

March 31, 2010

HQ H032883

OT:RR:CTF:VS H032883 YAG

CATEGORY: Valuation

Port Director  
Port of Charleston  
U.S. Customs and Border Protection  
200 East Bay Street  
Charleston, SC 29401

Re: Internal Advice Request; Applicability of Transaction Value; Related Party Transactions

Dear Port Director:

This is in response to the internal advice request, initiated by [\*\*\*] (the "Company") and filed by counsel, Damon V. Pike on February 4, 2008 regarding the proper method of appraisal of the merchandise imported by the Canadian subsidiary of the Company [\*\*\*]. We regret the delay in responding.

The Company [\*\*\*] has asked that certain information submitted in connection with this internal advice be treated as confidential. Inasmuch as the request conforms to the requirements of 19 CFR §177.2(b)(7), the company's request for confidentiality is approved. The information contained within brackets and all attachments to the internal advice request, forwarded to our office, will not be released to the public and will be withheld from published versions of this ruling.

**FACTS:**

The Company [\*\*\*] designs, manufactures, and markets specialized textile fabrics called Paper Machine Clothing ("PMC"). PMC is a highly-engineered textile fabric installed on paper machines to carry the paper stock through each stage of the paper-making process. It is stated that the design and composition of PMC has a significant impact on the quality of paper products and the efficiency of the paper machine on which it is used. The company also designs, manufactures, and markets technical fabrics for the non-woven, textile, filtration, and food industries as well as paper machine drainage equipment and filaments.

Each PMC fabric is tailor-made for specific end customers. Additionally, PMC is imported into the United States in two ways: (1) as Finished Goods ("FG") or (2) Works

in Progress (“WIP”). The merchandise is classified under subheading 5911.31 or 5911.32 of the Harmonized Tariff Schedule of the United States (“HTSUS”). The company is headquartered in [\*\*\*], which is also the global headquarters for all [\*\*\*] entities worldwide. The Company [\*\*\*] is a parent company that purchases PMC from its subsidiary in Canada, [\*\*\*] [\*\*\*], for resale to unrelated customers in the United States. The Company’s subsidiary in Canada acts as a non-resident importer for all merchandise sold to the Company [\*\*\*] and uses pro forma invoices to facilitate Customs’ clearance.

CBP issued a request for information (“CF 28”), dated August 28, 2006 covering Entry Number [\*\*\*] (importations from the Czech Republic). Additionally, on October 3, 2006, the Importer filed a Prior Disclosure, pertaining to the merchandise imported from the Czech Republic, stating that [\*\*\*], a seller, was a related party. On October 26, 2006, the Importer clarified the pricing of the merchandise imported from Czech Republic and stated that [\*\*\*] the related party seller erroneously appraised the merchandise under the “cost-plus” formula. On November 14, 2006, CBP issued subsequent CF 28s, covering Entry Numbers [\*\*\*] and [\*\*\*] concerning two (2) particular FG transactions: one from a related seller in Germany<sup>1</sup> and one in the Czech Republic. The CF 28s requested the Importer to submit a copy of the contract/purchase order, all correspondence related to the transactions subject to CF 28s, a breakdown of components with the method of appraisement, and proof of payment for the above mentioned entries. Furthermore, in additional submissions to the Port, dated September 18, 2006, October 26, 2006, and December 11, 2006, the Importer claimed that the merchandise was properly appraised under the deductive value method of appraisement. However, on August 20, 2007, during a meeting with the Assistant Port Director for the Port [\*\*\*], the Importer claimed that the transaction value method of appraisement was applicable to the imports of FG and WIP goods from the related party sellers. Therefore, on November 9, 2007, the Port [\*\*\*] issued a CF 28 covering a WIP fabric sent from an unrelated producer in [\*\*\*] to the Canadian subsidiary [\*\*\*] for further processing, and then imported into the United States for final finishing. This Internal Advice request followed.<sup>2</sup>

This decision is being issued subsequent to the following: (1) A review of the Company’s [\*\*\*] “Enterprise Pricing Model” (“EPM”) document, which went into effect on January 1, 2007; (2) A review of the Company’s [\*\*\*] Transfer Pricing Updates for Fiscal Years Ending December 31, 2005 and December 31, 2007 (prepared by outside consultant, Ceteris, Inc.); (3) the Company’s [\*\*\*] original Transfer Pricing Study, dated 2002 (prepared by outside consultant PricewaterhouseCoopers LLP); and, (4) Canada Border Service Agency’s Final Verification Report.

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<sup>1</sup> The Company [\*\*\*] has since sold its ownership interest in the German manufacturing entity and is no longer related to it within the meaning of CBP regulations.

<sup>2</sup> This decision with respect to the Importer’s request for Internal Advice only applies to the importations of PMC, which encompasses WIP and FG, but not filaments (monofilament yarn or filament is the basic “building block” of PMC fabrics).

