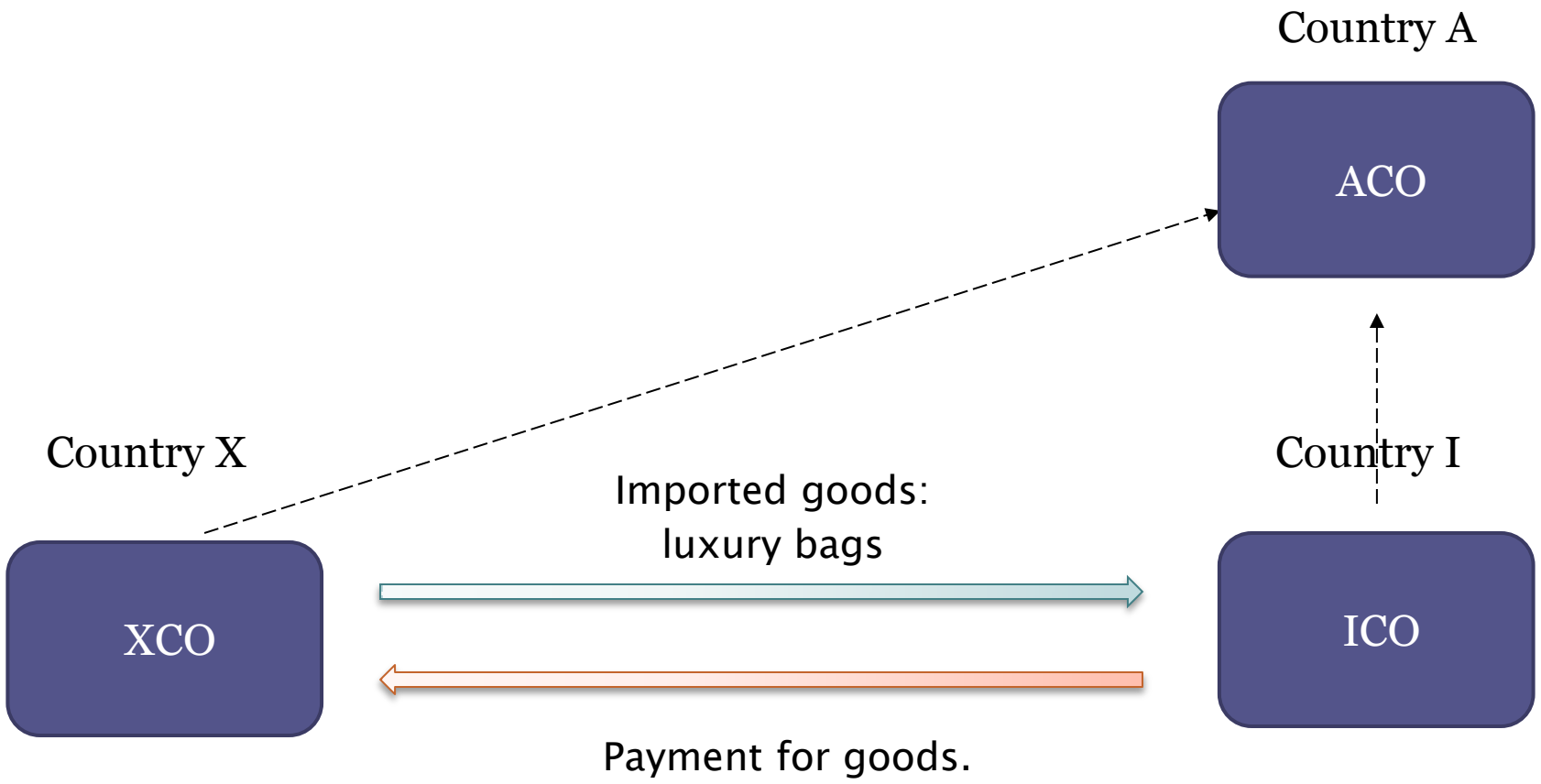
Case study 14.2
based on Resale Price Method

Scenario



XCO and ICO are wholly-owned subsidiaries of ACO

Facts of transaction I

- 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 in country I

… thus all luxury bags imported into country I are purchased by ICO from XCO

- The marketing strategy was established by XCO and undertaken by ICO

Facts of transaction II

- In 2012, ICO declared the price of imported luxury bags based on the value on the invoice issued by XCO

- Commercial documents submitted to Customs of country I indicated that there was no special arrangement or additional payments (such as restrictions as to the disposition or use of the goods or a trademark fee, etc.) which would prevent the use of the transaction value or require an additional adjustment to the import price.

