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How to Bring Transfer Pricing and Customs Together

Set Prices, Save Money, and Control Controversy

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Topics for Discussion

I. Income Taxes and Customs Duties:

Different treatment, purposes, and rules

II. Differences in Rules:

Application and enforcement

III. Governmental Coordination:

Legal and administrative efforts

IV. Corporate Coordination:

Case study and suggestions

Income Taxes and Customs Duties

Different treatment, purposes, and rules

Income Taxes and Customs Duties

Different treatment, purposes, and rules

■ Introduction

- This issue is important for multinational companies trading merchandise between related parties.
- There is potential inconsistent treatment by revenue and customs authorities, despite a common overall objective of reaching an arm's length price.
- Inconsistent treatment derives from inconsistent purposes and rules.
- Governments have been integrating enforcement of tax and customs pricing, generally without harmonizing relevant guidance.
- Companies can be proactive in planning to avoid or defend against controversies.

Income Taxes and Customs Duties

Different treatment, purposes, and rules

■ Different Purposes

- Revenue Authorities focus on income allocation.
- Customs Authorities focus on correct dutiable value.

■ Different Treatment

- Revenue Authorities may determine amount paid was too high, and income and tax were artificially too low.
- Customs Authorities may determine amount paid was too low, and customs duties were artificially too low.

■ Different Rules

Differences in Rules

Application and enforcement

Differences in Rules

Application and enforcement

■ Customs Valuation

- Focus on establishing the right price, for each entry of merchandise imported into a customs territory.
- Price is determined pursuant to the WTO Valuation Agreement, as implemented in each country (e.g., 19 U.S.C. 1401a; Article 29 et seq. of EU Customs Code).
- Hierarchy of methods; most use the Transaction Value method.
- TV Method captures the total payment for imported merchandise, as the “price actually paid or payable” for the merchandise when sold for exportation, plus
 - Packing costs,
 - Selling commissions,
 - Assists,
 - Royalties or license fees, and
 - Proceeds of subsequent resale, disposal, or use.

Differences in Rules

Application and enforcement

■ Customs Valuation

- If challenged, the TV Method is unacceptable in related party transactions, unless the importer can demonstrate that the relationship did not influence the price actually paid or payable (“circumstances of sale” test).
 - Related party transaction?
 - Is the related party transaction *bona fide*?
 - Did the relationship influence the price paid or payable?
 - Price consistent with industry pricing practices, OR
 - Price consistent with prices to unrelated buyers, OR
 - Price adequate to ensure recovery of all costs plus overall profit of the related supplier over representative period for the same class/kind of merchandise.
 - A transfer pricing study or advance pricing agreement is insufficient, by itself.
- Test Value Method: infrequently used

Differences in Rules

Application and enforcement

■ Customs Valuation

- If TV Method is rejected, other methods are available, all of which are used relatively exceptionally.
 - Transaction Value of Identical Merchandise
 - Transaction Value of Similar Merchandise
 - Deductive Value
 - Computed Value
 - Derived Value

Differences in Rules

Application and enforcement

■ Transfer Pricing Valuation

- Focus on establishing the right income, on an aggregate basis.
- Price is determined pursuant to various rules, much of which adhere to the OECD Guidelines, which is based in part on, but is not identical to, the U.S. rules under 26 U.S.C. 482.
- “Best Method” or “Most Appropriate Method” rules; generally no hierarchy of methods.
 - Transactional Methods: Comparable Uncontrolled Price; Resale Price; and Cost Plus Methods
 - Profit-Based Methods: Comparable Profits / Transactional Net Margin Method; Profit Split Methods
- Most use the CPM / TNMM, which captures the profitability of the importing party, generally based on its function.

Differences in Rules

Application and enforcement

- **Transfer Pricing Valuation**
 - Under the CPM / TNMM, and other methods to varying degrees, there is a focus on:
 - Comparability of functions, contractual terms, assignments of risks, economic conditions, and property or services rendered;
 - Quality of data and assumptions.
 - Adjustments are generally permitted / required.
 - Arm's length range of acceptable prices is determined.
 - Special circumstances may impact pricing.
 - Aggregation with other, different transactions.
 - Aggregation of multiple years of data.

Differences in Rules

Application and enforcement

Customs

- Authority over price of merchandise imported
- Prices determined at date of entry
- Price reported to authority with each entry of imported merchandise
- Duty at goods classification level
- Importer-initiated adjustments disallowed unless pursuant to an objective formula
- If TV rejected, hierarchy of methods
- Penalties, defenses, and documentation

Transfer Pricing

- Authority over item affecting taxable income
- Income determined when tax return filed
- Annual informational return required
- Tax on income in the aggregate
- Taxpayer-initiated adjustments allowed to ensure proper reflection of income
- If taxpayer's method rejected, best method analysis
- Penalties, defenses, and documentation

Differences in Rules

Application and enforcement

- Penalties, defenses, and documentation (U.S. example)
 - Customs
 - Penalty: 50%-200% of understated duty (negligence std.) and loss of revenue.
 - Defense: Importer must demonstrate use of reasonable care to determine TV in related party transaction, and must demonstrate acceptability of price under circumstances of sale test.
 - Documentation: must be maintained on a transaction-specific basis, which is generally done in the ordinary course of business
 - Transfer Pricing
 - Penalty: 20%-40% of understated tax, and tax owed, and repatriation.
 - Defense: Tested party must demonstrate reasonable cause and good faith, evidenced by contemporaneous documentation.
 - Documentation: must be maintained in accordance with how the transfer prices were tested, and meet certain enumerated requirements. This is not done in the ordinary course of business.
 - Authorities expect cooperation with foreign related parties in any investigation or audit.

