BEFORE THE CUSTOMS APPEAL AUTHORITY

Decision: [2021] NZCAA 07/19

UNDER	The Customs and Excise Act 2018
BETWEEN	**XXXX** Appellant
AND	**Chief Executive of the New Zealand Customs Service** Respondent

Hearing: 26 and 27 June 2019

Counsel: Mr Riaan Geldenhuys, counsel for the appellant.

Ms P Courtney and Ms R Tan, counsel for Customs

Decision: 28 February 2022

DECISION – INDICATIVE

Representatives: Riaan Geldenhuys, Barrister, Auckland, for the Appellant Crown Law Office, Wellington, for Customs

Introduction

[1] The Appellant is a clothing retailer, which operates shops in New Zealand. It is wholly owned by an Australian company (the parent company). The parent company is part of a wider international group of companies. The contentious issue arises from "royalty payments", which the New Zealand subsidiary pays to the parent company. The Appellant purchases and imports all its stock from the parent company.

[2] The dispute in the appeal is:

[2.1] The Appellant says the royalty payments are separate from the value of the goods the Appellant imports from the parent company, the royalties relate to other services and intangibles such as information; whereas

[2.2] Customs say the correct value of the goods includes the royalty payments. Effectively, that the nominated price of the goods between the Appellant as buyer and the parent company understates the true value. The royalty payments adjust that value to the true value.

[3] The royalty payments are calculated as a portion of net profit, payable only if the level of profit exceeds a percentage return on sales. Accordingly, the essential question for the Authority in this decision is to determine:

[3.1] Is the customs value of the goods the Appellant imports from the parent company adequately measured by the sale price to determine the customs value; if not

[3.2] Is it appropriate to add the royalty payments to the value, in part or in whole to determine the correct customs value.

[4] It is a mixed question of fact and law. It is necessary to determine what was supplied from the parent company to the Appellant, and what was paid and the reasons for the payment. Then, apply the law; which, requires a determination of the true value of the goods the Appellant imported, as they were when at the border. All the intangible values of the goods at the border need to be included, and that may require adjustments when the supplier and importer are related parties, as is the case in this proceeding.

Customs's decision

[5] The Customs decision subject to this appeal relies on cls 3(1)(a)(iv) and (v) of sch 2 of the Customs and Excise Act 1996[1]. Schedule 2 is concerned with the valuation of goods for the purpose of imposing customs tariffs. Clauses

3(1)(a)(iv) and (v) provide, the transaction value of goods shall be adjusted by adding:

> (iv) royalties and licence fees, including payments for patents, trademarks, and copyrights in respect of the imported goods that the buyer must pay, directly or indirectly, as a condition of the sale of the goods for export to New Zealand, exclusive of charges for the right to reproduce the imported goods in New Zealand; and

[1] The current Act is the Customs and Excise Act 2018.

(v) the value of any part of the proceeds of any subsequent resale, disposal, or use of the goods by the buyer that accrues or is to accrue, directly or indirectly, to the seller .

[6] Customs's decision said that the Appellant made royalty payments to the parent company during the financial years from 2014 to 2018, and reasoned:

[6.1] the Appellant's primary business activity was exclusively to retail goods the parent company sold to it (branded products not available to other New Zealand retailers);

[6.2] the retail goods had trademarks branding them;

[6.3] the parent company directs the Appellant's importing and sales operations;

[6.4] the Appellant could not procure its products without paying the royalty payments.

[7] The decision also said it rejected the Appellant's claim the royalty payments were for the use of the parent company's intellectual property concerning the operation of the New Zealand business.

[8] On this basis the decision concluded:

[8.1] the royalty payments were related to the goods imported; alternatively

[8.2] were "proceeds of subsequent resale of the goods" under cl 3(1)(a)(v) of the Act.

[9] **The Appellant's position**

Overview

[9] The Appellant characterises the royalty payments as "an arm's-length royalty" paid by it to the parent company for intellectual property. Accordingly, those payments are:

[9.1] for the complete and comprehensive bundle of intellectual property governing every aspect of the Appellant's retail operations; and, accordingly, not for the goods it imports; further

[9.2] the payments are not the proceeds of sale returned to the parent company.

Facts

[10] In support of that analysis the Appellant relies on the following facts:

General

[10.1] The relationship between the Appellant and the parent company involved the latter supplying goods, intellectual property, and services. Intellectual property included business know-how, not only registerable interests such as trademarks.

[10.2] Reflecting the three categories of supplies, the Appellant paid an inventory price for goods, a royalty for intellectual property, and a management fee for services.

[10.3] The three categories of payments were calculated and tested annually to determine they were on arm's length terms under a transfer pricing methodology. A major accounting firm reviewed the analysis, and it was accepted by Inland Revenue for tax compliance purposes.

[10.4] The respective obligations of the Appellant and the parent company were recorded in a contractual agreement.

The goods and payments for them

[10.5] The goods in issue were apparel, homeware and accessories. With minor exceptions they were only branded on labels such as size and care labels, not logos that were visible design features.

[10.6] The purchase price for the goods was calculated on the basis of cost plus a loading for duty, commission payments, freight, sampling, design and a profit margin. Accordingly, the payment was a full payment for the features of the goods, including design elements and trademarks

Services

[10.7] The Appellant employed retail store staff, and they had limited ability to make operational decisions. Beyond the day-to-day routine of the local retail stores the parent company provided the operational services. That included: management, administration, personnel/HR, finance, IT, legal, advertising, and marketing.

