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**A Single Solution for U.S. Transfer  
Pricing and Customs Issues**

by Damon V. Pike, Koichiro Fujimori,  
and Kerwin Chung

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# A Single Solution for U.S. Transfer Pricing and Customs Issues

by *Damon V. Pike, Koichiro Fujimori, and Kerwin Chung*

*Damon V. Pike, director, Deloitte & Touche's Customs and International Trade Services Group, Atlanta, Georgia; Koichiro Fujimori, transfer pricing manager, Deloitte & Touche's Washington National Tax office (on secondment from the Tokyo office of Deloitte Touche Tohmatsu); and Kerwin Chung, transfer pricing senior manager, Deloitte & Touche's Washington National Tax office.*

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**T**ransfer pricing and customs duty issues are two of the most important issues facing multinational corporations that import goods into the United States. While transfer pricing and customs rules both have the same goal of determining the arm's-length price for imported goods, the U.S. Internal Revenue Service and the Customs Service employ different methodologies. That may result in importers being whipsawed if the IRS claims that the importer paid too much and Customs claims that the importer paid too little.

Recognizing that their actions may result in undue hardship for importers, the IRS and Customs have been working with importers and their advisors to address the problem. The early results of that collaboration are two rulings that allow importers to coordinate their transfer pricing and customs compliance efforts.

## Transfer Pricing vs. Customs

### Different Paths to the Same Goal

Although the IRS and the Customs Service are both agencies in the Department of Treasury, their jurisdictions conflict. Transfer pricing and customs regulations seek to determine an arm's-length price for imported goods; however, the IRS and the Customs Service apply different substantive legal requirements to achieve that goal.

The IRS applies section 482 to determine an importer's income, whereas Customs applies the Customs statute to determine the value of imported goods.

The section 482 transfer pricing regulations list six methodologies — five specified and one unspecified — for determining the arm's-length price of tangible goods. Under Treasury reg. section 1.482-1(c)(1), importers must use the method that provides “the most reliable measure” of an arm's-length result. Those methods are the comparable uncontrolled price (CUP) method, the resale price method, the cost-plus method, the comparable profits method, the profit-split method, and unspecified methods.

In contrast, under 19 U.S.C. 1401a, there are five separate customs methodologies, ranked in the following order of priority: transaction value, transaction value of identical or similar merchandise, deductive value, computed value, and “adjusted” value (the fall-back method).

The IRS bases its enforcement efforts on information reported on the importer's tax return, which may be filed up to 8½ months after the close of the tax year. Transfer pricing penalties are equal to 20 percent or 40 percent of the underpaid tax, depending on the amount of the transfer pricing adjustment.

Conversely, in its enforcement efforts, Customs seeks to determine the correct appraised value on the date of entry. Customs penalties may range from the lesser of 200 percent of the underpaid duty or 20 percent of the dutiable value, to as high as the dutiable value of the imported goods.

***The ruling was a breakthrough for multinational corporations striving to achieve certainty on both their transfer pricing and customs valuations.***

## **Section 1059A — Some Convergence**

Under IRC section 1059A, the inventory basis of imported merchandise cannot exceed the declared customs value, with minor adjustments for costs, including international freight and insurance.

Therefore, taxpayers must reconcile two distinct goals: declaring a low value for imported goods and not running afoul of section 1059A, without which importers would compute a high inventory basis to obtain the largest deduction on their corporate income tax return.

Because taxpayers often determine the appropriate intercompany pricing based solely on section 482, without regard to the section 1059A “cap,” they inadvertently increase their Customs exposure and run the risk of increased examinations, adjustments, and penalties.

## **Innovative Customs Rulings**

### **Customs APA Ruling**

In a step toward resolving the jurisdictional conflict, Customs issued a landmark ruling on 30 August 2000 (HQ Ruling 546979). The ruling allows an importer that purchases merchandise from its foreign related parties to declare values for the imported goods based on prices established in a bilateral advance pricing agreement.

The case involved a bilateral APA requested by a large Japanese multinational corporation and its U.S. subsidiary. The U.S. subsidiary was a distributor, in the North American market, for consumer durable goods manufactured by the Japanese parent. All product design and development, as well as manufacturing, was done by the Japanese parent.

The taxpayers, assisted by Deloitte & Touche, conducted a transfer pricing study based on the comparable profits method (CPM). The CPM set an interquartile profitability range with considerations for results yielded by another transfer pricing approach, the profit-split method. The importer also applied to Japan and the United States for a bilateral APA.

While the APA was being negotiated, the U.S. subsidiary filed a customs ruling request seeking to validate the declared values using the transfer prices developed under the bilateral APA. A Customs representative participated in the APA negotiation process, at the request of the U.S. importer. That participation 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 the ruling, Customs stated that product imported by a U.S. distributor from its Japanese parent into the United States is generally appraised under section 402 of the Tariff Act of 1930. Customs found that the information submitted during the series of APA negotiations constituted a basis for the U.S. distributor to demonstrate that the circumstances of sales (COS) did not influence the price, and that the import values were, thus, arm’s length.

The ruling was a breakthrough for multinational corporations striving to achieve certainty on both their transfer pricing and customs valuations. Customs accepted the CPM result in the bilateral APA, and did not require any further breakdown of product line profitability.

However, Customs specifically noted in the ruling that the bilateral nature of the APA was persuasive in satisfying the COS test. In other words, Customs found that the National Tax Administration of Japan represented Customs’ position in the APA negotiations. Because the bilateral APA resulted from negotiations between two competing foreign authorities,

Customs accepted the result under the transfer pricing methodology, rather than a pure customs valuation application.

### **Transfer Pricing/First Sale Ruling**

Customs issued another innovative ruling (HQ Ruling 547382) on 14 February 2002. In that ruling, Deloitte & Touche helped a multinational corporation obtain a “first sale” Customs ruling based on section 482 methodology. Customs accepted the section 482 methodology, even though no foreign tax authority was involved, nor was there any outstanding transfer pricing issue.

The Customs ruling involved the sale of products manufactured by a U.K. manufacturer. The U.K. manufacturer sold the products to a U.S. importer through a U.K. related party. The U.K. related party was responsible for marketing, operations, product distribution, sales, and some product design and development of the products. Under the sale terms, the U.K. related party maintained title until all the payments were made.

Customs accepted that an arm’s-length transaction had taken place for Customs valuation purposes, on the basis of a section 482 transfer pricing documentation study. Specifically, Customs found the COS demonstrated that the relationship between the parties did not influence the first sale price, and that the price was supported by the transfer pricing study based on the IRS’s standards in section 482.

In ruling that the first sale price could serve as the basis for the appraisal of the imported goods, Customs relied on: a comparables study based on a functional analysis; financial statements for the U.K. related party, showing its profit and loss information for the U.K. manufacturer; and a capital adjusted interquartile profitability range for independent U.K. comparable companies.

### **Conclusion**

The two new Customs rulings represent the first steps toward ameliorating transfer pricing and Customs headaches for importers, and may open the door to additional coordination of transfer pricing and customs enforcement efforts. ♦