



TECHNICAL COMMITTEE  
ON CUSTOMS VALUATION

-  
43<sup>rd</sup> Session  
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VT1058E1a  
(+ Annex)

O. Eng.

Brussels, 23 June 2016.

SPECIFIC TECHNICAL QUESTIONS

RELATED PARTY TRANSACTIONS UNDER THE AGREEMENT  
AND TRANSFER PRICING –  
DRAFT CASE STUDY BASED ON RESALE PRICE METHOD

(Item V (a) on the Agenda)

Reference documents :

VT0935E1b (TCCV/38)  
VT0941E1b (TCCV/38 – Report)  
VT0949E1a (TCCV/39)  
VT0961E1a (TCCV/39)  
VT0967E1a TCCV/39 – Report)  
VT0975E1a (TCCV/40)  
VT0985E1a (TCCV/40)

VT0994E1a (TCCV/40 – Report)  
VT1002E1a (TCCV/41)  
VT1013E1a (TCCV/41)  
VT1028E1a (TCCV 42)  
VT1041E1a (TCCV/42)

I. BACKGROUND

1. At the 42<sup>nd</sup> Session, the Technical Committee continued to discuss the case presented by China, designed to provide guidance to Members in a situation where transfer pricing information based on the resale price method may be useful to Customs when examining a related party transaction. Following the 42<sup>nd</sup> Session, China provided an updated version of the draft case study, taking into account Members' comments made at the last Session.
2. A further version of the draft case study has been prepared, reflecting proposals from China, and others, which is available in the Annex to this document. Unless otherwise indicated, the proposed amendments were made by China or the Secretariat.

II. SECRETARIAT COMMENTS

3. Regarding paragraphs 18 to 20 which concern the application of alternative methods, (and the related texts in paragraphs 1 and 21), these are shown in square brackets following a proposal from the United States to delete this section. The Technical Committee agreed that it would first deliberate on the question of price influence and whether it was appropriate to reject the transaction value in this case. Once this point is finalized, it would then decide

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whether or not to examine the application of alternative methods. The relevant text can then be examined and amended accordingly.

### III. CONCLUSION

4. Members are invited to study the updated draft and submit written comments and suggestions to the Secretariat by 4 September 2016 at the latest. Members are kindly requested to send their comments in electronic format where possible (e-mail address : [valuation@wcoomd.org](mailto:valuation@wcoomd.org)). Members may also contribute their views and discuss the case via the WCO's Club de la Réforme platform.

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## DRAFT CASE STUDY BASED ON RESALE PRICE METHOD

### Introduction

1. This document describes an example of a case where Customs took into account information provided in a company's transfer pricing report, as well as additional information, when determining whether or not the price actually paid or payable for imported goods had been influenced by the relationship between buyer and seller under Article 1.2 (a) of the Agreement. **[In particular, the case illustrates how Customs in certain such cases, may determine that the price had been influenced by the relationship and that the Customs value should duly be determined under Article 7 of the Agreement.] (United States propose deletion)**

### Facts of Transaction

2. XCO of country X sells luxury bags to ICO, a distributor of country I. Both XCO and ICO are wholly-owned subsidiaries of ACO, the headquarters of a multinational enterprise and the brand-owner of the luxury bags. Neither XCO nor other companies related to ACO sell the identical or similar luxury bags to unrelated buyers in country I. ICO is the only importer of the luxury bags sold by XCO to country I. Thus, all luxury bags imported into country I by ICO are purchased from XCO.
3. In 2012, ICO declared the price of imported luxury bags based on the value on the invoice issued by XCO. The commercial documents submitted to Customs of country I indicated that there was no special circumstances or additional payments which would prevent the use of the transaction value as set out in subparagraphs (a) to (c) of Article 1 of the Agreement or require an additional adjustment prescribed by Article 8 to the import price.
4. In 2013, Customs in country I conducted a Post-Clearance Audit to verify ICO's declared import price, **because it had doubts about the acceptability of the price (United States)**. ICO's transfer pricing policy showed that the import price of all luxury bags was determined using the Resale Price Method (in accordance with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of the Organization for the Economic Cooperation and Development). At the end of each year, ICO estimated the resale price of the bags and the targeted gross margin for the next year. After the targeted gross margin for 2012 was determined at 40%, ICO then calculated the import price of luxury bags to be imported in 2012 by using the Resale Price Method according to the formula:  
*Import Price = Estimated Resale Price x (1 – Targeted Gross Margin) / (1 + Duty Rate)*.
5. **The luxury bag market of country I where the imported goods were resold has been very competitive. However, in 2012, due to the popularity of the imported luxury bags, the actual sales income of ICO far exceeded the estimated income<sup>1</sup>, even though ICO just followed the routine distribution work and did not undertake any more marketing activities in that year. Consequently, ICO's gross margin in 2012 was 64 % which was higher than the targeted gross margin stated in ICO's transfer pricing policy. Thus, by virtue of ICO earning a higher margin, XCO sold the merchandise at a lower price, which in turn indicated that ICO's prices were not settled in a manner consistent with the normal pricing practices of the industry. (United States)** During the

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<sup>1</sup> ~~Normally the luxury bags imported by ICO are first sold in their shops at full price. After several months, the rest of the bags would be sold at a discount. If the luxury bags of ICO are very popular, most of the bags will be sold at full price and the average selling price would certainly be higher than the estimated selling price. Therefore the gross margin will be higher than estimated. (United States)~~

audit, Customs asked ICO to provide further information in order to review the acceptability of its declared import price.

