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Transfer pricing alert
Customs and transfer prices - *Skechers v. CBSA*

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Import transactions in Canada are under scrutiny from the opposing perspectives of the Canada Revenue Agency (CRA) and the Canada Border and Services Agency (CBSA). On the one hand, the CRA is interested in lower transfer prices to increase taxable income and reduce tax base erosion while on the other hand, the CBSA looks to increase the customs value to increase custom duties payable and other import taxes such as the goods and services tax (GST). Multinationals must deal with the challenge of complying with two sets of regulations and determining the appropriate import price for both transfer pricing and customs purposes while balancing the objectives of the business.

During a Canadian customs audit, the administrative policy of the CBSA is generally to accept a transfer price that has been determined using one of the transfer pricing methods under the Canadian transfer pricing regime or under an Advance Pricing Arrangement (APA). This approach satisfies the requirements that the relationship of the parties has not influenced the selling price and the arm's length principle has been applied. To ensure that all appropriate adjustments to the import price have been made, the CBSA's review generally goes beyond the primary import transaction and typically examines all other intercompany payment flows, including payments such as royalties, research and development (R&D) fees and management fees for potential inclusion in the customs value of imported goods.

An issue that may arise is the treatment of post-importation payments and management/administration fees in the calculation of the value for duty. The guidelines from the CBSA stipulate that all payments made to or for the benefit of the vendor are required to be added to the price in determining customs value whether or not the payment is in respect of the goods or made as a condition of their sale. This view was recently confirmed in the *Skechers USA Canada, Inc. v. President of the Canada Border and Services Agency* (*Skechers v. CBSA*) case.

Skechers v. CBSA

On January 8, 2014, the Canadian International Trade Tribunal (CITT) made public its decision with respect to an appeal by Skechers USA Canada, Inc. (Skechers Canada) of seven decisions by the CBSA for the years 2005 to 2011.

The central issue in the case was whether R&D payments made by Skechers Canada to its US parent company, Skechers USA Inc. (Skechers USA), were made "in respect of" the footwear imported by Skechers Canada from Skechers USA and, therefore, subject to customs duties.

Background

Skechers Canada purchased all of the footwear that it distributes in the Canadian market from Skechers USA. The transfer price for footwear was set by Skechers USA and consisted of the factory invoice price paid by Skechers USA to third party manufacturers, plus the cost of transportation to the United States, warehousing in Skechers USA's distribution centre and an arm's length profit. In addition, to the transfer price for imported footwear, Skechers Canada also made other intercompany payments to Skechers USA.

The CBSA initiated a verification audit to determine whether the value for duty declared by Skechers Canada on the imported shoes in 2005 had been calculated appropriately. Upon completion of its audit, the CBSA determined that a portion of the R&D payments made from Skechers Canada to Skechers USA should be included in the price for the imported shoes for customs purposes. In particular, the CBSA included an R&D payment pursuant to a cost sharing agreement (CSA) between Skechers USA and Skechers Canada which was intended to apportion the costs of research, development, design, advertising and marketing activities associated with Skechers footwear.

Skechers Canada proposed adjustments to the CBSA's findings and filed requests for further redetermination, arguing that no part of the R&D payments should be included in the price of the imported goods. In response, the CBSA issued its decision that the entire amount of the R&D payments should be included in the price of the imported goods. Skechers Canada appealed the decision to the CITT.

Appeal to the CITT

In its appeal, Skechers Canada stated that considerable research, design and development activities are undertaken by Skechers USA in the production of footwear and from these activities approximately 40,000 to 50,000 prototype samples are produced each year. Of the 40,000 to 50,000 prototype samples designed and produced, only approximately 5,000 become successful footwear styles that are sold in the marketplace. Skechers USA initially incurs the costs of the research, design and development activities undertaken for both successful and unsuccessful styles of footwear but recoups a portion of these costs from Skechers Canada through the transfer price for footwear and through the R&D payment, pursuant to the CSA.

The transfer price paid by Skechers Canada to Skechers USA covered the cost of the moulds and samples used in the production of successful footwear styles imported into Canada; however, it did not cover any of the costs associated with unsuccessful prototypes and moulds, or any of the general research and design costs incurred by Skechers USA. In the context of the CSA, the R&D payment was the mechanism used to ensure Skechers Canada compensated Skechers USA for a portion of its costs associated with research, design and development for unsuccessful footwear styles and for other research and design costs. The actual percentage of R&D costs owed by Skechers Canada in any given year was calculated based on the ratio of the anticipated operating profit of Skechers Canada and the anticipated total operating profits of all the cost sharing participants.

The CITT's ruling

The CITT's decision was that the evidence presented by Skechers Canada did not adequately discharge its burden of proof that the R&D payments were not in respect of the imported footwear. The CITT ruled that the R&D payments were necessary for

the creation of the footwear, given that at the start of the R&D process, successful footwear models that would be ultimately sold in the marketplace were not distinguishable from the unsuccessful models. As such, the imported goods could not have been produced without the entire R&D process. Furthermore, the method in which the R&D payment was calculated pursuant to the CSA linked the R&D payments to the imported footwear. Since the R&D payment was tied to Skechers Canada's operating profits, under normal market conditions, if Skechers Canada's imports increased, its sales and profits would increase and so would the R&D payments it owed to Skechers USA.

The CITT rejected Skechers Canada's argument that the R&D payments were unrelated to the imported footwear since the company could have sourced footwear other than from Skechers USA. Although Skechers Canada could have hypothetically imported footwear from another supplier, the CITT's view was that such possibility is not sufficient to demonstrate that the R&D payments were not "in respect of" the imported footwear.

The CITT also rejected Skechers Canada's contention that the R&D payments were unrelated to the imported footwear because they were not made at the time of importation, but rather were paid as periodic instalments throughout the year. Given that the definition of "price paid" or "payable" in subsection 45(1) of the Canada Customs Act targets all payments "made or to be made", the fact that the R&D payments are made periodically and not in relation to any particular import is inconsequential.

Based on the evidence presented, the CITT ruled that the R&D payments made by Skechers Canada to Skechers USA must be included in their entirety in determining the value for duty of the imported goods.

Conclusion

The CITT's ruling in the *Skechers v. CBSA* case demonstrates the need for multinational corporations to consider the impact of transfer prices associated with intercompany payments on the determination of the value for duty for imported goods. With the importance of international commerce, both elements are key for compliance purposes, increasing the need for adequate documentation of all intercompany payments flows. Finding the balance between transfer pricing and customs valuation to align with the objectives of the business is critical for multinational enterprises to successfully meet potential challenges and avoid costly audits.

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