OFFICE OF
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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: May 31, 2000

MEMORANDUM FOR ASSOCIATE DISTRICT COUNSEL, KANSAS-MISSOURI DISTRICT

FROM: Steven A. Musher, Chief, Branch 6

SUBJECT:

This Field Service Advice responds to your memorandum dated October 4, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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ISSUES

1. Whether, for customs purposes, royalties or license fees paid by a U.S. importer to a foreign related party were properly taken into account in the dutiable value of the imported merchandise, as elements of the “price actually paid or payable for the merchandise when sold for exportation to the United States,” pursuant to 19 U.S.C. §§ 1401a(b)(1) and (b)(4)(A), or, alternatively, as proceeds of resale that “accrue[d] directly or indirectly to the seller,” pursuant to 19 U.S.C. § 1401a(b)(1)(E).

2. Whether, for customs purposes, the royalties or license fees were properly taken into account in the dutiable value of the imported merchandise, although they were paid to the corporate parent (Corporation B), rather than to the actual seller of the merchandise (Corporation C).

3. Whether the “dutiable value” for purposes of I.R.C. § 1059A was increased by reason of the importer’s prior disclosure and voluntary tender of customs duties, pursuant to 19 U.S.C. § 1592(c)(4), on the royalties or license fees, which had not been taken into account by Customs at liquidation.

4. Whether, for Federal income tax purposes, the taxpayer was required to take into account the royalties or license fees as capitalized costs pursuant to I.R.C. § 263A, rather than deducting them currently as selling expenses.

CONCLUSIONS

1. Yes. For customs purposes, the royalties or license fees were properly taken into account in the dutiable value of the imported merchandise either as elements of the “price actually paid or payable for the merchandise when

sold for exportation to the United States," pursuant to 19 U.S.C. §§ 1401a(b)(1) and (b)(4)(A), or, alternatively, as proceeds of resale that "accrue[d] directly or indirectly to the seller," pursuant to 19 U.S.C. § 1401a(b)(1)(E).

2. Yes. For customs purposes, the amounts were properly taken into account in dutiable value pursuant to 19 U.S.C. §§ 1401a(b)(1) and (4)(A), or, alternatively, pursuant to 19 U.S.C. § 1401a(b)(1)(E), although they were paid to a party related to the seller, rather than to the actual seller.

3. No. Because liquidations of the underlying entries had become final before the importer made a voluntary tender of duties with respect to the royalties or license fees, the U.S. Customs Service had "finally determined" the dutiable value of the imported merchandise for purposes of I.R.C. § 1059A and the regulations thereunder. The importer's post-liquidation voluntary tender did not increase the dutiable value from that determined upon liquidation.

4. Yes. In our view, the expenses in question were required to be capitalized in the inventory basis of the imported merchandise, pursuant to I.R.C. § 263A.

FACTS

Corporation A is a domestic corporation with headquarters in City, State. Corporation A's operations involve the importation, resale, installation, repair, maintenance, and upgrading of Product A. Product A is used in Process to form articles such as Products B. The years at issue in this case are Years A and B.

The shares of Corporation A are held a% by Individual, a U.S. national, and b% by Corporation B, a corporation organized pursuant to the laws of Country. Corporation C, another corporation organized pursuant to the laws of Country, is a wholly-owned subsidiary of Corporation B. Corporation C manufactures Product A (including Product C) and sells it to Corporation A for resale to unrelated customers in the United States. Corporation C sold the merchandise to Corporation A, which paid U.S. customs duty thereon on the basis of the amount on the commercial invoices from Corporation C. For these purposes, the value reported by the taxpayer did not take into account the royalties or license fees, which were separately paid to Corporation B. Corporation A claimed these amounts as current-period deductions for income tax purposes.

Some years earlier, on Date A, Corporation A entered into an agreement with Corporation B. The agreement, which gave Corporation A the right to sell and service Trademark Products A in perpetuity in the United States, provided as follows:

1. [Corporation B] agrees to license to [Corporation A] the right to sell a full line of its goods in adequate quantities, including but not limited to replacement [Products C] and replacement parts.

2. [Corporation A] and [Corporation B] agree that this license contract shall be perpetual.

3. [Corporation B] and [Corporation A] agree that [Corporation B] shall be paid [c]% as a license fee on sales by [Corporation A] from [Date B] through [Date C]; and [d]% license fee on sales by [Corporation A] after [Date D].

