USCIT News

By Tina Potuto Kimble, USCIT Clerk of Court

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Feature Articles

Royalty Payments to Third-Party Licensors for Intellectual Property and Customs Valuation: Recent CBP and E.U. Decisions Suggest an Increasing Tendency to Require that Importers Include Them in the Dutiable Value of Imported Merchandise

By Lars-Erik A. Hjelm and Christopher D. Priddy[1]

This article provides a general overview of some recent U.S. Customs and Border Protection (CBP) and European Union (E.U.) decisions that suggest an expansive approach to the issue of whether royalty payments to third-party licensors for intellectual property are subject to duty. These recent decisions suggest an increasing tendency to require importers utilizing the transaction value method of customs valuation to add certain royalty payments for intellectual property to the "price actually paid or payable" (PAPP) for imported merchandise. Because the addition of these payments to the PAPP may significantly increase importers' duty liability, importers should carefully analyze their intellectual property portfolio and any royalty payments made to third-party licensors for patents, trademarks or copyrights associated with imported merchandise, and implement appropriate, lawful steps to mitigate against this risk.

I. The U.S. Law Governing the Possible Duty Liability of Royalty Payments for Intellectual Property

There are four general premises of U.S. Customs law governing royalty payments for intellectual property. First, an importer is required to add royalty payments to the PAPP when they are a "condition" of the "sale . . . for exportation." Second, royalties for patents covering processes to manufacture imported merchandise are generally subject to duty. Third, royalty payments to third parties for the use of copyrights and trademarks in the United States are generally not subject to duty. Fourth and finally, notwithstanding the above-referenced factors, the central considerations in each case are whether the royalty payments are a condition of the sale for exportation and the circumstances under which the royalties were paid.

Specifically, Section 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 (TAA), provides that

> [t]he transaction value of imported merchandise is the price actually paid or payable . . . plus amounts equal to . . . any royalty or license fee related to the imported merchandise that the buyer is required to pay, directly or indirectly, as a condition of the sale of the

> imported merchandise for exportation to the United States. . . .[1]

CBP's implementing regulations further clarify that

> [r]oyalties or license fees for patents covering processes to manufacture the imported merchandise generally will be dutiable. Royalties or license fees paid to third parties for use, in the United States, of copyrights and trademarks related to the imported merchandise generally will be considered selling expenses of the buyer and not dutiable. The dutiable status of royalties or license fees paid by the buyer will be determined in each case and will depend on (1) whether the buyer was required to pay them as a condition of sale of the merchandise for exportation to the United States, and (2) to whom and under what circumstances they were paid.[1]

II. CBP's Historical Precedent: The "Hasbro Factors"[1]

CBP relies on the three-part "Hasbro Factors" to determine whether royalty payments for intellectual property are required to be added to the PAPP:

(1) Was the imported merchandise manufactured under patent?

(2) Was the royalty involved in the production or sale of the imported merchandise? and

(3) Could the importer buy the product without paying the fee?

If an importer affirmatively answers Questions 1 and 2, but answers Question 3 in the negative, the importer should conclude that the royalty payments are required to be added to the PAPP.[1]

The U.S. Customs Service (Customs), as it was then known, set forth these factors as a policy in 1993 in the "Hasbro II" decision, after it issued an earlier decision known as "Hasbro I" (HQ 544436 (February 4, 1991)). In Hasbro I, CBP analyzed a contractual arrangement between an importer and a foreign seller whereby the importer paid the seller a percentage of the importer's resale invoice price in exchange for the authority to purchase and sell products within an exclusive territory. The importer contended that the royalties based on a percentage of subsequent domestic sales were not a condition of sale for exportation. Customs agreed and cited as reasons the facts that the payments were separate and apart from the right of ownership and that they were not triggered by the sale for exportation but by the resale. For other reasons not directly relevant to the issue of whether royalties for intellectual property paid to third-party licensors are subject to duty, Customs concluded that the payments were proceeds of a subsequent resale that inured to the benefit of the seller and that they were subject to duty under 19 U.S.C. § 1401a(b)(1)(E).[1]

