

WCO
Guide to Customs
Valuation and
Transfer Pricing

New
edition
2018



WORLD CUSTOMS ORGANIZATION

CONTENTS

CHAPTER 1 : INTRODUCTION	4
1.1. WHO SHOULD READ THIS GUIDE?	4
1.2. WHAT IS THE ISSUE?	4
1.3. WHAT ARE THE BENEFITS ?.....	5
CHAPTER 2 : CUSTOMS VALUATION AND RELATED PARTY TRANSACTIONS.....	6
2.1. BACKGROUND TO CUSTOMS VALUATION METHODOLOGY	6
2.2. RELATED PARTY TRANSACTIONS: “TEST VALUES”	9
2.3. RELATED PARTY TRANSACTIONS: “CIRCUMSTANCES SURROUNDING THE SALE”	9
2.4. TRANSACTION VALUE – ADJUSTMENTS TO THE PRICE ACTUALLY PAID OR PAYABLE.....	10
2.5. ALTERNATE VALUATION METHODS	11
CHAPTER 3 : AN INTRODUCTION TO TRANSFER PRICING	14
3.1. WHAT IS TRANSFER PRICING?	14
3.2. HISTORY AND CURRENT STATE OF PLAY	17
3.3. LEGAL FRAMEWORK.....	19
3.3.1. <i>Domestic Legislation</i>	19
3.3.2. <i>Tax Treaties</i>	20
3.3.3. <i>OECD Transfer Pricing Guidelines</i>	22
3.3.4. <i>United Nations Practical Manual</i>	23
3.3.5. <i>Other</i>	24
3.4. THE ARM’S LENGTH PRINCIPLE AND ITS APPLICATION IN PRACTICE	24
3.4.1. <i>Arm’s length principle</i>	24
3.4.2. <i>Comparability</i>	25
3.4.3. <i>Transfer Pricing Methods</i>	32
3.4.4. <i>Selection of Transfer Pricing Method</i>	42
3.4.5. <i>Selection of Tested Party</i>	43
3.4.6. <i>Arm’s Length Range</i>	44
3.4.7. <i>Transfer Pricing Adjustments</i>	45
3.5. DISPUTE AVOIDANCE AND RESOLUTION	47
3.5.1. <i>Advance Pricing Arrangements</i>	47
3.5.2. <i>Mutual Agreement Procedure</i>	47
3.6. SELECTED PRACTICAL ISSUES	48
3.6.1. <i>Difficulties in obtaining comparable information</i>	48
3.6.2. <i>Secret Comparables</i>	49
3.6.3. <i>Use of whole of entity financials as comparables</i>	49
3.6.4. <i>Use of the profits based transfer pricing methods</i>	50
3.6.5. <i>Aggregation of controlled transactions</i>	51
3.6.6. <i>Business Restructurings and Typical Business Models</i>	51
3.7. TRANSFER PRICING COMPLIANCE	52
3.7.1. <i>Annual Reporting Schedules</i>	52
3.7.2. <i>Transfer Pricing Documentation</i>	52
APPENDIX 1 : EXAMPLES OF FINANCIAL INDICATORS CALCULATIONS.....	54
APPENDIX 2 : REFERENCES.....	56
CHAPTER 4 : LINKAGES BETWEEN TRANSFER PRICING AND CUSTOMS VALUATION	57
4.1. BACKGROUND.....	57

4.2.	PRACTICAL USE OF TRANSFER PRICING DOCUMENTATION	59
4.3.	JOINT WCO – OECD CONFERENCES / WCO FOCUS GROUP	59
4.4.	WORK OF THE TECHNICAL COMMITTEE ON CUSTOMS VALUATION (TCCV).....	60
4.5.	WCO COOPERATION WITH OECD AND WORLD BANK GROUP (WBG)	60
4.6.	PRIVATE SECTOR VIEWS - ICC POLICY STATEMENT	61
CHAPTER 5 : USING TRANSFER PRICING INFORMATION TO EXAMINE RELATED PARTY TRANSACTIONS.....		63
5.1.	INTRODUCTION.....	63
5.2.	EXAMINATION OF THE PHRASE “CIRCUMSTANCES SURROUNDING THE SALE” IN ARTICLE 1.2 (A) OF THE AGREEMENT VIA USE OF TRANSFER PRICING DOCUMENTATION.....	63
5.2.1.	<i>Background</i>	63
5.2.2.	<i>Key challenges</i>	64
5.2.3.	<i>Use of Advance Pricing Arrangements (APAs) and advance rulings for Customs valuation.....</i>	67
5.3.	CUSTOMS VALUATION TREATMENT WHERE A TRANSFER PRICING AGREEMENT INDICATES THAT THE DECLARED CUSTOMS VALUE WILL BE ADJUSTED AT A LATER DATE.....	68
5.3.1.	<i>Background</i>	68
5.3.2.	<i>Possible Customs treatment of transfer pricing adjustments</i>	69
5.3.3.	<i>Final determination of the Customs value following transfer pricing adjustments</i>	70
5.3.4.	<i>Practical challenges</i>	71
CHAPTER 6 : RAISING AWARENESS AND CLOSER WORKING.....		72
6.1.	INTRODUCTION.....	72
6.2.	GOOD PRACTICES FOR CUSTOMS VALUATION POLICY MANAGERS	72
6.3.	GOOD PRACTICES FOR BUSINESS.....	73
6.4.	GOOD PRACTICES FOR TAX ADMINISTRATIONS	73
ANNEX I : NATIONAL INITIATIVES		75
ANNEX II : MEETING OF THE FOCUS GROUP ON TRANSFER PRICING BRUSSELS, 26 OCTOBER 2007 – RECOMMENDATIONS		81
ANNEX III : TECHNICAL COMMITTEE ON CUSTOMS VALUATION - COMMENTARY 23.1		82
ANNEX IV: TECHNICAL COMMITTEE ON CUSTOMS VALUATION – COMMENTARY 4.1		84
ANNEX V : TECHNICAL COMMITTEE ON CUSTOMS VALUATION – CASE STUDY 10.1		86
ANNEX VI : TECHNICAL COMMITTEE ON CUSTOMS VALUATION – CASE STUDY 14.1		89
ANNEX VII : TECHNICAL COMMITTEE ON CUSTOMS VALUATION – CASE STUDY 14.2		93
ANNEX VIII : ICC POLICY STATEMENT		97
ANNEX IX : A GLOSSARY OF COMMON TRANSFER PRICING TERMS.....		106
ANNEX X : TRANSFER PRICING DOCUMENTATION : EXAMPLE OF STRUCTURE.....		111
ANNEX XI : ACKNOWLEDGEMENTS AND THANKS		113

Chapter 1 : INTRODUCTION

1.1. WHO SHOULD READ THIS GUIDE?

This Guide concerns the relationship between Customs valuation and transfer pricing. It is designed primarily to assist Customs officials responsible for Customs valuation policy or who are conducting audits and controls on multi-national enterprises (MNEs). It is also recommended reading for the private sector and tax administrations who have an interest in this topic.

The Guide does not provide a definitive approach to dealing with this issue. At the time of writing, the Technical Committee on Customs Valuation - the body which has the competence to consider technical interpretation of Customs valuation matters - continues to discuss the issue. Instead, the Guide provides technical background and offers possible solutions regarding the way forward, and shares ideas and national practices, including the trade view.

New in 2018 edition

The 2018 edition includes updates to reflect developments on transfer pricing at the OECD including the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project (Chapter 3), information on recent texts concluded by the Technical Committee on Customs Valuation (Chapter 4), updates to national initiatives (Annex I) and minor drafting changes.

