



TECHNICAL COMMITTEE ON
CUSTOMS VALUATION

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+Annex

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43rd Session
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O. Eng.

Brussels, 29 June 2016.

QUESTION RAISED DURING THE INTERSESSION

USE OF TP DOCUMENTATION TO EXAMINE RELATED PARTY TRANSACTIONS
ACCORDING TO ARTICLE 1.2 (A) OF THE AGREEMENT

Request by Uruguay

(Item VI (b) on the Agenda)

I. BACKGROUND

1. During the intersession Uruguay submitted a question for consideration by the Technical Committee.
2. The question refers to a related party transaction in which the seller does not sell its products to unrelated buyers nor does the buyer buy goods from unrelated sellers.
3. In order to determine whether the transaction value is acceptable, the circumstances surrounding the sale have been examined. A Transfer Pricing study based on the TNMM has been used to determine whether the relationship has influenced the price.
4. The question, which is reproduced in the Annex to this document, is accompanied by a proposed draft Case Study.

II. SECRETARIAT COMMENTS

5. The Secretariat notes that in this draft Case Study, the use of the TP study leads to the conclusion that the relationship has influenced the price and the transaction value is not acceptable (by applying the principles of Case Study 14.1).

III. CONCLUSION

6. The Technical Committee is invited to consider the question at the 43rd Session and determine whether it wishes to examine this issue as a Specific Technical Question at a future Session.

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USE OF TRANSFER PRICING DOCUMENTATION WHEN EXAMINING RELATED PARTY
TRANSACTIONS UNDER ARTICLE 1.2 (a) OF THE AGREEMENT.

1. In view of the recent adoption of Case Study 14.1, it is considered appropriate and necessary to have another Technical Committee document which in principle presents a similar factual scenario involving transactions between related parties but in which, at the time of examining “the circumstances surrounding the sale”, and in view of different findings, Customs must conclude the opposite, ultimately affirming Commentary 23.1.
2. This case also involves an importer that is related to its supplier and that, in the absence of “test values” specified in the Agreement, presents to Customs a transfer pricing study when the “circumstances surrounding the sale” are examined under Article 1.2 (a). The study also uses the Transactional Net Margin Method (TNMM) from the OECD Guidelines, has a bilateral Advance Pricing Agreement (APA), and demonstrates that the importer’s operating profit margin falls within the arm’s length range. However, in the light of other checks, the Customs administration must finally conclude that the commercial relationship did influence the transaction value.

ANALYSIS :

3. Annexed for initial discussion by the Technical Committee is a draft Case Study which follows the same format as Case Study 14.1.
4. Facts, analysis and conclusions differing from those in Case Study 14.1 have been highlighted in yellow for greater ease of reference and understanding.

PROPOSED OUTCOME :

5. The Technical Committee on Customs Valuation issues a document which ensures a uniform interpretation and application of these cases, both for its Members and for all private sector operators.

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DRAFT CASE STUDY

USE OF TRANSFER PRICING DOCUMENTATION WHEN EXAMINING RELATED PARTY
TRANSACTIONS UNDER ARTICLE 1.2 (a) OF THE AGREEMENT

Introduction

1. This document describes a case where Customs **in principle** took into account information provided in a company's transfer pricing study based on the Transactional Net Margin Method (TNMM) when examining whether the price of imported goods had been influenced by the relationship between buyer and seller in accordance with Article 1.2 (a). This case study does not indicate, imply, or establish any obligation on Customs authorities to utilize the OECD Guidelines and the documentation resulting from the application of the OECD Guidelines in interpreting and applying the WTO Valuation Agreement.

