

Customs & Trade in Israel

A Legal Newsletter

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Royalties for Operating Branded Concept Stores are Dutiable

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Background:

The subject of imposing custom duties upon royalties is at the center of a legal storm in recent years. The Supreme Court recently ruled on whether the goods' valuation for customs purposes includes royalties for operating branded concept stores.

Case Facts

The importers of the brands "Zara", "PULL&BEAR", and other brands, imported clothing and shoes to Israel ("the goods"), as per the franchise agreements between the importers and brand owners. The agreements include detailed marketing and management guidelines regarding various components, such as choice of location, internal design, the organization of the goods on the shelves, sale methods and more ("the services").

The goods are manufactured abroad by companies related to the brand owners, imported by the importers to Israel and then sold in dedicated "concept stores". The importers pay the manufacturers for the goods themselves, and pay separate royalties to the brand owners for the use of their trademark.

To Customs view, custom duties for importing the goods should relate not only to the purchase price of the goods themselves, but also to the royalties paid by the importers to the brand owners. Customs therefore issued deficit notices to the importers, charging them custom duties for both the goods' purchase price and the royalties.

To the importers' view, the royalties were paid for services - marketing and management guidelines related to the goods following their release in Israel, and therefore the value of the royalties should not be included to the goods' value for customs purposes. The importers sued Customs, requesting that the District Court declare that royalties to brand owners are not dutiable [TA (Central District) 4581-04-12, **Gottex Fashion Ltd. & Others V. The State of Israel - Customs Authority**, ruling given on 12.9.16].

The District Court rejected the importers' claims, ruling that they must pay the deficit notices issued to them by Customs, except for the fines for late payment. The District Court's ruling was based on the link between the imported goods and the services provided by the brand owners. The court ruled that these services must be viewed as an inherent component of the import conditions, with the sole purpose of "making the brand into what it is".

The importers appealed this ruling before the Supreme Court.

The Normative Framework

Section 133(a)(3) of the Customs Ordinance states that royalties and license fees related to imported goods must be included in the value of the goods for customs purposes, as long as the importer must pay the royalties and license fees as a condition for the sale of the goods in Israel.

The main question debated in this case is whether the royalties are related to the imported goods? Is payment of the royalties a condition for the sale of the goods in Israel?

The importers argued that both conditions for including royalties in the transaction value are not met in this case.

As for the first condition - the royalties grant the right to establish branded concept stores, as well as the right to use the business model, knowledge and services of the brand owners in relation to the stores. These services, which are paid for by the royalties, are provided in Israel after the import, and are not related to the imported goods.

As for the second condition - the payment of royalties does not constitute a condition for the sale of the goods in Israel, as there are cases in which the importers are not required to pay royalties for the imported goods.

The Supreme Court rejected the importers' appeal, upholding the District Court's ruling. The Supreme Court ruled that the District Court based its ruling on well founded facts, according to which the royalties paid by the importers to the brand owners are an additional payment for the imported goods (in addition to the purchase price paid to manufacturers related to the brand owners), and not an independent payment. The value of the royalties must therefore be included in the value of the goods for customs purposes.

The Supreme Court noted the following issues:

First of all, the court determined that the imported goods are trademarked (branded) at the time of import to Israel.

Moreover, the court relied on the fact that the imported goods are not only branded, the importer is obligated under his contract with the brand owner to sell the goods only as branded goods in concept stores, and may not sell products of a different brand in the store without the express permission of the brand owner.

In addition, the court determined that the main aspects of the business model that the importers view as an "independent service" for which they pay royalties are actually part of the characteristics of the goods they purchase from the brand owner. The Supreme Court ruled that the transaction price represents these business model characteristics and must therefore be viewed as part of the transaction's value.

The court determined further that even if we assume that the branding of the goods is done through their sale in concept stores, this was achieved not through the unique business model of the brand owner, but through the name of the brand set prominently at the store's entrance. In other words, it is not the unique knowledge supplied by the brand owner that enables the branding of the goods, but the permission to use the brand name in order to open a concept store. This permission is an integral

part of the import transaction, and it may not be viewed as an independent service that is exempt from custom duties.

[CA 471/17, **Gottex Retail Brands Ltd. V. The State of Israel - Customs Authority**, ruling given on 29.10.19. The importers were represented by our firm]

**The above review is a summary. The information presented is for informative purposes only,
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