4. [Corporation B] and [Corporation A] agree that this Agreement contains the entire agreement between the parties.

Although the parties apparently intended that Corporation A would become the exclusive U.S. distributor of Trademark Products A, this relationship was not formalized in a written document.

Upon examination of Years A and B, the Service determined that the royalties or license fees should have been taken into account in the dutiable value of the imported merchandise. On Date E, the Service issued an information document request (IDR) advising Corporation A that the royalties or license fees might be dutiable for customs purposes, and notifying Corporation A that, if in fact the amounts were dutiable, I.R.C. § 1059A might preclude deduction of the amounts for income tax purposes, on the grounds that they had not been taken into account in the dutiable value of the merchandise at the time of liquidation. Approximately seven months later, on Date F, the Service issued a Notice of Proposed Adjustment (Form 5701), reflecting its intent to deny the claimed deduction for royalties or license fees.

Approximately two weeks after Date F, in a Date G letter to the U.S. Customs Service (Customs), counsel for Corporation A gave notice of a potential violation of 19 U.S.C. § 1592. This letter informed Customs that the Corporation A had failed to declare the royalties or license fees as part of the dutiable value of the imported merchandise. Subsequently, on Date H, Corporation A made a voluntary tender of duties pursuant to 19 U.S.C. § 1592(c)(4), consisting of the "lawful duties" payable on the royalties or license fees. The same document contained a formal "prior disclosure" of a violation that might warrant penalties pursuant to 19 U.S.C. § 1592(a). Counsel for Corporation A represented that, "[t]he circumstances which warrant [Corporation A's] prior disclosure result from the importer's inexperience and an oversight and were not the result of intentional acts."

The prior disclosure and voluntary tender pertained to substantially all of Corporation A' s importations from Corporation C during the period from Date I through Date J, which included Years A and B. The voluntary tender was based on an entry-by-entry calculation of duties owed, at the rates applicable to specific imported items pursuant to the Harmonized Tariff Schedules of the United States (HTSUS). See 19 U.S.C. § 1202. In the aggregate, for customs entries from Date I through Date J, Corporation A tendered additional duties of $e, reflecting the duties owed, on an entry-by-entry basis, on the previously-unreported royalties or license fees of $f.[1] The royalty amounts reported to Customs corresponded to the royalty or license fee amounts in accordance with the Date A agreement (quoted above) claimed as deductions on Corporation A's tax returns for Years A and B, respectively (i.e., $g for Year A and $h for Year B).

Adopting the same position as in the Notice of Proposed Adjustment, the Service denied Corporation A's claimed deductions from taxable income of the royalties or license fees. A statutory notice of deficiency to this effect was issued on Date K, reflecting a total increase to taxable income of $g plus $h, or $i for Years A and B. The Service's rationale was as follows: because the royalties or license fees constituted dutiable amounts that the importer incorrectly failed to take into account in dutiable value, and because these amounts were properly taken into account in the basis of inventory for income tax purposes, they could not be deducted from taxable income, by operation of the section 1059A limitation.

Corporation A's initial disclosure to Customs on Date G and its formal prior disclosure on Date H both took place after the Service had advised Corporation A of the potential issue with respect to royalties or license fees, in Date L.

## LAW AND ANALYSIS

### General Background: Section 1059A Limitation on Inventory Basis of Merchandise Imported from Related Party

Section 1059A of the Code, which was added by the Tax Reform Act of 1986, provides in pertinent part as follows:

> LIMITATION ON TAXPAYER'S BASIS OR INVENTORY COST IN PROPERTY IMPORTED FROM RELATED PERSONS.

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[1] The imported merchandise was subject to duty on an ad valorem (i.e., value) basis, at distinct rates of duty applicable to individual HTSUS items. Section 1059A applies only to merchandise imported from a related party that is dutiable on a value basis.

> (a) IN GENERAL.–If any property is imported into the United States in a transaction (directly or indirectly) between related persons (within the meaning of section 482), the amount of any costs–
>
> (1) which are taken into account in computing the basis or inventory cost of such property by the purchaser, and
>
> (2) which are also taken into account in computing the customs value of such property,
>
> shall not, for purposes of computing such basis or inventory cost for purposes of this chapter, be greater than the amount of such costs taken into account in computing such customs value.
>
> (b) CUSTOMS VALUE; IMPORT.–For purposes of this section–
>
> (1) CUSTOMS VALUE.–The term "customs value" means the value taken into account for purposes of determining the amount of any customs duties or any other duties which may be imposed on the importation of any property.
>
> * * * *

I.R.C. § 1059A (emphasis added).

