Tax Clinic

Customs duty refunds on transfer-pricing adjustments

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FOREIGN INCOME & TAXPAYERS

Multinational companies (MNCs) often make periodic (including year-end) transfer-price adjustments to address target profit margins and other considerations pursuant to intercompany agreements and to comply with global income tax requirements. But whether claimed transfer-pricing adjustments involving tangible goods can be supported under the World Trade Organization Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (the "WTO Agreement," based on the 1979 GATT Valuation Agreement) is an important consideration for the C-suite, particularly given the increasing jolt of customs duties on companies' financial statements (e.g., cash and profits).

While many reasons exist to make transfer-pricing adjustments, some of the more common ones include adjusting profits to compensate for unexpected economic events like the COVID-19 pandemic, addressing specific market competitiveness factors, and/or reconciling expenses when transaction billing is based on budgeted costs for goods and services rather than actual costs. Still, one important issue often overlooked by MNCs is that customs value requirements differ from those of the income tax authorities and thus may sometimes produce different results or require additional planning and analysis. This is particularly noticeable when comparing documentation used for tax planning to the more granular criterion used by customs authorities to assess and collect duties. This discussion explores key considerations to keep in mind for claiming customs duty refunds on transfer-pricing adjustments.

An objective fixed formula must be in place to value goods prior to importation

For customs purposes, most import transactions globally are entered under the "transaction value" method, meaning the price actually paid or payable for goods. To use transaction value, customs rules require the formula for valuing goods to be fixed at the time of importation. When the invoiced price used to enter goods changes because of post-importation adjustment true-up processes, customs authorities naturally question whether the goods actually qualify for transaction value and whether the adjustments, when they result in a price reduction, may be applied to recover duties paid. (Naturally, customs authorities rarely question such adjustments when they result in price increases and additional duty payments to the government.)

In the United States, prices set according to an objective fixed formula agreed upon prior to importation satisfy this rule. But this is true only when the later adjusted price is based on some event or occurrence over which neither the seller nor the buyer has any control. For a transfer-pricing policy to be considered a formula, it must be prepared under the Sec. 482 requirements for

recognizing income for transactions between entities that share a common ownership. Furthermore, the United States and most other countries require that MNCs prepare documentation supporting their transfer-pricing policies and the allocation of taxable income among MNCs that results from that policy. On its own, however, documentation prepared for transfer-pricing purposes may not always be enough to support a customs claim.

In U.S. Customs and Border Protection (CBP) Headquarters Ruling Letter (HQ) H304841 (April 23, 2021), CBP took issue with supplier agreement language that stated the seller had the “right” to adjust the price (to achieve the required markup), but the policy did not say how the adjustments would be made. In that case, CBP determined that the language gave the seller the “discretion” to make adjustments but did not require it. Additionally, the agreement did not detail how adjustments would be handled, so the claimed adjustments were denied.

In HQ H157795 (June 29, 2015), CBP determined that an intercompany agreement based on multiple transfer-pricing studies prepared by independent accounting firms did not meet the requirement for a pricing formula because neither the agreement nor the studies specified how adjustments would be made. Additionally, arm’s-length profit benchmarks used blended company comparables for services provided in connection with aircraft and spare parts sales but did not provide operating margins for the respective services and sales. Customs did not find the blended margins helpful because the agency could not ascertain the arm’s-length margin for the imported spare parts.

Clearly, the requirement for a fixed formula, then, is that policies and supporting documentation must demonstrate how prices are determined at the product level and when and how adjustments will be applied to result in successful customs duty refund claims. Additionally, adjustments must relate to factors over which neither the buyer nor the seller has any control after importation.

Arm’s-length pricing benchmarks must target comparable products for customs purposes

It should be noted that transaction value for intercompany sales is an acceptable basis of appraisement if an examination of the circumstances of the sale indicates that the relationship did not influence the price paid. To this end, benchmarking studies of companies with similar assets, risks, and functions are often used to determine the appropriate compensation range for the services to be performed. Because customs duties are assessed at the product level, transfer-pricing benchmarking studies consisting of companies chosen based on risk and function will not be acceptable for customs value purposes if they do not also include companies that manufacture or distribute the “same class or kind of merchandise” as the importer.

