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An Unfamiliar Duty Burden: The Tariff Effect of Intellectual Property Payments

by Andrew Siciliano and Elizabeth Shingler

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In this article, the authors discuss how tariffs affect intellectual property payments for imported goods.

Most importers recognize that tariffs are generally assessed against the dutiable value of imported merchandise. What is not well known, however, is that tariffs may also be assessed against intellectual property payments for imported goods, such as royalties and license fees. What makes that a major concern in today's trade environment is that for many products, especially goods from China, the Trump administration has assessed tariffs of up to 25 percent against the transaction value of imported merchandise. As a result, should a royalty payment be considered dutiable by U.S. Customs and Border Protection (CBP), the value of the royalty will be subject to the same duty rate as the imported product. Also, CBP could retroactively recover five years' worth of duties, fees, penalties, and interest. Therefore, the overall liability associated with those payments could be considerable. Understanding when royalty payments are dutiable and proactively managing them will help control that hidden compliance risk.

The Impact

The payment of royalty and license fees by a U.S. company to a third-party brand owner, its foreign parent, or a related company is a common transaction. However, unless importing companies consider the customs impact at an early stage and adopt appropriate documentation and procedures, those IP payments may create unexpected risks. Royalty payments are typically associated with the right to produce, make, design, sell, import, export, and distribute goods in a specific market. In some circumstances, they may be dutiable, and a company's trade department is often unaware that they exist. As a result, those payments often go unreported to CBP.

Tariffs are essentially taxes assessed on imported goods based on various factors such as value, country of origin, and classification. A 10-digit classification code is assigned to every imported product based on the U.S. Harmonized Tariff Schedule (HTS). Globally, the HTS numbers are standardized to the sixth digit for any country that is a member of the World Customs Organization. That classification, in conjunction with the country of origin, determines the applicable tariff rate. In the United States, CBP administers import activity and duty payment collection.

For many years, U.S. tariff rates on goods were static. Although some industries were subject to high duty rates, tariffs did not change year to year, giving importers a sense of stability. In the last two years, however, the U.S. trade environment has been disrupted — first with the imposition of the section 232 (Trade Expansion Act of 1962) tariffs targeting steel and aluminum products, then with the section 301 (Trade Act of 1974) tariffs targeting most imports from China. The United States imposed the section 301 tariffs to curb China's alleged unfair trade practices, IP theft, and forced transfers of technology. The rates range from an additional 7.5 to 25 percent duty.

As a result, products that were assessed very low — or, in many cases, zero — rates are now subject to significant tariff costs. More recently,

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additional tariffs of up to 25 percent have been imposed on some EU products, and the U.S. Trade Representative has noted that it may amend the tariffs without warning.[1] Thus, in fiscal 2019, CBP collected $80.7 billion in duties taxes and other fees, 73 percent more than in fiscal 2018. Of that, the section 301 China duties accounted for more than $29 billion. Section 232 tariffs on steel and aluminum were much lower, however, totaling approximately $5.1 billion in duties.[2] It is unclear if these tariff actions will be removed.

IP Payments

Importers increasingly make royalty or license payments for the right to use another entity's IP. Those payments are often for rights such as trademarks, patents, distribution, manufacturing know-how, and so forth. The entity that owns the property grants the importer a license to use it contingent on the payment of royalty fees, which are often predicated on the volume of sales in the targeted market.

In some industries, specific types of royalty payments are common. For example, in the apparel and footwear industry, payments may be made for the use of trademarks to brand products because a specific word, sign, or symbol enhances the product's value. Further, royalty payments for the right to use patented processes in the manufacture of goods occurs frequently, especially in the production of footwear, life science or medical devices, and industrial machinery.

Although royalty payments may be made to related or unrelated license holders located domestically or overseas, they commonly arise between related parties. For example, a multinational entity with transfer pricing policies may license IP rights from its parent company and then make royalty payments at periodic intervals. Even when those payments are not made directly to the party selling the goods, they might still be dutiable. In determining whether payments associated with IP payments are dutiable, the WTO has promulgated rules to guide its members.

