

December 11, 2009

HQ **H037375** OT:RR:CTF:VS **H037375** YAG

CATEGORY: Valuation

Mr. Leon D. Sample
Field Director, Regulatory Audit, Ft. Mitchell Field Office
U.S. Customs and Border Protection
2220 Grandview Drive, Suite 215
Ft. Mitchell, KY 41017

Re: Internal Advice Request; Transfer Pricing; Related Parties; Circumstances of the Sale

Dear Mr. Sample:

This is in response to your internal advice request, dated September 2, 2008, inquiring as to whether Cardinal Health, Inc.'s ("Cardinal Health") basis of appraisal of its Alaris disposable products is acceptable under transaction value.

FACTS:

Cardinal Health is a publicly traded U.S. corporation and a parent company of a global group of companies operating within two major business sectors: (1) Healthcare Supply Chain Services; and, (2) Clinical and Medical products. In turn, Cardinal Health's two business sectors operate within four segments: (1) Healthcare Supply Chain Services "Pharmaceutical; (2) Healthcare Supply Chain Services "Medical; (3) Clinical Technologies and Services ("CTS"); and (4) Medical Products Manufacturing. It is stated that during the U.S. Customs and Border Protection's ("CBP") fiscal year 2008, the Office of the Regulatory Audit in Fort Mitchell, KY, completed an Importer Self-Assessment ("ISA") review of Cardinal Health, Inc.'s CTS business sector. Beginning January 1, 2006, Cardinal Health 303, Inc. ("CH 303," the Importer), a U.S. entity within Cardinal Health's CTS business sector and, thus, Cardinal Health's subsidiary, began importing Alaris disposable products that were manufactured by a foreign affiliate of Cardinal Health, Cardinal Health Switzerland 317 S.a.r.l. ("CH 317"). The entries are flagged for reconciliation at the time of importation.

This decision is being issued subsequent to the following: (1) A review of the Cardinal Health Overview of the U.S. Transfer Pricing Regulatory Framework; (2) A review of the ISA Team's Questions Regarding Transfer Pricing Methodology, and Cardinal Health, Inc.'s Responses; (3) A review of Cardinal Health, Inc.'s Valuation (Document Number: GTO-010.004); (4) A review of Cardinal Health, Inc.'s CBP ISA Memorandum of Understanding; (5) A review of Cardinal Health, Inc.'s Powerpoint Presentation, titled "Import Flow Chart," dated September 2007; (6) A review of Cardinal Health, Inc.'s Powerpoint

Presentation, titled "Working Together for Life;" and, (7) A review of Cardinal Health, Inc.'s Powerpoint Presentation, titled "Company Introduction," prepared for CBP ISA Team, dated September 18, 2007. Moreover, pursuant to CBP's requests for additional information, on June 15, 2009, Cardinal Health submitted the following documents: (1) ISA Submission to Customs; (2) US/Swiss Distribution Agreement; and (3) Internal Comparable results.

Pursuant to Paragraph 10 of the Importer's Distribution Agreement, dated January 1, 2006, the price charged by CH 317 (Manufacturer/Seller) to CH 303 (Importer) is CH 303's actual resale price minus a discount. It is stated that for the fiscal year ending June 30, 2008, CH 303's purchase of disposables from CH 317 totaled over [***] and CH 303's gross margin (discount) on the resale of CH 317 manufactured product was [***].

Cardinal Health engaged an independent accounting firm, Ernst & Young, LLP, to analyze and document certain intercompany transactions, between CH 303, the Importer, and CH 317, the Manufacturer and Seller. Subsequently, Cardinal Health submitted a Transfer Pricing Study, dated March 13, 2008 for our review. This transfer pricing study specifically applies to the Alaris line of products. It was also conducted in compliance with Section 482 of the Internal Revenue Code. However, according to Cardinal Health's submission, there is no Advance Pricing Agreement with the Internal Revenue Service.