In Hasbro II, CBP reconsidered its decision that the royalties were not a condition of sale and established, for the first time, the "Hasbro Factors." Without much in the way of analysis as to how Questions 1 and 2 were answered in the affirmative and how Question 3 was answered in the negative, Customs held in dicta that the royalties could have been considered to be dutiable under 19 U.S.C. § 1401a(b)(1)(D) but, ultimately, reaffirmed its decision that the royalties were dutiable as proceeds of subsequent sales inuring to the benefit of the seller. It is important to note that prior to the Hasbro II decision, Customs had nearly uniformly found that royalty payments calculated based on a percentage of sales occurring subsequent to the goods' importation were not a condition of the sale for exportation. However, indicating a slight shift in its analysis, Customs concluded that the method of calculating the royalty (e.g., on the resale price of the goods) was not relevant to determining the dutiability of the royalty payment.[1]

Nevertheless, Customs followed Hasbro II and its dicta therein with some decisions that continued the prior tendency of the agency to view the method of calculating royalties (e.g., percentage of net domestic sales) as a critical factor in determining whether such royalties were a condition of the sale for exportation (i.e., under Hasbro Factor 3, whether the importer could buy the product without paying the fee). For example, in HQ 546660 (June 23, 1999), the importer agreed under two agreements to pay its related-party seller and licensor royalties for licensed products and apparatus hardware. The royalties were based on a percentage of the importer's net sales and not based on a percentage of the import price.[1] CBP determined that the payments were not a condition of the sale for exportation in part because there was "no linkage between the sale for exportation of the imported merchandise and the payment of the royalties by the buyer."[1]

III. Post-Hasbro II and a Totality of the Circumstances Analysis

A July 2008 CBP decision suggests, however, that when CBP reviews importers' royalty payments to third-party licensors, CBP may no longer accept the proposition that these payments are not conditions of the sale for exportation because the calculation of these royalty payments are based on sales different from the sale for exportation. Rather, CBP will focus on the element of control that the licensor might understandably exercise in ensuring the integrity of its intellectual property. In HQ H024980, CBP faced the issue of whether to include in the dutiable value of imported snowboard binding systems the royalty payments that The Sports Authority (TSA) paid to a third-party licensor for the patents on the right to make and sell the snowboard binding systems.[1] Under the terms of TSA's licensing agreement, royalty payments were calculated at five percent of the imported snowboard binding systems' gross sales price. TSA subcontracted the manufacture of the snowboard binding systems to companies located outside the United States and imported the systems from these companies. TSA, the licensor of the binding systems, and the third-country manufacturers were all unrelated parties.

CBP analyzed the royalty payments between TSA and the licensor of the binding systems under the three-prong Hasbro Factors and concluded that the royalty payments were a condition of the sale for exportation. First, CBP determined that the binding system patent was a utility patent and stated that the royalties paid by TSA would seem to fall under the SAA's language that "'royalties and license fees for patents covering processes to manufacture the imported merchandise will generally be dutiable[.]'"[1] Second, CBP concluded that the royalty was involved in the production or sale of the imported merchandise because TSA could not have contracted with the third-country manufacturer for the binding systems without having entered into the licensing agreement. Third and finally, under what could be termed a "totality of the circumstances" analysis that may equate a third-party licensor's understandable control and defense of its intellectual property with placing a condition on the sale for exportation price between an unrelated manufacturer and importer, CBP concluded that TSA could not have purchased the binding systems without having paid the royalties to the licensor. Under this analysis, CBP concluded that the licensor had ultimate control over TSA's production and importation of the binding systems. CBP supported this decision by noting that TSA could not contract for production of the binding systems without the license for the binding systems. CBP also asserted that TSA's imports of the binding systems was dependent upon the licensing agreement's provisions granting the licensor a right to reject the manufacturers selected by TSA to produce the snowboard binding systems. Moreover, CBP highlighted the licensor's ability to require that TSA cease any production or sales of the binding systems if TSA failed to make the requisite royalty payments.

