



Legal Alert

Canada-US Cross Border Business Affairs

Division Co-Leaders

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Recent Development Regarding US Transfer Pricing

Last year, the US Government announced that related party imports (*i.e.*, import transactions between affiliates) had for the first time exceeded \$1 trillion and have almost doubled in just the last 10 years. With related party imports considered higher risk by US Customs and Border Protection (CBP) due to the potential of price manipulation, a dramatic increase in such imports places many more importers as potential targets for customs audit and enforcement actions. This is the case even for those importers with seemingly low-risk import operations by virtue of limited product diversity, absence of special duty arrangements, low or even zero duty rates, or relatively simple supply chains.

With related party imports at an all time high, the potential for customs penalties for valuation errors is great. Companies should not be comforted simply by having a transfer pricing study in the files of the tax department. A thorough analysis of such a study and development of additional information that fills any gaps is critical in fulfilling the importer's reasonable care obligations and supporting a company's transfer prices for customs valuation purposes.

Arent Fox can provide assistance in reviewing your Company's import, valuation, and transfer pricing policies in advance of a potential value or First Sale audit. At a minimum, we would recommend an initial assessment of your company's risk exposure and we would be glad to discuss with your company what this type of work would entail.

Differences Between Tax and Customs Requirements

Many companies perceive the risk of related party transactions to be limited to the tax area and paying the correct amount of corporate income tax. To the extent companies are aware that related party transactions raise customs valuation issues as well, such companies may reflexively point to transfer pricing studies prepared by their tax advisors in asserting the correctness of their customs valuations. Proactively addressing these issues can save a company from protracted and expensive disputes concerning the valuation of related party imports.



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A common misperception is that a transfer price meeting IRS requirements is also appropriate for customs valuation purposes. The assumption is not unreasonable, considering that the IRS and CBP are charged with revenue collection and, historically, both had served as part of the same federal agency. But each agency administers a different set of laws and regulations, including those provisions dealing with related party transactions.

The clear differences between the customs and tax regimes governing transfer pricing indicate that a transfer price study done for IRS purposes often cannot be relied on to validate transfer prices used to value imports from related parties. However, there are enough similarities and related concepts that would allow for a customs-specific analysis to be incorporated into a tax-based study without great difficulty. Thus, perhaps the most significant step that an importer could take is to define the scope of the study to include an evaluation of whether transfer prices meet CBP requirements. In this regard, the importer would basically be including in the study the same information that it would likely be required to present to CBP in demonstrating how the tax study is useful for customs purposes.

Interest in Transfer Pricing Issues is on the Rise

More recently, both CBP and businesses have become more focused on customs valuation issues. A few indicators worthy of note:

- **CBP focused assessment audits (FA)** invariably incorporate valuation as a core component of the audit. Large multinational related party importers are prime targets for FAs, and this means transfer pricing issues are front and center.
- Our practice has seen a marked increase in the number of valuation issues being raised through **formal information requests** (so called CF-28s), and other CBP inquiries.
- There has been a marked increase in the number **ruling and internal advice requests** to CBP related to transfer pricing issues.
- CBP recently issued a final rule that recognizes **post-importation adjustments** to transfer prices for customs purposes in certain circumstances. It is aimed at related party sales that are priced according to a transfer pricing formula, and where the importer participates in the CBP reconciliation program.
- CBP is also placing more attention on U.S. import transactions that are valued under the so-called **“first sale” rule** in which the sale from the foreign manufacturer to the middleman (which is often a related party transaction) is able to be used if certain specific requirements are met. Companies that import into the U.S. benefit from the “first sale” rule reap significant benefits because the “first sale” value is almost always lower than the valuation of the subsequent transaction between the middleman and the U.S. purchaser.

But there are other important drivers. These have driven an uptick in requests for rulings and other guidance, and again, for transfer pricing formulae. As a result, unusual transfer pricing schemes/formulae have proliferated as multinational businesses have developed ever more integrated supply chains and complex business structures.

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