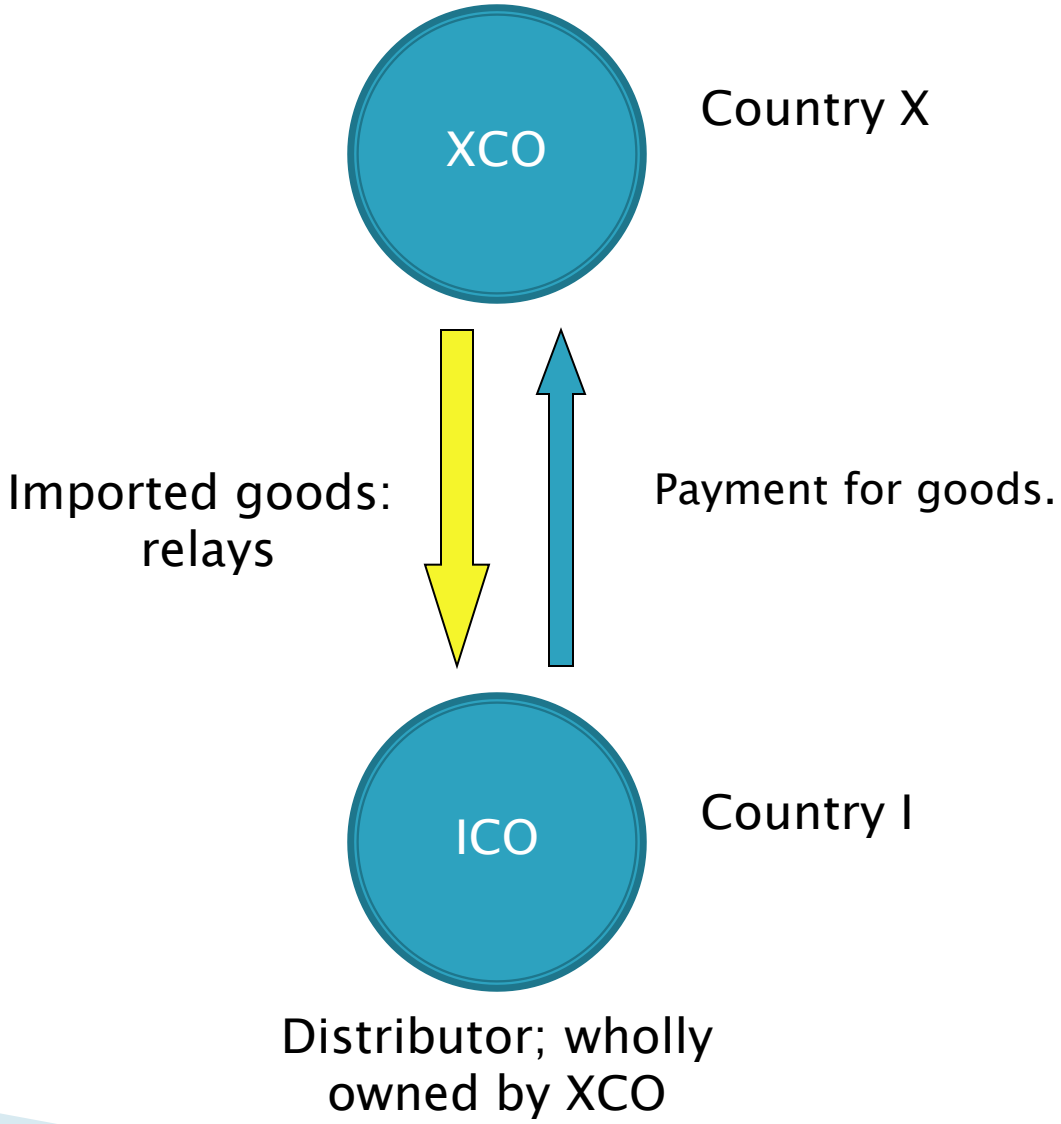
Technical Committee on Customs Valuation

Case Study 14.1

World Customs Organization

Scenario


XCO
Country X
Imported goods: relays
Payment for goods.
ICO
Country I
Distributor; wholly owned by XCO

Facts of transaction I

- XCO of country X sells relays to its wholly-owned subsidiary, ICO, a distributor of country I
- ICO imports the relays and does not purchase any products from unrelated sellers
- XCO does not sell relays or goods of the same class or kind to unrelated buyers

