WORLD CUSTOMS ORGANIZATION
ORGANISATION MONDIALE DES DOUANES
ORGANIZACIÓN MUNDIAL DE ADUANAS

TECHNICAL COMMITTEE ON
CUSTOMS VALUATION

VT1148E1a
+ (Annexes I and II)

-
47th Session
-

O. Eng.

Brussels, 9 July 2018.

SPECIFIC TECHNICAL QUESTIONS

ROYALTIES AND LICENCE FEES UNDER ARTICLE 8.1 (c) OF THE AGREEMENT (ROYALTY-INCOME TAX)

Request by China

(Item V (e) on the Agenda)

Reference documents :

VT1135E1a (TCCV/46)
VT1137E1a (TCCV/46 – Draft Report)

I. BACKGROUND

1. At the 46th Session, the Technical Committee agreed to discuss a question submitted by China on "royalties and licence fees under Article 8.1 (c) of the Agreement". The question was reproduced in Doc. VT1135E1a.

2. During the discussions at the 46th Session, one delegate suggested a third opinion to be included in the analysis of the case, i.e. that the withholding tax paid on the royalty payment should not form part of the Customs value as it is a domestic tax.

II. SECRETARIAT COMMENTS

3. Following the 46th Session, the Secretariat worked with China to adjust the text reflecting the third opinion as suggested by one delegate. The new text is reproduced in Annex I to this document. Changes are indicated in **bold.**

4. During the current intersession, Chile submitted written comments which are reproduced in Annex II to this document. In its comments, Chile is of the view that the

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income tax is an indirect payment in line with the example given in paragraph 1 of the Interpretative Note of the Agreement, since the buyer is settling a debt owed by the seller.

5. The Secretariat wishes to point out that if the withholding tax is deemed as the settlement by the buyer of a debt owed by the seller, the Technical Committee might wish to consider that this payment is part of the Customs value under Article 1 instead of being a royalty/licence fee under Article 8.1 (c) of the Agreement.

6. China noted that Advisory Opinion 4.16 deals with a similar situation where the income tax paid for the royalty is deducted from the royalty payment from the buyer to the seller. However, China has pointed out that, in its opinion, there are some differences between the Advisory Opinion and the case in question which justify the development of a new instrument.

7. The Secretariat notes that in Advisory Opinion 4.16, the income tax paid is deducted from the total royalty payment from the buyer to the seller while in this case, the income tax paid is a separate payment on top of the royalty payment from the buyer to the seller.

III. CONCLUSION

8. Members are invited to examine the question and submit their suggestions and comments in electronic form to the Secretariat (e-mail address: valuation@wcoomd.org) not later than **9 September 2018.** Comments received in response to this document will be published and circulated to Members of the Technical Committee for consideration at the 47th Session. Members may also contribute their views and discuss the case via the WCO's CLiKC! platform.

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Royalties and licence fees under Article 8.1 (c) of the Agreement

THE ISSUE:

1. Importer/buyer/licensee B of country of importation I enters into a license agreement with supplier/seller/licensor S of country of exportation X for use of a patent. As part of this arrangement the parties also agree that the royalty payable by B to S for the commercial use of the patent licensed in the agreement will be calculated by applying a rate of five percent (5%) of the net sale price of the patented goods in the country of importation.

2. Subsequently, S and B enter into a contract for the international sale of product P at a price of one thousand (1000) currency units. Under the contract, the patent has been incorporated in product P, such that the corresponding royalty may be considered to be related to the goods. In addition, the price does not include the royalty, which is paid as a condition of sale of the goods. Accordingly, all the requirements provided for in Article 8.1 (c) of the Agreement are met.

3. Given that the net sale price of product P in country I is two thousand (2000) currency units, the license fee which B owes S for use of the patent is one hundred (100) currency units.

4. In accordance with the domestic tax rules in force in country of importation I, the one hundred (100) currency units paid by way of a royalty for use of the patent are subject to income tax, the amount of which is determined by applying a nominal rate of ten percent (10%) to the total sum payable; the taxpayer should be licensor S, and importer B is the withholding agent who normally pays income tax on behalf of the licensor under a requirement to withhold tax at source.

5. Based on a clause in the license agreement, licensor S requires licensee B to pay the 10 currency units tax on behalf of the licensor, and the licensee must pay the total amount of the royalty due without any deduction.

6. Accordingly, B pays out a total of one thousand one hundred and ten (1110) currency units: one thousand (1000) currency units corresponding to the price of product P, one hundred (100) currency units by way of royalty for use of the patent, and ten (10) currency units for payment of the income tax. However, S receives only one thousand and one hundred (1100) currency units, including one thousand (1000) currency units for product P, and one hundred (100) currency units for the royalty and license fee.

