



**U.S. Customs and
Border Protection**

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CATEGORY: Valuation

Port Director
U.S. Customs and Border Protection
Port of Seattle
1000 Second Ave., Suite 2200
Seattle, WA 98104

RE: Internal Advice Request; Acceptability of Transfer Price; Transaction Value;
Related Party Transactions; Advance Pricing Agreement

Dear Port Director:

This is in response to the Importer's request for internal advice, prepared by its outside counsel, Damon V. Pike, seeking approval of the proper basis of appraisement for motor vehicles and parts, imported from [***], filed on behalf of [***] (the "Importer"), on May 27, 2008. We regret the delay in responding.

The Importer has asked that certain information submitted in connection with this internal advice be treated as confidential. Inasmuch as the Importer's request conforms to the requirements of 19 CFR §177.2(b)(7), the Importer'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 Importer/Buyer is a U.S. Corporation, which acts as an exclusive distributor of motor vehicles imported from the Seller/Manufacturer [***], the parent company, for re-sale in the U.S. market. The Importer also acts as the exclusive distributor for parts, accessories, and service tools imported from [***], the affiliate of the parent company. The Importer imports vehicles, parts, accessories, and service tools through numerous ports of entry. Furthermore, parts, accessories, and service tools are imported through these and other ports.

The Importer provided the following documents for our review: purchase orders, commercial invoices, packing lists, freight invoices, shipping advices, bank's advices of acceptance and debit advices reflecting payment, broker invoice, CF3461, CF7501, etc. Additionally, the Importer provided a detailed description of its sales process. At the beginning of the process, the Importer prepares its pricing proposals for each upcoming series/model. This pricing proposal is used to support the Importer's recommended FOB amount or the amount the Seller charges the Importer/Buyer, which is the value declared to CBP upon importation of the vehicles. Pursuant to the Importer's submission, the pricing proposal is an analysis of the market segment for the model and includes an overview of sales plans, retail pricing comparisons with competitor vehicles within the same vehicle segment, suggested trim levels, and recommended Manufacturer's Suggested Retail Price ("MSRP") and dealer margins. At the same time the Importer prepares its pricing proposal, the Manufacturer/Seller is preparing a similar recommendation of FOB amount, dealer cost, and MSRP based on sales and profit goals. It is stated that the parties negotiate an acceptable price and the Manufacturer/Seller prepares final pricing studies and management reports for internal approval.

Once the Importer negotiates the price with its parent company, it issues purchase orders to the Seller on a periodic basis, which are accepted and filled by the Seller at its various manufacturing locations in [***]. Once the vehicles are ready to be shipped, the Seller issues an invoice to the Importer/Buyer, which transfers title and risk of loss at the port of embarkation. The Importer bears the cost of international freight and insurance, which is itemized separately on each invoice, and the payment terms are 90 days, which is made via regular wire transfer. The Importer selects all of its customers (the dealers). Additionally, it sets the dealer cost and MSRP at the beginning of the process based on the information available during the negotiations with the Seller/Manufacturer. It is stated that the Importer could order the imported merchandise and have it delivered for its own inventory.

It is claimed that the pricing in the automobile industry is essentially "market driven MSRP," meaning that the end consumer determines the actual price they will pay for the vehicles they purchase. This end price takes into account the dealer's return and the distributor's return to cover its cost of distribution to the dealers. Any remaining profit or loss goes back to the parent company (manufacturer). As support, a paper, "Pricing Practices in the Automotive Industry" prepared by Ernst & Young, LLP, was submitted for our review.

In September of 2003, the Importer voluntarily applied for a bilateral Advance Pricing Agreement ("APA") with the Internal Revenue Service ("IRS") to cover all of its imported items (vehicles and parts) for the years of [***].¹ 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

¹ This period was expanded in the final APA to cover the years [***]. The Importer is in the process of negotiating a new APA with the IRS.

tax laws to be applied to transactions between related parties. The foreign Competent Authority in this instance is the [***].

After discussions, the IRS and the [***] reached mutual agreement regarding a bilateral APA governing the transfer price to be paid by the importer to the manufacturer relative to the importer's distribution of the manufacturer's products. The APA covers the sales of automobiles, light trucks, automotive parts, and accessories to the Importer. The tested party is the Importer.² The term of the importer's APA is for five tax years ending [***].

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.

In its APA, the Importer identified the comparable profits method ("CPM") as the best method for evaluating its related party or controlled transactions. 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 Importer sets its prices according to the CPM. The profit level indicator selected was the operating margin. The importer's operating margin is defined as follows: the sum of the Importer's operating profit for the APA term divided by the sum of its net sales revenue for the APA term.

According to the APA, the arm's length range is between [***]. 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. This range was proposed by the Importer to the taxing authorities of the United States and [***] in its Submission in Support of Request for Advance Pricing Agreement, which was included for our review, together with the internal advice request. In selecting comparables for its analysis, an independent accounting firm, KPMG, hired by the Importer, reviewed publicly-available databases and focused on companies under the following Standard Industrial Classification ("SIC") codes: 5000-5099 (Wholesale Trade – Durable Goods). After eliminating certain companies, KPMG used the Standard & Poor's Compustat ("S&P Compustat") database to obtain data for North American companies. This search generated a set of 125 unique companies out of which a final set of 21 comparable companies was selected, whose financial data was used to determine a target operating margin range for the Importer for the term of the proposed APA. It is important to note that although the accounting firm searched for companies that perform similar functions, incur similar risks, use similar intangible

² Under the IRS regulations, the tested party is the party with the least complex functions, which does not own valuable intangibles. The Importer was selected as the tested party because it performs only wholesale distribution functions, whereas [***], the parent company (seller), performs manufacturing, R&D, and other functions that are far more complex and involve the development and use of intangible property.

assets as well as sell similar products, the final set of comparable companies represents a set of companies that sell a variety of products from air conditioners and heating equipment to tires to roofing materials. It is stated that the Importer was not able to identify any current information on comparable companies in the automotive industry.

Furthermore, the Importer states that it does not make compensating adjustments pursuant to its APA. The Importer states that it engages in rigorous negotiations with its parent company to set vehicle prices which allow the Importer to earn an operating profit that meets the target interquartile range of the APA. Accordingly, these negotiations have resulted in prices that have never needed an adjustment (except for the years 1999-2001 when a compensating adjustment in the amount of approximately [***] was booked). Thus, the Importer is not requesting a ruling with respect to any compensating adjustments.

ISSUES:

1. Do transactions between the Seller and the Importer/Buyer constitute bona fide sales?
2. Do the circumstances of sale establish that the price actually paid or payable by the Importer/Buyer to the 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, however, 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 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