1.2. WHAT IS THE ISSUE?

For Customs valuation purposes, import transactions between two distinct and legally separate entities of the same MNE group¹ are treated as 'related party transactions'. Such transactions may be examined by Customs to determine whether the price declared for the imported goods is 'influenced' by the relationship. In other words, is the price at which the goods have been sold at a lower level than it would have been had the parties not been related and the price had been freely negotiated?

The methodology for determining the Customs value for imported goods subject to ad valorem duty rates is set out in the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 ("the Agreement"). All WTO Members countries have an obligation to implement the Agreement and apply this methodology. Some non-WTO Members also choose to adopt it, hence it applies to the vast majority of all international trade. Further details are provided in [Chapter 2](#).

MNEs also have a direct taxation liability on company profits in most countries around the world. The mechanism by which MNEs determine prices for goods, services and assets bought and sold within the group is known as 'transfer pricing'. The OECD has developed

¹ Multinational enterprise group (MNE Group): A group of associated companies with business establishments in two or more countries.(OECD Transfer Pricing Guidelines, 2010)

guidelines based on the 'arm's length principle' for the setting and testing of transfer prices for direct tax purposes. The arm's length principle is generally accepted as the international standard used by businesses and tax authorities. Further details on transfer pricing are provided in [Chapter 3](#).

The relationship between Customs valuation and transfer pricing has been discussed in various national and international fora over a number of years (see [Chapter 4](#)). The business community has raised the issue as a matter of concern, in particular advocating that Customs take into account available transfer pricing information prepared for direct tax purposes when examining related party transactions and also give consideration to the impact of transfer pricing adjustments on the Customs value. It has been recognised that at this stage any alignment or merger of tax and Customs methodologies is not a realistic proposition given the particulars of the existing legal frameworks upon which they are based. The essence of the issue therefore is contained in the following question: to what extent can information contained in transfer pricing documentation, primarily developed for taxation purposes, provide useful information for Customs to determine whether or not the price declared for imported goods has been influenced by the parties' relationship, in order to make a final determination of the Customs value?

The Technical Committee on Customs Valuation has confirmed the basic principle that transfer pricing documentation may provide useful information for Customs in respect of related party transactions, on a case by case basis (see [Chapter 4](#)). The focus is now on providing further guidance to Customs on how to examine and interpret transfer pricing documentation which may be helpful in this regard. The other key question is the impact of adjustments made (after importation) for transfer pricing purposes; in which cases, if any, should such adjustments be taken into account by Customs in determining the Customs value of the imported goods?

Additionally, the WCO is working with the OECD and World Bank Group to encourage Customs and tax administrations to establish bilateral lines of communication in order to exchange knowledge, skills and data, where possible, which will help ensure that each authority has the broadest picture of a MNE's business, its compliance record and can make informed decisions on the correct revenue liability.

1.3. WHAT ARE THE BENEFITS ?

Greater understanding of this issue and a sharing of ideas and solutions will provide more certainty for governments and business and will lead to a more consistent approach and accurate determination of duty liabilities. Burdens on business can also be reduced by taking a more joined-up approach, which can be seen as an important trade facilitation measure.

Chapter 2 : CUSTOMS VALUATION AND RELATED PARTY TRANSACTIONS

2.1. BACKGROUND TO CUSTOMS VALUATION METHODOLOGY

This chapter provides technical information on Customs valuation methodology, in particular the provisions relevant to the transaction value method and the conditions which apply to related party transactions. Further information on all aspects of Customs valuation can be obtained via the WCO website here:

<http://www.wcoomd.org/en/topics/valuation/overview.aspx> and via the WCO Bookshop link: <http://wcoomdpublications.org/valuation.html>

The Customs value of imported goods is primarily used as the basis for determining Customs duty liability for imported goods where ad valorem duty applies. Tariff classification and preferential origin are the other key elements necessary for establishing duty liability. Valuation, classification and origin are also vital for international trade statistics.

Customs valuation methodology is set out in the WTO Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (the 'Agreement'). The Agreement contains a hierarchy of valuation methods and establishes the transaction value method as the primary method. The General Introductory Commentary to the Agreement states that :

1. The primary basis for Customs value under this Agreement is "transaction value" as defined in Article 1. Article 1 is to be read together with Article 8 which provides, inter alia, for adjustments to the price actually paid or payable in cases where certain specific elements which are considered to form a part of the value for Customs purposes are incurred by the buyer but are not included in the price actually paid or payable for the imported goods. Article 8 also provides for the inclusion in the transaction value of certain considerations which may pass from the buyer to the seller in the form of specified goods or services rather than in the form of money. Articles 2 through 7 provide methods of determining the Customs value whenever it cannot be determined under the provisions of Article 1.

Furthermore, the Preamble to the Agreement states: "Recognizing that the basis for valuation of goods for Customs purposes should, to the greatest extent possible, be the transaction value of the goods being valued;". Many countries have reported that the transaction value is used in 90 – 95% of all importations.

As stated above, there are two main components to the transaction value. The first, described in Article 1, is the price actually paid or payable for the goods when sold for export to the country of importation. The second is a series of cost elements not included in the invoice price (known as 'adjustments') which are to be added to the price established under Article 1, where necessary criteria are met, to arrive at the transaction value. These adjustments are described in Article 8.

The first step is to determine whether the goods in question have been sold for export.

Advisory Opinion 1.1 states that the term “sale” should be interpreted as widely as possible. It also provides examples of situations in which the imported goods are deemed not to have been the subject of a sale, e.g. free of charge consignments, goods imported under a hire or leasing contract and goods imported by branches which are not separate legal entities.

With reference to the latter example, it is noted that subsidiaries within a MNE are often independent legal entities, rather than branches, hence in such cases, sales between, for example, parent and subsidiary, are treated as sales within the meaning of Article 1.

Article 1 also sets out certain conditions and restrictions which may affect the acceptability of the price actually paid or payable. Included in these criteria is the situation where the buyer and seller of the imported goods are related. The definition for related parties, contained in Article 15.4 of the Agreement, is as follows :

4. For the purposes of this Agreement, persons shall be deemed to be related only if :

- (a) they are officers or directors of one another's businesses;*
- (b) they are legally recognized partners in business;*
- (c) they are employer and employee;*
- (d) any person directly or indirectly owns, controls or holds 5 per cent or more of the outstanding voting stock or shares of both of them;*
- (e) one of them directly or indirectly controls the other;*
- (f) both of them are directly or indirectly controlled by a third person;*
- (g) together they directly or indirectly control a third person; or*
- (h) they are members of the same family.*

Having established that buyer and seller are related, the Agreement makes clear that this in itself is not grounds for regarding the transaction value as unacceptable. The transaction value may still be accepted provided that the relationship did not influence the price. If, in the light of available information, Customs has grounds for considering that the relationship influenced the price, it is required to conduct further enquiries with the importer before reaching a conclusion. Further details on the procedures to be followed by Customs and the importer are set out in Article 1.2; see key extracts reproduced below.

Article 1 and its Interpretative Note indicate two main approaches for examining whether or not, in a particular case, a related party transaction has been influenced by the relationship :

I. "Circumstances surrounding the sale "

Article 1.2 (a)

a) In determining whether the transaction value is acceptable for the purposes of paragraph 1, the fact that the buyer and the seller are related within the meaning of Article 15 shall not in itself be grounds for regarding the transaction value as unacceptable. In such case the circumstances surrounding the sale shall be examined and the transaction value shall be accepted provided that the relationship did not influence the price. (...)

Note to Article 1, Paragraph 2

2. Paragraph 2 (a) provides that where the buyer and the seller are related, the circumstances surrounding the sale shall be examined and the transaction value shall be

accepted as the Customs value provided that the relationship did not influence the price. It is not intended that there should be an examination of the circumstances in all cases where the buyer and the seller are related. Such examination will only be required where there are doubts about the acceptability of the price. Where the Customs administration have no doubts about the acceptability of the price, it should be accepted without requesting further information from the importer. For example, the Customs administration may have previously examined the relationship, or it may already have detailed information concerning the buyer and the seller, and may already be satisfied from such examination or information that the relationship did not influence the price.