Section 482 of the Internal Revenue Code (26 U.S.C. Â§482) requires that the arm's length result of a controlled transaction be determined under the method that, given the facts and circumstances, provides the most reliable measure of an arm's length result. The application of the best method establishes an arm's length range of prices or financial returns with which to test controlled transactions. As stated in CH 303's transfer pricing study, the Resale Price Method ("RPM"), applying internal and external comparables, was determined by Ernst & Young, LLP to be the best method to evaluate the inter-company tangible transactions between the foreign affiliate, CH 317 and the Importer, CH 303. We note that under this method, the arm's length price of goods acquired from a related party is determined by reducing the price realized on the resale of the goods to a non-related customer, by an appropriate gross margin. This gross margin is determined by reference to either the resale price margin earned by a member of the group in comparable uncontrolled transactions, or the resale price margin earned by an arm's length enterprise in comparable uncontrolled transactions. Under the RPM, comparable uncontrolled transactions may involve the same reseller or an appropriate gross margin derived from comparable uncontrolled transactions of other resellers (internal v. external comparables). Â§1.482-3(c)(3)(ii)(A). The gross margin should allow the seller to recover its operating costs and to earn an arm's length profit based on the functions performed, assets used, and the risks assumed. Where the transactions are not comparable in all ways and the differences have a material effect on price, the taxpayer must make adjustments to eliminate the effect of those differences.

As referenced in the transfer pricing study, RPM, applying internal comparables, was one of the methods used to evaluate transactions. This was accomplished by determining the distribution margin earned by CH 303 on the resale of medical products and devices manufactured by CH 317 and then comparing these distribution margins to the distribution margin earned by Cardinal Health 200, Inc. ("CH

200"), a U.S. affiliate of CH 303 and a member of the Cardinal Health consolidated group, on the resale of medical products and devices manufactured by unrelated third parties, such as Tyco, Kimberly-Clark, Johnson & Johnson, and 3M, et. al.

Pursuant to CH 303's additional submission, the gross margins for CH 200's resale of third-party manufactured products were identified for each of the years 2006, 2007, and 2008. These gross margins for CH 200 ranged from [***] with a simple average of [***], while the gross margins on third-party manufactured products ranged from [***]. This data reflects gross margins earned by CH 200 on the resale of medical products and devices manufactured by unrelated parties. It is stated that the intercompany transfer price has been adjusted to be higher than the results from the unrelated party products to reflect additional marketing and distribution activities done by CH 303 on the disposables versus the third-party products.

Moreover, CH 303's transfer pricing study also used RPM applying external comparables to evaluate the company's transactions. This was accomplished by determining the distribution margin earned by CH 303 in the resale of medical products and devices manufactured by CH 317 and then comparing these distribution margins to the distribution margin earned by unrelated sales and distribution companies on the resale of similar medical products and devices.

In selecting comparables for its analysis, Ernst & Young LLP, reviewed several on-line and CD-ROM databases and focused on companies under the following Standard Industrial Classification ("SIC") code: 5047 (Wholesale Trade: Medical, Dental & Hospital Equipment and Supplies). This search was conducted to identify public companies that distribute medical products and devices comparable to CH 303. The search identified 113 companies. In order to limit the search to unrelated companies with fact patterns most similar to CH 303, the following criteria were incorporated: (1) the company should not be a subsidiary; (2) the company should be a distributor; (3) the company should not remanufacture parts, or sell to the retail or aftermarket as a significant portion of its business; and, (4) at least 2 or 3 years of reliable profit information must be available. This evaluation stage also eliminated companies with unrelated business lines that made up a substantial portion of revenues, as well as start-up companies. This search and selection yielded six (6) comparable companies. It is important to note that all 6 comparable companies distribute medical products and supplies, and pursuant to Cardinal Health's submission, these companies are direct competitors of Cardinal Health. For the period 2004 through 2006, the interquartile range of comparable distributors' gross margins was [***], with a median of [***]. For this same period, the full range was [***].

ISSUES:

Whether transaction value is the appropriate basis of appraisal of the imported merchandise?

