CURRENT TRENDS IN THE DUTIABLE STATUS OF ROYALTY PAYMENTS

Frederic D. Van Arnam Jr.
CURRENT TRENDS IN THE DUTIABLE STATUS OF ROYALTY PAYMENTS

How the Hasbro Rulings Affect Importers

Frederic D. Van Arnam, Jr.*

I. INTRODUCTION

A recent pair of administrative statements issued by the United States Customs Service, known in the importing community as the Hasbro rulings,¹ changed the Customs Service's traditional way of analyzing whether payments made for certain intellectual property rights relating to

---

* Frederic D. Van Arnam, Jr. is an associate attorney at the New York office of Barnes, Richardson & Colburn, a law firm specializing in all aspects of customs and international trade law.

1. The first ruling, referred to as Hasbro I, was reported as Headquarter's Ruling Letter ("HRL") 544436 (Feb. 4, 1991), reprinted in 25 Cust. B. & Dec., No. 18, at 19 (May 1, 1991) [hereinafter Hasbro I]. The Hasbro II ruling was an administrative statement published in response to the Customs Service's request for comments on Hasbro I. It was published on January 21, 1993 under the title Dutiability of 'Royalty' Payments, Analysis of Comments, reprinted in 27 Cust. B. & Dec., No. 6, at 1 (Feb. 10, 1993) [hereinafter Hasbro II].
import transactions were dutiable as royalties and, if not, if the value of those rights was dutiable as the proceeds of a subsequent resale of the imported merchandise. In turn, these rulings have created confusion among importers who make payments pursuant to license agreements for various intellectual property rights related to imported merchandise, leaving them wondering whether such bona fide royalty payments are dutiable. This article first reviews how royalty payments were traditionally analyzed by the Customs Service and the types of payments found dutiable as proceeds under such an analysis. It then examines the Hasbro rulings, post-Hasbro administrative decisions issued by the Customs Service dealing with royalties, and the ramifications of the Hasbro rulings.

When imported merchandise enters the United States, its value must be declared to the U.S. Customs Service.2 The principal method of appraisement is transaction value.3 Transaction value is defined at 19 U.S.C. § 1401a(b)(1) as the

value of imported merchandise . . . actually paid or payable for the merchandise when sold for exportation to the United States, plus amounts equal to—

(A) the packing costs incurred by the buyer with respect to the imported merchandise;

(B) any selling commission incurred by the buyer with respect to the imported merchandise;

(C) the value, apportioned as appropriate, of any assist;

(D) any royalty or license fee related to the imported merchandise that the buyer is required to pay, directly or indirectly, as a condition of the sale of the imported merchandise for exportation to the United States; and

---

2. As a general principle, customs duties are calculated as the product of a specified ad valorem duty rate (i.e., five percent, etc.) multiplied by the appraised value of the imported merchandise.

3. 19 U.S.C. § 1401a(a) (1994). The other methods of appraisement are the transaction value of identical merchandise and similar merchandise, deductive value, computed value, or a mixture of the methods. Id. §§ 1401a(c)-(f).
(E) the proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue, directly or indirectly, to the seller.4

The cost, value, or amount of the expenses enumerated in subsection (b)(1) will be added to the price paid or payable to the extent it was not already included in that price5 and only if it is based on sufficient information.6 This article addresses only additions to value made under subsections (b)(1)(D) and (E).

Traditionally, Customs analyzed for appraisement purposes payments made pursuant to license agreements, including payments made for rights to use a copyright, trademark, or patented processes by which merchandise is made or used, to reproduce and distribute imported merchandise, to resell or use imported items, or for geographic exclusivity. If Customs found that the right was tied up with ownership of the imported merchandise, then the payment made to receive that right was dutiable. In the alternative, payments made by importers for these types of property rights, when not paid as a condition of the sale of imported merchandise, were not dutiable.7 The issue of the dutiability of a royalty payment still involves a determination by Customs that the right and the import are inextricably intertwined, and Customs looks closely at whether or not imported merchandise is manufactured under a patent, if a royalty payment is involved in the production or sale of the imported merchandise, or if importers could buy the imported merchandise without paying the fee, in order to determine the dutiability of such payments.8

In addition, as a result of the Hasbro rulings, Customs determines whether

4. Id. § 1401a(b)(1). The price paid or payable is defined as the total payment (whether direct or indirect, and exclusive of any costs, charges, or expenses incurred for transportation, insurance, and related services incident to the international shipment of the merchandise from the country of exportation to the place of importation in the United States) made, or to be made, for imported merchandise by the buyer to, or for the benefit of, the seller.

Id. § 1401a(b)(4)(A).

5. Id. § 1401a(b)(1)(D). For example, assume a foreign manufacturer pays a royalty to a third party for the right to manufacture a devise. This devise is eventually sold to the importer at a price that includes, as an element of its value, the amount paid by the manufacturer to the third party. The transaction value of the imported merchandise would thus already include the value of the royalty.

6. Id. § 1401a(b)(1).

7. Id.

a royalty payment, if not dutiable as a royalty, is dutiable as a proceed of a subsequent resale under subsection (b)(1)(E). It is this latter analysis that constitutes a major shift in policy and, it is submitted, is an impermissible extension of the valuation statute.

II. VALUATION BEFORE THE TRADE AGREEMENTS ACT OF 1979

Prior to the passage of the Trade Agreements Act of 1979 ("TAA"),

the dutiability of a royalty or licensing fee depended on whether the payment was "inextricably intertwined" with the imported merchandise. If the royalty was not inextricably intertwined with the production of the imported merchandise, was optional, or was paid for exclusive property rights apart from the price of the imported merchandise, the fee was nondutiable. The burden was on the importer to show that the royalty


12. The predecessor valuation statute to the TAA was found in Section 402 of the Tariff Act of 1930. Export value was the preferred basis of appraisement under the Tariff Act.

The export value of imported merchandise shall be the market value or the price, at the time of exportation of such merchandise to the United States, at which such or similar merchandise is freely offered for sale to all purchasers in the principal markets of the country from which exported, in the usual wholesale quantities and in the ordinary course of trade, for exportation to the United States, plus, when not included in such price, the cost of all containers and coverings of whatever nature, and all other costs, charges, and expenses incident to placing the merchandise in condition, packed ready for shipment to the United States. 19 U.S.C. § 1402(d) (1930). Export value was not based on the actual transaction between the importer and the exporter. Rather, it was based on the exporter's wholesale price. In addition, there was no specific additions to export value as there are for transaction value. Section 201 of the Trade Agreements Act of 1979 amended Section 402 of the Tariff Act of 1930. Trade Agreements Act of 1979, Pub. L. No. 96-39, § 201, 93 Stat. 144, 194 (amending Tariff Act of 1930, § 402, 19 U.S.C. § 1402 (1976)).

was not part of the selling price, which could be overcome by showing that the royalty was paid for separate rights and not as part of the purchase price of the imported merchandise.\footnote{14}

For example, in *Imperial Products, Inc. v. United States*,\footnote{15} the plaintiff imported cloth brush heads that were subsequently used to manufacture two types of finished brushes in the United States. One type of brush utilized a rotating handle on which a patent had been issued and was held by the exporter of the brush heads.\footnote{16} At entry, the brush heads were invoiced on a per unit basis, with the importer agreeing to pay a per unit royalty fee for the right to manufacture brushes incorporating the patented handle. The royalty was calculated based on one-third of the total number of imported brush heads.\footnote{17}

At trial, the Customs Court held that the payments were not dutiable royalties. Instead, the court found that the fee was separate from the price of the imported brush heads and was paid for a bona fide right obtained from the exporter.

\[T]his payment was for the exclusive right to manufacture and sell [the patented brushes] in the United States. It was a valuable right granted by the manufacturer to an unrelated purchaser for a fee paid in addition to the price of the brush heads.\footnote{18}

