HQ **W548692**
March 2, 2007
RR:CTF:VSP 548692 GG
CATEGORY: Valuation
Port Director U.S. Customs and Border Protection Los Angeles-Long Beach Seaport 301 E. Ocean Blvd., Suite 1400 Long Beach, CA 90802
RE: Internal Advice; Dutiability of Royalty Payments; 19 U.S.C. § 1401a(b)(1)(D);
Dear Sir:

This is in response to an internal advice request concerning the dutiability of certain royalty and license fees paid by Corporation A to LICENSOR. The request, dated December 14, 2004, and supplemented by another letter dated November 7, 2005, was presented as a ruling request. Its issues, however, were first raised during a Focused Assessment conducted by U.S. Customs and Border Protection ("CBP") auditors in Seattle, Washington, and thus we are treating the request as one for internal advice. The public version of this document has been drafted to avoid specific reference to information deemed confidential by Corporation A.
FACTS:

Corporation A purchases and imports "Pointing Devices" such as mice, game pads and joysticks from a Chinese manufacturer/vendor, Corporation B (also referred to as "Corporation B International Marketing, Ltd." in Corporation A's November 7, 2005, letter). As part of this process, Corporation A in March 2000 entered into a "Technology Transfer & License Agreement" (the Licensing Agreement) with LICENSOR. All three companies are unrelated. Pursuant to Section 2.1 of the Licensing Agreement, LICENSOR granted the following technology licenses to Corporation A:

A worldwide license to Non-Patented Intellectual Property; and A worldwide, exclusive license to LICENSOR Deliverables such as software, firmware, hardware, specifications, documentation and other materials related to XX Technology owned by LICENSOR.

These licenses are to be used to –
Use, copy, edit, format, modify, translate and create Derivative technology of XX Technology in Pointing Devices; Reproduce, license, rent, lease or otherwise distribute and have reproduced, licensed, rented, leased or otherwise distributed, to and by third parties XX Technology in Pointing Devices, and any Derivative Technology thereof; Grant license rights to XX Technology in Pointing Devices to third parties.

In addition, under Section 2.2 of the Licensing Agreement, LICENSOR grants to Corporation A and its affiliates a license under the XX Patents "to reproduce, make, have made, use, import, offer for sale and sell XX Technology in Pointing Devices." In consideration for the rights set forth in the Licensing Agreement, Corporation A agreed to pay an up-front non-refundable license fee to LICENSOR, a non-refundable royalty fee advance, and an ongoing per unit royalty based upon the direct or indirect sale of devices by Corporation A. (Section 4 Licensing Agreement.)
Corporation A has also provided a copy of the Master Manufacturing Agreement entered into between Corporation B and Corporation A on September 14, 1995. Under its terms Corporation B agrees under license to manufacture products for Corporation A according to specifications provided by Corporation A. (Section 2 Master Manufacturing Agreement.) The Master Manufacturing Agreement specifies that Corporation B shall manufacture the products solely for Corporation A. It also establishes the price that Corporation A will pay for the manufactured products.
ISSUE:

Whether the subject royalties and license fees are included within the transaction value of the merchandise as dutiable royalties.

LAW AND ANALYSIS:

Merchandise imported into the United States is appraised in accordance with section 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 (TAA) codified at 19 U.S.C. § 1401a. The preferred method of appraisement under the TAA is transaction value, defined as "the price actually paid or payable for the merchandise when sold for exportation to the United States," plus certain enumerated additions, including "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." 19 U.S.C. § 1401a(b)(1)(D). These additions apply only if they are not already included in the price actually paid or payable. For purposes of this decision we assume that transaction value is the appropriate method of appraisement.

Based on the information provided, it appears that the royalty payments are not part of the price actually paid or payable for the merchandise since they are not part of the total payment made for imported merchandise by the buyer to, or for the benefit of, the seller. See 19 U.S.C. § 1401a(b)(4)(A). In the present matter, and the evidence does not indicate otherwise, such amounts are not part of the price actually paid or payable. Therefore, we must consider whether the payments constitute royalties to be added to the price.

