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Of all the agencies of the U.S. federal government, none was so thoroughly transformed by the terrorist attacks of September 11, 2001 as U.S. Customs and Border Protection (“CBP” or “Customs”). In a matter of months, the agency was moved from the Department of the Treasury (where it had resided for 215 years) to the freshly-minted Department of Homeland Security. Its new mission was directed squarely towards supply chain security and intercepting potentially destructive cargo containing biological weapons or those of mass destruction. CBP’s long-standing focus on trade facilitation and its key role in helping feed America’s voracious appetite for imports were allowed to languish while the agency re-tooled itself and created a new security framework for global traders.¹

Now, nearly six years later, Customs appears to be re-gaining its grip on the role which importers and taxpayers had come to appreciate it playing: that of “partner” to the trade; an agency which responds to the concerns of multinational companies that account for the vast majority of goods traded across borders when measured by value. Its new “Office of International Trade” at Customs HQ in Washington, D.C. is one outward manifestation of this shift, but more important is the substantive re-focus on long-standing issues which had taken a “back seat” to security concerns. And value – the price declared to CBP when goods are imported – is the one issue which, once again, has risen to the top of the list of CBP decision-makers as well as tax and trade executives. Why?

First and foremost, the duties which CBP collects are primarily calculated on an *ad valorem* basis (as a percentage of the declared value). Hence, the declared value (normally the invoice price) has a direct impact on how much revenue the U.S. government collects, that is, the lower the value, the lower the duties. With duty rates hovering at or near zero for a wide range of products, CBP’s intense interest in this topic is understandable: preserving the “slices of a shrinking pie” comes naturally to any organisation which, under constant pressure from congressional budget-cutters, must continually justify its role as chief border guard and trade facilitator.

In addition, many importers have discovered (oftentimes the hard way, after a disruptive audit or unpleasant formal investigation) that the seemingly odd manner in which the U.S. Customs penalty statute is written imposes much higher

penalties on companies which pay zero duty than those which DO pay duty on their imported products.²

Finally, because of the impact of FASB Interpretation No. 48 (FIN 48: “Accounting for Uncertainty In Income Taxes”), U.S. executives have rightfully ramped up their focus on one of the most complicated and contentious areas for income tax compliance: transfer pricing under section 482 of the Internal Revenue Code. See 26 U.S.C. Section 482.

This heightened interest in proper transfer pricing dovetails with the renewed interest in trade facilitation that U.S. Customs is now demonstrating by seeking ways to reconcile its rules pertaining to “transaction value” with those of the income tax authorities, thus lessening the administrative burden of documenting compliance with two different sets of rules. Other customs authorities around the globe, most notably those in Australia, are also attuned to this critical issue, and are closely watching CBP’s lead.³ This article will review the rules for transaction value, discuss the ground-breaking rulings issued by U.S. Customs as well as the new “Informed Compliance Publication” released in April of 2007, and conclude by highlighting the issue of transfer pricing compensating adjustments, which further tangles the intersection between the tax and customs disciplines.

Transaction value

Like all major trading nations, the United States adopted the GATT (now World Trade Organisation) Valuation Agreement of 1979 in enacting laws which set forth the methods for valuing imported merchandise. “Transaction value”, the principal methodology employed by importers when declaring a basis of appraisal to CBP, is defined as “the price actually paid or payable for the merchandise when sold for exportation to the United States . . .”⁴ The U.S. statute (known as the “Trade Agreements Act of 1979”, as amended) also directs that transaction value be adjusted by adding amounts equal to:

- the packing costs incurred by the buyer;
- any selling commission borne by the buyer related to the imported merchandise;
- the value of any “assist,” apportioned as necessary;
- any royalty or license fee that the buyer is required to pay, directly or indirectly, as a condition of sale with respect to the imported merchandise; and
- the proceeds of any subsequent resale, disposal, or use of the merchandise that accrue, directly or indirectly, to the seller.⁵

The following items constitute “assists”:

- materials, components, parts, and similar items incorporated in the imported merchandise;
- tools, dies, moulds, and similar items used in the production of the imported merchandise;
- merchandise consumed in the production of the imported merchandise; and
- engineering, development, art work, design work, and plans and sketches undertaken elsewhere than in the United States and are necessary for the production of the imported merchandise.⁶

In an awkward bit of draftsmanship, the customs valuation statute states 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, the price includes non-cash consideration that cannot be valued, or compensation is dependent in whole or in part upon the price realised upon the occurrence of a future event that cannot be quantified in a reasonable period of time.⁷ Should importers choose to apply transaction value, it must be demonstrated that an examination of the “circumstances of the sale” of the imported merchandise indicates that the relationship between the buyer and the seller did not influence the price paid or payable. See 19 U.S.C. Section 1401a(b)(2)(B).