3. Where the Customs administration is unable to accept the transaction value without further inquiry, it should give the importer an opportunity to supply such further detailed information as may be necessary to enable it to examine the circumstances surrounding the sale. In this context, the Customs administration should be prepared to examine relevant aspects of the transaction, including the way in which the buyer and 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. Where it can be shown that the buyer and seller, although related under the provisions of Article 15, buy from and sell to each other as if they were not related, this would demonstrate that the price had not been influenced by the relationship. As an example of this, if the price had been settled in a manner consistent with the normal pricing practices of the industry in question or with the way the seller settles prices for sales to buyers who are not related to the seller, this would demonstrate that the price had not been influenced by the relationship. As a further example, where it is shown that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time (e.g. on an annual basis) in sales of goods of the same class or kind, this would demonstrate that the price had not been influenced.

II. "Test Values"

Article 1.2 (b)

(b) In a sale between related persons, the transaction value shall be accepted and the goods valued in accordance with the provisions of paragraph 1 whenever the importer demonstrates that such value closely approximates to one of the following occurring at or about the same time:

- (i) the transaction value in sales to unrelated buyers of identical or similar goods for export to the same country of importation;
- (ii) the Customs value of identical or similar goods as determined under the provisions of Article 5;
- (iii) the Customs value of identical or similar goods as determined under the provisions of Article 6;

In applying the foregoing tests, due account shall be taken of demonstrated differences in commercial levels, quantity levels, the elements enumerated in Article 8 and costs incurred

by the seller in sales in which the seller and the buyer are not related that are not incurred by the seller in sales in which the seller and the buyer are related.

(c) The tests set forth in paragraph 2(b) are to be used at the initiative of the importer and only for comparison purposes. Substitute values may not be established under the provisions of paragraph 2(b).

Note to Article 1, Paragraph 2

4. Paragraph 2(b) provides an opportunity for the importer to demonstrate that the transaction value closely approximates to a "test" value previously accepted by the Customs administration and is therefore acceptable under the provisions of Article 1. Where a test under paragraph 2(b) is met, it is not necessary to examine the question of influence under paragraph 2(a). If the Customs administration has already sufficient information to be satisfied, without further detailed inquiries, that one of the tests provided in paragraph 2(b) has been met, there is no reason for it to require the importer to demonstrate that the test can be met. In paragraph 2(b) the term "unrelated buyers" means buyers who are not related to the seller in any particular case.

Note to Article 1, Paragraph 2 (b)

A number of factors must be taken into consideration in determining whether one value "closely approximates" to another value. These factors include the nature of the imported goods, the nature of the industry itself, the season in which the goods are imported, and, whether the difference in values is commercially significant. Since these factors may vary from case to case, it would be impossible to apply a uniform standard such as a fixed percentage, in each case. For example, a small difference in value in a case involving one type of goods could be unacceptable while a large difference in a case involving another type of goods might be acceptable in determining whether the transaction value closely approximates to the "test" values set forth in paragraph 2(b) of Article 1.

These two approaches are further analysed as follows, starting with the latter :

2.2. RELATED PARTY TRANSACTIONS: "TEST VALUES"

As stated in Article 1.2 (c), test values are to be used at the initiative of the importer. So, the extent to which they are used depends on the importer's ability to access and produce relevant price data to Customs. It can be seen that the criteria to be met under Article 1.2 (b) (i), (ii) and (iii) require prices to be produced which pertain to identical or similar goods. However, manufactured goods often contain technology or intellectual property unique to the MNE so such comparison prices are typically not available. Furthermore, goods sold by MNEs within their own group are often not sold to unrelated parties. Hence, this option is rarely used in practice.

2.3. RELATED PARTY TRANSACTIONS: "CIRCUMSTANCES SURROUNDING THE SALE"

This option allows Customs to examine in broader terms how a price was determined. The Agreement states that is not intended that there should be an examination of the

circumstances surrounding the sale in all cases where the buyer and the seller are related, only in cases where Customs have doubts about the acceptability of the price.

When Customs decides to conduct an enquiry, the importer should be given an opportunity to supply further detailed information as necessary to enable it to examine the circumstances surrounding the sale in order to determine whether or not the price had not been influenced by the relationship

As quoted above, the Interpretative Note provides advice and examples of this, in the form of questions, which can be summarised as follows :

1. Has the price been settled in a manner consistent with the normal pricing practices of the industry in question?
2. Has the price been settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related to the seller?
3. Can it be demonstrated that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time (e.g. on an annual basis) in sales of goods of the same class or kind?

These options will be considered in more detail later in the Guide.

Example of Customs examining circumstances surrounding the sale - Case Study 10.1 – Application of Article 1.2

This instrument of the TCCV considers a situation where Customs examined the circumstances surrounding the sale of two products sold between related parties.

In the first case, the product concerned was sold by the seller to a related buyer in the country of importation and also to an unrelated buyer at a higher price. It was established that the costs incurred by the exporter were the same in the sales to both the related and unrelated buyers. The importer failed to explain why the price differed in each case and there were insufficient grounds to take the view that the price difference was not significant.

In the case of the other product, which was sold only between related parties, Customs established that the prices charged to the related buyer were adequate to recover all the seller's costs, including the costs of acquisition plus the costs of repacking, handling and freight charges, as well as to recover a profit that was representative of the firm's overall profit over a representative period of time. The transaction value in this case was therefore accepted.

The full case is reproduced in [Annex V](#).

2.4. TRANSACTION VALUE – ADJUSTMENTS TO THE PRICE ACTUALLY PAID OR PAYABLE

Article 8 of the Agreement details elements which should be included in the transaction value, in addition to the price actually paid or payable.

These adjustments include :

- selling commissions and brokerage, but not buying commissions;
- the value of certain goods and services supplied by the buyer free of charge or at reduced cost for use in connection with the production and sale for export of the imported goods, including :
 - o materials, components, parts incorporated in the imported goods;
 - o tools, dies, moulds etc. used in the production of the imported goods;
 - o materials consumed in the production of the imported goods and,
 - o engineering, development, artwork, design work, and plans and sketches undertaken elsewhere than in the country of importation and necessary for the production of the imported goods;

This category is known as “assists”.

- royalties and licence fees related to the goods being valued that the buyer must pay, either directly or indirectly, as a condition of sale of the goods being valued, to the extent that such royalties and fees are not included in the price actually paid or payable;
- the value of any part of the proceeds of any subsequent resale, disposal or use of the imported goods that accrues directly or indirectly to the seller.

Additionally, WTO Members have an option whether or not to include the following elements:

- (a) the cost of transport of the imported goods to the port or place of importation;
- (b) loading, unloading and handling charges associated with the transport of the imported goods to the port or place of importation; and
- (c) the cost of insurance.

The majority of WTO Members made the one-off decision to include these elements in the Customs value; known as CIF (cost, insurance, freight) basis. The system used by the few Members who chose not to include these elements is known as FOB (free on board).

The determination of whether or not Article 8 elements should be included in the Customs value in a particular case can be a complex process and typically requires consultation with the importer in order to establish all pertinent facts before reaching a decision. Substantial amounts of money may be at stake, particularly with such elements as royalties. The WCO Valuation Compendium contains many useful instruments issued by the TCCV, relevant to these topics which can assist with interpretation of particular case scenarios.

It is also noted in this context that several of these elements, such as commissions, royalties and assists relating to design work for example may be viewed as ‘services’ or ‘intangibles’. This highlights that although Customs role is to determine the Customs value and duty liability for imported ‘physical’ goods, certain intangible elements may also be includable in the Customs value of those goods.

