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Are Royalties Dutiable? A Tango between Transfer Pricing and Customs Valuation

S. Kuijper,
Y. Long,
M.L. Schippers and
B. van den Bongard[*]

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This article provides a theoretical framework on the interaction between transfer pricing and customs valuation with a specific focus on the treatment of royalties. In addition, the article provides the transfer pricing and customs analysis of a case study regarding the commonly seen structure of the fixed rate royalty and residual royalty model.

1. Introduction

The tax and global trade landscape has evolved significantly in the past few years, with more information oversight by governments on the value creation of multinational companies and increased scrutiny on cross-border movements of tangibles and intangibles. This trend is likely to continue to evolve, with governments looking to make up for the budget deficits generated by actions to fight the costly global pandemic. In that context, cross-border royalty payments are put on a microscope, and customs authorities have put greater focus on royalties to ascertain that the correct value is reflected in the customs value of imported goods. For both the customs valuation and transfer pricing (TP) treatment of cross-border royalty payments it is important to understand the economic value chain which is driving these in order to respond to audits initiated by the customs authorities. A holistic approach whereby customs and TP are assessed in tandem, can greatly strengthen the response to complex customs valuation cases as well as provide opportunities for multinational enterprises (MNEs) to better streamline their intangible pricing mechanism.

This article provides a theoretical framework on the interaction between TP and customs valuation. The customs analysis whereby royalty is added to the customs value is provided in section 2., followed by the customs and TP analysis of a case study, including a fixed-rate royalty model and a residual royalty model in section 3. The article concludes with the authors' main observations in section 4.

* **Sebastiaan Kuijper is a partner of Transfer Pricing and Operating Model Effectiveness (TP & OME) team of EY Netherlands based in Amsterdam. Yi (Elaine) Long is a manager of the TP & OME team of EY Netherlands based in Amsterdam. Martijn Schippers and Bram van den Bongard are members of the Global Trade & Sustainability team of EY Netherlands. Martijn Schippers is also an Assistant Professor at the Erasmus University Rotterdam. This article represents the opinions of the authors and does not represent the opinion of EY Netherlands.**

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2. Theoretical Framework

2.1. Interaction between TP and customs valuation[1]

2.1.1. Customs valuation methods

In principle, the customs value is the base value used to determine the amount of duties due if an ad valorem duty applies to the imported goods.[2] Globally, the rules on customs valuation are to a large extent harmonized by means of the WTO Customs Valuation Agreement (CVA).[3] The WTO members are obligated to implement the CVA in their own customs legislation. Based on the CVA, the preferred and primary basis for determining the customs value is the transaction value method.[4] The transaction value consists of the price actually paid or payable for the goods sold for export to the country of importation, adjusted where necessary.[5] One of the adjustments or price elements that need to be added to the transaction value, if certain conditions are met, are royalty payments (*see* section 2.3.).[6]

2.1.2. TP methods

Based on the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines (2022)), there are mainly five TP methods that can be used to establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm's length principle.[7] These five TP methods can be further grouped into two main methods:

(1) traditional transaction methods including the comparable uncontrolled price (CUP) method, resale price method (RPM) and cost-plus method; and

(2) transactional profit methods including the transactional net margin method (TNMM) and profit split method.

Unlike the customs valuation methods, there is no strict hierarchy or order for the selection of the appropriate TP methods. However, if a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method is preferable to the transactional profit method. Moreover, if the CUP method and another TP method can be applied in an equally reliable manner, the CUP method is to be preferred.[8]

The selection of a TP method aims at finding the most appropriate method for a particular case taking into consideration various factors, such as the nature of the controlled transaction, functional analysis, availability of information, level of comparability, etc. In addition, the OECD Guidelines mention that MNEs retain the freedom to apply methods not described above (i.e. other methods) on the condition that the selection can be supported by an explanation of why the OECD-recognized methods are regarded as less appropriate or non-workable in the circumstances of the case and why the selected other method was regarded as providing a better solution.[9]

2.1.3. Interaction between TP and customs valuation

For customs valuation purposes, the transaction value method can only be applied if there is a "sale for export" and four conditions have been complied with. One of these conditions implies that the price established between related parties can only