Background

- In 2013, Customs in country I conducted a Post-Clearance Audit to verify ICO's declared import price

- ICO's transfer pricing policy showed that the import price of all luxury bags was determined using the Resale Price Method (in accordance with OECD Guidelines)

- At the end of each year, ICO estimated the resale price of the bags and the targeted gross margin for the next year.

- ICO then calculated the import price of luxury bags using the Resale Price Method according to the formula: *Import Price = Estimated Resale Price x (1 – Targeted Gross Margin)* / (1 + Duty Rate).

Background

Formula: (regardless of the influence of customs duty)

Import Price=Estimated Sale Price × (1 – Targeted Gross Margin)

e.g. The targeted gross margin for 2012 was estimated at 40%.
Estimated Sale Price of one luxury bags is 1000 C.U.

Import Price=1000× (1 – 40%) =600 C.U.

Background

- ICO is a simple or routine distributor.
- The marketing strategy for the sales of bags in country I is in fact established by XCO. XCO also advises on the **levels of inventory** to be maintained, and establishes the **recommended sales price** of the bags sold by ICO, including the **discounting policy** to be used by ICO. XCO has also invested heavily in developing valuable intangible assets associated with the bags, such as the designs and trademark.
- As a result, XCO assumes the market risk and price risk in relation to the sales of the bags in country I.

Background

- In 2012, since more bags were sold at full price, and fewer at a discounted price than anticipated, the actual sales income far exceeded the estimated income.
- Therefore, ICO's gross margin in 2012 was 64% which was higher than the estimated gross margin. Therefore Customs asked ICO to provide further information in order to review the acceptability of its declared import price.
- ICO submitted its 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.
- The transfer pricing report was prepared in accordance with the OECD Guidelines.

Background

- According to TP report, ICO was a simple distributor that performs distribution functions and does not employ any valuable, unique intangible assets or assumes any significant risk.
- The TP report selected 8 comparable companies located in country I. The functional analysis indicated that the 8 selected comparable companies imported similar goods from country X, performed similar functions and assume similar risks as ICO.
- The arm's length inter-quartile range of gross margins earned by the selected comparable companies was between 35%-46%, with a median of 43%. The 64% gross margin earned by ICO did not fall within the arm's length range.
- At the time of PCA , ICO had not made any transfer pricing adjustments .

TP study

8 comparable uncontrolled distributors

A B C D E F G H

Range of gross margins
35 % – 46%

median gross margin = 43%

PCA

XCO → Related → ICO

gross margin = 64%

Issue for determination

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

Analysis I

- A transaction value is acceptable when buyer and seller are not related, or if related, the relationship does not influence the price.

- Article 1.2 provides different means of establishing the acceptability of the transaction value:

1. Examine circumstances surrounding the sale to determine whether relationship influenced the price (Art. 1.2 (a))
2. The importer can demonstrate that price closely approximates a test value (Art. 1.2 (b))

Analysis II

- It is not possible to apply Art. 1.2 (b) since no test values were provided by ICO

- 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."*

Analysis III

- Customs consider 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.

- Functional analysis showed that there were no significant differences in functions, risks, and assets between ICO and the eight unrelated distributors

Analysis IV

- TP study found the arm's length inter-quartile range of the gross margin earned by the comparable companies ranged was between 35 %-46 % with a median of 43 %.
- ICO earned a gross margin of 64 % which was much higher than the normal gross margins
- By virtue of ICO earning a higher margin, XCO sold the merchandise at a lower price
- TP study indicated that ICO's prices were not settled in a manner consistent with the normal pricing practices of the industry.

Conclusion

- After 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.

- Customs value should be determined by application of the alternative methods of appraisement in a sequential order.

- 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.

Questions?