Ottawa, Wednesday, September 1, 1993

Appeal No. AP-92-224

IN THE MATTER OF an appeal heard on May 6, 1993, under section 67 of the *Customs Act*, R.S.C. 1985, c. 1 (2nd Supp.);

AND IN THE MATTER OF two decisions of the Deputy Minister of National Revenue for Customs and Excise dated November 2, 1992, with respect to a request for a re-determination made under section 63 of the *Customs Act*.

BETWEEN

REEBOK CANADA INC., A DIVISION OF AVRECAN INTERNATIONAL INC. — **Appellant**

AND

THE DEPUTY MINISTER OF NATIONAL REVENUE FOR CUSTOMS AND EXCISE — **Respondent**

DECISION OF THE TRIBUNAL

The appeal is dismissed.

Sidney A. Fraleigh
Sidney A. Fraleigh
Presiding Member

John C. Coleman
John C. Coleman
Member

Arthur B. Trudeau
Arthur B. Trudeau
Member

Michel P. Granger
Michel P. Granger
Secretary

UNOFFICIAL SUMMARY

Appeal No. AP-92-224

REEBOK CANADA INC., A DIVISION OF AVRECAN INTERNATIONAL INC. — **Appellant**

and

THE DEPUTY MINISTER OF NATIONAL REVENUE FOR CUSTOMS AND EXCISE — **Respondent**

This is an appeal under section 67 of the Customs Act from two decisions of the Deputy Minister of National Revenue for Customs and Excise concerning the appellant's importation of men's athletic/sports shoes and women's walking/casual shoes bearing the "Reebok" trademark and women's leather shoes with rubber soles bearing the "Rockport" trademark. The issue in this appeal is whether the respondent correctly re-appraised the value for duty, as declared by the appellant, to include royalties paid by the appellant to Reebok International Ltd. and The Rockport Company for "the sole and exclusive right and license to use the Trade Marks in connection with the manufacture, advertising, merchandising, promotion, use, distribution and sale" of the footwear bearing the "Reebok" and "Rockport" trademarks.

***HELD**: The appeal is dismissed. The royalties paid by the appellant to Reebok International Ltd. and The Rockport Company are royalties or licence fees paid indirectly in respect of the footwear bearing the "Reebok" and "Rockport" trademarks and as a condition of the sale of the goods for export to Canada within the meaning of subparagraph 48(5)(a)(iv) of the Customs Act and were, therefore, correctly added to the price paid for the footwear for the purposes of determining the value for duty using the transaction value method.*

Place of Hearing:	*Ottawa, Ontario*
Date of Hearing:	*May 6, 1993*
Date of Decision:	*September 1, 1993*
Tribunal Members:	*Sidney A. Fraleigh, Presiding Member* *John C. Coleman, Member* *Arthur B. Trudeau, Member*
Counsel for the Tribunal:	*Shelley Rowe*
Clerk of the Tribunal:	*Janet Rumball*
Appearances:	*Darrel H. Pearson, Richard S. Gottlieb and Daniel Bereskin for the appellant* *Peter M. Southey, for the respondent*

Appeal No. AP-92-224

REEBOK CANADA INC., A DIVISION OF AVRECAN INTERNATIONAL INC. **Appellant**

and

THE DEPUTY MINISTER OF NATIONAL REVENUE FOR CUSTOMS AND EXCISE **Respondent**

TRIBUNAL: SIDNEY A. FRALEIGH, Presiding Member
JOHN C. COLEMAN, Member
ARTHUR B. TRUDEAU, Member

REASONS FOR DECISION

This is an appeal under section 67 of the *Customs Act*[1] (the Act) from two decisions of the Deputy Minister of National Revenue for Customs and Excise (the Deputy Minister) dated November 2, 1992, concerning the appellant's importation of men's athletic/sports shoes and women's walking/casual shoes bearing the "Reebok" trademark under transaction No. 14183-511269963 dated September 24, 1991 (Entry A) and the importation of women's leather shoes with rubber soles bearing the "Rockport" trademark under transaction No. 15362-550106014 dated July 11, 1991 (Entry B). In both decisions, the Deputy Minister re-appraised the value for duty, as declared by the appellant, to include royalties paid by the appellant to Reebok International Ltd.[2] (RIL US) and The Rockport Company (RC).

Three main issues were raised in this appeal. The first issue was whether the transaction value method was the appropriate method for determining value for duty in this appeal. The second issue was whether the royalties paid by the appellant to RIL US and RC constituted royalties or licence fees within the meaning of subparagraph 48(5)(*a*)(iv) of the Act. The last issue was whether the royalties were paid directly or indirectly as a condition of the sale of the "Reebok" and "Rockport" footwear within the meaning of subparagraph 48(5)(*a*)(iv) of the Act.

