

Importing software: IBM's global approach to customs valuation issues and new technologies

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Abstract

This article discusses current policy requirements for valuation for customs purposes with a focus on software imports and includes challenges from the practitioner's point of view. These challenges include applying valuation principles to the various types of solutions that include software, such as software on media and preinstalled software on hardware. As technology evolves, new offerings or products in this space are not clearly defined in the existing policy requirements. To maintain compliance, the importer may have to negotiate with various countries' customs authorities, which may result in added complexity and additional risk for the importer.

Introduction

In the current global economy, governments are looking to increase revenues through increased customs inspections and audits to ultimately drive more duties and taxes. The financial impact to an importer for failing to comply can result in fines, penalties, and disruption to its supply chain. Maintaining compliance in a global trade environment is a unique challenge. For multinational companies that operate in a large number of countries, the complexity can be significant. Cross-border transactions are governed by trade regulations which may be at a country, regional, or global level. In addition, a country's political interests, level of protectionism, established trade barriers and local customs procedures can increase the number of compliance requirements.

An accurate and complete customs declaration is a significant step in preventing supply chain disruption at country borders. A customs declaration is a statement of the tangible goods to be imported and also the basis for which duties will be determined. Customs valuation, which may be computed in several ways, is the primary source for determining duties and taxes. The primary valuation method is the transaction value and is defined as the 'price paid' for the good by the buyer to the seller. But the transaction value cannot always be used for all types of transactions related to imports of goods. Trade is much more complex than a simple price paid per physical item. Even when using the transaction value method, additional elements can come into play, such as software licences and royalties, subject to the condition of sale requirements. Complex contracts may drive additional payments subject to customs valuation and economic value incurred by the importer (that is, assists) to be declared as additions to transaction value. In light of the complex customs requirements and customs valuation rules, these additional elements and intangibles may be required for an accurate valuation. The diligence in gathering all of the material information required to calculate the transaction value for customs can be significant.

For large multinational companies, related party transactions can represent the vast majority of the goods to be declared and related party transaction restrictions can be a challenge in many countries. When transaction value cannot be used, there are several other approved methods for determining valuation. The other approved methods can bring additional complexity and administrative aspects with various countries' customs authorities. All parties involved would benefit by avoiding these complexities by establishing 'arm's length' principles for all related party transactions.

Finally, the global economic environment is broadening opportunities for multinational companies to grow and to enter new countries. This expansion along with complex acquisitions and joint ventures is leading to new types of business models and agreements, with implications for customs valuation as described above. With governments looking to make up for shortfalls in revenues, there is additional scrutiny of related party transactions and contract terms by customs and tax authorities.

Challenges with software valuation

One area of significant challenge is that of software valuation for customs purposes. Countries can vary in their methodology for valuing software imports. The non-standard application of the World Trade Organization (WTO) decision for valuing software on media leads to country-unique requirements and divergent processes for the importer. Understanding the various requirements is the first step but then having unique process steps, perhaps manually executed, increases compliance risk for importers. Also, the technologies are evolving faster than the regulations, creating potential gaps between the two. The new technologies, media types, and software types challenge the technical assumptions made when the regulations were first written. Knowing how to declare these new technologies ahead of time before the first import is a constant challenge for the importer.

Valuation of software on physical media, like CD/DVDs or tape cartridges is the simplest case, as opposed to software installed on other devices, such as a personal computer, a server, a new operating device or a smart phone. These devices are not considered carrier medium by definition. While the medium is the tangible good crossing the border, the content, the software, is the true purpose of the media shipment. Current valuation rules are established under the WTO valuation agreement but, prior to the WTO's creation in 1995, the multilateral General Agreement on Tariffs and Trade (GATT) regulated international trade. In 1984, the Technical Committee on Customs Valuation (TCCV) established under GATT published Decision 4.1, 'Decision on the valuation of carrier media bearing software for data processing equipment'. This decision reflected an alternative for countries to transaction value in the specific cases of carrier media bearing software for data processing equipment. It stated:

In determining the customs value of imported carrier media bearing data or instructions, only the cost or value of the carrier medium itself shall be taken into account. The customs value shall not, therefore, include the cost or value of the data or instructions, provided that this is distinguished from the cost or the value of the carrier medium (WTO 1995, G/VAL/1, p. 3).

This decision is an approved deviation to the transaction value method in the specific cases of media. This is helpful to importers but only when the country's implementation of the decision is known and clear. Because GATT gave recommendations, as opposed to requirements, customs authorities still have latitude in what valuation method they use to impose taxes and duties for software on media. These country-unique requirements continue to be challenging to importers.

In addition, some countries assess different duties for software products depending on the consumers of the product. Packaged software is considered to be 'shrink wrap' software intended to meet the needs of a variety of users. Customised software, however, is developed for a specific customer. There can be variances between customs authorities as to what software is considered to be packaged versus customised. Because the application of the carrier media exception can vary from country to country, this can have quite different implications for the importer. Ultimately, this can result in different treatment by different customs authorities. These country-unique requirements necessitate additional controls and steps for importers to manage customs compliance.