IV. European Union Perspectives

EU determinations of whether to value royalties and license fees are primarily governed by European Union Customs Code Article 32, as interpreted by Articles 157 to 162 of the Implementing Provisions. Specifically, Article 32(1)(c) provides that royalties and license fees should be added to the price actually paid or payable for imported goods if the buyer must pay these as a condition of sale and they are not included in the price actually paid or payable for the imported goods.

Last year, the European Commission (EC) Customs Code Committee provided guidance on the issues of valuing royalties and license fees in a compendium of Customs valuation materials.[1] In discussing the issue of whether royalty and license fees paid to third parties should be included in the dutiable value of imported merchandise, the Committee opined that one critical issue was the extent to which a party exercises control over the manufacturer.[1] That is, one should carefully consider whether the licensor of the patent, trademark, or other intellectual property has sufficient control over the manufacture of the imported goods such that a royalty payment for the licensor's intellectual property should be considered a condition of sale and included in the value of the imported products.[1] Some of the elements of control identified by the Committee include whether a licensor can designate to the buyer the specific company or companies that will produce the good as well as whether the licensor has control over the manufacturer's ability to produce competitive goods.[1]

V. Analysis: Considerations for Companies Importing Subject to Licensing Arrangements

Recent guidance from U.S. and European Customs agencies indicate that these agencies may engage in a "totality of the circumstances" analysis when determining whether importers' royalty payments for intellectual property should be included in imports' dutiable value. Such an analysis would focus on whether the license agreement was a critical "condition of sale" such that the merchandise would not have been imported but for the licensing agreement.[1]

CBP's recent decisions clearly indicate that it will carefully evaluate royalty payments to a third-party licensor for intellectual property under a "totality of the circumstances" approach. Importers will continue to question whether CBP's analysis is appropriate in light of the statute's requirement to include "any royalty or license fee related to the imported merchandise that the buyer is required to pay, directly or indirectly, as a condition of the sale of the imported merchandise."[1] Critics of what could be deemed CBP's "totality of the circumstances" approach to valuing third-party royalties will argue that the agency has misinterpreted the statute and failed to apply its direct language that the royalty must be a condition of the sale for exportation price between the importer and the manufacturer. Similarly, others will opine that CBP has exceeded the scope of the statute's intent by deeming payments to third-party licensors as "indirect" conditions of sale when these are not sufficiently related to the sale at issue – the import sale. In addition, there appears to be ample reason to question whether CBP has inappropriately equated the legitimate control and defense of intellectual property by third-party licensors with conditions that are placed on sales between unrelated manufacturers and importers.

One must also question whether CBP's "totality of the circumstances" policy for determining whether to include royalty payments in imports' dutiable value contravenes earlier CBP precedent and, if so, why. In its "Hasbro II" ruling, CBP stated that determining whether an importer could buy the product without paying the royalty "goes to the heart of whether a payment is considered to be a condition of sale."[1] One could argue that recent CBP decisions overly broaden the appropriate interpretation of whether a royalty is necessary for the importation of the merchandise under the third prong of the Hasbro II test. The CBP's recent *Sports Authority* decision (HQ H024980) was based on a determination that TSA could not have entered into a contract with the manufacturer for the snowboard binding system without having entered into the licensing agreement. Nonetheless, one may question whether this is true in that TSA's contract with its manufacturer was arguably distinct and separate from its licensing agreement. Although CBP relied in part on the licensing contract's termination provisions in finding that the third-party licensor exerted control over the manufacturing process, CBP has disregarded similar quality control provisions when analyzing the issue of control in other cases.[1]

The principal lesson to be learned from recent decisions in both the United States and the European Union is that companies importing goods into these regions must carefully structure importation arrangements vis-à-vis their licensing obligations. Drafting an appropriate licensing agreement is always a case-specific issue. However, in light of recent U.S. and E.U. decisions and policy announcements, third-party licensing agreements for intellectual property will need to be carefully drafted to specifically address the possibility that royalty payments to third parties will be included in the dutiable value of the imported merchandise. Under the emerging interpretations, and absent judicial review or legislative action, the two most important issues to address may ultimately be (1) whether the licensing agreement is drafted in such a way that the license can be considered essential for the production or the sale for exportation and (2) the degree of control the licensing agreement affords the licensor over the production and sale for exportation.

