

Customs & Trade in Israel

A Legal Newsletter

Adv. Gill Nadel, Chair of the Import, Export and International
Trade Law Practice, Tax Department

Royalties and Customs - Another Court Ruling

Adv. Gill Nadel, Adv. Dave Zeitoun, Adv. Omer Wagner

Background:

The subject of imposing custom duties upon royalties or other payments (such as advertising or store design costs) is at the center of a legal storm in recent years.

Although several rulings were already given on the subject by District Courts and even the Supreme Court (in one case), the last word has yet to be said, and we believe that there is still no clear, final ruling on the subject.

Marvidex & Lee Cooper - 2013-2016

The episode began with a ruling by the Central District Court in 2013. In that case, the importers of several leading brands (including Lee Cooper, Rip Curl, No Fear, Disney, Tom & Jerry, Scooby Doo, Garfield, Galit Levi, Snoopy, Pucca and The Simpsons) paid the factories which manufactured the goods, and paid the brand owners royalties separately, as is customary in the field.

The Customs Authority argued that the royalties are part of the goods and therefore the custom duties should apply to the price of the goods+royalties, while the importers argued that only the price of the goods is dutiable. The Customs Authority argued that the royalties are a precondition for the sale of the goods in Israel, and therefore are dutiable, while the importers argued that the royalties are not a precondition for the import transaction, and therefore exempt from custom duties.

The District Court accepted in principle the companies' arguments and ruled that in order for royalties to become dutiable, it must be proven that the importer has to pay them as a precondition for importing the products to Israel (and not their sale in Israel). The District Court ruled that for the purpose of this question (does the importer have to pay royalties in order to import), the language of the contract between the brand owner and the importer must be examined, as well as the parties actions in practice. Based on these definitions, the court ruled that part of the royalties for the goods in question were dutiable, while others were exempt from custom duties.

In November 2016 the Supreme Court ruled on the matter, rejecting most of the Customs Authority's appeal. The Supreme Court ruled that in order for the royalties to be dutiable, they must be related to

the goods and be a precondition for their import to Israel, as opposed to a precondition of their sale in Israel.

The Supreme Court ruled that in order to determine whether the royalties are a precondition for import, the language of the contract is not sufficient - the parties actions must be examined as well.

In other words, the Supreme Court ruled that the testimony of the brand owner may be used to understand whether he supervises the importer, to what degree, etc., in order to determine if the royalties are a precondition of the import transaction.

It should be noted that the Supreme Court relied extensively in its ruling upon the conduct of other countries across the globe, as well as international agreements, and ruled that the parties must act according to the international agreements.

[TA 5885/13, **Marvidex Surfing Products (2004) Ltd. & Others V. The State of Israel - Customs Authority**, ruling given on 1.11.16]

The Gottex Case 1 - 2016

In this case, the importers of the brands "Zara", "PULL&BEAR", "Nautica", "Nine West", "Easy Spirit", and "Anne Klein", imported clothing and shoes to Israel, as per the franchise agreements between the importers and brand owners. The goods were 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.

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.

As for the payment paid for advertisement services, 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.

The court ruled further that these payments are a precondition for the sale of the goods, for 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.

[TA (Central District) 4581-04-12, **Gottex Fashion Ltd. & Others V. The State of Israel - Customs Authority**, ruling given on 12.9.16. It should be noted that our firm is representing the importer in an appeal before the Supreme Court]

The Gottex Case 2 - 2018

Gottex imported clothing which were sold in stores under the brand name "Mango". These clothes were imported under a franchisee agreement between Gottex and Punto FA, the brand owner of the "Mango" brand. Beyond the payment for the clothes themselves, Gottex paid additional costs related to the purchase, including advertising and support costs of the stores in Israel.