Likewise, in *United States v. F.B. Vandegrift & Co.*,\footnote{19} the importer paid a license fee for the exclusive right to purchase three machines used in the manufacture of glass ampoules and to manufacture and sell similar machines.\footnote{20} Although the license fee was not referred to on the invoice, Customs argued that it should have been included in the value of the machines. The Court of Customs and Patent Appeals affirmed the

\begin{flushleft}
\end{flushleft}

\footnote{14} \textit{See} United States v. Imperial Prods., Inc., 570 F.2d 337, 340 (C.C.P.A. 1978).
\footnote{16} \textit{Id.} at 69. The contract of sale for the imported brush heads included a clause outlining the right to manufacture the patented brushes on an exclusive basis. \textit{Id.} at 70.
\footnote{17} \textit{Id.} at 69. Only one-third of the imported brush heads were actually used to manufacture brushes with the patented handle. \textit{Id.}
\footnote{18} \textit{Id.} at 71. This decision was affirmed by the Court of Customs and Patent Appeals. United States v. Imperial Prods., Inc., 570 F.2d 337 (C.C.P.A. 1978).
\footnote{19} 26 C.C.P.A. 360 (1939).
\footnote{20} \textit{Id.} at 362. This payment was in addition to the invoice price of the machines. \textit{Id.}
Customs Court, finding that the record compiled at trial showed that the license fee was paid in consideration for both the exclusive right to purchase and import the machines as well as to manufacture and sell similar machines in the United States. In concluding that the license fee was nondutiable, the court distinguished the facts at bar from those where an importer paid one price for the merchandise and a second sum, designated as a license fee, for its use. Because the right to use is an element of ownership, a license fee is part of the purchase price and thus dutiable.

United States v. Rohner Gehrig & Co. is another case dealing with the issue of dutiability of royalty payments. In Rohner Gehrig, the merchandise subject to reappraisement was an exhaust supercharging blower imported from Switzerland. At entry, a charge in addition to the invoice price of the merchandise was added. This charge was represented as a fee for both the personal services of the licensor, who had been hired to oversee the manufacture of a special diesel engine, and a license to use the licensor's patented system in the construction of the engine. The fee had nothing to do with the imported supercharger, which was purchased for use with the diesel engine.

At trial, the facts showed that the supercharger could be purchased without licensing the patented construction system or obtaining the personal services of the licensor and that the exporter and the licensor were unrelated. The trial court held that the fee paid to the licensor was not a part of the dutiable value of the imported supercharger; instead, it held that the fee was paid for separate property rights.

21. Id. at 365.
22. Id. at 364-65.
23. Id. at 364 (citing Billings v. United States, 232 U.S. 261, 280 (1914)).
25. Id.
26. Id.
27. Id.
28. Id. Since the licensor did not have an office in the United States, the exporter, pursuant to a contract between it and the licensor, collected the fee for the licensor as an accommodation, and remitted the amount directly to him. Id. at 592.
30. Id. at 554. The Customs Court held that the fee was "exacte for [the] professional services [of the licensor] in giving advice and permitting the use of his system of operating a diesel engine. Certainly, it forms no part of the value of the instant supercharger." Id. at 553.
On appeal, the Appellate Term of the Customs Court affirmed the trial court's decision that the payments were not dutiable as a royalty.\(^3^1\) The court found that the fee paid was separate from the import price of the supercharger because it was for the right to manufacture the special diesel engine in the United States and to use the patented specifications.\(^3^2\) In addition, the court held that the personal services agreement was not part of the dutiable value of the imported merchandise because the evidence showed that a sale of the supercharging blower had been made to another importer during the same period that did not include a service fee.\(^3^3\)

*Imperial Products, F.B. Vandegrift*, and *Rohner Gehrig* are three examples of cases in which the Customs Court and the Court of Customs and Patent Appeals analyzed the issue of the dutiability of license or royalty payments. In each case, the court held that unless a license or royalty payment was not intertwined with the imported merchandise and was being made for discrete property rights, then the additional payment was dutiable. The fees in these cases were not paid for the right to use the respective imported devices after importation, but for separate exclusive rights, such as the right to manufacture and sell the product in the United States or to be the sole importer in a specific geographic market. In each of these cases, both parties received consideration: the importer received valuable property rights and the holder of the rights received payments. Those rights and payments were separate from the obligation to pay for the related imports and were therefore held to be nondutiable.

The Customs Court reached a different result in *BBR Prestressed Tanks, Inc. v. United States*,\(^3^4\) which involved the sale and importation of a tank prestressing machine from Switzerland. At entry, the merchandise was appraised based on its invoice price plus an additional sum, which the importer argued at trial was a license fee paid to a separate organization that controlled the patents used to make the imported merchandise.\(^3^5\) The license agreement required that the imported machine be purchased from one of two companies, which in turn would remit the license fee to the patent holder. At trial, the Customs Court determined that the license

---


\(^{32}\) *Id.* The court held that "[t]here was no royalty involved in the production or sale of the supercharging blower which constituted the importation." *Id.*

\(^{33}\) *Id.*


\(^{35}\) *Id.* at 886. According to the license agreement, the importer agreed to pay the additional fixed sum to the patent holder whenever it purchased a machine. *Id.*
agreement obligated the importer to purchase merchandise from only those two sources and that payment of the fee was contingent upon that purchase. Based on these facts, the court held that the "payment was mandatory and was so linked with the purchase of the machine that, despite its characterization otherwise, it may properly be deemed a disguised addition to the price of the machine."

On appeal, the Appellate Term of the Customs Court affirmed, finding that each payment was "intimately associated" with each purchased machine, and rejecting the importer's claim that the payments were made for the purpose of obtaining geographic exclusivity. The court found that the causal identity of the fee was stronger with the price paid than with the territorial agreement, and that each compulsory fee payment was paid to the seller, rather than directly to the third party patent holder. Based on these facts, the court held that the importer had not overcome the presumption that the additional payment was part of the purchase price.

Thus, the license fee paid in BBR Prestressed Tanks was found to be dutiable because, unlike the fee payments in Imperial Products, F.B. Vandegrift, and Rohner Gehrig, it was mandatory, triggered by the sale for importation, and was not paid for separate property rights that could be differentiated from the purchase price. Under the court's analysis in BBR Prestressed Tanks, the so-called licensing fee was nothing more than an additional payment allowing the importer to use the merchandise and was therefore dutiable as a component of the purchase price.

A similar result was reached in Erb & Gray Scientific, Inc. v. United States, which involved the importation of an electron microscope that was appraised at a value that included a sum designated as the "New York Office Service and Operation Fee." This fee was paid by the importer to the exporter for the installation and service of the microscope after it was received by the importer and sold to one of its clients. At trial, the

36. Id. at 888.
37. Id.
39. Id.
40. Id.
41. 53 C.C.P.A. 46 (1966).
42. Id. at 47.
43. Id. at 48. The origin of the fee was important to the disposition of the case. Prior to the importer's agreement to pay the fee, it had the responsibility for paying the living expenses of the installation engineers, who were, nevertheless, supervised by the United
Customs Court held that the fee was nondutiable, finding that it was not paid as a component of the purchase price but in order to obtain the extra services, and that the sale price of the microscope was separate from the sum paid for its installation and servicing.\textsuperscript{44}

On appeal, the Appellate Term of the Customs Court reversed.\textsuperscript{45} It determined that once the importer prevailed upon the exporter to maintain the New York office, the importer obligated itself, as a part of the purchase price of the imported microscope, to contribute toward the office expense.\textsuperscript{46} Thus, as microscopes were no longer being sold to the importer without the service fee being paid, the court concluded that the fee had become a condition of the purchase price.\textsuperscript{47} This decision was then appealed to the Court of Customs and Patent Appeals, which affirmed the Appellate Term.\textsuperscript{48} It found that the trial court's record supported the conclusion that the fee was nothing more than a "disguised increased in the price" of the imported merchandise, the payment of which attempted to compensate the exporter for the increased expenses necessarily incurred in the sale of the merchandise to the United States.\textsuperscript{49}

In sum, the Customs Court and the Court of Customs and Patent Appeals, prior to the passage of the TAA, focused on whether a payment was made for separate, valuable property rights, as was the case in \textit{Imperial Products}, F.B. Vandegrift, and Rohner Gehrig, or whether a payment cloaked as a royalty was made as a condition of sale of imported merchandise, as was the case in \textit{BBR Prestressed Tanks} and \textit{Erb \& Gray Scientific}. In each case, the court focused on what the payment was made in exchange for and whether it could be segregated from the purchase price paid by the importer. \textit{If} the importer received discrete intellectual property rights separate from the value of the imported merchandise in exchange for its payment, then the payment was not dutiable. \textit{If} the

\begin{flushleft}


\textsuperscript{46} \textit{Id.} at 795.

