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# **Comparative Views of U.S. Customs Valuation Issues in Light of the U.S. Customs Modernization Act**

**Edward J. Hayward\***  
**Julie Long\*\***

The birth of NAFTA and its progress toward duty-free trade have begun to make customs valuation issues somewhat less significant in U.S.-Canadian cross-border transactions. Until all trade is entirely duty-free, however, the conflicts inherent between the importer's desire to pay as little as possible and a government's need to gain revenue and control trade continue to ensure that valuation issues will arise. Such issues will also continue to affect U.S.-Canadian trade in products originating in third countries. Moreover, changes in U.S. customs procedures brought about by Title VI of the NAFTA Implementation Act, colloquially known as the "Customs Modernization Act"<sup>1</sup> (Mod Act) mean that importers now have even more responsibility than in the past to know and follow valuation rules.

This Article outlines the obligations imposed on importers by the Mod Act, looks at developments in U.S. customs valuation law, and explores how these new standards can affect cross-border trade. Part I discusses the Mod Act and its application to U.S. and Canadian traders. Part II looks at several evolving areas of U.S. customs practice, including the U.S. Customs Service's treatment of royalties, commissions, and assists in the transaction value method; multi-tiered transactions; and the impact of related party transactions in each of the areas mentioned above. Additionally, the Article attempts to point out where the U.S. law differs from the treatment of the same issues in Canadian practice. Finally, in Part III, the Article discusses planning strategies that can help importers and exporters cope with the

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\* Partner, Oppenheimer Wolff & Donnelly, Minneapolis, Minnesota.

\*\* 1995 Summer Associate, Oppenheimer Wolff & Donnelly, Minneapolis, Minnesota.

1. Customs Modernization Act, Pub. L. No. 103-182, 107 Stat. 2057 (codified as amended in scattered sections of 19 U.S.C.).

new requirements of the Mod Act and evolving U.S. customs practice.

### I. DEVELOPMENTS IN U.S. CUSTOMS LAW: THE 1994 CUSTOMS MODERNIZATION ACT

The Customs Modernization Act<sup>2</sup> was the first major overhaul of U.S. customs procedure<sup>3</sup> since the Tariff Act of 1930.<sup>4</sup> Designed to bring U.S. law into compliance with NAFTA and to streamline and update U.S. customs practice in general,<sup>5</sup> the Mod Act amended many sections of the Tariff Act of 1930 and changed other related laws.<sup>6</sup> Although the Mod Act changes little in terms of the actual substance of customs valuation law,<sup>7</sup> it

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2. *Id.*

3. The substance of U.S. customs law was changed dramatically by the Trade Agreements Act of 1979. See 19 U.S.C. § 1401a (1988 & Supp. V 1993). The Mod Act does not alter the valuation requirements contained in the Trade Agreements Act, but instead changes the way in which Customs and the trade community relate to one another.

4. 19 U.S.C. § 1202 et seq. (1988 & Supp. V 1993).

5. H.R. REP. NO. 103-361(I), 103rd CONG., 1st Sess. 5 (1993), *reprinted in* 1993 U.S.C.C.A.N. 2552, 2555.

6. U.S. CUSTOMS SERVICE, U.S. DEPARTMENT OF THE TREASURY, INTRODUCTION TO WHAT EVERY MEMBER OF THE TRADE COMMUNITY SHOULD KNOW ABOUT: CUSTOMS VALUE (1995).

7. See *supra* note 3 and accompanying text. The Trade Agreements Act of 1979 establishes that the preferred method of appraisal is the transaction value. 19 U.S.C. § 1401a(1)(A)(1988 & Supp. V 1993). This is the price actually paid or payable for merchandise when sold for export to the United States, plus amounts equal to the packing costs incurred by the buyer; any selling commissions incurred by the buyer; the value, apportioned as appropriate, of any assist; any royalty or license fee the buyer is required to pay, directly or indirectly, as a condition of the sale; and the proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue, directly or indirectly, to the seller. 19 U.S.C. § 1401a(b)(1). The amounts listed are added only to the extent that each is not included in the price and if it is based on information which accurately establishes its amount. *Id.* If these two conditions cannot be met, the transaction value method cannot be used. *Id.*

The price actually paid or payable is the total payment, excluding international freight, insurance, and other C.I.F. charges, that the buyer makes to the seller. 19 U.S.C. § 1401a(b)(4)(A). The transaction value cannot be used if any of the following limitations are present: (1) restrictions on the disposition or use of the merchandise; (2) conditions for which a value cannot be determined; (3) proceeds of any subsequent resale, disposal, or use of the merchandise accrues to the seller, and an appropriate adjustment cannot be made; and, (4) related party transactions where the transaction value is not acceptable. 19 U.S.C. § 1401a(b)(2)(A)(i)-(iv).

Transaction value is acceptable in related party transactions if the relationship between the buyer and the seller did not influence the price actually paid or payable. 19 U.S.C. § 1401a(b)(2)(B). Alternatively, if the transaction value closely approximates one of the following test values, the transaction

creates a new environment in which traders and Customs officials must work.

Premised on the idea that Customs can maximize voluntary compliance if the trade community is fully informed of its legal obligations,<sup>8</sup> the Mod Act imposes a greater obligation on Customs to publish and otherwise make available information regarding the trade community's rights and responsibilities under Customs practices and related laws.<sup>9</sup> Concurrently, traders have the responsibility to engage in informed compliance. This mutual or "shared responsibility,"<sup>10</sup> is the essence of the new U.S. customs procedure. Customs must make its rulings and practices available and the trading community must exercise "reasonable care" in making itself aware of and in following the rules.<sup>11</sup>

Under the Mod Act, an importer who exercises reasonable care will not be penalized for mistakes it makes in dealing with Customs.<sup>12</sup> It is important to note, however, that simply reading and making a good faith effort to follow all applicable rules may not be enough to meet the Mod Act's "reasonable care" standard.<sup>13</sup>

Although the Mod Act does not substantively change the valuation methods or requirements that are applicable to U.S.-

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value is acceptable: (1) the transaction value of identical merchandise or similar merchandise in sales to unrelated buyers in the U.S.; or (2) the deductive value or computed value for identical merchandise or similar merchandise. *Id.* In determining if the related party transaction value closely approximates one of the test values, adjustments must be made to consider differences in commercial levels, quantity levels, costs, commissions, values, fees and proceeds that must be added to the price actually paid or payable. 19 U.S.C. § 1401a(b)(2)(C).

