



TRANSFER PRICE – CUSTOMS VALUATION: STRATEGIES TO EFFECTIVELY MANAGE THE NEXUS

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Transfer pricing analysis and documentation help companies to determine, document and manage a financial and/or tax result between related parties by establishing price ranges for cross-border activities and transactions. These efforts help companies comply with certain domestic and international tax regulations while also creating a certain level of transparency and predictability to inter-company financial results.

With the proper approach and thoughtful consideration, these efforts can also provide a foundation for setting and supporting values declared to customs authorities at import. Herein, we present some of the links between transfer pricing and customs valuation concepts, some important developments and decisions from authorities over the past few years that impact tax-paying importers, and some key benefits that an integrated strategy may provide to more effectively manage the transfer pricing and customs valuation nexus.

Similar yet different

Tax transfer pricing rules and customs valuation rules have different objectives. The tax objective is to allocate income to reflect overall taxable income. The customs objective is to define value of a specific imported item. Many importers buying from related parties are thus confronted with a conflicting choice between two reasonable business objectives: pay as little duty as possible by declaring a low customs value, but somehow also seek the largest possible corporate income tax deduction with a high transfer price.

The inevitable result of these divergent paths in the regulation of inter-company cross-border transactions is increased uncertainty and potential exposure. In pursuing both goals at once, the importer may be exposed to enforcement action by a tax authority that charges the importer with paying too much for imported merchandise (i.e., taking too large a tax deduction), and a customs authority that argues that the same merchandise was undervalued and thus, too little in *ad valorem* duty was paid.

Even with these relatively tight definitions, the interpretation and application of the ACV differs across jurisdictions and many tax and customs authorities are still



learning how the transfer price-customs valuation nexus works in practice. As recently as a decade ago, just a handful of countries had implemented transfer pricing rules and adhered to the ACV. Today, dozens of countries enforce formal transfer pricing rules and over 100 more apply the ACV.

In many jurisdictions where the implementation of transfer pricing rules and the ACV have run a roughly parallel course, there is some evidence of increasing inter-agency communication and cooperation. Tax and customs administrations in countries such as the U.S., U.K. and Australia are at the forefront in reviewing and monitoring where declared import prices and values meet the "arm's-length" standard. These countries' administrations have come to appreciate the benefits of working together in combating tax and customs fraud, improving taxpayer compliance, and collecting new revenues in the form unpaid duties, taxes, fines and penalties. In an effort to become more effective in the administration their respective rules, there is evidence that other jurisdictions such as Brazil, Canada and Peru are cross-training customs officers in transfer pricing regulations and deploying them on tax investigations, and vice versa.

For its part, the U.S. Bureau of Customs and Border Protection's (CBP) experience with both transfer pricing and the ACV is relatively extensive given that both sets of rules have been in place in the U.S. since the mid-1980s, and many importers/ taxpayers have come forward with customs valuation ruling requests and some have requested CBP's consideration of the applicability of Advanced Pricing Agreements to customs values. Therefore, it is instructive to consider how CBP views the transfer pricing and customs valuation nexus with respect to its role in accepting declared customs values build, in whole or in part, around inter-company transfer prices.

Case-by-Case Determination

Over the past few years, CBP has communicated its views on the transfer price-customs valuation nexus in certain customs valuation rulings for importers. In these rulings, the agency has shown a certain degree of flexibility in considering transfer pricing analysis as part of a broader determination of appropriate customs values. In general terms, it can be stated that CBP has not explicitly rejected transfer pricing analysis or the results determined there under as invalid, however, it has repeatedly affirmed that a traditional transfer pricing analysis alone is not sufficient to support the validity of an intercompany transfer price as the basis for customs value.



In the process of reviewing transfer pricing analysis and other documentation submitted on behalf of an importer, for example, CBP noted in Headquarters' Ruling #548482 that

... "The suggestion that the seller's prices to the buyer/importer are set in accordance with the normal pricing practices of [X] industry because the buyer/ importer allegedly earns an operating profit comparable [under transfer pricing analysis] to other allegedly "functionally equivalent" companies is not sufficient..."

A deeper look into CBP's positions on the matter reveals that there is an acknowledgement that there are circumstances where transfer pricing analysis could successfully be utilized to support (but not necessarily define) a customs value. Specifically, CBP has noted that the following conditions would need to be present:

1. the transfer pricing methodology applied has been accepted by the U.S. Internal Revenue Service through an Advanced Pricing Agreement (APA); the APA is bilateral;
2. CBP is provided access to all data utilized in the APA analysis;
3. the transfer pricing comparables analysis focuses on product similarity rather than function comparability; and
4. CBP approves of the methodology applied and the tested party in the analysis.