\textsuperscript{47} \textit{Id.}


\textsuperscript{49} \textit{Id.} at 52.
\end{flushleft}
additional payment was a condition of the sale or for the right to use the imported merchandise, then it was dutiable.

III. VALUATION UNDER THE TRADE AGREEMENTS ACT OF 1979

In 1979, the United States Congress enacted the TAA. With its enactment, Customs adopted a new primary method of appraisement known as transaction value, which bases dutiable value on the price actually paid or payable for merchandise when sold for export to the United States. Among its changes, the new value statute specifically included as a statutory addition to the value of the merchandise an amount equal to the value of any royalty or license fee related to the imported merchandise whether or not the importer was required to pay it directly or indirectly as a condition of the sale for importation. In other words, being a “condition of sale” for importation is the only requirement of dutiability specifically listed in the statute.

Customs regulations provide that the dutiability of royalties or licensing fees depends on the following:

1) Whether the importer was required to pay the royalty or fee as a condition of sale of the merchandise for exportation to the U.S.; and

2) To whom and under what circumstances they were made.

The regulations further provide that payments made by the importer to a third party for the right to distribute or resell imported merchandise were not dutiable so long as the payments were not a condition of the initial sale between the manufacturer and the importer.

The House of Representatives’ Statements of Administrative Action

52. Id. § 1401a(b)(1)(D).
54. Id.
was published as a guide to understanding the TAA. The section on royalties makes the following distinction between payments that are generally dutiable and those that are not. The *Statements* acknowledge that royalty payments for patents covering manufacturing processes used in producing imported merchandise are dutiable. On the other hand, payments by a buyer to a third party for the right to exercise in the United States that third party’s property rights in imported merchandise purchased from an unrelated seller are generally considered part of the buyer’s selling expense and are not dutiable. If, however, payments are made as a condition of the sale of merchandise exported to the United States, the amount would be dutiable.

Congress desired that the pre-TAA treatment of royalties continue under the TAA. Customs acknowledged this congressional intent in 1983, when it stated that “the basic rationale of prior decisions is essentially unchanged under the TAA . . . .” Following the enactment of the TAA, Customs continued to apply its pre-TAA analysis in determining the dutiability of payments as royalties or proceeds of subsequent resales. For example, Customs applied its pre-TAA rationale to determine the dutiability of royalties under the TAA in Headquarters Ruling Letter 544129, an administrative ruling involving the importation of a drug by a U.S. pharmaceutical products manufacturer. As part of the import sale transaction, the importer paid a royalty to a licensor, a company related to the exporting seller. In return for the payment of this...

---


56. Id. at 707.
57. Id.
58. Id.
59. This is reflected in the Act’s legislative history. For example, the House Ways and Means Committee stated that “[t]he existing treatment under the law of royalties for Customs purposes is intended to continue under the operation and administration of new section 402(b)(1) . . . .” H.R. (WAYS AND MEANS COMM.) REP. NO. 317, 96th Cong., 1st Sess. 1, 80 (1979). See also S. REP. NO. 249, 96th Cong., 1st Sess. 1, 120 (1979), reprinted in 1979 U.S.C.C.A.N. 388, 506 (containing the same language as H.R. Rep. No. 317).
60. HRL 543062 (Nov. 8, 1983). No relevant court decisions have yet addressed this issue.
61. HRL 544129 (Aug. 31, 1989)
62. Id.
63. Id. For purposes of the TAA, related parties are defined as
(A) Members of the same family, including brothers and sisters (whether by whole or half blood), spouse, ancestor, and lineal descendants.
royalty, the importer received the exclusive right from the licensor to use and sell the drug in the United States and, in certain circumstances, to manufacture it. The royalty was calculated as five percent of the importer's net sales of the drug, regardless of whether or not it was imported to, or manufactured, in the United States. Customs concluded that this royalty was not dutiable because it was not a condition of the original sale between the importer and the seller of the merchandise, that the rights acquired by the importer through the royalty agreement were separate and distinct from the right of ownership of the merchandise, and that the royalty payments were triggered by the resale of the merchandise, not the original sale.

Customs also issued an administrative ruling on a fact pattern where an importer and a seller entered into a license agreement under which the importer was granted the exclusive right to manufacture and sell the imported product. The importer was also granted the right to use the seller's trademark and technical data. In return, the importer agreed to pay a royalty to the seller, determined as a percentage of the importer's sales of the product it manufactured and sold in the United States. Customs held these payments were nondutiable because the importer was

(B) Any officer or director of an organization and such organization.

(C) Any officer or director of an organization and an officer or director of another organization, if each such individual is also an officer or director in the other organization.

(D) Partners.

(E) Employer and employee.

(F) Any person directly or indirectly owning, controlling, or holding with power to vote 5 percent or more of the outstanding voting stock or shares of any organization and such organization.

(G) Two or more persons directly or indirectly controlling, controlled by, or under common control with, any person.


64. HRL 544129 (Aug. 31, 1989).
65. Id.
66. Id.
67. HRL 542844 (June 17, 1982).
68. Id.
69. Id.
not required to pay royalties as a condition of importation.\textsuperscript{70} Its rationale was supported by the fact that the royalty payments were computed on the basis of the volume of the importer’s business conducted in the United States. In light of these findings, Customs concluded that “the royalty fees in question are not so inextricably intertwined with the imported merchandise as to be considered part of the purchase price. . . .”\textsuperscript{71}

In another administrative ruling, a license agreement was entered into between the importer as licensee and its parent corporation as licensor.\textsuperscript{72} Under the terms of the agreement, the importer received from the licensor the right to use certain trademarks, inventions, patents, and standard operating procedures in North America. In return, the licensor received a five percent royalty based on the licensee’s net sales of lenses.\textsuperscript{73} These lenses were not sold to the licensee by the licensor but were sourced to the licensee by other related parties.\textsuperscript{74}

Customs held this royalty agreement to be nondutiable.\textsuperscript{75} It determined that the royalty payments were not paid as a condition of sale of the lenses, but were paid for the use of the trademarks and techniques related to the lenses.\textsuperscript{76} In reaching this conclusion, Customs relied on the fact that the license agreement did not use the value of any imported merchandise in its royalty computation formula, but instead based the royalty on sales volume of merchandise purchased from other related companies.\textsuperscript{77} Thus, the fee was not related to the imported merchandise.

Favorable Customs rulings under the TAA were not limited to situations where royalty payments were made to a party other than the seller of the imported merchandise. In one ruling, Customs found nondutiable contractual royalty payments made by the importer to the seller for its use of the seller’s trademark.\textsuperscript{78} In that case the importer

\textsuperscript{70.} \textit{Id.} Customs noted that the importer would be able to purchase the imported merchandise regardless of whether or not the royalty fee was paid. \textit{Id.}

\textsuperscript{71.} \textit{Id.}

\textsuperscript{72.} HRL 543773 (Aug. 28, 1986)

\textsuperscript{73.} \textit{Id.}

\textsuperscript{74.} \textit{Id.}

\textsuperscript{75.} \textit{Id.}

\textsuperscript{76.} \textit{Id.}

\textsuperscript{77.} \textit{Id.} Customs concluded that “when a royalty or license fee is not part of transaction value under section 402(b)(1)(D) of the TAA, then it is not part of transaction value as ‘the proceeds of any subsequent resale . . .’ provided for in section 402(b)(1)(E) of the TAA.” \textit{Id.}

\textsuperscript{78.} HRL 542900 (Dec. 9, 1982).
produced finished microjectors from components it purchased from its parent corporation in England. The finished merchandise was later sold to unrelated third parties. By agreement, the importer paid to the seller a quarterly royalty fee for use of the seller's trademark. The five percent royalty fee was based on the difference between the import price of the components and the resale price of the finished merchandise sold by the importer in the United States. The Customs Service determined this royalty was not dutiable as a royalty under 19 U.S.C. § 1401a(b)(1)(D). While it could not conclude that the fee was not a condition of the sale, it found that the fee was not related to the imported merchandise. This conclusion was reached because the value of the imported components was specifically excluded from the royalty computation formula.

