



TECHNICAL COMMITTEE  
ON CUSTOMS VALUATION

30<sup>th</sup> Session

VT0726E1a  
(+Annexes I to V)

O. Eng.

Brussels, 13 January 2009.

RELATED PARTY TRANSACTIONS UNDER THE AGREEMENT  
AND TRANSFER PRICING

(Item VI (c) on the Agenda)

Reference documents :

VT0587E1a (TCCV/25)	VT0676E1a (TCCV/28)
VT0598E1c (TCCV/25 – Report )	VT0682E1a (TCCV/28)
VT0604E1a (TCCV/26)	VT0683E1a (TCCV/28)
VT0626E1c (TCCV/26 – Report)	VT0686E1c (TCCV/28– Report)
VT0647E1a (TCCV/27)	VT0703E1a (TCCV/29)
VT0662E1a (TCCV/27)	VT0712E1a (TCCV/29)
VT0663E1c (TCCV/27 – Report)	VT0715E1a (TCCV/29– Draft Report)
VT0675E1a (TCCV/28)	

I. BACKGROUND

1. At its 28<sup>th</sup> Session, the Technical Committee examined the issue along with the case study submitted by the United States which established the acceptability of a transfer pricing transaction based on the Transactional Net Margin Method (TNMM).
2. During the intersession, the Secretariat prepared a new working document, which was set out in Doc. VT0703E1a, along with the revised case study taking into account the discussions at the 28<sup>th</sup> Session, and in consultation with the OECD.
3. In response to that working document, comments were received from Australia, Israel, Japan and the United States. These comments were reproduced in Annexes I to IV to Doc. VT0712E1a. Annex V of the said document contained the revised case study incorporating Members' comments.
4. At its 29<sup>th</sup> Session, the Technical Committee continued to discuss the issue and the details of the Technical Committee's discussions can be found in paragraphs 120 to 136 of Doc. VT0715E1a (Draft report of the 29<sup>th</sup> Session).

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5. The Technical Committee also invited the Observer from the OECD to make a presentation on the Transactional Net Margin Method. That presentation is available on the WCO Members' Website at:  
[http://www.wcoomd.org/members/meetingdocuments/valuation/customs\\_valuation\\_committee/meeting\\_0029/English/presentations.htm](http://www.wcoomd.org/members/meetingdocuments/valuation/customs_valuation_committee/meeting_0029/English/presentations.htm)
6. The Technical Committee agreed to continue discussions at its 30<sup>th</sup> Session and asked the Secretariat to prepare a new working document incorporating the following issues in order to provide a better understanding of the issue as well as to facilitate further discussions:
  - Basic background and fundamental principles of related party transactions relating to transfer pricing;
  - General issues as well as specific questions to be discussed by the Technical Committee;
  - Revised case study.

## II. SECRETARIAT COMMENTS

7. In response to the decision of the Technical Committee at its 29<sup>th</sup> Session, the Secretariat has prepared the attached general information paper on customs valuation in relation to transfer pricing, which includes basic background as well as fundamental principles in order to promote better understanding of the issue and to share Members' experiences (Annex I).
8. Annex II addresses the general issues and specific questions that might be discussed by the Technical Committee.
9. The revised case study along with Members' comments is contained in Annex III to this document. The transaction chart of this case prepared by the Secretariat is at Annex IV.
10. The Technical Committee at its 29<sup>th</sup> Session also proposed that a case study be submitted based on the traditional methods (CUP method, Cost Plus method, and Resale Price method) under the OECD Guidelines. Accordingly, one of the case studies (Cost Plus method), which was submitted by a private sector participant to the Focus Group on Transfer Pricing in 2007 and presented to the Technical Committee in Annex III to Doc. VT0647E1a, is set out in Annex V to this document as a possible case study.

## III. CONCLUSION

11. Members are invited to submit their suggestions and comments to the Secretariat not later than **26 February 2010**. Comments received in response to this document will be published and circulated to Members of the Technical Committee for consideration at the 30<sup>th</sup> Session.
12. For the efficient work of the Secretariat, Members are invited to send their comments in electronic format to the extent possible. (E-mail address : [valuation@wcoomd.org](mailto:valuation@wcoomd.org)).

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## Information paper on transfer pricing in relation to customs valuation

### 1. Introduction

With the rapid globalization and the proliferation of multinational enterprises (MNEs), the number of international transactions between related parties (between a parent company and its affiliates or between affiliates of the same MNE) has been increasing dramatically. When goods, intangibles and services are transferred across borders within one MNE, transfer pricing becomes an important issue. Accordingly, transfer pricing has engaged the attention of MNEs as well as tax and Customs authorities over recent years.

As a consequence, this information paper is produced with a view to promoting a better understanding of the issue, sharing Members' experiences and providing assistance to Members.

Section 2 describes the general information on transfer pricing and customs valuation respectively. It also illustrates the linkage between customs valuation and transfer pricing. The initiatives taken by the WCO thus far as well as the outcome of those initiatives are summarized in Section 3. Members' experiences and conclusion on the issues are given in Sections 4 and 5 respectively.

### 2. General information on transfer pricing and customs valuation

#### (1) Outline of transfer pricing

Transfer pricing is the term used to describe how MNE's set prices for their intra-group transactions, for example the transfer of goods, services and (tangible and intangible) assets between related (or affiliated) companies situated in different tax jurisdictions. By using international taxation principles (the arm's length principle), transfer pricing seeks to serve the dual objective of securing the appropriate tax base in each tax jurisdiction concerned and to avoid double taxation.

The "arm's length principle" is defined in Article 9 of the OECD Model Tax Convention, which forms the basis of bilateral tax treaties as follows<sup>1</sup>:

*"When conditions are made or imposed between the two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."*

To determine the corporate tax liability in each jurisdiction, transfer pricing is based on the arm's length principle, i.e. a proxy for open market conditions. The main emphasis is that the conditions of transfers (or sales) within MNEs should approximate those that would be made between independent companies, i.e. an arm's length price in an arm's length transaction. Accordingly, this allows for the treatment of "controlled taxpayers" (or associated taxpayers) to be on a level footing with "uncontrolled taxpayers" (or independent

<sup>1</sup> Article 9 of United Nations Model Double Taxation Convention between Developed and Developing Countries contains the same provision. Paragraph 3 of the Commentary on Article 9 provides that "the Contracting States will follow the OECD principles which are set out in the OECD Transfer Pricing Guidelines. These conclusions represent internationally agreed principles and the Group of Experts recommend that the Guidelines should be followed for the application of the arm's length principle which underlies the article."

taxpayers). Further guidance on the application of the arm's length principle can be found in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines).

The arm's length principle is followed by OECD Member countries and by an increasing number of non-OECD economies, which implement it through their bilateral tax treaties and national tax legislation.

For transfer pricing purposes, the whole commercial and financial relationship between parties is examined. This does not always require that valuation is strictly performed for each individual transaction or for each individual product. Transactions can be combined or aggregated for evaluation purposes under certain conditions.

The arm's length principle requires a comparison of the conditions of a taxpayer's controlled transactions with the conditions of uncontrolled transactions under the same or similar circumstances. The OECD Guidelines discuss the factors to be employed to assess comparability between controlled and uncontrolled transactions (characteristics of property (goods) /services, functions performed by each party taking into account assets used and risks assumed, contractual terms, economic circumstances and business strategies).

There are two categories of transfer pricing methods for the determination of an arm's length price under the OECD Guidelines, consistent with the arm's length principle: three "traditional transaction methods" and two "transactional profit methods". In terms of hierarchical order, traditional methods are preferred over transactional profit methods. However, based on the experience acquired in applying transactional profit methods, the OECD proposes removing the hierarchy and replacing it with a standard whereby the selected transfer pricing method should be the "most appropriate transfer pricing method to the circumstances of the case".

