

## CITBA & Related News

### UPCOMING PROGRAMS

#### INTERNATIONAL LAW WEEKEND

**OCTOBER 21–23, 2010**

The overall theme for this year's International Law Weekend is "International Law and Institutions: Advancing Justice, Security and Prosperity." Events will take place at the Association of the Bar of the City of New York on October 21, 2010, and at Fordham University School of Law on October 22 and 23. CITBA is pleased to be a co-sponsor of International Law Weekend 2010. Accordingly, CITBA members are able to attend events at International Law Weekend free of charge. Details on this event can be found [here](#).

#### NYSBA INTERNATIONAL SECTION'S FALL MEETING

**OCTOBER 26–28, 2010**

The New York State Bar Association International Section's 2010 Fall Meeting will be held in Sydney, Australia from October 26-28, 2010.

The Fall Meeting's panels will qualify for CLE credit in both New York and Australia. Additionally, the speakers for this event include the Chief Justice of New South Wales, former Australian High Court Justice Michael Kirby and U.S. Ambassador to Australia Jeffrey L. Bleich. CITBA is pleased to announce that it is a cooperating entity for this program. Details on the 2010 Fall Meeting can be found [here](#).

#### ABA SECTION OF INTERNATIONAL LAW FALL MEETING

**NOVEMBER 2–6, 2010**

The ABA Section of International Law's 2010 Fall Meeting will be held from November 2-6, 2010 in Paris, France. CITBA is a cooperating entity for this program and its members will enjoy the same discount registration rates that members of the ABA receive.

The ABA Section of International Law expects over 1,000 international practitioners from over 60 countries in attendance. Attendees will be able to take advantage of a unique opportunity to network, and earn a full year's worth of CLE credits from a number of topical and cutting-edge CLE programs arranged in several program tracks. Details on the 2010 Fall Meeting can be found [here](#).

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Thus, CBSA won the battle over the legal interpretation of the regulations. It also went on to win the war in this particular case.

The regulations with respect to fungible goods clearly apply only to “fungible goods [that] are physically combined or mixed in inventory . . . .” On this point, the Tribunal found that canvases of the same size and style are “essentially identical” and, therefore, fungible. Further, the Tribunal found that the originating and non-originating goods were mixed in inventory.

The remaining question was whether § 7(16.1) applied to these circumstances to require the use of the same inventory accounting methodology for materials and for goods. Recall that the regulation states it applies where “when both fungible materials and fungible goods are withdrawn from the same inventory.” According to Tara, it maintained separate physical inventories of materials and finished goods. Consequently, it may choose to apply the specific identification methodology to its finished goods and is not bound by the application of the averaging ratio to shipments. CBSA disagreed, arguing for an expansive definition of inventory that encompassed both materials and finished goods.

The Tribunal refused to accept Tara’s narrow definition. According to the Tribunal, it is unlikely that producers would ever physically mix production materials and finished goods in the way Tara suggested. Rather, both materials and finished goods were both held at the same facility. The Tribunal found that sufficient to hold that the goods and materials were mixed into the same inventory. As a result, § 7(16.1) applied, forcing Tara to apply the averaging methodology to each shipment of finished goods.

This resolution of the question presented is certainly not the best for producers. Companies that rely on mixed originating and non-originating sourcing to produce goods in North America would prefer to have the maximum flexibility in allocating its originating goods to customers who can most benefit. Nevertheless, this decision, assuming it remains the final word, does provide a solid basis on which producers can determine how to manage their NAFTA systems.

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## CBP ISSUES FURTHER RULINGS ON TRANSFER PRICING

By: Damon V. Pike and Cylinda Parga\*

In addition to HQ H029658 (Dec. 9, 2009) which was highlighted in the Winter 2009-10 CITBA newsletter, U.S. Customs has recently issued two further HQ rulings which display further flexibility when importers seek to use income tax transfer pricing rules to support their declared values for imported merchandise. These two rulings are discussed in detail below.

### HQ H037375 (December 11, 2009)

In this case, the importer was a U.S. subsidiary of a global group of companies operating in the healthcare sector. The company imported disposable medical products from a sister-company located in Switzerland. As part of its business

planning, the importer engaged an outside accounting firm to create a transfer pricing study to analyze and document the intercompany sale of the imported goods, in accordance with Section 482 of the Internal Revenue Code (“IRC”). The importer did not, however, obtain an Advance Pricing Agreement from the IRS.

The transfer pricing study utilized the Resale Price Method (“RPM”) to evaluate the intercompany transactions between the importer and its Swiss affiliate and determine whether the transactions qualified as “arm’s length” transactions under Section 482 of the IRC. The RPM method calculates the arm’s length price for the subject goods by reducing the resale price by an appropriate gross margin; the gross margin is determined by examining the resale margin from comparable uncontrolled transactions involving either the same reseller (“internal” comparables) or other unrelated resellers (“external” comparables). Any differences between the subject transactions and the comparable transactions that have a material effect on price (and thus on the gross margin) must be accounted for to nullify the differences in the gross margin calculation. The transfer pricing study in this case used both internal and external comparables.

