

Achieving transfer pricing and customs nirvana:
Is it possible?

Transfer pricing perspectives

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Achieving transfer pricing and customs nirvana: Is it possible?

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One of the most difficult challenges multinationals face is concurrently managing transfer pricing and customs risks.

Because transfer pricing and customs are governed by different rules and often enforced by different authorities, situations can arise where a taxpayer receives a transfer pricing adjustment and also incurs additional customs duties on the same set of import transactions. This form of “double taxation” can be especially frustrating for taxpayers because it arises from seemingly contradictory positions taken by the tax and customs authorities.

Oftentimes, tax directors will focus their attention on demonstrating transfer pricing compliance, erroneously assuming that meeting the arm’s length standard for tax purposes will also demonstrate customs compliance. In fact, certain countries including the United States have issued official positions confirming that a transfer pricing study, in and of itself, is insufficient for satisfying customs requirements.

This article examines how instances of double taxation arise, reviews common transfer pricing pitfalls that can create customs exposure, and provides recommendations on how to mitigate double taxation risk.

The whipsaw

To begin understanding the potential for double taxation, it is necessary to become familiar with the transfer pricing and customs regulatory regimes.

Global transfer pricing standards are set forth in the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). The OECD Guidelines are intended to prevent taxable income from being shifted indiscriminately and provide guidance on transfer pricing methods that can be applied to test or demonstrate the arm’s length nature of prices.

Customs valuation rules are not “harmonised” in the same fashion but are part of international agreements. Currently, more than 150 countries are signatories to the World Trade Organization (WTO) Customs Valuation Agreement (WTO Agreement), formerly known as the GATT Valuation Code. Jointly administered by the WTO and World Customs Organization (WCO), the WTO Agreement requires signatories to adhere to a largely uniform system of appraisal for the assessment of customs duties and fees on imported goods.

Unfortunately, this basically means that for taxpayers importing products sourced from affiliates, the same set of import transactions will be subject to two sets of regulations intended to serve different purposes. This duality problem is exacerbated by the fact that the transfer pricing regulations are often enforced by different agencies with very limited interaction and coordination. Based on this inherent conflict, joint WCO-OECD task force meetings have been held to discuss these issues, identify the areas of concern, and attempt to develop a common approach. These meetings have included the WCO, OECD, WTO, customs administrations, tax administrations, and the private sector. Although they have reached agreement on the areas of concern and common problems, no concrete “solutions” have been developed to date. Interestingly, one outgrowth of these meetings has been knowledge sharing among customs administrations on common audit issues, resulting in a convergence in customs audits across multiple jurisdictions.

The potential for conflict becomes even more apparent when examining differences in how compliance with transfer pricing and customs is enforced through tax and customs audits, respectively. Tax auditors approach audits from a corporate income tax frame of reference, which means that they generally are concerned about identifying instances of above-arm’s length transfer prices and are predisposed to reduce transfer prices so as to increase taxable income. Customs auditors, on the other hand, generally focus on identifying instances of below-arm’s length transfer prices (for example, where customs declaration value was underestimated) and are predisposed to increase transfer prices to increase customs duties. The regulatory frameworks for tax and customs auditors also drive their differences in approach when they issue assessments.

At a fundamental level, the inconsistency between the transfer pricing and customs realms derives from the fact that, pursuant to the OECD Guidelines, the direct tax discipline focuses on the aggregation of results over a prescribed period, combined with a recognition that individual performance should be benchmarked against that of other entities undertaking comparable functions, regardless of incompatibility in other areas. In stark contrast, the prevailing customs valuation framework is founded on a transaction-by-transaction approach and requires a product-by-product compatibility for benchmarking of functionally comparable entities.

When reviewing transfer prices during a tax audit, auditors evaluate their arm’s length nature pursuant to the relevant transfer pricing regulations. The auditors request and analyse transfer pricing documentation (including transfer pricing study, copies of intercompany agreements, etc.) to determine whether the application of the most reasonable pricing method supports that the transfer prices paid by the taxpayer are consistent with the arm’s length concept. In most cases, the most reasonable transfer pricing method on import transactions is either the resale price method or the transactional net margin method.

Taxpayers and tax auditors derive an arm's length range of results based on a sample of comparable companies typically identified through Standard Industrial Classification code screening with consideration of functions performed, risks incurred, and assets employed.

It is important to note that even when the tax auditors agree with the taxpayer's transfer pricing method, they may disagree about the specific application of the method, particularly with regard to the selection of comparables. Taxpayers and tax auditors derive an arm's length range of results based on a sample of comparable companies typically identified through Standard Industrial Classification code screening with consideration of functions performed, risks incurred, and assets employed. The transfer pricing methods generally are applied to a taxpayer's aggregate import transactions during the year, and a transfer pricing adjustment is made if the profitability results on the taxpayer's import transactions fall below the arm's length range.