[10.8] The Appellant paid for the services based on the cost, plus a mark-up of 7.5%, described as a management fee. This fee did not include some senior executives who provided services, such as the CEO and it did not include intellectual property

Intellectual property

[10.9] The intellectual property in the Appellant's business systems is a broad category, which the Appellant describes as a sophisticated retail formula, including "know-how, trade secrets, confidential information, copyright in artistic works and marketing content, and brands". That included product selection, locating products, presentation, customer service standards, product line retail strategies, marketing, location and development of premises and store systems.

[10.10] There is difficulty in valuing these assets and services (they are not easily referenced to an arm's-length market price), they were priced at cost plus a margin. However, as part of the transfer pricing methodology by Inland Revenue the royalty payment was made. It was an additional cost imposed on the Appellant, calculated as a percentage of its net profit. The formula was 75% of earnings (on an EBIT basis), above a baseline profit of 5% of EBIT over sales.

Law

[11] The Appellant says the purpose and approach of the valuation provisions in sch 2 of the Act is to determine the true cost of imported goods, looking at the reality and the importer's full obligations[2].

[12] In respect of cl 3(1)(a)(iv) there are three cumulative questions[3]:

[12.1] whether a royalty is payable in respect of the goods, and

[12.2] if so is it payable to the seller, and also

[12.3] payable as a condition of the sale of the goods

[13] Accordingly, the Appellant's position is that it is necessary to add royalty payments made in respect of the goods, but not if they relate to other items such as information services[4]

[14] In respect of cl 3(1)(a)(v) the Appellant says its scope is uncertain, but must capture payments made for imported products, not something else. That is consistent with the objective of measuring the true cost of the goods, in the context of the overall transaction[5].

[15] The Appellant cited authorities, which variously have analogous and different features. However, the Appellant effectively advances a case that is determined on the factual finding as to whether in whole or in part the royalty payments were made to procure the goods in issue; or, in fact for other valuable intangible supplies delivered to it by the parent company.

Customs's position

Issues

[16] In significant respects Customs does not challenge the factual position advanced by the Appellant. The parties filed an agreed statement of fact. The material agreed facts, and contentious facts are identified in the discussion below.

[17] Customs agree with the Appellant that the appeal turns on sch 2 of the Act, and in particular cls 3(1)(a)(iv) and (v).

Overview

[18] Customs, like the Appellant say that the purpose of sch 2 is to set the "true cost of the goods to the importer at the time they cross the border"[6]. The central element of the argument advanced by Customs is that the true cost includes the intellectual property rights attached to and incorporated within those goods. To that point, Customs and the Appellant have a common position. The contentious element is that Customs says:

> "Without the goods being imported for sale, and sold by [the Appellant], there would be no reason for the services [the parent company] provides in respect of the

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2 Adidas New Zealand Ltd v Collector of Customs (Northern Region) [1999] 1 NZLR 558.

3 *Chief Executive of the New Zealand Customs Service v Nike New Zealand* [2004] 1 NZLR 238 at [60], [61].

4 *Ninette Trading v Bates* [1987] VR 431 and *Re Burroughs and Collector of Customs,* NSW(1985) 9 ALN N122, and SL Sherman and H Glashoff, *Customs Valuation: Commentary on the GATT Customs Valuation Code* (Kluwer Law and Taxation Publishers, 1988) at 124, [293].

5 *Adidas New Zealand Ltd v Collector of Customs (Northern Region)* (1999] 1 NZLR 558 at 564.

6 *Collector of Customs v Avon Cosmetics Limited* (2000) 1 NZCC 55,011 (CA) [Avon (CA)], at [20]. *Adidas NZ Ltd v Collector of Customs* (Northern Region) [1999] 1 NZLR 558 (CA) [Adidas (CA)], at 564 per Henry J.

brands (including any know-how and commercial strategy associated with them) to exist; and no profit upon which any amount would be payable.

[19] Accordingly, Customs take the position that on a "but for" analysis, the goods were imported and the true cost of the goods includes the post-importation support including the commercial strategy in the Appellant's retail operation.

[20] Customs say that view is consistent with existing authorities, saying that the High Court and Court of Appeal have previously held that payments for know-how, product development, distribution rights and marketing techniques should be included in the value of the imported goods when determining the value of imported goods for Customs purposes[7]. In support of that analysis Customs says that where a parent company has significant control over conditions of importation and the subsequent resale of the same goods, there is a risk of manipulation to minimise the duty paid. That is to say, loading costs into post-importation activities reduces the customs value.

[21] Customs view is that the approach of including post-importation costs such as distribution rights and marketing techniques is settled law in New Zealand, and it departs from the law in Australia and Europe. Customs cite the Court of Appeal's decisions in *Adidas NZ Ltd v Collector of Customs (Northern Region;*[8] and *Collector of Customs v Avon Cosmetics Limited*[9] (2000) 1 NZCC 55,011 (CA).

[22] Customs say the principle that payments, even if they relate to post-importation services, are to be included in the customs value on importation is mandated by the legislation:

[22.1] Clause 3(1)(a)(iv) includes "royalties" made "in respect of the imported goods", and those words are of the widest possible effect. The goods in issue could not have been imported by the Appellant without it agreeing to, and paying for, all the post-importation support.

[22.2] All of the royalty payments in issue related to the goods, and should be included in the value of the goods.

[22.3] In addition, as the royalty payments are funded from the sales of the goods cl 3(1)(a)(v) applies as the payments are necessarily "part of the proceeds of any subsequent resale" and paid to the parent company.