Moreover, on February 3, 2009, in response to our request for additional information, the Company [\*\*\*] provided the following documents to substantiate its arguments concerning the proper method of appraisal of the imported merchandise and the existence of a bona fide sale (the company chose to illustrate the bona fide sale and the determination of transaction value by submitting materials representative of sample FG and WIP transactions): (1) A representative Entry Summary for a FG shipment from the Company's Canadian subsidiary [\*\*\*], to the Buyer;<sup>3</sup> (2) FG purchase order, dated September 18, 2007, from [\*\*\*] ("K"), the end customer unrelated to either the Buyer or the Seller (their purchase order, dated September 18, 2007 to the Company [\*\*\*], initiated the manufacturing process for the imported [\*\*\*] fabric); (3) FG purchase order, dated September 10, 2007 from the Canadian subsidiary [\*\*\*] plant to the Buyer (this internal purchase order was prompted by the end customer K [\*\*\*] purchase order to the Company [\*\*\*]); (4) FG Bill of Materials for the sample importation transaction (the unique fabric number on the bill of materials is tied to the unique fabric number on the K [\*\*\*] purchase order, also provided for our review); (5) FG pro forma invoice, dated September 29, 2007 from the Canadian subsidiary [\*\*\*] to the Company [\*\*\*] (the invoice amount matches the amount reported to CBP on the CF7501 (also provided for our review) for the transaction in question<sup>4</sup>); (6) FG final invoice to the unrelated end customer, K [\*\*\*], dated July 24, 2008; (7) Entry Summary representative of a sample WIP transaction; (8) WIP purchase order from another unrelated end customer, ("T") [\*\*\*], to the Company [\*\*\*], dated September 13, 2006 (with the unique fabric number assigned by the Company [\*\*\*]); (9) WIP internal purchase order, dated October 30, 2006, from the Company's Canadian subsidiary [\*\*\*] to the Company's [\*\*\*] [\*\*\*] plant (this internal purchase order was prompted by the purchase order from the unrelated end customer T to the Company [\*\*\*]); (10) WIP print-out of the bill of material for the sample importation, listing style number, which ties to the fabric description on the intercompany purchase order; (11) WIP pro forma invoice, dated October 30, 2006 from the Canadian subsidiary [\*\*\*] to the Company [\*\*\*] for the fabric subject to this transaction (the invoice matches the amount shown on the bill of material; this amount is the same amount reported to CBP as the customs value); (12) WIP CF7501; (13) WIP final invoice to the unrelated end customer T in the United States, dated November 13, 2006 (the price matches the price on the original purchase order from T to the Company [\*\*\*] and ties to the unique fabric number on the purchase order as well); and, (14) intercompany account details for September and October of 2007, as well as month-end balance summaries. The Importer, the Company [\*\*\*], also provided the Canadian subsidiary's [\*\*\*] Segmented Income Statement by Transaction Type and its Transfer Pricing Documentation Chapter (Canada) for fiscal year ended December 31, 2007, prepared by outside consultant, Ceteris, Inc.

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<sup>3</sup> The representative summary that the Company chose to disclose to CBP in order to prove that there was a bona fide sale between the companies was the subject of a CF 28 request from the Port of [\*\*\*], dated November 9, 2007.

<sup>4</sup> The invoice amount differs slightly from the respective purchase order amount, because, according to the Importer, the intercompany sales price is always re-calculated as of the date of the shipment to make sure the prices remain consistent with the company's EPM. The company states that the FG price is determined at the time of shipment of the fabric to the customer or to the buyer.

Furthermore, the Company [\*\*\*] states that all invoice amounts are recorded in the Company's [\*\*\*] inter company trade account, which includes transactions with all foreign entities, including the Canadian subsidiary [\*\*\*]. This account uses "debits" and "credits" for each purchase/sale between the Company [\*\*\*] and its foreign entities, which are recorded as accounts payable and accounts receivable on its balance sheet. In other words, all shipments from the Canadian subsidiary [\*\*\*] are booked as accounts payable on a monthly basis in the trade account and represent the aggregate of all import values for that month. Likewise, all shipments from the Company [\*\*\*] to the Canadian subsidiary [\*\*\*] are booked as accounts receivables. At the end of each month, accounts payable are offset against the accounts receivables and a debit or credit is issued depending on the month-end balance. Therefore, the Company [\*\*\*] states that it uses a "payment in kind" system rather than a "cash payment" system. To substantiate these statements, the Company [\*\*\*] submitted intercompany account details for September and October of 2007, showing the amount charged in a representative sample FG transaction as a payable from the Company [\*\*\*] to the Canadian subsidiary [\*\*\*] and a receivable to the Canadian subsidiary [\*\*\*] from the Company [\*\*\*] (month-end balance is also shown on the statement). The term of sale of the merchandise is "FCA Seller Mfg Plant," which means that whenever a fabric is delivered alongside the carrier's truck at the Canadian subsidiary's [\*\*\*] respective Canadian plant, title and risk of loss pass to the Company [\*\*\*].