Prior to 1986, the courts held that imported value for customs purposes and value for income tax purposes need not be equivalent. E.g., Brittingham v. Commissioner, 66 T.C. 373 (1976), aff'd, 598 F.2d 1375 (5th Cir. 1979) (importers could claim a transfer price for income tax purposes that was higher than would be consistent with the transfer price claimed for customs purposes). The provision codified as I.R.C. § 1059A was enacted to overrule Brittingham. See S. Rep. No. 313, 99th Cong., 2d Sess. 418-19 (1986); see also Conference Report, H.R. Rep. No. 841, 99th Cong., 2d Sess. II-656 (1986).

Although Congress recognized that customs value and inventory value might not be equivalent in all cases,[2] it imposed a "ceiling" on the inventory basis for income tax

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[2] Customs value is determined under 19 U.S.C. § 1401a, which was enacted by the Trade Agreements Act of 1979, Pub. L. No. 96-39, 93 Stat. 144 (1979), in order to conform U.S. law with the 1979 Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade, commonly referred to as the "Customs Valuation Code." See generally S. Rep. No. 249, 96th Cong., 1st Sess. 20 (1979). The value of merchandise imported from a controlled party, for Federal income tax

purposes equal to the dutiable value: "Congress was concerned only with establishing a limit on the price an importer could claim for income tax purposes." Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 1062 (1987) (emphasis added) (hereinafter, General Explanation).

Section 1059A provides that, subject to certain exceptions not relevant here, the value of merchandise imported from a related party, as that value is taken into account for Federal income tax purposes (i.e., as inventory or cost of goods sold), may not be higher than the dutiable value taken into account by Customs, which formed the basis for liquidation (i.e., assessment of customs duties) on individual customs entries. Congress intended to prevent the "whipsaw" that could result where related-party importers were permitted to claim inconsistent values for tax and customs purposes. "Such practices between commonly-controlled entities could improperly avoid U.S. tax or customs duties." General Explanation at 1062. See also 132 Cong. Rec. S7922 (daily ed. June 19, 1986) (statement of Sen. Dixon) ("There can be no question but that [such] abuses have occurred in the past.").

The Treasury regulations state that, in computing the liquidated-value limitation under I.R.C. § 1059A (hereinafter, the section 1059A limitation), certain adjustments to customs value are appropriate. Specifically, customs value may be increased by, inter alia:

> (iv) Any other amounts which are not taken into account in determining the customs value, which are not properly includible in customs value, and which are appropriately included in the cost basis or inventory cost for income tax purposes. *See* § 1.471-11 and section 263A.

Treas. Reg. § 1.1059A-1(c)(2)(iv). Thus, for purposes of I.R.C. § 1059A, customs value may be increased on account of expenses (e.g., freight, insurance, etc.) that are properly excluded therefrom, provided that such expenses are required to be taken into account in cost of goods sold or inventory (as appropriate) for income tax purposes. In practice, this provision prevents I.R.C. § 1059A from applying in cases where the inventory value of merchandise for income tax purposes is greater than the entered value for customs purposes on account of bona fide differences between income tax accounting principles and customs valuation rules.

Issues 1 and 2: Appropriate Treatment of Royalties or License Fees for Customs Purposes

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purposes, must conform to the arm's length standard of I.R.C. § 482, and also must be taken into account in inventory or cost of goods sold (as appropriate) on the basis of proper income tax accounting principles.

In order to determine whether I.R.C. § 1059A applies in this case, we must first determine whether Corporation A correctly declined to take the royalties or license fees into account in entered value for customs purposes.

Section 402 of the Tariff Act of 1930, as amended, 19 U.S.C. § 1401a, provides rules for valuation of merchandise for purposes of determining the customs duty payable. One authorized method of determining dutiable value is by reference to "transaction value," which is defined as follows:

> [T]he <u>price actually paid or payable for the merchandise</u> when sold for exportation to the United States, <u>plus amounts equal to</u>–
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> (A) the packing costs incurred by the buyer with respect to the imported merchandise;
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> (B) any selling commission incurred by the buyer with respect to the imported merchandise;
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> (C) the value, apportioned as appropriate, of any assist;
>
> (D) any royalty or license fee related to the imported merchandise that the buyer is required to pay, directly or indirectly, as a condition of the sale of the imported merchandise for exportation to the United States;
>
> (E) <u>the proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue directly or indirectly, to the seller</u>
>
> * * * *