Facts of transaction II

- In 2012, ICO entered its goods using the transaction value, based on price stated on the commercial invoice
- No indication of special circumstances that would prevent the use of transaction value
- Pending final determination of the customs value, Customs of country I released the goods to the importer on provision of a security for duty

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Facts of transaction III

- Customs reviewed the circumstances surrounding the sale of goods, because it had doubts about the acceptability of the price
- In response to Customs request, ICO submitted a transfer pricing study, prepared by an independent accounting firm
- TP study was based on “TNMM ” comparing ICO’s operating margin with the operating margins of companies in Country I that conducted comparable uncontrolled transactions in the same periods

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Facts of transaction IV

- TP study indicated that ICO's operating margin on sale of relays purchased from XCO was 2.5% in 2011
- Study concludes that it is possible to find reliable comparables for ICO, so ICO was selected as the tested party
- TP study reviewed by tax authorities of countries I and X in the context of bilateral APA negotiation
- Information showed that profit margins on sale of relays are generally the same in the electrical apparatus and electronic parts industries

Facts of transaction V

- Information concerning **8** unrelated distributors found for comparison
- Functional analysis showed that risks assumed by ICO were similar to those assumed by the 8 distributors.
- Range of operating margins earned by the unrelated distributors = ***0.64 to 2.79%; av. 1.93%***
- Accepted by tax authority as an arm's length range
- ICO's operating margin = ***2.50%***

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Relevant data for ICO

Transfer Price	
Sales	100.0
COGS (i.e price paid/payable to XCO)	82.0
Gross profit	18.0
Operating expenses	15.5
Net operating profit	2.5
Net operating profit margin	= 2.5% of sales

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Case Study 14.1 :
Use of information from a TP study

Info. obtained from TP study (TNMM used)

8 comparable uncontrolled distributors

Range of operating margins
0.64 % – 2.79%
Av. 1.93%

XCO — Exporter/ parent co.

Related parties

Goods sold for export (transaction value)

ICO — Importer/ Distributor

Tested party
(distributor)
Operating margin = 2.5%

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Issues for Determination

Can the T.P. study be used to ascertain whether the transaction value of the imported goods is not influenced by the relationship of the parties under Article 1 of the Agreement?

Analysis I

- XCO does not sell the merchandise to unrelated buyers. Therefore, ICO is unable to demonstrate that price was settled in the same manner as in sales to unrelated parties
- It is not possible to apply Art. 1.2 (b) as the required test values do not exist

- Interpretative Note to Art.1.2 of the Agreement provides that *"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."*

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Analysis II

- Customs considered whether the examination of external comparables discussed in the T.P. study could be regarded as being consistent with the process of examining the normal industry pricing practices
- Functional analysis showed that there were no significant differences in functions, risks, and assets between ICO and the eight unrelated distributors

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Analysis III

- An adequate level of product comparability was observed
- Operating margin on resale of the imported goods was generally the same as in the industries in question
- T.P. study found that the arm's length range of comparable companies' operating margins was 0.64% to 2.79% (ICO margin = 2.50%)
- As all companies sell goods of the same class or kind, the T.P. study supports a finding that the price between ICO and XCO was settled in a manner consistent with the normal pricing practices of the industry.

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Analysis IV

Based on the information provided :

- The Sales figure can be accepted since ICO is selling only to unrelated parties (and it is assumed ICO is rationally seeking to maximize its profits in its dealings with unrelated parties)
- The Operating expenses amount has been accepted since it is determined that these expenses are paid by ICO to unrelated parties, with ICO seeking to minimize its costs and these expenses have not been paid for the benefit of the seller
- The TP study confirms that ICO's operating profit margin is within the arm's length range (i.e. based on a study of comparable, but independent (unrelated) distributors)
- The Cost of Goods Sold of ICO reflects the price paid or payable to XCO and represents the transaction between ICO and its related party, XCO. This is the transfer price in question.

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Analysis V

- By working back from the arm's length range of operating profit margins and the other accepted information set out above, it could be deduced that the transfer price is an arm's length amount. This demonstrates that information relating to the transaction between ICO and unrelated distributors can be helpful and relevant to Customs when examining the circumstances surrounding the sale between XCO and ICO.

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Conclusion

- 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 and additional information concerning operating expenses as deemed necessary, that under the provisions of Article 1.2 (a) of the Agreement, ***the relationship between the parties did not influence the price.***

- 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.

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