The Importer states that the Company [\*\*\*] uses its EPM to determine the prices of all products it produces, finishes, or distributes from the related party sellers/suppliers and buyers. The "enterprise price" is a combination of production costs and sales price, and varies by product. The EPM sets forth the following formulas for determining the global inter-company prices for WIP and FG merchandise:

- A. WIP – Cost to Produce plus [\*\*\*] %
- B. FG – Customer Price less [\*\*\*] %

The EPM formulas are updated yearly, based on the mandates outlined in the Company's [\*\*\*] Transfer Pricing Study, prepared by PricewaterhouseCoopers LLP and its updates in 2005 and 2007, prepared by Ceteris, Inc. as well as with the Canadian subsidiary's [\*\*\*] transfer pricing documentation Chapter – Canada, for fiscal year ended December 31, 2007. According to the Importer, all products are priced the same way according to their product category. All transfer pricing studies and updates are conducted in compliance with Section 482 of the Internal Revenue Code. However, according to the Company's [\*\*\*] submission, there is no Advance Pricing Agreement with the Internal Revenue Service ("IRS").<sup>5</sup>

The Company's [\*\*\*] initial transfer pricing study was prepared by an outside consulting firm, PricewaterhouseCoopers LLP, in 2002. PricewaterhouseCoopers, LLP was engaged by the Company [\*\*\*] and the Canadian subsidiary [\*\*\*] and related

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<sup>5</sup> An APA constitutes a prospective agreement between a taxpayer and the IRS (and in the case of bilateral APAs, foreign tax authorities) regarding the correct transfer pricing methodologies under tax laws to be applied to transactions between related parties.

affiliates to analyze tangible and intangible property intercompany transactions, as well as the intercompany provision of management and research and development services within the Company group [\*\*\*]. The first analysis under the initial transfer pricing study was conducted to determine the arm's length nature of the intercompany transactions related to the distribution of finished goods by the Company [\*\*\*] and the Canadian subsidiary [\*\*\*].

Section 482 of the Internal Revenue Code (26 U.S.C. §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 the Company's [\*\*\*] transfer pricing study prepared by PricewaterhouseCoopers LLP, the Comparable Profits Method ("CPM") was selected as the best method to evaluate the inter-company tangible transactions between the foreign affiliate/seller, (the Canadian subsidiary) [\*\*\*] and the parent company/buyer, (the Company) [\*\*\*]. The CPM examines whether the amount charged in a controlled transaction is an arm's length price by comparing the profitability of the tested party to that of comparable companies. The operating margin, defined in the study as operating profit divided by net sales, was selected as the most reliable profit level indicator ("PLI") to test the reasonableness of the intercompany pricing between the Company [\*\*\*] and the Canadian subsidiary [\*\*\*]. The tested party under the CPM transfer pricing analysis is the entity that performs the least complex functions and faces the least amount of risk. The Company [\*\*\*] and the Canadian subsidiary [\*\*\*] were each selected as the tested party in their respective parts of the analysis. Specifically, where the Canadian subsidiary [\*\*\*] distributes products that have been completely manufactured by the Company [\*\*\*], the Canadian subsidiary [\*\*\*] serves as a tested party. However, the Company [\*\*\*] serves as a tested party when it acts as a routine distributor for products completely manufactured by the Canadian subsidiary [\*\*\*].

In selecting comparables for its analysis, PricewaterhouseCoopers, LLP reviewed publicly-available databases and focused on companies under the following Standard Industrial Classification ("SIC") codes: 5084 (Industrial Machinery and Equipment) and 5085 (Industrial Supplies). The search identified 22 companies. In order to limit the search to unrelated companies with the distribution activities similar to the Company [\*\*\*] and the Canadian subsidiary [\*\*\*], the companies were eliminated if the following criteria applied: (1) the company was engaged in significant manufacturing or development activity; (2) the company was engaged in the distribution of gases, safety equipment, or other product lines involving a non-comparable industry; (3) the company was primarily involved in providing services. This search and selection yielded nine (9) comparable companies, which distribute industrial products, electronic computer-controlled embroidery machinery, cutting tools and products, textile and laundry equipment, and other industrial components. The financial data for the comparable parties identified were adjusted for differences in levels of accounts receivable, inventory, and accounts payable between tested parties and each

comparable company. Thus, for the Company's [\*\*\*] distribution activities, the arm's length range is between [\*\*\*] % and [\*\*\*] %, with a median of [\*\*\*] % for the comparable distributors. This arm's length range was established on the basis of an objective, third-pricing data for distributors (comparable companies), which perform similar functions and assume similar risks as the Importer. Utilizing the Canadian subsidiary's [\*\*\*] financial data, the same adjustments were performed on the financial data of the comparable distributors. The adjusted operating margin interquartile range for the comparable distributors in case of the Canadian subsidiary [\*\*\*] distribution activities extends from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %.