WTO Rules

The WTO provides guidance on customs valuation issues to achieve fair and uniform valuation practices among its members. It promulgates transaction value as the preferred method of appraisement, although there are six potential valuation methods applied in a hierarchy. Transaction value is 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 as a condition of sale of the imported goods by the buyer to the seller, or . . . to a third party to satisfy an obligation of the seller," according to WTO rules.[3]

The WTO allows some additions to the customs value that are also added to the invoice price of the goods. There are several payments, including some royalties and license fees, that may augment the value declared to customs. According to the General Agreement on Tariffs and Trade, royalties and license fees may be part of the price actually paid or payable when the buyer is required to pay them either directly or indirectly as a condition of sale and they are not already included in the price.[4]

As a result, member countries may include royalty and license payments as part of the dutiable value of the imported goods when they are a condition of sale. However, the interpretation and application of that requirement is left to the members and is an area in which treatment varies widely.

To assist members, in 2013 the WTO Technical Committee on Customs Valuation, which provides guidance and interpretation on valuation agreements, issued Advisory Opinion 4.15 on the treatment of trademark royalties. It commented on a fact pattern in which the trademark licensor and importer were related but neither was related to the manufacturer of the imported goods. In that case, the license agreement obligated the importer to pay a royalty

[1] "Notice of Modification of Section 301 Action: Enforcement of U.S. WTO Rights in Large Civil Aircraft Dispute," 85 Fed. Reg. 10204 (Feb. 21, 2020).

[2] Customs and Border Protection, "CBP Trade and Travel Report, Fiscal Year 2019," at 7 (Jan. 2020).

[3] WTO, "Technical Information on Customs Valuation," at "Method 1 — Transaction Value" (Feb. 13, 2020)

[4] WTO, "Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994," at article 8 (Feb. 13, 2020).

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based on a percentage of net sales of the product in the country of importation. Although the sales contract between the manufacturer and the importer did not require payment of the royalty, the licensor had a supply agreement with the manufacturer that limited the manufacturer to selling the product only to authorized companies.

To assess whether the payment of the royalty was a condition of sale, the committee examined the level of control the licensor exercised over the transaction. It found that the result of nonpayment of the royalty was that the licensor would withdraw the manufacturer's authorization to sell goods to the importer. As a result, a condition of sale existed, making the payment a dutiable royalty. Importers should note that the licensor's level of control in the relationship will frame the analysis regarding whether a payment is a condition of sale.

How the U.S. Determines Customs Value

Transaction Value: How It Works

The United States follows the valuation methods established by the WTO. Although there are six methods of appraisement, transaction value is the preferred one. The U.S. customs regulations[5] mirror the WTO's definition of transaction value, stating that it is "the price actually paid or payable for the merchandise when sold for exportation to the United States," plus specific statutory additions. The price actually paid or payable is the total payment "made, or to be made, for imported merchandise by the buyer to, or for the benefit of, the seller." So, generally, the regulations provide that the dutiable value includes payments that the buyer makes directly to the seller, or those that are not made directly to the seller, but from which the seller still profits.

In instances when the buyer and seller of the imported goods are related, transaction value may still apply, but the importer must be able to prove that the relationship did not affect the price. There are times when transaction value might not be appropriate, such as in related-party transactions involving goods that are steeply discounted based on the relationship between the entities. When that happens, the valuation methods are applied in their hierarchical order until a specific method is determined to be appropriate.

There are also instances when specific payments or items of value that might not be included in the invoice value are part of the transaction value and must be added. Those fees are called "additions" and include packing costs, selling commissions, assists, proceeds of subsequent resale, royalties, and license fees.

Assists occur when an importer provides materials, tools, dies or molds, or engineering or design work that occurs outside the United States to the seller for free or at a reduced cost that would normally be included in the invoice price.[6] When those materials or services are provided for free, the overall cost of the finished product is lowered, because if the buyer had not provided them, the seller would have procured them for a cost. To achieve an accurate customs value, those costs must be added to the value declared to CBP.

