Risks in Using Transfer Pricing Studies in Customs Valuation

By Myles Getlan (Arent Fox LLP)

Editor’s Note: This is the third in the series of articles on transfer pricing and customs valuation by Arent Fox LLP. The previous two articles appeared in the September 15 and October 15 editions of Strategies.

Earlier this year, the U.S. 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 U.S. 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.

Prior Disclosures: What Can the CBP Demand…and When?

By Elizabeth Hein and Chunlian Yang (Alston & Bird LLP)

Experienced importers are all too familiar with the reality that regardless of the strength of a corporate compliance program, things can, and do, go wrong during the customs entry process. When a violation is discovered, importers may avail themselves of the prior disclosure process and disclose to U.S. Customs and Border Protection (“CBP”) the circumstances of a violation. Under the customs penalties statute (19 U.S.C. § 1592) (hereinafter “Section 592”), a prior disclosure is considered valid when an importer discloses the facts of a violation and tenders the actual amount of unpaid duties, taxes, and fees at the time of making the voluntary prior disclosure or within 30 days after a demand by CBP.

But what happens if the actual amount of unpaid duties cannot be determined at the time of the disclosure? Can CBP make a demand under Section 592 for payment when the actual duties owed are unknown? Increasingly, we have seen CBP challenge the validity of a prior disclosure by making demands.
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for payment even in cases where the actual duties owed at the time of disclosure cannot be determined. The question then becomes: How can CBP make a demand for payment if the actual amount of duties is unknown? While Section 592 appears to empower CBP with broad statutory authority to demand unpaid duties from an importer, a review of the relevant statutory scheme reveals that CBP’s authority is not unrestrained and in fact, by law, CBP may only demand payment of actual unpaid duties.

Pursuant to the statutory scheme for importations, an importer is required to file an entry summary and to deposit estimated duties and fees at the time of entry. CBP may then review the entry documents and has a limited period of time in which it has the authority to reject the entry. According to Customs Directive 099-3550-067, CBP has up to 90 days to reject an entry summary; after this 90-day period has elapsed, an entry is considered accepted by default. Under the customs laws, once an entry has been accepted, CBP is unable to demand additional duties until the entry is liquidated or reliquidated. This is clear from 19 U.S.C. § 1505(b), which provides that CBP shall collect any increased or additional duties and fees as determined on a liquidation or reliquidation. While the statute does allow for certain refunds to an importer prior to liquidation, there is no similar provision that would allow CBP to collect additional duties prior to liquidation. Finally, after liquidation, CBP can collect the amount of any duties lost as a result of a violation of Section 592 if it initiates a penalty case or an importer submits and perfects a prior disclosure.

In the case of a voluntary disclosure or a CBP-initiated penalty case, CBP may demand no more than the actual duties owed by the importer; CBP is not permitted by law to demand the estimated amount of duties owed on the entries at issue. This practice is codified in the customs regula-
Post-Importation Payments: Canada Border Services Agency’s “Subsequent Proceeds” Policy

By Satinder Bains (KPMG) Daniel Kiselbach (Miller Thomson LLP)

Canadian Customs valuation rules can sometimes operate as traps for the unwary. For example, in some instances, importers must include post-importation payments in their value for duty calculations. These types of payments are often referred to as Subsequent Proceeds. When must importers include payments in value for duty calculations? What laws and policies apply? How can importers minimize duties on those payments? This article will answer these questions.

The Customs Act

This discussion begins with the legislation. Paragraph 48(1)(c), subparagraph 48(5)(v) and subsection 45(1) of the Customs Act indicate that if an importer uses the “price paid or payable” for the appraisal of goods: (a) the price paid or payable includes all payments made or to be made (directly or indirectly) by the purchaser to or for the benefit of the vendor; and (b) the value for duty includes proceeds of any subsequent resale, disposal or use of the goods that accrues to the vendor.

These provisions are reproduced below:

48.(1) Transaction value as primary basis of appraisal — Subject to subsections (6) and (7), the value for duty of goods is the transaction value of the goods if the goods are sold for export to Canada to a purchaser in Canada and the price paid or payable for the goods can be determined and if

(c) when any part of the proceeds of any subsequent resale, disposal or use of the goods by the purchaser is to accrue, directly or indirectly, to the vendor, the price paid or payable for the goods includes the value of that part of the proceeds or the price is adjusted in accordance with paragraph (5)(a)(v); …”

48.(5) The price payable in the sale of goods for export to Canada shall be adjusted

(a) by adding thereto amounts, to the extent that each such amount is not already included in the price paid or payable for the goods, equal to

(v) the value of any part of the proceeds of any subsequent resale, disposal or use of the goods by the purchaser thereof that accrues or is to accrue, directly or indirectly, to the vendor

45.(1) In this section and sections 46 to 55: “price paid or payable”, in respect of the sale of goods for export to Canada, means the aggregate of all payments made or to be made, directly or indirectly, in respect of the goods by the purchaser to or for the benefit of the vendor;

“sufficient information”, in respect of the determination of any amount, difference or adjustment, means objective and quantifiable information that establishes the accuracy of the amount, difference or adjustment.

