

Should multinationals include royalty payments in their customs valuations? If not for the past, what about for the future?

Reaching a conclusion on whether or not a royalty is dutiable under customs laws and regulations is not always clear cut and requires consideration of a number of factors. Given the complex nature of multinational businesses and international supply chains, it is easy for importers to overlook the fact that there is a royalty payment that even should be considered for import duty purposes.

The EU is drafting a new Customs Code and regulations which will become effective in May 2016. Expectations are that EU Customs Authorities will take a more aggressive approach with respect to royalties when these new regulations become effective.

Why do multinationals omit to include dutiable royalties in their customs valuations?

In practice, the three main reasons for this omission are:

- *Insufficient internal expertise/resources*: many multinationals do not have in-house customs specialists leading to a failure to even consider the point;
- *Insufficient internal visibility/coordination between different functions within a multinational*: whether or not a royalty will be payable (and at what value) is usually decided by the transfer pricing team. However, very often, customs is managed by the logistics or supply chain departments who will have little contact with their tax teams. Usually any linked royalty payment is not mentioned on the purchase invoice for the imported goods, even if royalty invoices are sent separately to the customs agent, then he may not include it in the customs value of the goods; or
- *IT systems restrictions*: because of the timing differences between the time of purchase/manufacture of the product and the royalty payment, it may be deemed to be too difficult to include as part of a business' IT processes, so gets missed.

Generally though, multinationals have been able to escape penalties for under-valuing their product at importation up to now because of the lack of coordination between the relevant tax authorities, and also, because the 'As Is' legal framework provided them with an opt-out.

But the question is whether multinationals may continue to rely on these favourable conditions for much longer when we are seeing more coordination between customs and tax authorities in countries worldwide (in Italy for example, the authorities are merging) and now also, the Customs legislation is changing at a pan-European level.

The 'As Is' position

Under the WTO Customs Valuation Agreement and the EU Customs Code, a royalty is dutiable if:

- It is related to the imported goods; and
- Paid as a condition of their sale.

It is important to note that both conditions must be met in order for an importer to be liable for paying duties against the royalty payment.

Current EU regulations concerning the duty treatment of *royalties provide that royalties paid to a third party are **NOT** dutiable unless the seller, or party related to it, require the buyer to make the payment.* The EU Commission has issued a commentary which provides further guidance on how to interpret this regulation.

The 'To Be' position

The EU is drafting a new Customs Code and regulations which will become effective in May 2016. *The draft regulations do **NOT** include the current regulation providing for a possible duty exemption for royalties paid to a third party not related to the seller.* The new regulations will serve as an interpretation of the new customs code, which retains the same two core requirements for a royalty to be dutiable which are mentioned above and are sacrosanct. By all accounts, the EU Commission has removed this regulation from the draft new regulations with the intention of treating more royalties as dutiable.

So are all royalties now dutiable?

We believe an argument can be made that the mere removal of this regulation does not change the legal treatment of royalties for duties purposes. Firstly, the regulations do not expressly state that such royalties are dutiable and, secondly, the current regulation could be viewed as a fair and reasonable expression of when the conditionality requirements are not met. That interpretation does not necessarily change by removing it.

Expectations are that EU Customs Authorities will take a more aggressive approach with respect to royalties when these new regulations become effective in May 2016. For this reason, we recommend that importers review their royalty arrangements now in preparation for such scrutiny of royalties going forward.

Our view is that not all customs authority challenges may be supportable under the core terms of customs laws, but that importers should be prepared for such challenges and also anticipate that heightened customs authority scrutiny may lead to the discovery of royalty payments that should have been treated as dutiable, but have not been up to now, through lack of awareness of the legal complexities surrounding their treatment by businesses.

Our Value Chain Management team can assist you with reviewing your existing royalty structures taking into account broader tax, non-tax, commercial and operational considerations. For more information regarding the treatment of royalties by your business, please contact Catherine Meotti, Olivier Sorgniard or your usual Value Chain Management contact.

Kind regards,

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