#### Traditional transaction methods

- Comparable Uncontrolled Price (CUP) Method
- Resale Price Method (Resale Minus Method)
- Cost Plus Method

#### Transactional profit methods

- Transactional Net Margin Method
- Transactional Profit Split

#### (2) Outline of customs valuation

The customs value of imported goods is determined mainly for the purposes of applying ad valorem rates of customs duties. It constitutes the taxable basis for customs duties.

While the transfer pricing deals with all commercial and financial transaction (transfer of goods, services, and assets), the scope of customs valuation is for imported goods only.

The Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (the Agreement) provides the international legal framework for determining the customs value of imported goods, including goods traded within related party transactions. All WTO Members are obliged to apply the provisions of the Agreement through their national legislation.

This Agreement is intended to provide a single system that is fair, uniform and neutral for the valuation of imported goods for Customs purposes, conforming to commercial realities and prohibiting the use of arbitrary or fictitious customs values.

The following six different methods are provided under the Agreement to be applied in a strict hierarchical order: The primary method of determining the customs value under Article 1 is the transaction value. Where the customs value cannot be determined on the basis of the transaction value, it will be determined using the other methods in hierarchical order.

- Transaction value method (Article 1);
- Transaction value of identical goods (Article 2);
- Transaction value of similar goods (Article 3);
- Deductive value method (Article 5);
- Computed value method (Article 6); and
- Fall-back method (Article 7).

Under the Article 1 of the Agreement, transaction value is acceptable as a customs value when the buyer and the seller are not related, or if related, the transaction value can also be accepted, provided that the relationship does not influence the price. Articles 1.2 (a) and 1.2 (b) stipulate about the measures on how to determine whether or not the transaction value is influenced by the relationship between the buyer and the seller, namely,

Article 1.2 (a): the circumstances surrounding the sale shall be examined to establish whether the relationship influenced the price

Article 1.2 (b): alternatively, the importer has an opportunity to demonstrate that price closely approximates to one of three test values

With respect to the methodologies, there are some similarities between transfer pricing and customs valuation, namely, Articles 2 and 3 of the Agreement (Transaction value of identical and similar goods) are similar to Comparable Uncontrolled Price (CUP) Method under the OECD Guidelines. Similarities can also be seen between Deductive value method (Article 5) and Resale Price Method, as well as between Computed value method (Article 6) and Cost Plus Method.

For customs valuation purposes, Customs needs to examine each product and each import transaction at the time of importation to determine what the actual value is for a specific product involved in a specific transaction. In contrast to such an entry by entry and product by product approach from the customs valuation perspective, the transfer pricing, as explained above, does not always require that valuation be correct for each transaction or for each product. The transactions, therefore, can be combined for evaluation together under certain conditions for transfer pricing perspective. This is one of the crucial differences between customs valuation and transfer pricing.

### (3) Impact of transfer pricing on customs valuation

The transactions between related party or associated enterprises are typically not subject to the same market forces as transactions between independent companies. As a consequence, there is potential for manipulation of the price of cross-border transactions. Accordingly, transfer pricing may be used for the minimisation of a MNE's total tax liability to a single economy.

For tax purposes, transfer pricing influences the tax base of each party earns and thus has an impact on the amount of income tax that is due in both the country of export and the country of import. A high transfer price has a negative impact on the tax base in the

country of importation and a positive impact on the tax base in the country of export. A low transfer price has the opposite effect.

For Customs purposes, the transfer price has a direct impact on the determination of customs value. The transfer price may form the basis of the transaction value of the imported goods under Article 1 of the Agreement. The lower the transfer price, the lower the transaction value and the applicable customs duties and inland taxes (e.g. VAT and excise) calculated on the basis of the customs value of imported goods.

Moreover, by taking advantage of differences in taxation rates (for example, customs duty and corporate tax), MNE's in practice might split their taxation liability to reduce their overall tax burden. This is generally achieved by adjusting the declared customs value of imported goods, in order to maximise any related tax benefits. For example, if a country's customs duty rates are lower than its corporate tax rates, an overstatement of the value of imported goods might occur in order to gain an overall revenue/tax liability advantage for that MNE. On the other hand, where the situation is the opposite scenario (customs duty is higher than its corporate tax rates), it might lead to undervaluation. In other words, the MNE will benefit by the transfer price by minimising or maximising the "price" of the imported goods in order to take advantage of the most favourable tax/duty rate.

Accordingly, transfer pricing influences the level of both direct and indirect taxes that governments collect. The price of cross-border transactions is the starting point for assessing customs duties and for determining profits arising to each party involved and therefore the allocation of tax bases among countries.

#### (4) Linkage between transfer pricing and customs valuation

With respect to the Agreement, neither the term "transfer pricing" or "transfer price" appears anywhere in it. However, the transfer price is the price established between related parties and the Agreement does address the issue of related party transactions. In particular, Article 1 of the Agreement stipulates certain restrictions on the use of transaction value when the buyer and the seller are related.

As regards transfer pricing, as it is explained above, it is based on the arm's length principle, that is, a proxy for open market conditions.

Consequently, in principle, both transfer pricing and customs valuation rules pursue the same objective, namely, ensuring that the price of transactions between associated enterprises or related parties is not influenced by the relationship that exists between them.

Institutionally, it is often the case that two different administrative bodies (Customs and tax authorities) value international transactions between related parties or associated enterprises. While both customs valuation and transfer pricing rules set standards for determining the "arm's length" or "non-influenced" value of those transactions, different international rules and guidelines have existed in the Customs and tax domain. Tax authorities use the arm's length principle under the OECD Guidelines and the Customs addresses transfer pricing through the provision of related party transactions under the Agreement.

Accordingly, with regard to transfer pricing, there is no legal requirement that the transaction value and the transfer price for imported goods between related parties should be the same. It is apparent, however, that when dealing with transfer pricing from the perspective of the importer's direct and indirect tax obligations, that the two types pull in opposite directions, that is, the customs duty obligation at the front end of the bus and the corporate tax obligation at the back end of the bus.

Even though there are some key differences between the two systems, there are also some similarities between customs valuation and transfer pricing methodologies. Consequently, this fact would lead to the discussion on exploring the possible convergence or coordinated administrative approaches between the customs valuation and transfer pricing.

### **3. Initiatives by the WCO in relation to transfer pricing and customs valuation**

The business community has been voicing their concerns about struggling to satisfy the regulatory framework of both tax and Customs authorities who each apply their own rules when the parties are related. MNEs have become increasingly concerned over the complications, compliance burden and costs that could result from inconsistent standards and different rules applied by different government agencies. Different rules of both agencies and absence of coordinated efforts could also lead to double taxation, which might create barriers to trade and investment against the objectives of international organizations and national governments concerned.

In response to those concerns, the following initiatives have been taken among Customs and tax authorities as well as the business community in order to seek a possible way forward for tackling the challenges:

#### **(1) First Joint WCO/OECD Conference on transfer pricing and customs valuation**

As a result of the increasing interest in transfer pricing and customs valuation by tax and Customs administrations as well as the private sector, the WCO and the OECD held the first joint WCO/OECD Conference on transfer pricing and customs valuation at the WCO Headquarters in Brussels in 2006. This event was attended by almost 300 participants from all over the world, representing Customs administrations as well as revenue authorities, multinational enterprises, international organizations, consulting firms and academic institutions.

During the two-day conference, panellists from the WCO, OECD, WTO, Customs administrations, tax administrations, academia and the business world discussed policy and technical issues. It therefore provided an opportunity for dialogue between tax and Customs administrations and between government and business.

