owner of the intellectual property can block the supply chain at any time as such preventing the buyer from purchasing the goods. Let us take the example of a seller manufacturing goods including intellectual property for which the royalty is being paid by the buyer to a licensor, unrelated to the seller. In case the buyer stops making the payment to the licensor, than the latter will exercise his legal right to stop the seller from manufacturing the goods, embodying the intellectual know-how for which the right has not been paid.

Let us take a look at Advisory Opinion 4.8 issued by the WTO Technical Committee on Valuation (1993) describing a three party royalty case focusing on rights to use a trademark in the country of importation and with all three parties unrelated to one another. The buyer pays the royalty to the licensor in order to obtain art and design work to be put on shoes (e.g. logo containing the brand name). The royalty amount is calculated as a fixed sum per pair of shoes sold. The art and design work is provided as an assist by the buyer to the seller. According to Advisory Opinion 4.8, the royalty payment for the trademark is not dutiable since the payment is not required by the seller as a condition of sale. Indeed the obligation for the buyer to pay the royalty is based on the royalty agreement with the licensor. Or in other words, the obligation to pay the royalty is emanating from obligations unrelated to the sale of goods transaction.

If we now make use of the new MCCIP condition of sale, the royalty payment might be considered dutiable since the buyer might be considered to be in a position where he is unable to purchase the good from the seller (who is selling for export to the country of importation) without paying to the licensor for the right to use the trademark in the country of importation. Therefore, the condition of sale might be met without the seller requiring the royalty payment, but simply by looking at the obligations of the buyer. If the buyer does not pay the royalty, the licensor is likely to block the supply chain and stop the sale. It may be concluded that the new MCCIP condition of sale concept is open for interpretation and may eventually be regarded more aggressive than what is meant with the condition of sale concept in the Valuation Agreement. Also, by means of applying the MCCIP rules, situations may occur were both the royalty payment as well as the assist may become dutiable.

Let us take a look once more at Advisory Opinion 4.3 issued by the Technical Committee on Valuation (1981), concerning a royalty for a patented manufacturing process paid by the buyer enabling him to manufacture products in the country of import post customs clearance. Although the machine imported embeds the specific process, the royalty was considered not dutiable since the royalty payment was not a condition raised by the seller. Under the new MCCIP rules, situations may be considered where the licensor would be in a position to block the manufacturer from manufacturing the specific machine or simply stop the buyer from obtaining the machine in case the latter does not pay the royalty for the protected right to use the machine.

To conclude, the new proposed EU interpretation of the condition of sale is perceived rather aggressive and seems at first sight, no longer in line with old Advisory Opinions.

Let us focus on the recent WTO Commentary 25.1 dated 2011, giving further although vague insight into the concept of condition of sale in view of third party royalties and license fees. It refers to cases where the buyer is unable to purchase without paying the royalty simply because the sales agreement includes such explicit obligation (para 8). Again, and in line with the Valuation Agreement, the condition of sale is explained by focusing on the seller requiring from the buyer the payment to the licensor. In case the sales contract does not include explicit conditions in terms of the royalty payment, than the Technical Committee on Customs Valuation informs that one should analyze all the facts surrounding the sale and importation of the goods, including linkages between the sales and license agreements amongst others. Some examples constituting a condition of sale have been included in the Commentary.

Article 9 of Commentary 25.1 of the WTO Technical Committee on Customs Valuation:

"[...] The folowing are factors that could be taken into account in determining whether payment of the royalty or license fee is a condition of sale.
a. There is a reference to the royalty or license fee in the sales agreement or related documents.
b. There is a reference to the sale of the goods in the royalty or license agreement.
c. According to the terms of the sales agreement or the royalty or license agreement, the sales agreement can be terminated as a consequence of breaching the royalty or license agreement because the buyer does not pay the royalty or license fee to the licensor.
d.There is a term in the royalty or license agreement indicating that if the royalties or license fees are not paid, the manufacturer would not be permitted to manufacture and sell the goods incorporating the licensor's intellectual property to the importer.
e. The royalty or license agreement contains terms that permit the licensor to manage the production or sale between the manufacturer and importer (sales for export to the country of exportation) that go beyond quality control.
"

From a perspective of the seller (article 9(a) and (c)), attention goes to a sales agreement making reference to the royalty or license fee; as well as to terms and conditions of the sales agreement indicating that the sales agreement may be terminated in case the royalty or license fee is not paid to the licensor.