The second analysis, conducted by PricewaterhouseCooper, LLP was to determine the arm's length nature of the intercompany transactions related to the manufacturing activities of the Company [\*\*\*] and the Canadian subsidiary [\*\*\*]. These transactions relate to the transfer of semi-finished goods. The CPM was chosen as the best method to conduct this analysis. The mark-up on total cost, defined in the study as operating profit divided by total costs, was selected as the most reliable PLI to test the reasonableness of the intercompany pricing between the Company [\*\*\*] and the Canadian subsidiary [\*\*\*]. Similarly to the distribution analysis, the Company [\*\*\*] and the Canadian subsidiary [\*\*\*] were each selected as the tested party in their respective parts of the analysis. Research was conducted to identify a set of comparable North American manufacturers. In selecting comparables for its analysis PriceWaterhouseCoopers, LLP reviewed publicly-available databases and focused on companies under the following Standard Industrial Classification ("SIC") codes: 2200-2299 (Textile Mill Products), 2821 (Plastics Materials, Synthetic Resins, and Nonvulcanizable Elastomers), and 2824 (Manmade Organic Fibers, Except Cellulosic). The search identified 140 potentially comparable companies. In order to limit the search to unrelated companies with the manufacturing activities similar to the Company [\*\*\*] and the Canadian subsidiary [\*\*\*], the companies were eliminated if the following criteria applied: (1) the company was engaged in manufacturing finished consumer products, such as apparel, carpet, and furniture; (2) the company was engaged in producing diversified chemicals or specialty materials; (3) the company was engaged in producing non-comparable plastic or polymer materials. This search and selection yielded eleven (11) comparable companies, which manufacture composite materials, technical textiles, paper machine clothing, filament, novelty and spun yarns, upholstery fabrics, mattress ticking, and other industrial fabrics. Additionally, two comparable companies discussed in this transfer pricing study are the direct competitors of the Company group [\*\*\*]. Using the Company [\*\*\*] financial data, adjustments were performed on the financial data of comparable companies.<sup>6</sup> The three-year (2000-2002) adjusted mark-up on total costs interquartile range for the comparable manufacturers extends from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Using the Canadian subsidiary [\*\*\*] financial data, the three-year (2000-2002) adjusted mark-up on total costs interquartile range for the comparable manufacturers extends from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %.

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<sup>6</sup> The financial data for the comparable parties identified were adjusted for differences in levels of accounts receivable, inventory and accounts payable between tested parties and each comparable company.

The initial PricewaterhouseCoopers, LLP analysis was updated in 2005 and 2007. Under both updates, CPM was selected as the best method for distribution and manufacturing activities of the Company [\*\*\*] and the Canadian subsidiary [\*\*\*]. Both companies, the Company [\*\*\*] and the Canadian subsidiary [\*\*\*] were chosen as tested parties. Pursuant to 2005 update, an updated search for U.S. and Canadian distribution companies was performed. This search resulted in seven (7) comparable companies (as opposed to 9 comparable companies under the initial transfer pricing analysis by PricewaterhouseCoopers, LLP). Due to unexplained reasons, two companies were dropped from the analysis. None of the 7 remaining comparable companies distributed the merchandise of the same class or kind or were direct competitors of the Company [\*\*\*] or the Canadian subsidiary [\*\*\*]. Adjustments were made to the comparable companies for the Company [\*\*\*] distribution function when there were at least three years of financial data available. Using an interquartile analysis, the range of the operating margin results for the comparable companies extended from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Similar to the Company [\*\*\*] distribution transactions, working capital adjustments were made to comparable companies for the Canadian subsidiary [\*\*\*] distribution functions when there were at least three years of data available. The interquartile range extended from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Based on these results, Ceteris, Inc. concluded that the Company's [\*\*\*] and the Canadian subsidiary's [\*\*\*] transfer pricing policy of a [\*\*\*] % operating margin target for distribution activities was within the arm's length for the most recent three-year period (2003-2005). The same search for comparable companies was performed by Ceteris for the companies' manufacturing activities. This search resulted in nine (9) comparable companies (as opposed to 11 comparable companies under the initial transfer pricing analysis by PricewaterhouseCoopers, LLP). Again, two companies were dropped from the analysis. However, the remaining 9 comparable companies manufactured the merchandise of the same class or kind as was mentioned in the initial PricewaterhouseCoopers, LLP transfer pricing study. Additionally, two comparable companies are the direct competitors of the Company group [\*\*\*]. Using the U.S. Company [\*\*\*] financial data, adjustments were performed on the financial data of comparable companies.<sup>7</sup> The three-year adjusted mark-up on total costs interquartile range for the comparable manufacturers extends from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Using the Canadian subsidiary [\*\*\*] financial data, the three-year adjusted mark-up on total costs interquartile range for the comparable manufacturers extends from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Thus, Ceteris, Inc. concluded that the Company's [\*\*\*] transfer pricing policy of a [\*\*\*] % return on total operating costs for manufacturing activities was slightly above the adjusted range for the most recent three-year period (2003-2005). The Canadian subsidiary's [\*\*\*] [\*\*\*] return on total operating costs was within the range. Therefore, based on updated comparables analysis for 2003-2005, the intercompany transactions were considered to be at arm's length.

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<sup>7</sup> The financial data for the comparable parties identified were adjusted for differences in levels of accounts receivable, inventory and accounts payable between tested parties and each comparable company.