19 U.S.C. § 1401a(b)(1) (emphasis added).

For purposes of this subsection, the term "price actually paid or payable" is defined as:

> [T]he <u>total payment (whether direct or indirect,</u> and exclusive of any costs, charges, or expenses incurred for transportation, insurance, and related services incident to the international shipment of the merchandise from the country of exportation to the place of importation in the United States) <u>made, or to be made, for imported merchandise, by the buyer to, or for the benefit of, the seller.</u>

19 U.S.C. § 1401a(b)(4)(A) (emphasis added).

Three judicial decisions have interpreted the term "price actually paid or payable." In Generra Sportswear Co. v. United States, 905 F.2d 377 (Fed. Cir. 1990), the U.S. Court of Appeals for the Federal Circuit considered whether certain import quota charges paid to the seller on behalf of the buyer were part of the "price actually paid or payable" for imported merchandise. Reversing the U.S. Court of International Trade, the Court of Appeals held that, "as long as the quota payments are made to the seller in exchange for merchandise sold for export to the United States, the payment properly may be included in transaction value, even if the payment represents something other than the *per se* value of the goods." Generra, 905 F.2d at 380. The Court also held that Customs was not required to perform extensive fact-finding to determine whether separate payments, all of which accrued to the seller in connection with the purchase of imported merchandise, were paid for the merchandise itself, or for some other purpose. Id., citing Moss Mfg. Co. v. United States, 896 F.2d 535, 539 (Fed. Cir. 1990).

In Chrysler Corp. v. United States, 17 CIT 1049, 1054-55 (1993), the Court of International Trade applied Generra and determined that, although tooling expenses paid by the buyer were part of the "price actually paid or payable," certain shortfall and special application fees paid by the buyer to the seller were not. With respect to fees in these latter categories, the evidence indicated that they were independent and unrelated costs, which were assessed because the buyer failed to purchase certain other, unrelated products from the seller. As such, they did not relate to the prices charged for the imported merchandise (automobile engines).

Recently, in Tikal Distributing Corp. v. United States, Slip Op. 2000-24 (Ct. Int'l Trade, Feb. 28, 2000), certain payments by an importer/buyer to an exporter/seller, made pursuant to a written, exclusive distributorship agreement, were held to be dutiable as elements of the "price actually paid or payable" for the imported merchandise. The court viewed these additional payments for exclusive distribution rights as integral components of the consideration paid, under the transaction-value approach. In effect, the court found that the exclusive rights and the payments in connection therewith constituted terms and conditions of the pre-existing distributorship arrangement.

Based on the foregoing precedents and the plain language of 19 U.S.C. §§ 1401a(b)(1) and (b)(4)(A), Customs applies a rebuttable presumption that all payments by a buyer to a seller constitute part of the "price actually paid or payable" for the imported merchandise. Only evidence indicating that the particular payments are unrelated to the imported merchandise (see, e.g., Chrysler), is sufficient to rebut this presumption. Customs applies this presumption to all categories of payments to the seller, including royalties and license fees.

In addition, Customs applies the Generra standard regardless of whether the payments are made directly to the seller or to an intermediate party related to the seller. In at least one (non-binding) advisory ruling, Customs noted that this approach is consistent with the statutory definition of "price actually paid or payable" as including indirect payments and payments made for the benefit of the seller. See Customs Headquarters Ruling 545770 (June 21, 1995).

Turning to the present case, the royalties or license fees should have been taken into account in the "price actually paid or payable" pursuant to 19 U.S.C. §§ 1401a(b)(1) and (b)(4)(A), because they were made by the buyer to Corporation B, a party related to the seller, Corporation C, and were related to the sales of Products A and C, per the license agreement. Absent evidence showing that the payments were unrelated to the imported merchandise, or that they did not accrue directly or indirectly to the seller (or provide any benefit to the seller), Customs would treat such payments as part of the "price actually paid or payable." Under the same analysis, the royalties or licensing fees may also (in addition or in the alternative) be considered to be "proceeds" of a subsequent resale of the imported merchandise, pursuant to 19 U.S.C. § 1401a(b)(1)(E).[3]

The fact that these payments were made to Corporation B (the corporate parent), rather than Corporation C (the actual seller), is immaterial for these purposes. Subsections (b)(1) and (b)(4)(A) encompass the total payment "whether direct or indirect . . . for the benefit of" the seller, and subsection (b)(1)(E) encompasses payments that "accrue directly or indirectly" to the seller. Customs' practice is generally to treat all proceeds of a subsequent resale that accrue to a related party of the seller as for the benefit of, or accruing indirectly to, the seller.