Another challenge is with respect to the following statement in Decision 4.1:

For the purpose of this Decision, the expression "carrier medium" shall not be taken to include integrated circuits, semiconductors and similar devices or articles incorporating such circuits or

devices; the expression “data or instructions” shall not be taken to include sound, cinematic or video recordings (WTO 1995, G/VAL/1, p. 3).

With the evolution of technology and the development of new ‘media’ devices that may include integrated circuits, some new types of media would not be covered under the carrier media exception as currently written. As the intent or the spirit of Decision 4.1 has seemingly not changed, there is a need to have the Decision updated to reflect current technologies and help to avoid inconsistent treatment upon import between countries and products. As technology evolves, carrier media for software continues to evolve, such as USB flash drives and portable hard drives. These types of new media create a new challenge for customs authorities. These devices were traditionally viewed as hardware devices rather than carrier media for software.

That being said, the spirit of Decision 4.1 was intended to cover only cases where the carrier media did not include a true computing machine, with integrated circuits, semiconductors and similar devices. Thus, pure hardware, such as personal computers, traditional servers, smart phones, tablets and similar products, are not technically covered by the scope of the carrier media exception. Since the carrier medium description does not include these types of products, the value of the software licence is required to be included as part of the declared value (no deduction from the transaction value) when pre-loaded on the goods being imported. This creates a complex assessment of the value of the data or instructions installed on all of the various devices or hardware being imported. There have been publicised cases where the importer tried to separate the software content value from the hardware transaction value and declare it as a separate line to benefit from duty exemption but they were unsuccessful.

Finally, an additional complexity for valuing software is when royalty or licence agreements exist between related and non-related parties. Under a licence agreement, there may be a one-time charge and sometimes an ongoing fee for use, like a monthly licence payment. It’s a ‘right to use’ agreement for an agreed period of time. In this scenario, there is no sale of the software at the time of import. The transaction value method requires the price paid for the good, therefore this valuation method does not work as there is no sale. No transfer of ownership of the software has occurred. As a result, the importer may be required to negotiate an agreement with various countries’ customs authorities on what method can be used to determine the software value for customs purposes. In light of the growing complexity with respect to royalty and licence agreements, and the customs valuation implications, the TCCV of the World Customs Organization (WCO) issued a large set of advisory opinions on the application of royalties in the context of customs valuation showing how complex and diverse the models can be. Managing these unique agreements ultimately increases compliance risk for importers.

Finally, there is an additional complexity concerning customised software. Since customised software is developed for a specific customer, the licence value can vary depending on the specific terms of use. The software vendor may use the same unique identifier, such as a part number, for customised software. Therefore, the same part number can appear on different invoices and have different licence fees. This can appear as a discrepancy to Customs as they would expect the same part number to have the same value.

Additional challenges

The major growth of software products, services, and offerings is increasingly electronically based. As a result, there is no cross border movement of any physical goods, so the transaction is outside of customs review. Despite the growth in electronic offerings, traditional software products and the ability to deliver software on physical media will still remain. For example, for enterprise level or customised software, customers may continue to want physical media for a variety of reasons. Downloading large software products is time-consuming and can be prone to failure of transmission depending on where the client is located versus where the download server is located. Even when the customer is willing to download

their purchased software, they may still want a backup copy of the software on their premises. As well, some banking and government organisations do not subscribe to electronic transmission of software to be compliant with their security policies.

While there is a continued desire from companies for electronic fulfilment for various reasons, it is not always an option. Unique challenges for the software vendor can exist related to the size of the software product itself. Media capacity limitations can dictate which type of media can be used for some software packages. Also, a customer's existing hardware peripherals can determine which media can be used by the software vendor. These varying requirements result in companies still having to maintain an inventory of physical media and media production equipment to fulfil unique customer requirements. In addition, some countries restrict or prohibit import of certain types of media. These country-unique requirements will continue to be a challenge. To accommodate the different requirements, multiple fulfilment processes and manual intervention may be required, resulting in increased compliance risk.

An additional area of growth is software appliances and computer appliances. Software appliances can be virtualised and offered as an alternative to Software as a Service (SaaS) cloud computing offerings. However, computer appliances are hardware with the software preinstalled. These appliances are integrated hardware and software solutions designed to perform specific tasks, often considered a software solution with just enough operating system and/or hardware to make the software run. The way that customs authorities determine carrier media exception applicability can vary, resulting in different software valuation method requirements for different countries.

Conclusions

Valuation of software for customs purposes continues to be a significant area of challenge for importers. Valuation is already complex and can be very challenging for large multinational companies that must adhere to related party transaction rules. Software offerings, in many cases, are evolving in a way that challenges the applicability of pure transaction values used for customs valuation purposes. Companies must closely scrutinise these scenarios as the complexities of globalisation and related party agreements continue to expand.

Given various countries' regulatory requirements and customs requirements, the complexity of delivering and importing software is still a risk and a challenge to the importer. As technology products continue to evolve, there are implications in the way countries interpret the carrier media exception. Until a clarification of Decision 4.1 can be issued, software shipments will continue to be a challenge for the importer.

References

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