If the transaction value cannot be used, the importer and Customs must use one of the secondary bases of appraisal considered in the following order: (1) transaction value of identical merchandise; (2) transaction value of similar merchandise; (3) deductive value; (4) computed value; or (5) values if other values cannot be determined. 19 U.S.C. at § 1401a(a)(1)(B)-(F). These methods are defined in 19 U.S.C.A. §§ 1401a(c)-(f). 19 U.S.C. at §§ 1401a(c)-(f) (West 1994). For additional explanations of valuation methods see U.S. CUSTOMS SERVICE, *supra* note 6, at 2-10.

8. See U.S. CUSTOMS SERVICE, *supra* note 6 at 1.

9. *Id.*

10. *Id.*

11. Munford Page Hall II, Reasonable Care/Recordkeeping/Regulatory Audits/Audit Procedures 2 (May 18, 1995) (unpublished manuscript on file with author). The words "reasonable care" are actually found in 19 U.S.C. § 1484(a)(1) (section addressing the filing of entry documents). *Id.* at 1.

12. *Id.*

13. U.S. CUSTOMS SERVICE, *supra* note 6 at 11.

Canadian cross-border transactions,<sup>14</sup> it does impose greater record-keeping and compliance responsibilities on parties importing goods into the United States. Manufacturers and exporters should be prepared to meet importers' new requirements for documentation and support. Moreover, as cross-border trade grows and Canadian companies continue to establish branches or subsidiaries in the United States, the requirements of the Mod Act will fall increasingly on Canadian businesses as well. As a result, despite the potential that NAFTA may someday largely eliminate the importance of valuation in U.S.-Canada cross-border trade, importers currently have an increased responsibility to know and use valuation rules. Canadian exporters should increase their awareness of the requirements of the Mod Act and U.S. substantive valuation requirements, as they will be increasingly faced with requests for information and assistance from their U.S. business partners and subsidiaries as those entities attempt to meet their Mod Act responsibilities.

## II. CURRENT ISSUES IN VALUATION: A CROSS-BORDER COMPARISON

Although the Trade Agreements Act of 1979<sup>15</sup> established standards by which the U.S. customs service values imports,<sup>16</sup> new trading methods and trade in new items keeps customs valuation practices in a state of flux. The expanded opportunities in international trade<sup>17</sup> that have accompanied the growth of international trade blocs<sup>18</sup> have encouraged companies to establish branches and subsidiaries in many foreign countries in an effort to compete more efficiently in the global market. In addition, trade in items subject to patents, licenses, trademarks, or other similar agreements has grown at an increasing pace. As a result, valuation is a complex, frequently modified procedure that Customs and the U.S. judicial system believe must be han-

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14. See *supra* note 3 and accompanying text.

15. 19 U.S.C. § 1401a.

16. See *supra* note 7 and accompanying text.

17. For example, after the first year under NAFTA, trade among the NAFTA partners increased 17% — an increase of over \$50 billion in one year. Kevin M. O'Brien, *NAFTA Compliance Under the Mod Act* (May 18, 1995) (unpublished manuscript, on file with author). Total U.S. trade with Canada reached \$243 billion, and U.S. trade with Mexico exceeded \$100 billion for the first time. *Id.*

18. Examples include the GATT and the WTO, the integration of the European Union, and other regional trade agreements such as NAFTA.

dled on a case-by-case basis.<sup>19</sup> The following sections describe and analyze recent developments in U.S. customs practice, and compare the current state of U.S. law to Canadian practices.

A. "ROYALTIES" AS AN ADDITION TO THE TRANSACTION VALUE:  
A NEW FOCUS

The issue of when and under what authority a payment described as a "royalty" or "license fee" is added to the transaction value is one that has occupied the Customs Service for a number of years. Prior to 1993, Customs focused solely on § 402(b)(1)(D) of the 1979 Trade Agreements Act,<sup>20</sup> the "royalties provision," when dealing with royalty or fee payments,<sup>21</sup> and specifically declined to analyze such payments under § 402(b)(1)(E).<sup>22</sup> Referred to as the "proceeds provision," this latter section requires that proceeds of subsequent resales remitted by the buyer to the seller be added to the transaction value.<sup>23</sup>

Under its prior interpretation of the Trade Agreements Act, as a condition of the sale for export to the United States, Customs added a fee or royalty payment to the transaction value if the buyer paid the fee directly or indirectly to the seller for patents covering processes necessary to manufacture the imported merchandise.<sup>24</sup> This interpretation essentially included any royalty or fee paid by the buyer to the seller, unless the buyer could establish that the payment was distinct from the price actually paid, or that the payment was not a condition of the sale for export to the United States.<sup>25</sup> Customs, however, did not add charges paid for the right to reproduce imported goods in the United States to the transaction value. In addition, if the buyer paid a third party for the right to use a copyright or trade-

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19. See U.S. CUSTOMS SERVICE, *supra* note 6; *Pier 1 Imports, Inc. v. United States*, 708 F. Supp. 351, 354 (Ct. Int'l Trade 1989).

20. This section is codified at 19 U.S.C. § 1401a(b)(1)(D)(1988 & Supp. V 1993).

21. Dutiability of "Royalty" Payments, 27 CUSTOMS BULL. & DECISIONS 1 (1993) ("Hasbro II Ruling").

22. Codified at 19 U.S.C. § 1401a(b)(1)(E)(1988 & Supp. V 1993).

23. HRL 544436, 1991 WL 502492 (Feb. 4, 1991)(discussing a number of rulings in which Customs did not pursue dutiability under § 402(b)(1)(E) once it determined the fee was not dutiable under § 402(b)(1)(D)).