2.5. ALTERNATE VALUATION METHODS

The alternate valuation methods are to be used only when the transaction value cannot be applied. There are three main situations where this will occur:

1) The transaction value is rejected on the basis of failing one or more of the conditions of Article 1 or,

2) The transaction value has been rejected following application of the procedures of WTO Decision 6.1, namely, Customs had doubts regarding the truth or accuracy of the declared value which were conveyed to the importer and Customs' doubts remained after due consultation process was followed.

2) No sale has occurred (e.g. leased goods, gifts, goods transferred between branches etc.).

Only in the above circumstances can consideration be given to the alternate methods. These are known as follows :

- the transaction value of identical goods (Article 2);
- the transaction value of similar goods (Article 3);
- the deductive value method (Article 5);
- the computed value method (Article 6);
- fallback option (Article 7).

The methods described in Articles 2 and 3 require a comparable consignment to be found where a transaction value has been previously accepted by Customs. The Agreement provides criteria for defining identical and similar goods, covering the goods themselves, time of importation, commercial level of consignment etc. The criteria for similar goods are less restrictive than for identical goods, allowing a broader range of comparable goods/consignments to be considered. If comparable consignments are found which meet the criteria in question for either Articles 2 or 3, and those consignments were cleared on the basis of the transaction value, that value can then be applied as the Customs value.

The method described in Article 5, known as 'deductive value', is based on the price at which the imported goods (or identical or similar goods) are sold on the domestic market. This establishes a 'unit price' from which are to be deducted costs pertaining to post-importation activities and elements, such as post-import transportation and storage costs and profit and general expenses (with an adjustment under Article 8.2 if applicable). The Customs value under Article 5 is based on the price after such deductions are made.

The method described in Article 6, known as 'computed value', is based on a price which is built up from the various elements which contribute to the manufactured goods. This includes cost of materials, components etc. manufacturing costs, profit and general expenses and transport. Typically, this method is used extremely rarely as it requires financial data which may be confidential to the manufacturer and will not be willingly made available to the importer or Customs in the importing country.

Article 7 is informally known as 'fallback' – it is not a specified 'method' as such but rather describes the possible means of establishing the Customs value when the previous methods cannot be applied. It also lists approaches which are expressly forbidden by the Agreement (e.g. values must not be based on minimum Customs values or arbitrary or fictitious values).

The above methods must be considered in the order specified by the Agreement, i.e. only if Article 2 cannot be applied should consideration be given to Article 3, and so on. Note that the order in applying Article 5 and 6 may be reversed if the importer so requests. When transaction value is not applicable, and the previous methods cannot be used to determine a value due to lack of data and comparative prices, Article 7 is applied.

It is important to note that when the alternate methods are used, there should be a process of consultation between Customs administrations and the importer with a view to determining a proper basis of value for Customs purposes.

The Agreement contains not only the valuation methodology but also a number of additional requirements including trade facilitation measures which establish rights and obligations for the importer, and also the rights of the Customs administration.

For more information on the transaction value, alternate methods and other Customs valuation matters, it is recommended to consult the links provided at the beginning of this Chapter.

Chapter 3 : AN INTRODUCTION TO TRANSFER PRICING²

3.1. WHAT IS TRANSFER PRICING?

When a **multinational enterprise (MNE) group** establishes itself in a new market by incorporating or acquiring a local subsidiary or establishing a branch, the local subsidiary or branch generally engages in transactions with other members of the group. As a result, a significant portion of international trade is estimated to be taking place between members of MNE groups.

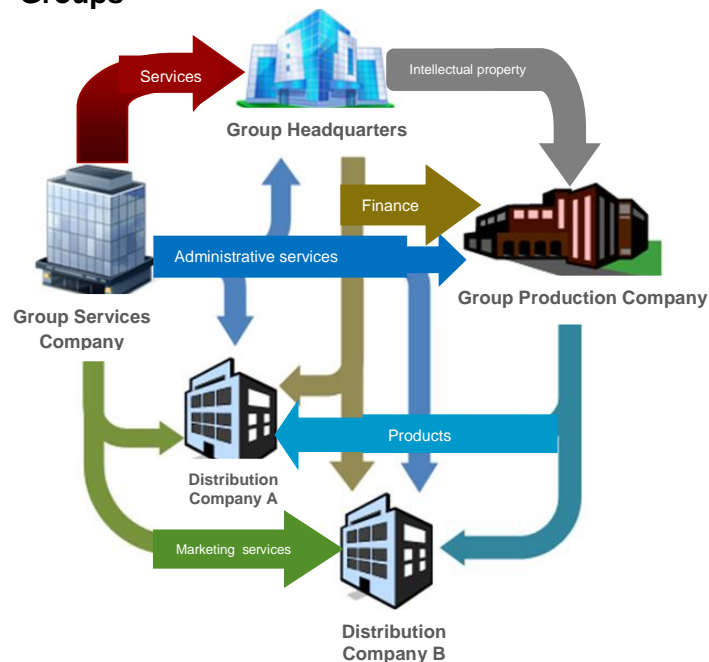
As a result of the common ownership, management, and control relationships that exist between members of an MNE group, transactions between them are not fully subject to many of the market forces that would have been at play had the transactions taken place between wholly independent parties. The prices charged—known as transfer prices—may be manipulated or set in a way that has the unintentional consequence of being unacceptable to external stakeholders.

This phenomenon is not limited to transactions within MNE groups. It also occurs in transactions between any other parties - such as family members or companies and substantial individual shareholders - whose relationship may allow them to influence the conditions of the transaction.

Transactions between parties whose relationship may allow them to influence the conditions of the transaction - **related parties** (also commonly referred to as “**associated enterprises**”) - can involve the provision of property or services, the use of assets (including intangibles), and the provision of finance, all of which need to be priced (see figure 1.1).

² Chapter 3 has been kindly supplied by the World Bank Group and is based on modified extracts from “*International Transfer Pricing and Developing Economies: A Handbook for Policy Makers and Practitioners*”, a World Bank Group publication. The content of this chapter does not necessarily reflect the views of the World Bank Group or its member countries.

Figure 1.1 Typical Transactions within Multinational Enterprise Groups



How transfer prices are determined in practice can be important for, and influenced by, a range of regulatory and non-regulatory factors, including, inter alia, taxes (such as corporate income tax) and duties.³

Transfer pricing is a neutral concept that simply refers to the determination of transfer prices for transactions between related parties. As pointed out by Tax Justice Network, “[t]ransfer pricing is not, in itself, illegal or abusive. What is illegal or abusive is ... transfer pricing manipulation or abusive transfer pricing.” (Tax Justice Network).

How transfer prices are determined is essential for defining the corporate tax base (direct taxation), but in some cases, it may also be important for a range of other regulatory and non-regulatory purposes, including the following:

- Taxes and duties (value-added tax, customs duties, mining royalties, and petroleum resource taxes, for example);
- Corporations law (directors’ duties, protection of minority shareholders, for example);
- Contractual requirements (investment contracts, for example);
- Statutory accounting requirements;
- Foreign exchange controls;
- Management accounting;
- Internal performance management and evaluation;
- Employee profit-sharing requirements;

³ Examples may include foreign exchange regulation, accounting requirement and practices, corporate law, trade statistics, contractual requirements, amongst others

- Competition law; and
- Official trade statistics.

The determination of appropriate transfer prices is also often required for subsidiaries to prepare stand-alone statutory accounts in order to meet local reporting requirements. Although standards or methodologies for determining these transfer prices may or may not be provided for under local, generally accepted accounting principles, the value of associated party transactions will generally require separate disclosure in the notes to the accounts, as may any uncertain tax positions related to them.

