

TRANSFER PRICING: CUSTOMS VERSUS TAX PRIMER

**Presentation to ABA
International Law Section**

Miami Beach, Florida, October 29, 2009

Case Study

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Transfer Pricing: More Than Income Tax

Case Study

- Britannia Motors of the U.K. sells vehicles and parts to its wholly-owned distributors in the USA, Canada, and Mexico.
- Each distributor is the exclusive distributor of these vehicles and parts in their territory, i.e., no sales are made to unrelated parties by the Parent.

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- The U.K. parent and U.S. subsidiary have entered into a 5-year bilateral Advance Pricing Agreement (“APA”) with H.M. Revenue & Customs and the IRS covering 2008-2012.
- The U.K. parent is considering a similar bilateral APA with the income tax authorities of Canada and Mexico as well.

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- The APA uses the Comparable Profits Method (“CPM”) which is the same as TNMM -- “Transactional Net Margin Method” under the OECD Guidelines.
- TNMM or CPM is one of the “profits-based” transfer pricing methods that apply to sales of tangible property. The other OECD methods are “transaction-based” like the Customs Methods.
- Essentially, CPM uses certain Profit Level Indicators (“PLI”s) to determine whether the amount charged is arm’s length based on what uncontrolled taxpayers engaging in similar business activities under similar circumstances charge.

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- Under CPM, the arm's length result is determined by calculating what the "tested party's" operating profit would have been on related party transactions if its PLI were equal to that of an uncontrolled comparable.
- Then it compares the result to the "interquartile range" calculated based on the results of the comparable companies.
- The "tested party" is normally the party in the transaction with the least complex functions and risk, i.e., the distributor.

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- The tested party in this APA is Britannia Sub, which must earn an aggregate operating profit between 1.2 - 4.6 percent – the “interquartile range.”
- Under the APA, if the operating profit is outside the range in any covered year, Britannia Sub must book a formal “compensating adjustment.”

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- 2008 showed an operating profit of 0.2 percent – below the APA range by 1%.
- Britannia Sub's 2008 tax return thus reflected a compensating adjustment to increase operating margin by 1 % and, thus, increase its taxable income.

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- To raise operating margin by 1%, Britannia Sub lowered the COGS in its accounting books and resulting financial statements.
 - Booked receivable from parent company in September of 2009.
 - U.K. parent company paid the COGS adjustment in October of 2009 via intercompany account settlement.
- Customs Entries flagged for Reconciliation in US or for Review (Audit) in Canada or Mexico beginning January 08.

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Alternative FACTS

1. Britannia Subs test their operating margin quarterly to ensure it is within the APA – mandated interquartile range?
 - If not, Britannia Motors adjusts invoice prices for succeeding quarter to bring subsidiary's previous quarter's results back into the range.

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- This “rolling true-up” prevents Britannia Sub from ever booking any formal compensating adjustment.
2. The 2008 compensating adjustment was reflected on the 2008 tax return, but Britannia Sub’s auditors determined that no adjustments to COGS in the financial statements were needed?
 - Thus, a “tax only” adjustment occurred.

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Issues For Consideration

1. Can an invoice price based on an Income Tax transfer pricing methodology serve as a valid “transaction value” for Customs purposes to begin with?

Overriding goal: taxpayers/importers want ONE invoice and ONE pricing methodology when tangible goods are sold between related parties.

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2. If so, how and which of the “circumstances of sale” tests are met?
3. What is the effect of compensating adjustments when they are made pursuant to a transfer pricing formula?
4. Do importers owe duty if COGS is raised pursuant to the pricing formula (to lower profit)?
5. Does Customs owe duty refunds to importers if COGS is lowered (to raise profit)?

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6. Must importers obtain a binding Customs binding ruling in order to make duty payments/claim duty refunds because of compensating adjustments?
7. What if no compensating adjustment is ever made because invoice prices are periodically revised throughout the fiscal year to keep the operating profit within the interquartile range?
8. What if the compensating adjustment is made only on the tax return but not on the accounting books/financial statements?

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9. What if the formula is set pursuant to a unilateral APA versus a bilateral APA?
10. What if there is no APA, but an importer relies only on its transfer pricing “study” (TPS prepared in-house or by outside advisors)?
11. What if Customs entries have not been flagged for Reconciliation in the U.S or for Review in Canada or Mexico—can refunds/payments still result from compensating adjustments?

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12. How does the selection of comparable companies for the APA/TP study impact customs valuation?
13. Does it matter if the transfer pricing method is “profit-based,” instead of “transaction-based?”
14. **Food For Thought – The Future.** What is the global perspective on these issues, per the recent Valuation Committee meeting at the World Customs Organization in Brussels?