24. HRL 544436, 1991 WL 502492 (Feb. 4, 1991) (determining the royalty payment was not a condition of sale for export to the U.S. and was therefore not dutiable); HRL 544611, 1991 WL 520473 (July 29, 1991) (holding that a royalty payment made by the buyer to the seller pursuant to a patent license and technical assistance agreement was not a condition of the sale for export to the United States, and was therefore not dutiable).

25. Dutiability of "Royalty" Payments, *supra* note 21, at 4.

mark in the United States, Customs did not consider that payment to be a condition of the sale for export to the United States and the payment was therefore not dutiable.<sup>26</sup>

Under Customs' prior interpretation, it was fairly simple to set up a transaction so that a fee was distinct from the price actually paid, or was not a condition of the sale for export to the United States.<sup>27</sup> As a result, parties were often able to exclude payments which arguably constituted part of the transaction value. Perceiving this situation to be a loophole that Congress did not intend to create when it adopted the Trade Agreements Act, Customs re-evaluated its position on the proceeds provision in 1993.<sup>28</sup> Asserting that the pre-1979 law required inclusion of the payments that were slipping through the cracks, and that Congress did not intend to change the dutiability of these payments when it adopted the 1979 Act, Customs announced that royalty payments would be subject to analysis under both the royalty and the proceeds provisions of the Trade Agreements Act.<sup>29</sup> This means that these royalty payments are potentially dutiable.<sup>30</sup>

Currently, Customs' policy indicates that the dutiability of a payment under the royalty provision is based on a three-prong test. A payment will generally be dutiable under the royalty provision if: (1) the merchandise was manufactured under a patent; (2) if the royalty was for an item or process involved in the

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26. *Id.* at 3; HRL 545486 1995 WL 524809 at 3-4 (July 14, 1995) (excluding payments to unrelated third party for trademark rights from dutiability).

27. *See, e.g., id.* at 5 (listing a number of rulings in which the payment was not dutiable); HRL 544611, 1991 WL 520473 (July 29, 1991) (holding that a royalty payment made by the buyer to the seller pursuant to a patent license and technical assistance agreement was not a condition of the sale for export to the United States).

28. Customs first articulated its new position in HRL 544436. *See* Dutiability of "Royalty" Payments, *supra* note 21. The decision was very unpopular, however, and Customs solicited comments on the change of position. *Id.* at 1. The new policy did not become effective until May of 1993. *Id.* at 12.

29. *Id.* at 1.

30. If, however, information regarding the amount of the royalty proceeds is not reasonably available, the transaction value may not be used. CSD 95-6, 545784 LR, 1995 WL 459433 at 6 (June 6, 1995). Customs appears to broadly construe whether sufficient information is available. It allows the use of the transaction value when proceeds are tied to a percent of subsequent sales, and this information is not available at importation. The importer should add payments for royalties or proceeds paid by the importer to the seller up to the time the entry is liquidated. *Id.* If this information is not available or cannot be determined, the transaction value cannot be used. *Id.* at 6-7.

production or sale of the imported goods; and (3) if the importer could not have bought the goods without paying the fee.<sup>31</sup>

If the payment escapes duty under the royalty provision, however, Customs may now include it in the transaction value if it is the functional equivalent of proceeds to the seller.<sup>32</sup> A payment is the functional equivalent of proceeds, and thus is likely to be included in the transaction value, if any portion of the fee or royalty accrues directly or indirectly to the seller.<sup>33</sup> Moreover, if proceeds accrue from the use of the imported product, as opposed to resale of the import itself, Customs will include the payment within the proceeds section.<sup>34</sup> In addition, Customs will evaluate payments made by the buyer to a party related to the seller. If these payments function as indirect payments to the seller itself,<sup>35</sup> Customs will also include them in the transaction value.

U.S. customs practice in royalty cases differs appreciably from the Canadian position.<sup>36</sup> Canadian courts and Revenue Canada apply a more liberal interpretation to the definition of a royalty or fee. For example, in contrast to U.S. law, payments for exclusive distribution rights are considered a royalty or fee within the confines of § 48(5)(a)(iv).<sup>37</sup> Moreover, Revenue Canada is more likely to include payments for the use of trademarks and copyrights in Canada in the transaction value<sup>38</sup>, and Cana-

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31. at 3; HRL 545370, 1994 WL 121584 at 3 (Mar. 4, 1994); C.S.D. 95-6, 545784 LR, *supra*, note 30, at 3; HRL 545770, 1995 WL 568430, at 3, 7 (June 21, 1995) (holding royalty payments for technical transfer and assistance, and for marketing and design information not dutiable). The importer must remember, however, that Customs evaluates cases on an individual basis, and a payment could be dutiable even if these questions indicate otherwise. *Id.* at 2. In addition, a royalty could potentially be dutiable as an assist, if the importer makes the payment to a third party on behalf of the manufacturer. Dutiability of "Royalty" Payments, *supra* note 21, at 6; HRL 545770 *supra*, at 5 (holding dutiable as assists, "royalty" payments for elements used in the production of goods).

32. HRL 545370, *supra* note 31, at 3.

33. CSD 544781, 1994 WL 121579, at 4 (Mar. 4, 1994); HRL 545486, *supra* note 26 at 4.

34. CSD 95-6, 545784 LR, *supra* note 30 at 5.

35. *Id.*

36. Robert G. Krekewitz & W. Jack Millon, Current Issues in Canadian Customs Valuation 38-40 (presented Aug. 21, 1995 at the 1995 Canadian Bar Association Annual Conference) (on file with author).

37. *Id.* at 38.

38. The Canadian Customs Act § 37(5)(a)(iv) indicates that an amount equal to "royalties and license fees, including payments for patents, trademarks and copyrights" must be added to the transaction value of imported merchandise. MAUREEN IRISH, CUSTOMS VALUATION IN CANADA 185 (1985).



dian law generally includes payments to third parties as well.<sup>39</sup> Finally, Canada does not subject payments labelled "royalties" or "license fees" to analysis under the proceeds provision.<sup>40</sup> As a result, although U.S. and Canadian law both closely follow international convention, and are therefore very similar, differing interpretations and practices can lead to different appraisals in royalties cases.