[23] In short, Customs say regardless of whether the Appellant establishes that the royalty payments related to post-importation services is a question of New Zealand law, and they must be included when determining the true cost of the goods to the importer at the time they cross the border.

Law

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[7] *Adidas* above at n 5, at 560 (know-how and technical data), *Avon Cosmetics Ltd v Collector of Customs* (1999) 1 NZCC 61,073; [1999] NZAR 345 (HC), *Collector of Customs v Avon Cosmetics Limited* (2000) 1 NZCC 55,011 (CA) [Avon (HC)] at 351; *Avon* (CA) at [8].

[8] As above.

[9] As above.

[24] Customs agrees that the Customs and Excise Act 1996 applies, rather than the Customs and Excise Act 2018 to the substantive issues. That is both correct and uncontentious and it is a correct view[10], which needs no further discussion.

[25] Customs noted that sch 2 of the Act was enacted to reflect and give effect to the World Trade Organization treaty *General Agreement on Tariffs and Trade 1994,* and reviewed the general structure. Customs also acknowledged the relevance of a purposive interpretation[11], and the value of uniformity when interpreting multi and bi-lateral international treaties[12].

[26] As noted, Customs say the legislation and the authorities applying it unequivocally include all royalty payments, whether or not they relate to the intrinsic qualities of imported goods (tangible and intangible), or post-importation services relating to the retail network in which the goods are sold.

[27] [Customs noted that the terms "royalties" and "licence fees" are not defined in sch 2, and their ordinary meaning refers to payments for the use of rights, privileges or intangibles such as information or services, or permissions. The point was not contentious.

Contractual arrangements

[28] The Appellant and the parent company had contractual arrangements relating to the royalty payments. However, Customs says that there was no legally binding agreement and the arrangements were informal.

Discussion

Overview

[29] There is significant commonality between the parties in terms of the approach to the statutory provisions. There can be no doubt that Customs correctly says the purpose of sch 2 of the Act is to provide a mechanism to establish the "true cost of the goods to the importer at the time they cross the border".[13]

[30] The critical difference between the parties is that:

[30.1] The Appellant says the true costs and accordingly the customs value is the value of the goods at the border, and the royalty payments are not related to that value. Those payments relate to the operations of its New Zealand retail shops.

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[10] The current Act applies to the procedural aspects of this appeal, as reflected in the intituling of this decision.

[11] *Terminals (NZ) Ltd v Comptroller of Customs* [2013] NZSC 139, [2014] 1 NZLR 121 at [39] per Glazebrook J for the Court, Interpretation Act 1999, s 5, and *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] NZSC 36, [2007] 3 NZLR 767 at [22].

[12] Citing three cases, said to be that are authoritative as to principles of interpretation; which involve use of the transaction value method of determining customs values of goods: *Integrity Cars (Wholesale) Ltd v Chief Executive of New Zealand Customs Service* CA128/00, 2 April 2001 at [7]-[8]; *Elitunnel Merchanting Ltd v Regional Collector of Customs* (2000) 1 NZCC 61,151 (CA) at [15]; and *Sigma Agencies Ltd v Collector of Customs (Northern Region)* [1997] 1 NZLR 467 (HC).

[13] *Collector of Customs v Avon Cosmetics Limited* (2000) 1 NZCC 55,011 (CA) [Avon (CA)], at [20]. *Adidas NZ Ltd v Collector of Customs* (Northern Region) [1999] 1 NZLR 558 (CA) [Adidas (CA)], at 564 per Henry J.

[30.2] Whereas, Customs say, the Appellant and the parent company are not at arm's-length. Accordingly, it is necessary to use the statutory mechanisms that attribute the correct value. Those mechanisms include payments for post-importation services and intangibles such as information. That is mandatory, and it ensures that related parties cannot manipulate customs values.

[31] There can be no doubt that Customs is correct that it must ensure that the full value of goods, including intangible value is assessed as the customs value. However, the proposition that under cl 3(1)(a)(iv) all payments made to the parent company sourced from the retail sales of the imported goods are included in the value could only be true if the statutory language clearly mandated that outcome. In this case all the money the Appellant pays to the parent company is sourced from retail sales of goods it purchases from the parent company. Some of those payments have no other connection with the imported goods (such as IT services, finance, and legal services).

[32] In my view it is essential to consider the categories of payments that the Appellant makes to the parent company, the way they are quantified and in particular to determine the true nature of the contentious royalty payments. The parties agree, the statutory provisions require a purposive approach, and should result in a measure of the true cost of the goods to the importer at the time they cross the border. I will accordingly consider the evidence dealing with those matters; and then apply the law to those facts.

Facts - the payments

[33] The evidence identifies three categories of payments the Appellant makes to the parent company:

[33.1] Payments for the sale of products, these are the imported goods in issue

[33.2] Licence and royalty payments are made for intellectual property;

[33.3] Payments for administrative services.

[34] The prices for all of these payments are made under a transfer pricing regime. For the Appellant and the parent company there are immediate obligations to the New Zealand and Australian revenue authorities, and no doubt other revenue authorities for the wider group.

Facts - how the customs value of the imported goods was calculated

[35] The parent company's General Manager Taxation gave evidence on behalf of both the Appellant and the parent company. She said:

> By virtue of the principles contained in the transfer pricing legislation and double taxation agreements, the ... Group members are compelled to ensure that its cross-border transactions are properly transacted and accounted for at market value. This imposes a legal obligation on the group members to calculate and pay for value received from another group member at arm's length.
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> The sale of products between group members are transacted and accounted for on a cost plus basis.