Under the TAA, Customs also issued a ruling finding a payment designated by the parties as a royalty dutiable as an assist, but not as a royalty. That ruling involved three proposed transactions. In the first, the importer entered into a royalty agreement with a United States-based patent holder. The patent holder provided the importer with a design drawing and a working model of certain patented merchandise in return

---

79. Id.
80. Id.
81. Id.
82. Id.
83. Id.
84. Id.
85. Id.
86. HRL 542152 (Dec. 4, 1980). An assist is defined in the TAA as any of the following if supplied directly or indirectly, and free of charge or at reduced cost, by the buyer of imported merchandise for use in connection with the production or the sale for export to the United States of the merchandise:

(i) Materials, components, parts, and similar items incorporated in the imported merchandise.

(ii) Tools, dies, molds, and similar items used in the production of the imported merchandise.

(iii) Merchandise consumed in the production of the imported merchandise.

(iv) Engineering, development, artwork, design work, and plans and sketches that are undertaken elsewhere than in the United States and are necessary for the production of the imported merchandise.

for royalty payments based on subsequent sales of the merchandise. The drawing and the model were fabricated in the United States and then provided to a foreign subsidiary of the importer, who produced the imported merchandise. The Customs Service ruled this transaction nondutiable because the proposed royalty payments went to an unrelated third party, the patent holder, and were not a condition of the sale of the imported merchandise.

The second proposed transaction involved the same facts as the first, except that the invention and working model were developed in Canada, the patent was obtained in that country, and the patent holder, to whom the royalties were paid, was Canadian. Here, the Customs Service held the payments dutiable as an assist. First, Customs determined that the cost of acquiring the design work and the model was an assist. It reached this conclusion because the drawing and the model, having been fabricated abroad, would have to be included in the price actually paid or payable for the imported merchandise. Customs then determined that the royalty payments were a part of the value of the assist. Customs stated that the patent holder was transferring technological knowledge, embodied in the model and designs and transferred through the patent rights, and that the design and model could not have been sold without the transfer of patent rights. Therefore, Customs concluded that the "value of the designs and model include whatever payments are to be made for the patent. We cannot segregate the acquired technical know-how from the physical forms embodying such knowledge." The third proposed transaction was deemed legally analogous to the second. Customs concluded that there was "... no difference in the fact that the patent was applied for and obtained in the United States rather than in Canada."

These rulings show that following the passage of the TAA, Customs continued to analyze the dutiability of royalties as it had prior to the Act's passage. With the exception of the ruling treating a royalty payment as an assist, if Customs determined that a payment was being made in
exchange for rights separate from, i.e., not inextricably intertwined with, the imported merchandise and not as a condition of sale of the merchandise, then the payment was not dutiable, even if made to the original seller. For example, if an importer paid ten dollars for an imported widget and an additional five dollars for the patented process to manufacture the imported widget, then the extra five dollars would be dutiable as a condition of the sale for importation of the widget. On the other hand, if the importer purchased the widget for ten dollars and paid an additional five dollars for certain exclusive and separate property rights, like geographic exclusivity or the right to manufacture the imported merchandise in the United States, then the extra five dollars would be a nondutiable fee paid for royalty rights, the payment of which was not a condition of the original sale for importation.

IV. THE DUTIABILITY OF ROYALTIES AS PROCEEDS OF SUBSEQUENT RESALE UNDER THE TAA

The TAA also included a specific provision requiring as an addition to the transaction value the amount of the proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrued, directly or indirectly, to the seller. As with royalties, Congress intended that Customs determine whether the proceeds of a subsequent resale are dutiable on a case-by-case basis.

The Customs regulations provide the following example of a dutiable proceed of a subsequent resale:

A buyer contracts to import a new product. Not knowing whether the product ultimately will sell in the United States, the buyer agrees to pay the seller initially $1 per unit with an additional $1 per unit to be paid upon the sale of each unit in the

96. 19 U.S.C. § 1401a(b)(1)(E) (1994). This section provides that the transaction value of imported merchandise is the price actually paid or payable for the merchandise when sold for exportation to the United States, plus amounts equal to—

(E) the proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue, directly or indirectly, to the seller.

United States. Assuming the resale price in the United States can be determined in a reasonable period of time, the transaction value of each unit would be $2. Otherwise, the transaction value could not be determined for want of sufficient information.\footnote{98}{19 C.F.R. § 152.103(g) (1995).}

The new proceeds provision was written to include as dutiable additional payments to the seller that are contingent upon the importer's post-importation resale, disposal, or use of the imported merchandise. The example provided in the regulations reinforces this limited reading. The language of the proceeds provision does not, however, mention as within its scope payments made for property rights granted to an importer by a seller/rights holder when the obligation to make such payments is triggered by the post-importation sale, use, or disposal of the import. Because such payments, regardless how the obligation is triggered, are still being made to obtain rights separate from the value of the merchandise, they are not a proceed of the resale of imported merchandise.

Customs traditionally construed the TAA in this manner, treating royalty and proceed payments as separate and distinct transactions and analyzing each under its respective provision.\footnote{99}{See, e.g., HRL 543773 (Aug. 28, 1986); HRL 542900 (Dec. 9, 1982).} If Customs determined that a royalty payment was non-dutiable under § 1401a(b)(1)(D), it refused to analyze the payment under § 1401a(b)(1)(E) as a proceed of a subsequent resale.\footnote{100}{HRL 542900 (Dec. 9, 1982). For a discussion of this ruling, see supra notes 78-85 and accompanying text.} For example, in its HRL 542900 ruling,\footnote{101}{See HRL 542900 (Dec. 9, 1982). In this ruling, Customs provided a clear statement of its position at the time on the issue of whether a nondutiable royalty was dutiable as a proceed of a subsequent resale. \textit{Id}.} Customs stated that the statutory division of payments into two separate categories—one specifically for royalties and the other specifically for the proceeds of subsequent resales—indicated that Congress did not intend for the two categories to overlap and cover the same transaction.\footnote{102}{\textit{Id}.} Customs' clear position was that where a royalty payment had been found to be bona fide and therefore nondutiable under 19 U.S.C. § 1401(b)(1)(D), no authority existed for including that fee in transaction value under 19 U.S.C. § 1401(b)(1)(E) as a proceed of subsequent sale.\footnote{103}{\textit{Id}.}
One ruling illustrating the types of payments traditionally found by Customs to be proceeds under § 1401(b)(1)(E) involved an imported chemical known as propranol.\textsuperscript{104} After importation, the chemical was further processed in the United States into pharmaceutical tablets domestically resold under the trade name "Inderal."\textsuperscript{105} The importer agreed to pay the seller an original import price for the merchandise;\textsuperscript{106} however, if the importer's resale price of the Inderal was increased by a certain percentage above the original import price, then the exporter's sale price for all of the imported merchandise was to be retroactively increased by the same percentage.\textsuperscript{107} A similar arrangement was provided for if the resale price fell.\textsuperscript{108}

Customs ruled that the prospective payments to the exporter were dutiable under § 1401a(b)(1)(E) as proceeds of subsequent resales.\textsuperscript{109} It determined that any price decrease after importation would be disregarded in calculating the transaction value, but that the statute specifically required the inclusion of price remissions and additions in the transaction value determination.\textsuperscript{110} Thus, if the importation sale price was adjusted upwards based on a post-importation occurrence, any additional payments were dutiable.\textsuperscript{111}