#### B. COMMISSIONS: DISTINGUISHING A BUYER'S AGENT FROM THE SELLER

The Trade Agreements Act of 1979 requires that commissions paid to the seller with respect to the goods purchased be included in the transaction value.<sup>41</sup> In 1989, Customs established a set of guidelines to evaluate the exclusion of payments importers claimed as buying commissions.<sup>42</sup> In spite of this, importers remain concerned about when they could exclude payments to an agent from the transaction value.<sup>43</sup> As a result, this area continues to be the subject of numerous inquiries and appeals to Customs headquarters<sup>44</sup> and to the judicial system.<sup>45</sup> In a General Notice entitled "Buying Agency Commissions," Customs stated that bona fide buying commissions are not added to the transaction value, but the importer must submit to

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39. *Id.* at 188.

40. *Id.* at 190.

41. See 19 U.S.C. § 1401a(b)(1)(B)(1988 & Supp. V 1993).

42. Buying Agency Commissions, General Notices, 1989 WL 454628 (Feb. 1, 1989).

43. 19 U.S.C. § 1401a(b)(1)(B) states that "any selling commission incurred by the buyer with respect to the imported merchandise" must be included in the transaction value. 19 U.S.C. § 1401a(b)(1)(B). Customs and the courts have concluded that this means buying commissions do not have to be included as long as a bona fide buying agency exists between the buyer and the agent. *Pier 1 Imports, Inc. v. United States*, 708 F. Supp. 351, 354 (Ct. Int'l Trade 1989); *Rosenthal-Netter, Inc. v. United States*, 679 F. Supp. 21, 23 (Ct. Int'l Trade 1988); *Jay-Arr Slimwear, Inc. v. United States*, 681 F. Supp. 875, 878 (Ct. Int'l Trade 1988).

44. See, e.g., HRL 545465, 1994 WL 598862, at 2 (Apr. 6, 1994) (discussing when a bona fide buying agency relationship exists); CSD 544781, 1994 WL 121579 at 2 (Mar. 4, 1994) (discussing when a commission paid to an agent constitutes a bona fide buying commission and is therefore not included in the transaction value); HRL 545036, 1993 WL 592465, at 3 (Dec. 14, 1993) (discussing when payments to a related party are bona fide buying commissions).

45. See, e.g., *Moss Manufacturing Co. v. United States*, 896 F.2d 535, 538 (Fed. Cir. 1990) (discussing when and what evidence is necessary to prove that payments to an agent are not dutiable); *Monarch Luggage Co. v. United States*, 715 F. Supp. 1115, 1116 (Ct. Int'l Trade 1989) (discussing what evidence is necessary to prove a payment was to a bona fide buying agent and is therefore not dutiable).

Customs evidence that clearly documents that the appropriate relationship exists between the agent and the importer for each transaction.<sup>46</sup> Most importantly:

[A]n invoice or other documentation from the actual foreign seller to the agent . . . [is] required to establish that the agent is not a seller and to determine the price actually paid or payable to the seller. Furthermore, the totality of the evidence must demonstrate that the purported agent is in fact a bona fide buying agent and not a selling agent or an independent seller.<sup>47</sup>

Customs specifically looks to a number of factors to determine if the totality of the evidence indicates an actual buying agency relationship exists between the buyer and the purported agent. "[T]he primary consideration is the right of the principal to control the agent's conduct with respect to those matters entrusted to the agent."<sup>48</sup> To find evidence of this relationship, Customs looks for a buying agency agreement; evidence that the agent did not purchase goods without specific authority from the importer; indications that the importer could have dealt directly with the manufacturer or seller; separate invoicing for the purchased products and the buying agent's commission; evidence that the agent did not take title to the goods and was not responsible for loss or damage; and evidence suggesting that the importer chose the manufacturer itself, or at a minimum, participated in the decision and was aware of which manufacturer or seller the agent selected.<sup>49</sup> In addition, Customs and the courts have looked to other factors such as whether the agent's actions were primarily for the benefit of the principal, whether the principal or agent was responsible for the shipping and handling, and whether the agent operated an independent business primarily for its own benefit, as opposed to acting solely for its principal's benefit.<sup>50</sup>

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46. Buying Agency Commissions, *supra* note 42.

47. *Id.* (quoting HRL 542141, Sept. 29, 1980); Jay-Arr Slimwear, Inc., 681 F. Supp. at 878-79 (indicating that the legal authority to act as an agent and actually acting as an agent are two separate matters, and Customs can examine both to determine if a bona fide agency relationship exists).

48. CSD 544781, 1994 WL 121579, at 4 (Mar. 4, 1994) (citing J.C. Penney Purchasing Corp. v. United States, 451 F. Supp. 973, 983 (Cust. Ct. 1978)).

49. See Monarch Luggage, 715 F. Supp. at 1116-17; Pier 1 Imports, Inc. v. United States, 708 F. Supp. 351, 354; Rosenthal-Netter, Inc. v. United States, 679 F. Supp. 21, 23-26; CSD 544781, 1994 WL 121579, at 5 (Mar. 4, 1994); HRL 545465, 1994 WL 598862, at 4-5 (Apr. 6, 1994); HRL 545036, 1993 WL 492465, at 4-5 (Dec. 14, 1993); HRL 544895, 1992 WL 564168, at 4 (July 22, 1992); HRL 544510, 1992 WL 564195, at 3-5 (Jan. 9, 1992); HRL 544338, 1989 WL 407041, at 4-5 (Sep. 13, 1989).

50. Rosenthal-Netter, 679 F. Supp. at 23; CSD 544781, 1994 WL 121579, at 5 (Mar. 4, 1994); HRL 545794, 1995 WL 568431, at 4 (Aug. 9, 1995).