Pursuant to either subsections (b)(1) and (b)(4)(A) or subsection (b)(1)(E), therefore, the royalties or licensing fees should have been taken into account in the dutiable value of the imported merchandise. Thus, the customs values declared by Corporation A at the time of entry, which formed the basis for liquidation, were erroneous.

Corporation A contends that the payments were not royalties or license fees, but rather were made in exchange for consulting services, research and development, intangible-exploitation rights, and market-support provided by Corporation B. These claims conflict with the written agreement between the parties. That agreement indicates that the payments were for marketing rights, i.e., rights similar to those in Tikal. Thus, the payments are properly included in the transaction value of the merchandise, as part of the "price actually paid or payable." Compare, e.g., Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) and Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992) (imposing a heightened standard of proof on a taxpayer when it attempts to disavow the form of its transaction).

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[3] Because the amounts are subject to 19 U.S.C. §§ 1401a(b)(1) and (b)(4)(A), or 1401a(b)(1)(E), we do not need to reach whether they may also be properly taken into account in transaction value as royalties or license fees pursuant to 19 U.S.C. § 1401a(b)(1)(D). Further facts would be necessary for that determination.

Corporation A also contends that the royalties or license fees were paid in connection with total U.S. sales, as opposed to sales of Products A and C imported from Corporation C. If the facts indicate Corporation A's U.S. sales of products other than Product A and Product C were substantial, then payment of royalties or license fees based on total sales might indicate that these expenses were at least in part not properly taken into account in transaction value, under the precedents described above. However, the importer bears the burden of rebutting the presumption that the payments were directly linked to resales of the imported merchandise. In this case, given the agreement between the parties, that burden is substantial.

Finally, we note that Corporation A explicitly admitted, in its prior disclosure to Customs pursuant to 19 U.S.C. § 1592(c)(4), that it had erroneously excluded the royalties or license fees from the entered value of the merchandise (which in turn constituted the liquidated value). Corporation A should not now be able to argue, contrary to its prior disclosure to Customs, that these same expenses were in fact not properly taken into account in the dutiable value of the imported merchandise. See also National Alfalfa and Estate of Durkin, supra.

Issue 3: "Customs Value" for Purposes of I.R.C. § 1059A

It is also necessary to determine the point at which the customs value of the imported merchandise was "finally determined," as that term is defined by Treas. Reg. § 1.1059A-1 and customs law.

The Treasury Regulations define a "final determination of value" by Customs as follows:

> (d) *Finality of customs value and of other determinations of the U.S. Customs Service.* For purposes of section 1059A and this section, a taxpayer is bound by the finally-determined customs value and by every final determination made by the U.S. Customs Service, including, but not limited to, dutiable value, the value attributable to the cost or value of products of the United States, and classification of the product for purposes of imposing any duty. The customs value is considered to be finally determined, and all U.S. Customs Service determinations are considered final, when liquidation of the entry becomes final. For this purpose, the term "liquidation" means the ascertainment of the customs duties occurring on the entry of the property, and liquidation is considered to become final after 90 days following notice of liquidation to the importer, unless a protest is filed. If the importer files a protest, the customs value will be considered finally determined and all other U.S. Customs Service determinations will be considered final either when a decision by the Customs Service on the protest is not contested after expiration of the period allowed to contest the determination or when a judgment of the Court of International Trade becomes final. For purposes of

> this section, any adjustments to the customs value resulting from a petition under 19 U.S.C. section 1516 (requests by interested parties unrelated to the importer for redetermination of the appraised value, classification, or the rate of duty imposed on imported merchandise) or reliquidation under 19 U.S.C. section 1521 (reliquidation by the Customs Service upon a finding that fraud was involved in the original liquidation) will not be taken into account. However, reliquidation under 19 U.S.C. section 1501 (voluntary relquidation by the Customs Service within 90 days of the original liquidation, to correct errors in appraisement, classification, or any element entering into a liquidation or reliquidation) or reliquidation under 19 U.S.C. section 1520(c)(1) (to correct a clerical error, mistake of fact, or other inadvertence within one year of a liquidation or reliquidation) will be taken into account in the same manner as, and take the place of, the original liquidation in determining customs value.