Moreover, the transfer-pricing policy must specify how the transfer price and any adjustments are determined with respect to “all products” covered for which the value is to be adjusted. As an example, tax benchmarking studies alone fall short of this requirement because the purpose of the report is to establish an arm’s-length profit range for all goods and services for income tax purposes, whereas the specificity of a customs formula requirement contemplates a business policy or agreement that targets a specific gross or operating profit margin for specific products (typically, for the manufacturer and not the distributor).

Another example can be found in HQ H157795 (June 29, 2015), in which CBP stated that transfer-pricing studies serve as evidence that transfer-pricing policies are representative of arm's-length transactions, but simply comparing profit margins does not explain how transfer prices are initially determined or how adjustments are allocated. Additionally, the comparable companies used in the studies were distributors of products outside the industry, so CBP questioned whether it was actually representative of an arm's-length range for the product at issue.

In scenarios where companies sell more than one product, care should be used to obtain company benchmarks for each relevant product.

Transfer-pricing policies must be implemented at the product level

Companies often focus on the bottom-line results when implementing pricing agreements (especially the targeted profit margin) but often struggle with product-level nuances. One reason could be that income tax rules focus on enterprise operating results and not on product-level profits. But when supporting customs value (particularly with respect to decreased values) more upfront planning for product profitability will be necessary before downward price adjustments can result in duty refunds.

As an example, in 2017, the Court of Justice of the European Union ruled against importer Hamamatsu Photonics Deutschland's claimed adjustments to customs value that were based on its intercompany agreement for goods under an advance pricing agreement (APA) concluded with the German tax authorities (*Hamamatsu Photonics Deutschland GmbH v. Hauptzollamt München*, No. C-529/16 (E.C.J. 12/20/17)). Pursuant to the APA, the company performed regular checks to verify conformity of actual profit results with the arm's-length targeted margins in the APA. During the period at issue, the importer's operating margin fell below the arm's-length range in the APA, and a compensating credit was subsequently received for €3.8 million, which indirectly lowered the customs value of the merchandise during the period of adjustment.

When the importer attempted to recover duties paid on the adjustment, customs in Germany denied its claim, stating that Article 29(1) of the EU's Customs Code refers to transaction value for individual goods and not a flat-rate adjustment across all products, here, over 1,000 individual shipments. At trial, the court ultimately found that flat-rate adjustments were incompatible with the Customs Code, which requires, in part, the "real economic value" to be reported for imported goods. This holding implies that a flat-rate adjustment applied across all products for transfer-pricing purposes could artificially reduce the economic value reported for certain products and is not supported under the customs rules.

But, conversely, in 2012, CBP accepted a transfer-pricing policy for customs value purposes where the company applied a standard discount to sales of products from list price within an individual product center, based on the normal pricing practices of the industry. In that case, the company organized its products into five product centers sharing similar characteristics by line. Notably, the list price was set when products were introduced, based on research of the market conditions, trends, reports, competing quotes from third parties, and what the market would bear. Adjustments were proportionate so that the gross margin of each product center conformed to the arm's-length margin of the benchmarking study to adequately compensate the U.S. distributor for

its efforts. Additionally, adjustments were booked to the cost of goods sold, affecting the value of the imported products. (See HQ H219515 (Oct. 11, 2012).)

Clearly, as exemplified in the rulings above, no single solution meets the needs of every industry or company, but companies should review individual policies and underlying documentation to verify that they address all relevant factors. Also, it should be noted that not all customs regimes permit downward price adjustments with duty refunds and that some jurisdictions require advance notice when policies contain price review clauses.

Customs value planning considerations

These cases highlight the importance of interdisciplinary business planning to fully cover total tax liability, including indirect taxes such as customs duties, excise tax, value-added taxes, etc., which are often paid at the time of import. Businesses can also consider other ways to legally lower the value of imported goods through cost unbundling exercises that examine key cost elements for goods to determine whether they are required to be included in customs value.

Businesses may also wish to review the following areas to better understand the interdependencies of international income tax, transfer-pricing, and customs-value rules to achieve positive outcomes:

■ Use a multidisciplinary approach to assess current transfer-pricing models to manage total tax liability and required adjustment processes, particularly for customs duties and other indirect taxes;

■ Evaluate policy and contract documentation from a customs duty perspective to ensure they reflect customs requirements;

■ Consider using APAs or other available transfer-pricing dispute-avoidance tools; and

■ Formally prepare contemporaneous documentation that fully covers the formula-pricing approach of the customs rules and comports with the economic analysis in any transfer-pricing studies or APAs.

Editor Notes

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