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1. For a more detailed discussion on the interplay between transfer pricing and customs valuation, *see* e.g. G. D'Angelo, *Interplay Between Customs Valuation and Transfer Pricing in the EU: General Observations and Administrative Practices in Four Countries after the Hamamatsu Case*, in G. D'Angelo, *Aspects of Customs Control in Selected EU Member States*, pp. 173-221 (Bologna University Press 2023); M. Friedhoff & M.L. Schippers, *ECJ Judgment in Hamamatsu Case: An Abrupt End to Interaction Between Transfer Pricing and Customs Valuation*?, 28 EC Tax Review 1, p. 32-42 (2019); J. Tuominen, *The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?*, 25 Intl. Transfer Pricing J. 6, pp. 436-453 (2018), Journal Articles & Opinion Pieces IBFD; E. De Angelis & T. Elshof, *The Interplay between Transfer Pricing and Customs Valuation in Case of Retroactive Profit Adjustments: The Position of the ECJ in the Case Hamamatsu Photonics Deutschland GmbH (C-529/16)*, 25 Intl. Transfer Pricing J. 4, pp. 300-305 (2018), Journal Articles & Opinion Pieces IBFD; D. Rovetta, L.C. Beretta & A. Smiatacz, *The Court of Justice of the European Union Judgment in the Hamamatsu Case: Defending EU Customs Valuation Law from the 'Transfer Pricing Folly' in Customs Matters*, 13 GTCJ 5, pp. 187–190 (2018); W.M. Methenitis, *Transfer pricing: understanding multinational firms' practices*, WCO News 2020(93), pp. 30-35 (2020).
2. For calculating ad valorem duties, it is required to determine the customs value, because in that case the customs duties are expressed as a percentage of the customs value. If specific duties are levied, there is no need to determine a customs value from a customs duty perspective, as it concerns a levy of a given amount of money per unit of the imported goods, such as quantity or volume.
3. Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994.
4. If the transaction value cannot be applied, the CVA provides for alternative valuation methods. These are set up in a strict hierarchical order and are subordinately linked to each other. As the "dutiability" of royalties are mainly of importance for determining the customs value according to the transaction value, the authors will not discuss the other methods further.
5. The adjustments that need to be considered are listed exhaustively in art. 8 CVA.
6. Art. 1 jo. art. 8 CVA.
7. *OECD Guidelines for Multinational Enterprises and Tax Administrations* (2022), para. 2.1. , Primary Sources IBFD [hereinafter *OECD Guidelines*].
8. Para. 2.3 *OECD Guidelines* (2022).
9. Para. 2.9 *OECD Guidelines* (2022).

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be used if the price has not been influenced by the relationship of those parties.[10] This condition should mitigate a distortion factor that would prevent that a price is set under ideal free market conditions. According to the CVA, there are two methods to prove that the price is uninfluenced:

- the circumstances of sales test; and
- test values.[11]

Test values are used when the importer can prove that the declared transaction value closely approximates a price produced for identical or similar goods. In practice test values are difficult, if not impossible, to identify due to several factors that must be taken into consideration in determining whether a test value is appropriate. Therefore, the circumstances-of-sales test is used in most cases. This test implies that the "circumstances surrounding the sale" should be substantiated by detailed information to prove that the price of the related-party transaction is not influenced. The circumstances-of-sales test should only be required where there are doubts on the acceptability of the price.[12]

The WTO provides examples in its Interpretive Notes to the CVA how one could meet the circumstances-of-sales test. These examples have been summarized into three questions.[13] There is a parallel between what is required by these three questions and certain TP elements, such as a price "consistent with the normal pricing practices of the industry" (similar to industry benchmarking studies), "consistent with the way the seller settles prices for sales to buyers who are not related to the seller" (similar to the CUP method) and "adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit" (similar to the TNMM).[14]

Despite these parallels and since there are no restrictions formulated to what information could sufficiently substantiate the uninfluenced nature of the transaction price, the question is whether indeed TP documentation and studies can be used to meet the circumstances-of-sales test. In this regard, the Technical Committee on Customs Valuation (TCCV) primarily addressed that due to the differences in nature between TP and customs valuation, TP documentation can be used, but this does not provide guarantees for successfully meeting the circumstances of sales and the relevance of TP documentation in evaluating the circumstances of sales should be assessed on a case-by-case basis.[15] Major customs jurisdictions such as the European Union, United States and Canada accept TP documentation to prove that the declared transaction value has not been influenced, although not always based on explicit legislation or guidance (i.e. the European Union) and in particular cases only under additional conditions (i.e. the United States[16] and Canada[17]).

2.2. Definition of royalty

2.2.1. Customs perspective

Calling something "royalty payment" does not make it a payment to be considered as royalty for customs. That means that for "testing" whether a royalty payment should be added to the price paid or payable for the imported goods (*see* section 2.3.), it should first be checked whether it is a royalty from a customs valuation perspective. The CVA does not provide for a clear definition of what constitutes a royalty. From the Explanatory Notes of the CVA, can, however, be extracted that "royalties may include, among other things, payments in respect to patents, trademarks and copy rights".[18] The Explanatory Notes of the CVA also stress that "the charges for the right to reproduce the imported goods in the country of importation"[19] and "payments made by the buyer for the right to distribute or resell the imported goods" should be excluded from the customs value if "such payments are not a condition of the sale for export to the country of importation of the imported goods".[20] The TCCV further specifies that it is crucial that the royalty is paid for the rights that are related to or embodied in the imported goods.