From a perspective of the licensor (article 9(b),(c),(d) and (e)), focus lays with (b) a royalty or license agreement making reference to the sales agreement; as well as with terms and conditions of the license agreement indicating that (c) the sales agreement may be terminated in case the royalty or license fee is not paid or (d) the licensor can prohibit the seller to sell goods embodying the right in case the royalty or license fee is not paid and (e) the licensor can manage the sale for export by the seller to the buyer (exercising restraint or direction going beyond quality control).

Although the Commentary stipulates that the condition of sale is likely to be met in case the buyer is unable to purchase the imported goods without paying the royalty, it is made clear that the Technical Committee on Customs Valuation relies heavily on contractual obligations and terms and conditions as well as on linkages between sales and license contracts when assessing the condition of sale. Focus is aimed at the 'seller' implicitly requiring the buyer to make the royalty payment and on the 'licensor' being able to interfere with the sale/

manufacturing process so the buyer cannot purchase the imported goods. In other words, Commentary 25.1 works with linkages between the license and sale of goods agreements, whereas the MCCIP in article 230-11.4(c) in addition captures also obligations emanating from the license agreement (without a link with the sale of goods agreement and obligations).

If we focus on the example of a seller selling a good for export embodying intellectual property owned by a third party, and there are no linkages between the transaction licensor-buyer and seller-buyer, because for example the third party seller merely receives from the buyer art work capturing the trademark, than the conclusion under the Commentary may be that the royalty payment is not dutiable. The licensor has no power to interfere in the sale for export between the seller and the buyer. Moreover, the buyer can purchase from the seller, even without paying the royalty.

In view of the MCCIP rules, and without further guidance from the Customs Code Committee on how to interpret article 230-11, one might conclude that although the licensor has no power emanating from contractual obligations or terms and conditions enabling him to interfere in the sale of goods transaction, he can still make use of his legal right to block anyone in the supply chain from making use of his intangible, without obtaining the royalty payment or license fee from the licensee (power emanating from the license agreement as such). In other words, even without the royalty payment being an implicit condition of sale, do the rights coming from owning a protected trademark for example, suffice to see the condition of sale being met?

Conclusion

To summarize, the new WTO Commentary 25.1 provides new incidences on how to interpret dutiability of royalties and license fees; these seem to extend previous interpretations captured by older Advisory Opinions 4.3 and 4.8. Main focus lies with the buyer being unable to purchase from the seller due to the licensor having the power – mainly based on contractual terms and conditions (but also other facts surrounding the sale) – to interfere with or simply prevent the sale for export. The mere fact that an owner of a protected intangible can stop anyone from using the intangible in one way or another without the royalty payment being made, does not seem like a fact surrounding the sale for export that can make the royalty payment a condition of sale.

The MCCIP condition of sale concept is to a great extent in line with the new Commentary, however it seems to capture – without having proper guidelines at hand explaining article 230-11 of the MCCIP in more depth – more situations whereby the licensor makes use of his legal right to stop any party anywhere in the supply chain from using his protected intangible in case the buyer omits to pay directly or indirectly the license fee. And this without the need for an (implicit) condition of sale being met as is prescribed by the Valuation Agreement. So there is no need for a relationship between seller and licensor for the royalty payment to become inclusive. It seems that the revised condition of sale rule in the MCCIP may be one bridge too far from the original Valuation Agreement. By speaking with Customs administration cross the EU, it is clear that the intention is to make more intangible transactions taxable, however there is a common sense that ideally, the Valuation Agreement should be modified, which is unlikely to happen since this would require a consensus amongst the WTO Members[46].

It goes without saying that the MCCIP condition of sale is more general than the current one (especially for trademark related royalties) and an increase in landed cost can be expected for many buyers.

