



Ottawa, Tuesday, July 28, 1998

Appeal Nos. AP-96-096 to AP-96-103

IN THE MATTER OF appeals heard on October 28, 1997, under section 67 of the *Customs Act*, R.S.C. 1985, c. 1 (2nd Supp.);

AND IN THE MATTER OF decisions of the Deputy Minister of National Revenue dated August 8, 1996, with respect to a request for re-determination under section 63 of the *Customs Act*.

BETWEEN

STYLE-KRAFT SPORTSWEAR LIMITED

Appellant

AND

THE DEPUTY MINISTER OF NATIONAL REVENUE

Respondent

AND

**PMI FOOD EQUIPMENT GROUP
(A DIVISION OF PREMARK CANADA INC.)**

Intervener

DECISION OF THE TRIBUNAL

The appeals are allowed.

Patricia M. Close
Patricia M. Close
Presiding Member

Arthur B. Trudeau
Arthur B. Trudeau
Member

Robert C. Coates, Q.C.
Robert C. Coates, Q.C.
Member

Michel P. Granger
Michel P. Granger
Secretary

UNOFFICIAL SUMMARY

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Appellant

and

THE DEPUTY MINISTER OF NATIONAL REVENUE

Respondent

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**PMI FOOD EQUIPMENT GROUP
(A DIVISION OF PREMARK CANADA INC.)**

Intervener

These are appeals under section 67 of the *Customs Act* (the Act) from decisions of the Deputy Minister of National Revenue under subsection 63(3) of the Act that certain “payments ... are royalties made in respect of the imported goods and as a condition of the sale of the goods for export to Canada” and that “[a]ccordingly, the payments form part of the dutiable value pursuant to subparagraph 48(5)(a)(iv) of the Customs Act.” The issue in these appeals is whether the amounts paid by the appellant under a licence agreement between it and Mossimo, Inc. (Mossimo) were properly added to the value for duty of imports of certain men’s clothing pursuant to subparagraph 48(5)(a)(iv) of the Act. Alternatively, the respondent argued that portions of the amounts paid pursuant to the licence agreement should be included in the value for duty as “design work” pursuant to clause 48(5)(a)(iii)(D) of the Act.

HELD: The appeals are allowed. The Tribunal finds, on the basis of the evidence in the appeals, that there was no affiliation between the licensor, Mossimo, and the appellant or any ownership or affiliation between the appellant or Mossimo and the third-party manufacturers. Moreover, the goods in issue were purchased and imported by the appellant from third-party manufacturers without any involvement of Mossimo. Although the licence agreement required that the appellant ensure that the goods be produced in accordance with certain standards, the witness for the appellant testified that the appellant has the full right to choose suppliers and that the appellant selects, for each and every style that it makes, the best supplier to produce that style. The appellant provides samples that it purchased from Mossimo to third-party manufacturers outside Canada and the manufacturers duplicate the samples. With respect to the provisions in the licence agreement dealing with preproduction and production samples, the witness for the appellant stated that the appellant does not send production samples to Mossimo. With respect to design and art work from Mossimo, the witness for the appellant indicated that, for the goods in issue, the design and art work purchased from Mossimo were in the form of actual film with screenprint designs on them which was used only by manufacturers inside Canada.

The appellant does use the same manufacturers as Mossimo and buys garments through Mossimo’s agents when it is more cost effective to do so. Of the total volume of the goods in issue, the witness for the appellant estimated that less than 20 percent are purchased and imported through Mossimo’s agents, which were not owned by Mossimo. The Tribunal finds that, without evidence as to any involvement of Mossimo, which is unrelated to the agents, in the transactions between the appellant and third-party manufacturers outside Canada, the fact that the appellant did, with respect to certain transactions, use the same agent as that

used by Mossimo, was not sufficient to find that the payment of licence fees to Mossimo was a condition of the sale for export of the goods produced by those third-party manufacturers.

With respect to the issue of whether portions of the fees are related to design work that is dutiable pursuant to clause 48(5)(a)(iii)(D) of the Act, the Tribunal relied on the evidence that the appellant never received drawings, art work and other written materials from Mossimo and was provided only with samples. The Tribunal finds that samples are not expressly included in the licensed rights as are the “drawings, artwork and other written materials” and that the appellant was invoiced for the samples. The Tribunal is, therefore, not persuaded that the samples constitute “design work” under clause 48(5)(a)(iii)(D) of the Act.

Place of Hearing: Ottawa, Ontario
Date of Hearing: October 28, 1997
Date of Decision: July 28, 1998

Tribunal Members: Patricia M. Close, Presiding Member
Arthur B. Trudeau, Member
Robert C. Coates, Q.C., Member

Counsel for the Tribunal: Shelley Rowe

Clerk of the Tribunal: Anne Jamieson

Appearances: Richard A. Wagner, for the appellant
R. Jeff Anderson, for the respondent
Kenneth H. Sorensen, for the intervener

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STYLE-KRAFT SPORTSWEAR LIMITED

Appellant

and

THE DEPUTY MINISTER OF NATIONAL REVENUE

Respondent

and

**PMI FOOD EQUIPMENT GROUP
(A DIVISION OF PREMARK CANADA INC.)**

Intervener

TRIBUNAL: PATRICIA M. CLOSE, Presiding Member
ARTHUR B. TRUDEAU, Member
ROBERT C. COATES, Q.C., Member

REASONS FOR DECISION

These are appeals under section 67 of the *Customs Act*¹ (the Act) from decisions of the Deputy Minister of National Revenue under subsection 63(3) of the Act that certain “payments ... are royalties made in respect of the imported goods and as a condition of the sale of the goods for export to Canada” and that “[a]ccordingly, the payments form part of the dutiable value pursuant to subparagraph 48(5)(a)(iv) of the Customs Act.” The issue in these appeals is whether amounts paid by the appellant under a licence agreement between it and Mossimo, Inc. (Mossimo) were properly added to the value for duty of imports of certain men’s clothing pursuant to subparagraph 48(5)(a)(iv) of the Act. Subparagraph 48(5)(a)(iv) of the Act provides as follows:

- (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.