The foregoing formed the factual basis for CBP’s inquiry whether the importer could validly use transaction value as the basis of appraisal for the imported merchandise. CBP used the “circumstances of sale” test to complete its inquiry, meaning that it examined the circumstances of the sale between the related parties to verify that the relationship did not influence the price actually paid or payable for the imported goods.

The importer submitted its transfer pricing study to provide evidence that it met the circumstances of sale test. Pursuant to its current (but still evolving) policy, CBP noted that it does not consider a transfer pricing study determinative that the circumstances of sale between related parties meet the arm’s length requirement necessary for the proper use of transaction value. However, in this instance, CBP determined that the transfer pricing study contained useful information for evaluating the circumstances of the sale, as the study analyzed comparable companies that were in the same industry as the importer and were in fact direct competitors of the importer which sold the same “class or kind” of merchandise as the importer.

The transfer pricing study demonstrated that the importer’s gross margin used to calculate the transfer price was within the range of gross margins reported by the comparable competitor companies. CBP determined that this indicated that the price between the related parties was set in a manner consistent with the normal pricing practices within the industry, which in turn meant that the price was not influenced by their relationship between the parties. Thus, according to CBP, the transfer price met the circumstances of sale test. Based upon this determination, CBP concluded that transaction value was the appropriate method of appraisal for the sales between the parties.

#### **HQ H032883 (March 31, 2010)**

This case involved related-party sales of highly specialized textile fabrics designed for industrial paper-making machines. The U.S. buyer at issue purchased the textile fabrics from a Canadian subsidiary, which also functioned as the non-resident importer of record. CBP issued the ruling in response to an internal advice request prepared by the U.S. company after the importer received multiple Customs Form 28 “Requests for Information” regarding the valuation of the purchased fabrics.

The U.S. buyer presented a variety of information to support its assertion that transaction value was the proper method of appraisal for the value of the goods it

purchased from its Canadian sister company. The main documentation submitted by the buyer included: (1) the company's original Transfer Pricing Study, completed in 2002; (2) two updates of the Transfer Pricing Study, completed in 2005 and 2007; and (3) an "Enterprise Pricing Model" ("EPM") document effective beginning in 2007, which EPM was essentially the company's internal inter-company pricing guide. The company provided these documents in addition to the standard transactional documents relevant to its intercompany transactions, e.g., purchase orders, commercial invoices, CBP entry summaries, etc.

In determining whether the transactions met the requirements for transaction value appraisal, CBP conducted the same inquiry as it did in the two previously discussed cases: (1) whether the sales between the related companies constituted bona fide sales under CBP regulations, and (2) if the transactions were bona fide sales, did the circumstances of the sale establish that the price paid or payable by the U.S. buyer to the Canadian seller was not influenced by the relationship between the parties, i.e., that the price was set at "arm's length."

In a lengthy analysis, CBP concluded that the facts of the case established that the transactions between the parties constituted bona fide sales. CBP based this conclusion upon the documentation provided by the buyer showing that all of the products purchased were custom-ordered for specific customers (as opposed to being ordered for inventory), that all payments from the buyer to the seller could be linked to specific shipments, and that the title to and risk of loss for the products transferred to the U.S. buyer at the Canadian plant. With this preliminary question answered, CBP turned its attention to the more complicated "circumstances of sale" analysis.

Unlike Ruling HQ H029658, which focused much attention on examining whether the prices were set in a manner consistent with the normal pricing practices of the industry, in this case CBP focused mainly on examining whether the price for the textile fabrics was adequate to ensure that the Canadian seller would recover all of its costs plus a profit equal to the Canadian company's overall profit on sales of goods of the same class or kind over a set period of time. Equal profits would indicate to CBP that the relationship between the buyer and seller did not influence the price of the fabrics, which would in turn establish that transaction value was the proper method of appraisal for the transactions.

To begin its "all costs plus a profit" inquiry, CBP examined the costs and profit on representative sample transactions provided by the U.S. buyer. The U.S. company purchased two kinds of goods from its Canadian sister-company: (1) "finished" goods, i.e., goods that needed no additional processing; and (2) "works in progress," i.e., goods that needed additional processing before being resold to consumers in the United States. CBP examined the costs and profits of each type of good separately. For finished goods that the U.S. buyer purchased from its Canadian sister-company, CBP determined that the Canadian seller made a gross profit margin well in excess of the company's total profit margin for finished goods sold to all its customers. CBP likewise determined that for work-in-progress goods, the Canadian seller made a gross profit margin on sales to its U.S. sister company in excess of the margin it made on its total sales of work-in-progress goods. Because its profit margins on the related-party transactions exceeded its margins taken as a whole, CBP concluded that this factor tended to show that the transfer price for the goods was not influenced by the relationship between the parties. After examining this persuasive "circumstance" of sale, CBP proceeded to discuss the multiple transfer pricing studies submitted by the U.S. buyer to supply additional evidence that the circumstances of sale did not influence the price in the related-party