In 2007, Ceteris, Inc. again updated the Company group's [\*\*\*] transfer pricing policy, by performing another search for comparable companies. With respect to the Company's [\*\*\*] and the Canadian subsidiary's [\*\*\*] distribution activities, this search resulted in 10 comparable companies, which again did not sell the merchandise similar to that of the tested parties. Adjustments were made to the comparable companies for the Company's [\*\*\*] distribution functions (adjustments were performed to take into account the differences in the levels of accounts receivable, inventory, and accounts payable). Using an interquartile analysis, the range of the operating margin results for the comparable companies extended from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Similar to the Company's [\*\*\*] distribution transactions, working capital adjustments were made to comparable companies for the Canadian subsidiary's [\*\*\*] distribution functions when there were at least three years of data available. The interquartile range extended from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Based on these results, Ceteris, Inc. concluded that the Company's [\*\*\*] operating margin of [\*\*\*] % for 2005-2007 was above the range, which means the Company [\*\*\*] earned at least an arm's length return on this transaction, and, therefore, no transfer pricing adjustments were necessary. For the same period the Canadian subsidiary [\*\*\*] earned an operating margin of [\*\*\*] %, and therefore and the Canadian subsidiary's [\*\*\*] operating margin target for distribution activities was within the arm's length for 2005-2007.

The same search for comparable companies was performed by Ceteris, Inc. for the companies' manufacturing activities. This search resulted in eight (8) comparable companies for 2005-2007, with similar descriptions as was articulated in the initial transfer pricing study in 2002. Additionally, two comparable companies in the analysis are the direct competitors of the Company group [\*\*\*]. Using the Company's [\*\*\*] financial data, adjustments were performed to the financial data of comparable companies.<sup>8</sup> The three-year adjusted mark-up on total costs interquartile range for the comparable manufacturers extends from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Using the Canadian subsidiary's [\*\*\*] financial data, the three-year adjusted mark-up on total costs interquartile range for the comparable manufacturers extends from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Thus, Ceteris, Inc. concluded that the Company [\*\*\*] transfer pricing policy of a [\*\*\*] % return on total operating costs for manufacturing activities was within the adjusted range for the most recent three-year period (2005-2007). The Canadian subsidiary's [\*\*\*] [\*\*\*] % return on total operating costs was within the range. Therefore, based on updated comparables analysis for 2005-2007, the intercompany transactions were considered to be at arm's length.

The Importer also provided us with the transfer pricing study of the Canadian subsidiary [\*\*\*]. This transfer pricing study also employs virtually the same set of comparable companies as they appeared in the original transfer pricing study prepared by PricewaterhouseCooper, LLC and 2005, and 2007 updates prepared by Ceteris, Inc. for the Company [\*\*\*]. The one major difference is that the Canadian subsidiary's

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<sup>8</sup> The financial data for the comparable parties identified were adjusted for differences in levels of accounts receivable, inventory and accounts payable between tested parties and each comparable company.

[\*\*\*] transfer pricing study includes the intercompany sale of products manufactured by the Czech Republic related seller and distributed by the Canadian subsidiary [\*\*\*]. This transfer pricing study similarly evaluates the Company's [\*\*\*] and the Canadian subsidiary's [\*\*\*] distribution and manufacturing activities. The Transactional Net Margin Method ("TNMM") was selected as the most reliable method. The TNMM is similar to the CPM method used in the United States. The TNMM examines the net profit margin relative to an appropriate base (e.g. costs, sales, and assets) that a related party realizes from a controlled transaction (or transactions that would be appropriate to aggregate under certain principles). The Company [\*\*\*] and the Canadian subsidiary [\*\*\*] were selected as tested parties. A set of 10 comparable companies was evaluated to arrive at the full range for the distribution activities (in the Canadian subsidiary's [\*\*\*] transfer pricing study, an interquartile range was neither used nor calculated due to Canada's application of the transfer pricing methodologies. According to the Company [\*\*\*], Canada does not use the "interquartile range" approach, common in the United States). None of the companies distribute the merchandise of the same class or kind as the Company [\*\*\*] or the Canadian subsidiary [\*\*\*]. With respect to the Company [\*\*\*] distribution activities, the adjusted full range of operating margins for the comparable companies was from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Since the Company [\*\*\*] earned an operating margin of [\*\*\*] % distributing the Canadian subsidiary's [\*\*\*] goods, the company was well within the range. The adjusted full range of operating margins for comparable companies with respect to the Canadian subsidiary's [\*\*\*] distribution activities was [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. Since the Canadian subsidiary [\*\*\*] earned an operating margin of [\*\*\*] % when distributing the Company [\*\*\*] goods, it was also within the range. To analyze the Company's [\*\*\*] and the Canadian subsidiary's [\*\*\*] manufacturing activities, a search for comparable companies resulted in eight companies, two of which were direct competitors of the Company group [\*\*\*], with other companies selling the merchandise of the same class or kind as the Company [\*\*\*] and the Canadian subsidiary [\*\*\*]. For the Company's [\*\*\*] manufacturing activities, adjusted full range of returns on total operating costs for the comparable companies extended from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. The Company's [\*\*\*] return on total operating costs was [\*\*\*] when manufacturing WIP goods distributed by the Canadian subsidiary [\*\*\*]. This markup of [\*\*\*] % was within the range. Similar to the Company [\*\*\*] manufacturing activities, the working capital adjustments were made to the comparable companies for the Canadian subsidiary's [\*\*\*] manufacturing functions. The adjusted full range of the total operating costs for the comparable companies was from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. For FY2007, the Canadian subsidiary's [\*\*\*] return on total operating costs was [\*\*\*] % when manufacturing WIP goods distributed by the Company [\*\*\*]. Accordingly, the Canadian subsidiary's [\*\*\*] markup of [\*\*\*] % was within the full range.

