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"BEPS" – The New Frontier for Customs Valuation

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After many years of hard work between the trade and U.S. Customs & Border Protection ("CBP"), the agency issued HQ W548314 (May 16, 2013). In this ruling, CBP articulated a significant policy change in the treatment of "transaction value" between related parties concerning post-importation pricing adjustments. The agency's new policy now acknowledges that post-importation adjustments (both upward and downward) may be recognized as part of the value of tangible goods -- provided that the price is based on a "formula" in place at or prior to importation. CBP created a 5-factor "roadmap" for importers to use in determining if such post-importation adjustments can be recognized, while reiterating that importers must still meet the "circumstances of sale" test to demonstrate that the prices are "arm's length."

As expected, this landmark ruling has generated much discussion among other global Customs authorities -- which have divergent approaches to recognition of post-importation adjustments. Many do not permit duty refunds for downward adjustments to the customs value of imported merchandise -- but still require the payment of additional duties for upward adjustments. The global debate will continue to evolve in the trade community and governments alike (mainly via the Technical Committee on Customs Valuation at the World Customs Organization). In the meantime, however, another major initiative has been launched by the Organisation for Economic Cooperation and Development ("OECD") that could have meaningful implications for customs and trade practitioners.

Based in Paris, France and founded in 1961, the OECD is an international economic organization of 34 countries whose stated goal is to stimulate economic progress and world trade. Those countries represent the "developed world" of major economies and include the United States, many European Union states, Japan, Australia, etc. Notably

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absent from this group of member states are all of the economies where most future economic growth is likely to occur, i.e., the "BRICS" countries of Brazil, Russia, India, China, and South Africa. (Only Russia has been formally invited by the OECD to begin discussions for membership, while the others have been relegated to "enhanced engagement.") Thus, the OECD can be fairly characterized as the "rich man's" club of developed countries, with sophisticated tax and Customs authorities (which -- unlike the U.S. -- are often housed within the same agency, e.g., H.M. Revenue & Customs in the United Kingdom).

Among the many topics on which the OECD is focused, tax is one of the most important -- for obvious reasons. Economic growth and stability are based largely on tax policies that rely upon market-driven principles. Core among these principles is the notion that all taxpayers (including corporations) should pay their "fair share" of tax to the various taxing authorities with jurisdiction over the economic activity on which the resulting revenue has been earned. Defining "economic activity" would involve a dissertation of some length (and so is not addressed here), but the output of all economic activity is either tangible goods or intangible products (such as services, intellectual property, etc.) With the dramatic rise in global trade over the past 20+ years (especially among related parties), those goods and intangibles earn revenue all over the world -- with resulting tax and customs duty bills in multiple countries. For corporate traders with global operations, the overriding question has evolved into a simple query: how can I apportion my global earnings so that the lowest legally permissible effective income tax is achieved in each jurisdiction where I operate?

In answering this question, many corporate giants have followed the "letter of the law" in planning their strategy. Nonetheless, the complicated tactics needed to support such strategy have produced angry reactions from the public when the true nature of this strategy (tax avoidance) has been revealed. (Witness the massive negative publicity that resulted in 2013 when Apple's use of U.S. and global rules surfaced, which rules allowed it to avoid paying an average of $10 billion a year to the Internal Revenue Service in 2008-2012.[2]) Nonetheless, the bad publicity has done little to date to change the three major tactics that all multinational corporate entities use to achieve their "low tax" strategy: tax deferral, "check-the-box," and transfer pricing.

However, change may soon be coming to irrevocably alter those tactics: the OECD's Base Erosion and Profit Shifting ("BEPS") initiative. As stated on the organization's website:

[2] "The Real Story On Apple's Tax Avoidance: How Ordinary It Is," Forbes (May 21, 2013).

In an increasingly interconnected world, national tax laws have not kept pace with global corporations, fluid capital, and the digital economy, leaving gaps that can be exploited by companies who avoid taxation in their home countries by pushing activities abroad to low or no tax jurisdictions. This undermines the fairness and integrity of tax systems. The project, quickly known as BEPS (Base Erosion and Profit Shifting) is looking at whether the current rules allow for the allocation of taxable profits to locations different from those where the actual business activity takes place and if not, what could be done to change this.

At the request of G20 Finance Ministers, in July 2013 the OECD launched an Action Plan on Base Erosion and Profit Shifting (BEPS), identifying 15 specific actions needed in order to equip governments with the domestic and international instruments to address this challenge. The plan recognises the importance of addressing the borderless digital economy, and will develop a new set of standards to prevent double non-taxation. This will require closer international co-operation, greater transparency, data and reporting requirements. To ensure that the actions can be implemented quickly, a multilateral instrument to amend bilateral tax treaties will be developed.

This Action Plan was fully endorsed by the G20 Finance Ministers and Central Bank Governors at their July 2013 meeting in Moscow as well as the G20 Heads of State at their meeting in Saint-Petersburg in September 2013. The actions outlined in the plan are aimed to be delivered within the coming 18 to 24 months. For the first time ever in tax matters, non-OECD/G20 countries are involved on an equal footing.

The details of the BEPS initiative are available on the OECD's website as well, but are notable for three reasons: (1) they include 15 specific areas of focus; (2) they include definitive timetables for these 15 "action points;" and (3) they fully aim to have the "deliverables" implemented on a global basis by all OECD member states. In a first for the organization, the G20 countries (including the BRICS countries which are not OECD members) have been included in the process of shaping the deliverables. Thus, the BRICS countries on which so much of the world's future economic growth depends are now "sitting at the table" with their wealthier (for now) counterparts, and will have input into the final recommendations due in December of 2015.

Whatever the outcome of the BEPS initiative, the resulting domestic laws in each member state (if adopted) will permanently alter the parameters in which transfer pricing operates. Because transfer pricing affects both tangible goods and intangibles, the current approach to "cost unbundling" will no longer be a relatively straightforward matter. The mechanics of stripping the tangible good's cost down to its lowest level and assigning the remaining value to "intangibles" that can be captured under any number of labels -- royalties, management fees, cost-sharing arrangements, etc. -- will need significant re-tooling based on the tax and duty impact that any new rules might create.

Indeed, whether such kind of "value engineering" has any continuing merit may be called into question when the BEPS initiative is finally concluded. Because the goal of BEPS is to eliminate corporate tax avoidance altogether, the worst offender in the current environment (use of intangibles to lower effective tax rate and defer income) may be made redundant. For customs practitioners, this outcome may have remarkable potential: at last, customs duties may finally predominate on the global tax planning agenda (at least for industries which produce goods that attract duties). Whatever the outcome, BEPS is an acronym with which all customs and trade professionals should become familiar so that the underlying proposals can be fully vetted for their customs valuation impact – and any resulting domestic legislation can reflect a balance between the two disciplines of customs duties and income tax that continually seem to be in conflict.