With regard to royalties, the Statement of Administrative Action (SAA), which forms part of the legislative history of the TAA, provides in relevant part:

Additions for royalties and license fees will be limited to those 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. In this regard, royalties and license fees for patents covering processes to manufacture the imported merchandise will generally be dutiable, whereas royalties and license fees paid to third parties for use, in the United States, of copyrights and trademarks related to the imported merchandise, will generally be considered as selling expenses of the buyer and therefore will not be dutiable. However, the dutiable status of royalties and license fees paid by the buyer must be determined on a case-by-case basis and will ultimately depend on: (i) whether the buyer was required to pay them as a condition of sale of the imported merchandise for exportation to the United States; and (ii) to whom and under what circumstances were they paid. For example, if the buyer pays a third party for the right to use, in the United States, a trademark or copyright relating to the imported merchandise, and such payment was not a condition of the sale of the merchandise for exportation to the United States, such payment will not be added to the price actually paid or payable. However, if such payment was made by the buyer as a condition of sale of the merchandise for exportation to the United States, an addition will be made. As a further example, an addition will be made for any royalty or license fee paid by the buyer to the seller, unless the buyer can establish that such payment is distinct from the price actually paid or payable for the imported merchandise, and was not a condition of the sale of the imported merchandise for exportation to the United States.

Statement of Administrative Action, H.R. Doc. No. 153, 96 Cong., 1st Sess., pt 2, reprinted in, Department of the Treasury, Customs Valuation under the Trade Agreements Act of 1979 (October 1981), at 48-49.

CBP has established a three-part test for determining the dutiability of royalty payments. This test appears in the General Notice, Dutiability of Royalty Payments, Vol. 27, No. 6 Cust. B. & Dec. at 1 (February 10, 1993) ("Hasbro II ruling"). The test consists of the following questions: 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? Affirmative responses to factors one and two and a negative response to factor three would indicate that the payments were a condition of sale and, therefore, dutiable as royalty payments.

In the present matter, first, it is not disputed that the imported merchandise is manufactured under patent, insofar as the patented technologies are utilized in the manufacturing process. Corporation A acknowledges this in its letter dated June 14, 2005.

With respect to the second question, i.e., were the royalties involved in the production or sale of the imported merchandise, Corporation A in its June 14th letter initially indicates that the royalty payment "is in consideration for the license to use the technology to manufacture the imported devices." Corporation A then modifies its position in its follow-up letter of November 7, 2005, by claiming that the license fees and royalties are not directly related to the production of the Pointing Devices, but instead relate to the technology used in the Corporation A specifications. Corporation A explains that it uses the intellectual property provided by LICENSOR to create specifications in the United States, which it then provides to Corporation B for use in the production of the mice, game pads and joy sticks. We find the idea that the royalties are not dutiable because they relate only to the technology used in the specifications, and not to the manufacture of the Pointing Devices themselves, to be unpersuasive. This is because the Licensing Agreement establishes a clear nexus between the royalties and the production of the merchandise. In particular, Section 2.2 of the Licensing Agreement grants Corporation A a license under the XX Patents to have another party make XX technology in Pointing Devices. Corporation A exercises this right by engaging Corporation B to make the imported items. In addition, Corporation A also evidently exercises its right, specified in Section 2.1 of the Licensing Agreement, to bestow license rights to the technology on third parties. It does so by granting Corporation B a license to manufacture the products in accordance with specifications provided by Corporation A. (Section 2 Master Manufacturing Agreement.) The exercise of these rights, both of which clearly involve the production of the imported goods, gives rise to the obligation to pay a royalty. We conclude, therefore, that the royalty was involved in the production of the imported devices.

The remaining question is whether Corporation A could buy the merchandise without paying the fee. In prior decisions, including the Hasbro II ruling, Customs acknowledged that the "answer to question three goes to the heart of whether a payment is considered to be a condition of sale." Although at times Customs may have indicated that a royalty less likely would constitute a condition of sale, and hence, be dutiable when the royalty was paid to a party other than the seller or a party related to the seller, this factor alone, especially when a patent is involved, does not automatically indicate that a payment is not a condition of sale.

In particular, the language included in the SAA provides that royalties and license fees for patents covering processes to manufacture imported merchandise generally will be dutiable. Furthermore, we note that the relevant portions of both the TAA and SAA which refer to royalties required to be paid as a condition of sale, do not state to whom, or for whose benefit, in particular, the payment is made. Although a reference to the seller is included in the definition of the price actually paid or payable, it is conspicuously absent from the instant provision. In our opinion, this, along with the language included in the SAA, to wit, that royalties for patents covering manufacturing processes generally are dutiable, indicates that in regard to patents, the framers of the TAA recognized that royalties paid to unrelated third parties could constitute a condition of the sale and, hence, be dutiable. See Headquarters Ruling letter ("HQ") 546513, dated February 11, 1998; and **HQ 545777**, dated September 1, 1995.

