The authors discuss the new case study released by the Technical Committee on Customs Valuation of the World Customs Organization. The case study is a significant development, providing a practical example of how certain transfer pricing documentation can be used by customs authorities to determine whether a relationship has influenced the price when assessing customs valuation.

1. Introduction

During the week of 18–22 April 2016, the World Customs Organization (WCO) Technical Committee on Customs Valuation held its 42nd session in Brussels. At this session, a new instrument was approved by the Committee concerning the use of transfer pricing documentation in assessing customs values (the case study). This new instrument is a breakthrough development, as it provides an illustrative example of how, in practice, transfer pricing documentation based on the transactional net margin method (TNMM) may be used by customs authorities to determine whether the relationship has influenced the price when assessing customs valuation. Furthermore, the approval of this new instrument represents another important step towards better coordination between these two subject areas.

2. Background

The interplay of transfer pricing and customs valuation was included on the agenda of the Technical Committee on Customs Valuation in 2007 (under the heading “Related Party Transactions under the Agreement and Transfer Pricing”) and has been a regular agenda item since the 26th session (Spring 2008). The first outcome of the work of the Committee on this topic was Commentary 23.1, which acknowledges the role that transfer pricing documentation may play in examining related-party transactions for customs value purposes. Since then, the Committee has been regularly discussing the subject at their meetings, with guest presentations from the OECD, World Bank Group and others.

3. The Case Study

The case study has been made available on the WCO website and will be published in the WCO Valuation Compendium, subject to approval by the WCO Council in July 2016. The following is a summary of the case study.1

<table>
<thead>
<tr>
<th>Table 1: I Co financial information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
</tr>
<tr>
<td>Cost of goods sold (COGS)</td>
</tr>
<tr>
<td>Gross profit</td>
</tr>
<tr>
<td>Operating expenses</td>
</tr>
<tr>
<td>Operating profit</td>
</tr>
<tr>
<td>Operating profit margin</td>
</tr>
</tbody>
</table>

The transfer pricing study was reviewed by the tax authorities of country I and country X in the context of a bilateral advance pricing agreement (APA). The tax authorities agreed that this was an arm’s length range for transactions comparable to I Co’s.

In order to examine the acceptability of the transfer price, and as I Co did not provide test values to prove it, country I customs authorities examined the transfer pricing study. The analysis is based on the data as shown in table 1.

Sales figures are accepted on the basis that sales are to unrelated parties. Likewise, the operating expenses are accepted, as they are payable to unrelated parties. On the other hand, operating profit is accepted as arm’s length based on the transfer pricing study. The COGS figure reflects the price paid to X Co and is therefore the transfer price.

---

1. A copy of the full case study is included as Annex 1.

---

* Joel Cooper is Co-Head of International Transfer Pricing at DLA Piper, London. He can be contacted at joel.cooper@dlapiper.com. Monia Volpato is an Economist at DLA Piper, London. She can be contacted at monia.volpato@dlapiper.com.
After examination of the circumstances, country I customs authorities concluded, by reference to the analysis of the transfer pricing study (including functional analysis and comparability level) and the figures above, that the relationship between the parties did not influence the price.

4. Analysis

The case study provides a good example of how a transfer pricing study may be used by customs authorities when examining related-party transactions. However, the fact pattern described in the case study is very specific, reflecting what are assumed to be the various concerns, experiences and positions of the delegates of the Technical Committee on Customs Valuation.

For example, the case study involves an application of the TNMM based on comparables which are located in the same country as the distributor and which deal in the same types of products. Whilst this raises doubts about the acceptance of so-called “foreign comparables” by customs authorities, it is expected that, over time, customs authorities will adopt a similar approach to that of tax authorities. That is, in the absence of local comparables and with proper economic analysis (and adjustments where necessary), comparables from other countries are accepted in most jurisdictions. However, differences in products and industry that are often acceptable for transfer pricing analysis may prove to be more problematic for customs authorities, given the particular significance of these factors in a customs context.

In the case study, the transactions are covered by a bilateral APA. The addition of this fact should not lead to the conclusion that there must be a bilateral APA agreement in place for the customs authorities to consider transfer pricing documentation, but rather that a thorough, two-sided transfer pricing analysis should be undertaken if customs authorities are to give weight to the transfer pricing documentation.

The case study also assumes that the importer does not buy products from unrelated parties and the seller does not sell to unrelated parties. In practice, there may be sales to, or purchases from, independent parties; however, due to the operating model of the business, these purchases or sales may not be comparable. For example, there may be differences in the level of the market, the geographic market, contractual arrangements and volumes. In practice, this would need to be addressed in the transfer pricing study, with due attention given to customs considerations.