6. ICO did not provide test values required for the application of Article 1.2 (b) and (c), as a means of demonstrating that the relationship did not influence the price. However, ICO submitted a transfer pricing report, which used the Resale Price Method that compared ICO's gross margin with the gross margins earned by comparable companies in their transactions with unrelated parties (i.e. comparable uncontrolled transactions). The transfer pricing report was prepared by an independent firm in accordance with the OECD Transfer Pricing Guidelines.
7. According to the transfer pricing report, ICO was a simple distributor that performed **routine** distribution functions and **did (United States)** not employ any valuable, unique intangible assets or assumed any significant risk. The transfer pricing report submitted by ICO selected eight comparable companies located in country I. The functional analysis indicated that the eight selected comparable companies imported comparable products from country X, performed similar functions, assumed similar risks **and did not employ any valuable intangible assets, just** as ICO.
8. The transfer pricing report indicated that the arm's length inter-quartile range of gross margins earned by the selected comparable companies in 2012 was between 35 %-46 %, with a median of 43 %. **Therefore**, the 64 % gross margin earned by ICO did not fall within the arm's length inter-quartile range. **(United States)**

#### Issues for Determination

9. **[Can Customs of country I reject ICO's import price based on an examination of information contained in the transfer pricing report submitted by ICO and, if so, duly determine the Customs value of the imported goods under Article 7 of the Agreement by using the Resale Price Method and the gross margins of the eight comparable companies?]**

**[Does the transfer pricing study, supplied in this case, provide information which enables Customs to conclude whether transaction value is acceptable under Article 1.2(a) of the Agreement?]** **(United States)**

#### Analysis

10. Under Article 1 of the Agreement, a transaction value is acceptable as the Customs value when the buyer and the seller are not related, or if related, the relationship does not influence the price. Where the buyer and seller are related, Article 1.2 of the Agreement provides two ways of establishing the acceptability of the transaction value when Customs have doubts concerning the price: (1) the circumstances surrounding the sale shall be examined to determine whether the relationship influenced the price (Article 1.2 (a)); or (2) the importer demonstrates that the value closely approximates one of three test values (Article 1.2 (b)). In this case, as indicated in paragraph 6, the importer did not provide test values therefore Customs examined the circumstances surrounding the sale.
11. Since no test values were provided, the circumstances surrounding the sale were considered in order to determine whether the transaction value was influenced by the relationship.

12. The Interpretative Note to Article 1.2 of the Agreement provides that in examining the circumstances surrounding the sale, “the customs administrations should be prepared to examine relevant aspects of the transaction, including the way in which the buyer and the seller organize their commercial relations and the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price.”
13. When examining the circumstances surrounding the sale concerning companies using Resale Price Method, a comparison of the gross margin of the company in question with the gross margin of comparable companies could indicate whether or not the declared price had been settled in a manner consistent with the normal pricing practices of the industry.
14. Based on the functional analysis, all eight comparable companies are located in country I; and they performed similar distribution functions, assumed similar **risks and do not employ any valuable intangible assets, just as ICO**. The eight comparable companies imported comparable products as ICO and these goods **are similarly manufactured in country X (United States). And these comparables had been deemed suitable for Customs valuation comparison purposes as well (Korea)**. Thus, there was no significant difference between ICO and the eight comparable companies.
15. According to the transfer pricing report, the arm’s length inter-quartile range of the gross margin earned by the comparable companies **ranged was (United States)** between 35 %-46 % with a median of 43 %. However, in 2012, ICO earned a gross margin of 64 % which was much higher than the normal gross margins **(United States)** of comparable companies in this industry. **It should be noted that the luxury bag market of importing country I was competitive, so that operating profit and costs of ICO should be similar with those of comparable companies (Korea). Considering ICO was a simple distributor, it did not undertake any more marketing activities in 2012, and there was no evidence showing it had performed its activities more successfully than the competitors, therefore there was no evidence of ICO giving added value to the transaction. Given that there was no substantial difference between ICO and the eight comparables in terms of functions, assets and risks, ICO's high gross margin in 2012 did not match its functions, assets and risks (China). Thus, by virtue of ICO earning a higher margin, XCO sold the merchandise at a lower price, which in turn indicated that ICO’s prices were not settled in a manner consistent with the normal pricing practices of the industry. (United States)**
16. Therefore the transfer pricing report supported a finding that the import price of ICO was not settled in a manner consistent with the normal pricing practices of the industry and provided Customs with reasonable doubts as to the acceptability of ICO’s import price in 2012. During the consultation when Customs communicated its doubts to ICO, the latter agreed that the **unexpected** popularity of the bags and under-estimation of the sales income had led to the high gross margin **which could be attributed to the reputation of the international brand**, and the value of goods imported in 2012 **had been declared at a lower value and thus** should be re-determined. At the time Customs conducted **the its** valuation audit, it was established that ICO had not made any transfer pricing adjustments **(United States)** in this regard<sup>2</sup>.

