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Royalties and Value for Duty

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CCRA CUSTOMS POLICY

ROYALTIES AND VALUE FOR DUTY

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On October 17, 2003, the Canada Customs and Revenue Agency ("**CCRA**") released its revised policy guidelines in Memorandum D13-4-9 "Royalties and Licence Fees" ("**D13-4-9**") in response to the Supreme Court of Canada ("**SCC**") and Federal Court of Appeal ("**FCA**") decisions in *Deputy Minister of National Revenue v. Mattel Canada Inc.* ("***Mattel Canada***")[1] and *Reebok Canada and the Deputy Minister of National Revenue for Customs and Excise* ("***Reebok Canada***"),[2] respectively.

Recent Jurisprudence

This recent 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 imported 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.

In the landmark decision in *Mattel Canada*, released on June 7, 2001, the SCC 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 SCC and a resounding defeat for the CCRA.

The decision in *Mattel Canada* restricts the collection of duties on royalties to circumstances where the contract of sale for the imported goods allows the foreign vendor to terminate the contract if the royalties are not paid. Under the test set out by the SCC in *Mattel Canada*, 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. The decision in *Mattel Canada* only dealt with situations where the foreign vendor and licensor were unrelated persons.

In the subsequent case of *Reebok Canada*, the FCA had an opportunity to consider the dutiability of royalties paid by a Canadian importer to a licensor, which was also the foreign vendor of the imported goods. Each purchase order constituted a new sale contract and created an independent sale obliga-

1 2001 SCC 36, 199 D.L.R. (4th) 598, 270 N.R. 153, 12 C.P.R. (4th) 417, [2001] 2 S.C.R. 100 (S.C.C.).

2 2002 FCA 133, 2002 CAF 133, 289 N.R. 174, 6 T.T.R. (2d) 674, 223 F.T.R. 160 (note) (Fed. C.A.).

tion. 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 (purchase orders) in place for future sales of goods between the vendor and the purchaser.

On that basis, the FCA 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 FCA said that the test "implies a prior obligation" (to sell goods) "from which the vendor is entitled to be relieved." The FCA 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.

CCRA's Revised Policies

The revised policies set out in D13-4-9 clearly confirm the following legal principles established in *Mattel Canada* and *Reebok Canada*:

- For the royalties to be payable as a "condition of sale" and dutiable, the commercial documentation (i.e., the sales contract) between the vendor and the "purchaser in Canada" must make explicit reference to the condition.
- "Condition of sale" is defined in reference to the applicable provincial sales of goods legislation and the common law to specifically mean that the vendor must have the right to rescind or repudiate the sales contract if the royalties are not paid.
- A "royalty" cannot be added to the value for duty ("VFD") by virtue of paragraph 48(5)(a)(v) of the *Customs Act* as a "subsequent proceed". It can only be added to the VFD by virtue of paragraph 48(5)(iv) of the *Customs Act*. If the payment is a royalty, the analysis should generally begin and end with paragraph 48(5)(a)(iv).

We had concerns that the CCRA might attempt to limit *Reebok Canada* to its own particular facts.[3] Specifically, where a sales contract imposes on the purchaser a continuing obligation to purchase from the foreign vendor/licensor, the CCRA could attempt to read into the contract a requirement to pay royalties as an implied condition of sale. Fortunately, that does not appear to be the case. At paragraph #19 of D13-4-9, the CCRA states in regard to the *Reebok Canada* decision that "the obligation to make the royalty payment to ensure the continuing supply of goods must be explicitly stated in the documentation between the purchaser and vendor or licensor for the royalty payment to be considered a condition of sale."

The above principles are clearly illustrated in the first three examples, as well as example #6, of **Appendix** A to D13-4-9.

D13-4-9 raises at least one serious concern for importers. Where a royalty is bundled with the purchase price for the imported goods, the royalty may become dutiable under subsection 45(1), according to D13-4-9. Furthermore, the CCRA states:

> If, subsequent to importation, a downward adjustment to the amount of a royalty or licence fee payment already included in the price paid or payable is made, no adjustment to value for duty will result. Paragraph 48(5)(c) precludes any decrease in the price paid or payable of goods after importation. (paragraph 3 of D13-4-9)

The CCRA's position in this regard could be challenged on at least a couple of fronts. Firstly, 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 payable for 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*. Secondly, we believe that it would be incorrect to characterize the rectification of the error as a post-importation rebate or decrease in the price paid or payable for the goods.

The CCRA does, however, appear willing in certain circumstances to allow the importer the opportunity to provide sufficient documentation in support of a reasonable allocation to royalties, when the royalties are bundled together with other charges in a single agreement. The CCRA places the burden of proof squarely on the importer, as required under paragraph 152(3)(d) of the *Customs Act*. How onerous a burden the CCRA will impose in this regard is another question.

On the plus side for importers, payments made for rights to distribute or resell goods should not be included in the VFD, according to D13-4-9. This policy position is consistent with the recent Canadian International Trade Tribunal decision in *Simms Sigal & Co. Ltd. v. CCRA*.[4] It is interesting to note, however, that the CCRA doesn't make specific reference to this decision in its list of key jurisprudence outlined in D13-4-9. Example #5 of **Appendix** A to D13-4-9 illustrates the CCRA's policy position in this regard.

Example #4 gives an example of where a portion of a fee is a non-dutiable royalty and another portion of the fee is dutiable as an "assist" under clause 48(5)(a)(iii)(D) of the *Customs Act*.

Planning Points

Where the vendor is also the licensor or is related to the licensor, the vendor and the purchaser would be wise, subject to competing business and/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 orders/sales contracts and royalty agreement should not cross-reference each other at all. Another planning point would be to make clear that goods can be purchased and imported into Canada without the purchaser ever making a royalty payment in respect of the goods.

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

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3 See, for example, *Customs Notice No. 390*, released on July 10, 2001, which is now superseded by D13-4-9.

4 [2003] 4546 ETC (CITT).

itor the dutiable status of royalties and structure their affairs, with professional assistance, so as to minimize their duties payable, particularly where the foreign 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).