The following specific topics were discussed:

- Transfer pricing methods

This session aimed at enabling all stake holders to gain a better understanding and perception of what transfer pricing is in light of increased globalization, how it works for multinational enterprises, and how important transfer pricing is for multinational enterprises and governments, in particular, tax and Customs agencies, and how transfer pricing is dealt with in accordance with the OECD Guidelines.

- Customs valuation of related party transactions

This session covered the Customs approach towards the customs value of the goods traded across the borders between related parties in accordance with the Agreement. National Customs experiences in this regard were shared and examined.

- Bridging the gap between customs valuation and transfer pricing methods

## Annex I to Doc. VT0726E1a

This was the main focus of the conference and issues discussed were how convergent or divergent customs valuation and transfer pricing requirements were in relation to cross-border transactions between related parties or associated enterprises, and how desirable and feasible it would be to have greater convergence of standards and more coordinated administrative approaches. National, regional and global practices in these regards were presented and analysed and business strategies to deal with the gap were proposed.

As a way forward, the following recommendations were offered during the Conference:

- At national level, there is a need to encourage more dialogue between Customs and tax authorities, in close consultation with business, with the possibility of establishing a mechanism for liaison.
- At international level, Customs and tax administrations through the WCO and the OECD should create an appropriate joint forum for dialogue, study and possible liaison, with invitations being extended to the WTO, business and academics. The issues for dialogue and study might include: (i) a more thorough comparison between the two sets of rules; (ii) the identification of areas for possible convergence of rules and a coordinated approach, including possible development of guidelines or explanatory notes; (iii) the examination of specific issues relating to the degree of acceptability by one agency of a value determination by the other, advance pricing agreements, joint audits, the consequences of subsequent adjustments of values made by one agency on another, the exchange of information, and cooperation between Customs and tax agencies.
- The recognition that there are regional variations that need to be taken into account in identifying needs and developing strategies for possible guidelines and a coordinated approach. It must also be accepted that such a joint initiative would mean a long road ahead, because the course of action would involve the review of own processes and systems by Customs, tax and business including the identification of where and how they can converge.

All the presentations made at the conference are available from the WCO Online Bookshop.

<http://bookshop.wcoomdpublishings.org/by-category/valuation/cd-rom-transfer-pricing-and-customs-valuation-2006.html>

### (2) Second Joint WCO/OECD Conference on transfer pricing and customs valuation

Based on the outcome of the first joint conference held in 2006, the WCO and the OECD organized the second joint WCO/OECD Conference to further address the interaction between transfer pricing, customs valuation, indirect taxes and VAT.

The Conference was attended by over 200 participants from Customs administrations, tax authorities and the business community, representing both developed and developing countries.

Through the presentations and discussions over the two days, the participants had further deepened the understanding with the following issues:



- Common features and similarities as well as significant divergences between customs valuation and transfer pricing
- The aspect of VAT was highlighted, prompted by recent EU regulation
- Recent regional developments towards convergence in approach, including the review of transfer pricing studies by Customs, joint actions and information sharing
- The future relationship between transfer pricing rules and customs valuation methods, two schools of thought for convergence
- The general view on the necessity of finding a way to improve consistency and increase certainty between transfer pricing and customs valuation, with many practical proposals
- The dispute prevention and resolution, by increasing use of APA, exchange of information and other measures, especially from a Customs perspective

Regarding a way forward, the following recommendations were made by the Conference:

- We needed to continuously encourage dialogue between Customs administrations, tax authorities and the business community, possibly by establishing a mechanism for liaison.
- A comprehensive government approach was needed between Customs administrations and tax authorities as this would facilitate better understanding between the two role-players.
- It would be helpful to explore the possibilities of a joint approach to audit, compliance and advanced pricing agreements as a means to enhance cooperation and coordination between Customs administrations and tax authorities.
- It was desirable that WCO/OECD member administrations continue to share best practices in this area.
- At the global level the WCO and the OECD should continue their existing cooperation relating to the sharing of knowledge, the development of training material, and the e-learning module initiative. This cooperation could be further enhanced by the suggestion to create a small focus group of Customs and tax experts to dialogue on and study issues involving the WTO and the business community initially targeting practical and concrete case studies based on commercial realities.
- We should continue to build administrative capacity to better address transfer pricing and customs valuation.
- The creation of a central arbitration body and the use of technology should be further explored.
- The Technical Committee on Customs Valuation could play a role in examining specific proposals from members

All the presentations at the conference are available at the WCO Online Bookshop.

<http://bookshop.wcoomdpublishings.org/by-category/valuation/cd-rom-transfer-pricing-and-customs-valuation-2007.html>

### (3) Focus Group on Transfer Pricing

As a sequel to the recommendations of the second joint WCO/OECD Conferences on transfer pricing and customs valuation, the Focus group on Transfer Pricing was established. It held its first meeting in October 2007, and was attended by several delegates from the WTO, WCO, OECD, Customs and Tax administrations and private sector.

Annex I to Doc. VT0726E1a

A series of presentations and discussions took place among the participants. Consequently, the following recommendations were made by the Focus Group as a way forward:

- The summary of these recommendations to be presented to the Technical Committee on Customs Valuation (TCCV) at the 26<sup>th</sup> Session in 2008 for the information of Members;
- Presentations and case studies presented to the Focus Group to be made available to the Members of the TCCV for their information;
- A proposal be made to the TCCV at their next session that the following technical points be taken up for examination and consideration of the need for further instruments:
- The phrase "circumstances of sale" in Article 1.2 (a) of the Agreement in respect of its application to transfer pricing situations.
- Consideration of the customs valuation treatment of situations where a transfer pricing agreement indicates that the declared customs value will be adjusted as necessary at a later date to achieve a pre-determined profit margin (known as price review clauses). This could be a development of earlier work of the Committee on price review clauses.
- Members of the Focus Group from the Private Sector could contribute to TCCV discussions on these issues, via the ICC or by the invitation of the Chairperson.
- Greater dialogue between Customs and tax administrations to be encouraged;
- The OECD to continue support.

All the presentations and summary of the meeting are available on the WCO Members' Website as follows:  
[http://www.wcoomd.org/members/members\\_valuationmainen\\_valutransferpricing.htm](http://www.wcoomd.org/members/members_valuationmainen_valutransferpricing.htm)

Also, the details about the deliberations and recommendations of the meeting were set out in Annex II to Doc. VT0647E1a

[http://www.wcoomd.org/members/meetingdocuments/valuation/customs\\_valuation\\_committee/meeting\\_0027/english/VT0647E1a.pdf](http://www.wcoomd.org/members/meetingdocuments/valuation/customs_valuation_committee/meeting_0027/english/VT0647E1a.pdf)

#### (4) Initiatives at the Technical Committee on Customs Valuation

Following the recommendations of the Focus Group on Transfer Pricing, the issue of transfer pricing was presented and discussed at the 26<sup>th</sup> Session of the Technical Committee on Customs Valuation in 2008.

According to the suggestions made by the Technical Committee on Customs Valuation, the presentations were made by the OECD and ICC at its 27<sup>th</sup> Session in order to have a better understanding of the issue. The panel discussions were followed after the presentations. The summaries of the presentations and the panel discussion are set out in Annex I to Doc. VT0675E1a and those presentations are available on the WCO Members' Website

Summary of the presentations and the panel discussions are given in Annex I to Doc. VT0675E1a:  
[http://www.wcoomd.org/members/meetingdocuments/valuation/customs\\_valuation\\_committee/meeting\\_0028/english/VT0675E1a.pdf](http://www.wcoomd.org/members/meetingdocuments/valuation/customs_valuation_committee/meeting_0028/english/VT0675E1a.pdf)

Presentations on transfer pricing at the 27<sup>th</sup> Session are on the WCO Members' Website:  
[http://www.wcoomd.org/members/meetingdocuments/valuation/27thsessionAgenda\\_Databas e.htm](http://www.wcoomd.org/members/meetingdocuments/valuation/27thsessionAgenda_Databas e.htm)

Since its 27<sup>th</sup> Session, the TCCV has been examining a case study which includes the issue of related party transaction in relation to transfer pricing as well as holding discussions on general matters.