[36] The statement is unexceptional and was not challenged. There was further elaboration in the Agreed Statement of Facts, which said:

> The price of stock sold from [the parent company] to [the Appellant] is calculated based on an FOB price paid by [the parent company] with some adjustments. Adjustments are primarily made to cover additional costs, including duty, third party sourcing commission payments, freight charges and sampling costs, a design fee plus a profit margin for [the parent company].

[37] The Agreed Statement of Facts cited a transfer pricing report. The report was prepared by PWC Australia. It identified that the report tested the prices paid by the Appellant for the imported goods. However, for present purposes there is an element of circularity. The conclusion in the report was that the product sale prices (between the parent company and the Appellant) were in the arm's length range. However, the methodology used the return on sales and the operating margin as the arm's-length condition. It follows the arm's-length condition took the cost of the royalty payment into account. Given there is a range, and the royalty payment is part of the calculation (effectively making it circular) I cannot regard this as evidence that determines the arm's-length value of the product at the border.

[38] It is important to bear in mind that it is not appropriate simply to apply transfer pricing methodology when determining a customs valuation. The customs value is confined to the true value of goods at the border. That may be one factor in a transfer pricing determination, but the enterprise's overall level of income is the ultimate issue for transfer pricing. Transfer pricing should ascertain an appropriate level of income for the local entity, that will generally determine its income tax liability. The components of the contributions to the calculation may be important for other taxation measurements, but not necessarily. Accordingly, arm's-length conditions may be used that compensate for imprecision in specific components when applying transfer pricing methodology.

[39] The General Manager Taxation was challenged in cross-examination on the quantification of costs. Customs suggested that not all of the parent company's cost of goods was recovered. However, she rejected that assertion and said all the parent company's costs, with additional margins and an allowance for profit were recovered. She rejected the royalty payments being a payment for intangibles incorporated into the goods as they were at the border, and said those payments were a profit split arrangement after properly accounting for the value of the imported goods. The royalty payments, she said, related to the New Zealand business structure and operations that were distinct from the value of the goods at the border. She explained that the New Zealand operations of the Appellant operated with little or no autonomy, and accordingly all the major decisions and strategy were under the close supervision and control of the parent company's personnel. I have no basis to reject that evidence, it is consistent with the materials presented in evidence and none of the witnesses presented a contrary view.

[40] Accordingly, I accept that as agreed the payments made for the goods were calculated on the price paid by the parent company, with adjustments to cover the tangible and intangible features of the items at that point. Elements such as design, and profit for the parent company were added to establish the value at the border. The General Manager of Taxation said the parent company's cost plus approximately 10 - 15% was added for design, sourcing and distribution.

[41] In summary, I have no basis on the evidence to conclude that there is any foundation to reach the view that the price paid for the imported goods did not represent their true value at the

border on entry. However, that is subject to a potential contrary inference. I must consider the nature of the royalty payments, if they are in fact related to underpricing the imported goods that is critical. It follows, that if the evidence shows the royalty payments reflect any part of the value at the border; or, adjusts the pricing due to something that is, then I must conclude the price paid for the stock was not the full value. To determine that issues I must rely on the direct evidence from the Appellant's witnesses, not the transfer pricing methodology.

Facts - *what the royalty payments related to and how they were calculated*

[42] I now turn to consider the royalty payments, to determine whether there is any inference that can be drawn from the evidence relating to them. In particular, whether the evidence relating to them can affect my view of the evidence concerning the value of the goods at the border, which indicates the parent company and the Appellant costs the goods on the basis of actual costs, plus its best measure of the design, sourcing, distribution and other costs.

[43] There is one royalty payment, and a two-step process to calculate it. The General Manager Taxation said:

[43.1] No royalty is payable if the Appellant's net profit is the equivalent of a routine return or less, which is equivalent to a 5% return on sales (the return on sales, which is calculated as net profit divided by net sales) or less (the Routine Return);

[43.2] If the Appellant's net profit exceeds the Routine Return, 75% of that excess is paid to the parent company as the royalty payment.

[44] Accordingly, whether the royalty is paid turns on the profitability of the Appellant. It is a mechanism that directs 75% of the excess profits to the parent company. That is consistent with the purpose of the payment, the greater business success from the parent company's contribution, the more it shares in the profits.

[45] From a transfer pricing perspective, the New Zealand revenue authorities will expect a level of profit that is consistent with the performance of a similar business operating on an arm's-length basis. It is permissible for higher profits to be allocated to the parent company (and from an Australian perspective, potentially mandatory).

[46] I now turn to the reasons why the Appellant and the parent company say that it is appropriate to direct 75% of the profits over the threshold to the parent company. However, if Customs had grounds to think that the Appellant and the parent company had reduced the Appellant's costs by undervaluing stock there would be every reason to be concerned, and there could be little doubt that statutory mechanisms would address that situation. However, the evidence is that substantial value was contributed by the parent company toward profitability, but none of it was in the form of undervalued supplies of product.

[47] In addition to the General Manager Taxation, five witnesses gave evidence. One of them provided contract services as a consultant to the parent company, the others were current employees, aside from an independent expert. The independent witness gave evidence relating to transfers of intangibles between the parent company and the Appellant, and their value. Key elements in the evidence of all the witnesses related to the qualities and quantification of the royalty payments. Material evidence included:

The General Manager Taxation

[47.1] The General Manager Taxation produced a copy of the royalty calculations, and noted they are included in the financial statements as a royalty expense. As discussed, it is a calculation that effectively splits profit between the Appellant and the parent company, and it conforms to the New Zealand and Australian transfer pricing rules that regulate the level of income to be returned in the respective jurisdictions.