In another ruling, the buyer imported vodka at a fixed price and agreed to pay the exporter one-half of the excess revenue above the importer's net cost generated by the resale of the vodka to the importer's customers.\textsuperscript{112} In most cases, the importer's net cost was the FOB price plus freight, and its selling price was calculated pursuant to a formula based primarily on anticipated inflation rates and total projected sales

\begin{itemize}
  \item \textsuperscript{104} HRL 542701 (Apr. 28, 1982).
  \item \textsuperscript{105} \textit{Id.}
  \item \textsuperscript{106} \textit{Id.}
  \item \textsuperscript{107} \textit{Id.}
  \item \textsuperscript{108} \textit{Id.}
  \item \textsuperscript{109} \textit{Id.}
  \item \textsuperscript{110} Under transaction value, the "price paid or payable" need not be established at the time the merchandise is entered into the commerce of the United States so long as a formula is fixed at that time which allows a firm sale price to be determined later on the basis of a condition subsequent, such as the closing price on a futures exchange. \textit{See} 19 U.S.C. § 1401a(b)(2)(A)(ii) (1994); 19 C.F.R. § 152.103(a)(1) (1995).
  \item \textsuperscript{111} HRL 542701 (Apr. 28, 1982). Customs also rejected, without stating its reason, the importer's argument that since the resold Inderal was different from the imported bulk chemical, the value of the proceed attributable to the post-importation sale of the imported merchandise could not be quantified. \textit{Id.}
  \item \textsuperscript{112} HRL 542729 (Mar. 29, 1982).
\end{itemize}
Customs ruled that the additional payments based on this formula were dutiable as proceeds of subsequent resales.114

Neither of these rulings involved payments associated with separate intellectual property rights. When the importer remitted additional monies to the seller, Customs used the proceeds of a subsequent resale provision to capture adjustments to the price paid or payable for imported merchandise. In rulings where the proceed provision has been held to be applicable, the importer had not received any separate and valuable rights in exchange for its post-importation payment back to the seller. Payments found to be proceeds in Customs’ rulings differed from true royalty payments and were viewed as merely ways for the importer to funnel additional money back to the seller pursuant to a pre-importation promise to pay any upward price adjustments.

V. THE HASBRO RULINGS

The Hasbro rulings constitute a reversal by the Customs Service of its long-standing treatment of royalties in determining transaction value. Today, a royalty found nondutiable under 19 U.S.C. § 1401a(b)(1)(D) may nevertheless be dutiable under § 1401a(b)(1)(E) as a proceed of subsequent resale.115

The Hasbro I ruling involved an importer, Hasbro, that purchased toys from an unrelated foreign seller, Takara Co., Ltd.116 A royalty agreement was entered into among Hasbro, Takara, and Takara U.S., a United States company related to the seller, whereby Hasbro agreed to pay Takara U.S. a fee upon the resale in the United States of the imported toys.117 The agreement set a variable royalty rate of five to seven percent of the resale invoice price and provided for a minimum annual payment of $1,000,000.118 In return, Takara U.S. granted Hasbro the exclusive

---

113. Id. These selling prices also had to be published in accordance with state liquor laws. Id.
114. Id. In other rulings, Customs found certain payments dutiable as proceeds when the parties shared profits under a profit sharing plan, HRL 554999 (Jan. 5, 1989), or when proceeds in excess of an agreed-upon price arose due to currency fluctuations, HRL 542879 (Nov. 3, 1982).
117. Id.
118. Id. at 20.
right to manufacture and sell the merchandise within a specified geographic territory.\(^{119}\)

Subsequently, this agreement was amended to make ninety percent of the royalties originally payable exclusively to Takara U.S. payable directly to the seller, Takara.\(^{120}\) Eventually, the parties further modified the original agreement to eliminate Takara U.S.' right to any royalties and providing that the foreign seller, Takara, would receive 100 percent of the royalty payments.\(^{121}\)

The Customs Service held that the royalty fees paid by Hasbro were not dutiable under § 1401a(b)(1)(D).\(^{122}\) Because the royalties were paid to obtain the right to sell the imported merchandise in a specific geographic area and to make the merchandise, Customs concluded that the royalties were not a condition of the sale of the imported goods and were therefore nondutiable under § 1401a(b)(1)(D).\(^{123}\)

The Customs Service then strayed from its previous position that royalties found nondutiable under 19 U.S.C. §1401a(b)(1)(D) could not be analyzed for dutiability as proceeds of subsequent resales and addressed the issue of whether these royalty payments were dutiable as proceeds under § 1401a(b)(1)(E).\(^{124}\) To support this action, the Customs Service reviewed a portion of the legislative history of the TAA that stated that “certain elements called ‘royalties’ may fall within the scope of the language under either new section 402(b)(1)(D) or 402(b)(1)(E) or both.”\(^{125}\) Based on this legislative history, Customs concluded that “Congress clearly stated that section [1401a(b)(1)(E)] of the TAA must be examined in cases such as this.”\(^{126}\) Customs then reviewed the transaction and determined that because the royalties became “due” upon the resale of the imported toys and inured to the benefit of the original seller,

\(^{119}\) Id. at 19-20. In addition, Takara agreed to make the merchandise available to Hasbro. Id.

\(^{120}\) Id. at 20.

\(^{121}\) Id. The parties also agreed to raise the minimum annual royalty to 1.5 million dollars. Id.

\(^{122}\) Id. at 21.

\(^{123}\) Id.

\(^{124}\) Id. at 22-23.


\(^{126}\) Id.
Takara, the royalty payments were dutiable as proceeds of the subsequent resale of the imported merchandise.\textsuperscript{127}

Thus, under Hasbro I, payments made pursuant to a royalty agreement, even if made to obtain valuable intellectual property rights separate from the value of the imported merchandise, are dutiable as the proceeds of a subsequent resale if the obligation to make the additional payments is triggered by the resale of the imported merchandise and the payments are remitted back to the seller.

On June 6, 1991, Customs announced that the dutiability of royalty payments would prospectively be analyzed on a case-by-base basis under both § 1401a(b)(1)(D) and § 1401a(b)(1)(E).\textsuperscript{128} On the same day, Customs also gave public notice that it was seeking comments from the importing community regarding this new approach.\textsuperscript{129}

Customs received thirteen comments in response to its request for public opinion and it published its analysis of those comments on January 21, 1993.\textsuperscript{130} This analysis, known as Hasbro II, not only supported the original conclusion of Hasbro I that the payments were dutiable under 19 U.S.C. § 1401a(b)(1)(E) as proceeds of subsequent resales, but also reversed and expanded the coverage of Hasbro I by holding that the payments were also dutiable as royalty payments under 19 U.S.C. § 1401a(b)(1)(D).\textsuperscript{131}

Instead of using Hasbro II as primarily a vehicle for supporting its rationale in Hasbro I for finding the payments dutiable as proceeds, Customs used Hasbro II as an opportunity to develop criteria to be used in determining whether payments made pursuant to license agreements were dutiable royalties under § 1401a(b)(1)(D).\textsuperscript{132} In its analysis, Customs

\begin{itemize}
\item \textsuperscript{127} Id. Customs also stated that if the subsequent resales were insufficient to meet the minimum requirement as stated under the royalty agreement and the importer was required to pay the difference, the amount of the difference paid would not be dutiable as no imported merchandise would exist against which this portion of the royalty could be applied. Id. In other words, this portion would not represent the proceed of a subsequent sale.
\item \textsuperscript{128} See Dutiability of “Royalty” Payments, reprinted in 25 Cust. B. & Dec., No. 25, at 8 (June 19, 1991).
\item \textsuperscript{129} Id. Although the request for comments stated that Customs would prospectively analyze payments under both subsections, the request appeared to ask for comments on the new application of the proceeds provision.
\item \textsuperscript{130} Hasbro II, 27 Cust. B. & Dec., No. 6, at 1 (Feb. 10, 1993).
\item \textsuperscript{131} Id.
\item \textsuperscript{132} Id. at 9-11.
\end{itemize}
reviewed the language of the valuation statute, its legislative history, and the way royalties were treated under the previous valuation statute.