LAW AND ANALYSIS:

Merchandise imported into the United States is appraised for customs purposes in accordance with

Section 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 (TAA; 19 U.S.C. Â§1401a). The primary method of appraisement is transaction value, which is defined as "the price actually paid or payable for the merchandise when sold for exportation to the United States," plus amounts for certain statutorily enumerated additions to the extent not otherwise included in the price actually paid or payable. See 19 U.S.C. Â§1401a(b)(1). Transaction value is an acceptable basis of appraisement only if, inter alia, the buyer and seller are not related, or if related, an examination of the circumstances of the sale indicates that the relationship did not influence the price actually paid or payable, or the transaction value of the merchandise closely approximates certain "test values." 19 U.S.C. Â§1401a(b)(2)(B); 19 CFR Â§152.103(l). While the fact that the buyer and seller are related is not in itself grounds for regarding transaction value as unacceptable, where CBP has doubts about the acceptability of the price and is unable to accept transaction value without further inquiry, the parties will be given the opportunity to supply such further detailed information as may be necessary to support the use of transaction value pursuant to the methods outlined above.

"Test values" refer to values previously determined pursuant to actual appraisements of imported merchandise. Thus, for example, a deductive value calculation can only serve as a test value if it represents an actual appraisal of merchandise under section 402(d) of the TAA. Headquarters Ruling Letter ("HRL") 543568, dated May 30, 1986. In this instance, no information regarding test values has been submitted or is available; consequently, the circumstances of the sale must be examined in order to determine the acceptability of transaction value.

Under this approach, the transaction value between a related buyer and seller is acceptable if an examination of the circumstances of the sale indicates that although related, their relationship did not influence the price actually paid or payable. The Customs Regulations specified in 19 CFR Part 152 set forth illustrative examples of how to determine if the relationship between the buyer and the seller influences the price. In this respect, Customs will examine the manner in which the buyer and seller organize their commercial relations and the way in which the price in question was derived in order to determine whether the relationship influenced the price. If it can be shown that the price was settled in a manner consistent with the normal pricing practices of the industry in question, or with the way in which the seller settles prices with unrelated buyers, this will demonstrate that the price has not been influenced by the relationship. See 19 CFR Â§152.103(l)(1)(i)-(ii). In addition, Customs will consider the price not to have been influenced if the price was adequate to ensure recovery of all costs plus a profit equivalent to the firm's overall profit realized over a representative period of time. 19 CFR Â§152.103(l)(1)(iii). These are examples to illustrate that the relationship has not influenced the price, but other factors may be relevant as well.

In order to show that the circumstances of the sale did not influence the price, CH 303 submitted its transfer pricing study for our review and consideration. We note that the existence of a transfer pricing study does not, by itself, obviate the need for CBP to examine the circumstances of sale in order to determine whether a related party price is acceptable. **HRL 546979**, dated August 30, 2000. However, information provided to CBP in a transfer pricing study may be relevant in examining circumstances of the sale, but the weight to be given this information will vary depending on the details set forth in the study. See **HRL 548482**, dated July 23, 2004. A significant factor, by the way of example, is whether the

transfer pricing study has been reviewed and approved by the IRS. See **HRL 546979**, dated August 30, 2000. Whether products covered by the study are comparable to the imported products at issue is another important consideration. See **HRL 547672**, dated May 21, 2002. The methodology selected for use in a transfer pricing study is also relevant. **HRL 548482**, dated July 23, 2004. Thus, even though CH 303's transfer pricing study by itself is not sufficient to show that a related party transaction value is acceptable for Customs purposes, the underlying facts and the conclusions reached in CH 303's transfer pricing study may contain relevant information in examining the circumstances of the sale.

