

European Court of Justice rules royalty paid for know-how required for manufacture of finished products in the EU may need to be added to customs value of imported semi-finished products

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Executive summary

On 9 July 2020, the European Court of Justice (ECJ) published its decision in the court case named "'Curtis Balkan' EOOD."¹ The ECJ ruled that royalties paid by the buyer to its parent company for the supply of the know-how required for the manufacture of the finished products in the European Union (EU), might be added to the customs value of imported semi-finished products if certain conditions are fulfilled. This is in particular the case if there is a sufficient close link between the royalties and license fees, on the one hand, and the imported semi-finished products, on the other hand. Such link exists for example where the know-how supplied under the licensing agreement is necessary for the manufacture of the imported goods.

This Alert summarizes the ECJ's decision. It becomes evident from this case that it is increasingly important to assess the customs valuation treatment of royalties and license fees if goods are imported into the customs territory of the EU, even if the imported goods concern semi-finished products and the royalties are paid for the manufacture of finished goods in the EU.

Detailed discussion

Background

Curtis Balkan, a company established in Bulgaria, is a wholly owned subsidiary of Curtis Instruments Inc. (Curtis Balkan). A Service Management Agreement and Patent Use Agreement govern the legal relationship between Curtis Balkan and Curtis USA:

- ▶ Under the Services Management Agreement, Curtis USA undertakes, inter alia, to carry out operational activities for Curtis Balkan, namely management, including marketing, advertising, preparing budgets, financial reports, information systems and human resources for an agreed monthly fee.
- ▶ Under the Patent Use Agreement, Curtis Balkan pays a fee for the right to use the patented technology which allows Curtis Balkan to produce and sell engine speed regulators and components for electric vehicles. The royalty is paid quarterly on the basis of the quarterly sales reports for the products.

For the production of the licensed finished products, Curtis Balkan purchases non-licensed components from third-party manufacturers established outside of the EU. These components are imported into the EU by Curtis Balkan and incorporated in the licensed finished products. The customs value of the imported non-licensed components is based on the agreed sales price between the third-party manufacturer and Curtis Balkan. The Bulgarian Customs Authorities were of the position that the royalties paid by Curtis Balkan to Curtis USA should be added to the customs value. In appeal, the Varhoven administrativen sad (Supreme Administrative Court, Bulgaria) asked for a preliminary ruling and brought 11 questions before the ECJ about the customs valuation treatment of the royalty payments. In essence the question is whether a proportion of the royalties paid by Curtis Balkan to Curtis USA in consideration for the supply of know-how for the manufacture of finished products in the EU must be added to the customs value of the imported semi-finished products which will be incorporated in the finished products.

Decision of the ECJ

The ECJ emphasizes that in principle the customs value is based on the transaction value of the imported goods. The transaction value is the price paid or payable for the goods sold for export to the customs territory of the EU. To make

sure the transaction value reflects the real economic value of the imported goods, the price paid or payable should be adjusted by adding certain price elements, such as assists, royalties and license fees and proceeds. In this particular case, the ECJ considered that the fee paid by Curtis Balkan to Curtis USA in return for the supply by Curtis USA of know-how for the purpose of the manufacture of the products in which the imported goods were incorporated, fall within the concept of "royalties and license fees." The ECJ stresses that royalties and license fees should only be added if three cumulative conditions are satisfied, namely that:

1. The royalties or license fees have not been included in the price actually paid or payable.
2. The royalties or license fees are related to the goods being valued.
3. The buyer is required to pay those royalties or license fees as a condition of sale of the goods being valued.

The first condition is fulfilled because the license fee paid by Curtis Balkan has not been included in the customs value of the imported components. It is for the referring court to determine if the second and third condition are fulfilled, although the ECJ does provide further guidance how these conditions should be interpreted. This guidance is discussed in greater detail below.

Condition 2 - Related to the imported goods?