In a departure from the GATT Valuation Agreement, the United States added a provision in the Trade Agreements Act which has taken on heightened importance in light of today’s transfer pricing debate. The provision states that

“any rebate of, or other decrease in, the price actually paid or payable that is made or otherwise effected between the buyer and seller after the date of importation of the merchandise into the United States shall be disregarded in determining the transaction value...” 19 U.S.C. Section 1401a(b)(4)(B).⁸

The significance of this provision will be discussed below.

Taken as a whole, the U.S. Customs valuation statute and implementing regulations (19 C.F.R., Subpart E) seek to ensure that the basis of appraisal declared to Customs by importers purchasing goods from related sellers represents an “arm’s length” price, and that any payments related to the imported merchandise which are not reflected in the commercial invoice price are nonetheless reported to Customs as part of the transaction value.⁹ In practice, this is the same price that one arrives at upon application of the income tax transfer pricing rules; indeed, the terms “transfer price” and “customs value” are now used almost interchangeably by tax and trade professionals.

U.S. Customs rulings and 2007 “Informed Compliance” publication

When the customs valuation statute was written in 1979, formal transfer pricing rules for income tax purposes did not exist in most jurisdictions. When the Internal Revenue Service finally issued its full set of formal rules in 1994, taxpayers recognised the impact that these rules had on their customs valuation declarations for imported merchandise: the amount of profit allocated to a given taxable jurisdiction was primarily dependent on the cost of goods sold captured in a company’s accounting books. The cost of goods sold figure essentially captures the total of all invoice prices (used as the basis of appraisal for

imported goods) in a given fiscal year. When profit (and thus taxable income) for tangible property needs to be re-allocated to meet the transfer pricing rules, this is normally accomplished through a “compensating adjustment” which increases or decreases the cost of goods sold.

While taxpayers increasingly sought rulings from U.S. Customs in the late 1990s to obtain guidance on the use of transfer prices for income tax purposes to support their declared customs values, it was not until after the advent of the Advance Pricing Agreement (“APA”) programme at the IRS that a taxpayer/importer presented a ruling request to U.S. Customs in 1999 which directly asked the agency to rule on the use of transfer pricing methodologies as a means of validating transaction value.

The ruling which was ultimately issued on August 30, 2000 (HQ546979) marked the “turning point” in how U.S. Customs approached the transfer pricing conundrum. In a nutshell, the importer sought to overcome the disconnect between the aggregate nature of transfer pricing reporting (one tax return, one figure for cost of goods sold in a fiscal year, one amount of taxable income, etc.) and CBP’s focus on transaction-based reporting (for each shipment/importation) and – in particular – the nature of line-item reporting based on a product’s tariff code.¹⁰ It invited CBP to participate with the IRS and a foreign tax authority in negotiations to secure a bilateral APA and issue a ruling validating the use of transaction value as the basis of appraisal.

In ruling in favour of the importer, CBP found that “the information submitted during the APA negotiation process constituted valuable information in applying the circumstances of sale (“COS”) test...” Customs noted that the importer’s invitation for the agency to participate in the APA process allowed CBP 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 most reliable PLI (Profit Level Indicator), the capital adjustments, and the use of the interquartile range.¹¹

Customs also cited the traditional 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 realised over a representative period of time in sales of merchandise of the same class or kind”.¹² Customs stated that the bilateral nature of the APA negotiations was persuasive in satisfying this requirement given 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.¹³

CBP was careful to note two items in its conclusion. First, the agency stated that it normally required more detailed information pertaining to the valuation of imported merchandise, that is, pricing information on a more detailed product-by-product level. In this ruling, it did not require a further breakdown of product line profitability for comparability since the APA covered all of the taxpayer’s imported products.¹⁴ However, Customs stated that in any future verification, it expected the importer to demonstrate that the

profit earned by product line, that is, tariff code, fell within the agreed-upon range specified in the APA.