In contrast, customs authorities typically apply added scrutiny to related party transactions to confirm that the price between the related parties meets the customs requirements for valuation purposes, because the appraisal forms the basis for duty assessment and ultimately customs revenue. In countries that adhere to the principles of the WTO Agreement, customs authorities require that upon entry (importation), imported merchandise be appraised and the customs value declared. The valuation framework set forth in the WTO Agreement provides a hierarchy of methods that must be applied sequentially.

The preferred method of appraisal is known as "transaction value," the price actually paid or payable for the goods when sold for export, with certain adjustments. Although this method is available in related party transactions, customs authorities can question the transaction value if they are concerned that the relationship between the parties has affected the transfer price. The authorities generally analyse the "circumstances of the sale" to determine whether the transaction was conducted in an arm's length manner: whether the price was settled in a manner consistent with either the normal pricing practices in the industry or the way the seller prices goods for unrelated buyers; whether the price is adequate to recover all costs plus a profit equivalent to the company's overall profit realised over a representative period in sales of merchandise of the same class or kind; etc.

In some jurisdictions, such as the United States and many European Union countries, the customs authorities consistently apply a straightforward interpretation of the aforementioned criteria in determining whether the transactions under review are undertaken at arm's length. When the taxpayer can support the arm's length nature of its transfer prices under any of the referenced alternative criteria, those prices generally are accepted as the basis of customs transaction value. If the transfer price declared by the importer is rejected by the local customs authority, the importer is required to apply the sequence of alternative valuation methods, which are generally more complex and impose a heavy documentary burden, until the authorities are satisfied that the customs value of the merchandise is appropriately reflected.

However, even in these jurisdictions with somewhat uniform practices, significant discretion exists in the manner in which the prescribed criteria can be met. For example, in many EU countries, customs authorities often accept and defer to transfer pricing studies as compelling and decisive support for the arm's length nature of prices determined as transaction values. In the United States, however, customs authorities have specifically noted that traditional transfer pricing studies alone are insufficient to support satisfaction of the arm's length criteria from a customs perspective.

In further contrast, customs authorities in other jurisdictions (including several Pan-Asian countries) are likely to compare the taxpayer's results to those of similar importers by using an internal database of customs declarations. If the customs authorities determine that the relationship of the parties affected the transfer prices, transaction value would be denied and an appropriate arm's length value for the transaction would be needed. The customs auditors typically apply either the deductive value method, which "backs into" the import value by focusing on the profit and general expense (P&GE) ratio achieved by the taxpayer on its import transactions, or the computed value, which focuses on the P&GE of the manufacturer selling the goods to the importer. Moreover, in deriving an arm's length P&GE ratio for deductive value, customs auditors screen for comparable transactions according to Harmonized System codes, with an emphasis on similarity of product as opposed to industry or functional similarity.

It is important to note that although customs auditors may make a request for a taxpayer's transfer pricing study or information on transfer pricing policies during their review, this information generally has limited usefulness because it tends to focus on supporting the arm's length nature of transfer prices from a corporate tax perspective rather than a customs perspective.

Given the differences in the tax and customs regimes, it is easy to see the potential for a taxpayer to get whipsawed between the tax and customs authorities. In certain respects, customs auditors may be viewed as applying a more stringent arm's length standard than tax auditors. Moreover, the relatively narrow approach taken by the customs auditors does not appear to easily accommodate taxpayers with unique fact patterns or business circumstances.

Taxpayers should understand the global pricing policies and be prepared to respond to inquiries based on the relevant regulations. The WTO Agreement provides various requirements for the import prices to be accepted as transaction values, and careful planning, in many cases, can avoid unnecessary scrutiny.

Common pitfalls

Given the increased focus on transfer pricing by tax administrations around the world and the rise in transfer pricing disputes, some taxpayers are so focused on demonstrating compliance that they take actions without considering the potential negative repercussions. In other cases, taxpayers simply overlook potential customs issues that are closely related to transfer pricing; this may be regrettable because awareness and careful planning could prevent customs issues from arising or escalating. Common pitfalls include the following:

Local adoption of global transfer pricing policies or price lists

Many multinationals manage transfer prices by developing corporate transfer pricing policies that they consistently apply to intercompany transactions on a global basis. In other cases, a multinational may use a global price list that is consistently applied to transactions with affiliates. During tax audits, it is common for taxpayers to try to defend the arm's length nature of transfer prices by citing their consistent global application of transfer pricing policies or price lists—particularly when these policies have been successfully defended in tax audits in other jurisdictions or when the taxpayer has negotiated an advance pricing agreement (APA) based on the policies.