Alternatively, the respondent argued that portions of the amounts paid pursuant to the licence agreement should be included in the value for duty as “design work” pursuant to clause 48(5)(a)(iii)(D) of the Act, which provides as follows:

- (iii) the value of any of the following goods and services, determined in the manner prescribed, that are supplied, directly or indirectly, by the purchaser of the goods free of charge or at a reduced cost for use in connection with the production and sale for export of the imported goods, apportioned to the imported goods in a reasonable manner and in accordance with generally accepted accounting principles:
- (D) engineering, development work, art work, design work, plans and sketches undertaken elsewhere than in Canada and necessary for the production of the imported goods.

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

These appeals relate to amounts paid by the appellant to Mossimo pursuant to a licence agreement between the appellant and Mossimo entered into as of September 21, 1993, which granted the appellant the right and licence to use the trademarks “Mossimo,” “M and Box Design” and “Mossimo and M and Box Design” in connection with the design, manufacture, advertisement, promotion, distribution and sale in Canada of certain men’s shirts, T-shirts, jackets and shorts bearing those trademarks (the Licence Agreement).

Mr. George Glen Knott, Merchandise Manager for Style-Kraft Sportswear Limited, appeared as a witness for the appellant. Mr. Knott adopted the contents of the appellant’s brief and testified orally concerning the conduct of the appellant’s business in respect of the importation of the goods in issue.

Mr. Knott gave evidence that Mossimo does not, in any way, own or control the appellant and that the appellant does not have any ownership, commercial or other interest in Mossimo.

In his evidence, Mr. Knott referred to certain specific provisions in the Licence Agreement which he negotiated. In particular, he referred to section 4.2 which sets out manufacturing standards. Mr. Knott testified that he understands this section to mean that Mossimo has the right to reject any products that the appellant may manufacture and to stop companies from manufacturing products that do not meet Mossimo’s quality standards. In Mr. Knott’s view, Mossimo would stop the appellant, not the manufacturers, from producing products that do not meet Mossimo’s quality standards.

Mr. Knott also referred to sections 4.3 and 4.4 which deal with preproduction samples. According to Mr. Knott, these sections provide that, for any garment produced by the appellant, a preproduction sample must be sent to Mossimo for its approval prior to production of the garments. In addition, following commencement of production, the appellant is to send two production samples and follow up bimonthly with additional samples and other products that may be in progress for approval. Mr. Knott indicated that, in practice, the appellant does not send production samples as required by section 4.4.

Section 4.5 of the Licence Agreement deals with third-party manufacturers and provides, in part, that the appellant “must independently determine that each third party manufacturer is capable of manufacturing the Licensed Products strictly in accordance with Section 4.2 of [the Licence] Agreement.” When asked whether section 4.5 provided the appellant with the full right to choose suppliers, Mr. Knott responded positively and stated that the appellant selects the best manufacturer for each and every style that it makes. According to Mr. Knott, Mossimo does not have any control over the appellant’s choice of manufacturers. The appellant deals directly with the manufacturers, does not have an agent’s agreement, travels exclusively overseas and selects manufacturers on its own.

According to Mr. Knott, the appellant does not operate any manufacturing facilities of its own and subcontracts with third-party manufacturers around the world and in Canada, none of which are owned or controlled by the appellant or have a relationship with Mossimo. In support of his statement regarding Mossimo, Mr. Knott introduced a letter from a representative of Mossimo which states, in part, that Mossimo has no relationship with any of the manufacturers.²

Mr. Knott stated that, in making its decision as to the third-party manufacturers from which to source its products, the appellant looks at a variety of factors, including price and capabilities of domestic manufacturers to produce certain products. In particular, Mr. Knott pointed out that, with respect to offshore

2. Exhibit A-8.

third-party manufacturers, the appellant may choose not to use those manufacturers used by Mossimo, as such manufacturers “realize that [Mossimo’s] only business is [its] branded business ... [and are] demanding perhaps higher payments than [the appellant is] willing to pay for the Canadian market.”³ Given the appellant’s prior relationships and experience with certain offshore third-party manufacturers, the appellant is often able to obtain a better price from its own manufacturers rather than from those used by Mossimo.

However, the appellant does use some of the same manufacturers as Mossimo. Mr. Knott indicated that purchases from manufacturers used by Mossimo represent under 20 percent of the appellant’s business. When purchasing from those manufacturers, the appellant buys garments through Mossimo’s agents when it is more cost effective to do so. Mr. Knott stated that Mossimo is not related to the agents used by the appellant.

Mr. Knott also discussed section 11 of the Licence Agreement which sets out the termination provisions. In particular, Mr. Knott referred to section 11.8.3 which provides, in part, that the appellant “shall discontinue and cause its third party manufacturers, distributors and other contractors to discontinue to manufacture, promote, distribute or sell in any manner the Licensed Products ... and shall execute any and all documents or instruments necessary to terminate or cancel its registered user agreement(s).” He described this section as indicating that, if the Licence Agreement is terminated, the appellant, not Mossimo, must immediately stop production by its suppliers of any goods being made under the Mossimo label.