Finally, it is stated that the Company [\*\*\*] does not participate in the Reconciliation Program, and, thus, does not make any post-importation adjustments to the values of merchandise imported during its fiscal year. The company states that its policy is to always remain within the interquartile range by "testing" its profitability through periodic review of the Segmented Income Statement. Its pricing formula is updated at the beginning of each fiscal year and the new EPM is followed after January

1<sup>st</sup> for all pricing in that subsequent year. The Importer states that it has not had any adjustments to date. Therefore, the Importer is not requesting a decision with respect to the compensating adjustments.

## **ISSUE:**

1. Do transactions between the Canadian subsidiary (Seller) and the Company (Importer/Buyer) constitute bona fide sales?
2. Do the circumstances of the sale establish that the price actually paid or payable by the Company (importer/buyer) to the Canadian subsidiary (seller) was not influenced by the relationship of the parties and is acceptable for the purposes of transaction value?

## **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. §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. §1401a(b)(1). When transaction value cannot be applied, then the appraised value is determined based on the other valuation methods in the order specified in 19 U.S.C. §1401a(a).

In order to use transaction value, there must be a bona fide sale for exportation to the United States. Several factors are relied on to determine whether a bona fide sale exists. See Headquarters Ruling Letter ("HRL") 546067, dated October 31, 1996.

Furthermore, there are special rules that apply when the buyer and seller are related parties, as defined in 19 U.S.C. §1401a(g). Specifically, transaction value between a related buyer and seller is acceptable only if the transaction satisfies one of two tests: (1) circumstances of the sale or (2) test values. See 19 U.S.C. §1401a(b)(2)(B). "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 appraisement of merchandise under section 402(d) of the TAA. 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.

1. Do transactions between the Canadian subsidiary (Seller) and the Company (Importer/Buyer) constitute bona fide sales?

In order for transaction value to be used as a method of appraisement, it is essential that a "sale" between the parties is available. In VWP of America, Inc. v.

United States, 175 F.3d 1327 (Fed.Cir. 1999), the Court of Appeals for the Federal Circuit found that the term “sold” for purposes of 19 U.S.C. §1401a(b)(1) means a transfer of title from one party to another for consideration (citing J.L. Wood vs. United States, 62 CCPA, 25, 33, C.A.D. 1139, 505 F.2d 1400, 1406 (1974)).

No single factor is decisive in determining whether a bona fide sale has occurred. See HRL 548239, dated June 5, 2003. CBP will consider such factors as to whether the purported buyer assumed the risk of loss for, and acquired title to, the imported merchandise. Evidence to establish that consideration has passed includes payment by check, bank transfer, or payment by any other commercially acceptable means. Payment must be made for the imported merchandise at issue; a general transfer of money from one corporate entity to another, which cannot be linked to a specific import transaction, does not demonstrate passage of consideration. See HRL 545705, dated January 27, 1995.

In addition, CBP may examine whether the purported buyer paid for the goods, and whether, in general, the roles of the parties and the circumstances of the transaction indicate that the parties are functioning as buyer and seller. See HRL H005222, dated June 13, 2007.

Finally, pursuant to the CBP’s Informed Compliance Publication, entitled “Bona Fide Sales and Sales for Exportation,” CBP will consider whether the buyer provided or could provide instructions to the seller, was free to sell the transferred item at any price he or she desired, selected or could select its own downstream customers without consulting with the seller, and could order the imported merchandise and have it delivered for its own inventory.

As noted in the FACTS portion of this ruling, the Company [\*\*\*] provided numerous documents to substantiate its claim that there was a bona fide sale between the Seller and the Buyer in this case with respect to the FG and WIP transactions. The Company [\*\*\*] demonstrated that the “like-kind” payment system used is linked to specific, individual import transactions and purchase orders. The parties arrive at an acceptable price, and based on the facts provided, the Company [\*\*\*] clearly provides instructions to the Seller, based on the specifications, contained in the unrelated customer’s purchase orders. Further, the Company states that although it could order fabric for its own inventory, as a business practice, this does not happen. According to the Company [\*\*\*], each fabric is produced to unique customer specifications, so that the manufacturing process never commences until a customer purchase order is obtained. Moreover, the term of sale in these transactions is “FCA Seller mfg plant.” Thus, whenever a fabric is delivered alongside the carrier’s truck at the Canadian subsidiary’s [\*\*\*] plant, title and risk of loss pass to the Company [\*\*\*]. Accordingly, based on the description of the Company’s sales process, substantiated by numerous documents, we find that the Company has sufficiently proved the existence of a bona fide sale between the Company and the Canadian subsidiary.

2. Do the circumstances of the sale establish that the price actually paid or

payable by the Company (Importer/Buyer) to the Canadian subsidiary (Manufacturer/Seller) was not influenced by the relationship of the parties and is acceptable for the purposes 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 §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 §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.

