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Cementing the Link: WCO Issues Comprehensive Guide To Customs Valuation, Transfer Pricing

The author examines the World Customs Organization's recently issued guide on customs valuation and transfer pricing. The WCO's supplying a single resource for global customs authorities represents progress in melding together the worlds of customs valuation and transfer pricing, he says.

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In the continuing global effort to harmonize the disciplines of customs valuation and transfer pricing for income tax, the World Customs Organization[1] in June 2015 published the "WCO Guide to Customs Valuation and Transfer Pricing."[2] Given that the primary users of the guide are intended to be customs officials of the WCO member states (of which three-quarters are developing countries), this document has the potential to significantly impact the global collection of customs duties. Coupled with the ongoing expansion of trade in the developing world, where most government revenue stems from import duties and not corporate taxes, trade and tax compliance professionals in the private sector stand to greatly benefit from a thorough reading and understanding of this important document.

As most seasoned global businesses know, the rules for customs valuation of imported merchandise are technical and complex—so much so that the WCO maintains a standing Technical Committee on Customs Valuation (TCCV) to resolve differences in interpretation of the rules between member states and to provide guidance to the trade community. As the link between customs valuation and transfer pricing became more

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[1] The WCO, formerly the Customs Co-operation Council, is an intergovernmental organization based in Brussels made up of 180 nations. The WCO's stated mission is to "enhance the effectiveness and efficiency of Customs administrations." See http://www.wcoomd.org/en/about-us/what-is-the-wco.aspx. Among other activities, the WCO maintains and updates the Harmonized System for tariff classification and administers the World Trade Organization's 1979 Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade.

[2] Available at http://op.bna.com/ITDTR.nsf/r?Open=mmos-9yxqas.

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and more apparent in the first few years of the new millennium,[3] transfer pricing garnered a spot on the agenda of each TCCV meeting from 2008 onward—and, as the WCO points out, will remain under discussion for the foreseeable future.[4]

The crux of the problem facing international traders always has been the ''whipsaw'' effect: actions taken to reduce customs duties by lowering the value of imported merchandise result in more corporate income taxes, and vice versa. Balancing the competing interests of these two goals has proved elusive due to the different rules that apply to customs valuation and transfer pricing. Not only have in-house tax and trade professionals and their outside advisers struggled to understand the differences (given that most tax professionals specialize only in income tax rules, while most trade professionals know only import and export rules), so too have global customs and tax authorities been challenged.

With the publication of the guide, the WCO has provided the first real substantive overview and analysis for decision-makers and businesses to follow in this vexing area. The guide consists of six chapters and nine appendices, including an extensive, 39-page ''introduction'' to transfer pricing—presumably aimed at the developing world because, as the guide notes on page 69, ''many tax administrations are still developing their transfer pricing legislation and technical capability.'' This lengthy chapter also serves as a useful refresher course for seasoned transfer pricing professionals. Several highlights of the chapter are summarized below, followed by a discussion of the thrust of the guide found in Chapters 4 and 5: ''Linkages Between Transfer Pricing and Customs Valuation,'' and ''Using Transfer Pricing Information to Examine Related Party Transactions,'' respectively.

WCO guide, Chapter 4: Introduction to transfer pricing

Although the arm's-length principle, the guiding standard for transfer pricing transactions, was evident in some early tax treaties and various model tax conventions, no formal international guidance on transfer pricing was issued until 1979, when the Organization for Economic Cooperation and Development published a report seeking to document the various practices used by member states in determining the transfer price for tax purposes.[5] After a lengthy lull, the OECD revised its guidelines in 1995, which still serve as the basis for most of the global transfer pricing legislation and practices in place today.

Interestingly, 1979 also was the year in which the World Trade Organization passed the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade—the valuation agreement that formally codified the bases of appraisement for global customs valuation purposes. In a sense, then, customs authorities were ahead of their tax counterparts in developing a workable international standard (although the valuation agreement was not developed specifically for related-party transactions but rather encompassed the valuation of all imported merchandise regardless of the relationship between the buyer and seller).