Progress, to be sure, but these conditions likely set too high of a bar for most importers. Moreover, with CBP reserving the right to have the final say on acceptability of a customs value, nothing appears to be guaranteed. With just a few hundred U.S. importers having a bilateral APA in place, the universe of potential importers – of which there are tens of thousands – to whom this may presently apply appears limited. Perhaps a broader segment of U.S. importers trading with related parties may more practically consider the position that CBP staked out in HQ Ruling #547382 some years ago wherein it accepted a transfer pricing methodology that had been determined without the involvement of a foreign tax authority (i.e., no APA). In that decision, CBP focused on whether the importer had satisfied the circumstances of sale test¹ via a review of a transfer pricing comparables study, the foreign party's financial statements, and an analysis of the profitability of the foreign party and the related foreign manufacturer.

¹ See: Section 402(b)(2)(B) of the Trade Agreements Act; 19 USC §1401a(b)(2)(B); and 19 CFR §152.103(l)(1)(ii) and (iii).



Broad guidance

Going beyond case-by-case, importer-specific rulings on the matter of transfer prices and customs valuation, in April 2007 CBP released an "Informed Compliance" publication to the importing community in the United States in an attempt to help bring more formal clarity to the issue of when and how transfer pricing analysis may support customs values. In *Determining the Acceptability of Transaction Value for Related Party Transactions*, CBP provided importer guidance into the usefulness and applicability of using transfer pricing studies (including APAs) for customs valuation requirements. Customs valuation regulations apply special rules when the parties involved in an import transaction are related. In particular, use of the transaction value method of appraisement is subject to certain conditions, including the ability of an import to prove the existence of an arm's-length sale. Proof of an arm's-length sale is evidenced when the importer is able to demonstrate that the transaction meets either the "circumstances of sale test," or the "test values method."

The circumstances of sale test is passed if the importer can properly illustrate that the related party aspect of the transaction did not influence the price. CBP offers three potential approaches to pass the test:

- 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 cost 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.

In commenting on these three approaches, CBP pointed out the need for close product similarity, as well as pricing practice in a specific industry. In particular, CBP noted that utilization of "functionally equivalent companies" is not sufficient evidence. Since utilization of functionally equivalent companies is acceptable under the transfer pricing regulations and routinely utilized, the applicability of an importer's transfer pricing study to pass the circumstances of sale test will be viewed by CBP as limited. Regarding the third point above, CBP views the costs plus profit to be a reference to the parent company profit. Since this is an objective test, utilization of an importer's transfer pricing study would not be relevant for purposes of passing the circumstances of sale test.

Regarding to the application and use of a transfer pricing study for purposes of the circumstances of sale test, CBP conceded that the broad goal of treatment of



related party transactions on an arm's-length basis is similar between the tax transfer pricing regulations and the customs regulations. However, CBP further noted that substantial legal requirement differences exist between the transfer pricing regulations and the customs regulations. CBP illustrated that the transfer pricing regulations allow a taxpayer to aggregate all imported products from a related party (or parties) for purposes of illustrating arm's-length treatment under the best method rule. However, the customs regulations require a customs value be determined for every imported product. Thus, a related party importer would have to illustrate that every individual related party transaction was arm's length, not simply the aggregate value of the transactions. Since a transfer pricing study would address the transactions in an aggregate basis, in order to comply with the transfer pricing regulations, CBP would view its usefulness in a customs valuation setting as somewhat limited.

The CBP guidance also discusses and contrasts the methodological approaches of the transfer pricing regulations and the customs regulations. CBP does acknowledge certain similarities between the transaction-based methods (i.e., Comparable Uncontrolled Price, Resale Price and Cost Plus) of the transfer pricing regulations and the methods of valuation in the customs regulations. However, CBP also indicates the Comparable Profits Method (CPM) has little similarity with the customs regulations methods. It notes the reliance of the CPM on a broad functional similarity, as opposed to product similarity. Since the customs valuation methods require product similarity, or comparison of pricing within an industry, CBP concludes that "the fact that the importer's transfer pricing methodology satisfies one of the IRS methods is not determinative of whether it is an acceptable transaction value for customs purposes."

As customs valuation is based on facts and circumstances, CBP indicates that a transfer pricing study can have very useful information concerning the facts of the related party transaction, as well as potential information on similar unrelated party pricing transactions. This is especially the case whereby the Comparable Uncontrolled Price (CUP) method (as opposed to a profits-based method, such as the CPM) was utilized in the transfer pricing study. CBP encourages importers that wish to utilize a transfer pricing study to support a circumstances of sale claim to submit additional evidence as to why the importer believes the transfer pricing study's conclusion are relevant to its circumstances of sale claim. CBP notes that submission of a transfer pricing study, in relation to circumstances of sale claim, without further support will be rejected.

