TRANSFER PRICING & CUSTOMS VALUATION

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Valuation Topics

- Related Party Transactions for Imports
  - Transaction Value
  - Related Parties and Related Party/Transfer Pricing
  - Value Risks in CBP Audits
  - Acceptability of Transaction Value in Related Party Transactions
  - Computed Value and Maquiladoras
  - Case Study on Related Party Pricing
Customs Valuation Hierarchy-

- Transaction Value;
- Transaction Value of Identical or Similar Merchandise (based on the transaction value of previously imported merchandise);
- Deductive Value (selling price in the US less certain post-importation costs);
- **Computed Value** (foreign supplier cost information for materials, processing, profit, general expenses, etc.); and
- Fallback Method (methodology based on a reasonable adjustment to the rules of one of the first four methods)
Transaction Value – 19 CFR 152.103

- Price **actually paid or payable** for the merchandise when **sold for exportation to the United States**, plus certain statutory additions to the price.
  - Transaction value is appropriate for most import transactions.
  - However, certain factors can change whether or not transaction value is appropriate for import valuation:
    - Related party transactions
    - Imports from Maquiladoras
RELATED PARTY TRANSACTIONS
Transaction Value – Customs Regulations at 19 CFR 152.102(g)

- When are Parties Considered “Related”?
  - Members of the same family;
  - Any officer or director of an organization and such organization;
  - An officer or director of an organization and an officer or director of another organization, if each such individual is also an officer or director in the other organization;
  - Partners, employer and employee;
  - Any person directly or indirectly owning, controlling, or holding with power to vote, 5 percent or more of the outstanding voting stock or shares of any organization and such organization; and
  - Two or more persons directly or indirectly controlling, controlled by, or under common control with, any person.
Related Party Pricing – Transfer Price

- A selling price between related parties is called a transfer price.
- Examples of transfer price:
  - Cost + 30% for Products in Segment X; Cost + 20% for Segment Y
  - List price less 40%
- Frequently, the company will have a transfer pricing matrix that shows the intercompany markup structure for each product segment.
- Importers will also frequently have an advance pricing agreement (APA) between the importer and IRS or other taxing authority that lays out an appropriate tax transfer pricing methodology for a set of transactions at issue over a fixed period of time.
Related Party Valuation Risks – CBP Audits

- If CBP is looking at related party transactions in an audit, they are going to assume:
  - Imports from related entities in Mexico should be appraised under computed value and the company should be filing reconciliation entries.
  - The importer should be able to get detailed country of origin information and records to substantiate free trade agreement or special duty provision claims.
  - The importer should be able to obtain detailed records to support country of origin (e.g., country of origin support for imports suspected of possible transshipment and subject to ADD/CVD).
  - The importer’s risk of valuation issues is very high and they will have improper valuation.
Related Party Valuation Risks – CBP Audits

- Regarding related party value, CBP will be looking for the following issues:
  - The seller is including a markup (i.e., cost + profit)
  - Acceptability of transaction value – more on this in a minute
  - Assists
  - Tooling payments
  - Royalties/Proceeds
  - Management Fees
  - Transfer price adjustments (true-ups)
  - And much, much, more...

- CBP will test specific related party import transactions (including proof of payment) and will also test transactions from accounts in the general ledger.
Related Parties – 19 CFR 12.103(j)

- *Limitations on use of transaction value*—(1) *In general.* The transaction value of imported merchandise will be the appraised value only if:
  - (iv) The buyer and seller are not related, or the buyer and seller are related but the transaction value is acceptable.

- The burden is on the importer to demonstrate that the relationship does not affect the price.
Acceptability of Transaction Value

- So how do I demonstrate that the value does not affect the price?
  - 19 CFR 152.103(j)(2) - The transaction value between a related buyer and seller is acceptable if an examination of the circumstances of sale indicates that their relationship did not influence the price actually paid or payable, or if the transaction value of the imported merchandise closely approximates a “test value”:
    - (A) The transaction value of identical merchandise; or of similar merchandise, in sales to unrelated buyers in the United States; or
    - (B) The deductive value or computed value of identical merchandise, or of similar merchandise.
    - Test Values – Good luck with that!
Circumstances of the Sale

- In order to support transaction value as an acceptable basis of appraisement, the importer must show that through an examination of the “circumstances of sale,” the relationship between the buyer and seller did not influence the price of the imported merchandise.

- Circumstances of the Sale tests:
  - The price was settled in a manner consistent with the normal pricing practices of the industry in question;
  - The price was settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related to it; or
  - The price is adequate to ensure recovery of all costs plus a profit that is equivalent to the firm’s (meaning parent company’s) overall profit realized over a representative period of time in sales of merchandise of the same class or kind.
Circumstances of the Sale - Options

- If the price has been settled in a manner consistent with the normal pricing practices of the industries in question.
  - For example, the price of imported copper is determined based on the London Metals Exchange price at the date of export, which is consistent with industry practice.