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10. If related parties are not successful in proving that the price paid or payable has not been influenced by their relationship, the transaction value cannot be applied, *see* section 2.1.1.
11. Art. 1(2)(a) and (b) CVA.
12. Interpretive Note to art. 1(2) CVA.
13. Advisory Opinion 4.17 of the WCO TCCV, Royalties and licence fees under art. 8.1(c) of the Agreement (Royalties paid under a franchise agreement) (adopted, 44th Session, 12 May 2017, VT1098E1c).
14. At the same time there are several differences between transfer pricing and customs valuation, *see* for a more comprehensive discussion on the parallels and differences the studies mentioned in *supra* n. 1.
15. In Oct. 2010, the TCCV of the WCO issued non-binding guidance on the use of TP documentation for the circumstances-of-sales test in Commentary 23.1, Examination of the expression "circumstances surrounding the sale" under art. 1.2(a) in relation to the use of transfer pricing studies (adopted, 31st Session, 29 Oct. 2010, VT0774E1c).
16. US Customs and Border Protection, Determining the Acceptability of Transaction Value for Related Party Transactions, US Department of Homeland Security (Apr. 2007).
17. Canada Border Services Agency, Transaction Value Method for Related Persons (17 Sept. 2015), Memorandum D13-4-5.
18. Interpretive Note to art. 8, para. 1(c) CVA.
19. Id.
20. Id.

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Major customs jurisdictions such as the European Union,[21] the United States[22] and Canada[23] have also not incorporated a definition of “royalty” in their customs legislation. In the European Union, the Court of Justice of the EU (ECJ) seems to have limited the concept of “royalties” to only cover payments made by a buyer to a seller for the use of intellectual property rights.[24] The Valuation section of the Customs Expert Group (CEG VAL) also provided guidance on what defines “royalty” by differentiating between “assists” and “royalties”.[25] Interpreting the view of the CEG VAL, a royalty constitutes the renumeration for licensed rights that contribute to the economic value of an imported good, whereas an assist is provided free of charge and based on the costs made to develop the immaterial goods required to produce the imported good. Royalties therefore seem to have more similarities with “marketing intangibles” as referred to in article 12 of the OECD Model (2017) than with ‘trade intangibles’ which have more similarities with assists.

2.2.2. Income tax/TP perspective

Although the EU customs legislation does not provide for a definition on royalties, article 12(2) of the OECD Model (2017) does provide for a general definition of “royalties”: “payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience”. In essence, royalties are the payment for the right to use certain intangibles.

From a TP perspective, based on OECD Guidelines, the word “intangible” is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.[26] In this respect, the definition of “intangibles” is broader under the OECD Guidelines than the OECD Model (2017) and as such, the payment derived from the intangibles from an OECD Guidelines perspective may be broader than the “royalty” definition under article 12 of OECD Model (2017). Nevertheless, the OECD Guidelines address the arm’s length principle for the analysis involving the intangibles, which, based on the customs legislation, is directly aligned with the circumstances-of-sale test. The International Chamber of Commerce (ICC) suggests that “businesses that establish prices between related parties in accordance with the arm’s length principle [as per article 9 OECD Model (2017)] have generally demonstrated the relationship of the parties has not influenced the price paid or payable under the transaction value basis of appraisement and consequently that prices establish the basis for customs value”.[27] Therefore, for purpose of the subsequent analysis in this article, the authors refer to the analysis framework and principles as stated in chapter XI of the OECD Guidelines on intangibles.

2.3. Conditions for a royalty payment to be added

If a payment is made for a royalty for customs purposes (*see* section 2.2.), these are not automatically considered dutiable (read: to be included in the customs value). Whether royalties are dutiable depends on three cumulative conditions. The royalty payments made should:

(1) not be included in the price actually paid or payable;

(2) relate to the goods being valued; and

(3) be paid by the buyer, either directly or indirectly, as a condition of sale.[28]

The first condition speaks for itself. For the third condition the decisive question is whether the supply of the goods would have taken place or not if the royalty payment would not have been made. Given the focus of this article, the second question is the most important one.

Like the circumstances of sales test and the question what constitutes a royalty for customs valuation purposes, the question whether royalties relate to the imported goods cannot be standardized and should therefore be assessed on a case-by-case basis. In practice, two approaches can be distinguished when determining whether the royalties are related to the imported goods: the contractual approach and the influence and control approach. The contractual approach bases the assessment on what is mentioned in the contract. If the contract does not contain a direct reference to the royalty agreement or cannot

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21. Under the old EU Customs Code, “royalty” was defined in art. 157 of the Community Customs Code Implementing Provisions.
22. There is, however, guidance in the US, *see* Royalty Payments and License fees - U.S. Customs and Border Protection Valuation Encyclopedia (1980-2015).
23. Canada Border Services Agency, Customs Valuation – Royalty and License Fees (14 Jan. 2014), Memorandum D13-4-9.
24. DE: ECJ, 19 Nov. 2020, Case C-775/19v, *5th Avenue Products Trading GmbH v. Hauptzollamt Singen*, Case Law IBFD, ECLI:EU:C:2020:948, para. 29.
25. Conclusion No. 30, paras. 28 and 29 of the Customs Expert group (Customs Valuation Section) concerning the application of articles 71(1)(b) and 71(1)(c) of the Union Customs Code.
26. Para. 6.6 *OECD Guidelines* (2022).
27. ICC, 2015, p. 2.
28. Art. 8(1)(c) CVA.