The case study further specifies that I Co’s operating expenses are paid to unrelated parties. This fact ensures that the purchase price of the goods is the only variable in the determination of the operating margin that may be influenced by the relationship between the parties. This allows the customs authorities to work back from the arm’s length operating margin to determine that the transfer prices are not influenced by the relationship. This implies that, in practice, to the extent that there are operating expenses resulting from transactions with related parties, demonstrating in the transfer pricing study that such expenses are consistent with the arm’s length principle will be critical in order for customs authorities to give weight to the study.

5. Conclusion

Although the case study clearly states that it does not “indicate, imply or establish any obligation on Customs authorities to utilize the OECD Guidelines and the documentation resulting from the application of the OECD Guidelines in interpreting and applying the WTO Valuation Agreement”, approval by the Technical Committee on Customs Valuation of this case study is a strong indicator of how views on transfer pricing studies are developing within the customs community.

While the facts of the case study are very specific, it does provide very useful guidance for customs authorities and taxpayers as to the application of Commentary 23.1, which, to date, has been largely ignored or narrowly interpreted by many customs officials. In practice, it is expected that the case study will serve as an influential publication for companies seeking to support customs values based on the transactional value method using a transfer pricing study, particularly in cases where the taxpayer has, or is seeking, an APA.

From a business perspective, this is a timely development. Multinational enterprises that are currently in the process of revisiting their approach to transfer pricing documentation in light of the OECD/G20 BEPS project Action 13 report on transfer pricing documentation and country-by-country reporting now have the opportunity to consider how this revised documentation can be tailored appropriately for customs purposes. In this regard, taxpayers updating their transfer pricing documentation and/or reviewing their transfer pricing policy should consider how appropriately prepared transfer pricing documentation can be used to help demonstrate to customs authorities that the relationship between the parties has not influenced the price. In addition, the potential to seek APAs that help to provide certainty concerning both transfer pricing and customs valuation, should also be considered.
6. In response to Customs request for additional information, ICO presented a transfer pricing study for the period 2011, prepared by an independent firm on behalf of ICO.

7. The transfer pricing study used the Transactional Net Margin Method ("TNMM") that, in this case, compared ICO’s operating margin with the operating margins of functionally comparable distributors of goods of the same class or kind, also located in Country I, that conducted comparable uncontrolled transactions in the same period of time. The transfer pricing study was prepared in order to comply with the requirements of Country I tax regulations and applied principles contained in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of the Organisation for Economic Cooperation and Development ("OECD Transfer Pricing Guidelines"). The transfer pricing study covered all relays purchased by ICO from XCO.

8. Relevant data for ICO, taken from the company’s financial records:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>- Sales</td>
<td>100.0</td>
</tr>
<tr>
<td>- Cost of Goods Sold (COGS)</td>
<td>-82.0</td>
</tr>
<tr>
<td>- Gross profit</td>
<td>18.0</td>
</tr>
<tr>
<td>- Operating expenses</td>
<td>-15.5</td>
</tr>
<tr>
<td>- Operating profit</td>
<td>2.5</td>
</tr>
<tr>
<td>- Operating profit margin</td>
<td>2.5% of sales</td>
</tr>
</tbody>
</table>

9. The transfer pricing study, using data taken from ICO’s company records, indicated that ICO’s operating profit margin on the sale of relays purchased from XCO was 2.5 percent in 2011.

10. The study concludes that it is possible to find reliable comparables for ICO and, accordingly, ICO was selected as the tested party in the transfer pricing study.

11. ICO’s transfer pricing study had been reviewed by the Tax authorities of countries I and X in the context of negotiating a bilateral Advance Pricing Agreement (APA). An APA was subsequently agreed between ICO, XCO and the Tax authorities of countries I and X with respect to all transactions between ICO and XCO. While in review by the Tax authorities of countries I and X, ICO provided information showing that the profit margins it earns on the sale of its relays are generally the same as those made by independent distributors in the electrical apparatus and electronic parts industries.

12. In the transfer pricing study, eight distributors, unrelated to their suppliers, were selected based on the substantial similarity of their functions, assets and risks, compared to ICO.

13. Information concerning these eight distributors was taken for fiscal year 2011 for purposes of comparison. The range of operating profit margins earned by these unrelated distributors was 0.64 to 2.79 percent, with a median of 1.93 percent. In the context of the APA negotiations, this range was accepted by the Tax authorities as an arm’s length range of operating profit margins for transactions comparable to ICO’s transactions with XCO. This arm’s length range was established using the operating profit margins of the eight comparable companies, using the financial records of
these companies available in public databases. ICO’s operating profit margin was 2.50 percent, thus falling within the range. The 2.50 percent margin achieved by the importer in the country of importation was a function of: a) the price actually paid or payable by ICO to XCO, b) ICO’s own sales revenue, and c) ICO’s own costs.