[47.2] The General Manager Taxation said the purpose of the royalty payment was to compensate the parent company for the work and effort contributed by the parent company's management teams. That included the merchandise, visual merchandise, and retail teams; in addition the value of strategic management of the Chief Executive, and the Brand Managing Director's input. In her oral evidence she explained that the New Zealand based employees had only a limited function, the day to day operation of the retail shops.

[47.3] The other witnesses elaborated on the nature of the contributions made by the parent company beyond the confined functions carried out by the Appellant's personnel based in New Zealand.

The Head of Retail

[47.4] The Head of Retail for the parent company has control of the day to day operations of all the retail stores in Australasia, and is responsible for the retail team members and store managers. He said his responsibilities (as leader of the retail team team) were for:

[47.4.1] Customer contact and service;
[47.4.2] Opening of the stores;
[47.4.3] Security of the stores;
[47.4.4] Back of house operations;
[47.4.5] Meeting sales and profit targets;
[47.4.6] In summary, he and his team were responsible for all interactions with customers throughout New Zealand and Australia.

[47.5] The Head of Retail explained that the in-store staff received specific guidance, using service programmes. The objectives of those programmes is to not only manage the customer relationship, but to also make "team members feel like experts." The effectiveness of this management of the retail environment is managed with evaluative techniques. He went on to illustrate the level of control over the retail environment by discussing innovations introduced by a new marketing director. She worked with an external expert to design a new customer service model. An important point of the Head of Retail's evidence was that these models for interaction on the retail shop floor were determined for the whole retail chain by staff at the head *office* level in Australia.

[47.6] As Head of Retail the witness explained the control exercised in relation to the whole retail network not only at the level of customer interaction, but also store systems (including point of sale transaction processing), and real estate. The evidence was confirmatory, and explanatory of the General Manager Taxation's evidence relating to the manner in which the Appellant's stores were managed and controlled by the parent company's staff, consistently with the stores throughout Australia and New Zealand.

The Head of Visual Merchandising

[47.7] The parent company's head of visual merchandising gave evidence of the role he and his team had on the operations of the Appellant. He explained that they were responsible for the visual touch points at all the stores, including the Appellant's New Zealand stores. That involved:

[47.7.1] Window presentation, including mannequins, and how they are dressed;

[47.7.2] Location of stock in the stores (including clear directions on location), systems for marketing, and all the marketing, mannequins and displays in the stores;

[47.7.3] These aspects have consistency across the network of stores.

[47.8] He went on to explain that his team was involved in overseeing the continuous development and improvement of the store design concept. That covered the in-store fixtures, layout, flow, proportions of functional areas, and finishings. He illustrated the importance of that work with a particular store redesign, which took about a year. He described the results of that redesign as "phenomenal"; and explained his team was integrated with the other teams and integrated the results with the brand across all the stores operating under the brand throughout New Zealand and Australia.

The Head of Merchandise

[47.9] The Head of Merchandise for the parent company gave evidence regarding her role. She had some 16 years with the parent company and Appellant's brand, three years in her current role and earlier experience with a major retailer in Australia.

[47.10] She is responsible for the brand's merchandising divisions (based on product lines), and manages the planning and production of product to indent. Part of her role is to manage the financial results of procuring product, including the product in issue which the Appellant imports into New Zealand. Her team has 43 members. She described how her team manages seasonality in the stores, the financial results of specific product lines, decisions relating to the specific product for individual shops, and ensuring the right amount of stock is placed in each shop. Her team also has a role in the mariagement of the customer experience, as other witnesses affirmed.

[47.11] Again, the control exercised over the New Zealand stores was a key feature of the Head of Merchandise's evidence.

Mr B - a trade consultant

[47.12] Mr B did not give evidence as an independent expert, he was a witness of fact who was employed by the parent company from 1986 to 1991, and later as a consultant. He is now semi-retired and provides consulting services to the parent company.

[47.13] Mr B gave evidence of agreements that had been in place relating to payments between the parent company and the Appellant. He described a 1997 management agreement, which was not signed. It was not clear whether there has been a signed document, regardless he acknowledged that the practices were not fully reflected in the 1997 agreement. He thought that there was a binding agreement relating to the royalty fees, and consistent practice relating to that.

[47.14] He maintained that position in his oral evidence, however it would be fair to say that reducing the agreed practices to writing was not done with complete rigour. However, it does appear clear that the financial records accurately disclose and reflect the arrangements between the parent company and the Appellant in respect of the royalty payments.

Mr Davies - Expert evidence on intellectual property

[47.15] Mr Davies gave evidence as an independent expert regarding the existence and nature of intellectual property. He relied on the evidence given by the parent company's team managers, and General Manager of Taxation to determine the factual circumstances of the Appellant's business. Mr Davies has technical intellectual property qualifications, but for present purposes it is more relevant that he has expertise in and provides professional advice on assessing, valuing and monetising intellectual property.

[47.16] An important distinction Mr Davies made is to differentiate a product company (say a smart phone manufacturer) from a retail business. The former may have a retail function, but it is a product business. In contrast a general retail business is selling products where the same or substitutable products are available elsewhere. He instanced a supermarket. For these businesses, the essence of the business is the service of retailing.

[47.17] Mr Davies considered that the Appellant's circumstances pointed clearly to it being a provider of retail services rather than a product company. He then reviewed the contributions the parent company's merchandising, visual merchandising, and retail teams provided to the Appellant. He then considered the contribution of the brand and marketing support.