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be linked to the royalty agreement, the royalties do not relate to the imported goods.[29] The influence and control approach bases the assessment on what level of control the licensor has over the licensee. The level of control is expressed in the extent to which the licensor controls the use and safeguard of the licensed rights by the licensee, e.g. in terms of safeguarding the know-how, patents, brand image and quality standards. It is remarkable that, although they all implemented the CVA, the WTO members apply different approaches to determine the relation to the imported goods.[30]

The TCCV provides guidance and examples of scenarios when royalties are or are not considered to be related to the imported goods in several instruments.[31] From those instruments it can for instance be derived that royalties are not related to the imported good if the imported goods are used in the manufacturing of the licensed product and if paid for brand marketing or use of system technology.[32] Also in the European Union, the "related to the goods" criterium is primarily linked to whether "the rights transferred under the license or royalties agreement are embodied in the goods" and not to "how the royalty is calculated" but to "why" it is paid, i.e. what in fact the licensee receives in return for the payment.[33] The crucial element to determine whether a royalty is related to the imported goods needs thus to be found in the reason why it is paid or what the licensee receives in return for the payment.[34] EU customs law also provides the option to include royalties partially in the customs value, since it is possible that part of the royalty relates to the imported goods and part of the royalty relates to other activities, e.g. activities that take place after import and therefore do not contribute to the value of the imported goods, also called "post-importation activities".[35]

3. Case Study

3.1. Assumptions and fact pattern of the case study

In this section, the following two scenarios regarding a typical royalty structure (i.e. fixed-rate royalty and residual royalty) are analysed from both a customs and TP perspective to demonstrate the potential customs valuation and TP implications. It should be noted that for the purpose of the analysis, it is assumed that the royalties are not included in the price paid and the royalties are paid as a condition of the sale for the imported goods. The customs valuation analysis below thus solely focuses on the "related-to-the-imported-goods" test. The TP analysis is based on the OECD Guidelines.

For the case study, the authors assume that an MNE has a principal company located in Country A that serves as legal and economic IP owner of the group. The IP rights owned by the principal company include, but are not limited to, the right to use the IP in connection with the manufacturing of the products and the IP in connection with the marketing and advertising in the local countries. The principal company has a distributor in Country B which is engaged in the distribution of the products in the local countries. The distributor also manages the production of the products by third-party manufacturers using the manufacturing IP granted by the principal. It should be noted that the functional profile of the local distributor may be different in the scenarios shown in Figure 1. and Figure 2.

The principal has one intercompany licensing agreement with the local distributor based on which the principal grants the local distributor:

- the right to use the IP in connection with the manufacture, importation and sale of the products in the specified jurisdiction (manufacturing IP); and
- the right to use the IP in connection with marketing and advertisement activities in the specified jurisdiction (marketing IP).

29. An example of a situation in which the contractual approach was leading was the Federal Appeal Court, 10 Apr. 2002, A-642-97, *Reebok Canada v. Canada (Deputy Minister of National Revenue.*
30. D. Cannistra & M.A. Rodríguez Cuadros, *The Dutiability of Royalty Payments: The Impact of the World Customs Organization's Advisory Opinion 4.15*, 9 GTCJ 2, pp. 61-65 (2014).
31. Commentary 25.1 of the WCO TCCV, Third party royalties and licence fees - General commentary. (Adopted, 32nd Session, 15 Apr. 2011, VT0800E1c), para. 6 and Advisory Opinions 4.1, 4.4, 4.7 and 4.9-4.17 of the WCO TCCV.
32. Advisory Opinions 4.17 of the WCO TCCV, Royalties and licence fees under art. 8.1(c) of the Agreement. (Royalties paid under a franchise agreement) (Adopted, 44th Session, 12 May 2017, VT1098E1c). In the European Union, the ECJ, however, seems to have broaden the scope by concluding that "the related to the goods" criterium is also met if there is a sufficiently close link between the imported non-licensed materials and know-how for the manufacture of finished products in the European Union for which the materials are used, ***see*** BG: ECJ, EU 9 July 2020, C-76/19, *Curtis Balkan*, ECLI:EU:C:2020:543.
33. Art. 136(1) of the Union Customs Code Implementing Act and Commentary 3, para. 8 of the 2022 Compendium of Customs Valuation Texts. For the related-to-the-imported-goods criterium, Canada seems to also look at how the royalties are calculated; ***see*** Exhibit AP-2013-017-08C at 16. The test was earlier articulated in Canadian International Trade Tribunal, 7 May 1992, Nos. AP-89-151 and AP-89-165, *Polygram Inc. v. Canada (National Revenue).*
34. Commentary No. 13: Guidance on Articles 128 and 136 UCC IA, para. 3.4.2 of the 2022 Compendium of Customs Valuation Texts.
35. In practice it is imposing significant burden on companies to provide for such a partial inclusion or apportionment. The case study in sec. 3. provides more practical experience on such apportionment.

