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- Transfer pricing: a developing issue
- US Customs propose new transfer pricing policy
- Business model optimisation
- Assessing litigation risk
- Will the OECD simplify transfer pricing compliance?

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From the editor

The downturn seems to have taken our eyes off Corporate Social Responsibility, but the first article this month turns the spotlight back on. Martin Hearson, from the charity ActionAid, discusses the role of transfer pricing in Africa, where developing countries' tax policy and administration in not protecting them from multinationals' aggressive tax planning. As aid campaigners turn their attention to MNEs tax planning as part of their CSR regime, the time may be coming where the bottom line is not the only consideration.

This month's second article is a welcome return to our pages of Customs specialist Damon Pike, discussing US Customs and Border Protection's proposed policy-change on post-importation transfer pricing adjustments. In this article, Mr Pike explains how MNEs can plan ahead to take advantage of the new policy if it is finally approved next year, and in an article next year will explain the ramifications of the final regulations.

Termination of an Agency agreement can lead to compensation payments to the Agent, but in some European jurisdictions the authorities will also argue that any local distributor should also be compensated. John Henshall and Daniel Bickenbach examine the situation in Germany.

Litigation may be a calculated risk – Andrew Hickman, Kirsty Rockall and Laura Hall analyse court cases around the world to assist in assessing whether the risk is worthwhile.

Many practitioners are positive about the use of safe harbours, as evidenced by the OECD's *Multi-country Analysis of Existing Transfer Pricing Simplification Measures* earlier this year. Benoît Desirotte and Leslie Van den Branden discuss their application and note that international consensus may not be easily reached.

Harvey Poniachek tackles the complex subject of global financial dealings and finds that the US Treasury and OECD definitions of global dealings are similar.

No doubt some of our readers will be mentoring young people just starting out on their tax career. I am sure that they will find Lorraine Eden's article on launching a transfer pricing career useful – and possibly something to pass on to their junior colleagues.

We return to location specific advantages with the last of a series of articles from Sébastien Gonnet, this time focussing on China, which is followed by this month's documentation article – The Netherlands examined by Michiel van den Berg.

Lillian Adams

US Customs propose new transfer pricing policy

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Light at the end of the tunnel

In a development sure to have global ramifications, US Customs and Border Protection ("CBP") has finally announced its long-awaited proposed change in policy regarding post-importation transfer pricing adjustments. The agency recently posted the notice illustrated overleaf on its website, and requested advance comments by October 22, 2011. Because this is one of the most significant developments in customs valuation law since the passage of the Trade Agreements Act of 1979 (the US statute which enacted Article VII of the General Agreement on Tariffs and Trade,[1] or "GATT Valuation Agreement"), readers should keenly consider the new policy proposed by CBP in light of their own income tax transfer pricing policy for related party sales of tangible goods. This article will offer comments on how tax and trade compliance professionals can "plan ahead" to take advantage of CBP's new policy if it is finally approved and implemented in 2012.

Request for Advance Public Comments on the Proposed Revocation of Headquarters Ruling Letter ("HRL") 547654 and of Treatment Relating to the Applicability of Transaction Value and Post-Importation Adjustments

(09/23/2011) Customs and Border Protection ("CBP") is in the process of re-examining its approach to the applicability of transaction value in the context of post-importation adjustments. Specifically, CBP is asking the public to provide comments on the broadening of CBP's interpretation of what constitutes a "formula" for purposes of using transaction value, thereby allowing post-importation adjustments. In order to permit the orderly administration of these upward and downward post-importation adjustments, CBP is considering modifying prior rulings in order to allow the transaction value basis of appraisement in these circumstances, provided that the importers use the reconciliation program for declaring the value of the affected importations.

Background: Many importations into the United States involve transactions between related parties, which present a number of appraisement issues, such as ensuring that the relationship between the parties does not affect the price. Moreover, such transactions often involve arrangements in which the parties have in place formal inter-company policies that call for adjustments after importation to the price paid (i.e., the transfer price). These arrangements raise the issue of whether transaction value is the proper basis of appraisement and, if so, how to treat the adjustments.