Finally, Customs concluded by noting that if, pursuant to the APA, the importer was required to make compensating adjustments, those adjustments had to be reported to Customs and any additional duties owed had to be tendered. The ruling was silent, however, with respect to whether *all* adjustments had to be reported, or just those resulting in additional duty owed because of an increase in the declared value, that is, cost of goods sold.¹⁵

Another importer came forward with a ruling request involving facts and circumstances very similar to those in the 2000 ruling, and also received a favourable ruling approving the use of transaction values based upon transfer prices set pursuant to a bilateral APA. See HQ548223 (Nov. 7, 2003). In this ruling, CBP clarified that all compensating adjustments, whether upward or downward, had to be reported to Customs and any additional duties owed had to be tendered.¹⁶ The ruling was silent with respect to the issue of potential refunds in duties due to downward adjustments where the importer's initially-reported value was overstated. Nonetheless, the ruling precipitated filings by importers to re-claim duty that was overpaid when downward compensating adjustments were booked, notwithstanding the directive in U.S. law cited earlier that any price *rebates* or similar decreases in price should be disregarded in determining transaction value.¹⁷

These two rulings launched a tide of inquiries and other ruling requests which sought to use transfer pricing studies and methodologies to support the use of transaction value. In response to the level of interest in this topic, CBP issued an Informed Compliance Publication ("ICP") in April of 2007 entitled "Determining The Acceptability Of Transaction Value For Related Party Transactions".¹⁸ This document comprehensively delineates the agency's current policy on the overlap between transfer pricing and customs valuation rules, and makes clear that transfer pricing documentation prepared for purposes of section 482 was, standing alone, insufficient to meet the requirements of 19 U.S.C. Section 1401a(b). The publication is also noteworthy because it specifically references the relevance of APAs and the rulings discussed above, and places the burden on the importer for identifying specific information in the APA or transfer pricing study which may be relevant to the COS test. The ICP also specifically stated that the Comparable Profits Method used in the two APA rulings discussed above would not, going forward, be given much weight in analysing the COS test.

Compensating adjustments and the use of transaction value

As noted in the ICP, CBP declined to address the issue of the applicability of transaction value when the related party price is subject to adjustment after importation or the proper treatment of post-importation adjustments in the determination of transaction value. To clarify its policy in this area, CBP is expected to publish a notice and request for comments in the *Federal Register*¹⁹ in the summer of 2007.

The notice will seek comments on the pervasive issue of compensating adjustments and how these impact the use of transaction value in the first instance. This issue stems from

the statute's definition of transaction value, that is, "the price actually paid or payable for the merchandise when sold for exportation to the United States . . ." 19 U.S.C. Section 1401a(b)(1). Some at CBP HQ believe that, because compensating adjustments to the invoice price take place *after* the date of importation, no "sale for export" has truly occurred and that a basis of appraisal other than transaction value must be used. Those in the private sector would counter that transfer pricing adjustments are a normal, indeed even expected, part of the pricing process, and that to invalidate the use of transfer prices on this basis would invalidate the use of transaction value by all importers which purchase merchandise from related sellers – a clearly untenable option given the enormous administrative costs (as well as needed education) involved for both importers and CBP in switching to other methods of appraisal.

Even if transaction value applies, those same policy-makers at CBP HQ tend to feel that the statute, as noted earlier, prohibits the recognition of post-importation rebates or other decreases in price. See 19 U.S.C. Section 1401a(b)(4)(B). A raft of rulings have been issued on this topic,²⁰ but all of these rulings generally involve facts where the contract price was incorrectly noted on the invoice or where price re-negotiations took place after importation – situations clearly distinguishable from transfer pricing adjustments, which are essentially "automatic" in that they take place according to a pre-determined formula which requires that prices fall within a certain range (normally the "interquartile range"). The adjustments are *required* under the IRS rules to bring the originally-declared invoice prices (transaction values) into the appropriate range, which ranges are determined pursuant to a transfer pricing study or other similar documentation prepared *prior* to the date of importation. The fact that these adjustments may not be known until after the filing of the tax return (and thus potentially well-after the date of import) should not affect the ultimate validity of the invoice price.

Conclusion

With CBP appearing to try and re-establish its traditional role as "trade partner" to the multinational enterprises that pay the duties which form the second largest source of revenue for the U.S. government (behind, obviously, income taxes), the topic of customs valuation and transfer pricing presents an ideal arena for the agency to demonstrate its real commitment to this role. The tax and trade community, already overburdened with regulatory overload from Sarbanes-Oxley and FIN48, is hoping that Customs will work more closely with the IRS to find a common approach to the seemingly intractable issue of harmonising customs valuation and transfer pricing rules – and that business planners can achieve the certainty that has long eluded them.