The G.B. Brands Limited Partnership imported clothes, bags and shoes sold under the brand name "Gap". These clothes were imported under a franchisee agreement between G.B. Brands and GPS Strategic Alliance, the brand owner of the "Gap" brand. Beyond the payment for the goods themselves, G.B. Brands paid additional costs related to the sale of the goods in Israel, including advertising.

The Customs Authority argued that under Section 132 of the Customs Ordinance, these extra payments to the brand owners should be considered an integral part of the cost of the imported goods, and thus should be dutiable.

The court ruled regarding both companies that although the franchisee agreement conditions the continued import of clothing with the payment of advertising costs, they must be viewed as two separate transactions - the import transaction, and the advertising transaction. Thus, the advertising transaction has a separate economic value, and should not be connected with the import transaction for customs duty valuation. Therefore, the court accepted the position of the importers.

The court rejected the arguments of the Customs Authority, distinguishing between a different court ruling regarding Gottex (presented in Gottex Case 1, above, currently in appeal before the Supreme Court) and the current case. The court determined that in Gottex case 1 the court concluded that the brand owner did not provide any other service of economic value other than the clothes themselves, while in this case the situation was proven to be different.

Even so, with regard to the G.B. Brands claim, the court ruled that the extra costs are dutiable under Section 133(a)(4) of the Customs Ordinance, which states that the following component will be included in the transaction value:

"the value of any part which may be attributed to the seller, either directly or indirectly, in the expected receipts from any sale or use of the goods, that were made after their sale for export to Israel";

[TA (Central District) 66117-12-14, **Gottex Retail Brands Ltd. & G.B. Brands Limited Partnership V. The State of Israel - Customs Authority**, ruling given on 25.7.18]

The relationship between the different Rulings

We believe the ruling of the Supreme Court in the Marvidex & Lee Cooper case is reasonable and appropriate. On the other hand, with all due respect, we feel the ruling of the District Court in the Gottex case 1 is over reaching, and extends to some extent beyond the ruling of the Supreme Court in the Marvidex & Lee Cooper case.

For example, it was determined in the Marvidex & Lee Cooper case (with the expressed agreement of the Customs Authority) that a payment by the importer to the brand owner for a "marketing concept" - such as store design - is not related to the goods and is exempt from customs. Contrarily, in the Gottex case 1 a different principle was set, under which a marketing concept is "fused" with goods and is dutiable.

In the Marvidex & Lee Cooper case it was determined that when a brand owner can halt production if not paid his royalties, this control results with the importer obligated to pay royalties as a precondition of the transaction. On the other hand, the Gottex case 1 expanded the ruling, determining that it is not necessary that the brand owner have the power to halt production, it is sufficient if he can change production conditions so that the product is no longer the same product. In the Gottex case 1 this fulfills the condition of the importer being obligated to pay royalties as a precondition for the transaction, and the royalties will therefore be dutiable.

In addition, we believe that the ruling of the District Court in the Gottex case 2 is correct in principle regarding whether or not advertising costs constitute a part of the transaction value for customs valuation purposes. This also contradicts the Gottex case 1 ruling to a certain extent.

While in the Gottex 2 case it was determined that payment for advertising constitutes a separate transaction not related directly to the goods, and therefore exempt from custom duties, in the Gottex case 1 a different principal was set.

Either way, with regard to the Gottex case 2, we believe, with all due respect, that it is unreasonable that the question of whether advertising costs are dutiable will be determined according to the contractual agreement between the parties, specifically whether the payments were calculated according to purchases or sales. We feel it would be proper to set a clear principal regarding the essence of the matter, not a rule derived from a technical calculation.

It should be noted that the Gottex case 1 is currently in appeal before the Supreme Court, and our firm is representing the importer.

It is our assumption that the parties will appeal the Gottex case 2 ruling, and it will also be debated by the Supreme Court.

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

**For more information, please contact Adv. Gill Nadel, Chair of the Import, Export and Trade
Law Practice**

Email: Gill.Nadel@goldfarb.com Phone: 03-6089979.