>In certain instances, CBP has allowed the adjustments, but not under transaction value. Rather, the adjustments were allowed under the "fallback" method of appraisement because the price was not determined via an objective formula. In other instances, CBP has disallowed the adjustments because CBP considered a decrease in the transfer price to be a post-importation rebate or decrease under 19 U.S.C. § 1401a(b)(4)(B). CBP has reviewed this matter and is considering proposing a broader interpretation of what is permitted under transaction value in the transfer pricing context.

*Legal Authorities:*Merchandise imported into the United States is appraised under 19 U.S.C. § 1401a. The primary method of appraisement is transaction value, defined as "the price actually paid or payable for the merchandise when sold for exportation to the United States," plus certain additions to the extent not otherwise included in the price actually paid or payable. See 19 U.S.C. § 1401a(b)(1). As provided in

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19 U.S.C. § 1401a(b)(4)(A), the term "price actually paid or payable" means the total payment (whether director indirect ?) made, or to be made, for imported merchandise by the buyer to, or for the benefit of, the seller. Normally, transaction value is fixed at the time of importation. However, transaction value may be arrived at by using a formula. See 19 CFR § 152.103(a)(1). Rebates, or any other decrease in the price actually paid or payable made or effected after the date of importation are to be disregarded for the purposes of determining transaction value. 19 U.S.C. § 1401a(b)(4)(B).

Analysis: Related party transactions may involve adjustments to initial transfer prices after importation, in accordance with the company's formal transfer pricing policy/formula. In some cases, the transfer pricing policy may provide for year-end "compensating adjustments" to comply with the requirements of an Advance Pricing Agreement ("APA") between the U.S. party and the Internal Revenue Service ("IRS"). Such adjustments could affect whether the price is considered fixed or determinable by objective formula at the time of importation.

The issue of the treatment of post-importation adjustments is addressed in HRL 547654, dated November 9, 2001. In HRL 547654, the price for the goods was arrived at pursuant to a methodology that included an initial sum subject to adjustments. CBP determined that transaction value did not apply because the price was not considered to be fixed or determinable pursuant to an objective formula prior to importation because at least one of the elements for determining the price was within the control of the buyer and/or the seller. Nonetheless, following the hierarchy of the valuation statute, CBP found that the goods could be appraised using the "fallback" method of valuation based on the related party price and that the adjustments could be reported (and claimed) to CBP through reconciliation.

Upon review of this matter, CBP is proposing that, even though the parties are related and certain costs may be within the control of the parties, if the transfer pricing policy is set before importation and is used by the parties, it may be considered an objective formula, allowing the use of transaction value, provided that certain additional criteria are met. In requesting reconsideration of HRL 547654, the importer described its transfer pricing policy and the distinction between its treatment of variable and fixed costs. According to the policy, none of the variable costs and profits are subject to any post-importation price adjustments. Therefore, the transfer price declared to CBP upon importation is fixed and any fluctuations are not re-invoiced or remitted back to the seller/exporter. The company also provided CBP with a copy of an inter-company memorandum, illustrating how the fixed costs are calculated and set in advance. According to the importer, the fixed costs paid are set; only allocation of those fixed costs to the individual import entries is not fixed until after the month has passed. Pursuant to its transfer pricing policy, the importer seeks to report, via reconciliation, the actual, final amount paid to the Seller for the imported goods. Furthermore, with respect to the profit margin element of the importer's transfer pricing formula, the margin is calculated based on a study of comparable and available data, of sales in the uncontrolled market to allow a reasonable profit to be earned. The margin is confirmed as often as required by the U.S. transfer pricing regulations, by a joint external study of the importer's and exporter's finance departments, also submitted by the importer for CBP's consideration.

