Suggested Approaches to Harmonization of Transfer Pricing and Customs Rules

The author proposes ways in which transfer pricing and customs valuation rules could be harmonized so as to provide greater certainty for taxpayers.

1. Introduction

With the liberalization of the world economy, cross-border trade of goods has increased many fold. A significant part of such trade takes place between associated enterprises. More than 60% of cross-border trade of goods (in terms of value) is between associated enterprises.1 Whenever cross-border transactions take place between associated enterprises, such transactions must pass through the oversight of customs authorities as well as income tax authorities. The prices of such goods must be determined separately for customs and transfer pricing (under income tax laws) purposes, for which countries typically have separate sets of laws, valuation rules, documentation requirements and administrative bodies to conduct audits and assessment.

Generally, the transfer pricing rules of most countries are based on the OECD Transfer Pricing Guidelines for Multinational Enterprise and Tax Administration (OECD Guidelines), whereas customs valuation rules are based on World Trade Organization (WTO) guidelines. The objective of both the OECD Guidelines and WTO valuation rules is to ensure that cross-border transactions between associated enterprises are at an “arm’s length price” or “fair value”, i.e. relationship of parties has not influenced the price of the transaction.

However, multinational enterprises face difficulties due to the diverging motivations of the income tax and customs authorities. The customs authorities aim to value imported goods at a high price so that they can recover higher customs duties, while the income tax authorities seek to prevent the shifting of profit to the exporting country by assessing a lower transaction value or price for imports, thereby increasing the income tax liability of the taxpayers. Thus, it is essential to align the two sets of rules and achieve a harmonized income tax and customs value for cross-border trade of goods between associated enterprises.

This article focuses on plausible ways to harmonize customs and transfer pricing rules, such that it provides certainty to multinational enterprises in respect of their transfer pricing and customs duties.

2. Plausible Approaches to Harmonization of Customs and Transfer Pricing Regulations

2.1. Use of transfer pricing documentation for customs purposes

The customs authorities generally determine customs duties on the purchase price of imported goods, which is deemed to represent an arm’s length price or fair value. However, where the exporter and the importer are associated enterprises, the arm’s length price or fair value is questioned. In such circumstance, the transaction value can still be used for customs valuation purposes if the importer can demonstrate that the relationship did not influence the price. In order to establish that the associated enterprise relationship has not influenced price, there is a need to harmonize the customs and transfer pricing regimes. One plausible way to achieve harmonization is to give authoritative recognition to transfer pricing documentation prepared in accordance with the OECD Guidelines for customs purposes. Accordingly, if the importer determines the value of imported goods using a methodology prescribed under the OECD Guidelines and prepares necessary transfer pricing documentation, such documentation should be considered as evidence for customs authorities that the price of the goods is not influenced by the associated enterprise relationship between the importer and exporter.

The transfer pricing methodologies prescribed under the OECD Guidelines are based on sound economic principles designed to result in arm’s length prices’ being charged, and the same result is sought by customs authorities when determining that prices have not been influenced by the relationship. Accordingly, recognition of transfer pricing documentation prepared in accordance with the OECD Guidelines for customs purposes would set up a convergence between transfer pricing and customs rules with regard to cross-border trade of goods between associated enterprises. By doing so, the arm’s length principles advocated by OECD Guidelines would be directly aligned with the rules for determining values for customs purposes.

To implement the above approach, it would be essential to modify the customs rules of the country by inserting a clause relating to recognition of transfer pricing documentation for satisfying the condition relating to influence of price by the associated enterprise relationship. Furthermore, transfer pricing rules should also be modified to incorporate necessary information and evidence that should be included in transfer pricing documentation.
which would be relevant for customs authorities to evaluate the condition relating to influence on price by the associated enterprise relationship. Additionally, relevant rules should be drafted which facilitate the best exchange of information between customs and tax authorities.

2.2. Recognition of post-transaction transfer pricing adjustments for customs purposes

Where the importer makes a post-transaction voluntary adjustment (for a number of reasons, such as a true-up or true-down adjustment to achieve a pre-agreed margin from related-party transactions for transfer pricing purposes) or where a post-transaction adjustment is made by the tax authorities as the result of an audit, such post-transaction adjustment (upward or downward) should be recognized and considered for customs purposes. The customs authorities should analyse the reason or circumstances underlying such adjustment, and if they are satisfied with the reason or circumstances that gave rise to such adjustment, due recognition should be given to the adjustment (whether upward or downward) as part of the price paid for the goods, and consequently as an element of the transaction value of the goods.

Where a post-transaction adjustment is a downward adjustment, it would result in a refund of customs duties for the importer taxpayer (which should be granted) or an adjustment against duties payable by the taxpayer in respect of other goods. On the other hand, if a post-transaction adjustment is an upward adjustment, it would result in payment of additional duties by the importer taxpayer. However, in such a situation, the customs authorities should not impose a penalty for short payment of duties if (i) the importer provides appropriate justification for such upward adjustment, and (ii) such adjustment was genuinely unforeseeable at the time of the transaction.

2.3. Advance pricing agreements to involve customs authorities

Present rules on advance pricing agreements in most jurisdictions provide an option for the taxpayer to apply for a unilateral, bilateral or multilateral APA. Irrespective of the type of APA, the scope of the agreement under an APA is restricted to only the applicant taxpayer and income tax authorities (either domestic or foreign income tax authorities where a bilateral or multilateral APA is entered into).

In order to achieve a meaningful convergence between transfer pricing and customs, which would enable taxpayers to obtain certainty in respect of both their transfer pricing and customs duties, the APA regime and customs rules could be modified as follows:

- a joint team of APA and customs authorities should be formed and provisions should be enacted for the exchange of information between the two departments;
- in the APA application, the taxpayer should be given the option to involve customs authorities in the APA process. By virtue of this, the taxpayer’s intercompany transactions would be jointly evaluated by APA authorities (part of the income tax authorities) and customs authorities; and
- where an agreement is achievable, the APA would be between the taxpayer, the income tax authorities and the customs authorities. The APA would provide certainty to the taxpayer in respect of pricing from both an income tax and customs perspective. Typically, it would provide certainty to the taxpayer concerning the method for determining the arm’s length price or fair value, the margins to be earned, satisfaction of requirements from a customs perspective that the price of the goods has not been influenced by the associated enterprise relationship between the importer and exporter, if certain conditions are fulfilled by the taxpayer. Such an agreement would also specify the set of documents and evidence to be maintained by the taxpayer to meet the requirements of both income tax and customs authorities.

3. Conclusion

Although it is not practical to achieve complete harmonization between transfer pricing and customs, if the above suggested approaches were to be implemented, it could align the two sets of rules to some extent and provide certainty to taxpayers regarding transfer pricing and customs duties.