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Inclusion of R&D payments in dutiable value of imported goods and Nova Scotia HST rate change

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CITT affirms CBSA's decision to include R&D payments in dutiable value of imported goods

On January 8, 2014, the Canadian International Trade Tribunal (CITT) made public their decision with respect to *Skechers USA Canada Inc. v. Canada Border Services Agency* (*Skechers v CBSA*). The case considered whether research and development (R&D) payments made by Skechers USA Canada Inc. (Skechers Canada) to Skechers USA Inc. (Skechers USA) were made "in respect of" footwear imported by Skechers Canada and therefore should be included in determining the import price (and customs value) for these imports. The CITT ruled against Skechers Canada and found that the R&D payments made to its parent, Skechers USA, were indeed in respect of the imported footwear and should be included in determining the value for duty. The outcome of this case should serve as a reminder to businesses to carefully consider the nature of all intercompany payment flows and their impact on customs value. This article provides a brief synopsis of the background and facts of *Skechers v. CBSA*, discusses the implications of the CITT's decision and offers guidance to companies to help minimize risk of undeclared amounts impacting the price paid or payable (PPP) and transaction value of imported goods.

Background

Skechers Canada purchases footwear from Skechers USA and is not involved in the shoe design process, other than to occasionally request minor changes to certain styles as requested by customers. The transfer price paid by Skechers Canada for the footwear it imports includes the R&D costs associated with developing the styles that make it into production (approximately 5,000 styles), but not the costs associated with developing the 35,000 to 40,000 unsuccessful models or the general R&D costs borne by Skechers USA. Skechers Canada, under a cost sharing agreement, makes R&D payments to Skechers USA to reimburse Skechers USA for a certain percentage of these R&D costs associated with the unsuccessful models and other general R&D costs noted above. Skechers Canada considered these R&D payments to be in respect of "intangibles" as they related to the development of the Skechers brand, were not physically incorporated into the imported goods, and were not necessary for the production of the goods or the basic use of the footwear. Therefore, Skechers Canada did not include these payments in determining the value for duty of footwear imported into Canada.

The Canadian Border Services Agency (CBSA), after conducting an initial audit of Skechers Canada, determined that a portion of the R&D payments made by Skechers Canada under the cost sharing agreement should be included in the determining the import price of the footwear. Skechers Canada appealed the decision and the CBSA, in its response to the appeal, determined that 100% of the R&D payments Skechers Canada made under the cost sharing agreement were in respect of the imported footwear and should be included in determining in the customs value as part of the PPP for the goods. Skechers Canada appealed the decision of the CBSA to the CITT.

The CITT did not accept Skechers Canada position that the R&D payments made under the cost sharing agreement related to intangibles. The CITT stated, in part based on the fact that the payments made under the cost sharing agreement were calculated by reference to relative operating profit, that a link exists between the import and sale of the footwear and the R&D payments to Skechers USA. Further, the CITT noted that the purpose of the R&D process is to develop footwear and is, therefore, directly aimed at the development of successful models for production and importation. The CITT also re-iterated in its decision that the burden of proof for demonstrating compliance with the valuation provisions of the *Customs Act* rests with the importer and Skechers Canada was unable to adequately demonstrate that the R&D payments are not in respect of the imported shoes.

Implications and risk mitigation

Skechers v CBSA highlights the importance of evaluating all payment flows to, or for the benefit of, foreign suppliers in order to determine their potential impact on customs value. The case is particularly relevant to related parties and emphasizes that it is important to consider transfer pricing policies and documentation from the perspective of the customs valuation rules. Often, there are adjustments to transfer prices that need to be made to ensure compliance with customs requirements and the obligation to report a correct value exists for dutiable and non-dutiable goods alike.

In structuring intercompany agreements and determining allocation keys for various payment flows, it is beneficial to consider the impact that each type of payment, and/or the type of allocation key used, may have on import value as there may be additional risks associated with one option over another or there may be an avenue to mitigate potential duty costs. It is important to consider such strategies in conjunction with the transfer pricing analysis to ensure that potential savings or reductions in income tax are not offset by increased duty costs and vice versa.

Companies should review all intercompany contracts and agreements and evaluate whether any payments made under these arrangements should be included in determining the import price. Some indications that a payment may be required to be included in the import value include: (a) whether the payment is made to the same party that is selling the imported goods to the purchaser; (b) whether payments for services (for example, management and administration fees, R&D) are paid to a person that is the vendor of imported goods, or is related to a person that is the vendor of imported goods; and (c) where additional payments are made to the vendor of imported goods after the initial invoice price has been paid (for example, when a period transfer pricing adjustment is made).