The CBSA’s Subsequent Proceeds Policy

Canada Border Services Agency (CBSA) memorandum D13-4-13 titled “Post-Importation Payments or Subsequent Proceeds” provides insight on the CBSA’s position respecting Subsequent Proceeds. It is important to note that the CBSA’s D-memoranda do not have the force of law. They are statements respecting the CBSA’s interpretation and position on customs issues.

Memorandum D13-4-13 notes that the expressions “post-importation payments or fees” or “subsequent proceeds” do not appear in the Customs Act. However, having regard to the above-noted provisions the CBSA takes the position that:

[Subsequent Proceeds] includes any type of payment made by a purchaser after the importation of goods into Canada. Payments made after the importation of goods can be remitted to the vendor of the goods or to a third party, and may have to be included in the value for duty of the imported goods.

Memorandum D13-4-13 indicates that importers often do not include Subsequent Proceeds in value for duty calculations. This is because such payments may be made separately from the payment for goods. Further, Subsequent Proceeds
payments may be made where the vendor and purchaser are related or unrelated parties. The focus of the memorandum is on payments that would typically be made by an importer to a related party vendor. This may be due to the fact that a substantial proportion of the amount of international trade in goods and services is between related parties.

Memorandum D13-4-13 indicates that payments made after the importation of the goods are Subsequent Proceeds whether they are made to the vendor of the good or to a third party (for the benefit of the vendor). The Customs Act does not require that Subsequent Proceeds be made as a “condition of sale” or “in respect of” the imported goods.

The CBSA has listed the following types of payments as Subsequent Proceeds:
(a) any payments based on the resale of the goods that cannot be related by the importer to services received;
(b) management or administration fees … subject to the exceptions outlined;
(c) contributions to research and development …;
(d) contributions for worldwide marketing or promotion …;
(e) overhead expenses related to the manufacturing of the goods but not captured in the selling price and recovered after the importation of goods …;
(f) interest on deferred payments …; and
(g) other payments made after importation.

A few observations can be made here. First, the listed payments are largely for services (e.g. management, administration, research and development, overhead). Second, they may typically be made between an importer and a related party purchaser. Third, some of the payments relate to costs (e.g. interest on deferred payments) incurred for the right to make use of the imported goods.

Subsequent Proceeds Included in the Value for Duty

Two conditions must exist in order to require the inclusion of Subsequent Proceeds in the value for duty calculations. These conditions are described as follows:
(a) the payments accrue directly or indirectly to the vendor of the goods (in this instance the use of the word accrue means to increase the amount you have by adding to it) and,
(b) the payments are based on, or a result of, the resale, disposal or use of the goods in Canada:

(i) a resale exists where a person who has sold goods or property to a purchaser sells them again to someone else; for valuation purposes resale can also mean the further sale of imported goods by the purchaser to someone else.
(ii) disposal or use means the sale, pledge, giving away, utilization, consumption or any other disposition of a good.

Most services for which payments are made by an importer to a related party vendor do not result from the resale, disposal or use of the (imported) goods. More likely they may involve payments provided by a subsidiary/purchaser to a parent/vendor for things such as: (a) administrative services, including advice respecting the implementation of the business plan; (b) information technology services, including programming and maintenance; (c) human resources services, including sales, staff training and awards programs; (d) corporate services, such as financial planning and accounting; (e) logistics services, such as purchasing and freight forwarding; (f) advertizing services, such as graphic design, printing, catalogues, publications and promotional materials; product design; (g) purchasing services, such as call centre agents and order centers; and (h) general management fees.

Payments Not Included in the Value for Duty

Given the diverse nature of post-importation payments that may be made by an importer to or for the benefit of a vendor, it is important to know when such payments can be excluded from the value for duty. An importer’s post-importation payments should not be treated as Subsequent Proceeds if it can establish that the post-importation payments meet three conditions.

First, the services must have been rendered for the operation of the business in Canada. Obviously, not every post-importation payment by an importer to a vendor is rendered for the operation of the business in Canada. For example, payments may be made by a Canadian subsidiary to a US parent for the cost of advertizing services. Unless those advertizing service costs were incurred for the operation of the Canadian subsidiary’s business, a CBSA officer will likely determine that the payments are Subsequent Proceeds.

