Transfer Pricing and Customs Valuation
Two worlds to tax as one

Introduction

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1. Introduction

The book you have in front of you aims to explain the role of transfer pricing and customs value in the cross border business environment, and its importance for multinational enterprises, tax authorities and customs administrations. The relationship between valuation for transfer pricing purposes and valuation for customs is examined by reviewing the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), the GATT/WTO Customs Valuation Agreement, and by discussing related issues, comparing country practices with country chapters and case studies and it ends with a summary and conclusions.

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2. The search for comparison

At least since 1973, and probably even earlier, governments/practitioners and judicial bodies have tried to look "over the fence" of their own discipline to see whether information resulting from customs can be used for transfer pricing or whether valuations performed for transfer pricing could be used for customs. One example where customs valuation was considered indicative for determining an arm's length transfer price (by the US Tax Court) was the Ross Glove case[2]. Another one is the Sundstrand case[3]. An early OECD Report in 1979 referred to customs and transfer pricing integration as well. Furthermore, when in 1986 Sec. 1059A[4] was included in the Internal Revenue Code, requiring importers in a related party transaction to use the same valuation for the purposes of income tax and excise duties, a relationship seemed established between transfer pricing and customs duties, at least in the United States[5]. The purpose of including Sec. 1059A in the Internal Revenue Code was to help prevent manipulation of values (for both corporate tax and customs purposes) in related party transactions[6].

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2 Ross Glove Co. v. Commissioner, 60 T.C. 569 (1973).

3 Sundstrand v. Commissioner 96 TC 226 (1991).

4 IRC 1059A was added by § 1248(a) of the Tax Reform Act of 1986, Pub. L. No. 99-514.

5 "Transfer Pricing and Customs Duties", by Yoshihiro Masui, IBFD Bulletin, July 1996 p. 315.

6 The General Explanation to the Tax Reform Act provides in relevant part: "Prior Law: Where a U.S. taxable entity imports goods into the United States for resale or use in its business, there may be an incentive to state a high price for the goods, thus reducing U.S. taxable income, particularly when the goods are purchased from a related foreign party that is not subject to U.S. tax. On the other hand, if imported goods are subject to a tariff or other import duty, there is an incentive to state a low value for U.S. customs purposes. [..] Reasons for Change: Congress understood that some importers could claim a transfer price for income tax purposes that was higher than would be consistent with the transfer price claimed for customs purposes. [..] Congress was particularly concerned that such practices between commonly controlled entities could improperly avoid U.S. tax or customs duties. Changes in U.S. customs law after the 1979 Tokyo Round generally make transactions-based pricing the rule for customs purposes. In enacting the new provision, Congress did not

In the Ross Glove case, a Philippine-based company manufactured gloves for a related company in the Bahamas that served as contractor for related company Ross Glove US. Initially, raw materials (sheepskin and rabbit linings) were owned by Ross Glove US and the Bahamian company operated on a broker commission of 5% which later was increased to 8%. Later on, the Bahamian company purchased the raw materials from Ross Glove US. The pricing between the Bahamian company and the Philippine manufacturer was based generally on the methods used by customs to value gloves imported from the Philippines into the United States. The revenue authorities deemed the commission by Ross Glove US paid to the Bahamian company not to be arm's length and imposed adjustments, and allocated a cost plus 5% margin to the Philippine manufacturing company and cost plus 5% to the Bahamian trading company. In this case the use of the customs pricing method (constructed value[7]) is discussed in detail. It is stated that such a mark-up is quite similar to the gross profit margin which is used in the cost plus method under Internal Revenue Code Sec. 482 that regards arm's length pricing. The Tax Court found that considering the similarity between the constructed value computation of Customs and the cost plus method of section 482, the markups used by Customs in computing the value of gloves imported by Ross Glove could serve as a basis for determining an arm's length price under Sec. 482. Such markups could be used because they were the best available evidence as to the amounts that a seller would receive to cover overhead and profit in an arm's-length sale[8].

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- On 26 October 2007, the WCO-OECD hosted a Focus Group meeting in Brussels at the WCO headquarters to solicit recommendations on the issue of convergence, the issue of intangibles and on compliance initiatives.
- In April 2009, the Australian Customs & Border Protection Service is scheduled to publish the final version of the Transfer Pricing Discussion Paper or Practice Statement with the purpose to ensure that industry understands customs requirements for assessing transfer pricing valuation advice applications.

The situations/events/facts listed above are merely examples of situations where effort was put into exploring overlap/comparisons or convergence. There will undoubtedly be many more incidences that merit listing, but the above may at least serve to show that there is a (global) trend towards and interest in looking at the two fields of tax law in a combined fashion.

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express the view that valuation of property for customs purposes should always determine valuation of property for U.S. income tax purposes. Instead, Congress was concerned only with establishing a limit on the price an importer could claim for income tax purposes."