(5) OECD Conference on Transfer Pricing and Treaties in a Changing World

This event organized and hosted by the OECD was held in September 2009 in Paris. It was part of the OECD's Global Forum on Tax Treaties and Transfer Pricing, which plays an important role in the OECD Committee on Fiscal Affairs' programme and brings together international tax experts from OECD and non-OECD countries to discuss international tax issues. The Conference was also open to participants from the private sector and universities.

That Conference consisted of a series of panels with guest speakers on specific topics including "Transfer Pricing and Customs". At the panel session of "Transfer Pricing and Customs", the WCO Secretariat made a presentation and the following recommendations were made by a panellist from the business community:

Government initiatives that would be useful to overcome the challenges of separate systems include:

- Improve consistency of methods (including providing guidance on how transfer pricing studies could be used to support customs valuations)
- Coordinated advance rulings for income tax and Customs
- Better coordination of audits with consistent recognition of results
- Simplified Customs procedures for dealing with retroactive adjustments

(6) Outcome of the WCO initiatives

In a series of the initiatives taken by the WCO, the following technical issues of customs valuation (related party transaction) relating to transfer pricing have been identified for consideration of the Technical Committee on Customs Valuation:

- The feasibility of utilizing the methods under the OECD Transfer Pricing Guidelines for the customs valuation purposes of examining "circumstance surrounding the sale" under Article 1.2 (a) of the Agreement.
- The possibility of utilizing an APA (Advance Pricing Agreement<sup>2</sup>) adopted by the Tax authorities for the customs valuation purposes of examining "circumstance surrounding the sale" under Article 1.2 (a) of the Agreement.
- The treatment of price adjustments after importation for customs valuation purposes, namely whether or not the customs value, which has already been determined by transaction value method (price actually paid or payable), could be amended based on the price adjustments made by tax authorities (either upward or downward).

It should be noted that the customs value should be determined by the price actually paid or payable between a buyer and a seller pursuant to Article 1 of the Agreement, in case the transaction value is not influenced by their relationship. Accordingly, the transfer price would not automatically establish the customs value.

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<sup>2</sup> An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations.

In essence, the issue at stake is that Customs, when conducting checks on related party transactions within a MNE, are increasingly confronted with the situation that the declared customs value has been based on a transfer price already agreed for corporation tax purposes. However, whether or not the transfer price has been accepted, Customs still need to satisfy themselves that the price is acceptable under the Agreement.

For customs valuation purposes, a transfer pricing study could be utilized only as a possible measure which could demonstrate as to whether or not the transaction value is influenced. Accordingly, any documents, which would be submitted by an importer, could be utilized by Customs for examining "circumstance surrounding the sale". Therefore, there is no need to limit the specific documents, such as a transfer pricing study, for determining the acceptability of the transaction value where a buyer and a seller are related.

#### **4. Members' experiences on the issues**

In order to have a better understanding of the issue, certain Members have provided useful information on their approach to transfer pricing in the context of customs valuation, as follows:

##### **(1) Australia**

The Australian Customs administration published "Australian Customs and Border Protection Service Practice Statement" on 13 July 2009. The subject of this Practice Statement is "Applying for a Valuation Advice relating to Transfer Pricing". The Practice Statement was published in order to provide guidance to the traders about the procedural requirements and documentary requirements in applying for a Transfer Pricing Valuation Advice by Customs in Australia.

This Practice Statement outlines:

- Legislative requirements for related parties' transactions;
- Policies concerning valuation advice relating to transfer pricing;
- Procedural guidelines for an applicant when applying for a transfer pricing valuation advice; and
- List of suggested supporting documents for an application for transfer pricing valuation advice.

This Practice Statement is available on the Australian Customs website at [www.customs.gov.au](http://www.customs.gov.au).

##### **(2) Canada**

The Canada Border Services Agency (CBSA) in cooperation with the Canada Revenue Agency issued Memorandum D13-3-6 "Income Tax Transfer Pricing and Customs Valuation" in October 2006. This Memorandum provides guidance for importers of goods imported to Canada as a consequence of a sale agreement between related parties where an intercompany transfer pricing has been established. It also provides information on the similarities and differences between customs valuation and income tax transfer prices, and the treatment for Customs purposes of costs and charges that may exist as part of transactions between related parties. The Memorandum is also available at <http://www.cbsa-asfc.gc.ca/>.

In determining the transaction value, the CBSA will ensure that all the elements of the price paid or payable are included in the transfer price (Memorandum D13-4-3) along with the adjustments provided for under Article 8 of the Valuation Agreement (Memorandum D13-

4-7). Furthermore, the CBSA will verify that there are no payments made after the importation of the goods (generally remitted separately from the payment for the goods themselves) and not included in the value of the imported goods. Such payments, referred to as "subsequent proceeds" will have to be added to the value of the imported goods (Memorandum D13-4-13).

Additional information is also available in Memorandum D13-4-5 "Transaction Value Method for Related Parties".

### (3) Korea

The Korea Customs Service signed a Memorandum of Understanding with the National Tax Service in January 2009 for mutual cooperation and consultation. Accordingly, the Korea Customs Service added a new Chapter titled "Inter-Agency Cooperation Related to Transfer Pricing" in its Notification on 25<sup>th</sup> February 2009 for achieving harmonization of transfer pricing and customs valuation.

Moreover, in order to deal with this issue within the framework of the current Customs Act in Korea, Korea Customs Service adopted the Advance Customs Valuation Agreement (ACVA). The ACVA Guidelines, which include information on transfer pricing, relevance of OECD Transfer Pricing Guidelines to customs valuation, as well as the process of Advance Customs Valuation Agreement, was drafted in May 2009.

### (4) The United States

The U.S. Customs and Border Protection (U.S. Customs administration) published its Informed Compliance Publication (ICP), entitled "Determining the Acceptability of Transaction Value for Related Party Transactions" in April 2007. This publication is intended to provide guidance and information to the trade community with respect to the policy and current practice of the U.S. Customs administration concerning the applicability of the transfer pricing principles and methodology in the context of customs valuation.

Specifically, the ICP summarizes the tests for determining the acceptability of transaction value for related party transactions; the U.S. Customs administration's application of the related party tests, including information and evidence needed to substantiate claims that transaction value is acceptable under these tests; the relevance of Advance Pricing Agreements (APAs) and Transfer Pricing Studies to the circumstances of sale test in determining the acceptability of transaction value; and the importers' obligations regarding the declaration of value in related party transactions.

Additionally, the ICP clarifies the U.S. position that an APA or transfer pricing study by itself is not sufficient to show that a related party transaction value is acceptable for Customs purposes. However, the underlying facts and conclusions of an APA or transfer pricing study may contain certain relevant information regarding the application of the circumstances of the sale test. The weight given to the facts and conclusions in an APA or transfer pricing study depends in large part on the particular circumstances presented and the transfer pricing methodology used. The burden of identifying the relevant information is on the importer.

The U.S. Customs' ICP can be located on the U.S. Customs website at [www.cbp.gov](http://www.cbp.gov).