Mr. Knott explained, in general terms, the process leading up to and following the production of goods bearing the Mossimo trademarks. Mossimo indicates to the appellant, in the form of sketches, the themes and styles that it is planning to run for the next season. The appellant may also purchase samples and, in some cases, design and art work, from Mossimo. The appellant generally examines sketches, samples, design drawings and art work and determines which represent the most popular styles, colours and garments. The appellant also reviews the information that Mossimo provides to it concerning the factories that it intends to use and the prices that it has negotiated. The appellant then decides which items it intends to send to its manufacturers inside and outside Canada for cost estimates and confirmation of the ability of suppliers to produce certain garments.

The design drawings and art work purchased from Mossimo were primarily in the form of actual film with screenprint designs used by domestic manufacturers.

Design drawings and art work are not generally available for third-party manufacturers outside Canada that are not also used by Mossimo. In those circumstances, the appellant provides to a third-party manufacturer a sample of the garment purchased by the appellant from Mossimo or a sample of a garment purchased elsewhere by the appellant and then modified with design changes.

Mr. Knott further indicated that the appellant has a merchandising department which, in certain instances, creates designs and design ideas that are sent to offshore third-party manufacturers, that then interpret these designs and design ideas into garments and send the appellant finished preproduction sample garments for its approval. Manufacturers may be provided with either the actual sample or a cutting from a sample. The manufacturers then send cuttings, fabric swatches or embroidery designs for the appellant’s approval, following which a prototype will be produced. The appellant sends Mossimo samples of the products that it is selling in the Canadian market. Where the appellant uses one of the manufacturers also

3. *Transcript of Public Hearing*, October 28, 1997, at 85.

used by Mossimo and Mossimo deals with a particular agent to purchase from that manufacturer, Mossimo does not provide design information to the appellant and the appellant deals directly with the agent.⁴

Mr. Knott introduced samples of certain of the goods in issue. With respect to two of the samples, men's black crinkle nylon jackets, style Nos. 525BAL⁵ and 526EDW,⁶ manufactured in India, Mr. Knott indicated that the appellant designed the jacket and that Mossimo was not involved in the design process. Mr. Knott explained that, within the sample line received from Mossimo, there are instances where the appellant feels that it needs additional garments and that, in this instance, the appellant was of the view that it needed some outerwear for that particular fall season. The appellant sent the manufacturer in India an original garment which had been purchased in a store in Europe or North America along with the design requirements and additional changes requested by the appellant.

Referring to a sample of a yarn-dyed, plaid, elastic-waist, pull-on short⁷ similar in construction and appearance to one of the garments in issue, Mr. Knott indicated that it was the original sample purchased from Mossimo on which that garment in issue, that was manufactured in Bangladesh, was based.

The agreement between the third-party manufacturers outside Canada and the appellant for the purchase of the goods is generally in the form of a purchase order and an open letter of credit to import the garments on the desired delivery date. Goods are then shipped directly from the offshore manufacturers to the appellant.

In argument, counsel for the appellant submitted that there are three criteria which must be met for royalty payments to be dutiable under subparagraph 48(5)(a)(iv) of the Act. These three criteria are: (1) the payments are a royalty or licence fee; (2) the payments are in respect of the goods; and (3) the payments are paid, directly or indirectly, as a condition of the sale of the goods for export to Canada. Counsel submitted that each of the criteria must be met in order for a royalty to be dutiable.

With respect to the first criterion, counsel for the appellant referred to definitions of the word "royalty," as well as the decision of the Tax Court of Canada in *Grand Toys Ltd. v. The Minister of National Revenue*,⁸ and submitted that, in order for a payment to be a royalty, that payment must be for a share of a sale or profit which is contingent on that sale or profit. Counsel submitted that the fees clearly meet the test for a royalty, since they are paid by the appellant, they are contingent on the appellant's sale of the goods, and they are a percentage share of those sales.

As to whether the fees were "in respect of the goods," counsel for the appellant submitted, based on the Tribunal's decision in *Polygram Inc. v. The Deputy Minister of National Revenue for Customs and Excise*,⁹ that to determine whether a royalty payment is "in respect of the goods," one must find if it is

4. *Transcript of Public Hearing*, October 28, 1997, at 92.

5. Exhibit A-1.

6. Exhibit A-2.

7. Exhibit A-3.

8. 90 D.T.C. 1059, Court File No. 88-1502(IT), December 13, 1989. In that decision, reference was made to *Vauban Productions v. The Queen* in which it was stated at 67: "The term 'royalties' normally refers to a share in the profits or a share or percentage of a profit based on user or on the number of units, copies or articles sold, rented or used."

9. Appeal Nos. AP-89-151 and AP-89-165, May 7, 1992. Leave to appeal denied, Court File No. 92-T-1967, December 18, 1992 (F.C.T.D.).

connected to or relates to the goods in issue. The royalty must relate to tangible goods, not a service or other intangible. In counsel's view, the fees were connected to the goods as set out in section 1.1 of the Licence Agreement, which provides that the licence is for the use of the licensed rights in connection with the design, manufacture, advertisement, promotion, etc., of the licensed products. On this basis, counsel submitted that the fees relate to the products and that the second criterion is met.

With respect to the third criterion, that is, whether the royalty was paid, directly or indirectly, as a condition of the sale of the goods for export to Canada, counsel for the appellant submitted three ways in which this criterion may be met.

First, the criterion may be met if there is an explicit condition in the export sales agreement between the vendor and the importer that royalties must be paid. Counsel for the appellant referred to *Signature Plaza Sport Inc. v. Her Majesty the Queen*¹⁰ as an example of when there is such an explicit condition. In *Signature Plaza*, counsel submitted, the Federal Court of Appeal held that the royalty holder was, in fact, the vendor, and, in the contractual arrangements with the purchaser, Signature Plaza Sport Inc., as indicated by the invoices, there was not only the price that they paid for the goods but also the royalty payment which was to be paid at the same time.