Subparagraph 48(5)(*a*)(iv) of the Act provides as follows:

> *48.(5) The price paid or payable in the sale of goods for export to Canada shall be adjusted*
>
> *(a) by adding thereto amounts, to the extent that each such amount is not already included in the price paid or payable for the goods, equal to*
>
> *...*
>
> *(iv) royalties and licence fees, including payments for patents, trade-marks and copyrights, in respect of the goods that the purchaser of the goods must pay, directly or indirectly, as a condition of the sale of the goods for export to Canada, exclusive of charges for the right to reproduce the goods in Canada.*

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1. R.S.C. 1985, c. 1 (2nd Supp.).

2. See Exhibit A-4, Restated Articles of Organization, Federal Identification No. 04-2678061, The Commonwealth of Massachusetts, changing name from Reebok U.S.A. Limited, Inc. to Reebok International Ltd.

As was explained by Mr. Steve Bellchambers, Comptroller for the appellant, the royalties included in the re-appraisal of value for duty for Entry A were paid pursuant to the Memorandum of Agreement between RIL US, a company incorporated in the State of Massachusetts in the United States which owns 100 percent of Avrecan International Inc. (Avrecan), and Reebok Canada Inc.,[3] signed December 28, 1988 (the Reebok Agreement). In Article 2.1 of the Reebok Agreement, RIL US grants to the appellant, Reebok Canada Inc.,

> *the sole and exclusive right and license to use the Trade Marks in connection with manufacture, advertising, merchandising, promotion, use, distribution and sale of Products.*[4]

Under Article 3.1 of the Reebok Agreement, in exchange for this right, the appellant is required to pay annually to RIL US an "ongoing royalty" in an amount equal to a specified percentage of the net sale price. Also, by verbal agreement between RIL US and the appellant, the first $100,000 worth of sales is not subject to the payment of the royalty.[5]

The goods imported under Entry A were purchased from two factories, Pou Chen Corporation and Shing Tai Plastic Industry Co., Ltd. in Taiwan, unrelated to the appellant, pursuant to contracts entered into on or about June 21 and July 24, 1991.

According to Mr. Bellchambers, Reebok Trading Far East (RTFE), a company incorporated in Hong Kong and jointly owned by RIL US and Reebok Worldwide Trading (RWT), acted as the appellant's buying agent for Entry A. As buying agent, RTFE normally obtains quotes and samples of the goods and arranges for the manufacturing of the goods, the quality control to ensure adherence to the design requirements and the inspection of the manufacturing process and materials used. RWT normally acts as a subagent for the appellant in respect of the production logistics, such as pricing and delivery from the factories. The orders are placed with RWT, which places them with the factory, following which RTFE confirms the order.

The royalties included in the re-appraisal of value for duty for Entry B were paid pursuant to Article 2.1 of the Memorandum of Agreement between the Highland Import Corporation, d/b/a The Rockport Company, which is 100-percent owned by RIL US, and Reebok Canada Inc., signed January 1, 1989 (the Rockport Agreement), in which RC grants to the appellant, Reebok Canada Inc.,

> *the sole and exclusive right and license to use the Trade Marks in connection with the manufacture, advertising, merchandising, promotion, use, distribution and sale of Products.*[6]

Under Article 3.1 of the Rockport Agreement, in exchange for this right, the appellant is required to pay annually an "ongoing royalty" in an amount equal to a specified percentage of the gross sale price. Mr. Bellchambers clarified at the hearing that, in practice, the appellant

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3. Reebok Canada Inc. and Avia Canada Inc. were amalgamated to form Avrecan International Inc.
4. Transcript of Public Hearing, Canadian International Trade Tribunal, May 6, 1993, at 83-84.
5. *Ibid.* at 66.
6. *Supra*, note 4 at 105.

pays the royalty on the net sale price. Article 3.1 of the Rockport Agreement also provides that the first $10,000 worth of sales is not subject to the royalty.[7]

Unlike the goods imported under Entry A, the goods imported under Entry B were purchased from RC as set out in Reebok Purchase Order No. PF1012F dated December 19, 1990.

Under both the Reebok and Rockport Agreements, the appellant does not pay the fee if the shoes are not sold, are given away or become obsolete.

Mr. Bellchambers explained that, based on the information given by the appellant's representative in the United States, RIL US uses standard agreements called "Manufacturing Agreement" and "Trim Manufacturing Agreement" in connection with the manufacture of "Reebok" and "Rockport" footwear for the appellant. At the hearing, Mr. Bellchambers confirmed that these agreements stipulate that a manufacturer can only make "Reebok" footwear for purchase by RIL US, its wholly owned subsidiaries or those authorized by RIL US to act as a purchaser.