[47.18] In summary, when he reviewed the contributions the teams made, he concluded:

> [47.18.1] Merchandise Team - Rather than specific design work for products, the principal contribution was for the provision of retail services in a way that led to a successful business operation. I note that the design work for products and a margin on it are included in the cost of the imported goods.
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> [47.18.2] Visual Merchandising Team - This team contributed know- how, trade secrets and confidential information to make the retail process effective and profitable.
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> [47.18.3] Retail Team - This team controlled and directed the instore staff and managers in a way that ensured the brand values of the network of stores was met and sales opportunities maximised. He emphasised a range of matters relating to obtaining valuable information from the network, adapting it to location, demographics and culture and thereby making the Appellant's stores and the stores in Australia operate to best effect.

[47.19] Mr Davies considered the brand under which all the stores in Australia and New Zealand operate was the most significant contribution of intellectual property. He observed:

> In application of the brand, it is noted that few of the products are visibly branded beyond the sizing and care instruction labels. Nor are the products themselves generally of such unique visual character as to clearly identify themselves as [the Brand] product. Instead, one of the most visual and significant interactions between a customer and the brand is in the customers interaction with brand on the store itself. This is independent of the products within the store. In this sense the customer is engaged in a retail experience rather than purchasing branded products *per se* and they participate in the [the Brand) experience.

> I note that while some of the characteristics of the brand, such as the sustainability or product quality may be exhibited by the products themselves, other brand values such as the interaction of the customer within the store as provided by the visual merchandising team and the retail team are not product centric values but values of retail services. Indeed, even the attributes such as sustainability are more general than simply on the products and it is not uncommon for retail services to take on such attributes. An example would be an organic food store. The products may be entirely third-party goods. The store is acting purely in the field of retail services. Yet the store still selects the products it carries to ensure they meet its own value proposition as a retailer.
>
> It would be my opinion that the majority of the brand values and characteristics are expressed through retail services rather than through the individual products.

[48] On this evidence I must conclude that there are certainly design elements that are incorporated into the garments. However, they are created by services which are included in the price paid by the Appellant for the imported goods, with a margin added. Certainly, I have been unable to find on the evidence that there is any underpayment for the goods. That is the apparent intention of the pricing methodology, by taking all the identifiable costs that are incorporated into the inherent and intrinsic qualities of the goods; and there is a margin and allowance for profit for the parent company added. The evidence is that the cost is as close to arm's-length as possible (within a transfer pricing regime).

[49] I cannot determine any component of the value of the goods at the border is incorporated into the royalty payments. That is because the quantum of the royalty payments has no quantifiable nexus with the cost or value of the imported goods. The quantification is a profit sharing formula, and the intention of the parent company and the appellant has been to share profits based on profitability. In a contemporary branded retail chain selling what are readily substitutable goods, the evidence is clear a critical driver of profitability is the retail system (in this case physical premises), the marketing techniques in the facilities, and the integration with brand and wider brand recognition and brand level marketing. It is unsurprising that the parent company and the appellant would choose to share profitability (to the extent the transfer pricing rules allow) based on profitability for which this factor is a key element.

[50] The highest the matter could be put is that to some extent the profit sharing formula would compensate the parent company had it underpriced the imported goods; but, I cannot conclude, on the evidence before me, that was either the intention of the Appellant or the parent company when setting prices for the imported goods. Regardless of intention, the evidence does not establish that was an effect of the pricing either.

The law

[51] I have concluded that the evidence establishes on the balance of probabilities, that:

[51.1] the Appellant paid an amount for the imported goods that reflected the true value of the goods at the border; and

[51.2] the royalty payments related to the post-importation retail process and the value added in that part of the Appellant's business.

[52] On the Appellant's argument that would result in it being successful in the appeal. However, Customs say that whether or not the royalty payments relate to post-importation process, they must, none-the-less, be added to the value of goods at the border as a question of law. Accordingly, I now consider the law relating the respective positions.

The Court of Appeal decisions

[53] The parties agree that two decisions of the Court of Appeal are a foundation for understanding the law regarding the value of imports at the border. The decisions are *Adidas NZ Ltd v Collector of Customs (Northern Region)*[14], and *Collector of Customs v Avon Cosmetics Limited*[15].

Adidas NZ Ltd v Collector of Customs (Northern Region)

[54] The *Adidas* decision concerned circumstances similar to the present case, in that the appellant was a wholly owned subsidiary of an overseas corporate. The appellant had an exclusive right to use the offshore corporate's intellectual property to manufacture and then sell those products in New Zealand. The licence agreement did not oblige the New Zealand subsidiary to pay royalties, but it did so. The Court took the view the products would not be available without the payment of the royalty, as a matter of commercial reality or substance (if not in law). The question was whether under the Tariff Act 1988 and Customs Act 1966, those royalties should be included in the customs value of the product at the border for Customs purposes. The Court of Appeal unanimously held the royalties should be included. It is of course necessary to consider the Court's reasoning.

[55] The Court's reasoning is expressed in the judgment of Henry J. The other members of the Court, [16]agreed with the reasoning, but had a reservation as to whether there was a legal obligation to pay the royalty. Thomas J considered the "commercial reality or substance of the arrangement" was that the royalty payment would be made. Blanchard J considered the royalty was paid as a condition of sale, notwithstanding it was neither stipulated in an agreement nor was there evidence it was imposed as a requirement of the supply. Blanchard J accepted that it was an obligation voluntarily accepted, and that was enough to make it a condition of sale.