Regulation of transfer pricing for direct tax purposes generally involves the prescription of standards or methodologies. Direct tax transfer pricing regulations, for example, generally require that transfer prices for transactions between associated enterprises be determined in accordance with the arm's length principle (discussed below). Noncompliance with these regulations will often result in adjustments to the tax liability and the imposition of penalties and interest.

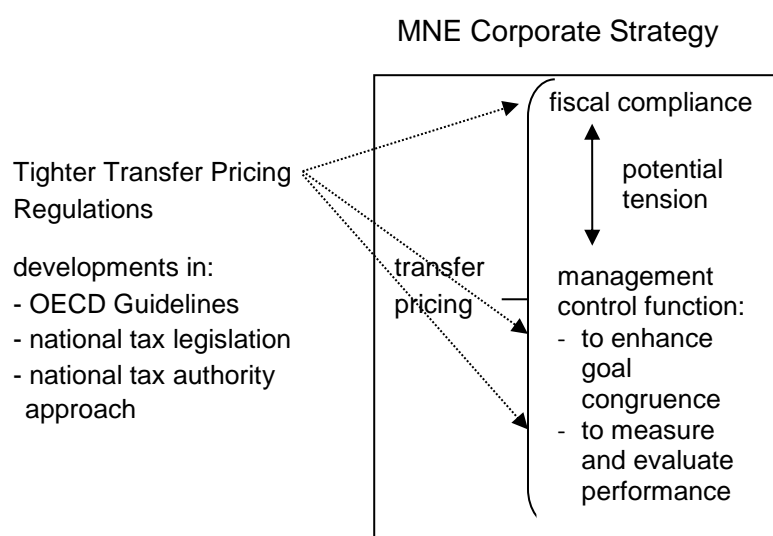
A study by Cools (2003) found that “because of the real threat of audits and penalties, the tax requirements of transfer pricing play a prominent role in the MNE’s decision-making process” (see Figure 1.2). As an increasing number of countries introduce transfer pricing legislation and increase audit capacity (see below), this trend will only increase.

Regulation of transfer prices for Customs purposes (i.e. determination of Customs values) and VAT purposes also generally involves the prescription of specific standards or methodologies that must be complied with. However, these standards or methodologies generally differ from those prescribed for direct tax purposes and have a narrower scope of application.

In addition to taxes and duties, foreign exchange controls, contractual requirements, and other regulations and administrative practices can have a substantial impact on the determination of transfer prices.

As a result of the different regulatory and non-regulatory factors that can influence the determination of transfer prices, MNE groups sometimes face conflicting requirements. Although congruence is theoretically desirable, different transfer prices may be recorded or reported for different purposes.

Figure 1.2 The Role of Transfer Pricing in Corporate Strategy



Source: Cools 2003

Note: Given the dominant role of direct tax legislation in the determination of transfer prices, the term 'transfer pricing' is commonly used to describe the regulation of transfer prices for direct taxation purposes (corporate tax, income tax, profits tax etc.).

3.2. HISTORY AND CURRENT STATE OF PLAY

The **arm's length principle**, which is the principle upon which countries have tended to base the provisions of their tax legislation concerning transfer pricing (see below), has its roots as the internationally adopted principle for dealing with transfer pricing for direct taxation purposes as far back as the early 1900's where it was implicitly included in treaties concluded by France, the United Kingdom and the United States. The principle was first adopted in an international context in Article 3 of the League of Nations Draft Convention on the Allocation of Profits and Property of International Enterprises (1933). It was then adopted in the 1963 OECD Draft Tax Convention, and the subsequent OECD (and UN) model tax conventions.

The first international guidance on transfer pricing was developed by the OECD in 1979 - *Report of the OECD Committee on Fiscal Affairs on Transfer Pricing and Multinational Enterprises*. This report sought to document "generally agreed practices in determining transfer prices for tax purposes". As the number and size of MNE groups, and the nature of international trade developed, increasing attention was paid to transfer pricing, and in 1995 the OECD issued revised guidelines – *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. These guidelines have played a lead role in influencing the development of transfer pricing legislation and practices globally. In the years following their publication, the OECD Transfer Pricing Guidelines (TPG) 1995 were supplemented with additional chapters providing guidance on specific issues, such as intangible property (1996), services (1996), cost contribution agreements (1997).

After numerous public consultations on specific issues (such as comparability and the use of the profit based methods) and with the benefit of more than a decade of practical application of the guidance contained in the OECD TPG 1995, in 2010 a revised version of the

guidelines was published (OECD Transfer Pricing Guidelines 2010). Important changes from the 1995 version included removal of the ‘last resort’ status for use of the profits based methods, revised guidance on the selection of transfer pricing method (i.e. introduction of ‘most appropriate method to the circumstances of the case’), inclusion of additional guidance on comparability analyses and the inclusion of an additional chapter of the transfer pricing aspects of business restructurings.

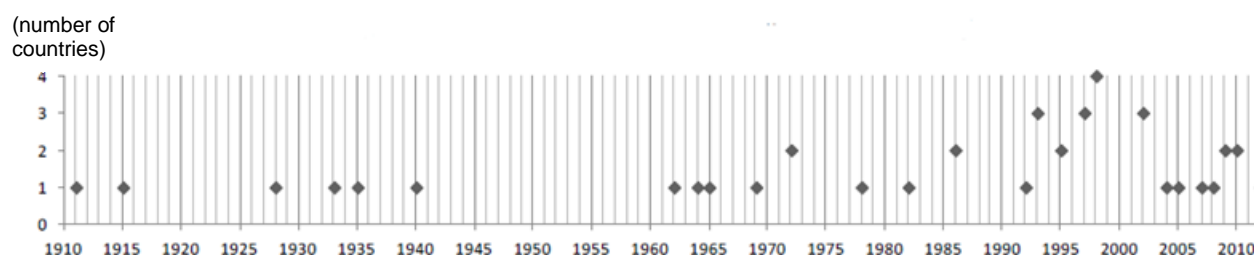
Notably, however, the implementation of the arm’s length principle has been vulnerable to manipulation schemes as a result of the overemphasis on the contractual allocation of functions, assets, and risks. Several of the action items in the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project (Actions 8, 9, and 10) were therefore focused on revising the OECD transfer pricing guidelines, focusing on problem areas such as transactions involving intangibles, allocation of risk, or profit allocation in contexts lacking a commercially viable rationale. The agreed revision of the guidelines emphasizes the need for a careful delineation of transactions. This process begins with the contractual agreements entered into by the parties, but emphasises the primacy of their actual conduct, and the real substance of the arrangements. In the case of intangibles, the result is that legal ownership alone does not concern any right ultimately to retain returns derived from the exploitation of the intangible. Remuneration within a group will be based on the actual contribution by group members. Similarly, risks that are contractually allocated by a party that cannot meaningfully control these risks or bear their financial consequences may be reallocated to a party that does and can.

The results of BEPS Actions 8, 9 and 10 were incorporated into the OECD Transfer Pricing Guidelines in 2016 and a completely revised and consolidated version of the Guidelines was published in 2017.