Treas. Reg. § 1.1059A-1(d) (emphasis added).

The Treasury regulation accords substantial weight to the event of "liquidation," which is a term of art under customs law: "Liquidation refers to the process by which the declared value and duty assessment become final. See 19 U.S.C. § 1504. Liquidation occurs automatically one year after an entry, unless the entry is held open by Customs. See 19 U.S.C. § 1504(a).2." United States v. Hitachi America, Ltd., 172 F.3d 1319, 1326 n.9 (Fed. Cir. 1999). See also 19 U.S.C. § 1500 (appraisement, classification, and liquidation procedures).

Thus, the regulation specifies three post-liquidation events potentially bearing upon appraised or liquidated value that may give rise to a change in the liquidated value for purposes of I.R.C. § 1059A:

- a final judgment of the Court of International Trade overturning Customs' denial of a customs protest with respect to valuation (see 19 U.S.C. § 1503); OR

- reliquidation pursuant to 19 U.S.C. § 1501 (voluntary reliquidation within 90 days of the liquidation, to correct errors in the liquidation); OR

- reliquidation pursuant to 19 U.S.C. § 1520(c)(1) (reliquidation within one year of liquidation to correct an error, mistake of fact, or other inadvertence).

The regulation similarly specifies two post-liquidation events potentially bearing upon appraised or liquidated value that do not give rise to a change in liquidated value for purposes of I.R.C. § 1059A:

- adjustments resulting from a petition by parties unrelated to the importer for redetermination of the value, classification, or other element of a liquidation (i.e., domestic interested party petition) (19 U.S.C. § 1516);[4] OR

- reliquidation upon a finding that fraud was involved in the original liquidation (19 U.S.C. § 1521).[5]

See Treas. Reg. § 1.1059A-1(d).

The regulation, therefore, comprehensively and systematically prescribes whether relevant provisions of customs law potentially bearing upon appraised or liquidated value may, or may not, give rise to a change in the liquidated value for purposes of I.R.C. § 1059A. By contrast, as will be discussed below, voluntary tenders pursuant to 19 U.S.C. § 1592(c)(4) do not potentially bear upon appraised or liquidated value and, therefore, have no affect on the outcome of the general rule that the dutiable value "finally determined" at liquidation is controlling for purposes of I.R.C. § 1059A.

Unless the importer files a protest contesting the liquidation of a particular customs entry or group of entries, and absent fraud or clerical error, that liquidation becomes "final" upon the expiration of ninety days from the date on which notice of liquidation is provided to the importer. 19 U.S.C. § 1514(a), (c)(2). All determinations by Customs that are necessary to the liquidation, including the appraised (dutiable) value, become final at that time. See 19 U.S.C. § 1514(a). With certain exceptions not relevant here, the dutiable value of imported merchandise, i.e., the basis on which ad valorem duties are assessed, consists of the "appraised value determined upon liquidation." 19 U.S.C. § 1503.

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[4] A domestic interested party petition, which requests Customs to apply a higher appraised value, a higher rate of duty, or a less-favorable tariff classification, to merchandise imported by parties unrelated to the petitioner, can only affect customs entries on a prospective basis. That is, if Customs' determination is affirmative, it applies only to entries made more than thirty days after publication in the Customs Bulletin of notice to the petitioner of the determination. Alternatively, if Customs' determination is negative, and that determination is reversed upon judicial review, liquidation of the affected entries is suspended as of the date that the Secretary publishes in the Federal Register notice of the adverse judicial decision, and the affected entries will be liquidated in accordance with the "final" judicial decision in the case. See 19 U.S.C. §§ 1516(d), (f).

[5] Where evidence indicates that an importer acted fraudulently, distinct statutory provisions may apply. E.g., 19 U.S.C. § 1521 (entry may be reliquidated within two years after date of liquidation, if Customs finds probable cause to believe that fraud took place); 19 U.S.C. § 1592(a) (Customs may assess penalties for fraud within five years after discovery of the fraudulent act).

Presumably, most or all of Corporation A's Year A and Year B customs entries had already been liquidated when the Service issued its notice of proposed adjustment on Date F, based on application of I.R.C. § 1059A. To our knowledge, none of these entries were subject to protest. Under these circumstances, the limitation amount for purposes of Treas. Reg. § 1.1059A-1(d) consists of the final "dutiable value," i.e., the "appraised value" of the merchandise as determined upon liquidation. See 19 U.S.C. § 1503.