Second, the amount of the charge must be in accordance with an arm’s length charge. This means that a benchmark price should be established. If, for example, information technology services are provided by a parent/vendor to a
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subsidiary/purchaser, then the payment should be consistent with the fair market value of those services in the market place (that is what a purchaser of those services would pay to an unrelated vendor).

Third, the services provided must be justified for the operation of the business in Canada. A CBSA officer may determine that a service was not justified (necessary) and payments for that service are Subsequent Proceeds. Consider, for example, a payment made by a Canadian subsidiary/purchaser to a parent/vendor for a US sales staff party. A CBSA verification officer may not consider such a payment to be justified for the operation of the Canadian business.

In order to establish the above noted conditions, an importer must provide “sufficient information” which, as noted, is defined under subsection 45(1) of the Customs Act as meaning “objective and quantifiable information”. Therefore the onus is on the importer to obtain and keep sufficient information in order to establish the conditions noted above.10

Transfer Pricing vs. Customs

CBSA’s Subsequent Proceeds policy appears to be designed to deal with transfer pricing concerns and the protection of the Crown’s revenue interest. Transfer pricing refers to the pricing of goods, services or other transactions between related companies. There is an inherent tension in tax and customs transfer pricing matters.

From an income tax perspective, a company may wish to shift profits from a country with a high corporate income tax rate to a country with a low corporate income tax rate.11 An importer in a country with a high corporate income tax rates may be tempted to overvalue costs in order to artificially suppress its taxable income.12

However, from a customs perspective, that same company may have an incentive to undervalue goods that it imports in order to reduce the value for duty, and the duties levied on the goods.13 An importer may undervalue goods by paying a less than fair market value for the goods, and paying an additional amount for management or administration fees to increase the service costs.

CBSA’s Subsequent Proceeds policy appears to be designed to require importers to justify customs valuation pricing decisions. CBSA verification officers who administer and enforce the policy may examine customs transactions and importers documents to determine whether payments to related parties for services should be include in value for duty calculations.

Trade in Services

The Customs Act relates to goods imported into Canada.14 From a customs perspective, the costs for services are dutiable only if the payments for the services can be traced to the imported goods. As noted, the Subsequent Proceeds provisions of the Customs Act do not require post-importation payments of services to be “in respect of the goods” or a “condition of sale” in order for the payment to be traced to the imported good.

An importer’s payments for service costs to a related vendor that are based on the resale, disposal or use of the imported goods in Canada are in many instances negotiated under a separate agreement or contract for services. CBSA’s policy indicates that an importer must evaluate whether

Importers should be aware of CBSA’s Subsequent Proceeds policy to avoid overpayment of duties.

Subsequent Proceeds Policy Administration and Enforcement

The CBSA policy of requiring importers to obtain and maintain sufficient information that post-importation payments were actually incurred, consistent with an arm’s length price and justified may seem unwarranted. The policy suggests that all post-importation payments are Subsequent Proceeds and should be included in the value for duty unless proven otherwise.
Experience indicates that CBSA verification officers will not, in practice, consider all post-importation payments to be subsequent proceeds. Even so, especially in respect of related party transactions CBSA verification officers may request objective and sufficient evidence to substantiate the importer’s claim that the payment is not a Subsequent Proceed.

There is a danger that the Subsequent Proceeds policy could lead to CBSA administration and enforcement decisions that go beyond what is mandated by the Customs Act. In such case, it is open to an importer to commence a challenge to an adverse CBSA decision pursuant to the Customs Act redetermination and appeal provisions. Decisions from the Canadian International Trade Tribunal and/or the Federal Court of Appeal could help to define the obligations of importers in this area.

**Summary**

Importers should be aware of CBSA’s Subsequent Proceeds policy to avoid overpayment of duties. Related party transactions must be evaluated in light of customs transfer pricing rules. For example, CBSA verification officers may assess whether or not administration and management fees paid by an importer to a related party vendor are dutiable. With proper advice and planning importers may minimize duties. They can do so by obtaining evidence that post-importation payments fees for services were actually incurred at fair market value and were justified for the operation of their business.