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Figure 1. Fixed-rate royalty

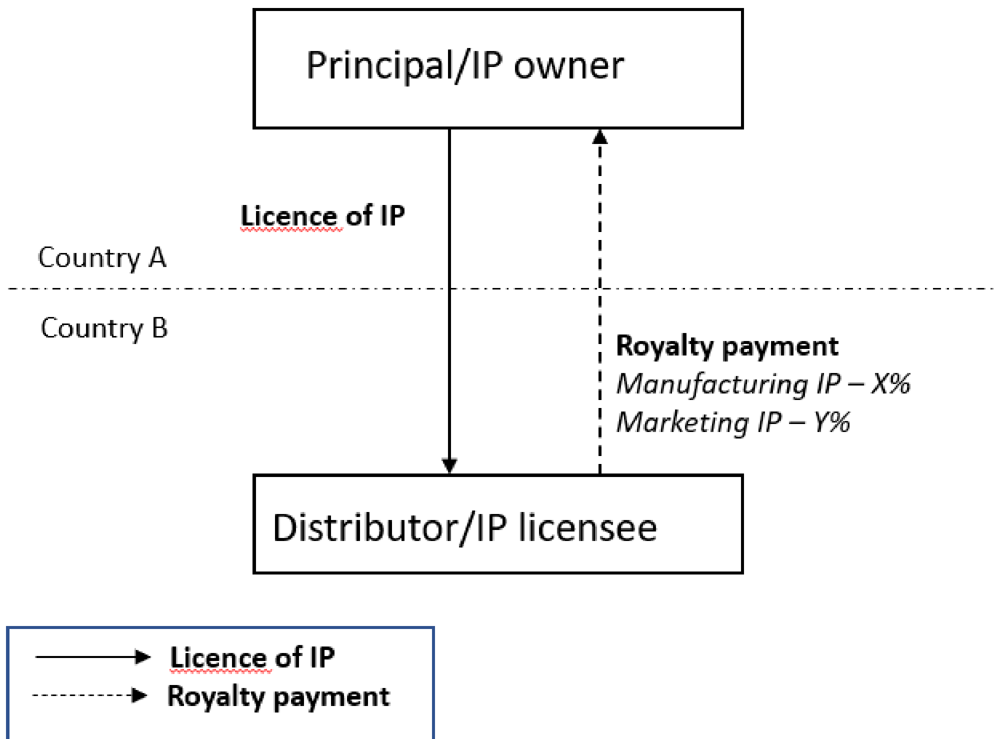

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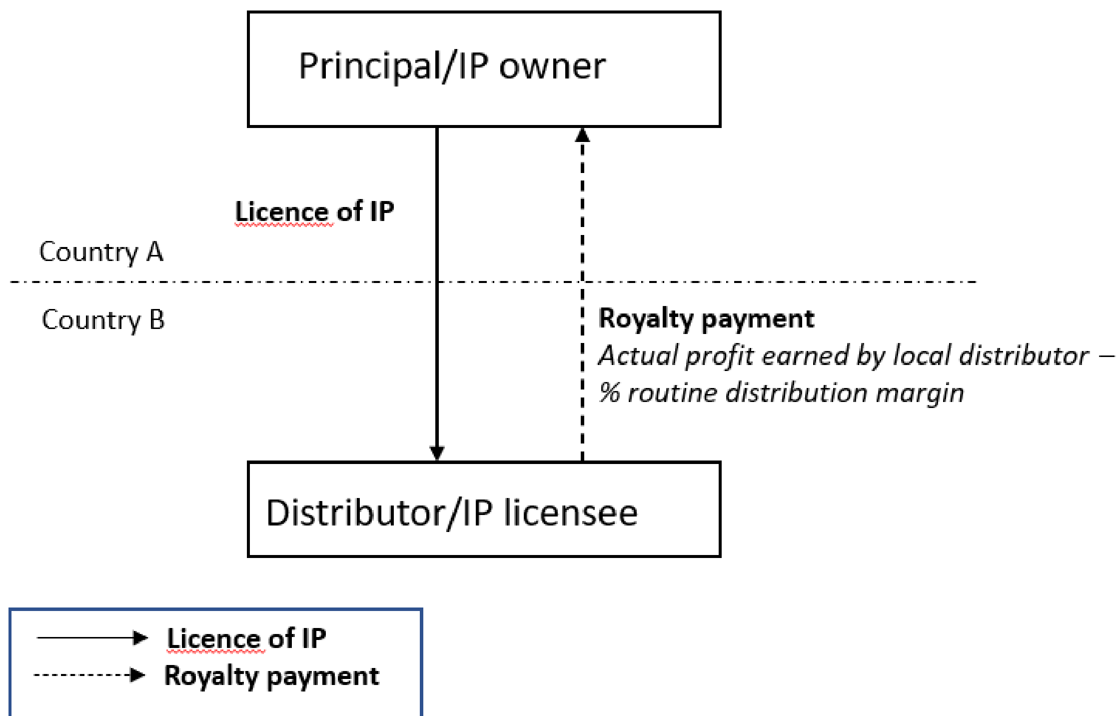
Figure 2. Residual royalty



