Transfer Pricing and Customs Valuation

Background and current developments
Transfer Pricing & Customs Valuation - Bridging the gap
What is Transfer Pricing?

- A price established for property, goods & services transferred between companies of a multi-national enterprise ("MNE") that control each other or that are controlled by a common entity.
- Sales within MNEs account for a large proportion of global international trade
- Transfer pricing can be used to shift profit to low tax jurisdictions
Objective of transfer pricing rules:

- Ensuring prices (and thus taxable profits) are what they would have been had the parties been independent of each other.

Countries introduce tax rules that:

- Require multinational enterprises to use *arm’s length pricing* for their internal transactions.
- .. and require them to demonstrate this by documenting their transfer pricing policies.
- Give tax administrations the authority to increase the tax measure of profit where multinational enterprises use non-arm’s length prices.
Transfer Pricing - foundations

- Ideally, involves testing the price against the price achieved in comparable, independent transactions (“CUP”)

- But, in practice, such data is often not available
  - 4 other OECD transfer pricing methods
  - Used to deduce the arm’s length price from available, sufficiently comparable, independent transactions
  - Ensuring profit aligned with value creation
Transfer Pricing - Adjustments

- Transfer pricing methods used to test transfer prices
  - Ideally applied transactionally
  - But in practice transactions often need to be aggregated → greater reliability given available, sufficiently comparable, independent data

- Periodic adjustments may be required
  - May be actual adjustments to price paid/payable
  - In some countries notional (i.e. for tax only) adjustments may be permitted
## Transfer pricing adjustments

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Compensating or.. ‘Year-end’ or.. ‘True -up’</td>
<td>Taxpayer – before tax return</td>
<td>Actual pricing</td>
<td>Compliance</td>
<td>Yes</td>
<td>Actual prices Taxable profit</td>
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<tr>
<td>Primary or .. ‘Audit’</td>
<td>Tax Administration- after tax return</td>
<td>Notional pricing</td>
<td>Enforcement</td>
<td>No</td>
<td>Taxable profit and (possible) penalties</td>
</tr>
<tr>
<td>Compliance</td>
<td>Taxpayer – in tax return</td>
<td>Notional pricing</td>
<td>Compliance</td>
<td>Yes</td>
<td>Taxable profit</td>
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<tr>
<td>Secondary</td>
<td>Taxpayer or tax admin – after a compliance or secondary adj.</td>
<td>Actual pricing or loan accounts or dividends</td>
<td>Take notional adjustment towards actual adjustments</td>
<td>Yes or no</td>
<td>Actual prices (possibly)</td>
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<tr>
<td>Corresponding</td>
<td>Tax administration</td>
<td>Taxable profit</td>
<td>Avoid double taxation</td>
<td>Yes-taxpayer requests, but not automatic</td>
<td>Taxable profit Notional prices</td>
</tr>
</tbody>
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OECD Transfer Pricing Guidelines

- Guidelines provide an international standard for direct taxation authorities. (not restricted to OECD Members)
- Guidelines require that determination of a corporate tax liability in each tax jurisdiction is based on the “arm’s length principle” incurred.
- Issued in 1979
- Substantially revised in 1995 and 2009
Comparison with WTO Valuation Agreement

- Comparable Uncontrolled Price (CUP)
  \[ \approx \text{identical value method \& similar value method (Article 2 \& 3)} \]

- Resale Price Method \( \approx \) Deductive value method (Article 5)

- Cost-plus Method \( \approx \) Computed value method (Article 6)

- Profit Methods:
  - Transactional Net Margin Method
  - Profit Split Method
  \[ \approx \text{Fallback value method (Article 7)} \]
Key Differences

**Customs Valuation**
- Goods only
- Transaction based
- Confirmed at point of customs clearance

**Transfer Pricing**
- Goods, services & property
- Based on aggregates/annual
- Confirmed retrospectively (some years after event)
Competing tensions

**Customs administration objective**
Ensuring all appropriate elements are included in the customs value

**Direct Tax authority objective**
Ensuring the transfer price does not include inappropriate elements

**Trade objective**
To minimise Customs value

**Trade objective**
To maximise transfer price (incl. cost of imported goods) to reduce taxable profit

Pull in opposite directions
What is the issue?

- Customs aim to verify whether a price has been influenced in a related-party transaction
- Multi-nationals offer a transfer pricing study as ‘proof’ that the transactions are ‘arm’s length’
  - Is this helpful to Customs?
- What are implications for Customs of TP adjustments?
Activities to date

- Two joint WCO/OECD conferences (2006, 2007)
- Focus Group 2007 – identified key issues
- On agenda of TCCV
- Commentary 23.1
Commentary 23.1

Examination of the expression “circumstances surrounding the sale” under Article 1.2 (a) in relation to the use of transfer pricing studies

- First text of the TCCV to refer to transfer pricing

- Key questions:
  - Has price been settled in a manner consistent with the normal pricing practices of the industry?
  - Is price adequate to ensure recovery of all costs plus a profit representative of the firm’s (seller’s) overall profit realized over a period of time?
  - Acknowledgement that a TP study may be of use in examining a related parties transaction
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%

Related parties

XCO

Exporter/manufacturer
parent company

 ICO

Goods sold for export
(transaction value)

Importer/ Distributor

Tested party
(distributor)
Operating margin = 2.5%