However, while some statutory payments or additions to the transaction value are almost always dutiable, royalties and license fees are dutiable only under specific circumstances. The statute provides that a royalty or a license fee may be added to the value of the imported goods when "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."[7] Essentially, the royalty or license payment is not dutiable unless the importation cannot occur without paying the fee. Although the statutory language appears clear, in practice it is often difficult to determine if the payment is a condition of sale.

The *Generra* Presumption

In determining what fees are included in the declared value, there is a presumption that all payments made by a buyer to a seller are part of the price actually paid or payable for the imported merchandise. That presumption — the *Generra* presumption — was established when the U.S.

[5] *See generally* 19 U.S.C. section 1401a.

[6] 19 C.F.R. section 152.102(a)(1).

[7] 19 U.S.C. section 1401a(b)(1)(D).

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Court of Appeals for the Federal Circuit found that an importer is responsible for demonstrating that payments to a seller are unrelated to the imported goods.[8]

However, the burden can be rebutted if an importer can truly establish that the payment is unrelated to the imported merchandise. To do so, a company must demonstrate that while a payment was made directly or indirectly to a seller, it was not related to the imported goods. For example, if a payment must be made regardless of whether the import occurs, such as the payment of legal fees, it might not be dutiable.

The key is to understand what payments are occurring and any nexus to the imported goods. However, when a payment is made to the seller of the goods and is related to the goods, it is often difficult to prove that it is non-dutiable.

In sum, as a starting point, if an IP (or any) payment is made to or for the benefit of the seller, a company must examine whether the payment should be included as part of the price actually paid or payable before considering whether it is an addition to the payment.

The *Hasbro* Test

Royalty cases can be tricky because royalty payments are not always made to the seller. As a result, it may appear that the payment is not dutiable because it did not meet the *Generra* requirements. However, CBP has found that a royalty payment may still be a condition of sale, and therefore included as an addition to the transaction value even when it is not made directly or indirectly to the seller.

In assessing whether royalty and license fees are dutiable as a condition of sale, CBP must identify whether the buyer was required to pay them as a condition of sale of the merchandise for exportation to the United States, and to whom and under what circumstances they were paid. To do so, it applies the three-pronged *Hasbro* test, examining whether:

- the imported merchandise was manufactured under patent;
- the royalty was involved in the production or sale of the imported merchandise; and
- the importer could buy the product without paying the fee.[9]

An affirmative answer to the first two questions and a negative answer to the third may indicate that the royalty is dutiable. However, the analysis is highly fact specific. Further, although subject to the same test, royalty and trademark payments are treated differently.

CBP presumes that payments associated with patents are dutiable because they relate to processes necessary to manufacture goods. By contrast, royalties and license fees paid to third parties for the right to use copyrights and trademarks in the United States are often considered the buyer's selling expenses and are not dutiable.[10]

Despite the presumption that trademark payments are non-dutiable under some circumstances, the importer must still demonstrate that the payment is not a condition of sale. In one ruling, CBP found that payments from Greenbrier to unrelated licensor Marvel for use of trademarks on imported merchandise were dutiable.[11]

The merchandise was purchased from a foreign party unrelated to either Greenbrier or Marvel. Somewhat unusually, a royalty or license agreement was not available. Although the merchandise was not manufactured under patent, CBP determined that the royalty was involved in its sale. The sale for exportation triggered the obligation to pay the fee, which was calculated based on the quantity of goods imported for the particular shipment. Further, merchandise could be purchased only from approved factories. As such, CBP concluded the royalty payment was involved in the sale of the goods.

Finally, because the fees were tied to every importation, Greenbrier could not buy the product without paying the fee. In finding that the last prong was met, CBP noted that Marvel approved both the factory selling the merchandise and the quantity purchased. The payment of the royalty was thus a condition of sale.

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[8] *Generra Sportswear Co. v. United States*, 905 F.2d 377 (Fed. Cir. 1990).

[9] "*Hasbro II*" (Feb. 10, 1993).

[10] Customs Ruling HQ H004991 (Apr. 2, 2007).

[11] Customs Ruling HQ H234735 (June 23, 2014).

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While that ruling may be an exception, it indicates that CBP will examine the unique factors of each trademark agreement.