In the first scenario (Figure 1 – Fixed rate royalty), for both royalty element X and Y a separate fixed rate for calculating the royalty payment is applied and based on a certain percentage of the sales revenue generated by the local distributor per year. In the second scenario (Figure 2 – Residual royalty), the local distributor pays the principal company a royalty amount based on the difference between the actual operating margin derived from the sales activities and the expected operating margin percentage, which is set based on the arm's length principle.

3.2. Customs and TP analysis

3.2.1. Customs perspective

It is common practice that multiple licensed rights are covered by one licence agreement. Often, the royalty payments are expressed as one value, without making a distinction between different licensed rights. In fact, the concepts and definitions used in licensing agreements to define the licensed elements covered by such agreements are usually broad and comprehensive. This is also true for the licence agreement in the case study that consists of two categories of licensed rights: (i) the right to manufacture, import and sell ("manufacturing IP"); and (ii) the right to market and advertise ("marketing IP") the licensed goods. In the case of the fixed rate royalty a distinction is at least made between both covered rights, but this is not the case for the residual royalty.

As explained in section 2.2.1., not all royalty payments are considered royalties from a customs perspective. The lack of a clear distinction, which is in particular the case for the residual royalty, may therefore have as a result that either the entire royalty payment becomes part of the customs value, or the transaction value is rejected because the value cannot be substantiated with objective and quantifiable data. Even if a clear distinction is made between what is considered a royalty and what is not, the royalty payment should also relate to the imported goods instead of, for instance, to post-importation activities. Customs authorities should allow for an apportionment of the royalty to the extent it is related to the imported goods if the distinction is

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substantiated by objective and quantifiable data. In practice customs authorities explain the “related-to-the-imported-goods” test differently.[36]

Zooming in on the different elements of the royalty payment in this case study, the following observations can be made. As put forward in section 2.2.1., marketing intangibles such as the rights to use the IP connection to marketing and advertising are typically treated as royalty for customs purposes, although the value for marketing of imported goods itself should not be considered part of the customs value nor shall such activities result in the rejection of the transaction value. Making a distinction between the payment for marketing and advertisement activities versus the right to market the goods (e.g. trademarks and copyrights) is, however, challenging, as these may well be incorporated in the payment for the marketing right without a clear distinction. If we look at the manufacturing IP, one can argue that since charges for the right to reproduce the imported goods in the country of importation shall not be added to the customs value and distribution rights are excluded from it unless they are paid as a condition of the sale, these should not be part of the customs value of the imported goods at all.

Again, if the distinction between dutiable and non-dutiable elements cannot be substantiated by objective and quantifiable data, the entire royalty payment might be considered dutiable, or the transaction value might be rejected. Bifurcation of agreements could avoid such discussions, but still the values assigned to each element of the dutiable and non-dutiable part of the royalty payment should then be substantiated with objective and quantifiable data and also taking TP angles into consideration. Especially in intercompany relationships, customs authorities want to obtain evidence that an appropriate value is assigned to each of the elements that equals its actual economic value. In intercompany relationships, TP studies may provide for a good source of information, especially if it includes a royalty rate benchmarking study. The royalty rate benchmarking study does, however, not always make a distinction between the elements that need to be separated from a customs perspective and therefore, it is important to revisit the search strategy of a benchmark when such distinction is required from a customs perspective. An additional challenge is that one needs to know the royalty for a particular product imported in a particular import jurisdiction, whereas royalties often do not provide for product or geographical demarcation.

3.2.2. TP perspective

After the determination of the dutiability of the relevant IP elements, it is important to determine the customs value in relation to the royalty payment. As the customs valuation method cannot be arrived at in isolation, under the transactional value method, the TP angles should be considered when determining the arm’s length price for the royalty payments that are considered as dutiable.

Based on the OECD Guidelines, in a TP analysis of a matter involving intangibles, it is important to identify the relevant intangibles with specificity. The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, the important functions performed and specific risks assumed in connection with the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangibles and the manner in which they interact with other intangibles, with tangible asset and with business operations to create value.[37] The sections below provides some TP considerations for both the fixed-rate royalty and residual royalty.