transactions. The submitted transfer pricing studies pertained to the U.S. buyer. CBP began its examination of the transfer pricing studies by once again stating that the mere existence of a transfer pricing study is not determinative of the validity of the transfer price between related parties for customs valuation purposes, and that CBP must still examine the circumstances of the sale. CBP further noted that transfer pricing studies may offer useful information regarding the circumstances of the sale, but that how much weight a transfer pricing study is given depends upon the level of detail provided by the study. Significant factors influencing CBP's regard for transfer pricing studies in valuation cases include whether the study has been reviewed and approved by the IRS, whether the products examined in the study are comparable to the imported products at issue, and the methodology selected for the study.

Based upon these factors, CBP expressed some doubts about the weight that it should give the transfer pricing studies submitted in this case. CBP first noted that none of the studies were reviewed or approved by the IRS, leaving CBP to speculate as to whether the studies would be acceptable to the IRS. CBP expressed further concerns regarding the fact that the studies utilized the comparable profits method ("CPM") to evaluate the distribution and manufacturing activities of the related parties. Although CBP acknowledged that it had in the past given weight to studies using the CPM methodology, it noted that it generally did so only in the presence of "special" circumstances such as: (1) the IRS's approval of the transfer pricing methodology through an Advance Pricing Agreement; (2) CBP's participation in the APA approval process, providing CBP access to information presented to the IRS; (3) the importer executing a waiver allowing CBP to access all of the documents submitted to the IRS during the APA approval process; (4) all of the importer's products were covered by the approved APA; and (5) the APA was bilateral, meaning that it was examined and accepted by the taxing authorities of two separate countries. (Note that these factors were present in HQ H029658 discussed above, and resulted in CBP giving the transfer pricing study significant weight in that case.)

After enumerating the above factors, CBP noted that none of them were present in this case. CBP was further troubled by the fact that the comparable companies selected to evaluate the related parties' distribution activities in the transfer pricing study were not engaged in the distribution of the same class or kind of merchandise as the companies at issue in the ruling. For these reasons, CBP stated that it was "reluctant" to rely solely on the analysis of the distribution activities presented in the transfer pricing studies.

CBP's reluctance to heavily rely the analysis of distribution activities presented in the transfer pricing reports was offset, however, by the information presented regarding the manufacturing and sales of the textile fabrics. This information consisted of the Canadian seller's most recent income statement, its 2007 transfer pricing study update, and the U.S. buyer's EPM, a model the U.S. buyer uses to determine the prices of all of the products produced, finished, or distributed from related parties such as the Canadian seller. The prices in the EPM are updated on a yearly basis based upon the requirements of the transfer pricing studies.

CBP found that the above information related to the manufacture and sale of the textile fabrics did substantiate the validity of the transfer prices under the all costs plus a profit inquiry. The Canadian seller's income statement showed earned profits on the work-in-progress fabrics that comported with the formula set by the EPM. Further, a significant number of the comparable companies identified in the transfer pricing study update to evaluate manufacturing activities manufactured and sold the same class or kind of goods as the imported merchandise at issue (as opposed to the dissimilar comparable companies chosen to evaluate the distribution activities, described above). CBP found that the fact

that a number of the comparable companies sold the same class or kind of merchandise as the Canadian seller supported the finding that the price of the work-in-progress fabrics was sufficient to ensure the recovery of all of the seller's costs plus a profit.

For the finished goods sold by the Canadian seller to its U.S. sister company, CBP first noted again that the transfer pricing study was not relevant because of the lack of truly comparable companies in the distribution analysis. However, CBP then acknowledged that the income statement submitted by the Canadian seller demonstrated that the net profit it earned from selling finished goods to its U.S. sister company was similar to the net profit it earned from selling finished goods to unrelated parties. Because of this consistency, CBP found that the transfer price of the finished fabric goods between the related parties was set in a manner consistent with how the seller set its prices in sales to unrelated buyers.

Based upon all of the foregoing information, CBP ultimately ruled that transaction value was the appropriate method of appraisal in the transactions between the U.S. buyer and Canadian seller.

### **Conclusion**

The two HQ rulings discussed above demonstrate that U.S. Customs HQ is developing a welcome flexibility in attempting to grapple with the very complicated issues involved when importers seek to validate the use of "transaction value" with income tax transfer pricing rules. Further changes in CBP's policy on this issue are expected shortly, as a "1625" notice will soon be issued which proposes to revoke or modify existing HQ rulings on this topic - and propose a new policy that will address the controversial subject of "compensating adjustments" and their impact on customs valuation, i.e, whether duty refunds should be allowed for such adjustments. Overall, however, the new direction which CBP HQ seems to taking is a welcome development in the years-long debate on transfer pricing and its impact on customs valuation.

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