RECONCILIATION AND RECONSIDERATION OF CUSTOMS VALUATION*

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With the recent evolution of the National Customs Automation Program Test pertaining to Reconciliation, Customs valuation issues have once again risen to the forefront of international trade law. The U.S. Customs Service has held numerous meetings over the past year on both the Reconciliation Prototype ("RP") and Customs valuation issues in general. Many importers, particularly those who purchase goods from related parties, have expressed some concern about participation in the RP.

Related party issues lend themselves to resolution through participation in the RP, and have also highlighted the degree to which Customs valuation issues overlap with those of transfer pricing. Both U.S. Customs and the Internal Revenue Service are well aware of this overlap and are examining ways to find common ground on these issues. Importers involved in related party transactions should be aware of this overlap and how they can best utilize the RP not only to resolve adjustments in valuing merchandise for Customs purposes, but also in adjusting income for income tax purposes.

I. RECONCILIATION PROTOTYPE

Title IV of the *North American Free Trade Agreement Implementation Act*[1] established the National Customs Automation Program, an electronic system for the automatic processing of commercial importations. Since that time, Customs has launched several program tests for various issues associated with importing merchandise, such as antidumping duties.[2] The most significant prototype test, however, will commence on October 1, 1998 and run through September 30, 2000. The details of this test—the RP—were published in the *Federal Register* on September 30, 1997.[3]

The RP addresses four specific issues where the importer may not have all of the necessary information at the time of entry to supply to Customs.[4] By utilizing the RP, the importer files a Notice of Intent at the time of entry which identifies the deficient issue(s) and transfers those issue(s) to reconciliation.[5] This action separates the issue(s) from the underlying entries and allows liquidation of those entries in the normal course while preserving for resolution at a later date the flagged issue(s). The reconciliation itself is treated as an entry for purposes of liquidation, reliquidation, and protest.[6]

Of the four issues covered by the RP, valuation is the one issue where importers can derive the most benefit from participation. This is particularly true for multinationals, which have a large volume of related party sales. In the current compliance environment, importers are expected to use "reasonable care" in declaring the proper value of imported merchandise. Assigning a Customs value for imported goods at the time of entry under this standard often amounts to an educated guess. Sophisticated businesses know that the price for merchandise is always fluid and subject to adjustments based on internal accounting mandates or mandates imposed by the various tax revenue authorities who do not seek to assign a value to imported goods on the day of entry, as do the Customs authorities. Rather, the tax collectors look to annual income reported on a single tax return instead of numerous entries that are filed throughout the year. The RP finally gives importers—especially those with related party sales—a vehicle to approach the valuation of merchandise for Customs purposes in much the same manner as they do for income tax purposes, *i.e.*, value as determined by actual costs.[7]

II. METHODOLOGICAL DIFFERENCES

Notwithstanding the opportunity that the RP represents, certain differences between the methodologies used by the U.S. Customs Service and the Internal Revenue Service to value imported merchandise have made related party importers hesitant to attempt to harmonize the overlap in the agencies' approach to valuation. The agencies' methodologies, while different, nevertheless are driven by a common goal, that is, to ensure that the value of imported merchandise reflects an "arm's length" price. As demonstrated below, this commonality of purpose might allow importers to use the RP as an effective tool in developing a consistent approach for both Customs and tax purposes.

The vast majority of import transactions in the U.S. are appraised for Customs purposes under the "transaction valuation" methodology: the price actually paid or payable for the goods when sold for exportation to the United States, with adjustments added for packing costs, selling commissions borne by the buyer, the value of any "assist,"[8] royalties or

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license fees that the buyer is required to pay with respect to the goods, and proceeds of any subsequent resale, disposal, or use of the merchandise that accrue to the seller, either directly or indirectly.[9]

Although other valuation methodologies exist,[10] they are administratively difficult to administer at the ports of entry, and transaction value is therefore the strongly preferred method of appraisement. This is true even for related party sales, despite the somewhat misleading directive of 19 C.F.R. § 152.103(j)(2) that "transaction value may not be used if the buyer and seller are related, unless the relationship did not influence the terms and conditions of sale . . .."[11] In fact, transaction value is used for most related party sales (even though, as noted above, most of the transactions are subject to internal and external accounting adjustments after the date of entry that would seem to make a "computed value" approach more logical.)

These adjustments, necessary to the calculation of transaction value, can be taken into account through participation in the RP, when *actual* costs theoretically will be used to determine the transaction value of imported goods. Use of actual costs should go a long way in demonstrating to Customs that the price paid or payable for merchandise in related party situations is not influenced by the relationship between the buyer and seller, and that the circumstances of the sale are based on what a willing buyer would pay for the same merchandise if purchased from an unrelated seller.

Unlike Customs valuation, which focuses principally on transaction value, the I.R.S.'s goal for importers who purchase goods from related parties is to properly determine income for the taxpaying entities. Valuation of the imported merchandise is a large part of that process, but is only a means to an end—unlike in the Customs world, where the valuation is an end in itself. For purposes of transfer pricing under section 482,[12] the taxpayer must determine the "best method" among six different methodologies for determining value:

1. Comparable Uncontrolled Price
2. Resale Price
3. Cost Plus
4. Comparable Profits
5. Profit Split
6. Unspecified Methods

In effect, the regulations prescribe an evaluation of these methods as they relate to an individual taxpayer, taking into account the availability of accurate and reliable data for the potential application of each method, the degree of comparability between controlled and uncontrolled transactions or companies to which the methods are applied, and the number, magnitude and accuracy of adjustments required to apply the method.