[56] The Court considered the Tariff Act 1988 and Customs Act 1966, the material provisions of those Acts required that the Customs value of good be adjusted by adding "Royalties and licence fees ... that the buyer must pay, directly or indirectly, as a condition of the sale of the goods for export to New Zealand ...".

[57] In that case the royalties were not calculated by reference to the price of importation, rather with reference to the net sales of licensed product distributed in New Zealand. The Court found it was of little relevance how the royalty was calculated, the key reasoning was that it is necessary not to simply look at the sale agreement governing the importation and licensing of the goods:

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[14] [1999] 1 NZLR 558 (CA).

[15] [2000] 1 NZCCC 5,011 (CA).

[16] Thomas and Blanchard JJ.

> ... the sale agreement is not to be looked at in isolation. An analysis would seem to disclose the view that when the obligation to pay a royalty arises from a separate agreement unrelated to the sale for export, or where the importer does not have to pay a royalty in order to purchase the goods, the royalty should not be included for duty purposes[17]

[58] It appears the Court, perhaps unsurprisingly, given the legislation is remedial and intends to establish a true commercial value looked at the substance of the arrangements not the mere legal form. Its reasoning was:[18]

> The obligation goes hand in hand with the importation of product which is sold. As Paterson J put it at pp 16 - 17: "Adidas NZ was committed to an arrangement under which each time it arranged for adidas Asia-Pacific to purchase from an Asian supplier adidas branded goods for sale in New Zealand, it was subjecting itself to a requirement to pay a royalty to adidas AG.

[59] On the facts of that case, the Court of Appeal had limited regard to the form of the agreement, but gave close attention to the fact of the royalty payment and why it was paid. The conclusion was that there was a nexus between the importation of goods, the commercial outcome of the importation, and the reality of an obligation that a payment would be made for obtaining the goods.

Collector of Customs v Avan Cosmetics Limited

[60] In the *Avon Cosmetics* case the Court of Appeal considered a similar business structure to the *Adidas* case and the present case, where a New Zealand distributor paid royalties to a parent company. In this case the parent company held its interest in the New Zealand company indirectly and other members of the same group of companies were involved in the arrangements.

[61] The *Avon Cosmetics* case concerned an essentially identical question to the *Adidas* case, and the present case "Royalties and licence fees ... that the buyer must pay, directly or indirectly, as a condition of the sale of the goods for export to New Zealand ...". There were no material amendments to the legislation differentiating those cases, or this present case.[19]

[62] In the *Avon Cosmetics* case the New Zealand and Australian companies each operated as "an independent subsidiary" within a wider group of companies. The Australian company supplied the New Zealand company with product. The Australian company set the inter-company price, and the New Zealand company set the retail price in New Zealand. With regard to the royalties, the parties' respective positions were:

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[17]Page 565 line 32.

[18] Page 565 line 46

[19]The provision was restructured, being in the 9th Schedule of the Customs Act 1966 in the period that applied to the Adidas and Avon Cosmetics case, and the Second Schedule for the present case. However, the determinative wording is the same.

[62.1] Avon said that under its legal arrangements the royalty payments were not paid to the Australian company, but instead to another company in the group (it exercised control over both the New Zealand and Australian companies). The royalty payments were not made as a condition of sale of the goods for export to New Zealand.

[62.2] Customs said as a matter of commercial reality and common sense the right to sell the goods in New Zealand was procured by the royalty payment, and therefore an essential cost; and it followed, a condition of the sale of the goods for export to New Zealand.

[63] The High Court had concluded, that the royalties paid to the more remote holding company that controlled both the New Zealand and the Australian companies was not a condition of the sale for export to New Zealand.

[64] The Court of Appeal in the Avon case applied the Adidas case. It considered that the High Court in that case was in error in not applying the test of "the commercial and legal reality".[20] It found that the reality was the entities involved in the arrangements were in the same group of companies, and whatever flexibility they had with written agreements they did "give full effect to the agreement as currently varied from time to time". The Court of Appeal concluded:[21]

> The expression "as a condition of the sale of goods ..." is necessarily wider than "as a condition of the contract of sale of the goods". It is that wider effect that is reflected in the judgments in *Adidas* and in cases in other jurisdictions. Here, as there, when the true nature of the arrangements is looked at the royalty was payable as a condition of the sale for export *(Henry* J) and the situation can properly be seen as involving as part of the purchasing arrangement an obligation on the New Zealand company to pay royalties to the particular parent company *(Blanchard* J).

[65] The Court concluded that approach is consistent with international authorities.

[66] The Court of Appeal in the *Adidas* case observed "the apparent intention of the valuation provisions of the Ninth Schedule, [is] to ascertain the true costs of the goods to the importer". The Court also referred to that reasoning in the *Avon Cosmetics* case.[22] That is to be ascertained by determining the "true nature ofthe arrangements"[23]

[67] It necessarily follows that I am required to make a factual determination of the nature of, the reasons for and all the material circumstances of the payments described as "royalties" in this case. It is neither sufficient to:

[67.1] Simply identify the payments as "royalties" and assume they have a nexus with the imported goods; nor is it acceptable.

[67.2] To regard that nexus as broken by whatever nomenclature is used to describe the payments, the legal structure of the payments, or any circuitous routes by which funds are remitted.

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[20] At [23].

[21] At [28].

[22] At [20].

[23] The Avon Cosmetics case [28].