7. The issue brought before the Technical Committee is whether the ten (10) currency units income tax paid by Importer B is part of the Customs value for the imported goods.

REFERENCES:

Article 1, Article 8.1 (c), paragraph 3 (c) of the Interpretative Note to Article 1, Advisory Opinion 4.16

ANALYSIS:

8. Based on the facts of the case, **three** different opinions have been proposed:

9. *Opinion 1:*
Based on the facts, the royalty fees (one hundred (100) currency units paid by buyer/licensee under the license agreement) are related to the imported goods, have been paid as a condition of sale of the imported goods and have not been included in the Customs value. Therefore,the payment of 100 currency units should be added to the price actually paid or payable under Article 8.1 (c) of the Agreement.

Additionally, pursuant to the license agreement, seller/licensor S requires buyer/licensee B to pay 10 currency units tax on behalf of S to the Tax authority of country of importation I. In accordance with the domestic tax rules in force in country of importation I, the taxpayer is the licensor, whilst the licensee is the withholding agent. So buyer/licensee B pays 10 currency units to the Tax authority together with one hundred (100) currency units to S.

Therefore, the buyer/licensee makes two payments for the commercial use of the patent, one is 100 currency units calculated by applying the fixed rate set out in the license agreement; the other is 10 currency units for withholding tax. Both payments are made for the right to use the patent. The ten (10) currency units are paid by the licensee to the Tax authority for the benefit of the licensor (to satisfy an obligation of the licensor) and should be regarded as an indirect payment of royalty.

Article 8.1 (c) of the Agreement provides that, in determining the Customs value, there shall be added to the price actually paid or payable royalties and license *fees "that the buyer must pay, either directly or indirectly […]".* Given that all the requirements provided for in Article 8.1 (c) of the Agreement are met in this case, thus the one hundred and ten (110) currency units of royalty should be added to the Customs value.

According to Advisory Opinion 4.16, the "duties and taxes of the country of importation" which shall be excluded from the Customs value as prescribed in Paragraph 3 (c) of the Interpretative Note to Article 1 relate to domestic taxes which may be levied on the import of goods rather than taxes which may apply to royalty income. Hence the ten (10) currency units tax should not constitute a reduction in the Customs value of imported goods.

10. *Opinion 2:*
Based on the facts, the royalty fees (one hundred (100) currency units paid by the buyer/licensee under the license agreement) are related to the imported goods, have been paid as a condition of sale of the imported goods, and have not been included in the Customs value. Therefore, the payment of 100 currency units should be added to the price actually paid or payable value under Article 8.1 (c) of the Agreement.

Additionally, pursuant to the license agreement, seller/licensor S requires buyer/licensee B to pay 10 currency units tax on behalf of S to the Tax authority of country of importation I. In accordance with the domestic tax rules in force in country of importation I, the taxpayer is the

licensor, whilst the licensee is the withholding agent. So buyer/licensee B pays 10 currency units to the Tax authority in addition to paying one hundred (100) currency units to S.

In this case, the licensee is also the buyer and the licensor is also the seller. The payment of ten (10) currency units could be considered as a payment made by the buyer for the benefit of the seller (to satisfy an obligation of the seller). According to Article 1 and paragraph 1 of the Interpretative Note to Article 1, this payment should be regarded as an indirect payment, which should be included in the price actually paid or payable.

According to Advisory Opinion 4.16, the *"duties and taxes of the country of importation"* which shall be excluded from the Customs value as prescribed in Paragraph 3 (c) of the Interpretative Note to Article 1 relate to domestic taxes which may be levied on the import of goods rather than taxes which may apply to royalty income. Hence the ten (10) currency units tax should not constitute a reduction in the Customs value of imported goods.

11. ***[Opinion 3:***

Based on the facts, the royalty fees (one hundred (100) currency units paid by the buyer/licensee under the license agreement) are related to the imported goods, have been paid as a condition of sale of the imported goods and have not been included in the Customs value. Therefore, the payment of 100 currency units should be added to the price actually paid or payable under Article 8.1 (c) of the Agreement.

Additionallly, pursuant to the license agreement, seller/licensor S requires buyer/licensee B to pay 10 currency units tax on behalf of S to the Tax authority of country of importation I. In accordance with the domestic tax rules in force in country of importation I, the taxpayer is the licensor, whilst the licensee is the withholding agent. So buyer/licensee B pays 10 currency units to the Tax authority together with one hundred (100) currency units to S.