[46] *p. 174, A Handbook on the WTO Customs Valuation Agreement, WTO, Sheri Rosenow and Brian J. O'Shea, 2010*

4. Royalty payments in a series of successive sales

Let us take one specific example of party A selling to party B selling to party C (importer of the goods into the customs territory of the EU) and the right for which the royalty is being paid by party C is embedded in the goods as of the first sale from A to B.

First sale for export

The WTO Commentary 22.1 dated 2007 interprets the sale for export to the country of importation as being the last sale before the goods are brought into the customs territory of the country of importation. This new interpretation is embedded in the draft MCCIP by virtue of article 230-02. However, on December 1st 2011, the European Parliament voted a resolution calling for the retention of the first sale concept, since it is of the opinion that the discussions, currently ongoing in the EU Customs Code Committee, with regard to establishing a transaction value do not comply with the 'sale for export' concept as laid down by the WTO Valuation Agreement. The European Parliament is not in favour of the MCC and MCCIP, nor WTO Commentary 22.1, supporting a shift towards a 'sale for import' concept. It is to be seen during the coming weeks and months whether the Council and Commission will accept this call for retention of the first sale concept.

Taking the assumption that the first sale will be retained, in other words the transaction A-B is regarded as the sale for export, let us than assess the dutiability of royalties for the case at hand in view of the CCCIP and MCCIP test criteria.

CCCIP test criteria

Currently, in case party C can evidence that party A sells for export to the EU, the transaction A-B qualifies as the sale for export transaction and the price charged by A to the buyer B may be used as a basis for the customs value. First question aims at resolving whether the royalty payment by party C can anyhow be included in the customs value based on transaction A-B. Only when the royalty payment made by party C could be considered to be an indirect royalty payment by party B, than the royalty is potentially inclusive.
Focusing on the condition of sale, generally speaking, Customs may agree that the royalty payment by party C to the licensor is not a condition raised by party A; in some cases Customs may however attempt assessing control factors between the licensor and party A.

In general, and under the CCCIP rules, the royalty paid by the importer would likely not become dutiable in a first sale scenario, however exceptions exist.

MCCIP test criteria

In order to assess a first sale scenario based on MCCIP rules, one should take into account that the rules regarding royalties have been written in conjunction with the abolishment of the first sale principle. It is only recently, that the European Parliament opted to retain the first sale principle.

Similar to above analysis, an assessment of the condition of sale is only useful in case the royalty payment made by party C could be considered to be an indirect royalty payment by party B. Indeed, article 230-9.1(c) of the draft MCCIP, similar to article 32.1(c) of the CCC, indicates that royalties may be dutiable in case the buyer is the party paying the royalties directly or indirectly as a condition of sale of the goods being valued.

Focusing on the new MCCIP condition of sale criteria, the royalty payment could be dutiable in case the goods cannot be sold to or purchased by the buyer without payment of the royalties or license fees to a licensor. In other words even when control factors and

relationships are lacking between party A and the licensor (see above), inclusiveness of the royalty payment is still considered possible. Given that the rights are yet embodied in the goods as of the first sale A - B, and in case the licensor could for example prohibit party B from buying based on legal rights to stop this purchase (so not emanating from obligations or conditions linked with the sale of goods), than the royalty may become dutiable. Indeed, article 230-11.4(c) of the draft MCCIP omits to define the party that should pay the royalty to the licensor (the buyer party B or the importer party C?). Do note that this specific condition of sale is not built around the concept of related parties (focus on control factors considered to be sufficient so a relationship exists between the seller and the licensor), but may be regarded as a catch-all clause. From the moment that in some way the licensor can prevent the sale of goods, than the royalty payment becomes dutiable.

To summarize, the likelihood of dutiability in a scenario of successive sales will increase due to the very general all-catching condition of sale introduced in the draft MCCIP.

5. Conclusion

I hope that underlying paper provided some useful insight in the current and future rules for assessing dutiability of royalty and license fees in the EU. Given that both the WTO Commentary 25.1 as well as the draft MCCIP rules are new and have not been fully tested in reality, one should await further guidance, especially from the EU Customs Code Committee, in order to fully capture all aspects of the revised rules and extended interpretations.