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1 The authors welcome comments to this article. Please see end of article for contact information.
2 July 8, 2009.
3 Memorandum D13-4-13, paragraph 2.
4 Memorandum D13-4-13, paragraph 10.
6 Memorandum D13-4-13, paragraph 9. In this instance, the term “condition of sale” refers to a situation where the purchaser is entitled to buy the goods at the time of sale by entering into an agreement with the vendor, or a person related to the vendor, to provide financing or terms for payment. The term also has a specific definition pertinent to royalty and licensing fees but this definition is relevant to another subparagraph (48 (5)(a) (iv)) of the Customs Act and is not in respect of subsequent proceeds.
7 Memorandum D13-4-13, paragraph 3.
8 From customs memorandum D13-4-13 – Post-importation Payments or Fees “Subsequent Proceeds”
9 Ibid.
10 Ibid.
12 Ibid.
13 Ibid.
14 The Customs Act defines duties as follows: “means any duties or taxes levied or imposed on imported goods under the Customs Tariff, the Excise Act, 2001, the Excise Tax Act, the Special Import Measures Act or any other Act of Parliament, but, for the purposes of subsection 3(1), paragraphs 59(3)(b) and 65(1)(b), sections 69 and 73 and subsections 74(1), 75(2) and 76(1), does not include taxes imposed under Part IX of the Excise Tax Act;”
15 The Manual of Statistics of International trade in Services published by Department of Economic and Social Affairs Statistics Division (UN) (see: http://unstats.un.org/unsd/publication/Seriesm/Seriesm_86e.pdf) provides the following: “It is estimated that services are the largest recipients of international investment flows, accounting for just over half of global outflows in 1999. Services comprised about one fifth of worldwide trade in balance of payment terms.”

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tions that specify the requirements for disclosures under Section 592; these regulations specify that a disclosing party shall tender any actual loss of duties, taxes and fees or actual loss of revenue. The regulation further defines the term “actual loss of duties” as the “duties of which the Government has been deprived by reason of the violation in respect of entries on which liquidation has become final.” The key is that CBP can only attribute “actual loss of duties” to liquidated entries, which is consistent with CBP’s practice that requires a disclosing importer to tender duty loss to CBP on liquidated entries.

CBP’s ability to demand only actual loss of duties is particularly relevant in cases where the violation involves an importer’s failure to post antidumping and countervailing duty cash deposits. These cash deposits are only estimated amounts of duties owed on the entries. The amount of actual duties owed is usually determined through administrative reviews that are conducted by the U.S. Department of Commerce.

Based on the statutory scheme discussed above, if an importer voluntarily discloses a failure to post cash deposits and CBP failed to reject the entries within the allowable 90-day window, CBP is unable to demand that the importer tender the cash deposits if the entries are subject to an administrative review and the outcome of the review is pending. For liquidated entries, the time for CBP to collect estimated duties has passed; for unliquidated entries, CBP’s demand for payments would be premature.

With respect to unliquidated entries, there is an additional legal restraint on CBP’s authority to demand estimated duties. Under the customs regulations, while CBP may liquidate the entry and collect duties before the conclusion of the investigation or final disposition of the penalty action, it cannot do so when the liquidation period of the case has been suspended as required by law. In the antidumping and countervailing duty context, this means that if the Department of Commerce has suspended the entries at issue pursuant to an antidumping and countervailing duty order, CBP must hold the penalty case or prior disclosure open pending the outcome of the review—until then, it is premature for CBP to demand the monies owed on the entries.

CBP’s legal ability to collect estimated duties is limited by the process set forth in the law, as outlined above; in practice, CBP, particularly at port levels, may have different views with regard to its authority to collect estimated duties and fees under Section 592. In a prior disclosure involving failure to post cash deposits, for example, a port might demand that the importer post the cash deposits to perfect its disclosure before the conclusion of an administrative review, and the importer’s failure to do so may result in penalty actions by CBP. While this practice may be driven by CBP’s position that the Government should be “made whole” before an importer receives the benefits of a prior disclosure, these types of demands which are contrary to the statute have the potential to discourage some voluntary disclosures, to the detriment of CBP and importers alike.

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Trade Barriers

Combating Foreign Non-Tariff Barriers

By Daniel Ogden (National District Export Council)

Consider this scenario—you are a SME who is a direct supplier of construction materials to contractors and builders in the U.S in what has become an increasingly competitive marketplace. You have always diligently abided by the ASTM standards for your industry, which are international in scope, and have used that fact as a marketing device. You have recently become aware that your competitors have begun aggressively selling into overseas markets and you realize to stay competitive, you must follow suit.

You venture over to your local U.S. Export Assistance Center to obtain some help in selecting a foreign market at which to try your hand as well as finding a suitable distributor in that market. You end up carefully selecting a foreign market and a distributor in that market that works for you, you enter into a two year supply agreement, and you excitedly begin to prepare your product for shipment as you see dollar signs dancing in your head as a result of finding a new market for your product. Subsequently, your product has been loaded into a 40 foot container, left the dock, and arrived at your foreign distributor’s warehouse.