In order to protect their tax bases, a significant, and growing, number of countries have introduced provisions in their tax legislation concerning transfer pricing and many have, or are, increasing the resources allocated to building specialist capacity within their tax administrations. Whilst several countries have had in place provisions concerning transfer pricing in their tax legislation based on the arm’s length principle since the early 1900’s, the vast majority have introduced such provisions in the past two decades (see figure 1.3). For example, during the period 1994–2014, the number of countries with “effective” transfer pricing documentation rules increased from 4 to more than 80 (see figure 1.4).⁴

⁴“Effective”, for these purposes, indicates that the country has specific legislation, regulations, or other guidance that, at a minimum, strongly suggest that transfer pricing documentation should be in place

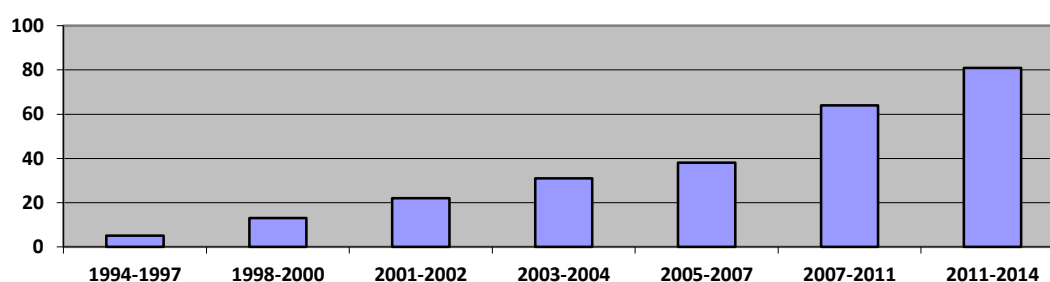
Figure 1.3 – Timing of introduction of the arm’s length principle in selected countries



Countries: Argentina, Australia, Austria, Belgium, Canada, Chile, China, Colombia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Russia, Singapore, Slovak Republic, Slovenia, Spain, South Africa, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

Source: OECD 2012

Figure 1.4 Timeline of effective transfer pricing documentation rules, 1994–2014



Source: Based on Oosterhoff (2008) and PwC (2014)

3.3. LEGAL FRAMEWORK

Whilst transfer pricing issues can, and do, arise in a purely domestic context (e.g. transactions between related resident taxpayers), transfer pricing is predominantly an international tax matter. Therefore, when considering the legal framework for transfer pricing, reference to both domestic legislation and the relevant international legal framework is required. Set out below is an overview of the role of domestic legislation, tax treaties and other relevant materials, such as the OECD *Transfer Pricing Guidelines* and the United Nation’s *Practical Manual on Transfer Pricing for Developing Countries*.

3.3.1. DOMESTIC LEGISLATION

Regulation of transfer prices for direct taxation purposes requires provisions in the domestic tax legislation. Whilst sovereign states are, in theory, free to adopt any legislation they see as being fit for purpose, this freedom may be curtailed by international obligations and is often influenced by a range of economic factors and the practices of other countries. In the case of transfer pricing, there is no single body of international law or specific international instrument concerning transfer pricing (as is the case for Customs valuation), however, the

vast network of bilateral tax treaties and various sources of guidance have shaped domestic legislation concerning transfer pricing.

To date, countries have tended to adopt relatively homogenous provisions in their tax legislation concerning transfer pricing, being legislation that is based on the arm's length principle and, in most cases, the key concepts elaborated in the OECD Transfer Pricing Guidelines.⁵ Whilst the underlying principles are typically the same, differences in domestic provisions are commonplace. Examples of common differences include: the scope of the provisions (e.g. the definition of related parties and the types of transactions covered) and the administrative requirements (e.g. requirements for transfer pricing documentation).

3.3.2. TAX TREATIES

Double taxation⁶ is generally recognized as a hindrance to international trade and investment. Thus, countries have generally sought to avoid and or eliminate cases of double taxation by entering into **tax treaties**. These (largely bilateral) treaties are agreements between the contracting parties (the states) concerning the allocation of taxing rights (i.e. extent to which each state may level tax in specific cases), amongst other things (such as exchange of information and other administrative procedures). There are over 3,000 bilateral double tax agreements currently in force.

As regards transfer pricing, tax treaties can provide taxpayers with a level of certainty regarding the treatment of their related party transactions by setting boundaries for the application of the contracting states' domestic tax legislation and by providing an international legal framework for the avoidance and elimination of economic double taxation. Tax treaties that incorporate provisions based on Article 9(1) of the OECD and UN models (see below), to the extent applicable to a particular transaction or set of transactions, establish the arm's length principle as the 'boundary' for applying each of the contracting states' domestic tax law provisions concerning transfer pricing.

⁵ The one noted exception at the time of this chapter being authored is Brazil. For an overview of Brazil's approach to transfer pricing see Chapter 10.2 of the UN TP Manual (2013)

⁶ Double taxation may be juridical (taxation of the same income in the hands of one person by more than one state) or economic (taxation of the same income in the hands of two different persons).

Article 9 of the OECD Model Taxation Convention on Income and Capital (2010)

1. Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly— profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

Tax treaties are generally not considered to create taxing powers additional to those provided for under each contracting state's domestic law; rather, their role is to place limitations on the contracting states' taxing powers in accordance with the agreed allocation of taxing rights under the treaty. The dominant view is therefore that Article 9 of a tax treaty itself is not a legal basis for a transfer pricing adjustment (a "primary adjustment") to be made by a tax administration and that a domestic legal basis is required in order for a tax administration to make such an adjustment (Lang 2010). The role of treaty provisions based on Article 9(1) is therefore to provide taxpayers with certainty regarding the treatment of their associated party transactions that fall within its scope and to provide a level of protection from economic double taxation.

Although Article 9 is titled "associated enterprises," the term is not elaborated on beyond the reference to participating "directly or indirectly in the management, control or capital" and neither of the models nor their commentaries provide any further insight as to when this threshold is considered to have been met. In accordance with Article 3(2) of the models, where a term is not defined, reference to the countries' domestic law may be required, which can lead to conflicting interpretations.⁷

⁷ As countries' domestic law definitions can, and do, reasonably differ, situations can arise in which the contracting states have different positions regarding the applicability of the article, potentially resulting in instances of economic double taxation for which there is no clear or explicit solution provided (Rotondaro 2000). In practice, the occurrence of these situations is minimal.

Tax treaty provisions based on Article 9(2) of the OECD and UN models provide mechanisms for the relief of economic double taxation arising from a transfer pricing adjustment made in accordance with the arm's length principle. The mechanism for relief from economic double taxation under Article 9(2) is generally referred to as a corresponding adjustment (or "correlative adjustment" under the UN model) and generally involves the other contracting state making an adjustment to the amount of tax charged in order to provide relief from economic double taxation.

Tax treaties also commonly contain other articles that are of importance to transfer pricing. For example, the relevant articles of the OECD model are: Article 25 (Mutual Agreement Procedure) (see below), and Article 26 (Exchange of Information) along with other articles that make reference to the arm's length principle (i.e. Articles 7, 11 and 12).⁸

3.3.3. OECD TRANSFER PRICING GUIDELINES

The OECD Transfer Pricing Guidelines are the most influential source on transfer pricing; they provide guidance for multinational corporations and tax administrations regarding the practical application of the arm's-length principle. As noted in section 3.2, the Guidelines were initially issued in 1995 and cover a range of transfer pricing issues and have been revised and supplemented on a number of occasions since then.

The guidelines are not a legal instrument per se, and, as a result, the legal and practical relevance of the guidelines varies significantly between countries and may depend on the applicability of a tax treaty containing an associated enterprises article based on Article 9 of the OECD or UN model tax convention (see above).

Where a tax treaty containing an associated enterprises article based on Article 9 of the OECD or UN model tax conventions is applicable, reference will typically be made to the OECD Transfer Pricing Guidelines when applying that article (for example, during a mutual agreement procedure). In this regard, paragraph 1 of the commentary to Article 9 of the OECD model notes that the guidelines represent "*internationally agreed principles and [provide] guidelines for the application of the arm's length principle of which [Article 9] is the authoritative statement*". However, this reference is made in the commentary to the model, the status itself of which can vary significantly between countries and is the subject of much debate.