In its letter of June 16, 2005, Corporation A indicates that it could purchase the pointing devices without paying the royalty, because the royalty was only triggered by Corporation A sales of the finished devices in the United States. Corporation A in its letter of November 7, 2005, cites to two rulings, **HQ 544129**, dated August 31, 1988, and **HQ 544436**, dated February 4, 1991 (C.S.D. 91-6; 25 Cus. Bull. 18, at p. 19) in support of its position.

HQ 544436 was the original Hasbro ruling. Its issuance as C.S.D. 91-6 generated considerable interest and resulted in public comment and the Hasbro II ruling, referenced above. **HQ 544436** involved a situation in which the importer Hasbro paid royalties to the seller for the right to manufacture the products and to sell them within a specified area. Customs in **HQ 544436** determined that the payments were not dutiable royalties, but instead were proceeds of a subsequent resale that accrued to the seller under 19 U.S.C. § 1401a(b)(1)(E). A major factor in finding that the payments were not additions under the royalty provision was that the payments were calculated on the basis of sales that occurred subsequent to the importation of the merchandise. Customs in Hasbro II reconsidered its decision in **HQ 544436** and, under a new approach based on case law, found the royalty payments to be additions to the price actually paid or payable under both the royalty and proceeds provisions of the valuation statute. Customs in Hasbro II also 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. Since the Hasbro II ruling in effect reversed the determination in **HQ 544436** that the payments were not dutiable royalties, Corporation A's reliance on **HQ 544436** to show that its royalties are not subject to duty is misplaced.

The other ruling upon which Corporation A relies, **HQ 544129**, is cited in both Hasbro rulings. In **HQ 544129** an importer paid royalties to a third party for the right to use and sell the licensed products in the United States, as well as to manufacture such licensed products in the United States if the overseas supplier could not fulfill the requirements of the supply agreement. Customs found that the royalties were not a condition of the sale of the imported merchandise because they were for rights that were separate and apart from the right of ownership on payment of the purchase price. In reaching this conclusion Customs noted that the royalty payments were triggered upon the resale, rather than upon the importation, of the product. **HQ 544129** was one of several rulings relied upon by Customs in **HQ 544436** for the initial finding that the Hasbro payments were not dutiable under the royalty provisions of 19 U.S.C. §1401a(b)(1)(D). Later in Hasbro II Customs made reference to **HQ 544129** when altering its position on the relevancy of the method of calculating the royalty in determining the dutiability of the royalty payment. Corporation A thus cannot rely on **HQ 544129** to promote its position that its royalties are not dutiable because they are triggered by the resale of the products.
The Corporation A facts and those of **HQ 544129** are also distinguishable because in the latter the intellectual property rights were for activities that took place exclusively in the United States, whereas in Corporation A's case the rights relate in part to activities such as manufacturing that occur overseas prior to importation. CBP has previously held that royalties that are paid solely in furtherance of domestic manufacturing and marketing operations are not dutiable royalties under section 402(b)(1)(D) because they were not involved in the production or sale of the imported merchandise and because they were not a condition of sale of the imported merchandise. See **HQ 545307**, dated February 3, 1995, **HQ 545951**, dated February 12, 1998, and **HQ 546660**, dated June 23, 1999. A different situation, however, exists here.

In the instant matter, it appears the royalty is to be paid on each imported item that is purchased and resold by Corporation A. It is evident from the language of the Licensing Agreement that the Pointing Devices only will be manufactured, imported and subsequently resold based on the understanding or condition that such royalties are paid. In particular, Section 2.2, which grants Corporation A a license under the XX Patents to reproduce, make, have made, use, import, offer for sale and sell XX Technology in Pointing Devices, and Section 4, which makes royalties payable on each unit sold, show the clear, substantial nexus existing between the imported merchandise, patented technology, and applicable royalty payments. It is evident that these payments cause the patented technology to be utilized in the processing of the merchandise that is then sold for export to the United States. For these reasons, it is our position that the importer cannot buy the imported merchandise without paying the fee, and based on this entire analysis, that the royalty payments relate to, and are a condition of sale of, the imported merchandise in accordance with 19 U.S.C. § 1401a(b)(1)(D).
HOLDING:

Based on the facts submitted, the royalty payments made by the importer to the licensor are included in the transaction value of the imported merchandise as royalties under 19 U.S.C. § 1401a(b)(1)(D).
Please mail this decision to Corporation A no later than 60 days from the date of this letter. On that date, the office of Regulations and Rulings will make the decision available to CBP personnel, and to the public on the CBP Home Page on the World Wide Web at www.cbp.gov, by means of the Freedom of Information Act, and other methods of public distribution.

Sincerely,
Monika R. Brenner Chief Valuation and Special Programs Branch