In Hasbro II, Customs developed three questions to be asked in determining whether a certain payment is dutiable as a royalty. The first question to be asked is, "was the imported merchandise manufactured under patent." Customs stated that a negative answer to this question pointed toward nondutiability. The second question to be asked is, "was the royalty involved in the production or sale of the imported merchandise." Again, Customs indicated that an answer in the negative pointed toward nondutiability. The third question to be asked is, "could

133. Id. at 3-11. For example, while acknowledging Congress' desire that the existing treatment of royalties continue, Customs noted that the TAA did not expressly state that "charges termed to be 'royalties' can only be dutiable under section 402(b)(1)(D)." Id. at 6.

Customs focused on certain passages from both the Senate and the House committee reports, both of which stated that "[t]herefore, certain elements called 'royalties' may fall within the scope of the language under either new section 402(b)(1)(D) or 402(b)(1)(E), or both. Similarly, some elements called 'royalties' may not be dutiable under either 402(b)(1)(D) or 402(b)(1)(E)." Id. at 5 (citing H.R. (WAYS AND MEANS COMM.) REP. NO. 317, 96th Cong., 1st Sess. 1, 80 (1979); S. REP. NO. 249, 96th Cong., 1st Sess. 1, 120 (1979), reprinted in 1979 U.S.C.C.A.N. 388, 506). Based on these passages, Customs concluded that

[b]y putting the term royalties in quotation marks, the committees left the decision to the Customs Service to determine whether the "royalty" payments claimed by the importer are bona fide royalty payments and/or are additional payments to the seller based on the resale, disposal or use of the importer merchandise.

Id. at 6. Customs then concluded that it could examine and determine the dutiability of the payments under either provision, both provisions, or neither provision. Id. at 9.

134. Id. at 9.

135. Id. Customs cited as authority for this conclusion Rohner Gehrig & Co., Inc. v. United States, 9 Cust. Ct. 591 (1942). Id. In that case, the Customs Court found that the payments were not dutiable because the patent covered the process to supercharge the engine and not the imported blower. Rohner Gehrig, 9 Cust. Ct. at 606. Customs also cited United States v. Imperial Prods., Inc., 570 F.2d 337 (C.C.P.A. 1978) as authority for this proposition. Hasbro II, 27 Cust. B. & Dec., No. 6 at 10 (Feb. 10, 1993).


137. Id. Customs cited both Rohner Gehrig & Co., Inc. v. United States, 9 Cust. Ct. 591 (1942), and United States v. Imperial Prods., Inc., 570 F.2d 337 (C.C.P.A. 1978), to support this answer. Id. In Rohner Gehrig, the royalty was paid to use a patented process in the United States. Rohner Gehrig, 9 Cust. Ct. at 607. In Imperial Products, the royalty was paid for the right to manufacture and sell patented brushes using imported brush heads in the United States. 570 F.2d at 337.
the importer buy the product without paying the fee."\textsuperscript{138} This question goes to the heart of whether the payment of a fee is a condition of the sale for import. If the answer to this question is affirmative, it points toward nondutiability.\textsuperscript{139}

Customs concluded its analysis in Hasbro II by stating that it would subsequently ask these three questions to determine whether payments were dutiable as royalties.\textsuperscript{140} However, only the third question has any basis in the statute and is consistent with Congress’ requirement that royalties, to be dutiable, be a condition of sale of the imported merchandise. The first and second questions are not authorized under the TAA and are not appropriate issues to consider when analyzing the dutiability of a royalty payment. Nevertheless, Customs proceeded to analyze the Hasbro I fact pattern under the new criteria.\textsuperscript{141}

In answering the first question, Customs stated the facts of Hasbro I were unclear as to whether the imported toys were manufactured under a patent.\textsuperscript{142} Customs reached this conclusion even though the importer was granted the right to use any patents that had been issued on the products in the designated territory.\textsuperscript{143} Customs then addressed the second question and concluded that the royalty appeared to involve the sale of the imported merchandise.\textsuperscript{144} This conclusion was based on the fact that the individual sales agreements or purchase agreements were subject to the terms and conditions of the royalty agreement.\textsuperscript{145}

In answering the third question, however, Customs determined that the royalty payments were to be paid on each imported item purchased

\textsuperscript{138} Hasbro II, 27 Cust. B. \& Dec., No. 6 at 11 (Feb. 10, 1993).

\textsuperscript{139} Id. To support this proposition, Customs cited United States v. Imperial Prods., Inc., 570 F.2d 337 (C.C.P.A. 1978). Id. In Imperial Products, the Court of Customs and Patent Appeals determined that the importer could buy the imported merchandise without paying the fee and, in fact, only one-third of the imported merchandise actually triggered the royalty obligation. 570 F.2d at 337. Customs also cited BBR Prestressed Tanks, Inc. v. United States, 64 Cust. Ct. 787 (1970). Hasbro II, 27 Cust. B. \& Dec., No. 6 at 11 (Feb. 10, 1993).

\textsuperscript{140} Hasbro II, 27 Cust. B. \& Dec., No. 6 at 13 (Feb. 10, 1993). Customs specifically stated that the analysis and conclusions set out in Hasbro II would be applied to merchandise entered 90 days from the date of its publication in Customs Bulletin \& Decisions (Feb. 10, 1993). Id.

\textsuperscript{141} Id. at 11-13.

\textsuperscript{142} Id. at 12.

\textsuperscript{143} Id.

\textsuperscript{144} Id.

\textsuperscript{145} Id.
from the seller, and that the facts failed to support the conclusion that the payments were not a condition of the sale for importation.\textsuperscript{146} Thus, under its new criteria, Customs determined that the payments evaluated in the \textit{Hasbro I} decision were dutiable as royalties under 19 U.S.C. 1401a(b)(1)(D).\textsuperscript{147}

In addition, Customs reaffirmed its previous conclusion that the payments in \textit{Hasbro I} were also dutiable as proceeds of subsequent resales.\textsuperscript{148} Customs stated that the obligation to pay the royalty to the seller accrued upon the resale of the imported products and was calculated based as a percentage of the resale price of the imported merchandise.\textsuperscript{149} Customs concluded that the income produced from the subsequent resale or disposition was therefore dutiable under 19 U.S.C. 1401a(b)(1)(E).\textsuperscript{150}

\textbf{VI. SUBSEQUENT APPLICATION OF THE \textit{HASBRO} RULINGS}

The result of the \textit{Hasbro} rulings has been that any royalty payment made to a seller that is triggered by the resale of imported merchandise, especially where the payment is calculated as a percentage of the resale price of that resold merchandise, will be analyzed first as a royalty and, if found nondutiable under the royalty provision, then as a proceed of a subsequent sale. Although it appeared that Customs would, based on the new analysis propounded in \textit{Hasbro II}, presume all royalty payments to be conditions of the sale of the imported merchandise unless the importer could establish facts to the contrary,\textsuperscript{151} a Customs Headquarters ruling that post-dated \textit{Hasbro I} but pre-dated \textit{Hasbro II} limits the future application of the \textit{Hasbro} rulings on the issue of whether payments not dutiable as royalties are dutiable as proceeds.\textsuperscript{152}

In the Customs Headquarters ruling, the importer, a wholly-owned American subsidiary of a Swiss corporation, imported components for

\textsuperscript{146} \textit{id.}

\textsuperscript{147} \textit{id.}

\textsuperscript{148} \textit{id.}

\textsuperscript{149} \textit{id.} at 13.

\textsuperscript{150} \textit{id.} Of course, a payment found dutiable as both a royalty and as a proceed will only be added once to the price paid or payable when calculating transaction value.

\textsuperscript{151} For example, it appears Customs will only apply § 1401a(b)(1)(E) to situations where the imported merchandise is resold in its imported condition.

\textsuperscript{152} This conclusion is based on Customs' statement that the facts in \textit{Hasbro II} failed to support the protestant's claim that the payments were not a condition of the sale for importation.
textile machines from its Swiss parent. The importer then assembled the components, sometimes combining them with components of United States origin, to create finished textile machines. The two parties entered into a technical services agreement, pursuant to which the importer was granted certain non-exclusive licenses and rights to make, use, and sell the textile machines. In return, the importer agreed to pay a royalty based on the invoice sales price “ex works” the importer’s United States-based operation.