3.2.2.1. Fixed-rate royalty

With respect to the fixed-rate royalty, there are various factors that should be considered from a TP perspective:

- The functional profile of the entities in scope. For a TP analysis, it is important to first understand the functional profile of the relevant entities and whether the current remuneration is in line with its functionality. Based on the current TP policy, the local distributor is paying a fixed-rate royalty to the IP owner based on a percentage of the revenue. In other words, it is assuming more risks compared to a routine buy-sell distributor and thus it is taking the residual profit/loss due to the set-up of the fixed-rate royalty (i.e. it can potentially be in a loss-making position if the sales are not sufficient to cover the full costs and royalty payment to the IP owner). Proper TP documentation should be prepared to substantiate the risk-bearing distribution activities and the remuneration in this case. The lack of TP documentation to support the arm’s length nature of the fixed-rate royalty may result in a challenge on the amount of the royalty payment, which is interlinked to the potential value to be included in the customs value.
- While this may be omitted from the TP analysis from time to time, in addition to the functional profile and the pricing in itself, it is important to assess the commercial rationale of the royalty agreement and review whether the terms and conditions in the licensing agreement are in line with the commercial rationale that third parties would agree upon.
- The IP elements included in the licensing agreements. Based on the fixed-rate royalty arrangements, it has been defined that the IP elements include manufacturing IP and marketing IP in local countries. From a TP perspective, when a

36. *See also* the country chapters of the IBFD collection *Transfer Pricing & Customs Valuation*, Country Tax Guides IBFD.
37. Para. 6.12 *OECD Guidelines* (2022).

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transaction has been formalized by associated enterprises through written contractual agreements, they provide a starting point for the delineation of the transactions. However, the contractual terms alone are unlikely to provide all the information required to perform a TP analysis and further information for commercial or financial relations (e.g. functional profiles of covered entities, characteristics of the IP elements, economic circumstances, business strategies, etc.) should be considered to ensure that all the IP elements have been captured in the licensing transaction to determine the potential customs value.

- The arm's length remuneration of the respective IP elements. With respect to the royalty payment, currently a fixed rate has been selected for the respective IP elements. To support the arm's length nature of the royalty, a benchmark study should be performed to determine the range for comparable transactions. The OECD Guidelines state:

  > where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP method is preferable over all other methods.[38]

  Therefore, in general, the CUP method is commonly chosen to support the pricing of intercompany licensing agreements. This can be supported by internal CUP and/or external CUP. However, due to the unique nature of the IP elements and the limitation of the external database, it may be difficult to identify the agreements that are fully comparable to the agreements under review. In practice, the tax authorities may be critical of intercompany royalties which are solely substantiated through the CUP method, and in particular of external agreements due to the limited available information to evaluate the comparability criteria. However, if there have been comparability analyses performed and documented regarding the selected CUPs, this can strengthen the position for the selection of the method. In addition, a secondary method to corroborate of the CUP method (e.g. the profitability level testing of the distributor post-royalty payment) may also help with the position.

3.2.2.2. Residual royalty

Residual royalty arrangements are commonly observed in third-party licensing arrangements which serve as a mechanism of allocating business risk and economic return between the licensors and licensees of such arrangements. From a TP perspective, it is important to understand the functionality of the entities in scope and whether it is appropriate to apply the residual royalty mechanism in the first place. The residual royalty captures the difference between the target margin and the actual operating margin earned by the local distributor (pre-royalty payment). As such, it ensures the routine remuneration of the local distributor/licensee and the IP owner to retain the residual profit/loss in relation to the distribution activities. Compared to the fixed-rate royalty, under the residual royalty, less risk-bearing functions are expected to be performed by the local routine distributor and the business risk and economic return are expected to be resided at the IP owner level. It is important to have sufficient TP documentation in place to substantiate the functionality profiles of both the local distributor (especially the routine margin kept locally) and the IP owner. The lack of the TP documentation to support the arm's length nature of the routine distribution functions may result in the challenge on the amount of the royalty payment, and it is also interlinked to the cost of products sold by the local distributor due to the internal price setting mechanism.

Furthermore, based on the OECD Guidelines, it is necessary to identify the intangibles and to determine the price for the use of the IP. Depending on the industry sector, among the DEMPE functions associated with the value creation of the intangibles, the exploitation of intangibles can account for either a large or small part of the group's value chain.[39] As such, it is crucial to delineate the licensing transactions and identify the relevant IP elements in scope and to assess their contribution to the overall value creation activities. To assess whether the royalty can be considered as dutiable, in connection with the customs considerations as described in section 0., the value drivers and the IP elements can be assessed from a TP perspective to distinguish between dutiable and non-dutiable elements.