Second, the criterion may be met if the vendor of the goods is also the owner or licensee of the rights for which the royalties are paid by the purchaser and the vendor would not sell and export the goods to the importer if the royalties were not paid, or would stop selling for export if the importer failed to pay royalties. Counsel for the appellant referred to *Signature Plaza, Polygram and PMI Food Equipment Group Canada, A Division of Premark Canada Inc. v. The Deputy Minister of National Revenue*¹¹ as examples of this scenario.

Third, the criterion may also be met, counsel for the appellant argued, if the vendor of the goods does not own or have any licence to use the rights for which the royalties are paid by the purchaser, but the vendor is owned or controlled by the owner or licensee of the rights, or the owner or licensee has the commercial power of the owner to stop the vendor from selling for export to the importer if the importer does not pay the royalties. Counsel referred to the decisions in *Polygram, Reebok Canada Inc., A Division of Avreca International Inc. v. The Deputy Minister of National Revenue for Customs and Excise*¹² and *Nike Canada Ltd. v. The Deputy Minister of National Revenue*¹³ by way of examples.

Counsel for the appellant specifically addressed the recent decision in *Reebok Canada, a division of Avreca International Inc. v. The Deputy Minister of National Revenue for Customs & Excise*¹⁴ (*Reebok-FC*) and submitted that it affirms the Tribunal's decision in *Reebok* that, on the basis of the facts,

10. 169 N.R. 321, Federal Court of Appeal, Court File No. A-453-90, February 18, 1994.

11. Canadian International Trade Tribunal, Appeal No. AP-95-123, January 10, 1997. The Tribunal's decision has been appealed and cross-appealed to the Federal Court of Appeal in Court File Nos. A-198-97 and A-283-97.

12. Canadian International Trade Tribunal, Appeal No. AP-92-224, September 1, 1993.

13. Canadian International Trade Tribunal, Appeal Nos. AP-95-197 to AP-95-202 and AP-95-206 to AP-95-212, October 10, 1997. The Tribunal's decision has been appealed to the Federal Court of Appeal in Court File No. A-905-97.

14. Unreported, Court File No. T-864-94, June 30, 1997. The Tribunal's decision in *Reebok* was appealed to the Federal Court of Canada - Trial Division and upheld. However, the latter is currently under appeal to the Federal Court of Appeal in Court File No. A-642-97.

where there was control by Reebok International Ltd. and The Rockport Company of the vendors, the payment of the royalty was a condition of the sale for export to Canada. Counsel submitted that the final conclusion and the real conclusion in *Reebok-FC* is at page 15, where it is stated:

The respondent urges that the relationships of the parties, the licence agreements, and the Manufacturing and Trim Agreements of RIL US with its foreign manufacturers support the conclusion that payment of royalties under the Reebok Agreement was an indirect condition of the applicant obtaining trade-marked shoes, and the same may be said under the Rockport Agreement. In my opinion, the inferences and conclusions of fact drawn by the CITT in respect of the royalties and the licence Agreements was within the discretion of the CITT on the basis of the evidence before it. The conclusion was commercially sensible and logical on the basis of the evidence.

In the case of the Reebok Agreement, RIL US controlled the supply by its third party manufacturers in Taiwan of trade-marked Reebok shoes. The conclusion drawn by CITT, was that failure of the appellant to pay royalties under its agreement with RIL US would result in termination of supply of footwear to the appellant. In the case of the Rockport Agreement, the relationship was even clearer, if the royalty were not paid to Rockport, the supplier, it is not illogical or perverse to conclude that supply to the appellant of Rockport footwear would be cut off. In either case, failure to pay would also result in [damages] against the appellant.

Conversely, counsel for the appellant submitted that royalty payments are not a condition of sale for export if the owner or licensee of the rights for which the royalties are paid has no ability to stop the vendor from selling and exporting goods to the purchaser in the event that the purchaser fails to pay any royalties. Counsel referred to the Tribunal's decisions in *Jana & Company v. The Deputy Minister of National Revenue*¹⁵ and *Mattel Canada Inc. v. The Deputy Minister of National Revenue*¹⁶ as examples of these circumstances. Counsel also referred to the Technical Committee on Customs Valuation¹⁷ Advisory Opinion 4.13 (July 1994)¹⁸ in support of his submission that, in such circumstances, a royalty payment would not be dutiable.

Finally, counsel for the appellant recounted that the various facts that he submitted had been established in evidence and clearly showed that the payment of the royalties by the appellant was not a condition of any purchases by the appellant. In particular, he referred to the fact that the Licence Agreement is between the appellant and Mossimo and that there is no affiliation between these two companies. The goods in issue are all purchased and imported from third-party manufacturers, and there is no ownership or affiliation between the appellant or Mossimo and the third-party manufacturers. The appellant is granted the full rights with regard to manufacture and hires and fires manufacturers without any say by Mossimo. The appellant provides samples that it purchases from Mossimo to third-party manufacturers that then duplicate the samples. In addition, most of the manufacturers used by the appellant are not used by Mossimo. Only 20 percent of the goods in issue are purchased from Mossimo's agents, which are not owned by Mossimo.

15. Appeal No. AP-94-150, September 3, 1996.

16. Appeal Nos. AP-95-126 and AP-95-255, January 15, 1997. The Tribunal's decision has been appealed and cross-appealed to the Federal Court of Appeal in Court File Nos. A-291-97 and A-292-97.

17. *GATT Agreement and Texts of the Technical Committee on Customs Valuation*, Customs Co-operation Council, Brussels.

