

# EY TAX Flash / Customs Valuation. Case study on transfer pricing

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The TCCV is a committee of customs authorities created by the World Trade Organization (WTO) Valuation Agreement and tasked with providing interpretation and guidance on the Valuation Agreement. It is administered by the World Customs Organization (WCO), an intergovernmental organization of 180 customs authorities. While its guidance is not binding on any jurisdiction, its pronouncements are regularly cited by customs authorities worldwide.

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## Background

While the objective of both income tax transfer pricing rules and customs related party valuation rules is the same – arriving at arm's length prices – the rules are different. As a result, customs authorities worldwide have struggled with whether documentation prepared to support income tax transfer pricing may be considered to support customs valuation.

The vast majority of importers declare import values based on the transaction value methodology, the price paid or payable for merchandise. Ease of documentation and recordkeeping are often primary reasons that a business prefers using transaction value.

However, when importers purchase from related parties, special rules apply in order to use transaction value. Transaction value is an acceptable appraisal methodology between related parties if either (1) an examination of the circumstances of the sale indicates that the relationship between the parties did not influence the price actually paid or payable, or (2) if the transaction value of the imported merchandise approximates certain test values. Test values are not commonly used, and importers usually attempt to demonstrate the acceptability of transaction value under the circumstances of sale test.

The circumstances of sale test examines the relevant aspects of a transaction to determine that the relationship between the buyer and seller did not influence the price. The Annex to the WTO Valuation Agreement provides three examples to demonstrate that the relationship did not influence the price:

- The price was settled in a manner consistent with the normal pricing practices of the industry in question;
- The price was settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related to it; or
- The price is adequate to ensure recovery of all costs plus a profit that is equivalent to the firm's overall profit realized over a representative period of time in sales of merchandise of the same class or kind (note that this example focuses on the exporter's costs and profit, not the importer's).

These examples are non-exclusive. However, because they are the only examples provided they have tended to be the frame of reference for many customs authorities.

## Case study facts

The case study deals with an importer of electrical relays manufactured by a related party. The related party pricing was determined in accordance with the OECD Transactional Net Margin Method (TNMM). Under TNMM, the profit margin of one of the related parties (the tested party) is compared to the profit margin of a group of benchmarked companies which have similar functions and risks to the tested party, but who transact with unrelated parties. In this case, the importer, which functions as a routine distributor is the tested party, and operating profits of the importer were compared to those of the benchmarked comparable companies. This is the most frequent transfer pricing scenario, but has been difficult for customs authorities because the costs and profits of the producer/exporter are not relevant to the transfer pricing approach. The case study goes on to note that the transfer pricing study is used as the basis of a bilateral Advance Pricing Agreement.

## Analysis

The case study makes the link between the transfer pricing study and the first example in the WTO Valuation Agreement annex, that the price between the related parties was settled in a manner consistent with the normal pricing practices of the industry. The case study focuses on the specific companies benchmarked in the transfer pricing study, which were distributors of electrical apparatus and electronic parts. The case study goes on to state that the term “industry” as used in the first example in the annex is meant to include the industry or industry sector that contains goods of the same class or kind as the imported products. In this case, the imported relays are considered part of the electrical apparatus and electronic parts industry. This is the same approach that was used by U.S. Customs and Border Protection in evaluating a transfer pricing study in a 2009 ruling given to Cardinal Health, HQ HO37375 (Dec. 11, 2009). Case Study 14.1, which was brought forward for consideration by the U.S., is loosely based on that ruling.

The analysis section of the case study explains that by working backwards from the arm’s length range provided by the transfer pricing study, the transaction between the exporter and importer could be deduced to be at arm’s length. The customers of the importer were unrelated parties, so the importer’s sales could be assumed to be arm’s length. The operating expenses of the importer were also considered reliable, as they were paid to unrelated parties. With the importer operating profit of 2.5% being within the 0.64% to 2.79% operating profit range determined to be arm’s length by the transfer pricing study, the only remaining variable, the cost of goods sold (which include the purchases of the importer goods), could also be considered arm’s length.

## Caveats

While the approval of this case study is welcome news to importers, there are several important cautions to note. First, with the focus of profits based transfer pricing methodologies like TNMM being on the comparability of the functions, assets, and risks of the tested party with the benchmarked companies, industry compatibility has not typically been a transfer pricing focus, and in some cases of integrated production, are difficult if not impossible to find. The U.S. has dealt with these situations by considering separate studies explaining the normal pricing practices of the industry in question. Of course, the case study does not address this situation. Second, the case study makes a specific point of noting that the customs authority may, as it deems appropriate, examine the operating expense of the company. This stems from concerns expressed by some customs authorities that expenses may be paid to benefit the exporter, or may be extraordinary and not reflect a presumption that the importer is rationally trying to reduce expenses. Finally, many customs authorities have expressed their obligation to apply the WTO Valuation Agreement, and not simply accept a transfer pricing study without examination and analysis of how it demonstrates that the circumstances of sale test is met. This resulted in “disclaimer” language that the case study does not impose an obligation on a customs authority to rely on transfer pricing documentation.

## Implications for taxpayers

Efforts by the TCCV, the WCO, and the OECD at convergence of transfer pricing and customs valuation approaches have been ongoing for a decade. Along with the release of the WCO Guide to Transfer Pricing and Customs Valuation in June 2015, Case Study 14.1 marks an important step forward in giving customs authorities comfort in assessing customs related party pricing in an OECD transfer pricing context. Businesses, in turn, can more confidently approach supporting income tax and customs related party pricing requirements with a consolidated approach. It is clear from the case study that this does not mean simply preparing transfer pricing documentation based on an OECD methodology and assuming customs will be satisfied. Instead, there should be thought as to how the documentation can best be prepared with both an income tax and customs audience in mind, with appropriate explanatory information for each on why the documentation satisfies the separate income tax and customs requirements.

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