Due to the nature of the residual royalty, it combines the royalty payment for manufacturing IP and marketing IP. From a contractual perspective, it is not possible to identify the royalty amount that should be allocated to each of the IP element. Therefore, the question arises as in how to allocate the royalty portion to the respective IP element under the combined residual royalty scheme. One can potentially look at the sales-based approach and the cost-based approach on the allocation, such as the following:

CUP method

As mentioned earlier, the CUP method is commonly selected as the primary method to determine the arm's length remuneration for the royalty payment if it is possible to locate the comparable uncontrolled transactions. In the case of a residual royalty, it is inherently difficult to directly find a comparable transaction in a legal agreement since (i) the IP elements

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38. Para. 2.15 *OECD Guidelines* (2022).
39. Para. 6.10 *OECD Guidelines* (2022).

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are blended in one licensing agreement and it is difficult to find the comparable agreement with the full suite of same/similar IP elements; (ii) the outcome of the residual royalty is difficult to assess per transaction as the financial information for the local distributor and the royalty amount may not be publicly available; and (iii) even if such comparable agreement can be located, it is difficult to split the royalty payment per IP element to quantify the potential value that should be subject to customs duties. Therefore, in this case, it is difficult to directly apply a CUP method to determine the arm's length price for each IP element under the residual royalty for customs analysis purpose. Nevertheless, one can potentially look at a standalone CUP per IP element and use the outcome per IP element to assess the weighing of each IP element under the residual royalty payment. The weighing can be used to further split the royalty payment per IP element. It should be noted that under this approach, however, one can challenge how representative a standalone CUP per IP element (e.g. similar to a fixed-rate royalty) is in the context of a residual royalty arrangement due to the different functionality and risk-bearing capacity compared to the operating model under the fixed-rate royalty setup.

Value chain analysis

In addition to the traditional transaction methods and the transactional profit methods, the value chain analysis can be considered (as "other method"). One can assess the arm's length remuneration that should be allocated per IP element based on identified value drivers within the IP licensing transaction, how the group manages these value drivers and the contribution of each value driver. The value chain analysis shall be performed together with the business team to understand the value drivers that contribute to the success of the business and revenue generation and subsequently to quantify the weighing of each IP element in the context of the residual royalty payment. This approach, however, is based on the business input and may be challenged on the level of "objective and quantifiable" criteria from a customs perspective.

Cost-based approach

Although this is not a TP method, it may serve as an alternative approach for the quantification of the royalty per IP element. While the first two approaches presented above are revenue-based analyses (i.e. the weighing calculated based on the sales-based royalty payment or the contribution to the sales generation), one may potentially look at the cost incurred for the development of the IP at the IP owner level and determine the total cost pool and the cost allocation per IP element to determine the weighing for the royalty split. The advantage of this approach is it can provide objective and quantifiable data per customs requirements as the costs can be traced in the bookkeeping and the generally accepted accounting principles (GAAP) approved financial statements. However, the downside of this approach can be:

- due to the nature of the IP licensing activities, the historical costs incurred are not the best indication of the future revenue generation activities (e.g. there may be initial/build-up costs incurred in the previous year for the DEMPE functions in relation to the IP which is not covered in the specific year cost pool/the costs incurred may be significant and, however, may only result in a margin income due to the economic circumstances);
- the costs incurred at the IP owner level are for purpose of the DEMPE functions performed for the IP applicable for the whole group and thus not specifically representative for that particular jurisdiction. In this case, it is difficult to assess to what extent the local distributor/IP licensees would benefit from these intangibles and whether the cost allocation percentages are representative. For example, if the group invests more on the marketing and distribution IP in a particular jurisdiction than another, the overall costs incurred for this particular IP may not be representative for all jurisdictions.

The approaches mentioned above are for illustrative purpose and not exhaustive. There are pros and cons per approach in relation to the split of the royalty and they should be assessed on a case-by-case basis.

In addition, after the quantification of the dutiable royalty, from a practical perspective, one should also consider how to perform the customs filing (e.g. one-off adjustment, unit price changes, applicable duties, etc.) in relation to the dutiable royalty.

4. Conclusion

The interaction between TP and customs valuation is like dancing a tango where both sides find a delicate approach to arrive at a dynamic balance. This interaction holds a pivotal role in today's complex global trade and tax landscape. These two domains are intricately intertwined, as they directly impact how MNEs structure their cross-border operations and their direct tax and indirect tax structure.

At the heart of this relationship lies the TP implications of increased scrutiny on royalty structures by customs authorities. In addition to the customs valuation analysis, such cases should be looked at through a TP lens, which helps the companies to assess the value creation of the underlying transaction, the contribution of the various IP elements, and the quantification of such royalty payment from an arm's length perspective.

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By proactively addressing these intricacies, companies can not only navigate potential challenges more effectively but also foster an environment of trust and cooperation between TP and customs authorities, ultimately leading to more efficient cross-border trade and reduced risk of disputes.

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