Companies should also review current processes and procedures for reporting the PPP of imported goods, and any applicable adjustments thereto, to consider whether there may be risk that additional amounts need to be included, even if those amounts

are based on prior negotiations with the CBSA. There are many importers that have previously negotiated with CBSA to report, for example, only a portion of payments made for R&D services on the basis that a certain portion of such payments is for “research” and not necessary for the production of goods that are ultimately produced and imported. This recent decision suggests that such apportionments may not be supportable and there are risks associated with continuing such a process, particularly where there is no formal ruling in place to support the practice. However, importers should not be too quick to capture any and all payments in import value. For example, where payments are made to a party that is not the vendor of the imported goods, these payments may not fall within the definition of PPP. However, these payments may fall within other provisions of the Customs Act to cause an adjustment to the PPP. Therefore, these types of payments should be reviewed on a case by case basis to determine their impact on the PPP.

Further, *Skechers v. CBSA* reminds us that companies must consider the impact of appealing CBSA decisions, particularly where concessions have been made by the auditor. Skechers Canada and the CBSA auditor had reached an agreement whereby only a portion of the R&D payments made by Skechers Canada to Skechers USA under the cost sharing agreement would be required to be included in determining the value for customs. Skechers Canada, in requesting a re-determination (appeal), was worse off than it would have been had it accepted the original determination by the CBSA auditor.

Finally, when choosing to file an appeal with CITT, *Skechers v CBSA* highlights the importance of being able to satisfy the burden of proof requirement. Despite providing plenty of detail on the nature of the R&D payments, the CITT found Skechers Canada did not satisfy the burden of proof for establishing that the manner in which it calculated value for duty was in compliance with the valuation provisions and, specifically, that the R&D payments were not made in respect of imported goods.

Conclusion

In recent years, the CBSA has been more aggressive in its interpretation of the customs rules, particularly as they relate to customs valuation and related party transactions. Auditors have been aggressively assessing intercompany payments outside of the invoice or transfer price, including management and administrative fees paid for services as well as R&D payments as in *Skechers v. CBSA*. Previously negotiated concessions may no longer be accepted as the Skechers Canada case supports that, at least in some situations, such concessions may not be considered valid. With many customs cases in recent years being focused on the valuation of imported goods, particularly in situations where there are multi-tiered sales transactions and/or where there are payment flows outside of the invoice or transfer price of imported goods, it is recommended that importers review the determination of import values in the context of recent decisions. This will ensure compliance with the customs valuation requirements, mitigate potential duty, interest and/or penalty related risks and exposures, and align, to the greatest extent possible, the transfer pricing policies and the determination of customs value with a view to achieving the best net result from both an income tax and customs duty perspective. It is also imperative to ensure that the nature of intercompany payment flows is adequately documented as the administrative policies of the CBSA may, in some cases, allow payments for services to be excluded from the value of imported goods.

Lisa Zajko and Alison Brady, Vancouver

Delay in Nova Scotia HST rate change

The planned reduction in the Nova Scotia HST rate from 15% to 14% on July 1, 2014 is not expected to proceed as planned.

Background

In April 2012, the Provincial NDP government introduced an amendment to the Financial Measures Act that formalized its intention to reduce the rate of the provincial component of the HST in Nova Scotia from 10% to 9% resulting in a reduction of the combined HST rate from 15% to 14% effective July 1, 2014. A further one percentage point reduction was planned in 2015 that would bring the HST rate down to 13%.

The NDP government was defeated in the Nova Scotia Provincial Election in the fall of 2013.

Update

On December 19, 2013, the newly appointed Liberal government announced a forecast deficit for the 2013-2014 fiscal year. As a result, the government has stated a reduction in the HST rate is not appropriate at this time because it cannot afford the loss in revenue. Therefore, a reduction in the HST rate is not expected to occur until the budget is balanced.

To date, there has been no formal announcement by the Nova Scotia Department of Finance regarding the cancellation of the planned HST rate reduction. We understand a formal announcement is not expected to be made by the Nova Scotia Department of Finance until the spring of 2014 when the updated financial forecast for fiscal 2013-2014 is released.

We will keep you updated through this publication as we learn more.

Leanne Landry, Halifax

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