



TRANSFER PRICING



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REPORT

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HIGHLIGHTS

Dutch to Publish APA Information, Address Harmful Tax Competition Critics

The Netherlands unveils an extensive redesign of its transfer pricing policies, including plans to become the first tax authority to release summaries or anonymous versions of advance pricing agreements. Practitioners say the various changes to the transfer pricing practices are aimed at assuaging criticisms that the Netherlands tax authority encourages harmful tax competition. **Lead Report, Page 443; Text, Page 456**

NTA Circular Provides Guidance on Comparables, Profit Splits

Japan's National Tax Administration issues a revised directive that reflects the agency's current policies on adjusting comparables, calculating arm's-length prices, and using profit split methods. . . . In a review of NTA practices, a government agency says the tax authority's ambiguous laws and guidelines have caused protracted delays in completing APAs and settling cross-border cases. **Page 452; Page 452**

Australia Issues Guidelines for Double Tax Relief, Draft Ruling on PEs

The Australian Taxation Office clarifies procedures for taxpayers seeking relief from double taxation caused by a profit reallocation. . . . A draft ATO ruling would confirm that permanent establishments must apply the arm's-length principle and other transfer pricing concepts to transactions between separate related parties and the PE. **Page 454; Page 453; Text, Page 514**

ANALYSIS

Practitioners Discuss Process of Joint Customs-IRS APA

A U.S. Customs Service ruling allowing the taxpayer to use prices negotiated in the Internal Revenue Service's APA Program may signal the next step toward greater coordination between Customs and the IRS, say three practitioners from Deloitte & Touche LLP. Steven C. Wrappe, Damon Pike, and Kerwin Chung outline the customs valuation methods and the process that led up to the ruling. **Page 549**

PERSPECTIVE

New Zealand's Revised Transfer Pricing Guidelines Examined

PricewaterhouseCoopers practitioners, Stean Hainsworth in Wellington and Jenny Croker in Auckland, discuss how New Zealand's final transfer pricing guidelines will raise questions about use of secret comparables and other issues. **Page 552; Text, Page 461**

ALSO IN THE NEWS

ADVANCE PRICING AGREEMENTS:

The IRS completes a record 61 APAs in fiscal 2000, bringing the number of total completed agreements to 271. **Page 446**

APPEALS:

United Parcel Service of America Inc. tells the U.S. Court of Appeals for the Eleventh Circuit it has no claim to income earned by Bermuda insurer Overseas Partners Ltd. **Page 447**

MOTIONS:

The government again asks a federal court to dismiss the lawsuit brought by Aloe Vera of America Inc. seeking damages from the IRS. **Page 447**

APPEALS:

A bank contests a Tax Court ruling that blocked the deduction of an \$85.6 million loss on a sale of loans to its U.K. parent. **Page 448**

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Analysis

Joint APA Effort Signals New Level of IRS-Customs Coordination

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Although both the U.S. Customs Service and the Internal Revenue Service are sister agencies within the Department of Treasury, their jurisdictions are inherently in conflict. The IRS, through its enforcement of Section 482, decreases the value of imported goods when it determines the transfer price has been set artificially high, while Customs, in its collection of customs duties, increases the price of those goods when it finds that the stated value of imported property is too low. As a step toward resolving this conflict, Congress in 1986 added Section 1059A to the Internal Revenue Code, which requires that the value of imported property reported for income tax purposes be no higher than the value reported for customs duty purposes.¹

In what may signal the next step toward greater coordination between the agencies, on Aug. 30, Customs issued a ruling allowing a taxpayer that imports merchandise from related parties to declare values for the imported goods based on prices established in a bilateral advance pricing agreement. This is the first case where Customs allowed a taxpayer/importer to obtain certainty for its customs valuation declarations, thus eliminating the taxpayer's exposure to customs examinations, adjustments, and penalties. The ruling may provide an opportunity for Customs to expand its ruling process to provide certainty on a more routine basis, as well as for other tax authorities with APA procedures to provide a greater degree of certainty with respect to their local customs laws.

Reconciling Customs, Section 482

For years, importers have struggled to reconcile the divergent tax and customs valuation rules concerning merchandise imported from related parties. Most importers use the transfer prices determined under Section 482 to set customs values without any in-depth con-

¹ Section 1059A does not allow a taxpayer to adjust upward its cost basis or inventory cost under Section 482 because the cost is less than the Customs value for the same property.