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1 This framework, known as the "Customs-Trade Partnership Against Terrorism", or C-TPAT, has been embraced by the World Customs Organisation ("WCO") and is being considered and/or implemented in one form or another by all of the major trading nations and

- customs unions. It should be noted that C-TPAT, while touted as a “voluntary” programme, has become a *de facto* requirement for all major importers given the hurdles that CBP can impose for non-participants, e.g., regular cargo exams that delay shipments.
- 2 See 19 U.S.C. Section 1592. For example, if a shipment is valued at \$1 million and has a zero duty rate, the importer can be potentially liable – at a minimum – for 20 percent of the declared value (\$200,000) for any material misstatement or omission. If that same shipment has a one percent duty rate (which would equal \$10,000 in duty), the minimum liability would only be two times the loss of duty, or \$20,000. The exposure is thus *tenfold* for the importer not paying duty than for one paying duty.
 - 3 The second joint conference on Customs Valuation and Transfer Pricing (sponsored by the World Customs Organisation and the Organisation of Economic Co-operation and Development) took place in Brussels, Belgium on May 22-23, 2007, and was well-attended by representatives of all major trading nations’ customs authorities.
 - 4 19 U.S.C. Section 1401a(b)(1).
 - 5 *Id.*
 - 6 19 U.S.C. Section 1401a(h)(1)(A). Incidental services performed overseas do not constitute assists if they are undertaken by U.S. domiciliaries acting in their capacity as employees or agents of the buyer of the merchandise. 19 U.S.C. Section 1401a(h)(1)(B)(iii).
 - 7 19 U.S.C. Section 1401a(b)(2)(A). This language seems to imply that importers with related party sales should not be using transaction value as a first recourse, when in fact this is exactly the case.
 - 8 Canada also added a similar provision to its implementing legislation when adopting the 1979 Valuation Agreement. See paragraph 48(5)(c) of Canada’s *Customs Act*.
 - 9 Alternative methods of appraisement must be applied in sequential order if transaction value is deemed inapplicable, but will not be reviewed herein. See 19 U.S.C. Section 1401a(c)-(f) for a complete exposition of the methods.
 - 10 All products imported into the U.S. must be assigned a 10-digit tariff classification code under the Harmonised Tariff Schedule of the U.S. (“HTSUS”). The HTSUS is based on the Harmonised System, a global coding nomenclature used by over 200 nations. Thousands of tariff code descriptions exist, each with their own corresponding rate of duty and preferential tariffs. In the transfer pricing arena, this leads to a natural concern on the part of CBP that taxpayers/importers will allocate a disproportionate amount of profit to zero-rated products, while leaving the higher-rated products with less profit, thereby short-changing the government of lawful duty.
 - 11 The APA at issue involved the use of the Comparable Profits Method, or “CPM,” known outside the U.S. as the Transactional Net Margin Method.
 - 12 19 C.F.R. Section 152.103(l).
 - 13 Specifically, Customs then held that “our review of the information, including attending the APA prefilling 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 organise 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 importer has demonstrated that the price has not been influenced by the relationship for purposed of the COS test.”
 - 14 The IRS does not require taxpayers to include all intercompany transactions in the APA.
 - 15 See also “Joint APA Signals New Level of IRS-Customs Co-ordination” by Steven Wrappe, Damon Pike, and Kerwin Chung, BNA Tax Management Transfer Pricing Report (Vol. 9, No.15), Nov. 29, 2000.
 - 16 It is important to note that, while the cited rulings pertained to situations where Advance Pricing Agreements were in effect, their directives have been widely understood to apply to *all* transfer pricing compensating adjustments, not just those applied in the context of an Advance Pricing Agreement. A transfer pricing adjustment is the same regardless of whether it is self-initiated as a result of an internal audit, a recommendation from its outside tax advisors or counsel, because it did not fall within the interquartile range specified in the APA, or whether the IRS initiates the adjustment after its own audit.
 - 17 Importers have been able to claim refunds due to CBP’s Reconciliation Programme, which allows them to “flag” issues for later reporting (within 21 months of the date of filing of the Entry Summary which must be filed for each shipment of imported merchandise) where information, such as value, is incomplete at the time of importation.
 - 18 This publication can be found on CBP’s website: www.cbb.gov, under “Legal,” and then “Informed Compliance Publications”. The documents contained therein are listed in alphabetical order by title.
 - 19 This publication is issued daily by the U.S. government (save for weekends and federal government holidays) and contains all official notices of the U.S. executive branch of government (such as Presidential Proclamations and all agency notices of rule-making). See www.gpoaccess.gov/fr/index.html.
 - 20 See HQ546311 (Sept. 19, 1996); HQ 545959 (Apr. 22, 1996); HQ546141 (Apr. 16, 1996); HQ546097 (Mar. 7, 1996).