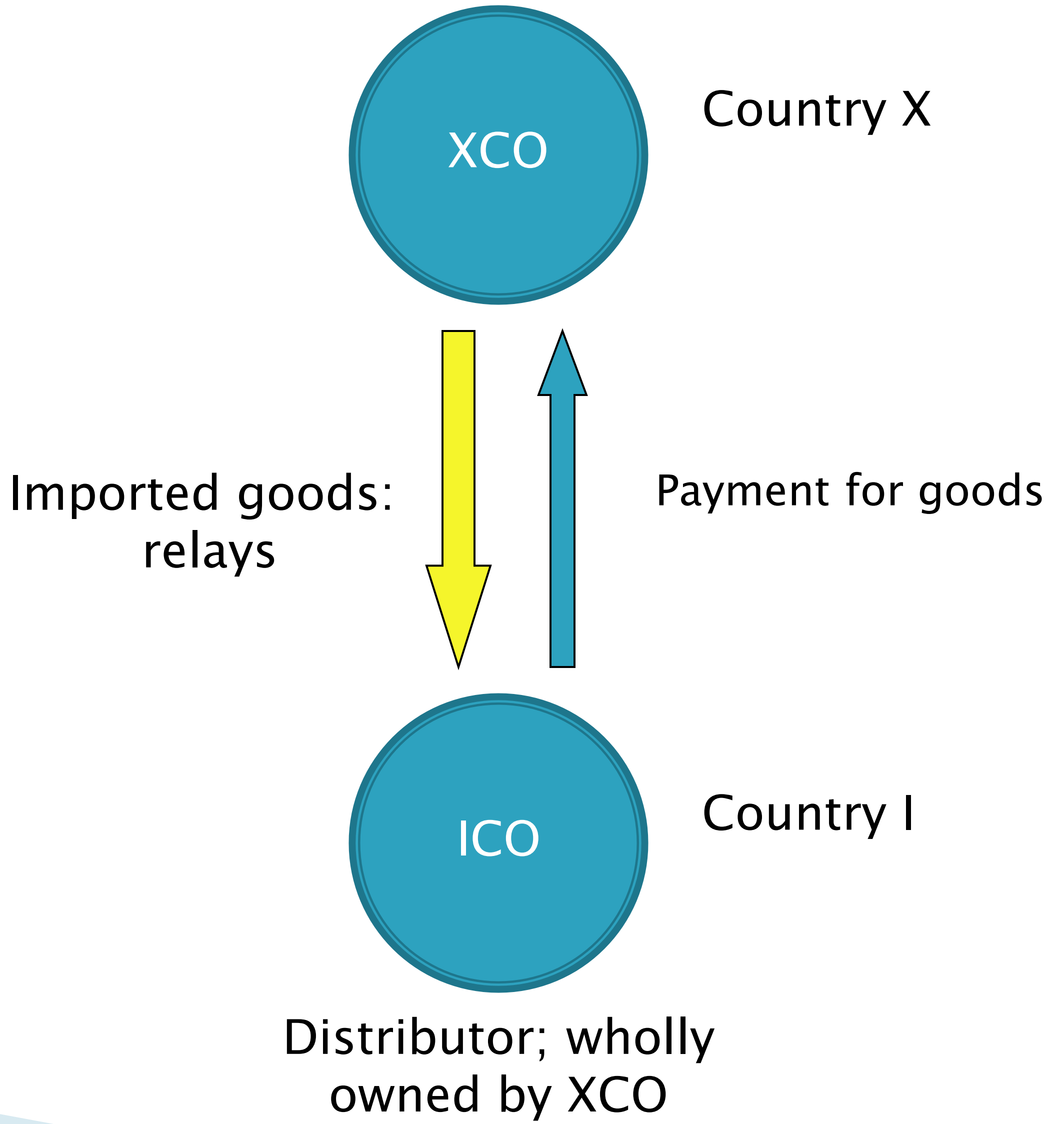
# Technical Committee on Customs Valuation

*draft case study*

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

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# 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

# 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
- As study concludes that it is possible to find reliable comparables for ICO, 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%***

# 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 sales | 2.5% of |

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# 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

- 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

- 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."*

# Analysis III

- 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

# Analysis IV

- 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.

# Analysis V

- Cost of Goods Sold (price paid or payable to XCO) is only figure **not** at arm's length (and therefore may not be reliable)
- Sales figure can be assumed to be reliable as ICO is selling to independent parties (assumed ICO is rationally seeking to maximise its profits in its dealings with arm's length parties)
- Operating expenses amount is assumed to be reliable since these expenses are paid by ICO to independent parties (assumed ICO rationally seeks to minimise its costs)
- Example assumes that an arm's length net operating profit margin for an importer such as ICO (i.e. based on a study of comparable, but independent importers) is 2.5% of sales

Therefore by working back from the arm's length net margin of 2.5%, the arm's length COGS (price paid/payable) amount can be deduced.

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