The second approach, under the customs regulations, to illustrate the acceptability of the transaction value is a test value approach. Under this



approach the related party transaction value (i.e., transfer price) is acceptable under the following "test values":

1. the transaction value of identical merchandise, or of similar merchandise, in sales to unrelated buyers in the United States;
2. the deductive value of computed value for identical merchandise of similar merchandise;
3. but only if each value referred to in clause (i) or (ii) that is used for comparison relates to merchandise that was exported to the United States at or about the same time as the imported merchandise.

It is clear from the very focused nature of the test value approach that if an importer desired to utilize its transfer pricing study to pass this customs regulation test, the study would have to use a CUP method. More specifically, the CUP would have to be identical, or similar, merchandise imported into the United States during the same time period. This very limited applicability makes utilization of a transfer pricing study for purposes of a test value claim a somewhat remote possibility.

In summary, CBP guidance is clear: An importer's sole use and submission of a transfer pricing study (including an APA) for purposes of the transaction value method of customs valuation is insufficient. In order to meet the circumstances of sale test, or the test value approach, the importer who submits a transfer pricing study must also submit additional supporting documentation illustrating why the transfer pricing study supports the claim of passing the circumstances of sale test or test value approach.

The forgotten statute: §1059A

For its part, the United States Internal Revenue Service ("IRS") can leverage a section of the U.S. tax code, 26 U.S.C. §1059A, to define the limits of customs values for tax purposes. This provision in the tax regulations essentially states that if any property is imported into the U.S. in a transaction between related parties, the amount of costs taken into account in determining basis or inventory cost for tax purposes cannot be greater than the customs appraised value (with some adjustments) declared for the imported goods at final liquidation.²

² Liquidation is the process by which the U.S. Bureau of Customs and Border Protection, after receiving an entry summary (CF 7501) filed by the importer and/or broker (hereafter collectively referred to as importer) to obtain an entry or release of merchandise into the United States, fixes the final appraisement, classification, and assessment of duties, taxes and fees with respect to that entered merchandise (19 U.S.C. §1500). Generally, final liquidation of an entry will occur within 314 days after the date of entry for the imported merchandise, unless an administrative protest under 19 U.S.C. §1514 is filed by the importer within 180 days after the date of liquidation.



In many instances, companies importing into the U.S. from related parties are required to make upward pricing adjustments in order to satisfy “arm’s-length” transfer pricing requirements. Although these upward transfer pricing adjustments may satisfy “arm’s-length” requirements for purposes of complying with tax laws and United IRS regulations, they may create potential uncertain tax positions due to the inventory valuation limitation under 26 U.S.C. §1059A.

The 1059A limitation could apply as a result of an upward transfer pricing adjustment, or where certain costs are excluded from the invoice value of the goods (e.g., tooling, engineering/designs, procurement fees, discounts, commissions, manufacturing technology/know-how, royalties, cost-sharing agreements, etc.) but are required to be added to the inter-company price in order to determine the proper appraised customs value of the imported goods. Where increases occur in either case (i.e., to satisfy tax or customs requirements), §1059A may require the importer to use the lower customs value determined at the time of final liquidation as the basis or inventory cost of the merchandise for tax purposes rather than the adjusted (higher) transfer price and/or customs retroactive value adjustment made after final liquidation. The application of 1059A in these instances and the requirement to record the lower price for tax reporting purposes could potentially result in an “uncertain tax position,” and possibly require a financial disclosure statement under the new Financial Accounting Standards Board FIN 48 rules.

Where price increases are required to satisfy either transfer pricing tax and/or customs valuation purposes, U.S. customs laws provide for certain administrative procedures that may be used by an importer to help prevent a possible §1059A limitation issue. Among these procedures are Post-Entry Amendments, Administrative Protests and the Reconciliation program. Each of these is discussed in more detail below:

Post-Entry Amendments

As a general rule, CBP will liquidate an entry within 314 days after the date of entry. Due to this 314-day liquidation cycle and to assist importers with making changes to entry summaries prior to liquidation, CBP implemented an administrative process whereby importers could submit post-entry amendments to their entry summaries for imported merchandise already filed but not yet liquidated. Where price increases occur post-entry amendments can be filed to declare and effectuate the increased prices for the imported merchandise. This action can help an importer/taxpayer



avoid the §1059A limitation on basis or inventory costs for tax purposes and, more broadly, a possible uncertain tax position.