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[2] 19 U.S.C. § 1401a(b)(1).

[3] 19 C.F.R. § 152.103(f). *Accord* Statement of Administrative Action, H.R. Doc. No. 153, 96 Cong., 1st Sess., Pt II, 1, 443-444 (1979), reprinted in 1979 U.S.C.C.A.N. 169, 707. It should be emphasized that the statute does not provide CBP with the authority to evaluate the "circumstances" under which an importer makes a royalty payment for intellectual property separate and apart from analyzing whether the importer pays the royalty directly or indirectly as a condition of the sale for exportation. In suggesting that these two inquiries are separate and unrelated, the regulations may go beyond the text of the statute. Equally important, the regulations do not provide any standards on how CBP will evaluate the "circumstances" under which an importer makes a royalty payment for intellectual property.

[4] *Dutiability of Royalty Payments*, 27 Cust. B. & Dec. No. 6 (Jan. 21, 1993).

[5] *Id.*
[6] HQ 544436 (Feb. 4, 1991).
[7] *Dutiability of Royalty Payments* (Jan. 21, 1993).
[8] HQ 546660 (June 23, 1999).
[9] *Id. See also* HQ 546478 (Feb. 11, 1998).
[10] HQ H024980 (July 22, 2008).
[11] *Id.* (citing SAA).
[12] *Compendium of Customs Valuation Texts*, European Commission TAXUD/800/2002-EN Update (Jan. 2007).
[13] *Id*. at 52 (providing that "when royalties are paid to a party which exercises direct or indirect control over the manufacturer . . . then such payments are regarded as a condition of sale."
[14] *Id.*
[15] *Id.* at 52-53, and 56.
[16] *See* HQ H004991 (Apr. 2, 2007) and HQ W548692 (Mar. 2, 2007).
[17] 19 U.S.C. § 1401a(b)(1) (emphasis added).
[18] *Dutiability of Royalty Payments*, Vol. 27, No. 6, Cust. B. & Dec. (Feb. 10, 1993).
[19] *See* HQ W563382 (May 25, 2006).

New Safety Requirements for Importers of Consumer Products

By Andrew Siciliano, Amie Ahanchian, and Anne Wessels[1]

Consumer Product Safety Improvement Act of 2008
On August 14, 2008, the Consumer Product Safety Improvement Act (CPSIA) was enacted to update the mandate of the Consumer Product Safety Commission (CPSC) and to impose new safety standards upon manufacturers of consumer products.

Under CPSC laws, a manufacturer is "any person who manufactures or imports a consumer product."[1] A consumer product is "any article produced or distributed for sale to a consumer for use or for the personal use, consumption or enjoyment of a consumer in or around a permanent or temporary household or residence, a school, in recreation, or otherwise."[1] Thus, the new requirements can affect manufacturers, importers, distributors, and retailers[1], and generally apply to a broad spectrum of products (children's products, jewelry, sporting goods, fabrics and wearing apparel, refrigerators, furniture, hazardous materials, paint, child-resistant caps, dietary supplements, pharmaceutical products, and all-terrain vehicles (ATVs).

Among the new CPSIA provisions, the general conformity certification and third-party testing may have the greatest effect on the importing community. The CPSIA also contains requirements applicable to domestic manufacturers and private labelers of consumer products. This article, however, only focuses on the requirements applicable to importers of consumer products.

<u>General Conformity Certification</u>
Effective November 12, 2008, importers of a product subject to a CPSC act, standard, or ban[1] must issue a certificate attesting to the product's compliance with all applicable consumer product safety standards.[1] As per the Federal Register Notice issued on November 10, 2008[1], the certificate requirement applies to subject products manufactured on or after November 12, 2008.

The certificate must contain all the following information:[1]

- Identification of the product covered by the certificate
- Citation to each CPSC product safety regulation to which the product is being certified
- Identification of the U.S. importer certifying compliance of the product
- Contact information for the individual maintaining records of test results
- Date and place where the product was manufactured
- Date and place where the product was tested for compliance with the CPSC product safety regulations
- Identification of any third-party laboratory on whose testing the certificate depends