All the methods seek to determine an arm's length price based on the comparability and quality of data and assumptions.[13] Nearly all of the IRS methods center on the determination whether an acceptable profit level is earned with respect to the transactions between related parties—hence the focus on valuation of merchandise.[14] Those transactions form the core of the analysis, with profit on those transactions being the prime variable in determining whether an arm's length transaction is present. The seller's profit determines its taxable income, and thus, the amount of tax it pays in a given year.

III. CONCLUSION

While the IRS valuation methodologies are different from Customs' transaction value and other methodologies, both agencies seek to derive a price for imported merchandise that reflects an arm's length transaction. Just as the agencies are now recognizing this inherent overlap in their respective methodologies, the RP presents importers who buy from related sellers with a vehicle to utilize this overlap to their advantage by using actual costs in determining the Customs value of imported goods. Given Customs' antiquated entry-by-entry approach to determining valuation, evolution of the RP may signal the beginning of a more business-oriented administration of the entry process and eventually move Customs to an era where the overlap in Customs and IRS valuation will lead to an annual "Customs return," just like an annual income tax return. Such a development would vastly decrease the administrative costs of importing and should be the first priority of importers during the coming millennium in international trade.

NOTES:

1. Pub.L. 103-182, 107 Stat. 2057 (December 8, 1993).

2. Testing of National Customs Automation Program components is provided for in 19 C.F.R. § 101.9(b). Several notices have been published in the *Federal Register* establishing and refining these tests. *See* 60 Fed. Reg 14,211 (March 16, 1995); 60 Fed. Reg. 35,105 (July 5, 1995); 60 Fed. Reg. 46,141 (Sept. 5, 1995); 61 Fed. Reg. 21,534 (May 10, 1996); and 62 Fed. Reg. 14,731 (March 27, 1997).

3. Modification of National Customs Automation Program Test Regarding Reconciliation, 62 Fed. Reg. 51,181 (Sept. 30, 1997). [**Ed. Note:** *See CR* issue 505 and the notice published at page 3 in this week's issue.]

4. These issues are (1) valuation, (2) classification, (3) "9802" merchandise, and (4) NAFTA goods.

5. The Notice of Intent is filed via an electronic indicator which attaches to the underlying entries.

6. For protest purposes, importers should be aware that liquidation of the underlying entries starts the 90-day protest clock for all issues *not* transferred to the reconciliation entry, and that liquidation of the reconciliation entry likewise starts the 90-day clock for *only* those issue(s) flagged for reconciliation.

7. Importers have voiced several concerns with the RP, among them the prohibition of 19 U.S.C. § 1401a(b)(4)(B) that any rebate of, or decrease in, the price actually paid or payable after the date of importation shall be disregarded in determining transaction value. In arriving at a transaction value based on *actual* costs, the RP clearly contemplates upward and downward adjustments to the value declared at the time of entry. Whether the statute prohibits the RP from recognizing downward adjustments is open to debate and may require a legislative fix.

8. "Assists", enumerated at 19 C.F.R. § 152.102(a)(1), are: (i) materials, components, parts, and similar items incorporated in the imported merchandise; (ii) tools, dies, molds, and similar items used in production of the imported merchandise; (iii) merchandise consumed in the production of the imported merchandise; and (iv) engineering, development, artwork, design work, and plans and sketches that are undertaken elsewhere than in the United States and are necessary for the production the imported merchandise.

9. 19 C.F.R. § 152.103(b).

10. *See* 19 C.F.R. § 152.101(b). The other methods, which must be applied in hierarchical order, are: transaction value of identical and similar merchandise, 19 C.F.R. § 152.104; deductive value, 19 C.F.R. § 152.105; computed value, 19 C.F.R § 152.106; and "other" value, 19 C.F.R. § 152.107.

11. If challenged by Customs, importers with related party importations must demonstrate either that the "circumstances of sale" did not allow the relationship to influence the price paid or payable, or that the price approximates certain test values. *See* 19 U.S.C. § 1401a(b)(2)(B); 19 C.F.R. § 152.103(j)(2).

12. Treas. Reg. § 1.482-3 (1994).

13. While prior regulations sought a single figure as the appropriate transfer price, current regulations permit a range of appropriate transfer prices. *See* Robert E. Culbertson, *A Rose By Any Other Name: Smelling the Flowers at the OECD's (Last) Resort*, 95 TNT 180-39, at 5 (1995). This may minimize the amount of adjustments needed to derive the actual costs for purposes of establishing transaction value under the RP because the declared value may already fall within the range of transfer prices called for under the IRS regulations.

14. The comparable uncontrolled price approach method does not look to profits, but instead evaluates the transaction between related parties by reference to the amount charged in a comparable uncontrolled transaction.