There is an inherent disconnect between the transfer pricing and customs duties perspectives in any given importing country. Transfer pricing and customs duties are both levied on transactions involving movement of goods and they use methodologies that, superficially at least, look very similar. Thus it may seems unreasonable that each of those perspectives in practice may produce very different results. One of the reasons for that is the fact that the corporate tax authorities have an incentive for the goods’ price to be low, which increases the profit earned in the importing country and the corporate tax payable, but the customs authorities have an incentive for the goods’ price to be high insofar as import taxes are payable against this value (eg, customs duties and import VAT). Given this fundamental contradiction, it is no surprise that devising appropriate pricing models for goods will be challenging for businesses.

Although the pressure on multinational enterprises to coordinate their approach across various areas of taxes is higher than ever, there are still instances of transfer pricing models being designed without taking into consideration the customs duties implications, which is a situation that is often difficult to unravel. Therefore, it is very important to recognise the areas where the transfer pricing and customs duties perspectives may overlap and the reasons why any differences in the approaches may arise in order to tackle tensions and identify solutions during the planning stages. When doing so it may not be always possible to completely align customs and transfer pricing approaches, but it seems practical to at least assess the materiality and benefits of each and select a solution that represents a conscious decision on where to make the trade off. It also seems reasonable that the documentation for the pricing policies implemented should be sensitive to both issues in case of challenges.

This article focuses on identification of such areas, explaining the reasons for the disconnect between the transfer pricing and customs duties approaches proposing solutions and best practice approaches.

The key challenge for businesses who import goods is the fact that customs authorities are often unfamiliar with the technical aspects of transfer pricing methodologies and not well connected with the practical approaches applied by taxpayers when it comes to pricing goods. This is important since importers must justify the transfer pricing approach taken for pricing goods to the customs authorities in order to prove the correct amount of import taxes were payable. Although the customs authorities are similarly concerned with the arm’s length nature of the goods’ prices, the methodologies under which they test this may differ. Lastly the amounts which must be included in the goods’ price under customs laws differ to some extent from those which must be included from the transfer pricing perspective. Therefore under certain circumstances the invoice price charged for goods may be different for customs purposes than that calculated for transfer pricing purposes.

The main triggers of tensions between customs and transfer pricing can be broadly split into existing and new events. The former include indirect tax efficiencies/impracticalities resulting from price setting under transfer pricing policies that are devised without consideration of the customs perspective (eg transfer pricing adjustments). The latter will fall within at least one of the below categories:

- Operating model changes;
- New intellectual property payments;
- New service fee payments;
- New sourcing flows.

In addition, the post Base Erosion and Profits Shifting (BEPS) project new country by country reporting requirements revealing margins in a number of taxpayers’ territories may lead to this data being used by the customs authorities who will typically focus on the territories with high margins, arguing that importers product prices are not high enough.

Tensions additionally arise from the different perspectives of the responsible authorities and their approach to evaluating whether the taxpayer’s approach arrives at the correct end result. For example, for transfer pricing purposes a transaction will be looked at and assessed on an annual basis, whilst for customs the price for goods will be evaluated on a shipment by shipment basis. This is only one example of the lack of alignment between the approaches of the two authorities. Other examples may include:
• Approach to comparability analysis, e.g. customs laws do not specifically allow for consideration of functional, assets and risk profile of a company but instead focus on simply the type of goods imported;
• Selection of the profit level indicator, e.g. in many cases customs authorities focus on a gross margin analysis whilst transfer pricing authorities often focus on the net margin;
• Approach to selection of the tested party, e.g. in some cases, the customs authorities may focus on testing the seller of goods even if they are the more complex entity, whilst from the transfer pricing perspective the focus is often put on the least complex party;
• Approach to positioning in and outside of the range, e.g. instances where a taxpayer achieves a result higher than the inter-quartile range increases the risk of customs authorities arguing the goods’ prices are too low;
• Consistent global solutions may be difficult to manage from both the customs and transfer pricing perspective which further increases the risk of misalignment in both areas of taxes.

