Canadian Customs

Advisory

Bulletin

October 2002

Opportunities for Canadian Customs Duty Relief and Recovery on Royalties and Licence Fees

Opportunities for Substantial Customs Duty Savings on Royalties

Recent Canadian jurisprudence has opened opportunities for importers to save Canadian customs duties on royalties and licence fees (collectively "royalties") payable in respect of imported products. For example, importers pay royalties for rights to distribute products in Canada with valuable trademarks, such as NIKE and Chaps Ralph Lauren, or with copyrighted artwork or designs, such as Walt Disney's Mickey Mouse and Pluto characters. Importers may also pay royalties for rights to use patented works or inventions.

Importers can realize substantial duty savings where they pay royalties on imported products subject to high duties. Clothing, textile and footwear products are notable examples. As well as not paying duties on royalties in the future, it may be possible to claim duty refunds going back four years.

Duties are direct costs of doing business and either have to be absorbed as costs by importers or passed on to their customers through higher sale prices. So duty savings can translate into increased competitiveness, more efficient operations and improved profitability.

Importers Fight Back and Win at the Supreme Court in Mattel Canada

Starting in the 1980's, the Canada Customs and Revenue Agency (the "CCRA") became very aggressive in including royalties in the customs value of imported products. The CCRA would assess duties on the royalties at the duty rates for the imported products.

So importers took issue with the CCRA's assessment policies and contested the assessments, ultimately resulting in substantial litigation. In the landmark decision in *Deputy Minister of National Revenue v Mattel Canada Inc.*,[1] released on June 7, 2001, the Supreme Court of Canada found that certain royalties were not dutiable because they were not paid as a condition of the sale of the goods for export to Canada. It was a unanimous decision made by all nine members of the court and a resounding defeat for the CCRA.

The decision in *Mattel Canada* restricts the collection of duties on royalties to circumstances where the sale contract for the imported goods allows the vendor to terminate the contract if the royalties are not paid.

The decision in *Mattel Canada* only deals with situations where the vendor and licensor are unrelated persons. In a *Customs Notice* released on July 10, 2001, the CCRA indicates that it would try to limit the scope of the decision so as not to apply where the vendor and the licensor are the same person or are related to each

[1] 2001 SCC 36 ("*Mattel Canada*")

other. Specifically, royalties would be considered part of the purchase price of the imported goods.

We disagree with the statutory interpretation on which the CCRA's view is based. In our view, the *Customs Act* does not permit royalties payable for *intellectual property* to be considered part of the purchase price of the *goods*. In our view, the only way that royalties can be dutiable is if they are paid as a condition of sale of the goods, as specifically mandated in the *Customs Act*.

Federal Court of Appeal Decision in Reebok Canada – Vendor and Licensor Same Person

In *Reebok Canada, A Division of Avrecan International Inc. and The Deputy Minister of National Revenue for Customs and Excise*,[2] the Federal Court of Appeal considered whether duties could be assessed on royalties where the vendor and licensor were the same person. The Tribunal and the Federal Court, Trial Division, upheld the inclusion of royalty payments in the customs value of certain imported footwear and the assessment of duties on those royalties. In a decision released on April 10, 2002, however, the Federal Court of Appeal allowed Reebok Canada's appeal and overturned the assessments.

Under the test set out by the Supreme Court in the *Mattel Canada* case, royalties can be considered to be payable as a condition of sale only if the vendor is entitled to refuse to sell to the purchaser if the royalties are not paid. In the *Reebok Canada* case, each purchase order constituted a new sale contract and created an independent obligation. The sale agreements (purchase orders) did not contain an express condition to the effect that the vendor could refuse to sell the goods subject to the purchase order if any royalties were unpaid and there were no agreements in place for future sales of goods between the vendor and purchaser.

On this basis, the Federal Court of Appeal found that the test set out in *Mattel Canada* was not satisfied because the vendor was under "no continuing obligation" to sell goods to Reebok Canada under a sale agreement. The Court said that the test "implies a prior obligation" (to sell goods) "from which the vendor is entitled to be relieved." The Court agreed that, as a practical matter or as a matter of economic reality, "the vendor in the present case would probably refuse to sell to the purchaser if the purchaser was not making royalty payments." It did not, however, find that the royalties were paid as a legal condition of sale.

The Federal Court of Appeal decision in *Reebok Canada* has not been appealed to the Supreme Court.

It will be interesting to see how the CCRA responds to *Reebok Canada* in future situations where the vendor and licensor are the same person or are related to each other. The CCRA may try to limit *Reebok Canada* to its own particular facts. Specifically, where a sale contract imposes on the purchaser a continuing obligation to purchase from the vendor, the CCRA may attempt to read into the contract a requirement to pay royalties as an implied condition of sale. In light of the *Reebok Canada* decision, the CCRA is currently revising its policy concerning the duty treatment of royalties.

The import community is eagerly waiting for the CCRA to update its policy concerning the dutiability of royalties. We understand that the CCRA's updated policy will explicitly state that where the vendor and licensor are the same person, or are related to each other, royalties have to be paid as a true legal condition of sale to be dutiable. We can only hope that the CCRA holds true to the spirit of these decisions and is not overly strict in applying them.

Planning Points

Where the vendor is also the licensor or is related to the licensor, the vendor and purchaser would be wise, subject to competing business or legal considerations, to use one-off purchase orders as sales contracts with no express reference to royalties payable under a separate agreement. In fact, the purchase order/sales contract and royalty agreement should not cross-reference each other at all. Another planning point would be to make clear that goods could be purchased and imported into Canada without the purchaser ever making a royalty payment in respect of the goods.

Duty Relief Opportunities

We have turned to a new page in the saga about the dutiable status of royalties. Companies should continue

[2] 2002 FCA 133 ("*Reebok Canada*")

to monitor the dutiable status of royalties and structure their affairs, with professional assistance, so as to minimize the duties payable, particularly where the vendor and licensor are the same person or are related to each other. The duty savings may be significant. Importers that have previously paid duties on royalties, may have duty refund opportunities (subject to the 4-year statutory limitation period for making those claims).

Full Implementation of Administrative Monetary Penalty System (AMPS)

With the full implementation of AMPS for commercial imports scheduled to take effect on October 7, 2002, importers need to pay special attention to Canadian customs valuation compliance to avoid valuation infractions and the imposition of harsh sanctions, including penalties under the AMPS, or the seizure of imported products. Note that even in a situation where the CCRA suffers no revenue loss (such as where the imported products are duty-free and GST payable on import is fully recoverable by way of input tax credit claims), the CCRA could still impose a penalty under AMPS.

For further information, please contact:

Jamie Wilks 416.865.7804 jamie.wilks@mcmillanbinch.com

Other References

On request, we can provide the following as additional references:

- Jamie Wilks' case comment on *Mattel Canada* published in the 2001 Canadian Tax Journal; and
- A paper co-authored by Jamie Wilks and McShane Devlin Jones of McMillan Binch LLP entitled "Customs Valuation in Canada and Transfer Pricing in Canada", presented on June 19, 2002 in Toronto at a conference sponsored by the Canadian Association of Importers and Exporters.

McMillan Binch llp

Telephone: 416.865.7000
Facsimile: 416.865.7048
Web: www.mcmillanbinch.com

BCE Place, Suite 4400, Bay Wellington Tower, 181 Bay Street, Toronto, Ontario, Canada M5J 2T3