Furthermore, the U.S. Customs administration published a number of rulings that deal with the issue of customs valuation in relation to transfer pricing that can be accessed online at <http://rulings.cbp.gov/>. Moreover, the Customs Valuation Encyclopaedia, which is also

Annex I to Doc. VT0726E1a

issued by the U.S. Customs, provides a summary of rulings on various issues. The U.S. Customs Valuation Encyclopaedia can be reviewed at [www.cbp.gov](http://www.cbp.gov).

## 5. Conclusion

Throughout the several occasions, the Customs community has recognized that transfer pricing is an increasingly important issue in the field of customs valuation. The recommendations from past events reveal that there are growing expectations for further initiatives from both Customs and tax authorities. Moreover, Members' experiences could also shed light on the issue and indicate a way forward for Customs administrations.

The WCO will continue to support Members in order to promote a better understanding of the issues and facilitate effective and efficient revenue collection. By providing some examples or suggestions, it will also encourage Members to have good coordinated administrative approaches with tax authorities, taking into account organizational structure, exchange of information, data sharing, joint audit, documentation, training, dispute resolution mechanism.

With respect to technical customs valuation matters relating to transfer pricing, the Technical Committee on Customs Valuation will continue the examination of these issues.

\* \* \*

**General issues and specific questions for consideration at the 30<sup>th</sup> Session of the Technical Committee**

**1. The examination of “circumstance surrounding the sale” under Article 1.2 (a) of the Agreement**

- Whether or not the transfer pricing study made by tax authorities, based on traditional methods (CUP method, Cost Plus method and Resale Price method) under the OECD Transfer Pricing Guidelines, could be utilized by Customs for the purpose of examining “circumstance surrounding the sale” under Article 1.2 (a) of the Agreement, that is, whether or not the transaction value is influenced by the relationship between a buyer and a seller.
- Whether or not the transfer pricing study made by tax authorities, based on the transactional profit methods (Transactional Net Margin method and Profit Split method) under the OECD Transfer Pricing Guidelines, could be utilized by Customs for the purpose of examining “circumstance surrounding the sale” under Article 1.2 (a) of the Agreement, that is, whether or not the transaction value is influenced by the relationship between a buyer and a seller.
- Whether or not Customs could make use of Transactional Net Margin Method (TNMM) for satisfying the concept of “circumstance surrounding the sale” under Article 1.2 (a) of the Agreement, especially where a “tested party” is an importer, as net operating profits would be established on the sale in the country of importation.

**2. The feasibility of utilizing an APA (Advance Pricing Agreement) adopted by tax authorities for the Customs purpose of examining “circumstances surrounding the sale” under Article 1.2 (a) of the Agreement**

- What elements need to be considered by Customs for identifying as to whether or not an APA, adopted by tax authorities, could be utilized for the purpose of examining “circumstances surrounding the sale” under Article 1.2 (a) of the Agreement?
- What elements need to be considered by Customs when Customs would utilize an APA, adopted by tax authorities, for the purpose of examining “circumstances surrounding the sale” under Article 1.2 (a) of the Agreement?

**3. The treatment of the price adjustments after importation (when the transaction value is adjusted by the tax authorities after importation)**

- Whether or not the adjusted transaction value after importation would be applicable as customs value under Article 1 of the Agreement, as the transaction value is not influenced by their relationship.
- Whether or not the adjusted transaction value after importation could be regarded as the price actually paid or payable under Article 1 of the Agreement.
- Whether or not Customs could accept the amendment of initial import declaration based on adjusted transaction value (either upwards or downwards).

\* \* \*

**Case Study submitted by the United States (with Members' comments)**

**[Introduction**

1. This case study details an importation where the importer makes a profit within the acceptable range as set by their transfer pricing study and therefore no adjustments are required.
2. There are circumstances in which importers may adjust the customs value of goods post importation when the importer of the goods makes a profit that is either greater than or less than the range agreed in the transfer pricing study. In such event, Customs is required to consider whether the transaction value method could be used to determine value of the goods after such adjustment.
3. If the transaction value method is found to be non-applicable then the other valuation methods should be considered in sequential order until an acceptable method is found (Australia).]

**Facts of Transaction**

1. ICO, a distributor of country I, purchases and imports relays from XCO, a related company of country X. XCO purchases the goods from an unrelated manufacturer in country Z. ICO does not purchase or sell any other products.
2. ICO of country I is a wholly-owned subsidiary of XCO of country X. ICO does not purchase relays from unrelated sellers. XCO does not sell relays or goods of the same class or kind to unrelated buyers. There is no indication of special circumstances set out in subparagraphs (a) to (c) of Article 1 of the Agreement.
3. ICO purchased from XCO 1,000 relays at 1.20 c.u. per unit, c.i.f. port of import, for the total invoiced price of 1,200.00 c.u. ICO entered its goods pursuant to transaction value, based on the value stated on the commercial invoice, which was submitted to Customs of country I.
4. Pending the final determination of customs value, Customs of country I released the goods to the importer in accordance with Article 13 of the Agreement.
5. ~~[After importation, ICO was selected for a post-clearance audit by Customs of country I. In the course of the post-clearance audit, Customs inquired whether any additional payments were made to XCO in connection with the imported goods. After reviewing additional documents submitted by ICO, Customs discovered that in addition to paying XCO for the price listed on the commercial invoice, ICO made additional payments of 50.00 c.u. to XCO for storage costs. The storage costs were paid by ICO directly to XCO for goods stored in country X at the time of the sale for export to country I. XCO invoiced the costs separately from the price of the goods (Australia)].~~
6. ~~[Additionally, Customs discovered that ICO provided tools free of charge directly to the unrelated manufacturer in country Z, in order to produce the imported goods. The tools were acquired from a non-related company of country I and the cost which ICO incurred was 100.00 c.u. The value of these tools was not included in the invoiced price of the goods (Australia)].~~
7. Furthermore, ICO provided Customs of country I various documents such as financial statements of ICO and XCO and detailed calculations in order to prove that the price charged in this particular transaction had not been influenced by the relationship of the parties.



8. The pertinent information received from ICO is as follows:

Sales (1,000 relays imported from XCO)	2,000.00
Cost of Goods Sold (invoice value)	<u>1,200.00</u>
Gross Profit	800.00
SG&A expenses for the sale in the country of importation	750.00
<del>Of which</del>	
<del>(Tools expenses</del>	<del>100.00)</del>
<del>(Storage expenses</del>	<del>50.00) (Australia)]</del>
Operating Income	50.00

Thus, ICO's operating margin is 2.50%.

9. Finally, ICO presented Customs with a transfer pricing study, prepared by an independent accounting firm on behalf of ICO. [In addition to relays, Aall (the US)] of the products imported [(relays) by ICO, such as relays, switches, and connectors (the US)] are included within the scope of the transfer pricing study. ~~[It is considered that the "Comparable Uncontrolled Price method"<sup>3</sup> does not apply because there are no comparable products sold between independent parties in comparable circumstances (the US)].~~ Based on a "functional analysis"<sup>4</sup> of the transaction, it is found that ICO is acting as a simple distributor, performing standard distribution functions, not employing any valuable, unique intangible and not bearing any significant risk. ~~[On the other hand, it is found that, in this transaction, highly valuable intangible assets (patents and trademarks) are contributed by XCO (the US)].~~ Furthermore, XCO is bearing the entrepreneurial risks in the transaction. [Therefore, ICO is a tested party under this study because ICO (rather than its parent company, XCO) has less complex functions and assumes less risk (the US)]. ~~[On that basis, it is found that the most appropriate method to the circumstances of the case would be a "Transactional Net Margin Method"<sup>5</sup> that would compare ICO's operating margin with the same of comparable uncontrolled transactions (the US)].~~ The transfer pricing study was prepared in accordance with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of the Organization for the Economic Cooperation and Development ("OECD Transfer Pricing Guidelines")

[As defined in OECD Transfer Pricing Guidelines, the TNMM examines the net profit margin relative to an appropriate base (e.g. costs, sales, and assets) that a related party realizes from a controlled transaction (or transactions that would be appropriate to aggregate under certain principles). The net margin of the related party from the controlled transaction should ideally be established by reference to the net margin that the same related party earns in comparable uncontrolled transactions. Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide. The OECD Transfer Pricing Guidelines state that a functional analysis of the associated enterprise and the independent enterprise is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results (Australia)].