18. Advisory Opinion 4.13 covers a situation where an importer paid a trademark royalty to a related licensor, but purchased sports bags from various unrelated suppliers. The Technical Committee on Customs Valuation found that the royalty was not dutiable and reasoned that the "imported goods are purchased from various suppliers under different contracts and the payment of the royalty is not a condition of the sale of these goods. The buyer does not have to pay the royalty in order to purchase the goods. Therefore, it should not be added to the price actually paid or payable."

With respect to the provisions in the Licence Agreement dealing with preproduction and production samples, the evidence was that the parties do not even abide by those provisions. Design drawings and art work obtained from Mossimo are used only in Canadian production and are paid for by the appellant when they are imported. Labels are also paid for separately upon importation. Finally, the appellant pays withholding taxes on its royalty payments, whether they are domestically made or imported goods.

Counsel for the appellant submitted that none of the three scenarios, where a condition of sale might be found to exist were present in the facts in these appeals and that the facts were most similar to those in *Jana*, where the Tribunal concluded that the royalty payments were not a condition of the sale for export to Canada. Counsel submitted that there was no explicit condition in any agreement, oral or written, between the appellant and the third-party manufacturers concerning the imported goods that royalty payments be made. Counsel argued that Mossimo owns all of the rights and that the vendors, the third-party manufacturers, are not the licensors and have no rights. Finally, with respect to the scenario where the vendor is owned or controlled by or subject to the commercial power of the licensor, counsel submitted that Mossimo could not stop the vendors/manufacturers from selling to the appellant, since it has no commercial power over the vendors that manufacture for various people and no contractual relationship with the vendors.

Although counsel for the appellant disputed the propriety of the respondent raising, for the first time in its brief, the question as to whether the payments could be considered “assists” in accordance with clause 48(5)(a)(iii)(D) of the Act, counsel submitted that the only thing which is given to the vendors (the third-party manufacturers) by the purchaser (the appellant) are samples, which do not qualify as engineering, development work or art work.

The intervener’s representative agreed with counsel for the appellant’s submissions and, in particular, his interpretation of *Reebok* and *Nike*. However, the representative made additional submissions regarding the issue of “assists.” He submitted that, in order to be considered “assists,” the goods must be enumerated in clause 48(5)(a)(iii)(D) of the Act, i.e. they must be “engineering, development work, art work, design work, plans and sketches,” must be necessary in the production stage of the imported goods, must originate elsewhere than in Canada and must be actually supplied to the vendor and used outside Canada. The representative submitted that any art work or designs provided to the appellant never leave Canada and, therefore, that the requirements of clause 48(5)(a)(iii)(D) are not met.

Counsel for the respondent submitted that the Tribunal should disregard any of Mr. Knott’s statements concerning Mossimo’s knowledge or views of contracts between the appellant and various third-party manufacturers. In counsel’s view, Mr. Knott is not in a position to give evidence that is only within Mossimo’s knowledge. However, counsel highlighted one fact which was uncontested, which is that, without the licence, the appellant would not be able to sell the Mossimo products in Canada. In counsel’s view, this fact is sufficient to establish that the payment of the royalty is a condition of the sale for export to Canada.

It was the view of counsel for the respondent that the Federal Court of Canada - Trial Division in *Reebok-FC* did not consider control or the fact that there was a parent company to be positive or determining factors. In counsel’s view, in *Reebok-FC*, the Federal Court of Canada - Trial Division relied on the agreement that enabled the purchase of the goods and on the fact that the royalties related to the use and the intellectual property value of the goods in issue. Counsel submitted that the Federal Court of Appeal in *Signature Plaza* also held that it was by virtue of the agreement and the inherent intellectual property rights that the royalty was found to be dutiable.

Counsel for the respondent submitted that this view is consistent with the Tribunal's view in *Nike*, where the Tribunal stated that "the Federal Court indicated that, as the royalties were related to the exclusive use and sale of goods bearing trademarks of value and were payments relating to the valuable intellectual property rights associated with the purchase and sale of the goods in question, they should be considered a condition of the sale for export to Canada and, thus, included in the value for duty."¹⁹

Counsel for the respondent noted that the appellant in these appeals is making the same arguments as did the appellant in *Nike*, namely, that the licensor and the manufacturer are unrelated, that the licensor is not the vendor of the imported goods and that the licensor does not exert control over the sales for export through ownership, contract or otherwise to make the manufacturer's sales conditional. Counsel submitted that, in *Nike*, the Tribunal referred to the fact that the Federal Court of Canada - Trial Division in *Reebok-FC* did not focus on the issue of control of Reebok International Ltd. over Reebok Canada, a division of Avrecon International Inc. in finding that the royalty payments were a condition of the sale for export to Canada and rejected the appellant's arguments.

In counsel for the respondent's view, the correct question to be asked by the Tribunal is whether the appellant could have, or would have, purchased and imported the goods without the Licence Agreement. Counsel submitted that, if not, the fee is a condition of the sale of the goods for export. Counsel submitted that it is clear, given the Licence Agreement between the appellant and Mossimo, that Mossimo is providing a right to the appellant to have access to its intellectual property to its designs, for a fee, and, if that fee is not paid, section 11 of the Licence Agreement can give rise to a termination of that agreement. Counsel argued that, without the payment of the fee, Mossimo will not allow the appellant to continue to promote, distribute and sell or otherwise manufacture the licensed goods, nor will Mossimo continue to provide samples which are sent to the manufacturers and used to produce patterns. In support, counsel referred to specific provisions in the Licence Agreement, including section 4.2, "Manufacturing Standards," section 4.5, "Third Party Manufacturers," section 5.8, "Inspections" and section 11, "Termination."