Facts of Transaction

2. XCO, a manufacturer in country X, sells **cars** to its wholly-owned subsidiary, ICO, a distributor of country I. ICO imports the **cars** and does not purchase any **other** products from unrelated sellers. XCO does not sell cars or goods of the same class or kind to unrelated buyers.
3. In **2013**, ICO entered its goods using the transaction value, based on the price stated on the commercial invoice, which was submitted to Customs of country I. There is no indication that special circumstances exist as set out in subparagraphs (a) to (c) of Article 1 of the Agreement that would prevent the use of transaction value.
4. After importation, Customs in country I decided to review the circumstances surrounding the sale of goods between ICO and XCO, pursuant to Article 1.2 (a) of the Agreement, because it had doubts about the acceptability of the price.
5. The importer did not provide test values in accordance with Article 1.2 (b) and (c), as a means of demonstrating that the relationship did not influence the price.
6. In response to Customs' request for additional information, ICO presented a transfer pricing study for the period **2012**, prepared by an independent accounting firm on behalf of ICO.
7. The transfer pricing study used the Transactional Net Margin Method ("TNMM") that, in this case, compared ICO's operating margin with the operating margins of functionally comparable distributors of goods of the same class or kind, also located in country I, that conducted comparable uncontrolled transactions in the same period of time. The transfer pricing study was prepared in order to comply with the requirements of country I tax regulations and applied principles contained in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of the Organization for Economic Cooperation and Development ("OECD Transfer Pricing Guidelines"). The transfer pricing study covered all **cars** purchased by ICO from XCO.
8. Relevant data for ICO, taken from the company's financial records :

-	Sales	1,000,000
-	Price actually paid to XCO	450,000

-	Costs of importation and other related costs (10 %)	45,000
-	Cost of goods sold	495,000
-	Gross profit	505,000
-	Operating expenses	400,000
-	Operating profit	105,000
-	Operating profit margin (benchmarked)	10.5 % of sales

9. The transfer pricing study, using data taken from ICO's company records, indicated that ICO's operating profit margin on the sale of cars purchased from XCO was 10.5 percent in 2012.
10. The study concludes that it is possible to find reliable comparables for ICO and, accordingly, ICO was selected as the tested party in the transfer pricing study.
11. ICO's transfer pricing study had been reviewed by the Tax authorities of countries I and X in the context of negotiating a bilateral Advance Pricing Agreement (APA). An APA was subsequently agreed between ICO, XCO and the Tax authorities of countries I and X with respect to all transactions between ICO and XCO. While in review by the Tax authorities of countries I and X, ICO provided information showing that the profit margins it earns on the sale of its cars are generally the same as those made by independent distributors in companies from the automotive sector dealing with passenger transport.
12. In the transfer pricing study, eight distributors, unrelated to their suppliers, were selected based on the substantial similarity of their functions, assets and risks, compared to ICO.
13. Information concerning these eight distributors was taken for fiscal year 2012 for purposes of the comparison. The range of operating profit margins earned by these unrelated distributors was 5.12 to 11.07 percent, with a median of 8.27 percent. In the context of the APA negotiations, this range was accepted by the Tax authorities as an arm's length range of operating profit margins for transactions comparable to ICO's transactions with XCO. This arm's length range was established using the profit margins of the eight comparable companies, using the financial records of these companies available in public databases. ICO's operating profit margin was 10.5 percent, thus falling within the range. The 10.5 percent margin achieved by the importer in the country of importation was a function of : a) the price actually paid or payable by ICO to XCO, b) ICO's own sales revenue, and c) ICO's own costs.
14. It was determined that no adjustments prescribed by Article 8 of the Agreement were required to be made to the price actually paid or payable. Additionally, ICO did not make compensating adjustments for tax purposes for the year 2012.
15. ICO sets its selling prices in order to allow the company to earn an operating profit that meets the target arm's length (interquartile) range as set out in the transfer pricing study. The price paid or payable to XCO has not undergone significant changes over the year.
16. Furthermore, Customs found that, of the eight unrelated distributors selected for the transfer pricing study, none imported identical goods – within the meaning of the Agreement – to those imported by ICO; but that one of them, JCO, only imported similar goods – again within the meaning of the Agreement – and was competing directly with ICO in the same market niche of the country of importation.

17. After analysing the financial records of JCO, Customs found that, for the same year 2012, for the same quantities of similar cars imported and sold as ICO, and with the same opening and closing goods inventory in both companies, the total figures for JCO were :

Sales	1,000,000
Price actually paid to unrelated suppliers	495,000
Costs of importation and other related costs (10 %)	49,500
Cost of Goods Sold (COGS)	544,500
Gross profit	455,500
Operating expenses	400,000
Operating profit	55,500
Operating profit margin (benchmarked)	5.55 % of sales

18. Customs examined the records of car importers but did not find other unrelated importers that imported identical or similar vehicles, within the meaning of the Agreement, to those imported by ICO and JCO.