<sup>3</sup> A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.

<sup>4</sup> An analysis of the functions performed (taking into account assets used and risks assumed) by associated enterprises in controlled transactions and by independent enterprises in comparable uncontrolled transactions.

<sup>5</sup> A transactional profit method that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction.

[TNMM is a method that requires a thorough examination of the company in question in order to determine the net profit margin relative to an appropriate base that the company realizes from a controlled transaction. As TNMM measures the relationship between net profit and an appropriate base, it is important to choose the appropriate base taking into account the nature of all the business activities (Australia)].

10. The transfer pricing study has not been considered by tax authorities of countries I or X. In selecting comparables for its analysis, the independent accounting firm, hired by ICO and XCO, performed a comparables search, including a review of publicly available databases.
11. The accounting firm searched for companies that perform similar functions, incur similar risks, use similar intangible assets, and sell similar products under the same or similar conditions as ICO. This search resulted in a number of potentially comparable companies chosen from the electrical apparatus and equipment, and electronic parts and equipment industries. After reviewing the companies to find the closest match possible, eight companies were selected as comparables. The eight selected distributors (the "Unrelated Distributors") purchased the goods from unrelated sellers of country X (the "Unrelated Sellers") and sold the goods of the same class or kind as the imported goods [in the country I (Israel)].
12. Additionally, the functional analysis showed that the functions performed by the eight unrelated distributors were similar to those of ICO in terms of their frequency, nature, and value. The functional analysis also identified and compared the assets employed by ICO and by the eight unrelated distributors and revealed that there is no significant levels of tangible or intangible assets among them. Furthermore, the functional analysis also showed that the risks assumed by ICO were substantially similar to those assumed by the eight distributors.
13. Based upon a comparability analysis, including a functional analysis (functions performed taking in account assets used and risks assumed), the transfer pricing study performed in accordance with the OECD Transfer Pricing Guidelines and the available data on comparable enterprises, concluded that the transfer price has to be established through a Transactional Net Margin Method ("TNMM") [that would compare ICO's operating margin with the same of comparable uncontrolled transactions (the US)]. Thus, ICO has a transfer pricing policy, and the company sets its prices according to the TNMM.
14. With regard to eight unrelated distributors, the period for comparison was the most recent fiscal year. The arm's length range established was 0.64 to 2.79 percent, with a median of 1.93 percent (this is the arm's length range of operating margins of companies comparable to ICO). ICO's operating margin was 2.50 percent, thus, falling within the operating margin of eight external comparables.

#### **Issues for Determination**

15. What is the customs value of the imported goods as determined under Articles 1 and 8 of the Agreement?
16. Can the transfer pricing study prepared on the basis of the OECD Transfer Pricing Guidelines be used to ascertain whether the transaction value of the imported goods is not influenced by the relationship of parties under Article 1 of the Agreement?

#### **Analysis**

17. Article 1 of the Agreement states that the customs value of imported goods shall be the transaction value, that is, the price actually paid or payable for the goods when sold for export to the country of importation adjusted in accordance with the provisions of Article 8.
18. Further, the Interpretative Note to Article 1 of the Agreement states that the price actually paid or payable is the total payment made or to be made by the buyer to or for the benefit of the seller for the imported goods. The value declared by ICO at the time of importation was 1,200.00 c.u. [~~However, based on the information provided by ICO to Customs of country I during the post-clearance audit, the price actually paid or payable for the shipment of 1,000 relays should be 1,250.00 c.u. Storage costs, in the amount of 50.00 c.u., are considered to be part of the price actually paid or payable since they are indirect payments made directly to or for the benefit of the seller at the time of the sale for export to country I (Australia).~~]
19. [~~Article 8 of the Agreement sets out the adjustments which are to be made to the price actually paid or payable for the imported goods when determining the transaction value. For example, the transaction value shall be adjusted for the value, apportioned as appropriate, of tools, dies, and molds and similar items used in the production of the imported goods, where supplied directly or indirectly by the buyer free of charge or at reduced cost for use in connection with the production and sale for export of the imported goods, to the extent that such value has not been included in the price actually paid or payable, shall be part of the transaction value. Therefore, the value of the tools provided by ICO directly to the manufacturer to produce the imported goods, in the amount of 100.00 c.u., is included in the transaction value and constitute an addition to the price actually paid or payable under Article 8.1(b)(ii) of the Agreement (Australia).~~]
20. [~~Accordingly, the customs value in this case is 1,350.00 c.u., which includes the price actually paid or payable in the amount of 1,250.00 c.u. and the value of tools in the amount of 100.00 c.u (Australia).~~]
21. However, given the concerns with the value declared at the time of importation, Customs advised ICO during the post-clearance audit that it had grounds for considering that the relationship influenced the price and that, in consultation with ICO, it would apply the tests set forth in Articles 1.2(a) and 1.2(b) in order to determine the acceptability of transaction value.
22. Based on the information obtained in the post-clearance audit, XCO does not sell to unrelated buyers; moreover, Customs does not have information about the customs value of identical or similar goods as determined under the provisions of Articles 5 and 6. Thus, the acceptability of transaction value cannot be established under Article 1.2(b). Similarly, because XCO sells only to related buyers, ICO is unable to demonstrate that the price was settled in the same manner as in sales to unrelated parties. Accordingly, ICO elects to demonstrate the acceptability of transaction value by showing that XCO's price is settled in a manner consistent with the normal pricing practices of the industry.
23. In an effort to justify the use of transaction value, ICO provided Customs with a copy of the transfer pricing study prepared in accordance with the OECD Transfer Pricing Guidelines. As discussed in the transfer pricing study, ICO uses the TNMM to set its prices.
24. [~~As defined in OECD Transfer Pricing Guidelines, the TNMM examines the net profit margin relative to an appropriate base (e.g. costs, sales, and assets) that a related party realizes from a controlled transaction (or transactions that would be appropriate to aggregate under certain principles). The net margin of the related party from the controlled transaction should ideally be established by reference to the net margin that the same related party earns in comparable uncontrolled transactions. Where this is not possible, the net margin~~

that would have been earned in comparable transactions by an independent enterprise may serve as a guide. The OECD Transfer Pricing Guidelines state that a functional analysis of the associated enterprise and the independent enterprise is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results (Australia)].