For importers making royalty or license payments associated with patents, overcoming the presumption of dutiability can be challenging. In another ruling, Coravin, an importer of a wine system, licensed the rights from a patent holder to include a dual-stage regulator component in its products.[12] The agreement included a requirement to order a minimum number of regulators.

In assessing if that royalty was dutiable, CBP again worked through its three-factor test. The royalty payment pertained to a payment, satisfying the first prong. For the second question, although the parties were unrelated, CBP found that the royalty was tied to the production of the goods, because the product was incorporated into Coravin's wine system. Without the licensed component, the product could not be made. Finally, the third prong was met: Coravin could not buy the product without paying the fee. To maintain the exclusive right to the product, a minimum quantity had to be purchased and license fees paid, or the agreement could be terminated. If that occurred, the wine system could not be produced because the necessary technology would not be available. Therefore, there was a nexus between the wine system, the patented technology, and the royalty payments, making the payments a condition of sale.

Importers making royalty payments associated with patents should be especially vigilant in assessing their agreements and documenting rationale if they believe the payments are not dutiable.

Proceeds of Subsequent Resale

Even when the *Hasbro* test appears to indicate that the payments are not dutiable, the importer must still clear one more hurdle before making a final determination. That is because even though the payments might not be dutiable as royalty payments, they might be dutiable as proceeds of a subsequent sale.

The customs regulations provide that "proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue, directly or indirectly, to the seller will also be an addition to the price actually paid or payable." That situation arises when the importer makes a payment to the seller (directly or indirectly) after it has sold or otherwise disposed of the goods. Those fees are typically dutiable because the assumption is that the seller would have charged a higher price at the time of sale if it was not receiving an additional payment, so the importer did not pay the full value of the goods at the time of import.

In one ruling, an automobile producer and parts manufacturer headquartered overseas established a territorial exclusivity fee that gave its U.S. subsidiary the exclusive right to distribute branded products and use the IP associated with them.[13] CBP considered whether those payments were included in the price actually paid or payable, and then whether they were dutiable as royalty payments. In both cases, it found that the payments were not dutiable.

CBP then turned to whether the fees were dutiable as proceeds, finding that even though the fees were paid to the manufacturer, they were not dutiable because they were not tied to reselling the imported merchandise.

Importers should be aware that CBP may perform an extensive analysis for each royalty or license agreement. They should be familiar with the details of each contract — the dutiability determination for one agreement may not apply to another.

Importer Successfully Challenges CBP

In a recent case, apparel importer Trimil SA successfully challenged CBP's inclusion of some advertising fees and trademark royalty fees paid to Armani and its subsidiary in calculating the transaction value of imported apparel.[14] The Court of International Trade found that trademark payments were not dutiable because the

[12] Customs Ruling HQ H294766 (May 31, 2018).

[13] Customs Ruling HQ H242894 (Dec. 4, 2013).

[14] *Trimil SA v. United States*, No. 16-00025 (Ct. Int'l Trade 2019).

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payments were neither part of the price actually paid or payable nor a condition of sale.[15]

Trimil licensed the right to use the Armani trademark from Modefine, a related Armani subsidiary. The trademark agreement gave Trimil a license to manufacture, purchase, and sell Armani-trademarked merchandise in the United States. The royalty fee was based on Trimil's future U.S. sales of the imported clothing. Failure to make royalty payments was grounds to terminate the agreement, as was Trimil's failure to maintain its status as a trademark licensee.

The court first rejected CBP's argument that because the royalty payment benefited the seller, it was included in the transaction value and dutiable, saying the alleged benefit was too attenuated. CBP argued that if Trimil did not pay Modefine the fees, the seller would have been unable to produce the clothes. The court rejected that argument by applying a narrow definition of the term "benefit" — although payments were made that resulted in U.S. sales, there was no quantifiable benefit to the seller. Further, it closely considered the statutory language associated with indirect payments, finding that the payments at issue were not indirect payments because they were not tied to a current importation. As such, the payments were not part of the transaction value.