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sideration of the customs valuation methodology. Since the IRS and Customs enforce their respective statutes from different perspectives, this approach has left many importers exposed to customs audits, investigations, and penalties.

IRS enforcement of Section 482 is designed to ensure the clear reflection of income arising from related party transactions. In this sense, determining the correct transfer price is the means to an end, i.e., the clear reflection of income. Customs enforcement, however, is designed to determine the correct appraised value. In this sense, determining the correct transfer price is not the means to an end, but rather is the end itself.

IRS and Customs also apply their rules differently. As stated above, the IRS applies Section 482 to determine income, whereas Customs applies the customs statute to determine value. In addition, the IRS applies Section 482 based on information reported on the taxpayer's tax return, which is filed after the year in which the import occurred. Customs, on the other hand, seeks to determine the correct appraised value on the date of entry.

Lastly, the IRS and Customs have different valuation methods.

Customs Valuation Methods

The goal of customs valuation is to determine the value of imported goods at the time of shipment from the exporting country. Unlike the five transfer pricing methods,² the customs valuation methods are hierarchical and must be applied in order of priority of use.

The customs valuation statute prescribes five methods:³

- (1) Transaction value;
- (2) Transaction value of identical or similar merchandise;
- (3) Deductive value;
- (4) Computed Value; and
- (5) "Adjusted" value (the "fall-back" method)

Although these methods are different from those prescribed by the Section 482 regulations, both sets of methods have as their goal the determination of an arm's-length value.

a) Transaction Value

Transaction value is the preferred method for valuing imported goods under the statute.⁴ The transaction

² For a description of the Section 482 methods, see Regs. §1.482-3.

³ 19 U.S.C. 1401a.

⁴ 19 U.S.C. 1401a(a)(1).

value of imported goods is equal to its appraised value, i.e., the price actually paid or payable when sold for export to the United States, but only if:⁵

- (1) There are no restrictions on the disposition or use of the goods by the buyer other than restrictions that are (i) required by law, (ii) limit the geographical area in which goods may be resold, or (iii) do not substantially affect the value of the goods;
- (2) The sale of, or the price actually paid or payable for, the goods is not subject to any condition or consideration for which a value cannot be determined;
- (3) No part of the proceeds of any subsequent resale, disposal, or use of the goods by the buyer will accrue, directly or indirectly, to the seller, unless an appropriate adjustment is made; and
- (4) The buyer and seller are *not* related, unless (i) the facts and circumstances indicate that the relationship did not influence the price paid or payable (the "circumstances of sale" rule"), or (ii) if the value of the imported goods closely approximates the transaction value of identical or similar merchandise sold to unrelated buyers in the United States or the deductive value for identical or similar merchandise.

The transaction value also includes the following amounts to the extent that they are not otherwise included in the price actually paid or payable:⁶

- (1) Packing costs incurred by the buyer;
- (2) Selling commissions incurred by the buyer;
- (3) The value of any assist (apportioned as appropriate);⁷
- (4) Any royalty or license fee (whether paid directly or indirectly); and
- (5) The proceeds of any subsequent resale, disposal, or use of the goods that accrue to the seller (directly or indirectly).

Transaction value is the preferred method of appraisal. This is true even for related party sales, despite the somewhat misleading directive 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. . . ." 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.

b) Transaction Value of Identical or Similar Property

If the transaction value, as described above, cannot be applied, the value of imported goods can be deter-

mined by looking at the transaction value of identical or similar property.⁸

c) Deductive Value

Deductive value is determined by taking the resale price of the imported goods and deducting the following amounts: commissions, transportation and insurance costs, customs duties and other federal taxes, and the value of any processing done in the United States.⁹

d) Computed Value

Computed value is determined by adding the following amounts: (i) the cost of materials and fabrication or other processing; (ii) an amount of profit and general expenses of the same class of goods; (iii) any assists; and (iv) packing costs.¹⁰

e) Other Valuation Methods

If none of the above methods can be successfully applied to determine the value of imported goods, such methods may be reasonably adjusted to determine value.¹¹

Advance Resolution

While the most efficient way to resolve a transfer pricing dispute would be through an APA, until now, no corresponding procedure allowed importers to obtain similar certainty for customs purposes.