25. In reviewing the transfer pricing study, one issue considered by Customs was whether the examination of external comparables discussed in the transfer pricing study could be regarded as being consistent with the process of examining normal industry pricing practices under the Note to Article 1.2(a), which allows Customs to conduct an analysis of profitability of similar companies in the industry. In this regard, it could be considered that the term "industry" includes the industry or industry sector that produces goods of the same class or kind as the imported goods. Customs reviewed the information contained in ICO's transfer pricing study and concluded that the products sold by comparable companies were of the same class or kind as the imported goods.
26. Further, in this case, because the transfer pricing study covered all products imported by ICO to country I, Customs determined that a breakdown of product line profitability for comparability purposes was unnecessary.
27. In this regard, Customs noted that comparable companies were chosen from the electrical apparatus and equipment, and electronic parts and equipment industries -- companies that sell the goods of the same class or kind as the imported goods. In other words, the operating margin comparison between ICO and the other comparable companies, as stated in the transfer pricing study, could be considered to be consistent with the market as a whole, thereby demonstrating that the price between ICO and XCO could have been settled in a manner consistent with the normal pricing practices of the industry.
28. Additionally, Customs was of the view that the language of Interpretative Note to Article 1.2 was broad enough to permit the use of the OECD Transfer Pricing Guidelines in determining whether the relationship influenced the price. In this instance, 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. Thus, the operating margin on the resale of imported goods was shown to be generally the same as in the electrical apparatus and equipment and electronic parts and equipment industries. On this basis, Customs was satisfied that ICO could meet the circumstances of the sale test based on the conclusions reached in the transfer pricing study in respect of the normal transfer pricing practices of the industry.
29. The transfer pricing study found that the arm's length range of the comparable companies' operating margins was 0.64 percent to 2.79 percent. As previously noted, ICO's operating margin was 2.50 percent. Thus, a comparison of the operating margins between ICO and other comparable companies show that the operating margin of ICO, as determined in the transfer pricing study, is equivalent or within the range of operating margin of other comparable companies. Accordingly, since all companies sell the goods of the same class or kind, the transfer pricing study supports a finding that ICO's price was settled in a manner that was consistent with the normal pricing practices of the industry.

### **Conclusion**

30. [As a result of the post-clearance audit, Customs determined that the additional payments formed part of the total payment for the goods and that an addition to the price actually paid or payable was required under Article 8. In addition (Australia)], in examining the related party transactions between ICO and XCO, Customs confirmed by means of the transfer pricing study that the application of the TNMM specified in the OECD Transfer

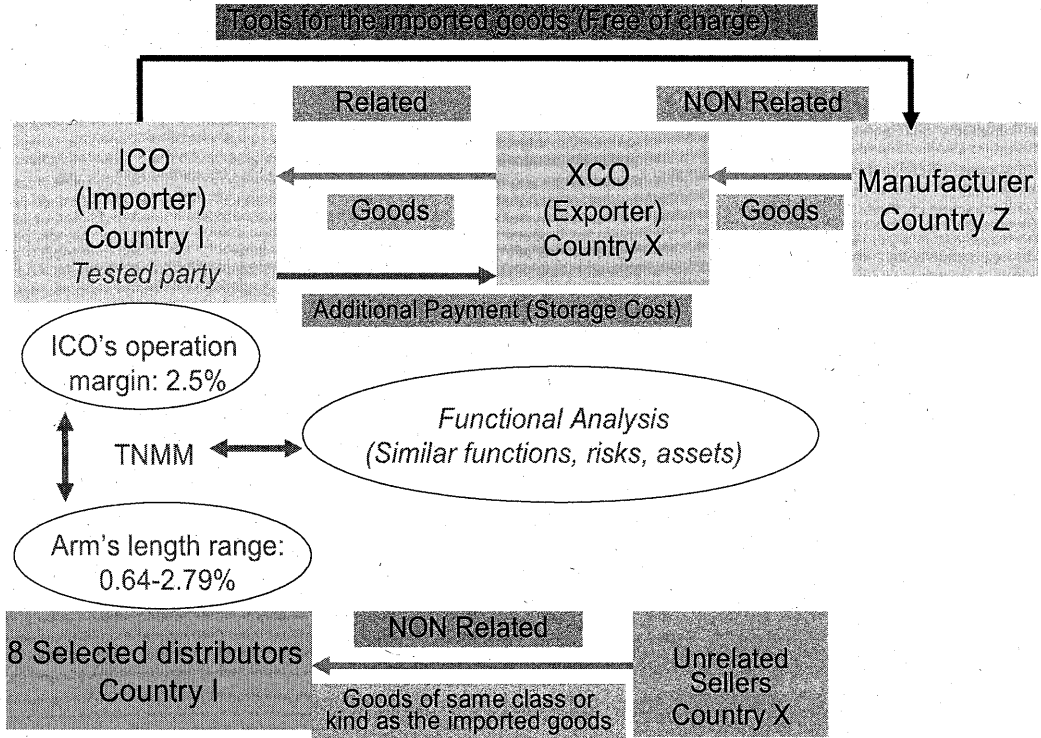
Pricing Guidelines satisfied the circumstances of sale test in the particular circumstances of this case.

**[Caveat to case study (Australia)]**

- [31. The problem for Customs when analyzing a transfer pricing study that uses TNMM is that the net profit of the comparable company may sometimes also come from activities other than importing goods, such as after-sales service or an inter-company loan, etc., making it difficult to accurately determine the net profit for only the imported goods (Australia)].
- [32. The tasks of selecting comparable companies for TNMM are complex. The fact that tax authorities can take years to agree on the comparables when preparing an advanced pricing agreement illustrates the complexity of these tasks. As Customs is not involved in the preparation of the advanced pricing agreement, it will be difficult for Customs to determine whether the comparables used for the TNMM are suitable for customs valuation purposes (Australia)].
- [33. As valuation of imported goods is governed by the requirements set out in the WTO Valuation Agreement and the tax value is determined in accordance with the OECD Guidelines, the operation of these two different sets of rules may sometimes result in different values being ascribed to imported goods for customs and taxation purposes. In such circumstances, the mere fact that a tax value differs from a customs value does not mean that one (or both) of the values are incorrect. It is important that each case be determined on a case-by-case basis and the values assessed on their own merits by using the relevant rules or guidelines in the respective agreements (Australia)].
- [34. This case study shows that the TNMM can be used to verify that the relationship has not affected the selling price of the goods in question (Australia)].
- [35. However, it is evidently clear from the above that whether TNMM could be employed for valuation purposes is a question of fact that varies from case to case. Therefore, it is important that the facts of each case should be thoroughly examined to determine whether TNMM could be used for valuation purposes (Australia)].
- [36. It may not be suitable to employ the TNMM method where the comparable companies are not from the same industry or the same economy. Also, it is easier to find comparable companies for the purposes of TNMM in large economies. However, in smaller economies, this may be difficult to find such comparables in smaller economies. Further, the transfer pricing study may use comparable companies that perform the same function, for example import and distribute goods, but the imported goods for this function may be different to the good considered for valuation purposes. Additionally, in some circumstances where there is no comparable company which performs the same functions, the transfer pricing study will use comparable companies from other countries. In such circumstances, it may not be suitable for Customs to use the TNMM method to determine whether the relationship has influenced the price of the goods (Australia)].