A. Factors to consider

CBP is considering that since the following criteria were met, the company may use the transaction value method of appraisement:

(1) a written "Intercompany Transfer Pricing Determination Policy," which sets out how the transfer price is to be determined prior to the importation; >(2) the importer/buyer is the U.S. taxpayer, and it uses its transfer pricing methodology in filing its corporate income tax returns and in determining the transfer price for the products covered by the transfer pricing policy;

(3) the company's transfer pricing policy specifically covers the products for which the value is to be adjusted;

(4) the policy specifies what adjustments must be made to the transfer price, and how those adjustments are to be determined;

(5) the adjustments, although to a certain extent within the "control" of the parties, do not result in value manipulation;

(6) if adjustments are made, the company provides detailed explanations and calculations of the adjustments incurred in the United States and claimed after the importation;

(7) the relevant transfer pricing policy, pursuant to which adjustments are claimed is in effect prior to the importation; and,

(8) there is an absence of other circumstances which may indicate that the compensating adjustments do not result in an arm's length price between the parties.

No single factor is determinative, and CBP's finding with respect to whether an objective formula exists will be made on a case-by-case basis.

Furthermore, CBP is considering that downward adjustments in the transfer price made pursuant to the transfer pricing study are not rebates of, or other decreases in, the price actually paid or payable that are made or otherwise effected between the buyer and seller after the date of importation of the merchandise into the United States (see 19 U.S.C. § 1401a(b)(4)(B)). Instead, the post-importation adjustments represent an element of the determination of the price actually paid or payable in accordance with 19 CFR § 152.103(a)(1). Therefore, the post-importation adjustments made pursuant to the transfer pricing policy

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in the proposed revocation simply reflect what should have been reported as the invoice price upon entry, had the exact price information of the imported merchandise been available at the time.
Of course as with any other transaction, in addition to the foregoing, companies must be prepared to show that transaction value is acceptable under one of the two tests:
(1) circumstances of the sale, or
(2) test values.
B. Reconciliation
In order for companies to claim post-importations adjustments, it is contemplated that importers must use the reconciliation program to properly apply transaction value and account for the total "price paid or payable for" imported merchandise where a formal transfer pricing study or policy, or an APA, provides for upward or downward post-importation adjustments that directly (or indirectly) relate to the value of the merchandise. Reconciliation allows companies to provide CBP with information not available at the time of entry summary filing and which is necessary to ascertain the final appraisement of imported merchandise. Furthermore, reconciliation allows for the information to be filed up to 21 months from the date of the first entry summary with extensions of time as available to importers. CBP believes this flexibility makes reconciliation an ideal tool to declare all adjustments (upward and downward) within the timeframe allowed by an APA or transfer pricing study or policy.
All comments relating to this pre-publication proposal should be sent to EarlyInputMailbox@dhs.gov no later than thirty days from the date of publication. Please put "Transfer Pricing" in the subject line. After analyzing the comments, CBP will consider whether to proceed further with this action in accordance with 19 U.S.C. § 1625(c) by publishing a proposed revocation of HRL 547654.
Please note that statements provided in response to this request and the names of the submitters are not confidential and may be subject to disclosure upon a written Freedom of Information Act request.

Given the breadth of this proposed change and the reality that transfer pricing policies have a global impact on the prices of goods sold to related parties, the first question that should be addressed in light of CBP's proposed policy change is: how will this new policy impact the customs valuation of merchandise imported into countries *other than* the US so that my company's policy is consistent throughout the world? This is not an easy question to answer, because in framing the proposed policy above, CBP based its changes on a specific US regulation not found in other countries, as well as a statutory addition to the Trade Agreements Act of 1979 that was not part of the GATT Valuation Agreement.

As noted above, CBP cited its regulation which allows the "transaction value" of imported merchandise (the primary method of appraisement for duty assessment purposes) to be based on a "formula". The regulation at issue reads in full:

> In determining transaction value, the price *actually* paid or payable will be considered without regard to its method of derivation. It may be the result of discounts, increases, or negotiations, or may be arrived at by the application of a *formula*, such as the price in effect on the date of export in the London Commodity Market. The word "payable" refers to a situation in which the price has been agreed upon, but actual payment has not been made at the time of importation. Payment may be made by letters of credit or negotiable instruments and may be made directly or indirectly. (Emphasis added).

