US Customs issues first APA ruling since 2003

Damon V. Pike
The Pike Law Firm, P.C., Atlanta

A recent ruling from US Customs represents a significant step forward for those supporting customs values with transfer prices

In a development sure to have implications for every major importer of merchandise into the United States which purchases goods from related sellers, US Customs HQ issued an Internal Advice ruling on December 8, 2009 (HQ H029658) which approved the use of transaction value when the import values were based on prices set pursuant to a bilateral Advance Pricing Agreement (APA). This ruling represents the first time that US Customs HQ has issued a ruling involving transfer pricing rules under section 482 of the Internal Revenue Code and a bilateral APA since November of 2003 (*see* HQ548223), and may signal a change in policy, that is, that US Customs and Border Protection ("CBP" or "Customs") is now ready to move forward and work with importers in finding a way to "bridge the gap" between the rules governing customs valuation of imported merchandise and the income tax rules governing inter-company pricing between related parties and the resulting al location of income on a global basis.

The facts surrounding HQ H029658 are important to understanding its outcome and significance. The company at issue in the ruling was a US corporation which functioned as the exclusive distributor of motor vehicles, parts, accessories, and service tools for its foreign-owned parent company. As part of a CBP "Focused Assessment" (an audit of an importer's internal controls over import reporting), the importer was asked to justify the arm's length nature of its vehicle and parts pricing.

The intercompany transfer pricing policy, it explained, called for a sales process between the importer and its parent company which begins with the US buyer/importer preparing a pricing proposal for each vehicle model that it will import during the upcoming year. This pricing proposal analyses the market segment for each model and includes information on competitor's vehicles, sales plans, and suggested vehicle trim levels. The pricing proposal also includes recommendations regarding dealer margins and the Manufacturer's Suggested Retail Price ("MSRP"). A similar proposal is also prepared by the foreign parent seller/manufacturer, and includes recommendations for an FOB amount for the vehicles, dealer costs, and MSRPs based on sales and profit goals. Once these proposals are created, the two parties negotiate an acceptable price that the buyer will pay for the imported vehicles. The US buyer/importer then uses this negotiated price on purchase orders it sends to the foreign seller/manufacturer, who in turn issues an invoice for the ordered vehicles that transfers title and risk of loss at the port of embarkation.

The US buyer/importer had previously applied for a bilateral APA with both the US Internal Revenue Service (IRS) and the foreign tax authority of the parent company. An APA is a prospective agreement between a taxpayer and the national tax authorities, and it establishes the correct transfer pricing methodologies to be applied to transactions between related parties. having an APA allows taxpayers to avoid audits and disputes, and validates that the covered transactions between the related parties subject to the APA, like those at issue in this case, are priced at "arm's length," or as if the parties were unrelated.

When an APA is bilateral, as it was in HQ H029658, the agreement has been examined and ratified by the tax authorities of the two countries involved, that is, that of the distributor and the manufacturer. The APA in this case was approved for a five-year term, and the

Damon Pike is President of The Pike Law Firm

transfer pricing method selected was the "comparable profits method" (CPM).[1]

Pursuant to the CPM, an arm's length price range of operating profits was selected by comparing the profitability of the "tested party" (in this case, the US buyer/importer/taxpayer) to that of a set of unrelated companies selected and refined through a sophisticated economic analysis performed by the importer's outside accounting firm. The comparable companies finally selected for examination in this APA were 21 companies identified as performing similar functions and assuming similar risks as the US buyer/importer. None of the 21 companies selected were automobile distributors or manufacturers because pricing data for sales from vehicle manufactures to unrelated distributors did not exist. Instead, the final comparable set of companies included those selling a variety of products, from heating equipment to tires to roofing materials. Using the CPM, the APA set forth an acceptable arm's length range of operating profits for transactions between the two companies, which range was ratified by both the IRS and the foreign tax authorities. As with all APA's, the agreement also provided for reporting formal "compensating adjustments" should the profits fall outside of the range for any given year covered by the APA Term.

> Customs examined whether the transactions between the US buyer and the foreign seller qualified as "bona fide sales"

Upon this factual background, the audit team (working with the local import specialist) was unable to make a determination about the appropriate basis of appraisement. Thus, the importer's outside counsel prepared a request for Internal Advice for the Port Director to forward on to Customs HQ, posing the dingle issue for resolution: whether the prices paid between the related seller/manufacturer and the buyer/importer, established pursuant to the approved bilateral APA, were acceptable for the purposes of using the transaction value method of appraisement under the US Customs regulations?

In answering this question, Customs first had to examine whether or not the transactions between the US buyer and the foreign seller qualified as "*bona fide* sales". This determination was necessary because the Customs regulations only permit importers to value goods using transaction value when the transaction qualifies as a "*bona fide* sale." In examining whether or not *a bona fide* sale has occurred, Customs considers such factors as risk of loss, transfer of title, whether the goods were paid for, and whether the parties generally functioned as a buyer and a seller. In this case, CBP determined that a *bona fide* did occur, based in part on the preparation of the pricing proposals by both parties, the price negotiations between the parties, the fact that the importer set the dealer cost and MSRP, and the overall "structure" of the transactions, which included the issuance of purchase orders and invoices that transferred title and risk of loss to the buyer at the port of embarkation.

After determining that the transactions between the US buyer/importer and foreign seller/manufacturer were *bona fide* sales, Customs focused on the other requirement for using transaction value - whether or not the price actually paid or payable by the buyer to the seller was influenced by the relationship between the parties. Customs made this determination by examining the circumstances of the sale ("COS") for signs that the parties' relationship influenced the sales price of the vehicles.