In practice, there are some common red flags that indicate a potential disconnect between customs and transfer pricing. The most common causes of red flags are issues around the pricing of goods and the existence of royalty payments which include the following:

• Goods sold at cost or small uplifts on external costs may indicate that no product related intellectual property rights are embedded in the product price as often required for customs purposes;
• The price for goods is not final at the time of import which may lead to under or overvaluation of goods and / or potentially difficult changes to import declarations after importations occurred;
• High margins indicate potentially low prices for goods and often challenged by customs authorities (particularly when returns achieved are higher than the inter-quartile range of comparable study data);
• Licensor not involved in the goods’ transaction flow indicates a high risk that part of the relevant royalty relates to product related rights which are treated as dutiable by customs authorities, but have not been included in the customs value;
• Various group entities receive royalty payments, increases the risk of potentially undervaluing goods or being in a position of having to add royalty payments to the goods’ price in an administratively burdensome process;

Despite the various disconnects and challenges highlighted above, taxpayers have opportunities to manage these tensions and to maximise both direct and indirect tax efficiencies. This is typically done by assessing pricing models through a joint transfer pricing and customs approach. The opportunity for adopting such an approach has become more enhanced in recent years due to developments at both the World Customs Organisation (“WCO”) and local country levels. For example WCO advisory documents at the international level expressly support use of transfer pricing approaches to document and support customs valuations (e.g. the New WCO Guide to Customs Valuation and Transfer Pricing, June 2015). As part of that the customs and tax authorities are encouraged to work together and exchange information and knowledge in this area. In addition, some territories have recently enacted policy changes accepting transfer pricing methodologies and demonstrating flexibility when reacting to transfer pricing developments, e.g. transfer pricing adjustments. For example Korea opened an opportunity for advance pricing agreements for both tax and customs duty purposes and implemented a rule which indicates that if one tax authority adjusted the price, the other authority cannot challenge it. These policy changes present further opportunities to manage tensions.

Linking together the transfer pricing and customs duties perspectives through a joint review and approach additionally manages risk, in particular from the customs perspective, and may also lead to joint tax efficiencies. It is also critically important for the relevant transfer pricing and customs documentation to be aligned in any joint transfer pricing and customs exercise. This is because the customs authorities are particularly focused on documentation and the underlying reasons supporting the customs valuations declared under customs laws and methodologies. Simply supporting the customs position using transfer pricing methodologies and documentation will in many cases not be acceptable.

In addition, more and more we see businesses simultaneously engaging tax authorities via advance pricing agreements (APA) and customs authorities via various customs rulings processes available depending on the local country rules. In such cases, the objective of the process is to obtain certainty in relation to the same transaction(s) from both perspectives. Such a formal approach may not always be necessary, although there may be an incentive for taxpayers to simultaneously obtain certainty over a specific period of time for both transfer pricing and customs.
The takeaway/conclusion

Managing the transfer pricing and customs tensions is often challenging for businesses. This is due to fundamental disconnects in the law, methodologies and approaches of the transfer pricing and customs authorities.

There are opportunities nonetheless to effectively manage these tensions and also gain additional cross tax efficiencies and reduce risk/administrative burden. To achieve this a joint transfer pricing and customs approach should be considered to:

- Consider materiality of the issue and identify the ‘low hanging fruit’;
- Analyse options for properly considered and implemented ‘unbundling’ (e.g. post import IP/services);
- Minimise or appropriately planning for transfer pricing adjustments; and
- Build compliant good prices to avoid post import challenges and/or admin burden.
- Design appropriate legal and transaction documentation;
- Consider engaging with both authorities.

Whilst there continues to be challenges in convincing customs authorities to accept transfer pricing approaches, international and local country developments suggest that there is a movement towards greater harmonisation. Whilst we see more and more examples of local solutions enabling more significant alignment between customs and transfer pricing, it may not be always possible to completely match those approaches. It seem however practical that the pricing policies implemented should at least be designed taking into account both areas and any supporting documentation should be sensitive to both issues in case of challenges.

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