However, overemphasising the adoption of global transfer pricing policies or price lists can highlight the significant differences presented by the arm's length requirements of tax and customs and, from a customs perspective, suggest that the pricing is artificially set based on aggregate sales. In fact, for customs purposes, new prices often serve to call into question the legitimacy of old prices, and reduced pricing does not usually permit the importer any duty refund.

To help mitigate this risk, taxpayers should understand the global pricing policies and be prepared to respond to inquiries based on the relevant regulations. The WTO Agreement provides various requirements for the import prices to be accepted as transaction values, and careful planning, in many cases, can avoid unnecessary scrutiny. Although customs valuation methods may not exactly match transfer pricing methods, certain aspects in the customs regulations can be applied to the specific fact patterns at hand. As with most tax issues, preparation is key.

Taxpayer-initiated transfer pricing adjustments or changes in transfer prices

Taxpayers that apply transfer pricing policies by targeting a specific arm's length margin will often find it necessary to make transfer pricing adjustments when actual financial results diverge from projected results. Transfer pricing adjustments are made periodically during the year or at the end of the year. An alternative to making a transfer pricing adjustment is simply to adjust or change the transfer price during the year. Although these transfer pricing adjustments are generally intended to demonstrate pricing compliance and mitigate pricing risk, they can have the unintended effect of creating significant risk from a customs perspective.

Initiating a transfer pricing adjustment or changing transfer prices can indicate that the customs transaction value was subject to influence because of a special relationship. It can also raise doubts about whether the customs transaction value originally declared was representative of a fair value. Taxpayers can also face a classic "heads, we win; tails, you lose" scenario where an upward transfer pricing adjustment will result in additional duty liability, whereas a downward adjustment in price will not automatically result in a refund of duty payments. Fluctuations in import prices will generally attract the attention of the customs authorities. Moreover, given the customs authorities' propensity to apply the deductive value method based on a specific P&GE ratio, significant fluctuations in import prices can result in significant duty assessments.

Another concern/risk relates to the method of declaring the adjustment to the customs authorities. While some countries have voluntary "disclosure" concepts for companies to declare the adjustment and avoid the threat of penalties, many countries have no method to correct the customs declarations without penalty risk, and other countries may not have any mechanism to correct the declarations. This can be particularly troublesome in jurisdictions with foreign exchange control rules, and if the customs value cannot be changed for the goods, the only method to effect payment would be to attribute the payment to services, which creates tax and value-added tax concerns.

To mitigate customs risks associated with adjusting transfer pricing or changing transfer prices, taxpayers should carefully monitor variance between actual and budgeted performance. This can reduce the need to make large transfer pricing adjustments or significant changes in transfer prices.

Royalty payments, cost contribution arrangements, and management service fees

Tax auditors closely scrutinise royalty payments, cost contribution agreements, and management service fees. To help establish the deductibility of these expenses, taxpayers generally exert significant time and effort preparing detailed documentation that supports

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their arm's length nature. Despite the intense focus on these charges from a tax perspective, many taxpayers are oblivious to their potential customs implications.

Customs auditors also generally focus on reviewing these charges, and if they are deemed to be related to the imported goods and exist as a condition of sale, the charges may be dutiable (added to the transaction value). In some instances, only a portion of such payments should be added to the transaction value, especially when the importer is engaged in multiple business activities, such as distribution, manufacturing, and provision of services. Directly linking "add back" items to the specific imported goods may present a challenge to many companies.

Advance pricing agreements (APAs)

APAs, in which the local tax authorities in either one (unilateral) or both (bilateral) of the jurisdictions involved in the transaction affirm the arm's length nature of a taxpayer's transfer prices, are generally seen by taxpayers as the ultimate achievement of certainty around the acceptability of their transfer prices. All too often, however, the process of securing an APA does not include any analysis of the customs implications of what is being proposed to the tax authorities. Nor is any attempt generally made to advise or include the customs authorities in the APA negotiations. Accordingly, it is common for taxpayers to find themselves committed in a binding APA arrangement to transfer pricing methods that can have deleterious effects on the customs valuation of imported merchandise.

Whenever possible, companies should seriously consider jointly approaching both the tax authorities and the customs authorities in any APA negotiations involving the cross-border movement of goods.

Achieving nirvana

In a perfect world, a taxpayer would be able to apply a single arm's length price that would satisfy both the tax and customs authorities. Unfortunately, we don't live in a perfect world. Moreover, the increased attention and friction between transfer pricing and customs valuation have created the need for an integrated, coordinated approach to transfer pricing and customs compliance.

Although differences between the tax and customs regulatory regimes make achieving this state of nirvana difficult, it is not impossible. To manage the risk of double taxation, taxpayers are encouraged to engage in careful planning that considers tax and customs ramifications from the outset when structuring related party transactions. This will reduce the likelihood of getting whipsawed between the tax and customs authorities.

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