7 Which is equal to the cost of materials and processing of any kind employed in producing such or similar merchandise, the cost of packaging the merchandise and an amount for general expenses and profit equal to that usually reflected in sales of merchandise of the same general class or kind as the merchandise undergoing appraisement.

8 It should be noted that the Ross Glove case was decided before the U.S. customs valuation law went into effect in 1979 (the Trade Agreement Act) and the value methods used then are not directly tied to the WTO Customs Valuation Agreement.

3. Why seek integration of customs and transfer pricing?

To understand why integration or joint approaches are being considered, it is necessary to get a sense of the importance of the issue for multinational enterprises, tax authorities and customs administrations.

A significant portion of cross-border trade of goods takes place between associated enterprises. Although providing accurate figures is not really possible, a figure of 60% was mentioned by Michel Danet, Secretary General of the WCO, during the May 2006 WCO-OECD joint conference in Brussels. The (individual) prices of these goods are currently being determined separately for customs purposes (indirect taxation) and for transfer pricing (direct taxation), however.

Both disciplines have their own set of rules and valuation/pricing methods, and both disciplines have their own (sometimes fairly elaborate) evidence/documentation requirements. Multinational companies are exposed to risks and potential adjustments (and penalties) resulting from independent audits regarding the correctness of the transfer prices and customs values applied. Transfer pricing adjustments may have potential effect on customs matters and vice versa. Both disciplines take up significantly large resources at government level, and require government training and management. Both disciplines are usually reviewed by different administrative and judicial bodies in case of disputes. So it is easy to see that wherever convergence or joint processes could be established for these two disciplines, there are potential opportunities for simplification and significant cost and time savings.

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There would certainly be a benefit if it could be decided by the powers that be, that either a transfer pricing adjustment has no effect for customs purposes, or when it does, that the customs consequences do not only work out to the detriment of a taxpayer, but also to the benefit of a taxpayer, as the case may be, and can be considered in a mutual agreement procedure. It should not be a surprise that convergence is being explored. A different issue is whether convergence is really possible and if so to what extent. The case for convergence does not necessarily mean that actual and full convergence is the only solution to achieve cost savings/simplifications and mutual benefits. There may be smaller achievements that still can make a major difference to taxpayers and customs administrations alike.

4. Some key differences between customs and transfer pricing

Although both referenced as “taxes,” customs and transfer pricing are each rooted in entirely distinct disciplines. One belongs to the area of indirect taxation and the other to the area of direct taxation. This in and of itself is a major and most determinative distinction.

Customs valuation is governed by domestic laws based on the applicable customs code. The European Community's basic customs legislation is contained in the Community Customs Code (Council Regulation (EEC) No 2913/92 of October 12, 1992) and the Community Code's Implementing Provisions (Commission Regulation (EEC) No 2454/93 of July 2, 1993). Implementing powers are conferred on the Commission which is assisted by a Customs Code Committee. The customs duty burden on goods is determined by three factors: product classification, origin and the customs value. The Customs Code's Arts. 28-36 are based on the General Agreement on Tariffs and Trade's valuation provisions of Art. VII.

Transfer pricing at its core is a subpart of corporate income taxation, the tax that primarily targets the income earned by companies. This means that transfer pricing is audited after a tax return is filed, which is usually at the earliest after the taxable year has closed, and is dependent on financial statements and specific transfer pricing documentation that is nowadays required in almost all situations by law or upon audit.

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The field of transfer pricing gained particular attention when the 1986 US Tax Reform Act incorporated a so-called "commensurate-with-income" test in the US Internal Revenue Code, to tackle harmful transfer pricing practices. The commensurate-with-income test, in practical terms, serves to check whether a transfer of intangibles between associated parties was conducted at arm's length by looking at the value of the intangibles *after* the date of transfer. It is essentially a look-back rule that allows the tax authorities to correct the transfer price between the associated parties if later in time the intangible appears to be far more valuable (and generates more revenue) than estimated at the time of the transfer.

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So in sum, there are different sets of rules that apply, different valuation regimes, different mechanisms of collection of the tax and different systems for auditing whether the taxes are correctly reported.

In addition, it should probably be noted that in many developing countries, particularly those at lower income levels, indirect taxes, such as taxes on imports remain the most important single source of government revenue[9]. For example, in the Middle East and Africa, it is reported that import duties generate about twice as much revenue as in other regions[10]. Customs duties are often a significant source of a State's revenue and surpass corporate tax revenue in those countries, whereas developed countries tend to raise more revenue through direct taxes than do developing countries.

9 Chapter 27: Taxing Imports, "Taxation of imports in LDCs: Suggestions for Reform", by Luc de Wulf, Taxation in Developing Countries, John Hopkins University Press, p. 323.

10 "Quantitative characteristics of the tax systems of developing countries", by Vito Tanzi, Taxation in Developing Countries, John Hopkins University Press, p. 17.