Upon inspecting your shipment, your distributor suddenly notifies you that your product does not meet the local country standards for construction materials within your particular industry. You are very surprised at this notification as you have always complied with the prevailing international ASTM standards for your industry and find this local country standards requirement to be unusual to the point of being absurd. Having contractually obligated yourself to supply a certain volume of materials to your foreign distributor at a fixed price in a price-sensitive industry, you are all of a sudden faced with the prospect of having to ship

a product to your new foreign customer at a loss due to the necessary changes in your product mandated by the standards of the foreign country in which your product will be distributed.

This scenario is all too common for exporters who are new to the global marketplace. While ideally, every exporter performs their due diligence upfront and determines what product changes are needed to ensure that their products are marketable in their chosen foreign markets in terms of local country requirements, this often is not the case—many exporters have received contracts for a foreign sales only to find that that there is some non-tariff barrier in that foreign market, such as an off-the-wall standards requirement, that inhibits exports to that market. While foreign trade barriers have always been an issue for exporters, this fact as of late has become prominent due to the increase in free trade agreements and the subsequent reduction or elimination of tariffs that often results. One presumption in international trade in general is that countries tend to be protectionist in nature or, at least, even if committed in principle to free trade, nevertheless face protectionist pressures from local industry, labor unions, and political circumstances. This has resulted in a measurable increase in the use of non-tariff barriers by many countries in order to protect local producers from the effects that the reduction or outright elimination of tariff barriers have on exports into that country.

The types of these foreign non-tariff barriers faced by exporters are often bewildering in scope. They range from standards, certification and quality barriers, and from rules of origin and customs clearance barriers, to intellectual property barriers, and government procurement and import licensing barriers, among others. One of the thorniest challenges for exporters in this regard is, when such a barrier is faced, determining which such barriers they can work around and which prevent deals completely. The National District Export Council recently conducted a survey of exporters in an effort to determine the types of foreign non-tariff barriers these exporters have confronted, and their responses to such barriers. Interestingly, most exporters, upon encountering such a barrier, continued to export to that country.
It is important to note that not all foreign trade barriers rise to the level of either violating a trade agreement or are protectionist in nature. For example, foreign customs clearance procedures of a routine nature are part of the normal import process in all countries where an export market exists. However, when these procedures are unusual and are not rationally related to a legitimate end result, then such procedures very well may in fact be a non-tariff barrier designed to discourage exports to that country.

For U.S. exporters, they can turn to several avenues for support when encountering foreign non-tariff barriers. The U.S. Department of Commerce has a division that exists in part for this purpose. One of the major missions of the Commerce Market Access and Compliance unit (MAC) is “identifying existing and potential market access problems and initiating government action to overcome market access problems” and “overseeing a program to monitor and seek foreign compliance with U.S. trade agreements.”

One of the ways MAC accomplishes this mission is through the Trade Compliance Center (TCC), which is a “one-stop shop for getting U.S. government assistance in resolving the trade barriers or unfair situations you encounter in foreign markets.” The TCC has a means by which U.S. exporters can report foreign non-tariff barriers they are facing in their export business. While MAC does not act as a U.S. exporter’s trade lawyer, and does not always act upon every barrier reported on their TCC web site.

When a barrier comes to their attention which either violates an existing trade agreement or is a barrier that MAC concludes is so pernicious that it has the potential to cause a major impact on the U.S. trade position or have a significant effect on U.S. industry, MAC will step in and engage in commercial diplomacy and in trade agreement compliance.

In conclusion, in regard to combatting foreign non-tariff barriers, exporters are well advised to incorporate the following into their strategic planning process prior to exporting to a particular foreign market:

- proactively research the potential foreign trade barriers that might exist in a particular market as they relate to the exporter’s products or the import process in that country;
- analyze any such barriers to determine whether a barrier is one that is not routine or is out of the ordinary (such as bizarre foreign standards requirements);
- in light of the strategic importance of that particular market, calculate whether such barriers render exports to that market as unprofitable and/or too burdensome;
- report such barriers to the U.S. government as a means to combat the barrier.

1 Please see http://trade.gov/mac/about.asp.
2 Please see http://tcc.export.gov.
3 Please see http://tcc.export.gov/Report_a_Barrier/index.asp.
4 To learn more about how MAC can help in this regard, please see http://trade.gov/mac/how-mac-can-help.asp.

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Many companies perceive the risk of related party transactions to be limited to the tax area and the payment of 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. In this article, we discuss several aspects of a typical transfer pricing study that could undermine the ability of companies to rely on such studies to support customs valuation. Proactively addressing these issues can save a company from protracted and expensive disputes concerning the valuation of related party imports.