- If the price has been settled in a manner consistent with unrelated buyers.
  - If the seller sells the same products to other U.S. companies at the same price. Note that sales to other countries or sales within the seller’s home market will not be considered.
Circumstances of the Sale - Options

- If it is shown that the price is adequate to ensure recovery of all costs plus a profit, which is equivalent to the firm's overall profit realized over a representative period of time (e.g., on an annual basis), in sales of merchandise of the same class or kind, this would demonstrate that the price has not been influenced.
  - This where most importers end up.
  - Requires a comparison of the profit recognized on import transactions versus firm’s overall profit recognized.
    - Firm’s overall profit generally means that of the parent company.
    - You can’t necessarily take the overall parent profit margin – it has to be goods of the same class or kind as those imported.
Transfer Pricing Studies and IRS Advance Pricing Agreements

- “Wait a second, we have an approved APA with the IRS. Our related party transactions have already been approved.”
  - CBP published updated guidance on related party transactions in 2007 through an informed compliance publication and through ruling W548314 (May 2012).
    - The mere fact that the importer has satisfied IRS requirements does not mean that transaction value is acceptable.
    - Importer must analyze whether the related party transaction satisfies the circumstances of sale test or test values before making a value declaration.
    - “An importer that relies solely on a transfer pricing study or APA to conclude that transaction value is acceptable would not be exercising reasonable care”.

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Transaction Value – When It Doesn’t Work

“So what do I do when transaction value is not an acceptable basis of appraisement?”

- It depends!
- Following hierarchy, move to another basis of appraisement
- It should be noted that all bases of appraisement are based on the availability of sufficient information.
- Examples:
  - Moving to computed value (most common in maquiladora transactions, but also used in non-MX related party transactions).
  - Appraising under fallback and adjusting the profit on the import transactions to the firm’s overall profit. (e.g., increasing value of import transaction from line item profit of 5% to firm’s profit of 18%)
Maquiladoras and Computed Value – A Simple Approach

- Importer has a maquiladora in Mexico and does not pay on a per/shipment basis. The importer actually funds the entire operation of the plant and provides the majority of materials and equipment free of charge. Transaction value does not apply to this type of scenario.

- Importer declares standard cost at time of importation for imports from maquiladora in Mexico and flags each importation for value reconciliation.

- Importer is required to declare “actuals”; thus, a cost submission needs to be prepared that totals the aggregate actual computed value of imports.

- The total value declared to CBP (standard cost) over the course of the year is subtracted from the total actual computed value to identify a variance.

- The variance is declared to CBP via a reconciliation entry and any additional duties and fees are remitted.
Computed Value

As defined in 19 CFR 152.106, the computed value of imported merchandise is the sum of:

1. The cost or value of the materials employed in the production of the imported merchandise;
2. The cost of fabrication, assembly, or other processing of any kind employed in the production of the imported merchandise;
3. An amount for profit and general expenses;
4. Any assist, not already included in sections (1) through (3) above; and
5. Any packing costs, not already included in sections (1) through (4) above.
Cost Submission

- A cost submission is utilized to calculate the total computed value for a product segment (sometimes) or all products (more often) produced by an entity and is generally composed of the following categories, to calculate a total computed value.
  1. Materials – Standard cost of materials plus variances to update to actual costs
  2. The cost of fabrication, assembly, or other processing – taken directly from the Mexico financials;
  3. An amount for profit and general expenses – taken directly from the Mexico financials
  4. Any assist, not already included in sections (1) through (3) above; and
  5. Any packing costs, not already included in sections (1) through (4) above.
Cost Submission – Part 2

- Once the total computed value has been calculated, there are certain deductions, that are totally dependent on a particular scenario.

- Deduction Examples:
  - Production that is not shipped to the U.S. (e.g., shipped directly from the maquiladora to South America)
  - HTS 9801/9802 Materials – this ultimately depends on where material variances are applicable and if included in original materials calculation

- Once adjustments are made for deductions to calculate a revised total computed value, you subtract the total value declared to CBP to calculate a variance.

