



The ICC policy statement on the interaction between transfer pricing and customs valuation

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The transfer pricing/customs problem

- ▶ Same overall objective: arm's length pricing
- ▶ Two sets of substantive rules, reflecting differing agency goals
- ▶ Conflicting agency concerns in importing country
 - ▶ High transfer price: low taxable income, high duties
 - ▶ Low transfer price: high taxable income, low duties

Transfer pricing basics

- ▶ Most countries' rules follow OECD guidelines
- ▶ 5 specified methods for tangible goods
- ▶ Taxpayer can select “best” method. Profits based methods focus on:
 - ▶ Function and risk of the tested party
 - ▶ Degree of comparability with “uncontrolled” transactions (those between unrelated parties)
 - ▶ Quality of data and assumptions
- ▶ Transactional net margin method (comparable profits method in the US) is the most commonly used
- ▶ Contemporaneous documentation generally needed to avoid penalty

Customs valuation basics

- ▶ All WTO members must adopt the WTO Valuation Agreement
- ▶ Methods are sequential
- ▶ Transaction value is primary method
- ▶ Transaction value is allowed for related party sales if the relationship did not influence the price, which may be determined by:
 - ▶ Test values (which rarely exist)
 - ▶ Circumstances of sale
- ▶ Importers prefer transaction value, and consequently appropriately documenting “circumstances of sale” is critical

Fundamental differences in approach— tangible property

	<u>Transfer Pricing</u>	<u>Customs</u>
▶ Item to be taxed	annual net income	specific product
▶ Relevant timeframe	return due dates	date of import
▶ Level of application	overall results	transactional

Post-transaction adjustments

- ▶ A necessary part of profits based transfer pricing methodologies
- ▶ For tangible property, adjustments are sometimes viewed as inconsistent with transaction value, which requires that the price paid or payable is “not subject to any condition or consideration for which a value cannot be determined.” US has recently changed its position on this point, allowing adjustments to transaction value.
- ▶ Must be reported if part of transaction value; a few countries have formal mechanisms for reporting (US reconciliation program)

Customs enforcement trends

- ▶ Wide variance in approach
- ▶ Heightened awareness globally
- ▶ Significant difficulty with concept of “circumstances of sale”
- ▶ Issues with product price and dutiability of royalties, along with other related party payments for services, etc.
- ▶ Issues with respect to “post import” transfer pricing adjustments

Circumstances of sale – three examples

- ▶ Non-exclusive examples appear in Annex to Valuation Agreement
- ▶ Often the frame of reference for customs officials
- ▶ Examples do not directly align with transfer pricing methods:
 - ▶ Price settled in accordance with normal pricing practices of the industry
 - ▶ Price settled in a manner consistent with sales to unrelated buyers
 - ▶ Price is adequate to ensure recovery of all costs plus a profit equivalent to the firm's overall profit realized over a representative period of time in sales of merchandise of the same class or kind
- ▶ Third example is particularly deceptive
 - ▶ Merchandise of same class or kind; no reference to functional analysis
 - ▶ Seller's profit, not buyer's is relevant
 - ▶ Seller's profit benchmarked to "firm's overall profit," which is undefined
 - ▶ Profit not defined, no "profit level indicators" referenced

Convergence efforts

- ▶ World Customs Organization and OECD joint programs in 2006 and 2007
- ▶ Focus Group on Convergence
 - ▶ Jointly sponsored by WCO and OECD in 2007-08
 - ▶ Global participants, public and private sector
 - ▶ 2008 recommendations to Technical Committee on Customs Valuation:
 1. Current WTO Valuation Agreement broad enough to accommodate income tax TP methods as support for arm's length nature of related party pricing
 2. Standards be established to allow declarations to Customs for post importation price adjustments made to satisfy TP obligations (e.g. ACS Reconciliation in the US)
- ▶ TCCV issued Commentary 23.1 in October 2010, stating that transfer pricing studies may be considered in a circumstances of sale analysis
- ▶ Transfer pricing adjustments currently being discussed

Background for ICC Policy Statement

- ▶ Related Party Pricing uncertainties faced by multi-nationals in both developed and developing countries:
 - ▶ Climate of uncertainty and complexity
 - ▶ Increases in compliance costs
 - ▶ Conflicts between tax and customs administrations within same country
 - ▶ Significant risk of penalties
- ▶ Not necessary to change WTO rules
- ▶ Realization that it is not realistic to seek total harmonization of customs and tax rules or even to impose one's view onto another
- ▶ WTO rules and OECD methods can be aligned by finding common way of interpreting 'price not influenced by the relationship of the parties' vis a vis the arm's length principle
- ▶ Acknowledgement of Commentary 23.1

Goal of the Policy Statement

- ▶ The goals of the policy is to:
 - ▶ Secure harmonized tax and customs valuation of transactions between related parties in an international context
 - ▶ Clarify rules for both companies and administrations
 - ▶ Suppress or at least reduce financial impact linked to divergent valuation
 - ▶ Simplification