\* \* \*

### Related Party Transactions



\* \* \*

### **Case Study (Cost Plus method)**

#### *Facts of transaction*

1. ICO of country I purchased and imported a natural ingredient used in the production of food flavourings from XCO of country X.
2. At the time of clearing the goods, ICO declared to Customs in country I that it was related to XCO.
3. After importation, Customs in country I decided to conduct a review of the circumstances surrounding the sale of goods between XCO and ICO, pursuant to Article 1.2 of the Agreement, because it had doubts about the acceptability of the price. To this end, Customs forwarded a questionnaire to ICO which sought information regarding the sale of products by XCO to other buyers in country I and, if necessary, justification of any price difference as well as information relating to XCO's cost of production and profit. At the request of ICO, Customs also forwarded a questionnaire to XCO. From the responses received, facts as set out below were established.
4. ICO purchased the natural ingredient from XCO for the production of food flavourings. The natural ingredient has been acquired by XCO from other manufacturers. It is not manufactured or processed by XCO.
5. The ingredient is sold only to ICO in country I and there are no importations of identical or similar goods into country I.
6. XCO does not sell other goods.
7. Five sellers in country X sell synthetic ingredients to unrelated buyers in country I. The synthetic ingredients have been acquired by the sellers from other manufacturers. They are not manufactured or processed by the sellers. The unrelated buyers purchased the synthetic ingredients from the sellers also for the production of food flavourings.
8. The natural ingredient and the synthetic ingredients fall within the range of goods produced by the ingredients sector of the food flavouring industry. Therefore, they may be regarded as "goods of the same class or kind".
9. ICO provided Customs with a transfer pricing study which was prepared on the basis of a cost plus method, as described in Subchapter C (iii) of Chapter II of the OECD Guidelines.
10. Since XCO does not sell the natural ingredients to unrelated buyers, then the cost plus mark up was established by reference to the cost plus mark up that would have been earned in comparable transactions by independent enterprises.
11. ICO provided information showing that the profit margins on the sale of synthetic and natural ingredients are generally the same in the food flavouring industry.
12. The functional analysis showed that the number of functions performed by XCO, in connection with the natural ingredients, was substantially similar to that of the five unrelated sellers. The functions performed by XCO were as significant as those performed by the five unrelated sellers in terms of their frequency, nature and value. The functional analysis also identified and compared the assets employed by XCO and by the five unrelated sellers. Both XCO and the five unrelated sellers have no inventories of ingredients and insignificant levels

of fixed assets. The functional analysis also showed that the risks assumed by XCO when selling to ICO were substantially similar to those assumed by the five sellers when selling to the unrelated buyers.

13. ICO provided Customs with information showing that the contractual terms in transactions between the five sellers and the unrelated buyers were substantially similar to those in transactions between XCO and ICO.

14. In the relevant fiscal year, the cost plus mark up of XCO in its transactions with ICO was 30%. In the same fiscal year, the cost plus mark ups of the five sellers in transactions with unrelated buyers in country I were:

Seller 1	33 %
Seller 2	30 %
Seller 3	27 %
Seller 4	25 %
Seller 5	23 %

15. The median of the range is 27 %. The first and third quartiles are 25 % and 30 %, respectively.

16. Customs established that the prices charged to ICO were adequate to recover all XCO's costs, including the costs of acquisition plus the costs of repacking, handling and freight charges, but it could not establish whether such prices were adequate to recover a profit that was representative of the firm's overall profit over a representative period of time, because 100 % of the firm's overall profits were the profits from the sale of the natural ingredient to ICO in country I.

#### *Suggested determination of Customs value*

17. The Interpretative Note to Article 1.2 provides that "*the customs administrations should be prepared to examine relevant aspects of the transaction, including the way in which the buyer and 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*". This involves a complete analysis of the transaction in question and uncontrolled transactions in order to determine whether the relationship influenced the price. The examination of those aspects must always have a comparability purpose, since this is the only mechanism authorized by the Agreement for determining whether the relationship influenced the price. The language of the Interpretative Note to Article 1.2 is broad enough to permit a functional analysis and a comparison of contractual terms, economic circumstances and business strategies (in the context of a comprehensive transfer pricing study) under the more detailed rules of the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* of the Organization for the Economic Cooperation and Development (hereinafter "OECD Guidelines") in determining whether the relationship influenced the transaction value.

18. The Interpretative Note to Article 1.2 gives some guidance in relation to the circumstances that Customs should examine and to the information that importers should submit. However, such guidance is very general. Customs administrations and importers cannot be expected to solve complex transfer pricing problems solely on the basis of such general provisions.

19. Furthermore, the Interpretative Note to Article 1.2 only provides examples of circumstances or aspects of the transactions which could be examined by Customs. Such



examples do not constitute the only circumstances or aspects that Customs might explore and should be taken only as a starting point and as illustrative.

20. The second example of the Interpretative Note to Article 1.2 provides guidance on the type of examination of the circumstances of sale required by the Agreement. It does not require that the methodology used by the importer in the examination of the circumstances of the sale be identical to the one used for purposes of the example. Otherwise, the Interpretative Note would not have used the words "*as an example*" and "*as a further example*" but, rather, a more prescriptive language.

21. In this context, the use of the cost plus method, as described in the OECD Guidelines, is consistent with the examples of the Interpretative Note and with the objective and purpose of the Agreement. Furthermore, the use of external comparables (i.e., the use of cost plus mark ups of unrelated sellers in the absence of sales by XCO to unrelated buyers) is also consistent with such examples and with the objective and purpose of the Agreement. Firstly, the use of external comparables is not arbitrary or fictitious, being, therefore, consistent with the preamble of the Agreement. Secondly, the examination of external comparables would be generally consistent with the process of examining the "normal pricing practices of the industry". Thirdly, although not directly applicable in the context of paragraph (a) of Article 1.2, the Interpretative Note to Article 6 allows the use of external comparables. In effect, where the producer's own figures for profit and general expenses are not consistent with those usually reflected in sales of goods of the same class or kind as the goods being valued which are made by producers in the country of exportation for export to the country of importation, the amount for profit and general expenses may be based upon relevant information other than that supplied by or on behalf of the producer of the goods. Taking into account that a treaty shall be interpreted in accordance with the ordinary meaning to be given to the terms of the treaty in their context, the provisions of Article 6 and its Interpretative Note are part of such context and, therefore, provide guidance for interpreting and applying Article 1.2.

22. The OECD Guidelines indicate that "*the cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful where semifinished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services... The cost plus mark up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark up that the same supplier earns in comparable uncontrolled transactions. In addition, the cost plus mark up that would have been earned in comparable transactions by an independent enterprise may serve as a guide.*"

23. The OECD Guidelines also provide that an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the cost plus method if one of two conditions is met:

1. none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market; or
2. reasonably accurate adjustments can be made to eliminate the material effects of such differences.

24. In making comparisons for purposes of the cost plus method, fewer adjustments are normally needed to achieve comparability, because minor product differences are less likely to have as material an effect on profit margins as they do on price. These comparability standards are also observed in the Agreement. In effect, the product comparability standard is less rigid in the second example of the Interpretative Note to Article 1.2 (goods of the same class or kind) where a profit margin comparison is required, than in its first example or in Article 1.2(b)(i) where a price comparison is required. The same logic is followed throughout the other Articles of the Agreement (Articles 1.2(b)(i), 2 and 3 require identical or similar goods, while Articles 1.2(b)(ii), 1.2(b)(iii), 5 and 6 require goods of the same class or kind).

25. The functional analysis showed that there were no significant differences in functions, risks and assets between XCO and the five unrelated sellers. Also, ICO demonstrated that the contractual terms in sales made by the five unrelated sellers and by XCO were substantially similar.

26. In addition, an adequate level of product comparability – as required under the cost plus method – is observed between the transactions of the five unrelated sellers and those of XCO. In effect, synthetic and natural ingredients may be regarded as goods of the same class or kind and the profit margins on the sale of those ingredients are generally the same in the food flavouring industry.

27. Customs established that the prices charged to ICO were adequate to recover all XCO's costs, including the costs of acquisition plus the costs of repacking, handling and freight charges. XCO's cost plus mark up (30%) is above the median of the range of cost plus mark ups charged by the five unrelated sellers. In fact, it is equal to the third quartile of the range.

28. Therefore, XCO's prices are adequate to recover a profit that is representative of the comparable unrelated sellers' profit realized over a representative period of time (i.e. the relevant fiscal year) in sales of goods of the same class or kind. In accordance with paragraph 3 of the Interpretative Note to Article 1.2, transaction values in respect of the natural ingredients may be acceptable for Customs purposes.