(1) The EU condition of sale built around the concept of “related parties” is withheld in the draft MCCIP. However, the current freedom of source concept for trademark related royalties has been abolished and dutiability of such royalties should be assessed based on the new general condition of sale criteria applicable to all royalties and licenses (art. 230-11.4 of the draft MCCIP). From a perspective of the Customs Administrations, taxation of trademark related royalties will become far more easier than compared to the current EU dutiability criteria.

(2) In case royalty payments are made by the buyer satisfying an obligation of the seller, than this indirect payment is considered to be a condition of sale. This is a new rule incorporated in the MCCIP in comparison to the CCCIP, however one may wonder whether such indirect payments are not already supposed to be taxed under the rules of the Valuation Agreement (direct and indirect payments) and current article 32.1(c) of the CCC.

(3) In terms of the condition of sale rule “goods cannot be sold by the seller or cannot be purchased by the buyer without the royalties or license fees being paid to the licensor”, one can only hope that the objective of the EU Customs Code Committee is not to make royalties for rights which are protected by law dutiable as such / per definition. According to the Committee, obligations not emanating from the sales of goods agreement can still result in the royalty payment becoming dutiable, even in case where a relationship between seller and licensor is lacking. In other words, the EU Customs Code Committee is no longer reviewing the condition of sale merely in view of the sale of goods but also in view of the intellectual property transactions, which may be totally unrelated to the sale of goods transaction.

(4) It is clear that the interpretation of the condition of sale by the WTO has also been broadened over time (see WTO Commentary 25.1 in comparison to Advisory Opinions 4.3 and 4.8), since the WTO currently explains the condition of sale in view of linkages between sales and license agreements enabling the licensor to prohibit the seller from selling and the buyer from purchasing. The aforementioned linkages are not included in the new MCCIP rules.

(5) In regards of a series of successive sales the MCCIP potentially considers royalty payments for which the rights are embodied in the concerned goods, dutiable in the case of the importer making the royalty payment to a licensor whereby the 'sale for export' and the buyer linked with that transaction are to be found further upstream in the chain of sales. Therefore, it would not suffice to have a transaction to which no royalty payments are attached, qualifying as the sale for export, in order for the royalty payment not to be added to the actual price. In comparison to the CCCIP rules, the likelihood of taxation of royalties, be it in a series of successive sales scenario or in a one sale scenario, does increase.

To conclude, the "condition of sale" concept remains a difficult concept to grasp, although it is crystal clear that both the EU as well as the WTO are aiming to extend its scope making more royalties dutiable in the future.

The objective of the EU Customs Code Committee seems to make many royalties for which the rights are embodied in the goods under valuation, dutiable as such, by turning the condition of sale almost into a catch-all clause.

When comparing the Valuation Agreement and Commentary 25.1 with the condition of sale rule of article 230-11.4(c) of the draft MCCIP, I get the impression that the aforementioned article is no longer in line with the Valuation Agreement.

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Appendices

Appendix 1

Art. 1.1 of Council Regulation (EEC) No. 803/68 of 27 June 1968:

"1. For the purpose of applying the common customs tariff, the value for customs purposed of the goods imported shall be taken to be the normal price […]"

Art. 3.1 of Council Regulation (EEC) No. 1224/80 of 28 May 1980:

"1. The customs value of imported goods determined under this Article shall be the transaction value, that is, the price actually paid or payable for the goods when sold for export to the customs territory of the Community, adjusted in accordance with Article 8, provided […]"

Appendix 2

The Valuation agreement consists of :

- *General introductory commentary*
- *Part I - Rules on customs valuation (articles 1 – 17)*
- *Part II - Administration, Consultations And Dispute Settlement (articles 18 – 19)*
- *Part III: Special and Differential Treatment (articles 20)*
- *Part IV: Final Provisions (art 21 – 24)*
- *Annex I: Interpretative Notes*
- *Annex II: Technical Committee on Customs Valuation*
- *Annex III*