The court then explored whether the payments were dutiable as royalty fees made as a condition of sale for the import. It determined that Modefine's right to cancel the agreement and stop production if the fees were not paid did not qualify the payments as a condition of sale. Further, the language of the agreement addressed only Trimil's ability to use the trademark, not its ability to export the goods to the United States. The court therefore rejected the argument that the fees were dutiable as royalty payments. Interestingly, it did not address Trimil's argument that the fees were non-dutiable as selling expenses.

In *Trimil*, the court took a narrow reading of what constitutes a benefit to the seller, even when the parties to the transaction are related. It also seems that the court will examine a licensing contract's language to assess if payment of the fee is a condition of sale — that is, it does not appear that the court will infer that this element is met.

Trimil may ultimately benefit importers that are making royalty payments associated with trademark licensing, although it is unclear how CBP will apply the court's rationale.

How Does CBP Identify Royalty Payments?

Royalty payments continue to be an area of interest to CBP during audits. CBP auditors want to validate that those potential additions to the price are either (1) dutiable, and the importer is correctly paying any additional duties, or (2) not dutiable, and the importer has documented the supporting rationale.

As part of a CBP audit, an auditor typically asks the importer to provide the company's chart of accounts so she can identify accounts of interest. CBP then conducts an unreported review in which it selects accounts that it believes may contain dutiable payments. The auditor then requests a written summary of the types of payments in each account. Once that has been provided, the auditor selects payments in each account to test. The audit team will most likely request that the company provide supporting documentation regarding each payment, including a description, the entry packet, and supporting documentation.

For importers making payments associated with IP, CBP often identifies those payments during a review of the chart of accounts, trial balance, and general ledger transactions. CBP may also ask for copies of all the importer's license or royalty agreements, as well as the importer's determination regarding the payments' dutiable status. If the related payments are dutiable, CBP will ask to see evidence that duties were remitted.

The problem is that many importers are not aware that patent or trademark agreements are in place for the imported products. In the worst-case scenario, the importer learns about IP payments during an audit. That typically occurs because the group responsible for executing the agreements is unaware that license payments have possible customs implications, so it does not consult with the trade compliance group. Further, if regular unreported analyses are not performed, the

[15] The court also reviewed the dutiability of the advertising fees Trimil paid to Modefine, finding that they were not dutiable. That discussion is beyond the scope of this article.

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payments might not be identified. If CBP independently discovers dutiable IP payments, the importer may be unable to submit a prior disclosure, which would otherwise allow fines or penalties to be mitigated.

Even if CBP determines that the payments are not dutiable, the audit results could be affected. During an audit, CBP is also evaluating the importer's valuation controls. If the importer cannot show that it reviewed the agreement, then it would be challenging to argue that the company has sufficient processes in place to ensure accurate values are declared and that it is exercising reasonable care over its customs compliance requirements.[16]

Key Considerations

An important component of any compliance program is a regular review of the company's chart of accounts, trial balance, and specific general ledger transactions to identify potentially dutiable accounts and transactions. A representative number of payments in those accounts should be tested to validate if they are dutiable. If so, the company should determine what corrective actions are necessary.

Frequent communication between the trade compliance department and other departments such as tax and legal are best practices to help understand potential hidden risks. That also provides an opportunity to discuss where other payments associated with imports may be recorded.

After assessing the company's royalty payments, internal processes and procedures should be implemented so that the trade compliance group is informed if a new royalty agreement will be executed. That will allow it to determine if the agreement is dutiable and the process for remitting any additional duties.

One common way importers correct values with CBP is through the reconciliation program. By joining that program, importers may leave customs entries open for 21 months to adjust the declared value. That is an excellent program for situations when the actual value of the goods is not known at the time of entry, such as with royalty payments.

In sum, it is critical that importers understand the customs requirements associated with royalty and license fee payments. Further, compliance can be enhanced by implementing clear procedures across the enterprise. In today's trade environment, failure to assess those risks could result in material exposure, especially for imports from China subject to 25 percent tariffs.[17] ■

[16]19 U.S.C. section 1484(a)(1) requires importers to exercise reasonable care when entering, classifying, and valuing merchandise.

[17]These comments represent the views of the authors only, and do not necessarily represent the views or professional advice of KPMG LLP. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

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