



# *The Arm's Length Standard*

*Global Transfer Pricing Developments  
Special Edition - August 1998*

## **Customs/Transfer Pricing Special Reports**

### **Canada**

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*In an increasing number of countries, the tension between the pricing of goods for Customs purposes and the pricing of goods for income tax purposes is receiving significant attention from the agencies charged with enforcement of Customs and tax laws. In this special edition of The Arm's Length Standard we present reports from Canada, Australia, New Zealand, the United Kingdom, the United States and South Africa, which provide a status report on the efforts being made in those countries to coordinate Customs and transfer pricing enforcement, and provide guidance for companies that seek to harmonize their Customs and transfer pricing policies.*

Several recent changes to Canada's Customs laws, transfer pricing laws and tax administration could spell trouble for companies that do not conduct a full analysis of their cross-border related party transactions for both income tax and Customs purposes. As a practical matter, many companies simply use their price as determined for income tax purposes in their transfer pricing study as their Customs value. As discussed below, the differences in Canada's substantive Customs law make it highly unlikely that the two values will, in fact, be the same. The collective impact of the differences makes it imperative for companies that import goods into Canada a related party to, at the least, conduct a full review of both their transfer pricing and their customs practices.

#### **Administrative changes**

In a significant change that may signal a shift in enforcement policies, on June 4, 1998, the Canadian government introduced legislation that would change the overall structure of Revenue Canada. The agency, which has traditionally functioned in three separate, autonomous divisions, would be the

"Customs and Revenue Agency" (Agency). This new Agency would be responsible for the administration of the Customs Act, Income Tax Act and Excise Act (GST) as well as the regulations associated with those Acts.

Simultaneous with the proposed change in structure, the legislature is considering granting specific authority to the agency's auditors to share information with each other, regardless of the specific tax being examined. To date, the lack of explicit authority to share information has stymied transfer pricing auditors from obtaining information bearing on a company's Customs practices and alerting a Customs auditor to open an audit. With the proposed legislative changes, it is to be expected that auditors will be more alert to potential income tax/Customs discrepancies. This effort is also aided by the increased effort on the part of the Agency to cross-train auditors to be conversant in all of the revenue acts. Thus, while an income tax auditor might not be able to conduct a Customs audit, he or she will be able to "issue spot" and alert a Customs auditor to a potential Customs adjustment.

acceptable value for duty, if it is the "first sale" of the goods for export to the EU. The first sale for export of the goods, as compared to the final price for all the functions of a multinational corporation purchased by the importer, is capable of separate recognition and can produce easily managed and reconcilable differences. The justification of the difference is usually equivalent to the levels of proof the two authorities look for before sanctioning the prices.

Second, the transfer pricing adjustment, if required, may be made by adjusting the prices of imports made later in the year. Some may argue that this arrangement is a price reduction for the earlier sales and is wholly influenced by the association of the parties. But Customs officials are fundamentally pragmatic and provided such arrangements are made with good reason and give certainty at the time the import declaration is made they are not immediately rejected.

Another strategy for handling the differences might be to separately

invoice the price of the goods and those less tangible costs that are often not liable to duty. Management charges, pure research costs and advertising that will be part of the transfer price can all be considered in this category.

As for certainty; advance pricing agreements may be made with the Inland Revenue, but they do not exist under this name with Customs. Nevertheless, Customs may accept a declaration of the methodology for determining the customs value, which is valid for three years, so long as the stated conditions do not change.

**Conclusion**

There is no single approach a company may use which will provide absolute certainty that both its transfer prices and its customs valuations will be accepted by the respective UK taxing authorities. Recent events strongly suggest that the authorities are sharing information and strategies with each other, which heightens the need for companies to develop a coordinated tax and customs policy in the UK.

**United States**

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Both the US Customs Service ("Customs") and the Internal Revenue Service ("IRS") have the duty to evaluate cross-border related party transactions, to ensure that the value of imported merchandise reflects an "arm's length" price. Despite this common goal, there are very practical differences in the Customs and tax approach to the item to be valued, the relevant time for valuation, and the level of detail needed for the valuation. These differences can leave a poorly-prepared taxpayer whipsawed between the two agencies, exposed to expensive, time-consuming audits and additional tax liabilities.

From a Customs perspective, importers who purchase goods from related sellers must declare the correct dutiable value of specific imported goods on a transaction-by-transaction basis. This value is typically based on the transfer price

established for tax purposes. The relevant time for determining the correctness of a transfer price for Customs purposes is the date of entry of the item into the US.

The tax rules seek to allocate income between related parties to achieve the clear reflection of income and prevent income shifting between jurisdictions. The relevant time for determining the correctness of a transfer price for tax purposes is the date on which the tax return is filed. [*Treas. Reg. §1.482-1(a)(3).*] The IRS's goal of clear reflection of income does not require that the valuation be correct for each transaction, but only that the cumulative transactions for the year produce an appropriate income result. This difference allows for aggregation of transactions and offsetting adjustments for tax purposes. [*Treas. Reg. §1.482-1(g)(4)(i).*]

### Customs approach

The majority of import transactions in the US 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 US, with adjustments added for packing costs, selling commissions borne by the buyer, the value of any "assist," royalties or license fees that the buyer is required to pay, and proceeds of any subsequent resale, disposal, or use of the merchandise that accrue to the seller, either directly or indirectly. [19 C.F.R. §152.103(b).]