3(1)(a)(v) of schedule 2 of the Customs and Excise Act 1996

[68] The Court of Appeal's decisions in the *Adidas* and the *Avon* Cosmetics cases concern the wording of what is now cl 3(1)(a)(iv) of sch 2 of the Customs and Excise Act 1996. To that extent they apply directly. As observed Customs also relied on cl 3(1)(a)(v) of sch 2, arguing it is a more expansive provision, providing the Customs value of goods has added to it:

... the value of any part of the proceeds of any subsequent resale, disposal, or use of the goods by the buyer that accrues or is to accrue, directly or indirectly, to the seller ..

[69] The parties acknowledged that there is a lack of authority on the meaning of the provision. Of course, the *Adidas* and *Avon Cosmetics* cases both observed that that the apparent intention of the set of provisions that are now in sch 2 is to set the true market price. A literal application of the words in cl 3(1)(a)(v) could, in some cases, entirely undermine that approach. The present case is a simple example. More, or less, the Appellant procures 100% of its stock from its parent company. It remits a portion of its net profits from retail sales to its parent company (constrained by transfer pricing rules). Arguably even if the stock purchased from its parent company is priced at the full market price at the border, cl 3(1)(a)(v) has the effect of artificially inflating the Customs value by the full extent of retail profits remitted to the parent company. If so, the provision is inconsistent with the purpose identified by the Court of Appeal.

[70] I am satisfied that is neither the intention of the provision, nor the structure of sch 2. The Court of Appeal identified both the purpose, and the effect of the wording in the regime. It is to set the true market value at the border, not a discounted value that fails to take account of other ways in which value is remitted to the supplier; and not an inflated value that takes account of value that is remitted to the supplier for things that do not relate to the value of the goods at the border.

[71] Clause 2 of sch 2 makes it clear that the price adjustment process involves discretionary decision making, to determine the true value, not an artificial process where linguistic analysis of nomenclature attaching to payments substitutes for a true evaluation of the real value. Schedule 2 cl 2 provides that the transaction value is the primary basis of valuation, generally it will prevail where the pricing is between arm's-length parties and there are no other exchanges of value relating to the goods. That clause provides that in the case of related persons:

> "... for the purpose of showing that the relationship did not influence the transaction value, the importer shall produce evidence that the transaction value of the goods being valued, taking into consideration any relevant factors including such factors and differences as may be prescribed, closely approximates the Customs value of other goods exported at the time or substantially at the same time as the goods being valued ..."

[72] In the present case, the Appellant did that. It provided evidence that Customs did not challenge to the effect that the imported goods were priced at cost plus a margin that the Appellant said reflected all of the value in the goods at the border (including design features, and profit for the parent company). Clause 2(3) provides that the chief executive "shall give the importer a reasonable opportunity to satisfy the chief executive that the relationship did not influence the price". That is wholly consistent with the Court of Appeal's observations, the provisions in the schedule have the effect of giving ample power to establish the true market price at the border. Of course, the factual issues and the methodology can be complex,

where unique features apply to the transaction. That is particularly acute where goods do not have a market price as the supply is between related parties, and the goods (say pharmaceuticals) have intellectual property protection where there is no other legitimate source of supply for a unique product. Regardless, those are factual challenges not arising from any lack of clarity in the law.

[73] I am accordingly satisfied that while cl 3(1)(a)(v) of sch 2 does permit Customs to take account of any remission of value from subsequent resale, disposal, or use of the goods by the buyer back to the seller; that is not authorisation to do so to create an artificially inflated value for goods at the border.

Applying the law to the facts

[74] For the reasons discussed, I am satisfied the Authority's duty is to evaluate the evidence to determine the true value of the goods at the border, using the full range of techniques in sch 2 of the Customs and Excise Act 1996. The objective being to establish a price that removes any elements affecting the transactional price due to the relationship between the parent company and the Appellant. The parties have focused the case on cl 3(1)(a)(iv) and (v) of sch 2 and I do not need to go beyond them.

[75] The first material factual conclusion is that the Appellant gave evidence that the transactional price at the border was its cost of procurement, substantially from third parties, plus a margin intended to account for internal costs and profits. I have no reason to reject that evidence, except to the extent that Customs say the royalties establish it is an undervalue and not reflective of the value at which arm's-length parties would transact.

[76] Accordingly, I must consider the merits of the argument that the royalties are evidence of remission of value in the price of the goods at the border. I immediately accept that such a mechanism could have that effect. However, I must evaluate the evidence that the reasons for payment of the royalties is not due to underpricing the goods at the border. Instead the Appellant says the royalties related to services and information applied to the retail operations of the New Zealand retail stores. There was, essentially unchallenged, evidence that the parent company controls the operation of those retail stores in a very prescriptive manner; so as to maintain consistency across all of the branded stores in Australasia. That evidence is plausible and unsurprising, large scale branded retail operations depend on impressively sophisticated information systems, understanding and application of the psychology of persuasion, logistics and relationships with internal and third-party service providers. Those sophisticated aspects of the operations are critical to profits in businesses, which often rely on high volumes with thin profit margins.

[77] I have no basis to reject the evidence that the royalties are entirely related to the services described by the Appellant's witnesses, and that the transactional value it attributed was not influenced by the relationship between the parent company and the Appellant.

Decision

[78] The appeal is allowed, the transactional values submitted by the Appellant are the correct Customs value.

[79] I reserve any issues of quantum that the parties not be able to resolve.

[80] If costs are not agreed the parties may submit a memorandum within one month (extended if issues of quantum have to be resolved).

Dated at Wellington 28 February 2022.

G D Pearson
Customs Appeal Authority