Issue for determination

19. Does the transfer pricing study supplied in this case, prepared on the basis of the OECD Transfer Pricing Guidelines and used as the basis of a bilateral APA, provide information which enables Customs to conclude whether or not the price actually paid or payable for the imported goods is influenced by the relationship of the parties under Article 1 of the Agreement ?

Analysis

20. 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 to one of three test values (Article 1.2 (b)). In this case, as indicated in paragraph 5, the importer did not provide test values, therefore Customs examined the circumstances surrounding the sale.
21. The Interpretative Note to Article 1.2 of the Agreement provides that in examining the circumstances surrounding the sale, “the customs administration 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.”
22. Based on the information obtained from ICO, XCO does not sell the merchandise to unrelated buyers. Therefore, ICO is unable to demonstrate that the price was settled in the same manner as in sales to unrelated parties, specified in Note 1 to Article 1.2 (a) of the Agreement.
23. During its review of the circumstances surrounding the sale, Customs took into account the examination of information discussed in the transfer pricing study when determining whether the price had been settled in a manner consistent with the normal industry pricing practices under the Note to Article 1.2 (a). In this regard, the term “industry” includes the industry or industry sector that contains goods of the same class or kind (including identical or similar goods) as the imported goods.

24. The information provided in paragraphs 8, 16 and 17 and in the transfer pricing study presented by ICO indicates that :
- (a) The functional analysis showed that there were no significant differences in functions, risks and assets between ICO, JCO and the other unrelated distributors.
 - (b) The comparable companies chosen imported and sold passenger vehicles of the same class or kind as the goods imported by ICO.
 - (c) JCO is the only distributor unrelated to its supplier which imports goods similar to those imported by ICO.
 - (d) ICO and JCO compete in the same sector of the domestic market in cars, in country of importation I.
 - (e) The sale prices, operating costs and percentage costs of importation for ICO and JCO “closely approximate” each other, and their operating profit margins (5.55 % and 10.50 % respectively) fall within the arm’s length (interquartile) range in the transfer pricing study.
25. However, Customs was able to verify that the price actually paid by JCO for the goods it purchased from its unrelated supplier was 10 % higher than the price paid by ICO to its related supplier over the same period. This difference in the car market was materially substantial and significant, and no commercial or logical reason was found to justify it.
26. Given these facts, Customs formally informed ICO that it was unable to accept the transaction value of its imports from XCO, and gave it a further opportunity to provide additional information demonstrating that the commercial relationship with its seller did not influence the price. As it was unable to provide additional information justifying this difference in price, ICO and Customs ended up agreeing to reject the use of the transaction value method and to determine the Customs value using the subsequent methods in the Agreement.

Conclusion

27. After examination of the circumstances surrounding the sale in respect of related party transactions between ICO and XCO, Customs concluded, including by analysis of a transfer pricing study based on the TNMM, on the additional information concerning operating expenses as deemed necessary, and on the analysis of imports of identical or similar goods, that under the provisions of Article 1.2 (a) of the Agreement, the relationship between the parties did indeed influence the price.
28. In this case, the operating profit margin of an importer related to its seller is within the arm’s length range set out in a transfer pricing study which uses the Transactional Net Margin Method (TNMM). On the other hand, however, Customs identified in this case a significant and unjustified difference compared to the price level of the only unrelated importer of identical or similar goods, and accordingly had to conclude that the commercial relationship influenced the transaction value. A situation which, in terms of the transfer pricing regime, was acceptable and reasonable since the importers’ operating profit margins fell between the first and third quartiles of distribution, was not so in Customs terms since it presented a substantial difference in market prices which could only be explained by the commercial relationship between the related parties having influenced the price.
29. As indicated in Commentary 23.1, the use of a transfer pricing study for examining the circumstances surrounding the sale must be considered on a case-by-case basis.