In OECD member countries, the OECD Council has recommended that the OECD Transfer Pricing Guidelines be followed by the tax administrations of OECD countries and they encourage taxpayers to follow them (OECD 2010b). In some OECD member countries, the status of the guidelines is made clear as explicit reference is made to them in the legislation (e.g. Australia, United Kingdom, Ireland). Whilst in others, despite undoubtedly having high practical relevance, their legal relevance may be less certain. However, even when there is

⁸ For example, Article 7 (Business Profits) requires that the profits attributable to a permanent establishment be determined in accordance with the arm's length principle, and Article 11 (Interest) and Article 12 (Royalties) are worded so as to apply only to the arm's length amount of interest or royalty income.

no explicit reference to the Guidelines in the relevant domestic statute, they are generally considered to be highly persuasive, at least in OECD member countries and are often referred to in practice by tax administrations and the private sector.

In non-OECD countries the situation is less clear. In numerous non-OECD countries, such as Albania, Georgia, Namibia, the Philippines, Serbia and South Africa, the legislation or administrative guidance implicitly or explicitly refers to the OECD Transfer Pricing Guidelines, making their relevance clear. However, in many other non-OECD countries, no reference is made to the OECD Transfer Pricing Guidelines, despite the fact that in many cases the domestic transfer pricing legislation is largely based on the guidance found in therein.

In many countries, despite the lack of reference to the Guidelines in domestic law and the applicability of a tax treaty, the OECD Transfer Pricing Guidelines will be considered as at least a relevant source of reference by taxpayers, the tax administration, and even the judiciary. According to Alnashir Visram J in *Unilever Kenya Ltd v. Commissioner of Income* (Income Tax Appeal 752/753 of 2003) KENYA “...it would be foolhardy for any court to disregard internationally accepted principles of business as long as these do not conflict with our own laws. To do otherwise would be highly short-sighted.” In the absence of clearly conflicting legislation or guidance in a country, it is therefore reasonable to assume that the OECD Transfer Pricing Guidelines will have a significant influence on transfer pricing practices in that country.

3.3.4. UNITED NATIONS PRACTICAL MANUAL

The UN’s Committee of Experts on International Cooperation in Tax Matters constituted the ‘Subcommittee on Transfer Pricing – Practical Issues’ at its annual session in 2009. The subcommittee was given the mandate to produce a practical manual on transfer pricing based on the following principles (UN 2012):

- (a) It should reflect the operation of Article 9 of the UN Model Convention, and the arm’s-length principle embodied in it, and be consistent with relevant commentaries of the UN Model Convention;
- (b) It should reflect the realities for developing countries at the relevant stages of their capacity development;
- (c) Special attention should be paid to the experience of other developing countries;
- (d) It should draw upon the work being done in other forums.

In the foreword to the manual, it is noted that the guidelines are “a practical manual rather than a legislative model”, that “a key “value added” of the is to be its practicality...” and that in developing the manual “consistency with the OECD Transfer [Pricing] Guidelines has been sought...” (UN 2017).

The Committee of Experts approved the publication of the first edition of the manual in May 2013. The manual was described as “... a living work however, which will be improved and

added to over time by drawing upon further experiences and expertise” (UN 2012). A second edition of the manual was published in 2017⁹ to reflect more recent developments, including the outcomes of the OECD/G20 BEPS project, by adding, for instance, chapters on intra-group services, cost-contribution arrangements, and the treatment of intangibles.

The UN manual is playing an increasingly influential role in the development of transfer pricing practices in transition and developing economies. As the manual is not a legal instrument, its status and influence will therefore depend on domestic law references and practices in each country. It is also important to note that the manual was not adopted by consensus of all UN member states but by the Committee of Experts (comprising of 25 members nominated by governments, but acting in their personal expert capacity).

3.3.5. OTHER

In addition to the OECD Transfer Pricing Guidelines and UN Practical Manual there are several other international and regional sources of guidance that may be of relevance to a particular country. These include the EU arbitration convention and the various soft law instruments and reports prepared by the EU Joint Transfer Pricing Forum (EUJTPF)¹⁰ and endorsed by the European Commission and the Pacific Association of Tax Administrators (PATA)¹¹ transfer pricing documentation package and operation guidance on mutual agreement procedures.

3.4. THE ARM’S LENGTH PRINCIPLE AND ITS APPLICATION IN PRACTICE

This section provides an overview of the arm’s length principle and its application in practice. In particular the fundamental concept of **comparability** is explained, along with the **transfer pricing methods**. This section is largely based on the guidance provided in the OECD Transfer Pricing Guidelines, with references, where applicable, to the UN TP Practical Manual and any specific approaches commonly observed in practice.

3.4.1. ARM’S LENGTH PRINCIPLE

The arm’s length principle requires that the conditions (prices, profit margins etc.) in transactions between related parties should be the same as those that would have prevailed between two independent parties in a similar transaction under similar conditions. The principle can be expressed and applied in various ways,¹² however, the most commonly referred to expression is that which is found in Article 9(1) of the OECD and UN model tax treaties, which both read as follows:

“... conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent

⁹ <http://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf>

¹⁰ http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/

¹¹ Australia, Canada, Japan and the United States

¹² Numerous countries’ transfer pricing legislation use terms such as “market price” or “fair market value.” When used in a similar context, these terms are generally interpreted as equivalent, or similar, to the arm’s length principle. However it should be noted that the terms “market price”, “fair market value” as used in financial valuations etc., are different concepts to the arm’s length principle.

enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

In short, the arm’s length principle requires that related parties price their transactions with each other as if they were wholly independent of each other.

3.4.2. COMPARABILITY

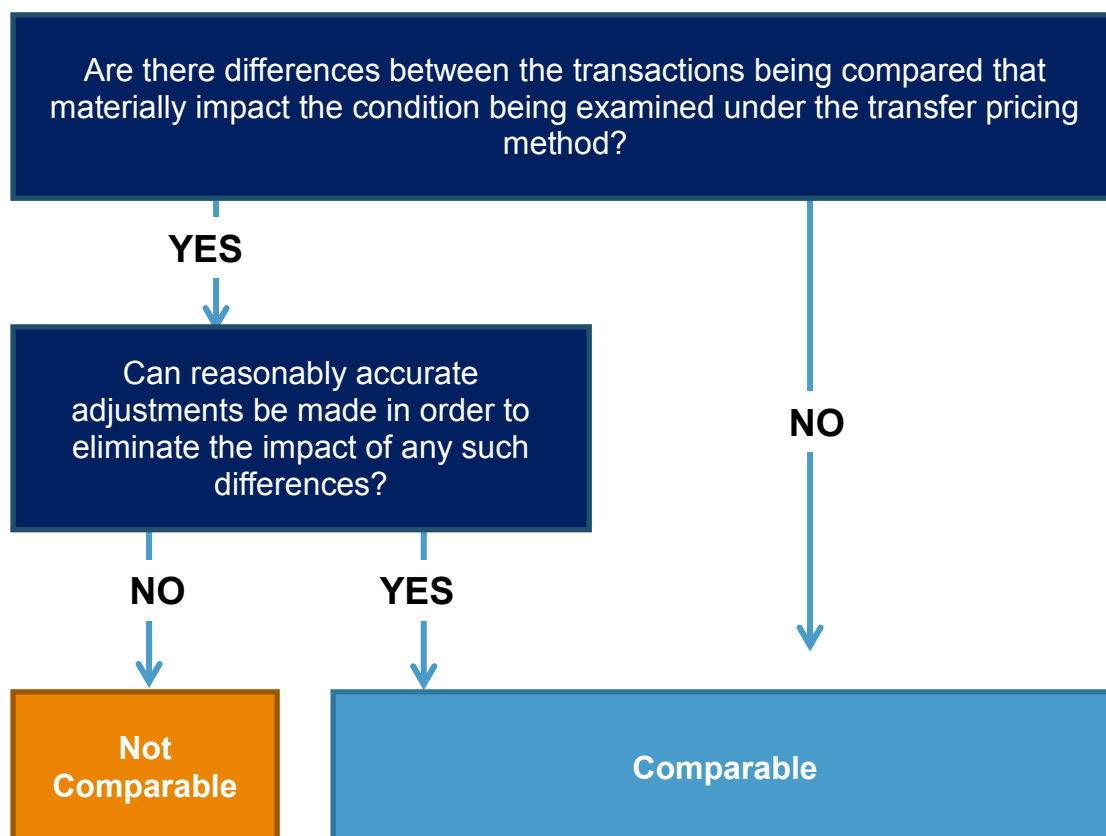
The application of the arm’s length principle is typically based on a comparison of the conditions in the controlled transaction with the conditions in ‘comparable’ transactions between independent parties. This approach necessarily requires the identification of comparable transactions, and thus the undertaking of a comparability analysis. That is, it draws a comparison of the conditions in the transaction between the related parties (the **controlled transaction**) with the conditions in transactions between independent parties (**uncontrolled transactions**) that have been found to be comparable.