- This variance is then apportioned to entries, as applicable, through the reconciliation process.
Related Party Transactions – Audit Case Study

- Importer was the subject of a Focused Assessment
- Imported from several related parties from North America, Europe, and Asia
  - Mexico
    - 1 traditional maquiladora operation in Mexico where the U.S. owned the inventory and funded all operations
    - 1 traditional vendor operation in Mexico whereby the U.S. importer paid for each unit and did not fund operations
  - Parent company located in Japan
Related Party Transactions – Audit Case Study

- Prior to the start of the audit, the importer filed a prior disclosure that included valuation issues related to related party transactions:
  - Royalties, proceeds, and tooling payments (Millions of $)
  - Computed value issues with maquiladora operation in Mexico
    - Required the company to prepare cost submissions going back 5 years to quantify the value variance between standard cost declared at importation and actual cost under computed value (Variance was approx. 70%/year) as the company failed to update standard costs on northbound invoices
Related Party Transactions – Audit Case Study

- As part of the FA testing, Regulatory Audit required that the importer substantiate the acceptability of transaction value for related party shipments. CBP elected for the importer to substantiate 2 shipments:
  - Importation from related party in Mexico (traditional vendor – not the traditional maquiladora operation whereby computed value was applicable)
  - Importation from related party vendor in China.
Circumstances of the Sale – Case Study

Based on the transactions, it became apparent that we would need to show that the price was adequate to ensure recovery of all costs plus a profit as the other circumstances of the sale tests were not appropriate and test values are realistically impossible.

Plan of Action:

- Obtain breakdown from vendors on components of selling price, including profit, with corroborating documents as needed.
- Obtain financial statements of parent company in Japan and try to identify profit margin for sales of goods of the same class or kind.
- Compare the profit margins and write up a careful analysis for CBP.
Circumstances of the Sale – Case Study

- **Transaction 1 – Mexico**
  - Traced 2 products identified by CBP from invoice and traced these to the transfer pricing agreement, which corroborated the prices used for entry.
  - Obtained cost breakdown for each part from Mexico that showed a breakdown of material costs, overhead, profit, etc.
  - Analysis showed a profit 5%.

- **Transaction 2 – China**
  - Traced 2 products identified by CBP from invoice and traced these to the cost breakdown for each part from China that showed a breakdown of material costs, overhead, profit, etc.
  - Analysis showed a profit of 6.5%.
Circumstances of the Sale – Case Study

- Parent Company Profit
  - Obtained financial statements from Japan.
  - Firm operated in 3 distinct product segments and had an overall profit of 1.75%.
  - Obtained breakout by sector and identified sector that pertained to same products as what was imported.
  - Analysis showed a profit in this sector of 2.1%.

- Conclusion
  - The profit margin on the import transactions exceeded the firm’s overall profit on sales of goods of the same class or kind. This is good!
    - Mexico – Profit on import transactions was 5% vs. firm profit of 2.1%.
    - China – Profit on import transactions was 6.5% vs. firm profit of 2.1%.
Circumstances of the Sale – Case Study

- Carefully drafted the explanation and analysis and submitted to CBP Audit team with supporting documentation.
  - Auditors agreed with presentation.
  - A few weeks later, the Assistant Field Director calls and says the analysis was not valid and does not agree with transaction value as an appropriate basis of appraisement.
  - The AFD was improperly interpreting the valuation law, but we couldn’t convince until we were able to show a nearly identical ruling substantiating the all costs plus a profit methodology utilized.
  - AFD finally agrees, but requests additional support (standard vs. actual):
    - Support for labor
    - Costed Bills of materials for each item
    - Provide at least 2-3 invoices from 2-3 calendar quarters substantiating the highest value component from the bill of materials for each import.
Circumstances of the Sale – Case Study

- Additional documented obtained:
  - Support for direct labor:
    - Mexico – screen shots from system substantiating the direct labor portion of the costs
    - China – traced per/unit labor costs to financial statement segregated by imported unit.
  - Support for materials:
    - Bill of materials for each imported item
    - Obtained 6 purchase invoices for the highest value component from the bill of materials for each item from the entirety of the calendar year
      - Analysis showed only slight variations in unit price that would have an insignificant impact on the overall material cost of the imported item.
Circumstances of the Sale – Case Study

- Conclusion!
  - Provided all requested additional support to CBP with a thorough documented analysis showing that the price was adequate to ensure recovery of all costs plus a profit for sales of goods of the same class or kind and documenting all of the requested material and labor support requested by CBP.
  - After 3 months and over a 100 pages of analysis and supporting documentation, CBP accepted transaction value as the appropriate basis of appraisement for the two transactions.

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Takeaways for Related Parties

- **Value Issues:** Nearly every importer has some additions to value (assists, royalties, etc.) or supplemental payments (tooling, engineering, surcharges, transfer price adjustments). If you’re not aware of any, keep looking!

- **Can you use T/V?** Evaluate the acceptability of transaction value on your imports before CBP does.

- **Transfer Price under Customs:** Your APA or transfer pricing study does not exclude you from having to demonstrate the acceptability of your related party transactions through test values or through the circumstances of sale.

- ** Likely No T/V for Maquiladoras:** In most instances, maquiladora importations should be appraised under computed value, which essentially means you most likely need to be in reconciliation.

- Don’t be afraid to ask for help. This Customs valuation stuff can get really complicated!
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