The ECJ considers that where the imported goods are merely a component of goods manufactured in the EU, an adjustment to the price actually paid or payable for the imported semi-finished products is only to be made when the royalty relates to those semi-finished products. The method of calculation can in that respect be indicative, however, is not in itself conclusive. There must be - and this is generally a new criterium introduced by the ECJ - a sufficiently close link between the royalties or license fees, on the one hand, and the imported semi-finished products, on the other hand. The ECJ indicates that such link exists where the know-how supplied under the licensing agreement is necessary for the manufacture of the imported goods. That is indicative of the fact that the semi-finished products were specifically designed for incorporation into the licensed product without any other reasonable use being envisaged. According to the ECJ, it is up the referring court to decide if such a sufficiently close link exists. In that regard all relevant factors, in particular the relationships of law and of fact between the persons involved, should be examined.

Condition 3 - Condition of sale?

The ECJ explains that the "condition of sale test" comes down to the question of whether in the course of the contractual relations between the seller, or a person related to the seller, and the buyer, the payment of the royalty or of the license fee is so important to the seller that, without such payment, the seller would not have concluded the sales contract. In circumstances in which the seller of the goods being valued is separate from the licensor, it is ultimately necessary to know whether the person related to the seller is capable of ensuring that the imports of goods are subject to the payment to him or her of the royalties or license fees in question. In other words, is that person legally or operationally in a position to exercise restraint or direction over the seller. This should be tested with respect to the relationship between Curtis USA and the third-party manufacturers of the imported semi-finished products by the referring court.

It is questionable how the ECJ's explanation of the condition of sale test in the present case relates to the ECJ's ruling in the GE Healthcare case.² In that case the ECJ held that: *[...] royalties or licence fees are a 'condition of sale' of the goods being valued where, within a single group of undertakings, those royalties or licence fees are required to be paid by an undertaking related to both the seller and the buyer and were paid to that same undertaking.* One may argue that this consideration of the ECJ means that the condition of sale test, within a single group of undertakings, is automatically fulfilled (deemed condition of sale). The present case, however, seems to nuance this view. To determine whether the condition of sale test is fulfilled the decisive question is always, in the light of all the relevant factors, whether the supply of the goods would have taken place if the royalty payment has not been made.

Union Customs Code

Although this court case is decided under the Community Customs Code (CCC), this case seems to be even more important under the Union Customs Code (UCC) which

governs the customs valuation rules in the EU as of 1 May 2016. The UCC introduced more stringent rules for royalties and license fees. These rules on royalties seem to have increased the taxable scope, as under the UCC, royalties and license fees are included sooner in the customs value than under the CCC. For instance, in a scenario whereby the buyer, the seller and the licensor are all unrelated, a royalty or a license fee may still need to be part of the customs value as also "a license holder" can impose a condition of sale. Moreover, the rule focuses on the obligations of the buyer, rather than the requirements of the seller. Put differently, a licensor in many cases cannot block a (non-affiliated) seller from selling the product to a buyer (even if affiliated to the licensor), but it can block the purchase of the product if the royalty is not paid by the buyer (certainly when the buyer is affiliated to the licensor). Consequently, the royalty would become dutiable in many more situations than under the current legislation. The decisive question, according to the ECJ, to determine whether a royalty is paid as a condition of sale will sooner be answered in the affirmative under the UCC compared to similar facts under the CCC because of the more stringent rules for royalties and license fees explained above.

Next steps for businesses

It follows from this ruling that it becomes increasingly important to assess the customs valuation treatment of royalties and license fees, even if the imported goods concern semi-finished products and the royalties are paid for the manufacture of finished goods in the EU. Businesses should work with their local tax professional to:

- ▶ Map and visualize the supply chain of companies including the goods, invoice/PO and royalty flows
- ▶ Assess existing or new contracts that (will) govern the legal relationship between the seller, the buyer and - if the seller is not the license holder - the license holder
- ▶ Identify if royalties and license fees fall within the concept of royalties and license fees for customs valuation purposes and whether they should be added (in part) to the customs value of the imported goods into the EU

Endnotes

1. ECJ 9 July 2020, C-76/19 ('Curtis Balkan' EOOD), ECLI:EU:C:2020:543.
2. ECJ 9 March 2017, C-173/15 (GE Healthcare GmbH), ECLI:EU:C:2017:195.

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