According to Advisory Opinion 4.16, the *"duties and taxes of the country of importation"* which shall be excluded from the Customs value as prescribed in Paragraph 3 (c) of the Interpretative Note to Article 1 relate to domestic taxes which may be levied on the import of goods, rather than taxes which may apply to royalty income. However, in this case, the income tax is paid in addition to the royalty payment made by the buyer to the seller while in the case of Advisory Opinion 4.16, the income tax paid is deducted from the total royalty payment made by the buyer to the seller.

Therefore, the income tax is viewed as a tax of the country of importation and it can be distinguished from the price paid or payable for the imported goods. Hence, the ten (10) currency units tax should not be included in the Customs value of the imported goods.]

Draft conclusion

12. In summary, there might be **three** different views:

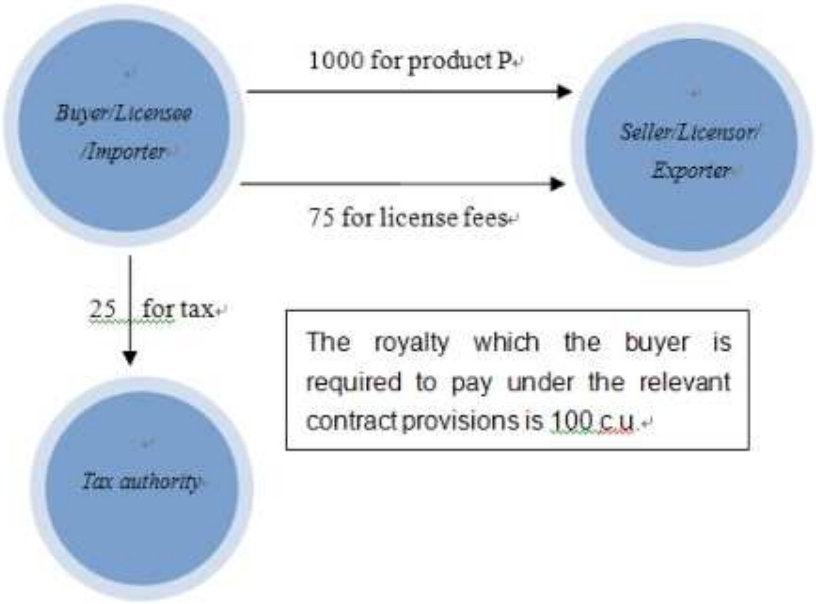
Opinion 1: According to Article 8.1 (c) of the Agreement, the ten (10) currency units paid by the buyer/licensee to the tax authority for the benefit of the licensor/seller should be regarded as an indirect payment of royalty, and thus the total payment of royalty - one hundred and ten (110) currency units should be added to the Customs value. Therefore the Customs value in this case is one thousand one hundred and ten (1110) currency units.

Opinion 2: According to Article 8.1 (c) of the Agreement, the one hundred (100) currency units of royalty should be included in the Customs value. According to Article 1 and paragraph 1 of the Interpretative Note to Article 1, the ten (10) currency units paid by the buyer/licensee to the tax authority for the benefit of the seller/licensor should be regarded as an indirect payment for the imported goods, which should be included in the price actually paid or payable. Therefore the Customs value in this case is one thousand one hundred and ten (1110) currency units.

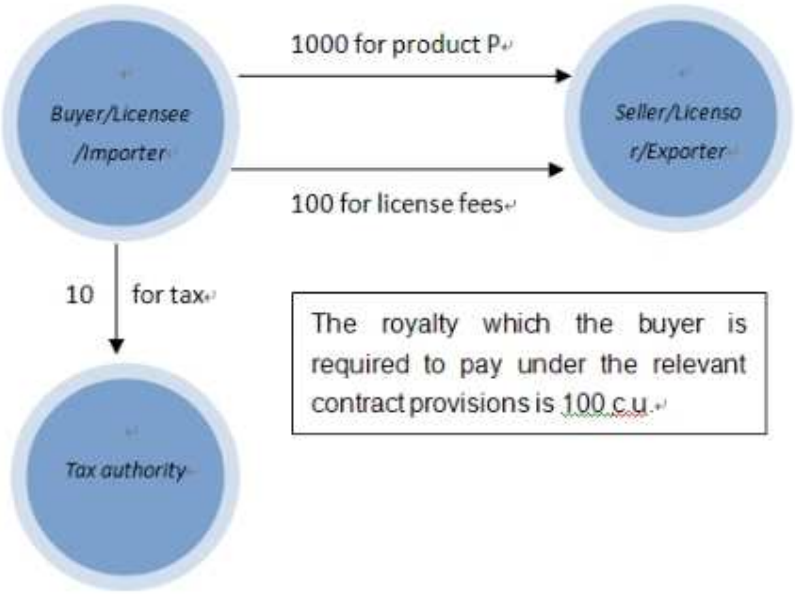
Opinion 3: According to Article 8.1 (c) of the Agreement, the one hundred (100) currency units of royalty should be included in the Customs value. According to paragraph 3 (c) of the Interpretative Note to Article 1 of the Agreement, the ten (10) currency units paid by the buyer/licensee to the tax authority for the benefit of the seller/licensor should be regarded as a tax of the country of importation and not for the imported goods, which should not be included in the price actually paid or payable. Therefore the Customs value in this case is one thousand one hundred (1100) currency units.