19 C.F.R. § 152.103(a).

In addition to this regulation, several countries (such as Canada and Australia) adopted a provision in their domestic legislation which mirrored the one enacted in the US – despite the fact that this provision is not found in the GATT Valuation Agreement:

> 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 the importation of the merchandise into the United States shall be disregarded in determining the transaction value . . . .

19 USC. § 1401a(b)(4)(B).[2]

The statute's legislative history shows that when the Trade Agreements Act of 1979 was enacted, the US Congress intended for this "post-importation rebate" provision to be strictly limited to very specific kinds of rebates and similar price decreases. The legislative history states:

> During the Committee consideration of the Customs Valuation Agreement, the Members decided to provide in statutory language a prohibition on any modification of the transaction value for imported merchandise *because of a subsequent rebate*. Accordingly, new section 402(b)(4)(B) states that "any rebate of, or other decrease in, the price" changes in a price actually paid or payable which are arrived at subsequent to the time of importation shall not be taken into account in determining a transaction value [grammatical error in original]. *This would apply to renegotiated, deferred quantity discounts, or rebates*. (Emphasis added).

H.R. Rep. No. 317, 96th Cong., 1st Sess. 81 (1979).

Thus, any application of this statutory provision beyond price rebates, discounts, or similar decreases in the price after the date of importation which were not included in the originally-negotiated contract in place between the buyer and seller prior to the date of importation would contravene the intent of Congress in passing this statute. Transfer pricing adjustments are clearly outside the scope of this provision because importers are simply reporting the price finally – and *actually* – paid for the imported goods. CBP's proposed change in policy has sensibly embraced this reality.

For multinational companies with global operations, however, the US is not the only country where tangible goods are imported. Those other countries' customs valuation rules must also be met – even though almost all substantive rules for all major trading nations are the same (and based on the GATT Valuation Agreement, as noted above.) Taken together, the above "US-only" provisions can actually help global planning because – if adopted – the new US policy will certainly provide the "clearest roadmap" yet issued by any customs authority about the treatment of post-importation transfer pricing adjustments and their impact on declared customs values. Stated another way, as long as companies plan ahead to meet the requirements of CBP, i.e., plan to meet very detailed and stringent mandates pertaining to documentation and support of transfer pricing values and adjustments, then any challenge by another global customs authority should be easily overcome.

Thus, with an eye towards establishing a global customs valuation and transfer pricing "formula", tax and trade planners should not overlook the following steps in setting a coherent and practical policy that can be implemented on a worldwide basis. Based in part on several of the specific factors mentioned in CBP's notice above, taxpayers and importers should:

1. Make sure the "macro-level" transfer pricing policy is accurately reflected on the "micro-level" (transaction-based) commercial invoices presented to customs authorities when tangible goods are imported. This often requires co-operation between the selling (parent) company and the importer (subsidiary) given that profit margins – even between related parties – are often a closely-guarded secret. Begin a conversation to determine how the profit margin reflected in the unit price is determined.
2. Importers should seek to ensure that profits on the "class of kind"[3] of imported merchandise are equivalent to the seller's (producer's) overall profit, or to the importer's overall profit when it re-sells the goods after importation. This step is necessary to document the profit margin figures which CBP typically requests or examines in determining whether its "circumstances of sale" test for related party transactions are met.[4] Note that the term "profit" is not defined in any customs authority's regulations; hence, "operating profit", "gross profit", EBIT, or other measures of profit may be considered. In addition, because target profit margins are not normally set at the product-level, resort to costed Bills of Materials is often the only recourse to determine unit-price profit levels.
3. Transfer pricing studies are known to use "operating profit" as the Profit Level Indicator because the most common method for income tax transfer pricing is the Transactional Net Margin Method, or "CPM" (Comparable Profits Method) as it is known in the US. Because studies of this kind typically focus on the aggregate operating profit of companies (typically, distributors) with the same function and risk profile as the importer (which is normally the tested party), CBP has consistently stated that studies which do not cover companies distributing the same kinds of products as the importers are of limited use. Thus, refinement of the selection of the comparable companies used as the basis of a transfer pricing study to include such kinds of companies is almost now required in order to pass muster with CBP – and likely any other customs authority.[5]
4. Adopt a practical and user-friendly procedure to test and track profits regularly on an aggregate and product-level basis. While most companies routinely perform monthly or quarterly testing to gauge profit levels for overall sales, few take this further to the product-level required by customs authorities – despite the fact that aggregate adjustments (typically booked to lower or increase Cost of Sales/Cost of Goods Sold to, respectively, increase or decrease profit) are made all the time in the normal course of business. Because these adjustments are poised to represent duty refund opportunities if CBP's proposed policy is adopted, taxpayers would be well-served to "drill down" to the "micro-level" as back-up for the aggregate-level profit testing.
5. Prepare a legally-binding inter-company agreement that sets forth (a) the global income tax transfer pricing policy; (b) how the policy supports the use of transaction value for customs valuation purposes (including how the "circumstances of sale" tests are met); (c) how profit levels are tested, calculated, and booked to the financial statements; (d) the time period covered by the agreement (because "formulas" are acceptable only if they are in place at or prior to the date of importation); and (e) includes a detailed explanation of how profit margins outside of the targeted range are reported to customs and income tax authorities.