The guide sets forth a comprehensive review of the various transfer pricing methods, including helpful information for customs authorities that focuses on the strengths and weakness of each of those methods. For instance, the transfer pricing method most favored by customs authorities is the comparable uncontrolled price (CUP) method because it generally examines the *price* of the products at issue—the same objective of customs valuation. The guide notes that, even though the main strength of the CUP method is the fact that the *actual* price in the transaction is being compared and analyzed, even minor differences in products can have a material impact on the outcome, thus skewing the analysis. For this reason, as the guide notes on page 31, CUP almost never is used when other transfer pricing methods are available.

Conversely, the transfer pricing method most favored by tax authorities, the transactional net margin method, or TNMM (known in the U.S. as the comparable price method, or CPM), is disfavored by customs authorities. This is not surprising, because TNMM does not *necessarily* focus on product pricing comparability. However, because TNMM examines the operating margin that the ''tested party'' earns in related-party transactions, product pricing is inherent in the method when the tested party is a distributor or manufacturer of tangible goods—as will be noted below in discussing the linkages between transfer pricing and customs valuation. As the guide notes on page 37, ''the main strengths of TNMM are that as the condition being examined is at the net margin level there is a greater pool of potential comparable information available vis-à-vis the CUP [and other methods].''

WCO guide, Chapter 5: Linkages between transfer pricing, customs valuation

One stumbling block to developing further links between customs valuation and transfer pricing concerns the lack of a transfer pricing hierarchy—that is, the ''best method'' for determining the transfer pricing generally is selected after reviewing all of the facts and circumstances of the conditions seeking to be valued. This means that the taxpayer in essence gets to select the transfer pricing method, which is not the case with customs valuation. The 1979 valuation agreement clearly mandates that the various customs valuation methods are to be applied sequentially. That is, the first method, transaction value, must be applied, and if it cannot or does not apply based on the various requirements and definitions, then, and only then, can the second method, and then the third, and so on, be applied. Thus, for all intents and purposes, transaction value is the only one

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[3] For instance, U.S. Customs & Border Protection (CBP) issued rulings that allowed customs values to be based on prices established under bilateral advance pricing agreements. See HQ 546579 (Aug. 30, 2000); HQ 548233 (Nov. 7, 2003). While these rulings required that post-importation transfer pricing adjustments be reported to CBP, the agency accepted duty payments but did not formally allow duty refunds resulting from these adjustments until July of 2012. See Damon V. Pike and Cylinda Parga, ''US: Customs' new landmark transfer pricing policy,''

[4] WCO guide at 57. See note 2, above.

[5] WCO guide at 17.

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of the customs valuation methods for which a linkage with transfer pricing can be developed.[6]

The guide at page 56 makes clear that *audits* are the primary vehicle through which tax and customs administrations can verify that the proper amount of duties and income tax has been paid by the taxpayer-importer. Given that audits rely on documentation (including that associated with accounting, inventory and payment records), the most natural question arising in the customs valuation and transfer pricing context always has been to what extent the information contained in transfer pricing documentation—including information pertaining to the various kinds of adjustments that take place for transfer pricing purposes—can be useful to customs authorities.

Beginning with conferences at the WCO headquarters in 2006 and 2007 that were co-sponsored with the OECD, government officials and practitioners sought to ''bridge the gap'' between the two disciplines of transfer pricing and customs valuation.[7] While some suggested a formal merger between the two sets of rules, this outcome was deemed unworkable given the fact that the 1979 valuation agreement would have to be completely updated—and then enacted into local legislation among various member states.[8]