As indicated above, if it can be shown that the related party price is adequate to ensure recovery of all costs plus a profit equal to the firm's overall profit realized over a representative period of time, in sales of merchandise of the same class or kind ("all costs plus profit" test) then the circumstances of the sale test is met when the analysis reveals that the relationship between the buyer and seller did not influence the prices paid. In other words, the all costs plus profit example examines whether the related party compensates the seller for all its costs of production, plus a profit. 19 CFR §152.102(h) defines the merchandise of the same class or kind as the merchandise, including, but not limited to, identical merchandise and similar merchandise, within a group or range of merchandise produced by a particular industry or industry sector. See 19 CFR §152.102(h).

The Company argues that the Canadian subsidiary [\*\*\*] as the producer earns back all of its material and processing costs as well as overhead costs and a profit on each of the FG and WIP representative sample transactions, discussed in detail in the FACTS portion of this decision. The Company provided us with Bills of Material for each kind of a product to substantiate its claim. For the sample FG transaction, the Company compared the gross profit margin of [\*\*\*] %, stated on the Bill of Material, to the Canadian subsidiary's [\*\*\*] total gross profit of [\*\*\*] %, to show that on the sample import transaction, Canadian subsidiary [\*\*\*] earns a healthy margin. For the WIP transaction, the amounts reflected on the Bill of Materials and invoices from the Canadian subsidiary [\*\*\*] to the Company [\*\*\*] with respect to the sample transaction, result in a gross profit margin of [\*\*\*] %. Since the Canadian subsidiary's [\*\*\*] total gross profit for WIP products is [\*\*\*] %, the Canadian subsidiary [\*\*\*] earns a healthy margin on the sale of WIP products. Therefore, based on the company's assertion that

the same results occur for every other FG and WIP transaction because all PMC transactions follow the respective EPM for the FG and WIP shipments, and the gross profit for both WIP and FG sample transactions exceed the total gross profit of the Canadian subsidiary in sales of the goods of the same class or kind, we find that it is likely that the purchase price is not artificially low for Customs purposes and the relationship of the parties did not influence the price.

Additionally, in order to show that the circumstances of the sale did not influence the price and to substantiate the all costs plus profit test, the Company [\*\*\*] submitted multiple transfer pricing studies pertaining to the buyer, the Company [\*\*\*], 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 the 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 the application of the circumstances of the sale, but the weight to be given this information will vary depending on the level of detail provided by the study. See HRL 548482, dated July 23, 2004. A significant factor, by 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 the Company [\*\*\*] transfer pricing studies by themselves are not sufficient to show that a related party transaction value is acceptable for Customs purposes, the underlying facts and the conclusions reached in such transfer pricing studies may contain relevant information in analyzing circumstances of the sales.

We note that none of the transfer pricing studies submitted to CBP by the Company have been reviewed by the IRS leaving CBP unaware as to whether the assumptions on which the study is based and the conclusions derived would be acceptable to the IRS. See HRL 548482, dated July 23, 2004. Further, all of the transfer pricing studies utilize the CPM methodology to evaluate distribution and manufacturing activities of the buyer and the seller. Although Customs has, in the past, given some weight to an importer's transfer pricing methodology when it has been based on the CPM, special circumstances were present. See HRL 546979, dated August 30, 2000. It is important to note the following special circumstances or other factors that were present in HRL 546979: 1) the transfer pricing methodology had been approved by the IRS through the Advance Pricing Agreement program; 2) Customs participated in the APA pre-filing conference between the importer and the IRS, and had access to the information provided to the IRS throughout the APA process; 3) the importer provided Customs with a waiver that enabled access to the documents that were submitted to the IRS in the APA process; 4) all of the importer's imported products were covered by the APA; and 5) the transfer pricing agreement was a bilateral agreement for which the transactions had been examined and accepted by the taxing authorities of both the United States and Japan. A similar outcome was achieved in HRL H029658, dated December 8, 2009 in which CBP determined, based on these

unique circumstances and the overall structure of the transaction, that the circumstances of the sale were satisfactory. None of the factors relied upon in HRL 546979 and HRL H029658 are present in this case.

Furthermore, we note that the comparable companies, chosen in the Company's [\*\*\*] transfer pricing studies to evaluate distribution activities of the buyer and the seller, are involved in the distribution of industrial products such as electronic controlled embroidery machinery, cutting tools, textile equipment and laundry equipment, mobile equipment, diesel engines, and other industrial components. While the comparison in the transfer pricing study between an 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, we find this information to be less valuable since the comparable companies chosen for the distribution analysis of the Company [\*\*\*] and the Canadian subsidiary [\*\*\*] in this case are not engaged in the sale of the same class or kind of merchandise. Therefore, under the circumstances of this particular case, we are reluctant to solely rely on the analysis of the distribution activities of the Company [\*\*\*] and the Canadian subsidiary [\*\*\*], provided for in the Company's [\*\*\*] transfer pricing study prepared by PricewaterhouseCoopers LLP, its updates in 2005 and 2007, and the Canadian subsidiary's [\*\*\*] transfer pricing study, prepared by Ceteris, Inc.

