

# Related-Party Pricing

## *U.S. Customs and Border Protection Versus the IRS*

By Alan Goggins

The U.S. Customs and Border Protection (CBP) issued a new Informed Compliance Publication, *What Every Member of the Trade Community Should Know About: Determining the Acceptability of Transaction Value for Related Party Transactions*, in April 2007. While this publication breaks no new ground, it is a signal that in the near future the CBP may scrutinize related-party valuation issues more closely.

Related-party transactions typically arise whenever either an overseas exporter or a U.S. importer directly or indirectly owns or controls 5% or more of the voting stock of the other party, or if both directly or indirectly control, are controlled by, or are under common control of, a third party. The prices in such related-party transactions are regulated in the United States by both CBP and the IRS, and may be regulated overseas as well by the exporting country's counterpart of the IRS.

The requirements imposed by CBP and the IRS are similar in theory because both seek to establish that the related-party prices are determined in an arm's-length transaction. However, these requirements are sometimes drastically different in the details of their application. Under the valuation statute (19 USC section 1401a) administered by CBP, the value declared for imported merchandise is almost always determined under the transaction value standard, because the statute requires that the secondary methods of appraisal (transaction value of identical or similar merchandise, deductive value, or computed value) be used only after the primary transaction value method is rejected. The U.S. Customs Service defines transaction value as "the price actually paid or payable for the merchandise when sold for exportation to the United States" plus certain additions. If such prices are between



unrelated parties, the inquiry ends. If related parties are involved, however, CBP may inquire as to whether such prices are acceptable for determining transaction value.

If the exporter and importer are related, one way to avoid a CBP inquiry into

the acceptability of the related-party prices is first-sale appraisal. First-sale appraisal is possible if the related exporter purchases the merchandise from an unrelated factory and the transactions otherwise qualify as sales for exportation



stances-of-sales test is met if the related-party prices are settled in a manner consistent with the normal pricing practices in the industry, such as when the related-party prices are tied to quoted public market prices, such as for traded commodities.

Variation 2 is met if the related-party prices are settled in a manner consistent with the way the seller settles prices in sales to unrelated buyers. For example, if the exporter sells the same merchandise to unrelated buyers in the U.S. or in other countries and uses the same pricing for-

if such sales do not exist in the United States and the exporter provides an adequate explanation of such sales.

Variation 3 is met if the related-party price is adequate to ensure recovery of all the exporter's costs plus a profit equal to its overall profit realized over a representative period of time, such as a year in sales of merchandise of the same class or kind. Anytime an analysis of the cost of production is undertaken, the amount of documentation necessary to satisfy CBP as to the accuracy of such costs is enormous; therefore, variation 3 is recommended only as a back-up method or if variations 1 and 2 do not apply.

The records necessary to satisfy CBP that the circumstances-of-sales test is met deserve mention. CBP will often reject circumstances of sales analyses because they contain statements that are not supported by evidence. Thorough documentation is a must for any circumstances-of-sales analysis.

**Test values.** The second method of establishing the acceptability of related-party prices is to determine whether such prices closely approximate the appraised value of the merchandise if one of the secondary methods of appraisal were used. Three variations exist. The first test value is the transaction value of identical or similar merchandise in sales to unrelated buyers in the United States. This variation requires the exporter to sell to unrelated buyers in the United States, or to have access to and documentation of its competitors' prices in sales to unrelated U.S. buyers.

Deductive value is the second possible test value and starts with the U.S. importer's resale prices to unrelated buyers in the United States, and then subtracts the duties and freight, the importer's selling, general, and administrative costs, and the profits in the United States.

The last possible test value is computed value, which looks at the exporter's cost of production, general overhead, and profits.

Unfortunately, CBP has a policy of not accepting any test values unless one of the secondary appraisal methods was actually used in a previous importation and was accepted by CBP. This policy effectively rewrites the statute and eliminates test values. If the valuation statute requires an importer to use transaction value unless

such method is rejected, then an importer would not have had the opportunity to use a secondary method of appraisal until after CBP questioned the acceptability of the related-party prices. According to CBP, by then it is too late.

Only a few court cases have addressed related-party pricing under the customs laws. Although the CBP's standing policy has been raised in those cases, the court decisions have not discussed it. Therefore, test values should be used only as a back-up method.

### IRS Transfer Pricing Tests

Unlike CBP, whose only options are accepting or rejecting related-party prices for transaction value appraisal purposes, the IRS can adjust transfer prices for tax purposes if such prices do not meet the IRS's tests. The IRS has several profit-based methods and three transaction-based methods for reviewing transfer prices. In addition to using one of these methods, the IRS requires a taxpayer to demonstrate that the method used provides the best and most reliable measure of the arm's-length nature of the transfer prices.

**Profit-based methods.** The profit-based methods include the comparable profits, comparable profit split, and residual profit split methods, all of which focus on overall profits and not on specific transactions. Profit comparisons are made either between the related parties or between the related parties and competitors. Because a customs value must be ascertained for each imported article, these IRS methods will generally not establish the acceptability of such related-party prices for CBP purposes.