Reconciliation Program

CBP has recognized the fact that many elements of a transaction, including customs valuation, may be undeterminable at the time the imported merchandise is entered into the U.S. In order to assist importers with declaring accurate information on the entry summaries in these instances, CBP established the Reconciliation program. Reconciliation allows an importer, using reasonable care, to file entry summaries with CBP with the best available information at the time of importation under the mutual understanding that certain elements, such as the appraised customs value for imported merchandise, remain outstanding. The undeterminable information is "flagged" on the entry summary filed with CBP for the imported merchandise at the time of entry. At a later point in time (generally within 21 months after the entry is filed) when the specifics have been determined and are known, the importer files a Reconciliation entry providing the accurate and correct information for the given entry(s) to CBP. The reconciliation entry is then liquidated with the accurate and correct information (e.g., increased customs value) for the respective entry(s).

From the import compliance and operational management perspectives, participation in the Reconciliation program is the most effective administrative method available to avoid a potential §1059A limitation issue for future import transactions.

Administrative Protests

Although an entry may be liquidated within 314 days after the date of entry, an importer can challenge liquidation of an entry, including customs appraised value, by filing a protest within 180 days of the date of liquidation. If this route is chosen, the liquidation of an entry becomes final and binding on all parties only after the expiration of that 180-day period. Consequently, where price increases occur an administrative protest may be filed within 180 days after the date of liquidation in order to properly effectuate the increased customs value and avoid the detrimental effect of the §1059A limitation.



When all else fails

In some cases, price increases made by importers are undeterminable or unknown until after the liquidation of the entry(s) has become final with CBP. To manage risks arising from these situations, the increased prices and/or customs value may be voluntarily disclosed to CBP for all final liquidated entries. This "prior disclosure" – prior because it is made known by the importer before the authorities identify it – can help an importer to avoid potential monetary penalties being assessed by CBP for valuation errors. (CBP can assess monetary penalties ranging from 200% to 800% of the duties, or 20% to 100% of the import value for duty free/zero rated goods, against a U.S. importer for using the incorrect customs value for the imported merchandise.)

Importantly, the IRS has ruled that the filing of a voluntary prior disclosure with CBP does not extend the final liquidation date of an entry for customs purposes and the application of §1059A. Its stated position is that the "...customs value is considered to be finally determined, and all CBP determinations are considered final, when liquidation of the entry becomes final." As such, its view is that a taxpayer's subsequent voluntary tender of additional duties would not increase the "dutiable value" of the imported merchandise for purposes of the §1059A limitation.³ Depending on the amounts involved, this position could create a potential uncertain tax position for the taxpayer/importer. Thus, importers/taxpayers must recognize that while a potential customs valuation exposure may be addressed with a prior disclosure, this remedy will not resolve a §1059A limitation for tax purposes.

To help reduce the risk of a §1059A inventory basis limitation and the creation of a possible uncertain tax position, U.S. importers/taxpayers should carefully consider these administrative procedures as part of their focus and diligence in managing the transfer pricing and customs valuation nexus.

Strategic thinking

As shown above, an importer's sole reliance on transfer pricing analysis is generally insufficient to support the proper customs appraisal of merchandise. To proceed otherwise creates a real risk of fines, penalties and/or the mandated application of an alternative customs valuation method that may be difficult and costly to implement and sustain.

³ See, for example, IRS FSA 200036015 (May 31, 2000); See also, 2003 WL 18767 (IRS NSAR) 2000 IRS NSAR 274 (January 2, 2003).



Nonetheless, transfer pricing analysis and related documentation can be leveraged to provide a basis from which a customs value may be divined and defended. (This assumes, of course, that all required statutory adjustments are applied and other relevant factors are considered.) Those companies that develop and implement an integrated, balanced and coordinated transfer pricing and customs valuation strategy may benefit in the following ways:

- A foundation for establishing inter-company pricing policies for customs purposes that help to decrease accounting issues that are created by gaps, lack of coverage, or contradictions among inter-company pricing initiatives.
- The ability to significantly reduce the potential of a customs audit as well as the financial exposure related to penalties associated with non-compliance of customs regulations.
- A globally coordinated inter-company customs valuation documentation compliance solution that considers products, market conditions and other key economic factors.
- A basis for proactively managing value adjustments to achieve arms-length results required under both tax and customs regulations.
- A foundation for pursuit of Advanced Pricing Agreements that may also be considered by customs authorities as evidence of an appropriate arm's-length value.
- The ability to identify planning opportunities related to the valuation of merchandise and intangibles (e.g., royalties, license fees, R&D, warranties, marketing & advertising, cost-sharing arrangement, etc.) via alternative methods of appraisements.
- The development of limits to customs authorities' ability to interpret Art. 1.2(a) and (b) of the WTO Customs Valuation Agreement relating to the acceptability of using the transfer price as an initial basis for the customs value of imported merchandise.
- Enhanced financial reporting compliance related to intercompany cross-border transactions to satisfy obligations under Sarbanes-Oxley reporting requirements.

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