Corporation A argues that a voluntary tender alters the "customs value" of the underlying entries, as that term is defined in I.R.C. § 1059A(b)(1). Thus, Corporation A argues that because the voluntary tender remedied the loss of duties that resulted from its original, erroneous reporting, the fisc was made whole, and no abuse was present. However, this argument finds no support in the statutory provisions governing liquidation or voluntary tenders, or in the language of Treas. Reg. § 1.1059A-1. Because the statute, as construed by the regulation, defines the section 1059A limitation by reference to customs value, which is the value determined by Customs at the time of liquidation, the Service's authority to utilize another value that reflects post-liquidation events, is expressly limited. See Treas. Reg. § 1059A-1(d) (listing events that do and do not warrant adjustment of liquidated value, quoted above).

Importantly, the procedure of prior disclosure and voluntary tender pursuant to 19 U.S.C. § 1592(c)(4) serves to reduce customs penalties that might otherwise be applicable as a result of errors or omissions by the importer. Whether or not Customs assesses monetary penalties pursuant to 19 U.S.C. § 1592(a), it may also require the importer to restore all "lawful duties," i.e., duties that should have been, but were not collected upon liquidation. 19 U.S.C. § 1592(d). However, the importer's act of voluntarily tendering such duties has no effect on the dutiable value as determined at liquidation. In fact, 19 U.S.C. § 1592(d) is a specific grant of authority that permits Customs to assess penalties and/or to collect "lawful duties," notwithstanding that liquidation has taken place and has become final pursuant to 19 U.S.C. § 1514. See id.[6]

Corporation A also contends that its voluntary tender was a payment of "other duties," as that term is defined in I.R.C. § 1059A(b)(1). Consequently, Corporation A argues, the customs value for purposes of the section 1059A limitation should be

[6] If the importer files a protest (which may contest, inter alia, appraised value), and the protest is granted, "any duties . . . found to have been assessed or collected in excess shall be remitted or refunded . . . ." 19 U.S.C. § 1515(a). However, this has no effect on the dutiable value. Only if Customs denies the protest, the importer files a civil action contesting that denial, and the court enters a final order requiring reliquidation, does appraised value change from the amount determined at liquidation. See 19 U.S.C. § 1503. A voluntary tender creates no right to protest, nor is Customs' collection of "lawful duties" pursuant to 19 U.S.C. § 1592(d) subject to review by traditional means (i.e., by challenge to denial of a protest) in the Court of International Trade. See Tikal Distributing Corp. v. United States, 970 F. Supp. 1056, 1060 (Ct. Int'l Trade 1997).

increased by the amount of the royalties or license fees. The cited provision reads in full as follows:

> (1) CUSTOMS VALUE.–The term “customs value” means the value taken into account for purposes of determining the amount of any customs duties or other duties <u>which may be imposed on the importation of any property</u>.

I.R.C. § 1059A(b)(1) (emphasis added).

In our view, in this context, “other duties” refers to duties other than those specifically provided for in the HTSUS, <u>i.e.</u>, other duties that are imposed based on the value of imported merchandise. <u>See</u>, <u>e.g.</u>, 19 U.S.C. § 1304(f) (10% duty for failure for mark imported merchandise with country of origin); I.R.C. § 4461(b) (Harbor Maintenance Tax of 0.125% imposed on value of commercial cargo; tax treated as a “duty” for administrative and enforcement purposes, <u>see</u> I.R.C. § 4462(f)). In this case, the duties tendered by Corporation A were based on an element of transaction value, royalties or license fees, which Corporation A erroneously excluded from the value declared at the time of importation. The lawful duties in this case were general customs duties, rather than “other duties,” within the meaning of the regulation.

Nothing in I.R.C. § 1059A(b)(1) suggests that Congress intended to alter the well-established concept of finality of liquidation. Accordingly, the argument that an importer’s voluntary tender of duties somehow “re-opens” liquidations that are otherwise final, must be rejected. As demonstrated above, if liquidation has taken place and become final, a voluntary tender cannot affect dutiable value. <u>See</u> 19 U.S.C. § 1503. The Treasury regulations specify that, “[t]he customs value is considered to be finally determined, and all U.S. Customs Service determinations are considered final, <u>when liquidation of the entry becomes final</u>.” Treas. Reg. § 1059A-1(d) (emphasis added). Consequently, Corporation A’s voluntary tender did not increase the dutiable value of the merchandise for purposes of the section 1059A limitation.