While the above-list cannot be a completely comprehensive guide to preparing for the future, the detailed guidance set forth in CBP's notice and request for "advance comments" provides executives with some assurance that the steps taken above will deliver benefits for both the importer and for CBP. The obvious benefit for importers is that business certainty can finally be achieved in the area of customs valuation and post-importation pricing adjustments. For the government, business certainty leads to increased compliance. Knowing that duty refunds may soon be allowed when adjustments go in the importer's favour will also lead to far more duty payments when adjustments are in favour of CBP – resulting in a "win-win" for both taxpayer and customs alike.

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NOTES

[1] The organisation was re-named the World Trade Organisation as of January 1, 1995, and is based in Geneva, Switzerland.

[2] Australia enacted a provision in its domestic legislation similar to the US law discussed above. However, in the Australian Customs Service Manual (Vol. 8A, Valuation), the government expressly limits this provision to "discounts or rebates" that are not included in the sales contract: "[t]his [provision] means that discounts or rebates that are not available to the purchaser at the time of export should be disregarded." *Id.*

[3] "Merchandise of the same class or kind" generally includes, but is not limited to, identical merchandise and similar merchandise within a group or range of merchandise produced by a particular industry or industry sector. 19 C.F.R. § 152.102(h).

[4] The regulations of CBP summarising these tests read as follows: "Customs will consider pertinent details of the transaction, e.g., the manner in which the parties organise their commercial relations and the meth-

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odologies utilised to derive the price in question, to determine whether the relationship influenced the price actually paid or payable. *Interpretive Note 1* – 19 C.F.R. § 152.103(l)(1)(i). In making this determination, Customs will also seek evidence that the price has been settled in a manner consistent with the normal pricing practices of the industry in question, or with the manner in which the seller settles prices for sales to unrelated buyers. *Interpretive Note 2* – 19 C.F.R. § 152.103(l)(1)(ii). Furthermore, if it is shown that the price is adequate to ensure recovery of all costs plus a profit that is equivalent to the seller's total profit realised over a representative period of time, in sales of merchandise of the same class or kind, then Customs will accept that the relationship did not influence the price. *Interpretive Note 3* - 19 C.F.R. § 152.103(l)(1)(iii)." These tests appear with substantially the same language in the 1979 GATT Valuation Agreement.

[5] This step should also apply for any company that utilises an Advance Pricing Agreement ("APA"), although the inclusion of a comparable company or companies which produce/distribute similar products may skew the outcome for income tax authorities – who may ultimately reject these kinds of comparables for inclusion in the APA's economic analysis. Nonetheless, taxpayers can still prepare independent economic analyses that include such kinds of comparable product-profit data to meet the requirements of CBP and other customs authorities.