Instead, the focus shifted to language in the 1979 valuation agreement concerning the ability of customs authorities to examine the ''circumstances of the sale'' when wishing to validate the acceptability of transaction value between related parties.[9] This examination can take several forms. Customs authorities may examine the way in which the buyer and seller organize their commercial relations and the way in which the price was arrived at. When the buyer and seller can demonstrate that they carry out transactions with each other as if they were not related, it would indicate that the price has not been influenced by the relationship. This would be the case, for example, when the price has been settled in a manner consistent with the normal pricing practices of the industry in question, or in the way prices were settled in sales to unrelated buyers. Where the parties can show the price is adequate to ensure recovery of all costs plus a profit that is representative of the firm's overall profit realized over a representative period of time (such as on an annual basis) in sales of goods of the same class or kind, this also would indicate that the price had not been influenced.[10]

As the guide aptly notes, while the TCCV issued a formal Commentary on this topic in 2012, it has yet to issue a full case study. Two studies, however, are in the drafting stages. One concerns TNMM and one concerns another transfer pricing method, the resale price method. Thus, at the international level, the WCO's current formal guidance is limited to the 2012 Commentary simply acknowledging that a transfer pricing study may be ''of use'' to customs authorities in determining the acceptability of transaction value for related-party sales. Prompt issuance of the case studies would be a welcome further development on this issue.

Using transfer pricing information to examine related-party transactions

In focusing on the two core areas noted above, the guide at page 60 acknowledges that there is ''much information contained in transfer pricing studies and documentation which can assist customs authorities in conducting [a circumstances-of-sale] analysis.'' It notes, however, that customs ''will make a decision based on 'the totality of the evidence' which may include various sources. However, in certain cases a decision may be reached primarily based on the transfer pricing data.''[11]

In seeking to reach a decision, customs authorities frequently are challenged by the sheer volume of data set forth in the average transfer pricing study—a fact not highlighted in the guide. Knowing where to even begin sifting through the reams of information generally found in a transfer pricing study can be daunting for the official tasked with making that decision at the port of entry.[12] The guide, then, provides a useful tool in helping those officials focus on the key areas of consideration.

First, as the guide notes on page 61, the ''single product versus product range'' presents challenges for customs valuation. Because transfer pricing studies normally cover a range of products, the direct benefit of such a study may be difficult for customs officials to grasp. However, a liberal interpretation of language from the valuation agreement might help bridge the gap. Specifically, Article 15.3 states that, in applying the circumstances-of-sale test quoted above regarding ''all costs plus a profit,'' goods of the same class or kind means ''goods which fall within a group or range of goods produced by a particular industry or industry sector, and includes identical or similar goods.'' Thus, as the WCO correctly notes on page 61, ''details of costings and profits for the range of products may be relevant for each individual product within that group.'' The guide also sets forth a helpful example calculating the various profits that may be used in this circumstances-of-sale test.

[6] According to the guide, between one-third and 60 percent of all international trade takes place between related parties (WCO guide at 14), so developing this link is not inconsequential.

[7] See ''OECD, WCO Officials, Practitioners Urge Coordinating Customs, Transfer Pricing Rules,'' 15 *Transfer Pricing Report* 61, 5/24/06; ''More Countries Combining Customs, Transfer Pricing Enforcement, Audits,'' 15 *Transfer Pricing Report* 60, 5/24/06; ''Customs, Transfer Pricing Convergence Remains Desired, But Practitioners Say Achieving Objective Remains Elusive,'' 16 *Transfer Pricing Report* 115, 6/13/07.

[8] Indeed, many expressed the view that the valuation agreement has worked out rather well in the decades since its enactment in providing a global language for customs valuation—summarized colloquially as ''if it ain't broke, don't fix it.''

[9] WCO guide at 57.

[10] See the valuation agreement, note to Article 1, para. 2, section 3. These examples, as noted in the regulations of CBP and elsewhere, are illustrative, not exhaustive examples. See 19 C.F.R. §152.103(l).

[11] Although not explicitly stated in the guide, the WCO appears to have embraced the standard first articulated by CBP in December 2009 in HQ H029658 (see ''WCO Technical Valuation Committee Endorses Use of Transfer Pricing Studies,'' 19 *Transfer Pricing Report* 843, 12/2/10) and now used and cited routinely by the agency in all of its headquarters rulings on this topic. See, for example, HQ H238027 (Feb. 19, 2015).