Differences between Tax and Customs Requirements

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 IRS is concerned that a company report an appropriate amount of income on an annual basis, regardless of whether certain transactions during the year did not meet targeted profit margins. For multinational companies with related party import transactions, this means apportioning income between the U.S. company (buyer) and its foreign counterpart (seller) such that an acceptable level of profit is apportioned between the two. The relative overall profitability is the key determinant, without necessarily considering the impact of specific transactions. Thus, a year-end adjustment could remedy transactions that miss profit targets earlier in the year. By contrast, the customs law requires that valuation be accurate for each transaction. For example, transactions that are undervalued in September and October cannot be “offset” by overvaluing imports in November and December. CBP would consider this scenario to result in valuation errors in all four months.

Further, the customs valuation rules establish a hierarchy of valuation methodologies. CBP requires importers to value merchandise according to “transaction value” whenever possible. If the information is not available to utilize this methodology, then valuation must be based on an alternative series of methodologies given preference in an articulated statutory hierarchy. Thus, if transaction value is not viable, CBP looks to transaction value of identical or similar merchandise, deductive value, computed value, or adjusted value based on these alternatives (i.e., “fallback” method), in that order. On the other hand, while many U.S. taxpayers use the comparable profits method (CPM) to validate transfer prices, U.S. tax rules give no priority to any particular method of testing transfer prices, requiring instead that taxpayers determine the validity of transfer prices using the “best method” available. In this regard, customs valuation rules can be viewed as more rigid than those administered by the IRS.

Failing to meet appropriate profit benchmarks can also lead to different results depending on whether the IRS or CBP is your audience. If CBP considers transfer prices not meeting customs requirements, then the valuation will be considered erroneous, leaving the importer vulnerable to penalties. By contrast, if transfer prices yield an insufficient profit/income amount for IRS purposes, the taxpayer will be expected to make a year-end adjusting payment or credit so that the corporate taxes ultimately paid will be consistent with IRS requirements.

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.

Potential Gaps in Transfer Pricing Studies

A transfer price study undertaken for tax purposes can contain information that is important in supporting customs valuation, though the importer (and not CBP) bears the burden of identifying such information and filling the gaps as they exist. But CBP will not consider a transfer pricing study prepared for IRS purposes as dispositive evidence in validating transfer prices.
Transfer Pricing

for customs valuation purposes. The elements of a transfer pricing study discussed below should guide trade compliance personnel in their evaluation of the utility of a transfer pricing study as support for the company’s customs valuation.

• **Is There an Advance Pricing Agreement?**
  Most transfer pricing studies are not reviewed by the IRS. However, when such information is reviewed and accepted by the IRS in the form of an Advance Pricing Agreement (APA), CBP places greater trust in the study/APA and will more likely accept transfer prices established pursuant to the APA as appropriate for customs valuation. To the extent that the importer does not have an APA, addressing the potential issues below becomes more critical.

• **Which Entity Does the Study Cover?** CBP regulations focus on the costs and profits of the foreign seller – that is, did the foreign seller receive a price that enabled recovery of all costs plus a reasonable profit? A transfer pricing study focusing on the profitability of the U.S. taxpayer is thus not preferred for U.S. customs purposes.

• **Do the Comparison Companies Sell the Same Merchandise that is Imported?** Transfer pricing studies using the comparable profits method often identify comparable companies as those that are functionally equivalent to the company that is the subject of the study. That is, the studies will treat retailers as comparable to retailers, manufacturers to manufacturers, distributors to distributors, etc. However, CBP regulations focus on the particular merchandise being imported, requiring that profit be evaluated on the sale of the same “class or kind” of merchandise as the imported merchandise. A study that includes profit analysis of companies that sell different products than the imported products will have less value in support of customs valuation than a study that compares companies in a similar line of business.

• **How Does the Study Measure Profits?** Often depending on the industry, some transfer pricing studies evaluate margins on the basis of gross profits. However, CBP considers operating profit to be the more appropriate basis to evaluate the profits of a company. An importer seeking to use a transfer pricing study using gross profits or some other measure should expect to have to explain why operating profits are not an appropriate basis of comparison.

• **What Costs are Included in the Profit Calculations?** Related to the above point, the customs statute provides that transfer prices may be sufficient if they enable the seller to recover “all costs,” though this concept is not further defined. It is not uncommon for certain finance or overhead costs to be excluded in deriving operating profit. In such cases, the importer should be prepared to explain why any excluded costs do not pertain to the imported merchandise.