In the event that the Tribunal found that the fees are not dutiable royalties, counsel for the respondent raised, as an alternative argument, that portions of the fees are payable for design work and that these portions should be included in the value for duty of the goods in issue pursuant to clause 48(5)(a)(iii)(D) of the Act. Counsel pointed out that section 1.1 of the Licence Agreement expressly provides that it is for the right and licence to use the licensed rights in connection with the "design." Counsel submitted that the only evidence before the Tribunal is that the design work with respect to the jackets brought as exhibits was done in Canada by the appellant. Counsel agreed that the value of this design work would not, therefore, be included in the value for duty. However, counsel submitted that there are no further examples where any sort of design work was done in Canada with respect to the remaining goods in issue. Counsel took the view that, in those circumstances, it could be presumed that the design work with respect to the remaining goods in issue was done outside Canada.

As for art work and design drawings, counsel for the respondent accepted the evidence of Mr. Knott that the only type of art work sent to Canada is the film itself and that, since the film never left Canada, it could not be considered an assist. However, counsel queried the impact of section 3.1 of the Licence Agreement which provides that "MOSSIMO has already delivered to LICENSEE all drawings, artwork and other written materials included in the Licensed Rights and shall ship to LICENSEE ... samples of all of the Licensed Products." Counsel referred to the evidence of Mr. Knott that the appellant received the samples but that, other than the film, Mossimo had not sent any art work, drawings or other written materials.

19. *Supra* note 13 at 10.

With respect to the samples that were provided by Mossimo to the appellant and, in turn, sent to the manufacturers, counsel for the respondent submitted that these are assists within the meaning of clause 48(5)(a)(iii)(D) of the Act. Counsel submitted that, although samples are not specifically enumerated under clause 48(5)(a)(iii)(D), development work, art work and design work, as well as plans and sketches, are embodied in those samples which are produced by Mossimo in the United States. Although the appellant pays for the samples, the appellant does not pay for the underlying design work, unless a specific design is requested. In counsel's view, the samples are necessary for production, and, as such, the value of the design work to make the samples should be included in the value of the goods in issue.

Finally, counsel for the respondent noted that it is not clear exactly what portion of the value of the net percentage payable under the Licence Agreement could be included as an assist. Counsel stated that this was something that the parties would have to work out if it was determined that a portion of the value was an assist.

The Tribunal has reviewed its previous decisions and those of the Federal Court of Canada concerning the issue of the inclusion of royalties in the value for duty of imported goods. It is generally accepted that, in order for a payment to be dutiable under subparagraph 48(5)(a)(iv) of the Act, it must: (1) be a royalty or licence fee; (2) be in respect of the imported goods; and (3) be paid, directly or indirectly, as a condition of the sale of the goods for export to Canada. The appellant does not dispute that the payments are royalties or that they are "in respect of the goods." However, the appellant disputes that the royalties were paid, directly or indirectly, as a condition of the sale of the goods for export to Canada.

The issue of determining when a payment is a condition of a sale of goods for export to Canada is a controversial one and has been the subject of great debate between various importers and the Department of National Revenue. The decision in *Reebok-FC* provides some guidance on this issue and has been subsequently applied by the Tribunal in *Nike* and *Chaps Ralph Lauren, A Division of 131384 Canada Inc. and Modes Alto-Regal, Inc. v. The Deputy Minister of National Revenue*.²⁰ In *Nike and Chaps*, the Tribunal interpreted the general statement that the royalties "related to the exclusive use and sale of goods bearing trademarks of value and were payments relating to the valuable intellectual property rights associated with the purchase and sale of the goods in question"²¹ as being the test applied by the Federal Court of Canada - Trial Division to determine whether the payment of a royalty is a condition of a sale for export. However, upon further reflection and consideration of the arguments made in the context of these appeals, the Tribunal is persuaded that this general statement must be interpreted and applied in the context of the particular facts in *Reebok-FC* and in conjunction with the additional statement of the Federal Court of Canada - Trial Division that its finding is consistent with the previous decisions in *Polygram* and *Signature Plaza*.

In *Reebok*, with respect to one of the transactions at issue, there was a "Manufacturing Agreement" and a "Trim Manufacturing Agreement" between the manufacturers and the licensor. The Tribunal found that these facts indicated that the licensor exercised a substantial degree of control over the production of the licensed goods and that the manufacturers were only permitted to produce the licensed goods for subsidiaries of the licensor or purchasers that had been approved by the licensor. With respect to the second transaction, the licensor was both the vendor and the manufacturer. The Tribunal concluded, based on the facts relating to both transactions, that, if the appellant did not pay the royalties pursuant to the licence agreements, the appellant would not have been able to purchase the licensed goods.

20. Appeal Nos. AP-94-212 and AP-94-213, December 22, 1997. The Tribunal's decision has been appealed and cross-appealed to the Federal Court of Appeal in Court File No. A-53-98.

21. *Supra* note 13 at 10.

In *Polygram*, the appellant imported sound recordings from foreign affiliated companies, one of which was the licensor in a licence agreement with the appellant which gave the appellant the right to promote certain music and artists and to distribute and sell sound recordings to the public. The Tribunal found that, without the signed licence agreement, which clearly sets out the appellant's obligation to pay a fee, the appellant would not have been able to purchase the sound recordings from its foreign affiliates and import them into Canada.

A review of *Signature Plaza* indicates that the Federal Court of Appeal did not merely rely on the fact that the royalties related "to the valuable intellectual property rights associated with the purchase and sale of the goods in question" to find that the royalties were dutiable. Rather, the Federal Court of Appeal did "an analysis of the rights and obligations created by the agreements" and stated that this is "normally a question of mixed law and fact."²² The Federal Court of Appeal then drew conclusions from its analysis of the rights and obligations resulting from the agreements and its understanding of the relationship between the licensor, the licensee/purchaser in Canada and the third-party manufacturers outside Canada. The Federal Court of Appeal found that the licensor, which arranged for the offshore purchase, cutting, making and trimming of fabrics by offshore plants and the delivery to the licensee/purchaser in Canada of the finished products, was, in effect, the vendor and not an agent of the licensee, as contended by the licensee. In reaching this conclusion, the Federal Court of Appeal relied, in particular, on the fact that the licensor maintained the exclusive right to produce the licensed goods. Therefore, royalties paid by the licensee/purchaser in Canada to the licensor were found to be a condition of the sale of the licensed goods for export to Canada under subparagraph 48(5)(a)(iv) of the Act.