Evidence that the buyer or seller and the agent are not financially related also supports the existence of an agency relationship, although the fact that the parties are related does not preclude such a finding.<sup>51</sup> For example, in Headquarter's Ruling Letter (HRL) 544895, an importer asked for a ruling on the dutiability of a buying commission where the purported agent was related to the foreign manufacturer. Customs noted that "while such a relationship does not preclude the existence of a buying agency, the circumstances surrounding such related party transactions are subject to closer scrutiny when determining whether a commission is bona fide."<sup>52</sup> Because the principal proved control over the purchasing process and because none of the commission would "inure[ ] to the benefit of the manufacturer,"<sup>53</sup> Customs was satisfied that the importer had sufficient control over the agent to overcome the fact that the agent was related to the manufacturer.<sup>54</sup> Similarly, HRL 544510 granted a protest from an initial Customs finding that commissions paid by the importer to its subsidiary were dutiable.<sup>55</sup> Because the subsidiary had no authority to bind the parent company except on written authorization; the parent had control over the manner of payment to the manufacturer; the subsidiary did not have the discretion to deduct its commissions or bear the risk of loss; and the commissions did not benefit the manufacturer, Customs held that the payments were bona fide buying commissions, and hence did not form part of the transaction value.<sup>56</sup>

If the principal cannot adequately prove that it controlled the agent's conduct, Customs will generally add the commissions to the transaction value, whether or not the parties are related. For example, the importer in *Rosenthal-Netter, Inc. v.*

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51. HRL 544895, 1992 WL 564168, at 3-4 (July 22, 1992); HRL 544510, 1992 WL 564195, at 4 (Jan. 9, 1992); HRL 545794, *supra* note 50, at 5.

52. HRL 544895, 1992 WL 564168, at 3-4 (July 22, 1992).

53. *Id.*

54. *Id.*

55. HRL 544510, 1992 WL 564195, at 1-2 (Jan. 9, 1992). *See also* HRL 544338, 1989 WL 407041, at 4-5 (Sept. 13, 1989) (holding that commissions to be paid to a related entity for services as a buying agent were not dutiable as a bona fide buying agency relationship existed between the two parties); HRL 544244, 1989 WL 381602, at 2-3 (June 16, 1989) (holding that the importer had sufficient control over a related party acting as buying agent to ensure that commissions paid for the agent's services were not dutiable); HRL 544895, 1992 WL 564168, at 5 (July 22, 1992) (holding that commissions paid to a buying agent which are not included in the payment made to the seller are not part of the appraised value despite the fact that the buyer, seller, and agent are related).

56. HRL 544510, *supra* note 51, at 4-5.

*United States* did not sufficiently control its agent, and was therefore charged duty on the commissions it paid.<sup>57</sup> Specifically, the Court of International Trade found that the importer could not have known from whom the agent purchased the goods, because it did not control the choice of factory from which the merchandise was selected, and the invoice from the agent omitted the name of the manufacturer.<sup>58</sup> In addition, the agent purchased quantities significantly larger than the amount ordered by the importer,<sup>59</sup> and the importer did not control the shipping and handling, as the agent retained total discretion to negotiate prices with transportation companies.<sup>60</sup> Finally, the importer did not control the manner of payment. Instead, the importer gave the agent master letters of credit which it used to open new letters of credit to pay suppliers, and from which the agent deducted its commission, handling and freight charges, and other expenses.<sup>61</sup> The court held that these factors, among others, indicated that the agency relationship between the parties was not bona fide, and that the commissions must be included in the transaction value as part of the price paid or payable.<sup>62</sup>

If the importer does not provide Customs with an invoice or other documentation from the foreign seller that indicates the price paid or payable, Customs will generally include any claimed commission as part of the transaction value. Moreover, in the absence of a separate invoice, Customs does not have the statutory authority to deduct purported commissions inadvertently included in the seller's invoice, even if the buyer can prove the existence of a bona fide agency relationship.<sup>63</sup> Customs may also include payments to a bona fide buying agent in the transaction value if the circumstances of a specific payment indicate it passed to the seller or manufacturer.<sup>64</sup> In *Moss Manufacturing Co. v. United States*, for example, the Court of Appeals for the Federal Circuit upheld a Customs determination that an inadequately explained payment to a bona fide buying agent should be included in the transaction value.<sup>65</sup> The court stated

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57. Rosenthal-Netter, 679 F. Supp. at 23.

58. *Id.*

59. *Id.* at 24.

60. *Id.*

61. *Id.* at 24-25.

62. Rosenthal-Netter, 679 F. Supp. at 23.

63. *Id.*

64. *Moss Manufacturing*, 896 F.2d at 538.

65. *Id.*

that although Moss established that its relationship with its agent was valid, the payment was appropriately added to the transaction value because it was actually made to the seller, who was then required to disburse a portion of the payment to the agent as the agent's commission. Despite the fact that the seller benefited only minimally from having held the payment prior to disbursement, the court determined that Customs properly included the payment in the transaction value of the merchandise.<sup>66</sup>

To help determine if the buyer has sufficient control over the purported agent, Customs will also look at evidence of the previous practices of an importer and agent and compare them with evidence submitted in a current case.<sup>67</sup> If this past evidence indicates that the buyer's practices are not sufficient to adequately control the agent, Customs will include the commissions paid in the transaction value of the merchandise in question.<sup>68</sup>

Canadian law requires adding to the transaction value "commissions and brokerage in respect of the goods incurred by the purchaser . . . other than fees paid or payable by the purchaser to his agent for the service of representing him abroad in respect of the sale."<sup>69</sup> This is clearer than comparable U.S. law, because it specifically exempts buying agent commissions from the transaction value. U.S. importers, alternately, have had to rely on Customs and judicial decisions to reach the same conclusion.<sup>70</sup> As in U.S. law, the major dilemma in Canadian law is determining if a buying agency relationship exists between the parties. In answering questions of this type, Canadian interpreters have followed the precedent established in the pre-Customs Act cases of *Woodward Stores Ltd. v. DMNRCE*<sup>71</sup> and *Magnasonic Canada Ltd. v. DMNRCE*.<sup>72</sup> In a fashion similar to U.S. law, Canadian courts will look at the degree of control or management the buyer exercises over its supposed agent. As a

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66. *Id.* at 539.

67. HRL 545140, 1993 WL 668155, at 2-3 (Aug. 24, 1993).

68. *Id.*

69. Canadian Customs Act § 37(5)(a)(i); Kreklewitz & Millon, *supra* note 36, at 48-49 (citing Revenue Canada, Customs and Excise, Adjustments to the Price Paid or Payable, Memorandum D13-4-7, para. 6 Jan. 1, 1985); IRISH, *supra* note 38, at 179.