14. It was determined that no adjustments prescribed by Article 8 of the Agreement were required to be made to the price actually paid or payable. Additionally, ICO did not make compensating adjustments for tax purposes for the year 2011.

15. ICO sets its selling prices in order to allow the company to earn an operating profit that meets the target arm’s length (interquartile) range as set out in the transfer pricing study. The price paid or payable to XCO has not undergone significant changes over the year.

**Issues for Determination**

16. Does the transfer pricing study supplied in this case, prepared on the basis of the OECD Transfer Pricing Guidelines and used as the basis of a bilateral APA, provide information which enables Customs to conclude whether or not the price actually paid or payable for the imported goods is influenced by the relationship of the parties under Article 1 of the Agreement?

**Analysis**

17. Under Article 1 of the Agreement, a transaction value is acceptable as the Customs value when the buyer and the seller are not related, or if related, the relationship does not influence the price. Where the buyer and seller are related, Article 1.2 of the Agreement provides two ways of establishing the acceptability of the transaction value when Customs have doubts concerning the price: (1) the circumstances surrounding the sale shall be examined to determine whether the relationship influenced the price (Article 1.2 (a)); or (2) the importer demonstrates that the value closely approximates one of three test values (Article 1.2 (b)). In this case, as indicated in paragraph 5, the importer did not provide test values therefore Customs examined the circumstances surrounding the sale.

18. The Interpretative Note to Article 1.2 of the Agreement provides that in examining the circumstances surrounding the sale, “the customs administrations should be prepared to examine relevant aspects of the transaction, including the way in which the buyer and the seller organize their commercial relations and the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price.”

19. Based on the information obtained from ICO, XCO does not sell the merchandise to unrelated buyers. Therefore, ICO is unable to demonstrate that the price was settled in the same manner as in sales to unrelated parties, specified in Note 1 to Article 1.2 (a) of the Agreement.

20. During its review of the circumstances surrounding the sale, Customs took into account the examination of information discussed in the transfer pricing study when determining whether the price had been settled in a manner consistent with the normal industry pricing practices under the Note to Article 1.2 (a). In this regard, the term “industry” includes the industry or industry sector that contains goods of the same class or kind (including identical or similar goods) as the imported goods.

21. Based on the information provided in Paragraph 8:
   - The Sales figure can be accepted since ICO is selling only to unrelated parties (and it is assumed ICO is rationally seeking to maximize its profits in its dealings with unrelated parties)
   - The Operating expenses amount has been examined and accepted as reliable since it is determined that these expenses are paid by ICO to unrelated parties, with ICO seeking to minimize its costs and these expenses have not been paid for the benefit of the seller
   - The transfer pricing study confirms that ICO’s operating profit margin is within the arm’s length range (i.e. based on a study of comparable, but independent (unrelated) distributors)
   - The Cost of Goods Sold of ICO reflects the price paid or payable to XCO and represents the transaction between ICO and its related party, XCO. This is the transfer price in question.

By working back from the arm’s length range of operating profit margins and the other accepted information set out above, it could be deduced that the transfer price is an arm’s length amount. This demonstrates that information relating to the transaction between ICO and unrelated distributors can be helpful and relevant to Customs when examining the circumstances surrounding the sale between XCO and ICO.

22. The functional analysis showed that there were no significant differences in functions, risks, and assets between ICO and the eight unrelated distributors. In addition, an adequate level of product comparability was observed. The comparable companies were chosen from the electrical apparatus, and electronic parts industries (companies that sell goods of the same class or kind as the imported goods). Thus, the operating profit margin on the resale of the imported goods was shown to be generally the same as in the electrical apparatus and electronic parts industries.\(^1\) Specifi-

\(^1\) In this case, Customs accepted the operating profit margin as a more accurate measure of ICO’s real profitability because it revealed what ICO actually earned on its sales once all associated expenses have been paid. Nevertheless, in certain circumstances, gross profit may be considered by Customs to illustrate the appropriately deducted associated expenses and the establishment of the accurate transfer price.
cally, the transfer pricing study found that the arm’s length range of the comparable companies’ operating profit margins was 0.64% to 2.79%. As previously noted, ICO’s operating profit margin was 2.50%. Accordingly, since all the comparable companies sell goods of the same class or kind, the transfer pricing study supports a finding that the price between ICO and XCO was settled in a manner consistent with the normal pricing practices of the industry.

**Conclusion**

23. After examination of the circumstances surrounding the sale in respect of related party transactions between ICO and XCO, Customs concluded, including by analysis of a transfer pricing study based on the TNMM and additional information concerning operating expenses as deemed necessary, that under the provisions of Article 1.2 (a) of the Agreement, the relationship between the parties did not influence the price.

24. As indicated in Commentary 23.1, the use of a transfer pricing study for examining the circumstances surrounding the sale must be considered on a case-by-case basis.