• **When Did the Transactions Covered by the Study Take Place?** An importer cannot expect a study establishing the validity of transfer prices in one year to be useful in supporting customs valuation for related party imports in another year, unless compelling evidence to the contrary can be provided. To the extent an importer seeks to use a transfer pricing study as evidence to support customs valuation, such importer should expect to commission these studies on a routine basis.

A transfer price study undertaken for tax purposes can contain information that is important in supporting customs valuation, though the importer (and not CBP) bears the burden of identifying such information and filling the gaps as they exist.

• **Does the Study’s Conclusion Support Customs Valuation?** As noted above, a study’s conclusion that transfer prices are appropriate for tax purposes does not necessarily support customs valuation. When applying the comparable profits method, a study typically considers whether the profit of the subject company falls within the inter-quartile range of the comparable companies. If the subject’s profit is higher than this range, it indicates that transfer prices were not greater than arms length and that income is not understated, resulting in appropriate taxes being paid. However, in the customs context, profit margins that exceed those of comparable companies suggest that transfer prices may be too low, resulting in undervalued imports. It is incumbent on the importer to demonstrate why its profit margins may fall outside the range of comparable companies.
Enhancing the Value of a Transfer Pricing Study for Customs Purposes

The issues and risks discussed above provide a roadmap to importers on how to enhance the value of a transfer pricing study for customs valuation purposes. While we discussed clear differences between tax and customs requirements relating to transfer pricing, 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.

Beyond expanding the scope of the study, which may not be feasible for many companies, there are several less comprehensive steps that an importer can take. First, the study should focus on the prices set and profits earned by the foreign, selling party rather than the U.S. importing entity. Second, the importer commissioning the study should direct its advisers to include in the study profit data from companies that manufacture the same or similar merchandise as the importer. Even if the study is based on a broader range of companies that are functionally the same, including data from companies producing the same “class or kind” of merchandise will permit an analysis that is more aligned with CBP requirements. Third, the study should include financial data and profit calculations that are sufficiently detailed to confirm that the transfer prices cover “all costs” incurred by the seller and an appropriate profit margin.

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.

For further information on transfer pricing issues in the customs context, please see the first two articles on transfer pricing and customs valuation rules in Strategies.

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Round Up

Trade & Customs Round Up

By Linda Zhang (Thomson Reuters)

U.S., EU Agree to Promote Collaboration among SMEs

The U.S. Department of Commerce’s International Trade Administration and the European Enterprise Network—an international group of 600 business and enterprise support organization—signed a memorandum of understanding (MOU) to encourage collaboration between small and medium-sized companies (SMEs) in the U.S. and EU, according to the Office of the United States Trade Representative’s official website. The agreement refers to joint trade shows, collaboration on small business events and networking. The 5-article document highlights broad recognition of the partnership between the SMEs in the U.S. and EU, as well as the aims and effects of such an alliance.

In early December, the U.S. Trade Representative Miriam Sapiro and EU trade representative Daniel Calleja hosted the Transatlantic Economic Council’s 4th U.S.-EU SMEs Workshop at the White House. The workshops brought business owners
and government officials together to exchange best practices and address mutual recognition of trade barriers that affect SMEs.

**BIS Offers Clarifications on Export Control Reform**

According to the American Association of Exporters & Importers, the Bureau of Industry and Security (BIS) is currently proposing changes that will affect the understanding of the Commerce Control List (CCL), as part of a White House Initiative to reform export control. The new changes will clarify the definitions and descriptions of select terms on the list, including the shifting of some items from the United States Munitions List (USML) to the Commerce list.

In late November this year, the BIS introduced two proposed rules. Specifically, the Revisions to the Export Administration Regulations (EAR) To Make the Commerce Control List (CCL) Clearer will address specific changes to clarify the definitions of terms such as “equipment” and “components”, in addition to other suggestions identified by the trade community to address the vagueness of the current CCL. The military equipment exports include military electronics (Category XI) which will be transitioned to new Export Control Numbers (ECCNs) 3A611, 3D611, and 3E611. The proposed rules also included other measures to change existing controls.

The Defense Department, State Department, and the Commerce Department took part in the review of Category XI, upon which they based their suggestions.

**Trade Legislation**

**U.S. Senate OKs Russia Trade and Rights Bill, Angering Moscow**

*By Doug Palmer (Reuters)*

The U.S. Senate on Thursday approved legislation to punish Russian human rights violators as part of a broader bill to expand U.S. trade with Washington’s former Cold War enemy.

Passage of the bill, by a 92-4 vote, drew an immediate angry response from Moscow, which had been warning that the human rights provisions would damage relations.

“The decision of the U.S. Senate ... is a performance in the theatre of the absurd,” Russia’s foreign ministry said in a statement. A senior Russian lawmaker said Moscow could retaliate with a similar law.

