INSIGHT: Multinationals Face Formidable Challenges in Valuing Intangibles: Part II - Customs

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In light of the recent elevation of protectionism that created uncertainties and tension to international trade, we review the latest gap-bridging efforts between transfer pricing and customs valuation regimes in Part II of this article.

In the first part of this two-part article, we explored the similarities and differences of the intangibles valuation between transfer pricing and financial statement purposes, focusing on purchase price allocation.

Valuation of Intangibles in Transfer Pricing and Customs

The Customs Valuation Framework

Besides the purchase price allocation of intangibles, another contentious issue taxpayers face is customs valuation. World Trade Organization (WTO) members use the transaction value method for customs valuation, which is based on the price of goods paid or payable upon import, plus adjustments for commissions, shipping, licensing, insurance and other costs. What this implies is that the customs valuation is inclusive of the value of intangibles. Article 8 of the WTO Customs Valuation Agreement states that the transaction value should also include royalties and license fees related to the goods being valued that the buyer must pay.

When the buyer and seller are related, the Agreement states that this fact by itself does not mean the transaction value is not acceptable. If the relationship does not influence the price, the transaction value will still be respected. If the customs authority believes the relationship influences the price, it would conduct further inquiries with the importer. Thus, customs and tax authorities are similar in that they follow a risk based audit procedure.

The Issue

The inherent conflict of interest between the direct tax and customs authorities has been well-documented and acknowledged. Specifically, a lower price on import goods leads to a lower customs duty for the importing country, which translates to lower costs of goods sold in the same country, resulting in higher business profits and taxable income.

Despite the competing incentives, the customs and the direct tax authorities are actually trying to achieve similar objectives in a related party context: they both want to ensure the price of an underlying transaction is set as if the parties are independent third parties. However, the two sides do approach the issue slightly differently—customs authorities would like to confirm all appropriate elements (including intangibles) are included in the customs value and therefore the value is not understated; whereas tax authorities would like to make sure the transfer price does not include inappropriate elements and is not overstated.

The recently updated World Customs Organization (WCO) Guide to Customs Valuation and Transfer Pricing (WCO Guide) pointed out certain similarities between WTO methods for customs valuation and OECD methods for transfer pricing valuation. For example, the WTO deductive method (Article 5) is based on the resale price of the goods, close to the OECD resale price method. In addition, the WCO computed value method (Article 6) is based on a value built up from materials and manufacturing costs etc., plus profit, similar to the OECD cost plus method. The WCO Guide reflects the conclusion of OECD’s Base Erosion and Profit Shifting
Project, which includes addressing the vulnerability resulting from over-emphasizing the contractual allocation of functions, assets, and risks, and stressing the importance of accurate delineation of transactions in comparability analysis, focusing on actual conduct and the real substance of the arrangements. The Guide also incorporates the three-tiered transfer pricing documentation approach that is now part of the Chapter V of the OECD Transfer Pricing Guidelines.

The Coordination

Over the last decade, there were dialogues between international organizations from both customs and direct tax sides to bridge the gap. We provide a short review of recent developments.

It has long been recognized that because the WTO Valuation Agreement would not be revised any time soon, it is unlikely there would be some formal alignment or merger of the two system of methodologies. As such, the practical solution had been to work around the constraints of the existing WTO Agreement provisions. Consistent with this understanding, recent efforts have been focusing on knowing to what extent the customs authorities would use transfer pricing information when carrying out examinations of related party transactions.

As of late 2017, WTO has issued three instruments directly on the topic of coordination with transfer pricing. In 2014 the WTO’s transfer pricing manual recognizes that there are some similarities between customs valuation and transfer pricing methods, although the former may not always be aligned with the latter. Examining customs values may provide relevant information and a useful starting point for transfer pricing purposes and may also help taxpayers reduce the compliance burden. It also states that “in appropriate circumstances the verified customs value may be useful to tax administrations in evaluating the arm’s length character of the transfer prices of imported goods in international transactions between associated enterprises.”

The OECD’s discussion is brief, but takes a comparable view and states that the arm’s length principle is applied by many customs administrations. However, valuation methods for customs purposes may not be aligned with transfer pricing methods. The OECD’s recommendation is that customs valuations may be helpful for tax administrations in evaluating the arm’s length nature of the transactions and vice versa.

The Differences

Despite the recognition of the similarities, the WCO pointed out the following areas that could make leveraging transfer pricing studies challenging: first, transfer pricing data may cover a range of products as opposed to the single imported product. This is the primary reason for customs officials to reject the reference to a transfer pricing study. Because the customs authorities follow the principle of “goods of the same class or same kind,” which could apply a narrower definition than the typical Standard Industrial Classification (SIC) code selection in transfer pricing. The issue gets more complicated once we consider imbedded intangibles in products.