The royalties paid pursuant to the Licence Agreement in these appeals can be distinguished from those in *Reebok-FC*, *Polygram* and *Signature Plaza*. The Tribunal accepts that the amounts were paid for the exclusive use and sale of goods bearing the Mossimo trademarks and the valuable intellectual property rights associated with the purchase and sale of those goods. However, the Tribunal is not persuaded by the evidence in these appeals that the licensor became, in effect, the vendor and could have affected the appellant's ability to purchase the goods in issue from the third-party manufacturers outside Canada if the appellant had not paid the royalties to the licensor.

In the Tribunal's view, the royalties at issue are similar to those considered and found not to be dutiable in *Jana*. In *Jana*, the royalties were paid for the right to produce, promote, sell and distribute in Canada clothing bearing certain trademarks. There was no relationship, contractual or otherwise, between the manufacturers of the clothing and the licensors to suggest that there was some connection between the sale of the clothing by those manufacturers for export to the appellant in Canada and the payment of the royalties by the appellant to the licensors. The licence agreements governing the royalties in *Jana* indicated that the licensors did maintain certain quality control rights, such as the right to inspect samples and production facilities and processes, and that the licensors may have been able to influence some manufacturers because of the concentration of business that they did with those manufacturers. However, there was evidence in that case that the licensors provided Jana & Company, not the manufacturers, with samples, designs, etc., and permitted the appellant to have the clothing manufactured by a company of its choice. Moreover, in practice, the appellant's choices of manufacturers were never questioned, and the licensors did not exercise their rights concerning inspection of facilities and samples.

In *Jana*, the Tribunal found that the evidence was not sufficient to show that the licensors exercised a substantial degree of control over the manufacturers such that Jana & Company's ability to purchase clothing from those manufacturers would be restricted if it did not pay the royalties to the licensors. Taking

22. *Supra* note 10 at 12.

all of the facts into account, the Tribunal found that the royalties were, therefore, not a condition of the sale of the goods for export to Canada.

Finally, the Tribunal noted, in *Jana*, that its finding was consistent with Advisory Opinions 4.8 and 4.13 of the Technical Committee on Customs Valuation which, it stated, provide circumstances where the obligation to pay a royalty arises from a separate agreement unrelated to the sale for export of the goods or where the purchaser does not have to pay the royalty in order to purchase the goods are circumstances where the royalty should not be included in the value for duty of those goods.

Like in *Jana*, the Tribunal finds, on the basis of the evidence in these appeals, that there is no affiliation between the licensor, Mossimo, and the appellant, nor is there any ownership or affiliation between the appellant or Mossimo and the third-party manufacturers. The goods in issue were purchased and imported by the appellant from third-party manufacturers without any involvement of Mossimo.

Counsel for the respondent referenced several provisions in the Licence Agreement, including sections 4.2, 4.5, 5.8 and 11, which, he submitted, showed Mossimo's involvement in the importations of the goods in issue. In the Tribunal's view, it is not possible to properly determine the legal nature of the contractual relationship between the appellant and Mossimo based solely on the legal language used in the Licence Agreement. The Tribunal must conduct an analysis of the rights and obligations created by the Licence Agreement.²³ Although section 4.5 of the Licence Agreement required that the appellant ensure that manufacturers produce goods in accordance with certain standards, Mr. Knott testified that the appellant has the full right to choose suppliers and that the appellant selects, for each and every style that it makes, the best supplier to produce that style. The appellant provides samples that it purchases from Mossimo to third-party manufacturers outside Canada and the manufacturers duplicate the samples. With respect to the provisions in the Licence Agreement dealing with preproduction and production samples, Mr. Knott stated that the appellant does not send production samples to Mossimo. With respect to design drawings and art work from Mossimo, Mr. Knott indicated that, for the goods in issue, the design drawings and art work purchased from Mossimo were in the form of actual film with screenprint designs on them, which were used only by manufacturers inside Canada.

Mr. Knott stated that the appellant also uses the same manufacturers as Mossimo and buys garments through Mossimo's agents when it is more cost effective to do so. Of the total volume of the goods in issue, Mr. Knott estimated that less than 20 percent of the goods in issue are purchased and imported through Mossimo's agents. He testified that these agents are not owned by Mossimo. In the Tribunal's view, without evidence as to any involvement of Mossimo, which is unrelated to the agents, in the transactions between the appellant and third-party manufacturers outside Canada, the fact that the appellant did, with respect to certain transactions, use the same agent as that used by Mossimo is not sufficient to find that the payment of licence fees to Mossimo was a condition of the sale for export of the goods produced by those third-party manufacturers.