70. See *supra* notes 43-45 and accompanying text.

71. App. 1060, Nov. 27, 1974, 6 TBR 184 (T.B.); IRISH, *supra* note 38, at 179.

72. App. 1330, Aug. 29, 1978, 112 Canada Gazette, Part I, p. 7264 (T.B.); IRISH, *supra* note 38, at 179.

result, courts will find the existence of an agency even if the parties did not so expressly agree.<sup>73</sup> As a result, Canadian traders and agents should be cautious when drawing up invoices and other documentation to ensure they do not mistakenly contain buying commission charges.

C. ASSISTS: CHANGES IN POLICY FOR MATERIALS DESTROYED, SCRAPPED OR LOST

The value of any assist,<sup>74</sup> appropriately apportioned, must be included in the transaction value of any imported merchandise. In May of 1995, Customs published a notice indicating that it intended to modify its policy concerning the treatment of materials otherwise qualifying for inclusion in the transaction value as assists, but which are lost, destroyed, or scrapped.<sup>75</sup> Traditional Customs practice held that materials that were lost, scrapped or destroyed were not actually imported into the United States.<sup>76</sup> As a result, they were not assists, and were not required to be added to the transaction value of imported merchandise.<sup>77</sup>

In order to bring its practice in line with the language legislative history of the 1979 Trade Agreements Act and Customs

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73. See *Signature Player Sport, Inc. v. The Queen* (1990) TCT 5120 (FCTD), aff'd (1994) ETC 22830 (FCA) (holding actual in fact relationship precluded court from finding an agency relationship; fee paid was therefore dutiable; *Kreklewitz & Millon, supra* note 36, at 49.

74. The term "assist" is defined in the Trade Agreements Act of 1979 as:

Any of the following if supplied directly or indirectly, and free of charge or at a 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 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.

19 U.S.C. § 1401a(h)(1)(A)(1988 & Supp. V 1993).

75. Proposed Modification and Revocation of Customs Ruling Letters Relating to Assists, General Notices, 1995 WL 330886, at 1 (May 1, 1995) (hereinafter Proposed Modification); 29 CUSTOMS BULL. AND DECISION 20 (May 17, 1995); Modification and Revocation of Customs Ruling Letter Relating to Assists, General Notices, 1995 WL 782830, at 3 (Nov. 30, 1995) (hereinafter Modification).

76. Modification, *supra* note 75, at 3.

77. *Id.*

Regulations,<sup>78</sup> and after lengthy public comment,<sup>79</sup> Customs has chosen to include the value of lost, scrapped or destroyed items as assists after February 20, 1986.<sup>80</sup> Customs believes that no authority exists in the Trade Agreements Act or in Customs Regulations to adjust the cost of the assist for lost, scrapped or destroyed materials. Instead, it asserts that the manufacturer would calculate this risk of loss into the amount of materials it would have to purchase. As a result, if the buyer supplies the materials to the manufacturer, that shifting of the risk of loss is part of the assist, and must be added to the transaction value.<sup>81</sup>

This change represents a significant shift in Customs policy. The change revokes HRLs 54462, 543831, 543623, and 543093, and applies to merchandise entered or withdrawn from the warehouse for consumption on or after February 20, 1996.<sup>82</sup> After that date, importers will be expected to appropriately value all lost, destroyed or scrapped assists in future importations.<sup>83</sup> Customs received written comments on the proposed change until June 16, 1995, and is currently considering the responses it received. If adopted, the Headquarters Ruling Letters listed in the General Notice referenced above will be modified to incorporate the changes, and importers will be expected to appropriately value all lost, destroyed, or scrapped assists in future importations.<sup>84</sup>

#### D. MULTI-TIERED OR MIDDLEMAN SALES: THE IMPACT OF *NISSHO IWAI*

In December, 1992, the Court of Appeals for the Federal Circuit decided *Nissho Iwai Corp. v. United States*<sup>85</sup> At issue was whether the price between the importer and the middleman, or the price between the middleman and the manufacturer, represents the price actually paid or payable for imported merchandise.<sup>86</sup> Abandoning the practice of determining which part of a multi-tiered sale was the "sale for export" to the United

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78. *Id.* at 2.

79. *Id.* at 1.

80. *Id.* at 3.

81. Proposed Modification, *supra* note 75, at 26-28 (citing proposed modification to HRL 543093).

82. Modification, *supra* note 75, at 1-2.

83. *Id.*

84. *Id.* at 15 (containing attachments E through I, which indicate the proposed changes to the text of the Ruling Letters at issue).

85. 982 F.2d 505 (Fed. Cir. 1992).

86. *Id.* at 508.

States, the court held that when both prices are viable under the statutory provisions outlining the use of the transaction value, the price between the middleman and the manufacturer, which is usually lower than the price between the middleman and the importer, is the one that must be used for valuation.<sup>87</sup> This rule, however, applies only when there is a "legitimate choice between two statutorily viable transaction values."<sup>88</sup>

The manufacturer's price represents a viable transaction value when it is the result of arm's length negotiation, the goods are clearly destined for export to the United States, and there are no non-market influences that affect the legitimacy of the sale price.<sup>89</sup> If the manufacturer's price is not statutorily viable, then the price between the middleman and the end-purchaser is the price actually paid or payable.

This holding represents a dramatic — and seemingly unwelcome — change in Customs practice, and in putting it into effect Customs has retained some of its past habits. For example, it continues to favor the price between the middleman and the importer, in spite of the Federal Circuit's clear preference for the manufacturer's price. In HRL 545262, Customs stated that:

Customs presumes that the price paid by the importer is the basis of transaction value . . . . [I]n order to rebut this presumption the importer must, in accordance with the court's standard in *Nissho*, provide evidence that establishes that at the time it purchased or contracted to purchase, the imported merchandise[,] the goods were "clearly destined for export to the United States."<sup>90</sup>

Arguably not in keeping with the Federal Circuit's more expansive holding in *Nissho*, Custom's interpretation places an additional burden on importers and manufacturers. Importers who wish to claim the manufacturer's price as the basis for valuation now must document that the items actually imported were earmarked for export to the United States. When the items or the ordering methods are individualized, such as for large items or those items made to order, this standard will not be difficult to meet. When, however, the ordering process is less personalized, it will be inconvenient for manufacturers and importers to prove the items were manufactured for export to the United States. HRL 545262 indicates that one way to meet this standard is to show that the items were manufactured according to

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87. *Id.* at 512.