The bill, which will be signed into law by President Barack Obama, grants “permanent normal trade relations,” or PNTR, to Russia by lifting a Cold War-era restriction on trade.

The bill also grants PNTR to Moldova.

Business groups have been pushing Congress for months to approve the bill, which would ensure that U.S. companies get all the market-opening benefits of Russia’s entry into the World Trade Organization. Russia joined the WTO on August 22.

Without it, the groups feared they would be left at a disadvantage compared to companies around the world that already have full WTO relations with Russia.

Business groups have been pushing Congress for months to approve the bill, which would ensure that U.S. companies get all the market-opening benefits of Russia’s entry into the World Trade Organization.

In addition, the United States cannot use the WTO dispute-settlement system to challenge any Russian actions that unfairly restrict U.S. imports until PNTR is signed into law.

“American businesses and workers will have better access to the growing Russian market on
the same terms as their global competitors,” the Obama administration’s trade representative, Ron Kirk, said in a statement.

“The United States will have WTO procedures available to help ensure that Russia abides by its commitments,” he said.

Many U.S. lawmakers refused to approve PNTR, which required lifting a 1974 human rights measure known as the Jackson-Vanik amendment, without new human rights legislation.

Jackson-Vanik tied the most favourable U.S. tariff rates to the rights of Jews in the former Soviet Union to emigrate freely. While it is broadly considered a success, it is a relic of the Cold War and at odds with WTO rules.

Death of Anti-corruption Lawyer

The bill approved on Thursday directs Obama to publish the names of Russians allegedly involved in the abuse and death of Sergei Magnitsky, a Russian anti-corruption lawyer who died in a Russian jail in 2009.

It also would require the United States to deny visas and freeze the assets of any individual on the list, as well as other human rights violators in Russia on an ongoing basis. Moscow has warned that the human rights provision would hurt relations and has promised to retaliate if it becomes law.

“The allegations that this legislation infringes on Russian sovereignty is nonsense ... It cannot force human rights abusers in Russia to stop what they’re doing,” Senator John McCain, an Arizona Republican, said.

“But if they continue, what this legislation does is to tell those individuals that they cannot bank their money in the United States, they are not welcome in this country and they cannot visit this country and they will have no access to the U.S. financial system,” McCain said.

Senator Ben Cardin, a Maryland Democrat who helped craft the Magnitsky provision, said he would continue pushing to make it universal in scope so it could be used to punish other human rights violators around the world.

The PNTR bill also contains measures that pressure the White House to make sure that Russia abides by WTO rules.

“If there are areas where Russia is not in compliance with its obligations, the administration is required to develop an action plan to address them,” said Senator Orrin Hatch, the top Republican on the Senate Finance Committee.
EU, U.S. Step up WTO Action in Argentina Trade Row

By Robin Emmott and Doug Palmer (Reuters)

The European Union and the United States stepped up their fight against Argentine trade practices on Thursday, formally requesting the World Trade Organisation rule on whether the South American country’s import restrictions are illegal. The move followed similar challenges from Japan and Mexico, meaning Buenos Aires is now embroiled in disputes with four major trade partners, who say its rules discriminate against foreign goods at a time when trade is central to their hopes of an economic recovery.

“Argentina’s import restrictions violate international trade rules and harm EU exports,” EU trade chief Karel De Gucht said in a statement. “Today’s decision ... is the EU’s last resort to see Argentina’s unfair trade practices lifted.”

EU trade relations with Argentina have worsened since April, when President Cristina Fernandez seized control of oil firm YPF from its parent, Spain’s Repsol (REP.MM). U.S. Trade Representative Ron Kirk said Washington had also asked the Geneva-based WTO for a so-called dispute settlement panel, a process which can oblige a country to remove restrictions or face fines.

Argentina, continued on page 16
Argentina too initiated WTO cases on Thursday, accusing the EU of curbing imports of its biodiesel, and the United States of restricting imports of its lemons and beef.

Brussels and Washington say Argentina requires businesses to apply for import licenses to be able to sell to Latin America’s third largest economy after Brazil and Mexico.

But Buenos Aires does not grant the licences automatically as required by global trade rules, they say.

“Argentina’s persistent use of protectionist measures broadly impacts all U.S. exporters of goods to Argentina,” Kirk said.

The European Commission, which handles trade for the 27 EU member states, says EU exports affected by the restrictions range from luxury cars and mobile phones to clothes and food.

Since Argentina tightened restrictions earlier this year, the EU executive says a de facto barrier to all EU exports to Argentina has been erected.

Such exports were worth 8.3 billion euros in 2011.