In addition, the selection of certain comparable companies under the comparable profits method for transfer pricing purposes focuses on the comparable functions and risks, which may not even be in the same four digit SIC code; therefore, they may not be in the same industry or product group as the taxpayer/importer. This is reasonable for transfer pricing studies but may not be acceptable under customs requirements.

Second, both customs and direct tax authorities may conduct audits several years after the importation of goods and the taxable year end, respectively. What the customs authorities would likely to ensure is that the transfer pricing data contained in the studies relates to the specific periods under review. Transfer pricing studies generally apply the most recently available data, which may not cover the same taxable years as the transactions happened.

Additionally, although all three international organizations (OECD, WTO, and UN) recognize the improved cooperation between direct tax and customs administrations, and encourage all countries to continue enhancing such coordination, they still caution the careful use of the other side’s information because potential differences do exist. This might seem disappointing from a glass half-empty point of view; however, a glass half-full perspective would see the improved information sharing and coordination, as evidenced by the differences between the two versions (2013, 2017) of the United Nations’ transfer pricing manuals. The 2017 version of the United Nations’ transfer pricing manual painted a more promising picture in terms of coordination between direct tax and customs administrations.

A recent development that was perceived as a drawback to the convergence effort between transfer pricing
and customs valuation involve the Court of Justice of
the European Union’s (CJEU) decision on the Ha-
manatsu case (C-529/16) in December 2017. The CJEU
ruled that a transfer price that is subject to retroactive
adjustments after the year-end could not form the basis
for the transaction value method for customs valuation
purposes. Because the transaction value reflects the
economic value of the goods at the time of importation
and all elements that influence value should have al-
ready been taken into account, there is no basis for al-
lowing retroactive adjustments.

The fact pattern involving the Hamamatsu case is
disconcerting because the underlying intercompany
transactions, Hamamatsu Germany imports goods from
its parent Hamamatsu Japan, are covered by a bilateral
Advanced Pricing Agreement (APA) with the German
and Japanese tax authorities. At year-end 2010, Ham-
amatsu Germany’s profitability was below the range
prescribed in the APA, the group therefore made year-
end adjustments to lower the transfer prices for goods
purchased by Hamamatsu Germany to increase the
subsidiary’s profit. Because Hamamatsu Germany used
the initial transfer prices determined by the APA as the
customs value of the goods, it filed for a customs duty
refunds application after the transfer pricing adjust-
ment. Both the German customs authority and the court
denied the refunds application, and CJEU concurred
with this conclusion.

This decision potentially would affect many multi-
national enterprises that import products into the EU in
an intercompany setting, and would have the largest im-
 pact on the entities that routinely use transfer prices at
import as the transaction value and retroactively adjust
the prices later. Considering the recent tariff and trade
dispute, some practitioners caution that, although the
WTO concurs it is reasonable to adjust prices of im-
ported goods to reflect changes of the duty costs, com-
panies need to monitor and evaluate the target profit
levels closer and more frequently. The implication from
the ruling, which intensifies the disjoint between trans-
fer pricing and customs valuation, would certainly
make the monitor and adjustment process more chal-
lenging in the current economic environment. On the
other hand, there may still be reason to believe some
customs authorities will subscribe to a more harmo-
nized view between transfer pricing and customs valu-
ation. Because CJEU’s ruling is based on the Commu-
nity Customs Code that was in effect until April 30,
2016, the customs authorities in the EU may take a dif-
f erent view with the updated Union Customs Code. The
WCO Guide does not specifically mention the Ha-
manatsu case; however, it is generally believed that the
EU is striving for streamlined and simplified customs
legislations and procedures.

Conclusion

Looking across the three different valuation disci-
plines, the PPA looks at transactions from a market par-
ticipant’s perspective in an orderly market, and the
market participants’ individual specifics do not neces-
sarily have to be identified. For transfer pricing valu-
ations, it looks at the value chain and emphasizes the
facts, functions and risks to determine the specific en-
tity or transaction’s position within the value creation
process. Finally, the customs engages in a more de-
tailed valuation approach and focuses on the features of
the goods when they pass the border, inclusive of any
imbedded intangibles.

What is the best practice for maneuvering between the
three sets of requirements? Relying on a study prepared
for another discipline is certainly not the ideal policy. In
a transfer pricing audit, the agents may not appreciate
a copy of the PPA analysis in response to their request
for a transfer pricing study. Similarly, as a recent cus-
toms’ case study illustrated, taxpayers that only use
transfer pricing studies to support the prices reported
on customs invoices might be inviting more inquires.

However, this is not to say that there is nothing to le-
verage between the three disciplines. For example,
when deciding the useful life of an intangible, both PPA
and transfer pricing studies presumably obtain this in-
formation through the same process—by talking to en-
gineers, marketing professionals, or reviewing financial
or technical specs. As such, there should be a great level
of coordination on this matter. Every time taxpayers
use a certain study for another purpose, they either
need to pay attention to more granular details, or raised
the study to a higher-level perspective, focusing on the
stylized characteristics.

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