

Outsourcing manufacturing: customs duties, intellectual property and R&D

When outsourcing manufacturing to low cost countries, consideration must be given to customs duties, due upon importation into the EC. Customs duties are "above the line" taxes, which add to the cost of the product on the EC market.

The amount of duties payable is based on the applicable duty rate and the customs value of the imported goods. The duty rate depends on classification of the goods in the Combined Nomenclature ("CN") and the origin of the goods. The CN is the EC customs product code catalogue based on the worldwide Harmonised System. Customs value is mostly established by the price paid or payable for the goods.

Added costs to dutiable value

As far as not included in that price, some cost elements may have to be added to the price in order to achieve customs value. In this respect, we would like to mention assists and royalties or license fees paid for using rights relating to manufacturing, using and/or (re)selling the imported goods.

Assists

Assists are goods and services the buyer supplies to the seller free of charge or at reduced cost in connection with the production and/or sale of the imported goods. Assists may either be supplied directly or indirectly by the buyer to the seller. Assists may consist in tangible items, such as materials, components, tools, dies, etc., or in intangible items, such as engineering, development, design work, plans, etc. These intangible items must be added to the customs value if the relevant work (engineering, etc.) is undertaken outside the EC. However, the cost of general research and preliminary design sketches do not have to be added to the customs value.

Royalties and license fees

Rights relating to manufacturing are, for example, patents, designs, models and manufacturing know-how. Rights relating to use and/or (re)sale of the imported goods are, for example, trade marks, registered designs, copyright and manufacturing processes. Royalties and/or license fees paid for using these (intellectual property) rights must be added to the customs value if these

relate to the imported goods and constitute a condition of sale of these goods. When the buyer of the imported goods pays royalties and/or license fees to a third party, these payments are only added to the customs value if the seller or a person/entity related to him requires the buyer to make these payments.

Planning opportunities

Large multinational companies often concentrate research and development in an R&D center. The work of this R&D center is used by the manufacturers and is often supplied to them free of charge by a trading company responsible for the European market. The question is whether the costs of the R&D center have to be included in the customs value of the goods that are imported into the EC by the trading company.

As said, the work of the R&D center may be qualified as an assist. In that respect, the costs of the R&D centers do not have to be added to the customs value if research and development is undertaken within the EC.

If, however, research and development is undertaken outside the EC, these costs generally must be added to customs value as (dutiable) assists as set out above.

An alternative may be to comprise R&D efforts and their results as applied in manufacturing into (registered) intellectual property rights such as patents, registered designs, etc. The use of the R&D information then attracts a (contractually agreed) license fee/royalties.

The manufacturer or the purchasing company then pays the licensor (i.e. the R&D center) royalties/license fees for using these rights. Whether these payments have to be added to the customs value of the imported goods depends on the relationship between the licensor and the manufacturers. If the licensor has "sufficient control" over the manufacturers it is considered to be "related" to these manufacturers. The consequence is (see above) that these payments must be added to customs value. Whether the licensor can be considered to have "sufficient control" over the unrelated manufacturers depends on various elements, such as (direct) contracts in place, its control over production locations, production methods, etc.

"Tolling" vs. "Buy/sell"

The above situation may exist in cases where a central purchasing entity contracts manufacturers under a tolling agreement (where the purchaser sources the raw materials and only pays a processing fee to the manufacturer) and where a marketing entity within the same group as the purchasing entity procures the products from the purchasing entity. For that reason, it is recommendable to ensure that the contract with the manufacturer is structured to the extent possible as a straight "buy/sell".

General research

The planning options discussed above can result in part of the cost of R&D efforts being classified as non-dutiable royalties and license fees rather than dutiable (intangible) assets. In most cases, however, this will not result in the entire R&D cost being considered as royalties or license fee.

The general rule that general research is not dutiable provides a second possibility to reduce duty exposure. In most instances it is virtually impossible to prove (by means of financial data which can be audited in accordance with GAAP) what is (not dutiable) general research and what is (dutiable) product development.

Nevertheless, such a distinction is negotiable with customs authorities by applying (for example) criteria such as (i) costs up to the stage of prototype development are considered not dutiable general research, all other costs dutiable product development; (ii) capitalisation of R&D costs (as intellectual property rights) for corporate taxation purposes, etc.

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