Nevertheless, to further substantiate the all costs plus a profit test, the company supplied us with a print-out of the Canadian subsidiary's [\*\*\*] most recent Segmented Income Statement covering fiscal year 2007 and its 2007 transfer pricing study update prepared by Ceteris, Inc.<sup>9</sup> It is clear from the Canadian subsidiary's [\*\*\*] Segmented Income Statement that the Canadian subsidiary [\*\*\*] earned a [\*\*\*] % gross profit on sales of the WIP products to the Company [\*\*\*]. Therefore, this profit comports with the EPM formula calling for a price of cost plus [\*\*\*] % for the WIP products. Furthermore, as stated in the 2007 Canadian subsidiary's [\*\*\*] transfer pricing study update prepared by Ceteris, Inc., the adjusted full range of the total operating costs for the comparable companies was from [\*\*\*] % to [\*\*\*] %, with a median of [\*\*\*] %. The total return on operating cost (gross margin) for the 2007 WIP transactions, as mentioned in the Segmented Income Statement, is [\*\*\*] %, therefore, this gross margin meets and exceeds the median of [\*\*\*] %, thus, satisfying the transfer pricing formula for WIP transactions. Further, to analyze the Company's [\*\*\*] and the Canadian subsidiary [\*\*\*] manufacturing activities, according to the Canadian subsidiary's [\*\*\*] transfer pricing study, a search for comparable companies resulted in eight (8) companies. We reviewed the information contained in the Canadian subsidiary's [\*\*\*] transfer pricing study and conclude that eight (8) comparable companies manufacture and sell the products of the same class or kind as the imported merchandise. In fact, all comparable companies relevant to the manufacturing analysis of the Canadian subsidiary [\*\*\*],

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<sup>9</sup> According to the Company, the income statement is segmented because the Canadian subsidiary's [\*\*\*] profitability is measured based on the three functions it performs as reflected in the updated Ceteris transfer pricing study. These functions include: (1) the Canadian subsidiary's [\*\*\*] function as a full manufacturer (it manufactures FG products and sells them to its customers, related or unrelated); (2) contract manufacturer (covers all WIP imports into the United States; and, (3) as a distributor for products purchased from the Company [\*\*\*] and sold in Canada.

manufacture composite materials, technical textiles, paper machine clothing, filament, novelty and spun yarns, upholstery fabrics, mattress tickings, and other industrial fabrics. Such merchandise clearly falls within a group or range of the merchandise produced by the industrial fabrics industry, or more specifically, paper machine clothing industry sector. Additionally, two (2) of the comparable companies in the Canadian subsidiary's manufacturing analysis are direct competitors of the Canadian subsidiary [\*\*\*]. Accordingly, since all comparable companies in the analysis manufacture and sell the merchandise of the same class or kind, and despite the use of the TNMM methodology to evaluate the manufacturing activities of the Canadian subsidiary [\*\*\*], the Canadian subsidiary's [\*\*\*] transfer pricing study supports a finding that the Canadian subsidiary's [\*\*\*] price for WIP products was adequate to ensure recovery of all costs plus a profit equal to the firm's overall profit realized over a representative period of time, in sales of merchandise of the same class or kind.

Furthermore, for FG transactions, even though we do not consider the distribution analysis of the Company [\*\*\*] under the TNMM methodology to test the Canadian subsidiary [\*\*\*] as a manufacturer to be pertinent to the examination of the all cost plus a profit method, we observe that the Canadian subsidiary's [\*\*\*] Segmented Income Statement demonstrates that the Canadian subsidiary [\*\*\*] sells the PMC to unrelated customers in Canada. We note that the gross profit amount of [\*\*\*] % of the Canadian subsidiary's [\*\*\*] sales to unrelated customers in Canada is lower than [\*\*\*] % profit the Canadian subsidiary [\*\*\*] earned on the FG sales to the related party in the sample transaction. However, the net profit margin of [\*\*\*] % in sales to unrelated third parties is closer to the [\*\*\*] % net profit margin to the related parties because the Canadian subsidiary [\*\*\*] absorbs selling expenses for the sale of FG to third parties, as opposed to its sales to the Company [\*\*\*]. Therefore, since the net profit margin of the Canadian subsidiary's [\*\*\*] sales to unrelated third parties is similar (or higher) to the net profit margin of the Canadian subsidiary's [\*\*\*] sales to the related parties, we find that the related party prices with respect to FG transactions in this instance are settled in a manner consistent with the way the seller settles prices in sales to unrelated buyers.

Accordingly, based on our review of the information submitted, we have examined the relevant aspects of the transaction, including the way in which the Company [\*\*\*] and the Canadian subsidiary [\*\*\*] organized their commercial relations, as well as the way in which the price in question was arrived at between the parties. Based on this analysis of the circumstances of the sale, we hold that the Company [\*\*\*] has demonstrated that the price has not been influenced by the relationship.

#### **HOLDING:**

In conformity with the foregoing, transaction value is the appropriate method of appraisal for to sales between the Company [\*\*\*], (the Importer), and the Canadian subsidiary [\*\*\*] (the Seller).

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](http://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