- ▶ And thereby:
 - ▶ Reduce compliance costs to companies
 - ▶ Eliminate the risk of penalties resulting from disputes arising from divergent views taken by customs and tax authorities
 - ▶ Streamline intercompany operations and facilitate international business

P1 Recognition of Arm's Length Principle

P1: Concerning related parties, formal recognition of arm's length principle (Article 9 OECD Model) in order for the Customs to determine the customs value

- ▶ Consistent with Commentary 23.1 of the WCO TCCV, for importers that establish related party pricing policies in accordance with the OECD Transfer Pricing Guidelines and provide the necessary transfer price documentation, such documentation could be considered a solid basis on which customs administrations can evaluate the circumstances surrounding the sale.
- ▶ The OECD guidelines are based on sound underlying economic principles designed to result in arm's length prices being charged – the same result sought by customs administrations when determining that prices have not been influenced by the relationship.

P1 Recognition of Arm's Length Principle continued

- ▶ Consistent with Commentary 23.1, in certain instances ICC recommends that importers who set prices in accordance with the OECD Transfer Pricing Guidelines demonstrate that the relationship between the buyer and the seller did not influence the price.
- ▶ The arm's length principle (Article 9 OECD Model Tax Convention) may be directly aligned with the rules for determining the acceptability of transaction value under either the circumstances of sale test or test values.
- ▶ This should be formally recognized by customs administrations and doing so will set up a formal link between the OECD and WTO rules with regard to the value of transactions between related parties.

P2 Recognition of adjustments

P2: Recognition by the customs administration of post transaction transfer pricing adjustments (upward or downward). This recognition should be applicable for adjustments made either as a result of a voluntary compensating adjustment – as agreed upon by the two related parties – or as a result of a tax audit.

- ▶ Post transactions adjustments are permitted by both the OECD guidelines and WTO customs valuation rules. These post transaction adjustments can be done for a variety of reasons, including voluntary adjustments, but also for year-end adjustments when trying to get within a pre agreed range or price at the end of a year or period. However, such adjustments are subject to separate sets of rules, and often disregarded by customs authorities when the adjustments are downward.
- ▶ It is recommended that companies be permitted to perform customs value adjustments without being required to set up a provisional valuation procedure or being subject to penalties due to valuation adjustments.

P3 Simplicity in calculations

P3: It is recommended that in the event of post transaction transfer pricing adjustments (upward or downward); customs administrations accede to review the customs value according to one of the following methods as selected by the importer. These methods being applicable to the value of the goods impacted by the adjustment:

- ▶ A: Application of the weighted average customs duty rate: the weighted average customs duty rate is calculated by dividing the customs duties total amount for the year by the respective customs value total amount for the same year. This may include the possibility of a lump-sum adjustment at the end of the year.

For example, if at the end of the year, the TP adjustments result in an additional payment to the seller, then we recommend that the importer be able to report this lump-sum amount. That way customs will be able to allocate this to all entries declared within the year and the duty adjustment will be the weighted average duty rate.

- ▶ B: Allocation of the transfer pricing adjustment, according to the nomenclature code, and to information provided by the importer or customs authorities disclosing all commodity codes and all relevant import data available in their national statistics.

P4 Simplicity in reporting

P4: It is recommended that in the case of post transaction transfer pricing adjustments (upward or downward), companies be relieved from:

- ▶ The obligation to submit an amended declaration for each initial customs declaration. Instead, a single recapitulative return referring to all the initial customs declaration would be lodged.
- ▶ The payment of penalties, as variations of the transfer price. In fact, these variations depend on various factors which have absolutely nothing to do with an intention to evade customs duties.

P5 Flexible approach

P5: It is recommended that OECD methods be acceptable to customs administrations with an accommodation of the following elements:

- ▶ Identical or similar goods: recognition of the geographical and temporal circumstances of the market to enable a simplification in the level of requirements according to the needs of the country of import and to permit an approach based on market segment / regional area / comparable market conditions.
- ▶ Recognition of corporate legal entities (performing specific functions and adding value within a group) in order to enable customs authorities to acknowledge TP documentation and functional analysis in the broad economic context, and not narrowly according to the chronology of transactions.

P6 Recognition of transfer pricing documentation

P6: Recognition of the acceptability of TP documentation by the customs administration

- ▶ Tax transfer pricing documentation is a tax legal requirement almost all over the world. Its content is largely aligned across the countries and can hence be considered fairly standard. It normally includes all of the information required to analyse the circumstances of sale, the parties involved, the added value, and the functions performed by each party. It is recommended that customs requirements, in addition to those of tax authorities, be defined so as to enable incorporation of those requirements into TP documentation to serve both purposes.

Conclusion

This policy statement breaks new ground in a highly complex and contentious area within the global tax and customs world. It is to be expected that many around the world will contribute to this topic in the foreseeable future.