<u>Issue 4: Correct Treatment of Royalties or License Fees for Income Tax Purposes</u>

Next, we consider whether, for Federal income tax purposes, the royalties or license fees were properly taken into account in the inventory basis of the imported merchandise. <u>See</u> Treas. Reg. § 1.1059A-1(c)(2)(iv). We conclude that the expenses are subject to capitalization pursuant to I.R.C. § 263A.

Section 263A, enacted by the Tax Reform Act of 1986, contains the so-called uniform capitalization rules, which require that certain expenses be capitalized rather than deducted currently. Section 263A(b)(2) provides that these rules apply to “property acquired for resale.” This term is defined in I.R.C. § 263A(b)(2)(A) as including, <u>inter</u> <u>alia</u>, “personal property described in section 1221(1) [(<u>i.e.</u>, inventory)] which is acquired for resale.”

The uniform capitalization rules with respect to personal property do not apply to taxpayers that have average annual gross receipts of less than $10 million for the three years preceding the year at issue. I.R.C. § 263A(b)(2)(B). In determining whether this threshold is satisfied, aggregation rules similar to those in I.R.C. §§ 448(c)(2) and (3) apply. <u>See</u> I.R.C. § 263A(b)(2)(C). For purposes of this advice, we assume that Corporation A's gross receipts are above the $10 million gross-receipts threshold.

Treasury and the IRS issued temporary and final regulations pursuant to I.R.C. § 263A. The final regulations, Treas. Reg. § 1.263A-1(e)(3)(ii)(U), apply to tax years beginning on or after January 1, 1994. For taxable years that began prior to January 1, 1994, including Years A and B in this case, the temporary regulations were applicable. For such years, taxpayers were obliged to take positions that were reasonable in light of the temporary regulations, as well as revenue rulings, revenue procedures, and announcements applicable to those years. <u>See</u> Treas. Reg. § 1.263A-1(a)(2)(ii).

The temporary regulations require capitalization of a broad category of "indirect costs," defined as follows:

> (ii) <u>Indirect costs–general description</u>: The term "indirect costs" includes all costs other than direct material costs and direct labor costs. <u>All costs that directly benefit or are incurred by reason of the performance of a production or resale activity</u> must be capitalized with respect to the property produced or acquired unless otherwise provided in paragraph (b)(2)(v) of this section . . . .

Temp. Treas. Reg. § 1.263A-1T(b)(2)(ii) (emphasis added). The royalty or licensing fees in this case are within the scope of indirect costs that are subject to capitalization. The requirement that Corporation A pay the fees is set forth in the License Agreement dated Date A. That agreement granted Corporation A "the right to sell a full line of [Trademark] products in adequate quantities." Based on the plain language of the agreement, as well as other evidence available to date, these fees were "incurred by reason of the performance of a production or resale activity," within the meaning of the temporary regulation, and therefore must be capitalized.

The temporary regulation exempts the following costs, among others, from the capitalization requirement:

> marketing, selling, advertising and distribution expenses;
>
> bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer;
>
> certain general and administrative expenses;
>
> Section 174 research and development expenses;

Section 165 losses.

Temp Treas. Reg. § 1.263A-1T(B)(2)(v). Based on the evidence currently available, the fees in this case are not subject to the above exceptions.

As noted above, taxpayer contends that the fees in question were paid, not in connection with the licensing agreement, but as compensation for consulting services, research and development, intangibles-exploitation, and other market-support provided by Corporation B. If in fact the fees can be so characterized, they may be deductible currently, pursuant to Temp. Treas. Reg. § 1.236A-1T(b)(2)(v). However, such a characterization would be in direct conflict with the parties' written agreement and with Corporation A's treatment of these fees as royalties on the tax returns. A taxpayer faces a heightened standard of proof when it attempts to disavow the form of its transaction. E.g., Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974) and Estate of Durkin v. Commissioner, 99 T.C. 561, 572-75 (1992). Subject to specific facts emerging other than those of which we have been advised so far, in our view taxpayer has not met the heightened standard as applied in this case.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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Please call (202) 874-1490 if you have any further questions.

STEVEN A. MUSHER
Chief, Branch 6

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8 [redacted]