In applying the so-called "COS test," Customs focused on three main areas:

1. whether the sales prices of the transactions were settled in a similar manner to the way the seller settled prices with unrelated parties or with the normal pricing practices of the industry;
2. whether the sales prices were adequate to ensure the recovery of all costs plus a profit equivalent to the company's overall profit realised over a representative period of time; and
3. whether there were any other factors that indicated that the relationship between the buyer and seller did not influence the sales prices.

Customs first examined whether the sales prices of the transactions were settled in a similar manner to the way the seller settled prices with unrelated parties or with the normal pricing practices of the industry. Although the manufacturer at issue had some independent distributors of its vehicles in other jurisdictions (especially in South America), CBP agreed that because of different volumes, consumer preferences, and government regulations in those countries, using those prices as surrogates to determine whether transaction value was acceptable would yield a meaningless comparison. HQ H029658, at 7.

The ruling then turned to a discussion of whether the sales prices were set in a manner consistent with the normal pricing practices of the automotive industry. Customs acknowledged that the importer had submitted evidence (although not "entirely objective" evidence, *id.*) describing the "market-driven" pricing of how the automotive industry sets it vehicle and parts pricing, and agreed that "vehicle pricing at all levels is based on the market driven MSRP. In other words, once a vehicle has been produced, pricing through the chain of manufacturing, assembly, marketing, and retail sale is based on actual retail prices paid by consumers, and not on some hypothetical and expected prices or costs used in the development stage." *Id.* Although the ruling then declined to ad-

dress the validity of the comparables selected and approved by both the IRS and the foreign taxing authority, CBP nonetheless found that that the importer had submitted "some evidence that the price was settled in a manner consistent with the normal pricing practices of the industry." *Id.* at 8.

Customs next examined whether the declared import values were adequate to ensure the recovery of all costs plus a profit equivalent to the company's overall profit realised over a representative period of time in sales of merchandise of the same class or kind, as required by 19 C.F.R. Section 152.102(i)(1)(iii) to demonstrate that the relationship between the parties did not influence the price paid for the merchandise. To support its claim that the sales prices were adequate the importer relied on the approved bilateral APA, in which the IRS and the foreign tax authority had approved the importer's submitted range of profitability based upon comparisons made between the importer's profitability and the profitability of the 21 "comparable" companies. The importer asserted that the IRS's approval of its profitability range would ensure that the company recovered "all costs plus a profit" as required by CBP's regulations, and that this in turn supported the importer's claim that the sales prices it paid to its parent company for the vehicles were set at arm's length and could properly be used with the transaction value appraisal method.

While Customs acknowledged that the APA's comparison between the importer's profitability and that of other companies "may provide some evidence that the price is adequate to ensure recovery of all costs plus a profit" *id.* at 9, Customs found this kind of information to be "less valuable since the companies are not engaged in the sale of the same class or kind of merchandise." *Id. at 9.*

Customs also addressed the importer's argument that the *buyer's* overall profit over a representative period of time should be considered in determining whether the relationship between the seller/buyer influenced the price. Although the ruling noted that Customs has normally examined the *seller's* (manufacturer's) profit in addressing this part of the regulation, it also found that "the buyer's overall profit may be relevant," *id.*, and that "the buyer's overall profit is one of the factors that may be considered to indicate that the relationship between the buyer and the seller did not influence the price". *Id.*

Finally, Customs focused its attention on whether any other factors indicated that the relationship between the parties did not influence the sales price. To begin this examination, Customs once again turned to the approved APA. Despite having expressed concerns about the aspect of comparing profits of "functionally equivalent" companies to those of an automotive importer for purposes of the "all costs plus a profit" examination, CBP stated that, overall, it found "that the information submitted to the IRS and the fact that there is a bilateral APA constitute valuable information in evaluating the circumstances of the sale." *Id.* at 9. Customs noted that the existence of an APA covering *all* of the buyer's imported products reduced the possibility of profit manipulation between the buyer and the seller. *Id.* Customs also stated that while CBP did not participate in the APA pre-filing conference that was held between the importer and the tax authorities, the importer did give CBP access to all of the documents submitted to the IRS during the APA approval process. *Id.* These documents provided Customs with additional support to substantiate the claims the U.S importer made in its Customs ruling request. Another factor showing that the parties' relationship did not influence the price, according to Customs, was the fact that a *foreign* tax authority approved the APA profit levels, indicating that the foreign seller also earned sufficient profit to cover its operating costs. *Id.* Finally, Customs identified the rigorous price negotiations between the buyer and the seller that set an FOB price which allowed the importer's operating profit to fall within the profit range established by referencing the unrelated comparable companies as another factor indicating the relationship between the parties did not influence the sales price. *Id.* at 10.

In conclusion, while HQ HH029658 does not represent the "panacea" some may have hoped for in answering some of the vexing questions which have dogged the years-long debate over using transfer prices to support declared customs values, it nonetheless represents a significant step forward. US Customs is now demonstrating some welcome flexibility in developing some answers to this very complicated question, and further developments are sure to come in 2010.

Damon Pike *is President of The Pike Law Firm, P.C., which is based in Atlanta, Georgia, and specialises in customs and international trade consulting and litigation. He may be contacted at:*
damon@thepikelawfirm.com

NOTES

[1] Under the OECD Guidelines, the "international version" of CPM is the Transactional Net Margin Method ("TNMM").

01/10 Copyright © 2010 by The Bureau of National Affairs, Inc. ISSN 1472-0841