As indicated above, if it can be shown that the price in question was settled in a manner consistent with the normal pricing practice of the industry in question, this will demonstrate that the price has not been influenced by the relationship. CBP has noted that the Importer must have objective evidence of how prices are set in the relevant industry in order to establish the "normal pricing practices of the industry" in question, and present evidence that the transfer price was settled in accordance with these industry pricing practices. See **HRL 542261**, dated March 11, 1981 (CBP determined that the transfer price was defined with reference to prices published in a trade journal (the posted price) and other buyers and sellers commonly used the posted price as the basis of contract prices). The pricing practices must relate to the industry in question, which generally includes the industry that produces goods of the same class or kind as the imported merchandise. **HRL 546998**, dated January 19, 2000; and **HRL 548095**, dated September 19, 2002. CBP does not consider the industry in question to consist of other functionally equivalent companies if those companies do not sell goods of the same class or kind. See **HRL 548482**, dated July 23, 2004. In this respect, we reviewed the information contained in CH 303's transfer pricing study and conclude that the products sold by the comparable companies are of the same class or kind as the imported merchandise. All comparable companies distribute medical products and supplies, and most importantly, these companies are direct competitors of Cardinal Health, Inc. Under these circumstances, the comparison between CH 303 and the other comparable companies, as stated in the transfer pricing study, may be considered to be consistent with the market as a whole, thereby demonstrating that the price between CH 317 and CH 303 was settled in a manner consistent with the normal pricing practices of the industry. An adequate level of product comparability was observed. Thus, the gross margins on the resale of the imported merchandise were shown to be generally the same to those in the medical product and supplies industry. On the basis of the transfer pricing study, we are satisfied that the circumstances of the sale establish that the price was settled in a manner consistent with the normal pricing practices of the industry.

The transfer pricing study found that the inter-quartile range of the comparable companies' gross margins is [***]. Pursuant to Paragraph 10 of the Importer's Distribution Agreement, dated January 1, 2006, the price charged by CH 317 (Manufacturer/Seller) to CH 303 is CH 303's actual resale price minus a discount. CH 303's gross margin (discount) on the resale of CH 317 manufactured products is [***]. Thus, a comparison of the gross margins between CH 303 and other comparable companies show that the gross margin of CH 303, as determined in the transfer pricing study, is within the range of other comparable companies. Accordingly, since all companies sell the merchandise of the same class or kind, the transfer pricing study supports a finding that CH 303's price was settled in a manner that was consistent with the normal pricing practices of the industry.

Furthermore, Cardinal Health used the RPM, applying internal comparables, to evaluate the transactions subject to review in the transfer pricing study. This was accomplished by determining the distribution gross margin earned by CH 303 on the resale of medical products and devices manufactured by CH 317 and then comparing these distribution gross margins to the distribution gross margins earned by CH 200, a U.S. affiliate of CH 303, on the resale of medical products and devices manufactured by unrelated third parties. As stated previously, Cardinal Health identified the gross margins for CH 200 on the resale of third-party manufactured products for the years 2006, 2007, and 2008. The gross margins for CH 200 ranged from [***] with a simple average of [***]. The gross margins for CH 200 on the sale of the merchandise purchased from unrelated parties are lower than the gross margins on the sale between CH 303 and CH 317. Since the CH 303's gross margin on the resale of CH 317 manufactured products is [***], it is [***] higher than the gross margins for CH 200. According to Cardinal Health, the intercompany transfer price has been adjusted to be higher than the results from the unrelated party products to reflect additional marketing and distribution activities done by CH 303 on the disposables versus the third party products. We find this argument persuasive and determine that the gross margin, and, therefore, the related party price, CH 303 earns on the resale of the merchandise manufactured by CH 317 is comparable to the gross margins CH 200 earns on the resale of the merchandise manufactured by third party producers.

Based on our review of the information submitted, we conclude that we have examined the relevant aspects of the transaction, including the way in which the Importer and the Manufacturer organized 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 Cardinal Health has demonstrated that the price has not been influenced by the relationship for purposes of the circumstances of the sale test, and, as such, transaction value is the acceptable method of appraisal.

HOLDING:

In conformity with the foregoing, transaction value is the appropriate method of appraisal in respect of sales between CH 303 and CH 317. However, if the circumstances set out in the Cardinal Health's submission change, the status of the approval of the transfer pricing methodology should be discussed with CBP as the change in circumstances or any change in the annual transfer pricing study might necessitate the issuance of another decision.

This decision should be mailed by your office to the party requesting Internal Advice no later than 60 days from the date of this letter. On that date, the Office of Regulations and Rulings will make the decision available to CPB personnel, and to the public on the CPB Home Page on the World Wide Web at www.cbp.gov, by means of the Freedom of Information Act, and other methods of public distribution. Please do not hesitate to contact us at (202) 325-0042 if you have any questions or concerns.

Sincerely,

Monika R. Brenner, Chief - Valuation and Special Programs Branch