[12] Indeed, most countries do not even issue binding valuation rulings. Notably, the U.S. does; CBP has issued many comprehensive and informative headquarters rulings on customs valuation and transfer pricing that essentially are used by many of the WCO members for guidance given their own lack of local published rulings.

In addition, the guide at page 62 points out that transfer pricing documentation—or even independent studies of a particular industry sector—may be useful in analyzing another one of the circumstances-of-sale tests: the ''normal pricing practices of the industry.'' In fact, CBP has ratified the use of the latter in several headquarters rulings.[13] However, absent an ''industry practices report,'' CBP and other global customs authorities are reluctant to rely on transfer pricing studies to support this circumstances-of-sale test, claiming that ''objective'' evidence is needed (such as that which might appear in a trade journal or academic publication). Such a standard, though, can almost never be satisfied, for the obvious reason that related parties are not going to publish articles concerning how they set intercompany pricing and profits. Doing so would be tantamount to giving away trade secrets, which no corporation would willingly do as a commercial matter, let alone for purposes of obtaining customs' approval of its transaction value. Hopefully, then, this language from the guide will allow a more open-minded examination of transfer pricing studies in demonstrating that the price of imported merchandise is arm's-length—especially given that the normal practice of every industry is to prepare a transfer pricing study for income tax purposes.

Finally, the guide sets forth a discussion of the all-important topic of transfer pricing adjustments. First, it notes on page 66 that any *pre-importation* pricing adjustments always should be reported to customs. Regarding post-importation adjustments, the guide stresses that global consistency on this issue is elusive; some Customs authorities require payments when prices are adjusted upward (to lower profit), but refuse to issue refunds when prices are adjusted downward (to increase profit). Again, this inconsistency reflects the tension between customs valuation and transfer pricing.

The guide then refers to ''price review clauses'' that were the subject of its Commentary 4.1, wherein the price for imported merchandise is provisionally fixed at the time of importation and subject to later adjustment based on provisions in the contract of sale itself. This scenario closely reflects that in which the price is based on a ''formula'' in effect prior to the importation of the subject merchandise, such as that found in documented internal pricing policies and procedures.[14] Thus, the WCO guide on page 67 concludes that a ''basic requirement'' for allowing the inclusion of post-importation adjustments into transaction value is ''that a transfer pricing policy should be in place prior to importation or clearance of the goods concerned, which indicates the criteria (or 'formula') that will be applied to establish the final transfer price.''

Finally, the guide aptly notes that most post-importation adjustments arise in the context of a customs audit. In due course, other failures to report proper elements of arise, such as royalties or license fees, design and development costs undertaken outside the importation jurisdiction, and management fees. An added benefit of undertaking the documentation of a transfer pricing formula, then, could be the prevention of penalties by facilitating a disclosure by the importer for these kinds of oversight.

Conclusion

While progress in melding together the worlds of customs valuation and transfer pricing has taken time, its progress continues. The guide contributes to this progress by supplying a much-needed ''single resource'' for global customs authorities—especially in the developing world, where most of the world's future growth will occur. As learning increases, so trade will follow. Especially in jurisdictions where tax and customs officials are housed within a single agency, such as H.M. Revenue & Customs in the U.K., closer cooperation between the two disciplines should lead to increased revenue collection of both duties and corporate taxes. The trade can contribute to this progress by implementing the suggestions of the guide, and taking a proactive approach in helping educate local customs about this ever-increasingly important topic—and perhaps even minimizing their own duty and tax obligations in the process.

[13] See, for example, HQ H029658 (Dec. 8, 2009), on automotive industry practices and HQ H238027 (Feb. 19, 2015) on the Swiss watch industry.

[14] Unlike almost all other major trading nations, the U.S. specifically incorporates the use of a formula as a valid basis of transaction value into its customs regulations. See 19 C.F.R. §152.103(a)(1).

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