Customs determined that the fees paid were not dutiable under the royalty provision because they were based on the “ex works” price of the finished merchandise, which sometimes included additional components of United States origin. In other words, the fees were not determined solely from the value of the merchandise as imported. In addition, Customs found that these fees were to be paid regardless of whether the importer purchased any parts from its Swiss parent. Customs acknowledged that the payments were not connected to the importation and ownership of the imported components, but were paid for technical information and know-how relating to the use of the components in the textile machines.

Customs then addressed the issue of whether the royalty payments were dutiable as the proceeds of a subsequent resale. In concluding that the payments were not based on the resale of the imported product, Customs stated that since the payments to the seller were based on, and triggered by, the resale of the finished textile machines, not the imported components, the payments were not dutiable as proceeds.

This ruling cut back on the scope of the Hasbro I decision in two ways. First, Customs stated it would not apply the Hasbro I ruling to entries made prior to February 4, 1991. Second, and more important, Customs did not extend the application of § 1401a(b)(1)(E) to a fact pattern that differed from that of Hasbro I.

154. Id.
155. Id.
156. Id. at 6.
157. Id. at 9.
158. Id.
159. Id. at 8.
160. Id. at 9.
161. Id.
This limitation appeared again in Customs Headquarters Ruling Letter 545114,162 issued after the Hasbro II ruling. The imported merchandise in HRL 545114 was a chemical that served as an active ingredient used in the production of a pharmaceutical product known generically as nifedipine.163 Pursuant to a license agreement, the importer received an option from the exporter to make, use, and sell nifedipine in the United States.164 In exchange for the right to use the exporter’s patent and know-how, including the patented process for making nifedipine, in the United States, the importer agreed to pay a royalty calculated as a percentage of its sales of nifedipine in the United States.165 Subsequently, the importer and the exporter entered into a supply agreement obligating the importer to purchase its requirements of the chemical ingredient from the exporter. No royalty would be due if the imported chemical was used, resold, or disposed of in a manner that did not involve the sale of the finished nifedipine.166

Customs analyzed this case by applying the new criteria it announced in Hasbro II. First, it found that the imported merchandise was not manufactured under a patent.167 To support this finding, Customs noted that the importer had shown that the chemical ingredient was available from several sources, none of which required a sale of the chemical to be accompanied by a license from a patent holder.168 Customs also noted that the importer’s license to use the patented process for producing nifedipine did not require that the ingredient be sourced from the exporter.169 Addressing the second question, Customs determined that the royalty was paid for the right to use the patented manufacturing process in the United States.170 It found that the act of importing the chemical ingredient did not require the payment of a royalty.

Customs addressed the third question, whether the payment was a condition of sale, by asking whether the buyer could purchase the imported merchandise without paying the fee. It answered this question

163. Id. at 30.
164. Id.
165. Id.
166. Id. at 31.
167. Id. at 33.
168. Id.
169. Id.
170. Id.
in the affirmative because the importer could buy the imported merchandise without paying the license fee, which was triggered only if the importer used the patented process to make nifedipine.\textsuperscript{171} Customs concluded that the sale of the imported chemical ingredient was not a condition of the payment of the fee and that the importer's obligation to pay a fee on sales of nifedipine it produced with the patented process was not obviated if it purchased the ingredient from another party. Customs therefore held that the royalty payments were not dutiable under § 1401a(b)(1)(D).\textsuperscript{172}

Customs then reviewed the payments to determine whether they were dutiable as proceeds of subsequent resales. The importer argued that the royalty was not based on the value of the imported merchandise, but on the value of the finished product, eighty-nine percent of which was comprised of United States materials, labor, and overhead.\textsuperscript{173} Customs found that the imported merchandise was substantially processed in the United States and that the use of the patented process caused a chemical reaction that changed the starting materials, including the imported merchandise, into a different finished product.\textsuperscript{174} Based on these facts, Customs held that the payments were not dutiable as proceeds of a subsequent resale.\textsuperscript{175} It found that the finished product was created by more than simply mixing or finishing, and that the royalty/license fee payments [were] made for the right to use a patented process and know how necessary to manufacture, compound and formulate the finished royalty products. The royalty/license fee payments are based on the resale of a finished product that includes a substantial percentage of U.S. ingredients. Accordingly, the payments . . . are not dutiable under section 402(b)(1)(E) of the TAA.\textsuperscript{176}

In other post-\textit{Hasbro} rulings, Customs has found payments made to unrelated third parties to be nondutiable under either section of the transaction value statute. In one such ruling, Customs reviewed the

\textsuperscript{171.} \textit{Id.}

\textsuperscript{172.} \textit{Id.}

\textsuperscript{173.} \textit{Id.} at 34.

\textsuperscript{174.} \textit{Id.}

\textsuperscript{175.} \textit{Id.} at 33.

\textsuperscript{176.} \textit{Id.} at 35. Customs also acknowledged that the facts were similar to those found in HRL 545114, which ruling it followed.
dutiability of certain payments made to three different licensors to settle alleged copyright infringements. The first agreement concerned imported garments made from a fabric with a design that allegedly infringed a copyrighted fabric design owned by licensor A. The buyer of the imported merchandise was released from all claims of infringement in exchange for its agreement to pay the licensor a lump sum amount equal to a percentage of the buyer's net revenues from sales of the infringing merchandise. The third agreement with licensor C was substantially the same as the agreement with licensor A. In its agreement with licensor B, which also related to imported merchandise that allegedly infringed a copyrighted fabric design, the buyer agreed to pay the licensor a lump sum for previously imported garments. The buyer was granted a seven-year exclusive license to use the design in exchange for its agreement to pay licensor B a percentage of the net revenues from its sales of garments made with fabric using the infringing design.

Customs reviewed each of the different agreements under the three criteria of Hasbro II and held that none of the payments they provided for were dutiable as royalties. In each case, Customs answered the first two questions in the negative. It concluded that the merchandise was not manufactured under patents because the payments were for rights to use copyrighted designs. Similarly, it found the payments were separate from the price of the imported garments because the payments merely allowed the importer to sell the merchandise made with fabric using the copyrighted design in the United States. Finally, in answer to the third question, Customs stated that the payments made to third parties and calculated as a percentage of the sale of the imported merchandise were not made for the actual sale for importation.

177. HRL 545312 (Mar. 18, 1994).
178. Id.
179. Id.
180. Id.
181. Id. Because the payments were made as settlement for prior bad acts, Customs reviewed the three transactions as if the payments had been made ab initio. Id. In other words, Customs reviewed the transactions as if the buyer had recognized its duty to pay, and in fact had paid, a license fee for the right to import garments manufactured with those fabric designs.
182. Id.
183. Id.
184. Id. Thus, Customs concluded that the payments could not be considered a condition of sale for importation. Id.
In another factually similar post-Hasbro ruling, Customs again held that payments made to a third party for the use of its copyrighted fabric designs in garments manufactured by the importer were not dutiable as either royalties or proceeds.\(^\text{185}\) After finding that the payments were not dutiable as royalties,\(^\text{186}\) Customs held that the payments were not dutiable as proceeds of subsequent resales because the payments were made to a third party, not to the seller of the imported merchandise.\(^\text{187}\)

**VII. RAMIFICATIONS OF THE HASBRO RULINGS**

Before the Hasbro rulings, payments made pursuant to license agreements covering tangible property rights separate from the value of imported merchandise were not dutiable as royalties or as proceeds. Drafters of royalty agreements must now focus on how the obligation to pay the royalty is structured. The outgrowth of the Hasbro rulings and their progeny is that royalty payments, albeit paid for legitimate and separate property rights, may be dutiable as proceeds if they are triggered by the post-importation sale of the imported merchandise, calculated as a percentage of post-importation sale revenues, and paid to the seller of the imported merchandise.