The Tribunal notes that the facts in these appeals are significantly different from those in *Chaps*. In *Chaps*, the Tribunal found the relationship between the agent and licensor to be significant in determining whether the payment of certain royalty fees was a condition of the sale for export of the goods. The Tribunal found "that the commercial reality for the goods in issue [was] that the sale of [the goods in issue] for export to Canada would not occur if the royalties were no longer being paid. Polo Sourcing, the agent for Modes, had to inspect the merchandise before the manufacturers could cash the letters of credit and ship the merchandise to Canada. Polo Sourcing was, at that time, a subsidiary of Polo US. Although Polo Sourcing was acting as agent for Modes in the day-to-day transactions, it would not necessarily do so in the case of the

23. *Supra* note 10 at 12.

termination of the licence agreements, at which point, according to the licence agreements, the goods, which are in the process of being manufactured, come under the option of possession by the licensor.²⁴ In these appeals, the appellant does purchase goods using agents also used by Mossimo. However, those agents are not related to Mossimo, and there is no evidence of any involvement of Mossimo in the purchases by the appellant or in directing the agents' activities in respect of the purchases by the appellant, such that the failure by the appellant to pay the licence fees to Mossimo could result in the agent refusing to complete transactions with the third-party manufacturers outside Canada.

In view of the foregoing, the Tribunal is of the view that the fees are royalties in respect of the goods in issue. However, the fees were not required to be paid, directly or indirectly, as a condition of the sale of the clothing for export to Canada, and the fees should not, therefore, be added to the price paid or payable for the imported clothing pursuant to subparagraph 48(5)(a)(iv) of the Act.

Having determined that the fees are not dutiable royalties pursuant to subparagraph 48(5)(a)(iv) of the Act, the Tribunal will consider the respondent's alternative argument that portions of the fees relate to design work, which is dutiable pursuant to clause 48(5)(a)(iii)(D). To decide this issue, the Tribunal must determine the following: (1) whether the fees are payments for design work; (2) whether the fees are for goods or services supplied, directly or indirectly, by the appellant, for use in the production and sale for export of the imported goods; and (3) whether the design work is undertaken elsewhere than in Canada and is necessary for the production of the imported goods.

With respect to the first issue, whether the fees are payments for design work, the Tribunal notes that in *Capital Garment Co. Inc. v. The Deputy Minister of National Revenue*,²⁵ it found that the term "design" may be interpreted as "an outline, sketch, or plan, as of the form and structure of a work of art, an edifice, or a machine to be executed or constructed."²⁶ A "plan" was defined as "a formulated and esp. detailed method by which a thing is to be done; a design or scheme."²⁷ Section 1.1 of the Licence Agreement specifically grants the appellant certain rights in connection with design. Section 3.1 of the Licence Agreement provides that Mossimo provided the appellant with all drawings, art work and other written materials included in the licensed rights. In the Tribunal's view, drawings, art work and other written materials may be considered to be design work within the scope of clause 48(5)(a)(iii)(D) of the Act.

However, as stated above, the Tribunal finds it relevant not only to look at the legal language used in the Licence Agreement but also to analyze the rights and obligations created by the Licence Agreement. The Tribunal notes that Mr. Knott indicated that the appellant never received such drawings, art work and other written materials from Mossimo. According to him, the appellant was provided only with samples. However, the samples are not expressly included in the licensed rights under section 3.1 of the Licence Agreement as are the "drawings, artwork and other written materials" and the appellant was invoiced for the samples. The Tribunal, therefore, is not persuaded that the samples at issue constitute "design work" under clause 48(5)(a)(iii)(D) of the Act.

The Tribunal notes that the facts in these appeals are significantly different from those in *Chaps*, where the Tribunal found that certain fees paid pursuant to design agreements were for "design work" and were correctly included in the value for duty of certain imported goods in accordance with clause 48(5)(a)(iii)(D) of the Act. In *Chaps*, there were design agreements which provided, in part, that the licensee "desires, in order to exploit the rights granted to it under the [licence agreements], to engage and

24. *Supra* note 20 at 14.

25. Canadian International Trade Tribunal, Appeal No. AP-96-002, June 3, 1997.

26. *Ibid.* at 7.

27. *Ibid.*

retain [Mr. Ralph] Lauren to create and provide to [it] the designs for its line of Licensed Products.²⁸ The agreements further provided that Mr. Ralph Lauren would furnish such designs and render such services on the basis set forth in the design agreements and included provisions for Mr. Lauren's compensation based on the net sale price of licensed products sold under the design agreements.

In *Chaps*, pursuant to the design agreements, the appellants supplied, either directly or through their agent, the manufacturers with "broad design themes and concepts," written descriptions, photographs, concept boards and colour stats, which provide more detailed information concerning the style, colours and fabrics for the items present in the fashion grouping, as well as specifications, if they were available, and fabric swatches and information about the fabric mill. The Tribunal was persuaded that these items constituted "design work" within the meaning of clause 48(5)(a)(iii)(D) of the Act. The Tribunal was further of the view that, without this "design work," the manufacturers would not have been able to produce the "Ralph Lauren" clothing for that season and that the "design work" was necessary for the production of the clothing.

In these appeals, the items which are claimed to fall under the description "design work" in clause 48(5)(a)(iii)(D) of the Act are not provided pursuant to a design agreement separate and apart from the Licence Agreement and, for the most part, these items are samples that have been purchased by the appellant. The Tribunal is not persuaded that the evidence shows that fees paid by the appellant in respect of purchases by it, on its own or through an agent, were for anything but the right to buy the licensed goods manufactured by a third-party manufacturer. In the Tribunal's view, the evidence does not show that the appellant, directly or indirectly, passed on design work to third-party manufacturers as required by clause 48(5)(a)(iii)(D) of the Act. The appellant merely purchased the goods in issue through an agent, and those purchases tended to be more expensive.

Based on the foregoing, the Tribunal concludes that the samples are not dutiable assists under clause 48(5)(a)(iii)(D) of the Act.

Accordingly, the appeals are allowed.

Patricia M. Close
Patricia M. Close
Presiding Member

Arthur B. Trudeau
Arthur B. Trudeau
Member

Robert C. Coates, Q.C.
Robert C. Coates, Q.C.
Member

28. *Supra* note 20 at 2.