



**Goldfarb Seligman**  
Law Offices | Established 1930

Issue 3

## **Customs & Trade in Israel**

### **A Legal Newsletter**

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#### **Design Services for Stores in Israel are Dutiable**

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The Central District Court recently published a precedential ruling, in which it ruled that payments made by clothing importers to brand owners abroad for various services, such as shop design, sale methods, or advertising advice, are dutiable (in a case referred to hereafter as "the Gottex case").

#### **Background:**

The importers of the brands "Zara", "PULL&BEAR", "Nautica", "Nine West", "Easy Spirit", and "Anne Klein", import clothing and shoes to Israel, as per the franchise agreements between the importers and brand owners. The goods are then sold in dedicated "concept stores".

The stores are established and run according to detailed guidelines sent by the brand owners in all marketing and management aspects, including choice of location, internal and external design, the type of equipment used, the organization of the brand goods on the shelves, advertising campaigns, sale methods, and more.

The importers paid the factories abroad for the products, and made separate, additional payments to the brand owners (some of which are connected with the factories) for trademark usage, design services for stores in Israel, advertising advice, sale methods, and more.

#### **Detailed Arguments:**

The Customs Authority argued that these payments are dutiable, as they should be classified as 'royalties' paid to a trademark owner. It should be noted in this context that royalties are dutiable when the following two conditions are met: 1. The royalties relate to the goods. 2. The importer is required to pay the royalties as a precondition for selling the goods.

As for the first condition (the royalties relate to the goods), the importers argued that the payments to the brand owners do not fully relate to the imported goods, as for the most part they relate to marketing and management services which compose a "business model for success", services provided to the importer after the goods were imported. Therefore, argued the importers, these payments should not be dutiable.

One of the importers added that its payment to the "Nine West" brand owner for advertising services is completely unrelated to the goods, and should be exempt from customs duty.

Conversely, the Customs Authority argued that the services offered are closely related to the imported goods, and their price should therefore be included in the dutiable value of the goods.

As for the second condition, (a precondition for sale), the importers claimed that the payments are not a prerequisite for import. The importer of the "Keds" brand added that it designs the products, not the brand owner, arguing that this fact strengthens its claim that the brand owner does not control the production of the goods, and therefore the royalties are not a precondition for sale.

### **The Ruling:**

The court cast doubts on the importers claim that the payments are for services, determining that the services were dictated to the importers by the brand owners, which makes them contractual conditions inseparable from the import of the goods, and designed to serve the interests of the brand owners. The court ruled that the clear linkage between the imported goods and the marketing and management guidelines received from the brand owners makes it impossible to view the guidelines as anything other than an inseparable part of the import conditions, all serving the same, exclusive purpose of branding a brand.

The court ruled further that it is inconceivable to intellectually separate the concepts of service and product, as the court felt that the services, or in other words, "the packaging" the importers received from the brand owners, is what makes the product, the brand, what it is.

The court expanded the definition of the term "royalties that relate to the goods", ruling that while applying the term to branded goods, the goods include both a physical component and an intellectual component, and its value is derived from both of these components. In most cases the value of the intellectual component is greater, even much greater, than the physical component.

Further to the above, the court ruled that royalties "that relate to services that relate to the goods" are dutiable, as long as the services are what create the brand, and as long as one cannot sell the goods without paying for these services.

As for the payment paid to the brand owner of "Nine West" for advertisement services, the court ruled that it should be dutiable, either as royalties according to clause 133 to the Customs Order, or as part of the value of the goods themselves according to clause 132 of the Customs Order.

The court ruled that the fact that the brand owner portrays the payment as a payment for participation in advertising expenses is irrelevant, as is the question of whether the payment was made to the brand owner or a third party. This is due to the fact that the advertising is not an initiative of the importer, but an act performed by the brand owner for which the importer is required to share part of the burden of expenses.

Therefore, it was determined there is a close relation between the service and the product, and custom duty should be paid for both as one, since the payment for the services "relates to the goods" as defined in the Customs Order.

As for the second condition, "the importer must pay the royalties as a precondition for sale" -

The court ruled that as long as the brand owner has a certain amount of control over the production process, so that he can ensure that the imported goods will be different from his branded products, that is sufficient to make the royalties dutiable. The court ruled further that if the brand owner possesses information regarding the identity of the manufacturer, this fact would strengthen the claim that the brand owner controls the production and can halt the process if royalties are not paid.

The court also noted that although the importers benefit from the services received, this does not diminish the fact that they were dictated by the brand owners and are a precondition for import of the goods. Without the services, the importers have no way to import the goods, and therefore the payment for the services constitutes a prerequisite for import and is dutiable.

### **Comments:**

As for the first condition (the royalties relate to the goods), we feel the court's ruling strays from the principle set in an earlier ruling given by the same court in 2013 ("the Marvidex case"). In that case, the court ruled (reportedly with the Customs Authority consent) that a payment by the importer to the brand owner for a "marketing concept", such as store design, does not relate to the goods and is exempt from customs.

Now the court ruled according to a different principle in the "Gottex" case, stating that payment for a marketing concept "adheres" to the goods and is dutiable.

Moreover, the current ruling in the "Gottex" case seems to imply that in certain cases, customs duty can be levied on services provided after import.

As for the second condition, "the importer must pay the royalties as a precondition for sale", here too the court strayed from a previous ruling in the "Marvidex" case. In that case the court ruled that as long as the brand owner can halt the production process if royalties are not paid, the royalties become a precondition for sale.

On the other hand, in the "Gottex" case the court expanded its ruling, stating that the brand owner need not be capable to halt production. It is sufficient that the brand owner be able to dictate conditions to the importer regarding the manufacturing method in order for the payments paid to the brand owner to be considered a precondition for sale, in a way that makes them dutiable. It is important to note that the final word in the "Marvidex" case has not yet been said, as the matter is awaiting the ruling of the Supreme Court in an appeal submitted back in 2013.

In addition, the court gave a broad ruling regarding payments paid to a supplier for marketing expenses, ruling that these expenses are to be added to the value for tax purposes, significantly expanding the range of payments to suppliers which are dutiable.

If until the "Gottex" ruling it was possible to draw a clear distinction between payment for goods and payment for other components (in accordance with certain expenses detailed in the Customs Order which are mandatory), now the line between the two is definitely blurred.

It seems this ruling will force the importers to reconsider including such costs (and other costs) in the valuation for tax purposes. Furthermore, it will require reexamination of import depositions filled by importers.

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**The above review is a summary. The information presented is for informative purposes only, and does not constitute legal advice.**

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