Governmental Coordination

Legal and administrative efforts

Government Coordination

Legal and administrative efforts

- Many differences lead to many disparate results
- Recognized need for harmonization and cooperation at a governmental level
 - Alleviate disparate results
 - Better enforcement
- World Customs Organization and OECD
 - Suggest transfer pricing methods can be used to support the TV method in applying the Circumstances of Sale test, with proper guidance.
 - Suggest developing standards to allow for adjusting post-importation customs prices to satisfy transfer pricing obligations.

Government Coordination

Legal and administrative efforts

- Dutiable value as determinative of cost basis
 - E.g., United States (26 U.S.C. 1059A)
- Formal Cooperation – Information Sharing
 - E.g., Norway, South Korea, Spain, Sweden, United Kingdom
- Formal Cooperation – Joint Audits
 - E.g., South Korea
- Joint Guidance
 - E.g., Australia, Canada

Government Coordination

Legal and administrative efforts

■ Advance Agreements

- Belgium – method determined to be appropriate for fixing the arm's length price for income tax purposes and the transaction value for customs purposes
- Canada – bilateral transfer pricing APA could satisfy the TV method
- South Korea – Advanced Customs Value Agreement
- United States – Customs rulings allowed (only rarely) for prices determined by
 - bilateral transfer pricing APA (where Customs representative attended APA negotiations)
 - Transfer pricing study (very specific facts)

Government Coordination

Legal and administrative efforts

- Question #1
- Has your company been subject to audits for customs and transfer pricing in the last two years?
 - A. We have not been audited for either.
 - B. We have been audited for just one of these issues.
 - C. We have been audited for both.
 - D. I don't know.

Corporate Coordination

Case study and suggestions

Corporate Coordination

Case study and suggestions

- Consider the following facts
 - A non-EU manufacturer sells finished products to an EU affiliate (importer).
 - The transfer pricing method implemented is the Resale Price Method (in-market resale price to unrelated customers).
 - The prices vary by jurisdiction, leading to different import prices.
 - To reconcile with the transfer pricing method, the importer may be tempted to use the Deductive Value Method (customs “equivalent” of RPM, instead of the TV Method).

Corporate Coordination

Case study and suggestions

■ Consequences

- The transfer pricing method leads to different import prices.
- Customs will favor comparables derived from the country of importation. Are these the same as your transfer pricing comparables?
- Customs will attempt to use comparable transactions occurring within a 90-day period, within a well-defined sector. Will this be true of the transfer pricing comparables as well?
- More importantly, one single customs value will be derived from the unit price that is common to the transactions with the greater aggregate sales quantity. Is this going to reconcile with the transfer pricing method?
- Conclusion: Companies should consider both regimes to balance the financial costs (duties and taxes) and benefits of various methods.

Corporate Coordination

Case study and suggestions

- Should you continue to treat Customs and Tax as separate departments?
 - Pricing may be consistent, but is the evidence?
 - If pricing is inconsistent, are prices justified under separate rules, and can they be reconciled?
 - Will defense for one type of pricing harm defenses for the other?
 - Procedures in place to reconcile prices in event one is adjusted?
 - If Customs is less important because most transactions are internal to EU, consider that VAT typically is based on Customs valuation and similar issues are present.

Corporate Coordination

Case study and suggestions

- Should you get the team together toward a common goal?
 - Develop common and/or reconcilable methods for pricing, with common and/or reconcilable documentation, to avoid disparate results including penalties.
 - Satisfy basis rules such as 26 U.S.C. 1059A.
 - Alleviate concerns about developments in information sharing, joint or coordinated audits, and having one department's actions harming another. Focus on something more important.
 - Better enable later price reconciliations.
 - Allow for APAs which can be used for both purposes. Although this is not yet the norm, an APA or other ruling has precedential value elsewhere.

Corporate Coordination

Case study and suggestions

- Question #2
- Does your company actively consider customs pricing when setting and documenting transfer prices, or vice versa?
 - A. Yes.
 - B. No.
 - C. I don't know.

Corporate Coordination

Case study and suggestions

- Circumstances of Sale Test as the Bridge between Customs and Tax?
 - Price consistent with industry practices: “Industry” for Customs purposes generally tracks same class or kind of merchandise, not comparability of functions.
 - Price consistent with sales to unrelated parties: Rare.
 - Price adequate to recover seller’s costs, plus a profit equal to overall profit:
 - Seller as tested party?
 - Class of goods?
 - How to test profit?
 - Possible, but not the silver bullet.

Corporate Coordination

Case study and suggestions

■ Pricing Going Forward

- Companies considering pricing are best candidates for coordinating their groups
 - Assessing impact of economic recession on current transfer pricing methods?
 - Addressing new customs rules, new products, or new markets?
 - Frequent contentious audits from either front?
 - Restructuring or streamlining supply chain?
 - Newly acquired or sold businesses?

Corporate Coordination

Case study and suggestions

■ Pricing Going Forward

- Consider both sets of rules when setting prices and creating documentation.
 - Use consistent adjustments in determining price under both rules.
 - Arrange or reconcile transfer pricing with a product line (rather than aggregate) analysis.
 - Benchmark the manufacturer's, and not just the distributor's profits.
 - Be cognizant of pressures and historical rationale on both sides.
- Don't assume that transfer pricing studies will protect you for customs purposes.
- Make sure the foreign related affiliate is part of the team because it will be part of an investigation or audit.

Conclusion

- Different customs and transfer pricing rules
- Different impacts on tax, duty, loss of revenue and deductions, penalties, and defenses
- Increasing volume of controversies
- Internal communications are essential
- Internal evaluation of risk and opportunities

Questions & Answers



Thank you

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