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<sup>2</sup> It is acknowledged that normally a voluntary adjustment would generally occur in this situation. However, it depends on compliance level and management system of different countries. In cases of no adjustments made, Customs may either communicate with the Tax authorities or take steps on its own initiative, taking into account the existing management of that country. It should be noted that implementing WTO Agreement is Customs priority. Based on the Agreement, Customs should re-

17. Based on given information and forgoing analysis, Customs arrived at the conclusion that the import price was not settled in a manner consistent with the normal pricing practices of the industry in question. ~~So by examining the circumstances surrounding the sale under Article 1.2(a), Customs could determine that the import price had been influenced by the relationship between buyer and seller (United States)~~ and the Customs value should be re-determined accordingly by application of the alternative methods of valuation in a sequential order.
18. [Owing to a lack of identical goods and similar goods, neither Articles 2 nor 3 of the Agreement could be used. Even if the eight comparable companies, according to the transfer pricing report, imported comparable products to ICO, the actual goods imported by the comparable companies could not be regarded as similar goods for Customs valuation purposes, because they were of different brands they could not be considered commercially interchangeable and there was a difference between the resale price of the goods imported by ICO and the goods imported by the eight comparable companies. **Article 5 is not applicable because the necessary information for the deduction based on reliable source was not available from ICO and the public sector (Korea).** Article 6 could not be applied, since XCO could not provide the relevant information required. Finally, Customs and ICO agreed to use reasonable means under Article 7 of the Agreement and determined the Customs value of imported goods by using the Resale Price Method based on the arm's length gross margin of the comparable companies as a flexible interpretation of the deductive value method.
19. To re-determine the Customs value, ICO and Customs both agreed to use the median of the arm's length inter-quartile range, since the median gross margin could reflect the normal profit level of the same industry. Given that, Customs and ICO calculated the Customs value of the goods imported in 2012 according to the formula: *Average Resale Price x (1 - Median of Arm's Length Range of the comparable companies) / (1 + Duty Rate)*.
20. For example, at the end of 2011, ICO estimated that the average sale price of Bag A of 2012 would be 60 c.u., and ICO's targeted gross margin would be 40%, and the duty rate is 10%. So the import price of bag A of 2012 was 32.72 c.u.<sup>3</sup>. However the actual average resale price of Bag A in 2012 was 100 c.u. The median of arm's length range of eight comparable companies was 43%, so the Customs value of bag A should be 51.82 c.u.<sup>4</sup> ] **(United States propose to delete paragraphs 18 - 20)**

### Conclusion

21. In examining the circumstances surrounding the sale between ICO and XCO under the provisions of Article 1.2 (a) of the Agreement through the review of the transfer pricing report, Customs concluded that the declared import price ~~had been influenced by the relationship between the parties (United States)~~ and was not settled in a manner consistent with the normal pricing practices of the industry. **[After considering each valuation method in a sequential order, Customs decided to use the median gross margin of the arm's length range of comparable companies, as a flexible interpretation of the deductive value method, for determining the Customs value under Article 7]. (United States propose deletion) [Therefore, customs value should be**

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determine the Customs value of the imported goods and collect the duty legally due where the declared price has been influenced by the special relationship between the buyer and seller,

<sup>3</sup>  $60 \times (1 - 40\%) / (1 + 10\%) = 32.72$  c.u.

<sup>4</sup>  $100 \times (1 - 43\%) / (1 + 10\%) = 51.82$  c.u.

**determined by application of the alternative methods of appraisal in a sequential order.] (United States)**

22. This case study illustrates a situation where a transfer pricing report using Resale Price Method was useful for Customs' examination of related party transactions. ~~**In this case, the comparable companies listed in the transfer pricing report and the arm's length range of the gross margins thereof were helpful for Customs to verify whether or not the relationship influenced the price and to determine the Customs value of the imported goods. (United States)**~~ However, it should be noted that the use of a transfer pricing report as a possible basis for examining the circumstances surrounding the sale should be considered on a case by case basis as specified in Commentary 23.1.
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