The Hasbro and subsequent Customs rulings create other potential problems. For example, under the North America Free Trade Agreement, ("NAFTA"),\(^\text{188}\) certain merchandise, in order to qualify for NAFTA treatment, may have to satisfy a regional value content requirement.\(^\text{189}\) If the value of a NAFTA product is increased because it must now incorporate bona fide royalty payments that may be found dutiable as proceeds, it becomes more difficult for such merchandise to qualify under

---

185. HRL 545370 (Mar. 4, 1994).

186. Id. Customs determined that the royalty was not payable for the production or sale of the imported merchandise. It stated that "[t]he royalty is paid for the exclusive right of the importer to utilize the copyrighted patterns. This right is separate from the purchase price of the garments." Id.

187. Id.


189. Under NAFTA, a minimum regional value content requires that a certain percentage of the value of a good be of North American origin. Id. art. 289(1)(d)(ii). Other trade agreements have similar requirements.
NAFTA's regional value requirement. This would be especially true where payments are made to a non-NAFTA based licensor.  

Finally, if a product has a greater dutiable value because of the inclusion of nondutiable royalty payments found dutiable as a proceed, the importer will owe more customs duties. Obviously, this is of concern to importers.

VIII. EVALUATION OF THE HASBRO RULINGS

The Customs Service's new method of analyzing payments for intellectual property rights under both §§ 1401a(b)(1)(D) and (E) is flawed for several reasons. First, the valuation statute does not state that royalty payments, paid for separate property rights, are to be analyzed under the proceeds of a subsequent resale provision. Instead, the statute recognizes two different types of transactions, dutiable royalties and dutiable proceeds, and imposes no requirement that a payment that is not dutiable as a royalty be analyzed under both sections.

Section 1401a(b)(1)(D) covers the dutiability of royalty payments. A true royalty payment involves the transfer of consideration: the payment of a fee in return for a valuable proprietary right, such as the use of a trademark, a patented process, or geographic exclusivity. In these circumstances, the importer is receiving a valuable asset that is separate from the value of the imported merchandise. If payment for such an asset is not a condition of the sale for importation, then it is not dutiable under the TAA. However, if the imported merchandise is manufactured under a patent and the foreign manufacturer is required to pay a royalty in order to create the imported merchandise, and that royalty payment is subsequently charged downstream to the importer, then the fees paid by the importer to cover the manufacturer's royalty are dutiable as part of the transaction value of the imported merchandise. Under such circumstances, the importer is not getting an additional bundle of rights and its payment of royalties is part of the value of the imported merchandise.

By comparison, § 1401a(b)(1)(E) applies in situations where the importer receives no separate and valuable asset in exchange for its payment of an additional fee to the seller. Traditionally, these payments were made as merely a continuation of the previous transaction. The types of transactions that the proceeds provision was intended to encompass
ROYALTY PAYMENTS

were clearly identified in Customs rulings applying § 1401a(b)(1)(E) issued prior to the Hasbro rulings.\textsuperscript{193} The payments found dutiable as proceeds in those rulings were triggered after importation but pursuant to price adjustment formulas negotiated by the parties prior to importation.\textsuperscript{194} Unlike the situations involving bona fide royalties, where the importer pays one price for the merchandise and an additional fee for separate intellectual property rights relating to the merchandise, the proceeds rulings involve fact patterns where the importer does not receive a separate bundle of rights in exchange for additional payments. Additional payments in these rulings were made only to acquire the imported merchandise.\textsuperscript{195}

Thus, Customs’ treatment of Hasbro-type payments as dutiable proceeds misses the mark and is inconsistent with its previous rulings on proceeds and royalties. Like payments evaluated in earlier proceeds rulings, the payments in Hasbro I were triggered by the resale of the imported merchandise and calculated according to a formula based on that resale price.\textsuperscript{196} Unlike Customs’ earlier proceeds rulings, the payments in Hasbro I were made in exchange for a certain property right, specifically the right to manufacture and/or sell the merchandise in a specific geographic area. Only a portion of the total price the importer paid in Hasbro I represented the value of the imported merchandise; the remaining portion represented the value of the property right it acquired.\textsuperscript{197} The fact that the seller was also the licensor does not obviate the fact that the royalty payment was made in exchange for something other than the value of the imported merchandise.

In addition, the position taken by Customs in the Hasbro rulings regarding the proceeds analysis is contradictory to the legislative history underlying the TAA. Congress clearly stated that the pre-TAA treatment of royalties was to continue under the TAA.\textsuperscript{198} Thus, unless “inextricably intertwined” with the imported merchandise and a condition of its sale for importation, such payments were not dutiable as royalties and were not analyzed under the proceeds provision. In citing, in Hasbro II, the

\textsuperscript{193} See part V, supra.
\textsuperscript{194} Id.
\textsuperscript{195} Id.
\textsuperscript{196} Id.
\textsuperscript{197} Id.
legislative statements made in both the House and Senate Reports that "certain elements called 'royalties' may fall within the scope of the language under either new section," Customs disregarded the sentence directly preceding this statement that calls for the continuation of the existing treatment of royalties. Clearly, Congress did not intend bona fide royalties, which traditionally were not dutiable or even analyzed as proceeds, to now be dutiable as proceeds of subsequent resales.

In each sentence from the legislative history Customs cited to support its Hasbro rulings, the word "royalties" is in quotations. The reason Congress set off the word royalty in quotation marks is not clear; however, it is arguable that in using quotation marks, Congress recognized that certain payments claimed by an importer to be royalties may not necessarily be bona fide royalties, but instead may be intended as payments for the imported merchandise under the guise of royalty payments. For example, as highlighted in the Customs Regulations, the parties could enter into an agreement under which the importer agreed to pay the seller one dollar per unit at entry and one additional dollar upon the resale of the merchandise in the United States. Nothing prohibits the parties from calling the additional payment a "royalty" even though the importer is not receiving the additional bundle of rights that traditionally accrue to it under bona fide royalty agreements. These payments would not in fact be royalties, but rather payments of the purchase price for the merchandise disguised as "royalties." The payments analyzed by the courts in both BBC Prestressed Tanks, Inc. v. United States and Erb & Gray Scientific, Inc. v. United States, which were designated by the parties as "licensing fees" but were held to be increases in the price of the imported merchandise, are two examples of payments disguised as royalties.

IX. CONCLUSION

Customs erred in its Hasbro rulings by failing to acknowledge that a "proceed" is an additional payment for the merchandise to the seller that


occurs after importation, and not a return paid for separate and identifiable rights merely triggered by a resale, regardless of who it is paid to. While the Hasbro royalty criteria provide a method for determining the dutiability of payments under the royalty provision, if Customs is concerned that part of the value of the imported merchandise is being paid back to the seller disguised as a royalty, this concern should not be addressed by treating legitimate royalty payments as dutiable proceeds.\footnote{202} The end result of the Hasbro rulings is the creation of a disincentive for importers to purchase merchandise from certain manufacturers, when those importers, in order to obtain the benefit of a specific trademark, patented process, or geographic exclusivity, must also make royalty payments to the manufacturers.

Instead of engaging in the three part Hasbro analysis, Customs should analyze the royalty and attempt to qualify the value of the property rights that the importer is purchasing. Customs can easily identify true royalty payments, as such payments are made to acquire property rights distinct from ownership of the actual merchandise. Royalty payments differ from payments made by importers to sellers based on the proceeds of a subsequent resale, because the importer acquires no additional property rights for payments it makes from proceeds. While it is inherently difficult to place a value on intellectual property rights, Customs has increased the difficulty of valuation and performed a great disservice to the importing community by mischaracterizing legitimate royalty payments as the proceeds of subsequent resales.

\footnote{202. One could envision an unscrupulous importer and manufacturer agreeing to overvalue the worth of related intellectual property rights while undervaluing the worth of the imported merchandise related to the royalty payments in an attempt to decrease the dutiable value of the imported merchandise, and then triggering the payment of the royalty on the resale of the imported merchandise. Notwithstanding the fraudulent nature of this type of transaction and the civil and criminal remedies available to Customs to combat this scenario, Customs can independently analyze the true value of the related property rights and the imported merchandise. It need not create the legal fiction that the entire value of the royalty is dutiable as a proceed of a subsequent resale.}