**Transaction-based methods.** The IRS's transaction-based methods include the comparable uncontrolled price (CUP) method, the resale price method, and the cost-plus method. The CUP test compares the related-party transfer prices to the prices in sales to unrelated parties. Therefore, this method is very similar to variation 2 of CBP's circumstances of sales test and could possibly be met by the same type of documentation: an analysis comparing such related and unrelated prices and the sales invoices demonstrating such prices.

The IRS's resale price method compares the gross margin earned in related-party

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mulas, or if the prices are comparable at the same level of trade, then the related-party prices are acceptable for CBP purposes. The documentation necessary to satisfy CBP here would include a comparative analysis of the related and unrelated prices converted into a common currency, along with sales invoices from the exporter demonstrating such prices. CBP prefers a comparison using prices in sales to unrelated parties in the United States, but will accept comparisons to prices in sales to unrelated parties outside the United States,

sales to the gross margin earned in sales to unrelated parties. This method is typically used for a reseller. The IRS's cost-plus method is ordinarily used for a manufacturer, and again compares the gross margins earned in related- and unrelated-party sales. Therefore, the resale price method is somewhat similar to CBP's deductive test value, and the cost-plus method is somewhat similar to variation 3 of CBP's circumstances of sales test or the computed test value; but both of these IRS methods would have to undergo significant adjustments before they were acceptable to CBP.

### CBP Versus the IRS

Proactive U.S. taxpayers can obtain an advanced pricing agreement (APA) either with the IRS or with the IRS and the overseas taxing authorities. If they do not have an APA, many multinational companies prepare their own transfer pricing studies based on the IRS methods. In the aforementioned Informed Compliance Publication, CBP serves notice that the existence of an APA or a transfer pricing study will not by itself satisfy its inquiries into the acceptability of related-party prices for transaction value appraisal purposes. Instead, the importer must demonstrate how the IRS transfer pricing method used also satisfies one of the CBP tests. Similar in effect to an APA, a proactive importer can apply for a CBP ruling approving its related-party pricing. The CUP test is the only IRS method that appears to readily satisfy a CBP test as well. Information found in the other IRS transaction-based methods may help support one or more CBP tests, but significant adjustments would be required.

One other aspect of the interplay between the IRS and CBP with regard to related parties deserves mention. Under IRC section 1059A, the inventory costs of imported merchandise taken into account by a related-party importer for IRS purposes shall not exceed the value declared to CBP. This statute does not apply to first-sale appraisements, but applies a double penalty when, for example, a related-party importer does not declare an assist, one of the required additions to the price paid or payable. (Common assists include materials, components, tools, and dies or

molds supplied free of charge or at a reduced cost by the buyer of imported merchandise to the overseas parties.) Not only is the importer subject to CBP penalties for undervaluing its imported merchandise, but the IRS can disallow the tax deduction for the cost of that assist.

### Preparing Answers for Questions

Many companies devote significant time and resources preparing for when the IRS questions their transfer prices. Companies typically do not, however, devote comparable time and resources preparing for the

day CBP questions the acceptability of the related-party prices for purposes of transaction value appraisal. The recent Informed Compliance Publication serves notice that the CBP will probably raise these questions sooner rather than later. □

*Alan Goggins, Esq., CPA, a partner of the law firm Barnes, Richardson & Colburn, is a member of the NYSSCPA and its Relations with the Legal Community, Apparel and Textile, and Chief Financial Officers committees.*

## FIRST-SALE APPRAISEMENT

**T**he impetus for CBP's proposal to eliminate first-sale appraisal is a recent interpretation made by the World Trade Organization (WTO)'s Technical Committee on Customs Valuation of the definition of "sold for exportation to the United States," a phrase that also appears in the customs valuation statute [19 USC section 1401a(b)(1)] enforced by CBP. Such WTO interpretations, however, are not binding law in the United States.

A long line of court decisions dating back to the prior valuation statute known as export value, which included similar "sold for exportation to the United States" language, approved first-sale appraisal. More recently, the Court of Appeals for the Federal Circuit recognized that first-sale appraisal applies equally as well under the current transaction value statute, in effect since 1979 [see *Nissho Iwai American Corp. v. United States*, 982 F.2d 505 (Fed. Cir. 1992)].

The relevant language of the customs valuation statute has not been amended since *Nissho Iwai* was decided, and no court has overturned that decision. Judicial interpretations of statutes remain the law of the land until they are overturned by a higher court or Congress amends the statute to make the interpretation no longer applicable.

The CBP proposal is problematic for two reasons. First, CBP, as an administrative agency, is a part of the executive branch of the federal government, but its proposal seeks to usurp the authority vested solely in the legislative branch to make a judicial interpretation of a statute no longer applicable. Second, CBP's proposal, in effect, seeks to overturn judicial precedent.

If CBP adopts this proposal, the issue will end up in litigation, where the courts are likely to reject CBP's position. Nevertheless, CBP could extend this litigation for years by filing appeals. In the interim, importers that have employed first-sale appraisal will be forced to pay higher duties and seek refunds. CBP recently extended the due date for comments on this proposal to April 23, 2008; sometimes such comments succeed in getting CBP to reconsider its position.