With respect to the issue of valuation, counsel for the appellant submitted that the transaction value method was not appropriate for determining the value for duty, since the value of the royalties cannot be determined until after the importation, as they are based on the net sale price.

Alternatively, counsel for the appellant argued that, no matter which method of valuation is used, the resulting value for duty should be the same. They described the deductive value under paragraph 47(2)(*c*) of the Act as the net sale price, after various expenses, namely, marketing costs, and submitted that the royalties would be deducted as a cost of marketing the goods. They also described the computed value under paragraph 47(2)(*d*) of the Act, which includes general expenses defined as direct and indirect costs, charges and expenses of producing and selling goods for export, and submitted that the royalties would not fall under the description of general expenses and would, therefore, not be included in the computed value. They concluded that, since the royalties would not be included in the value of the goods using the deductive or computed value method, they should not be included in the value using the transaction value method, but should be treated as costs of distribution and accounted for as selling or administrative expenses.

In considering the nature of the royalties, counsel for the appellant argued that the royalties do not constitute royalties or licence fees within the meaning of subparagraph 48(5)(*a*)(iv) of the Act, since they do not relate to property rights. Counsel for the appellant submitted that the royalties relate to the right of exclusive distribution which should be distinguished from trademark, patent and copyright rights. Counsel submitted that the royalties are not paid "in respect of the [shoes]," but are paid for the promise of RIL US and RC that they will not sell similarly marked shoes in the Canadian market except through the appellant.

Counsel for the appellant referred to the decision of the Supreme Court of Canada in *Consumers Distributing Company Limited v. Seiko Time Canada Ltd.*[8] to support its position that the exclusive right to distribute goods covered by a trademark is fundamentally different from an

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7. *Supra*, note 4 at 71.
8. [1984] 1 S.C.R. 583.

exclusive right under a patent or copyright. In the case of a patent or copyright, the holder of right can prevent others not specifically authorized from reselling such goods. However, with respect to trademarked goods, a trademark registration cannot be used to prevent the resale of genuine goods unless there has been a misrepresentation.

According to counsel for the appellant, subparagraph 48(5)(*a*)(iv) of the Act requires that the payment of the fee be a condition of the sale imposed by the vendor and from which it derives, directly or indirectly, a benefit. Counsel argued that the vendors that produced the shoes and exported them to the appellant in Canada derived no benefit from the payment of the royalties. Furthermore, counsel submitted that the exclusive rights, in respect of which the royalties were paid, could not be in relation to the sale from the vendors since they did not own any rights in relation to the trademarks. The royalties, therefore, could not be a condition of sale imposed by the vendor.

Counsel for the respondent submitted that the transaction value method is the appropriate method for determining the value for duty. Counsel submitted that the sale price upon which the appellant pays the royalties can be estimated, since the appellant knows the wholesale price that it intends to charge. Alternatively, counsel submitted that, even if the deductive or computed value method were used, the royalties would still be included in the price paid when determining the value for duty.

Counsel for the respondent submitted that subparagraph 48(5)(*a*)(iv) of the Act does not require the royalty or licence fee to be paid to the vendor, but only requires that the fee be added to the price paid to the vendor.

According to counsel for the respondent, the royalties meet all of the criteria under subparagraph 48(5)(*a*)(iv) of the Act. First, the royalties are royalties or licence fees, as is indicated by the language in the Reebok and Rockport Agreements. Second, the fee is based on the sale price of the footwear and is, therefore, paid in respect of the imported footwear. Finally, counsel argued that the appellant could not purchase the shoes without paying the royalties, and that, therefore, the fee is indirectly a condition of the sale of the imported shoes.

Finally, counsel for the respondent referred to the decision of the Tribunal in *Polygram Inc. v. The Deputy Minister of National Revenue for Customs and Excise*[9] in which it was determined that a fee paid pursuant to a licence agreement between Polygram Inc. and Polygram B.V. for the right to promote certain music and artists and to distribute and sell the recordings to the public was a royalty or licence fee. Counsel submitted that this appeal is similar to the *Polygram* appeal in that the goods were manufactured and invoiced by a company other than the intellectual property holder, the importer could only purchase the goods for resale by virtue of its status as a licensee of the intellectual property right, and the fee could only be estimated at the time of importation because it was also based upon resale of the goods in Canada.

In the view of counsel for the appellant, the decision in *Polygram* can be distinguished on the basis that: (1) the fee in that case was paid in respect of something intrinsic to the imported goods, namely, the music and the right to use the name and likeness of the performer; (2) the importer needed a licence to resell the goods in Canada; (3) the vendor was a licensee

9. Appeal Nos. AP-89-151 and AP-89-165, May 7, 1992; leave to appeal to Federal Court of Canada, Trial Division, refused on December 18, 1992.

and had an obligation to pay the royalty to a third party; (4) the royalty was a condition of sale; and (5) the copyright holder and the vendor were related.