In this case, the importer, a U.S. wholesale distributor, filed a Customs ruling request in early 1998 seeking to validate the declared values using the transfer prices developed under a bilateral APA. During the APA negotiating process (and while the ruling request was pending at Customs), a Customs representative participated at the request of the importer. This involvement during the actual APA negotiations played a central role in Customs' analysis and made it easier for the agency to issue a favorable ruling.

In its ruling, Customs noted that merchandise imported into the United States is generally appraised in accordance with section 402 of the Tariff Act of 1930¹² and that the preferred method of appraisal is "transaction value."¹³ The agency further noted that transaction value (the "price actually paid or payable") between related parties is acceptable if the importer demonstrates that the circumstances of sale (COS) demonstrate that the declared values are arm's length.

In determining whether the COS test had been satisfied, Customs found that "the information submitted during the APA negotiation process constituted valuable information in applying the COS test . . ." Customs noted that the importer's invitation to participate in the APA process allowed it to review the selection of the tested party, how the comparable companies were selected, the determination of financial results related to the controlled transactions, the selection of the years for comparison, what accounting adjustments were made to the financial statements of the comparable companies and the tested party, the selection of the

⁵ 19 U.S.C. 1401a(b)(2).

⁶ 19 U.S.C. 1401a(b)(1).

⁷ Assists cover items such as design and engineering work performed outside the United States, tooling and machinery used to produce the imported goods, and items consumed in the production of the imported merchandise. An item is not considered an assist unless the seller provides it to the buyer free of charge or at reduced cost.

⁸ 19 U.S.C. 1401a(c).

⁹ 19 U.S.C. 1401a(d).

¹⁰ 19 U.S.C. 1401a(e).

¹¹ 19 U.S.C. 1401a(f).

¹² 19 U.S.C. §1401a

¹³ Even though the Section 482 regulations do not prioritize the transfer pricing methods, it should be noted that the comparable profits method has been used in 58 percent of the completed APAs.

most reliable profit level indicator, the capital adjustments, and the use of the interquartile range.

Customs also cited the tests contained in its regulations for determining that the relationship between the parties did not influence the price, including that "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."¹⁴ Customs stated that the bilateral nature of the APA negotiations was persuasive in finding that this requirement was satisfied because it ensured that both the IRS and the foreign tax authority reviewed the pricing information—including profit margins—and negotiated a fair result for both taxing authorities.

Customs agreed with the importer's position that the information submitted in the APA request provided Customs with the necessary profit information to conclude that the COS test was met. Thus, it found, the transaction value was the proper method. Specifically, Customs then held that:

[o]ur review of the information, including attending the APA prefiling conference and review of information submitted to the IRS . . . allows us to conclude that we have examined the relevant aspects of the transaction, including the way in which the importer and its related suppliers organize their commercial relations, as well as the way in which the price in question was arrived at between the parties. Based on this review, we hold that the [i]mporter has demonstrated that

¹⁴ 19 C.F.R. § 152.103(l).

the price has not been influenced by the relationship for purposes of the COS test.

Customs was careful to note that it normally requires more detailed information on the valuation of imported merchandise and generally prices information on a product-by-product level. In this ruling, it did not require the importer to provide Customs with a further breakdown of product line profitability for comparability since the APA covered all of the imported products.¹⁵ However, Customs stated that in any future verification it expected the importer to demonstrate that the profit earned by product line falls within the agreed-upon range specified in the APA.¹⁶

This landmark ruling signifies a marked shift in the manner in which Customs approaches valuation and also adds significant value to the APA process. Importers may now achieve certainty on both their transfer prices and their customs valuation for little additional cost.

However, Customs and the IRS's willingness to work closely could spell trouble for taxpayers that take inconsistent positions for Customs and tax purposes. In time, we are hopeful that other countries with APA programs will also develop a similar process to provide certainty about their own customs laws.

¹⁵ The IRS does not require taxpayers to include all of their intercompany transactions in the APA negotiations.

¹⁶ This "product line" issue is extremely relevant in the computation of duties because the duty rate for all imported merchandise is determined by the Harmonized Tariff Schedule of the United States classification—which is determined on a product-by-product basis.