Although other valuation methodologies exist, they are administratively difficult to administer at the ports of entry, and transaction value is therefore the strongly preferred appraisement method. This is true even for related party sales, despite the somewhat misleading directive of 19 CFR §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 of the sale . . ." In fact, transaction value is used for most related party sales even though most of the transactions are subject to internal and external accounting adjustments after the date of entry that make the value of any given product a "moving target." Therefore, Customs' practice of valuing imported merchandise on the date of entry is a somewhat outdated approach that does not reflect today's business practices.

### IRS approach

The IRS's goal for importers that purchase goods from related parties is the overall determination of income. Valuation of the imported merchandise is a large part of that process, but is only a means to an end — unlike the Customs approach, where valuation is an end in itself. To set a proper transfer price under §482, the taxpayer must determine the "best method" among six different methodologies for determining value: comparable

uncontrolled price; resale price; cost plus; comparable profits; profit split; and unspecified methods.

The regulations require taxpayers to judge the relative reliability of the methods taking into account the availability of accurate and reliable data, the degree of comparability between controlled and uncontrolled transactions or companies, and the number, magnitude and accuracy of adjustments required to apply the method. Nearly all of the IRS methods focus on whether an acceptable profit level is earned with respect to the transactions between related parties, with profit on those transactions being the prime variable in determining whether an arm's length transaction is present.

### Overlap of tax and customs enforcement

In response to a concern that the transfer price reported for tax purposes could substantially exceed the price reported for customs purposes, allowing related parties to avoid federal tax or customs duties, Congress added §1059A to the Code in 1986.

Section 1059A applies to any property imported into the US in a transaction between related persons within the meaning of §482. While §1059A does not limit the authority of the IRS to increase or decrease the claimed basis or inventory cost under §482, [Treas. Reg. §1.1059A-1(c)(7).] it does preclude importers from claiming a higher tax basis for imported property than the reported Customs value. The §1059A regulations apply the Customs value basis limitation to all transactions between controlled taxpayers, excluding imported items that are not subject to Customs duties, and subject to certain allowable adjustments. If an item or a portion of an item is not subject to Customs duty, or is subject to a free rate of duty, that item or portion of the item is not subject to the coordination provision. [Treas. Reg. §1.1059A-1(c)(1).]

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#### Agency coordination efforts

When assigning Customs values, most importers who purchase from related parties base that value on the transfer price because they know that the goal of the two agencies is the same, i.e. to find the arm's length price.

The government is now catching up to the trade community and is seeking ways to sanction the overlap in the two methodologies. Numerous public meetings have been held at U.S. Customs Headquarters in Washington with the participation of high level officials from the IRS and from the related party importers. While no formal decisions have been made by either agency, importers can expect the ongoing dialogue between the IRS and Customs to continue and should actively seek to participate in the process so that business concerns can be factored into the eventual outcome of these discussions.

#### Mod Act

In late 1993, Congress—at the strong urging of the U.S. Customs Service and in cooperation with the trade community—passed the Customs Modernization Act (“Mod Act”). This legislation radically changed the rules of the road for importers because it placed full legal responsibility for classification and valuation of imported goods on the importer. Before the Mod Act, importers had usually supplied “best guess” information to Customs and it was the agency’s responsibility to determine whether such information complied with the law. Since the Mod Act, importers have been obliged to fully exercise “reasonable care” and report correct information pertaining to imported goods to the U.S. Customs Service. Failure to exercise reasonable care may subject the importer to audits, investigations, fines and penalties which are much more severe than those imposed for violations of the tax laws.

#### Reconciliation

Title IV of the North American Free Trade Agreement Implementation Act [ *Pub. L. 103-182, 107 Stat. 2057*

(December 8, 1993).] 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. 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. [*Modification of National Customs Automation Program Test Regarding Reconciliation, 62 Fed. Reg. 51,181 (Sept. 30, 1997).*]

The RP addresses four issues [valuation, classification, “9802” merchandise, and NAFTA goods], where the importer may not have all of the necessary information at the time of entry to supply to Customs. 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. This action separates the issue(s) from the underlying entries and allows liquidation of those entries in the normal course while preserving the flagged issues(s) for later resolution. The reconciliation itself is treated as an entry for purposes of liquidation, reliquidation, and protest. 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.

Of the four issues covered by the RP, related party importers derive the most benefit from valuation, because the exact value of imported goods on the day of entry is often not known. As noted above, assigning a Customs value for imported goods at the time of entry 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 tax revenue authorities who do not assign a value to imported goods on the day of entry. 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.

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.

## Conclusion

While the IRS and the Customs 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.

## South Africa

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### Introduction

In South Africa, as in many countries, there is a strong possibility of conflict between the income tax laws and the customs laws regarding the proper value to assign to goods that are subject to a cross-border transfer between related parties.

The following hypothetical scenario illustrates the issue. A camera manufacturing company in the United Kingdom wishes to enter the Southern African market, and in order to do so, establishes a local subsidiary to distribute its products. The question then arises as to what is the appropriate transfer price for the cameras sold to the South African company.

Theoretically, the transfer price could simply be determined by market

forces, but in reality the process is not that easy. For example, the UK parent could adopt a business strategy to capture market share that would require the product to be sold in South Africa initially at a low price. Where the local subsidiary has outside shareholders, however, they may not be prepared to accept initial trading losses, and the UK parent could then agree to reduce the initial transfer price between the related parties, thereby allowing the subsidiary to show a profit.

A decision of this nature could have significant tax, duty and other related consequences, (such as the possibility of being charged with "dumping" by competing local manufacturers), and accordingly, when faced with such a decision a company must consider both the