Annex: Comparison between Advisory Opinion 4.16 and this case

AO 4.16



This case



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COMMENTS BY CHILE

The Chilean Customs Administration thanks the Secretariat and the Chinese Customs Administration for presenting the subject of royalties and licence fees under Article 8.1 (c) of the Agreement, as set out in Doc. VT1135E1a and its Annex.

1. Having regard to the context of the case, the subject concerns a buyer/importer entering into a licence agreement with a seller for use of a patent. Both parties, under the agreement concerned, agree that the buyer must pay the seller a royalty for the use of the patent based on a percentage, calculated from the net sale price of the patented goods in the country of importation. In this case, the three conditions set out in Article 8.1. (c) of the Agreement, determining whether it is appropriate to add the amounts of royalties to the customs value, have been met.

2. Furthermore, the domestic tax rules in the country of importation provide that the royalty payments for the use of the patent are subject to income tax, the amount of which is a percentage of the total royalties paid.

3. In the light of the foregoing, the Chinese Administration has sought an opinion from the Technical Committee in order to establish whether the income tax that is paid for the payment of royalty should form part of the customs value.

4. China considers that there might be two different views for this question, namely :

   (a) According to Article 8.1 (c) of the Agreement, the payment of income tax made to the domestic tax authority should be regarded as an indirect payment of royalty for the benefit of the seller, and should be added to the customs value; or

   (b) According to Article 1 and paragraph 1 of the Interpretative Note to Article 1, the amount of income tax paid by the buyer to the domestic tax authority is for the benefit of the seller and should be regarded as an indirect payment for the imported goods, which should be included in the price actually paid or payable.

5. The Chinese Administration and the WCO Secretariat point out that there is a technical instrument on this matter, Advisory Opinion 4.16, which deals with the payment of income tax based on a percentage of the total royalties paid in the country of importation in which the buyer pays on behalf of the seller and where the total payment from the buyer to the seller includes the price of the imported goods and the royalties.

6. Moreover, the WCO Secretariat draws the Technical Committee's attention to paragraph 3 of the Interpretative Note to Article 1 of the Agreement, which reads as follows :
   "The customs value shall not include the following charges or costs, provided that they are distinguished from the price actually paid or payable for the imported goods :
   (c) duties and taxes of the country of importation."

7. In the opinion of this Valuation Department, the comments by the Secretariat are relevant, given that paragraph 3 (c) of the Interpretative Note to Article 1 ("Price actually paid or payable") excludes from the customs value "duties and taxes of the country of importation" and paragraph 12 of Advisory Opinion 4.16 indicates that this rule relates to domestic taxes which may be levied on the import of goods rather than taxes which may apply to royalty income.

8. In this case, and according to the considerations set out in the text presented by the Chinese Administration, particularly in paragraph 5, licensor S, the seller, requires licensee B, the

buyer, to pay 10 currency units by way of income tax, based on a percentage (10%) of the royalty required, which in this case amounted to 100 currency units (5% of the net sale price of the imported goods = 2,000 currency units).

9. In accordance with the above, and in the view of this Customs Administration, the cost of the income tax paid to the domestic tax authority (10 currency units) is determined on the basis of a clause of the licence agreement, so that it is in line with Article 8.1 (c) of the Agreement, given that it is an indirect royalty payment laid down as a condition of sale. Moreover, that indirect payment is in line with the example given in paragraph 1 of the Interpretative Note to Article 1 of the Agreement, since the buyer is settling a debt owed by the seller.

10. Notwithstanding the above, we would point out that, in Advisory Opinion 4.16, which dealt with a similar matter, payment of the domestic income tax by the importer on behalf of the seller was not added to the royalty, and this matter should be clarified as part of the resolution of the present case so as to avoid the inference that the absence of any reference to this matter in the aforementioned Advisory Opinion 4.16 means that the amounts paid by way of income tax arising from a royalty should not be added to the customs value of the goods.

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