88. *Id.* at 509.

89. *Id.*

90. HRL 545262, 1994 WL 495842, at 5-6 (Mar. 11, 1994).



U.S. standards.<sup>91</sup> In the case before Customs in HRL 545262, detailed, generic U.S. engineering standards were available. When the product in question is not subject to such standards, however, this solution will not be available.

A second issue that has surfaced as Customs has attempted to apply the Federal Circuit's guidance in *Nissho* deals with transactions between related parties. *Nissho* asserts that the middleman price will serve as the transaction value only when "there is a legitimate choice [to be made] between two statutorily viable transaction values."<sup>92</sup> As a result, when the manufacturer and the middleman are related, the importer must first establish that the relationship between the manufacturer and the middleman did not affect the price paid for the merchandise, and that the manufacturer's price therefore meets the statutory requirements.<sup>93</sup>

Almost a year after the Federal Circuit's decision, Customs published a ruling which distinctly limited the impact of the *Nissho* decision.<sup>94</sup> In HRL 544975, Customs stated that the parties in *Nissho* were not related and therefore dealt with each other at arm's length. Customs asserted that the *Nissho* rule did not apply to the transaction at issue because the related parties had not dealt at arm's length.<sup>95</sup> Instead, the parties conducted business so as to insure that the subsidiary middleman achieved what the parties claimed was the industry-wide average return.<sup>96</sup> Customs found that the parties had not proved that the return was actually valid industry-wide. Moreover, the fact that the parties conducted their relationship so as to ensure a guaranteed return to the middleman was fatal to a finding that the transaction resulted from arm's length negotiations.<sup>97</sup> As a result, the manufacturer's price was not statutorily viable as the transaction value, and therefore, the proper transaction value was the price between the middleman and the importer.

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91. *Id.* at 6.

92. *Nissho*, 982 F.2d at 509.

93. 19 U.S.C. § 1401a(b)(1988 & Supp. V 1993); *Nissho*, 982 F.2d at 509 (asserting that the manufacturer's price constitutes a viable transaction value when the goods are clearly destined for export to the United States and when the manufacturer and the middleman deal with each other at arm's length, in the absence of any non-market influences that may affect the legitimacy of the sales price).

94. HRL 544579, 1993 WL 668097, at 3 (Sept. 30, 1993).

95. *Id.* at 4.

96. *Id.*

97. *Id.* at 4-5.

While this interpretation is in keeping with the letter of the *Nissho* holding, it represents an important limitation on the importer's ability to use the *Nissho* rule. Importers must be sure that they are aware of the way in which related manufacturers and middlemen conduct their relations if they wish to take advantage of the manufacturer's price as the basis of the transaction value. As a result, Canadian exporters who use middlemen to sell to U.S. importers can expect to receive inquiries from their U.S. business partners requesting details regarding the exporter's relationship with its middleman.

It appears that Canada also applies a rule favoring the manufacturer's price as the basis for appraisal when that price represents a statutorily valid transaction value.<sup>98</sup> Nevertheless, prior to February, 1995, Canada's rule for judging the statutory viability of the price differed in part from that of the U.S. Customs Service.<sup>99</sup> Before the recent Federal Court decision in *Canada v. Harbour Sales*,<sup>100</sup> Revenue Canada used a standard to appraise multi-tiered transactions based in part on whether or not the middleman was a resident of Canada.<sup>101</sup> More specifically, Revenue Canada asserted that a specific transaction was a sale for export to Canada only if the purchaser was a Canadian resident.<sup>102</sup> As a result, if the middleman was a resident, then the transaction between the manufacturer and the middleman met the "sale for export" requirement, and the manufacturer's price could serve as the basis for the transaction value. If, however, the middleman was not a Canadian resident, the sale between the manufacturer and the middleman was not considered "for export to Canada,"<sup>103</sup> and the price between the middleman and the end-purchaser served as the transaction value.

In *Harbour Sales*, the Trial Division of the Federal Court of Canada (F.C.T.D.) refused leave to appeal the Canadian International Trade Tribunal's (C.I.T.T.) rejection of this line of reasoning.<sup>104</sup> Indicating that the residency requirement had no basis in the Canadian Customs Law, the court was of the view that the residency of the middleman was not a valid factor to

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98. *Harbour Sales (Windsor) Limited v. Deputy Minister of National Revenue*, C.I.T.T. No. 43, Appeal No. Ap-93-322 (1994).

99. *Canada v. Harbour Sales, Inc.* 1995 F.C. No. 173 at para. 3.

100. *Id.*

101. *Harbour Sales (Windsor) Limited*, *supra* note 98.

102. *Canada v. Harbour Sales*, *supra* note 99 at para. 3.

103. *Id.*

104. *Id.* at para. 5.

determine if a sale met the "for export to Canada" requirement.<sup>105</sup>

Although the F.C.T.D. did not outline which factors Revenue Canada could use in determining when a sale is for export to Canada, the C.I.T.T. did list a number of significant factors, including: where the goods are scheduled for delivery and are actually delivered; whether the middleman took title; whether the goods entered the commerce of any other country; and whether any other person took title to the goods after exportation but before importation into Canada.<sup>106</sup> Interestingly, these factors closely approximate the considerations examined under U.S. law prior to the *Nissho* decision.<sup>107</sup> As *Nissho* does not appear to have Customs' full support,<sup>108</sup> U.S. and Canadian law may be closer in practice than they appear on paper. Revenue Canada and the Canadian Parliament seem to be rejecting the Canadian judiciary's attempt to change Customs' treatment of multi-tiered sales.<sup>109</sup> Revenue Canada does not follow *Harbour Sales*, and legislation is currently pending which will incorporate a residency requirement in the Canadian customs law.<sup>110</sup>

### III. PLANNING STRATEGIES AFTER THE MOD ACT

The previous sections and the new requirements of "informed compliance" and "reasonable care" demonstrate that importers must develop a strategy to successfully navigate through the system. Of course, "importers" includes Canadian companies with subsidiaries and branches acting as importers in the United States. In addition, "informed compliance" and "reasonable care" may cause U.S. importers to put increased pressure on their Canadian business partners as U.S. traders strive to comply with the Mod Act and Customs Service requirements. U.S. importers will require additional information and documentation, and in some cases may even desire to restructure business arrangements to ensure they can meet Customs requirements. As a result, it will be beneficial for Canadian businesses to be well informed about changes in U.S. Customs practices.