In the Tribunal's view, the royalties paid by the appellant pursuant to the Reebok and Rockport Agreements are royalties or licence fees as described in subparagraph 48(5)(*a*)(iv) of the Act and were, therefore, correctly added to the price paid or payable for the imported footwear bearing the "Reebok" and "Rockport" trademarks in determining the value for duty using the transaction value method.

In response to the first issue, the Tribunal finds that the method of valuation to be used for determining the value for duty in this appeal is the transaction value method. Subsection 47(1) of the Act provides that,

> *[t]he value for duty of goods shall be appraised on the basis of the transaction value of the goods in accordance with the conditions set out in section 48.*

The use of the word "shall" indicates, in the Tribunal's view, that the use of the transaction value method is mandatory, provided that it is applied in accordance with the conditions set out in section 48 of the Act, which states that,

> *the value for duty of goods is the transaction value of the goods if the goods are sold for export to Canada and the price paid or payable for the goods can be determined.*

Section 48 of the Act also establishes other conditions, namely, that there must not be restrictions respecting the disposition or use of the goods, the sale or the price paid or payable must not be subject to a condition for which a value cannot be determined, proceeds from the sale which are to accrue to the vendor must be accounted for in the price, and finally, where the purchaser and vendor are related, that relationship should not influence the price paid or payable, or the transaction value must closely approximate that of goods sold to an unrelated purchaser. From the evidence presented, the Tribunal is satisfied that the conditions of section 48 of the Act are met and, therefore, that the value for duty should be determined using the transaction value method.

With respect to the second issue, the Tribunal finds that the royalties are "royalties and licence fees" within the meaning of subparagraph 48(5)(*a*)(iv) of the Act. Based upon a plain reading, the Tribunal is of the view that subparagraph 48(5)(*a*)(iv) of the Act does not limit the types of fees to be included to those relating to patents, trademarks and copyrights, as is indicated by the word "including." Furthermore, the inclusion of "trade-marks" in the list with the other intellectual property rights, namely, patents and copyrights, indicates that they were not to be treated any differently in respect of royalty and licence fees that are to be included for the purposes of determining value for duty. Thus, the Tribunal does not find it necessary to distinguish between patents, copyrights and trademarks, as was suggested by counsel for the respondent. In the Tribunal's view, the royalties that were paid for the sole and exclusive right and licence to use the "Reebok" and "Rockport" trademarks in connection with the manufacture, advertising, merchandising, promotion, use, distribution and sale of "Reebok" and "Rockport" footwear were paid for "trade-marks" and, therefore, constitute royalty and licence fees under subparagraph 48(5)(*a*)(iv) of the Act.

Finally, the Tribunal finds that the royalties were paid as a condition of the sale of the footwear under Entry A and Entry B. The fact that the phrase "as a condition of the sale" in subparagraph 48(5)(*a*)(iv) of the Act is preceded by the words "directly or indirectly" suggests that, although a fee may not be required pursuant to the terms of the purchase itself, it may still be considered to be a condition of the sale, as long as there is some connection between it and the goods purchased. Applying this interpretation to the facts of this appeal, the Tribunal concludes that the royalties were paid indirectly as a condition of the sale of "Reebok" and "Rockport" footwear for export to Canada.

With respect to Entry A, the testimony of Mr. Bellchambers and the provisions of the "Manufacturing Agreement" and the "Trim Manufacturing Agreement" indicate that RIL US exercises a substantial degree of control over the production of the "Reebok" footwear and that manufacturers are only permitted to produce "Reebok" footwear for subsidiaries of RIL US or purchasers that have been approved by RIL US. Thus, if the appellant did not pay the royalties pursuant to the Reebok Agreement, the Tribunal is of the view that the appellant would not be able to purchase the "Reebok" footwear.

With respect to Entry B, the connection between the payment of the royalties and the sale of the "Rockport" footwear is clearer, since RC is both the vendor and the manufacturer. In the Tribunal's view, if the appellant did not pay the royalties to RC, the latter would simply refuse to manufacture the "Rockport" footwear for purchase by the appellant.

Since the royalties are royalties or licence fees paid indirectly in respect of the footwear bearing the "Reebok" and "Rockport" trademarks and as a condition of the sale of the footwear for export to Canada within the meaning of subparagraph 48(5)(*a*)(iv) of the Act, they are to be added to the price paid for the footwear for the purposes of determining value for duty.

Accordingly, the appeal is dismissed.

<u>Sidney A. Fraleigh</u>
Sidney A. Fraleigh
Presiding Member

<u>John C. Coleman</u>
John C. Coleman
Member

<u>Arthur B. Trudeau</u>
Arthur B. Trudeau
Member