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105. *Id.*

106. *Harbour Sales (Windsor) Limited*, *supra* note 98, at 23.

107. *Nissho Iwai Corp. v. United States*, 982 F.2d 505, 509 (Fed. Cir. 1992).

108. *See supra* notes 94-97 and accompanying text.

109. *Kreklewitz & Millon*, *supra* note 36, at 23.

110. *Id.* Specifically, the proposed amendment states "[T]he value for duty of goods is the transaction value of the goods if the goods are sold for export to Canada, to purchaser in Canada . . ." *Id.* (italics indicate new language).

## A. SOURCES OF INFORMATION

Reasonable care under the Mod Act demands that importers be thoroughly familiar with and attempt to closely follow customs regulations and practices.<sup>111</sup> The following sources can assist a trader in keeping up to date with changes in U.S. customs practice:

1) The Customs Electronic Bulletin Board (CEBB) is an automated system which provides current, relevant information regarding Customs rules, laws, and practices. The CEBB posts information including proposed regulations, general notices, Customs publications, and news releases. This service is provided by the Customs Service at no charge.<sup>112</sup>

2) As part of Customs' efforts to meet its own obligations under informed compliance and shared responsibility, the Commercial Rulings Division (CRD) is preparing publications designed to provide general information to the trade community regarding customs practices and laws. CRD completed and released the first publication, entitled "Customs Value" in March, 1995.

3) The *Federal Register* publishes many items of customs-related information, including general notices, proposed changes to Customs regulations and other valuable information.

4) The *Customs Bulletin and Decisions* publishes more detailed customs-related information, including Customs decision and general notices.

5) Customs cases which make their way into the judicial system are reported in several places. Opinions of the Court of International Trade are reported in the Federal Supplement, and the opinions of the U.S. Court of Appeals for the Federal Circuit appear in the Federal Reporters.

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111. Hall, *supra* note 11, at 2.

112. Interested parties can receive information about the CEBB by calling the U.S. Customs Service at (703)440-6236. The CEBB supports modem speeds from 2400 to 14400 baud. The user's terminal must be set to the following parameters:

Terminal:	ANSI
Databits:	8
Parity:	N
Stopbits:	1

The CEBB's modem number is (703)440-6155. Log on with your name and choose a password. The computer will ask a few questions, and then you can receive up-to-date customs information. See U.S. CUSTOMS SERVICE, *supra* note 6, at 11.

6) LEXIS and Westlaw carry judicial opinions, Customs decisions and letter rulings, as well as law review and news articles regarding Customs issues.

#### B. EXPERT ASSISTANCE

Reasonable care probably also requires that an importer obtain expert assistance.<sup>113</sup> As with many areas of U.S. law, establishing an active, comprehensive, and up-to-date customs compliance program with the help of a customs expert can help to mitigate any penalties that may be assessed if an importer makes a mistake. Customhouse brokers, customs lawyers, and Customs Service officials can provide the information necessary to ensure that the importer meets its informed compliance and reasonable care requirements. At a minimum, an importer should designate an in-house expert, or depending on the volume of the importer's customs activity, create a staff of customs experts.

#### C. RECORD-KEEPING

Through participation in the Record Keeping Compliance Program an importer can minimize its potential liability under Customs record-keeping requirements.<sup>114</sup> Customs published the draft Record-keeping Compliance Manual in October of 1994. The draft has been the subject of significant criticism, and is currently being redrafted by Customs. In spite of the controversy, the Compliance Manual forms the foundation of the compliance program, and gives all the information necessary to meet record-keeping requirements.<sup>115</sup>

#### D. PRIOR DISCLOSURES

Should an importer's planning strategies fail, the prior disclosures provisions of § 592 of the Mod Act<sup>116</sup> provide importers with a defense to a penalty action.<sup>117</sup> Section 592 serves to limit penalties to which an importer can be subject, if the importer reports the violation to Customs before or without knowledge of

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113. *Id.* at 3, Introduction.

114. Recordkeeping is addressed in 19 U.S.C. §§ 1508 and 1509; Hall, *supra* note 11, at 5.

115. Hall, *supra* note 11, at 5.

116. Codified at U.S.C. § 1592 (1988 & Supp. V 1993). See F. Gordon Lee, Penalties and Enforcement Under the Customs Modernization Act 5 (May 18, 1995) (unpublished manuscript, on file with author).

117. Lee, *supra* note 116, at 5.

a Customs investigation into the matter. In addition, if the importer makes the disclosure in a timely manner, the merchandise in question will not be seized. If Customs has initiated an investigation, the importer has the burden to prove that it was not aware of the investigation at the time the disclosure was made.<sup>118</sup> Importers must be careful, however, to manage disclosures appropriately, and to be sure to meet the myriad of rules associated with the prior disclosure provisions. If the disclosure is properly timed and carefully carried out, it can be of tremendous benefit to an importer facing a penalty action.<sup>119</sup>

#### IV. CONCLUSION

The Customs Modernization Act makes it more important than ever for importers to be aware of the ever-changing provisions of Customs practices and policies. Although NAFTA should significantly diminish the importance of valuation rules and the problems Canadian and U.S. traders experience with the valuation of imported merchandise, the Mod Act will increase the immediate need for information about new developments in valuation procedures for traders on both sides of the border.

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118. *Id.*

119. *Id.* at 6.