Many developing countries face a range of practical challenges in conducting comparability analysis, including limited information availability and administrative capacity constraints. To support practical implementation of transfer pricing regimes that apply the arm’s length principle in this context, the Platform for Collaboration on Tax - a joint initiative of the IMF, OECD, UN, and World Bank Group – has recently published a toolkit to assist tax administrations with these issues. It provides an outline of steps in the comparability analysis and presents relevant policy options to address information constraints.¹³

According to the Platform toolkit and the OECD Transfer Pricing Guidelines, the UN Practical Manual and the legislation/guidelines of the vast majority of countries with developed transfer pricing rules, comparability for the purposes of applying the arm’s length principle does not require that the transactions being compared are identical. Rather, comparability requires that none of the differences between the transactions being compared materially impact on the condition being examined in the transfer pricing methodology that is to be applied (i.e. the price or the profit margin); or, that where such differences do exist, that reasonably accurate adjustments (**comparability adjustments**) can be made in order to eliminate the impact of any such differences on the condition being examined.

¹³ <http://documents.worldbank.org/curated/en/447901498066167863/pdf/116573-REVISED-PUBLIC-toolkit-on-comparability-and-mineral-pricing.pdf>

Figure 4.1 Comparability Flow Chart



Comparability Factors

When determining whether or not there are any differences between the transactions being compared that materially impact the condition being examined there are five **comparability factors** that the OECD Transfer Pricing Guidelines and the UN Practical Manual specify identify as important to consider:

- Contractual terms
- Functional analysis
- Characteristics of the product or service
- Economic circumstances
- Business strategies

These five comparability factors are referred to directly or indirectly in the legislation/guidance of most countries with established transfer pricing rules. To address vulnerability to manipulation schemes as a result of over-emphasis on the contractual allocation of functions, assets and risks, recent revisions to the first chapter of the OECD Transfer Pricing Guidelines stress the importance of accurate delineation of transactions in comparability analysis. This requires a determination of actual functions performed, risks assumed, and assets contributed or used by the relevant parties. The revisions highlight the importance of proper fact-finding and looking beyond mere contracts in undertaking a comparability analysis. The outcome is to either supplement or replace contractual

arrangements where required.¹⁴ The Platform toolkit on addressing difficulties in accessing comparables data mentioned above provides a detailed summary of the relevant steps in comparability analysis, including examples and cross-references to the relevant sections in the OECD and UN guidelines.

Contractual Terms

Contractual agreements are commonly the starting point for delineating a transaction, but may need to be supplemented (or replaced) by information on the actual conduct of the parties in their commercial or financial relations (actual functions performed, assets contributed or used, risks assumed, etc.). The contractual terms of a transaction will influence the allocation of functions and risks between independent parties and, therefore, the prices charged and margins earned. Accordingly, differences in the contractual terms applicable to the controlled transaction and uncontrolled transaction(s) require identification and analysis.

One of the benefits of forming a multinational enterprise (MNE) group, besides creating synergies, is a reduction in transaction costs (i.e. costs of negotiating and drawing up agreements). It is, therefore, not uncommon that MNE groups do not have formal contractual arrangements in place for some of their intragroup dealings. Where formal contractual arrangements are not in place, for transfer pricing purposes the terms may need to be deduced from the economic relationships of the parties and their conduct. This may be best evidenced by correspondence and communication between the parties. Where formal contracts are in place, it is important to check whether the terms of the contract are actually adhered to in practice and are congruent with conduct of the parties.

Details of the contractual terms of potentially comparable transactions between independent parties will often be limited or unavailable. The impact of such informational deficiencies on comparability will depend on the method being applied, the transactions under examination, and the particular facts and circumstances. Informed judgment is required in this regard.

Examples of contractual terms that may influence the price or margin may include, but are not limited to:¹⁵

- Differences in volumes;
- Differences in payment terms (for example, net 30 days as compared to net 90 days);
- Shipping terms (for example, FOB as compared to CFR or CIF);¹⁶
- Geographic area, exclusivity, duration in relation to the licensing of intangibles; and
- Currency, security, and call and repayment options in relation to financial transactions.

Functional Analysis

¹⁴ See Revisions to Chapter 1, Section D 1.36. Amendments in October 2015 by the Final Reports on BEPS Actions 8-10: “Aligning Transfer Pricing Outcomes with Value Creation.”

¹⁵ See further, chapter on comparability analysis in the *UN Manual*.

¹⁶ Under the Incoterm standard published by the International Chamber of Commerce, FOB stands for “Free On Board” and designates that the passing of risks occurs when the goods pass the ship’s rail at the port of shipment, CFR (Cost, Freight) and CIF (Cost, Insurance, Freight) and on the other hand designate that the risk is transferred to the buyer once the goods are loaded on the vessel, and that the seller pays costs and freight (and insurance in the case of CIF) to bring the goods to the port of destination.

In so far as the comparability analysis may be considered the cornerstone of the arm's length principle, the **functional analysis** (which involves an analysis of functions performed, risks assumed and assets employed) may be considered as a cornerstone of the comparability analysis.

In transactions between independent parties, the compensation will usually reflect the functions that each party to the transaction performs, the assets they employ, and the risks they assume. For example, the more functions a party performs, the greater risks it bears, and the higher the value of the assets employed in relation to a transaction, the greater the remuneration it would expect to receive from the other party in relation thereto. As a result, the remuneration of a party, and therefore its profit potential, with respect to a transaction (or set of transactions) will generally be correlated with the functions it performs, the risks it bears, and the assets that it employs.¹⁷

Functional analysis – example functions, assets and risks	
Functions	<ul style="list-style-type: none"> ▪ Design ▪ Manufacturing ▪ Assembling ▪ Research and development ▪ Servicing ▪ Purchasing ▪ Distribution ▪ Marketing ▪ Advertising ▪ Transportation ▪ Financing ▪ Management
Assets	<ul style="list-style-type: none"> ▪ Plant and equipment ▪ Valuable intangibles ▪ Financial assets <p><i>Note:</i> the age, market value, location, property right protections etc. may also require consideration, along with the legal, economic and beneficial ownership of valuable intangibles</p>
Risks	<ul style="list-style-type: none"> ▪ Market risks such as input and output price fluctuations ▪ Risks of loss associated with investment in and use of property, plant and equipment ▪ Risks of failure or success in research and development ▪ Financial risks such as those caused by currency exchange rate and interest rate variability ▪ Credit risks

Source: Based on OECD Transfer Pricing Guidelines 2017

An analysis of the economically significant functions performed, risks assumed, and assets employed by the parties in relation to the transaction(s) being examined is necessary not only to assess comparability, but it also plays an important role in accurately delineating the transaction(s) and from that, determining how the transfer prices should be set or tested (e.g. selecting the most appropriate transfer pricing method how it should be applied).

¹⁷ Simply performing more functions, bearing greater risks, and employing greater assets does not necessarily lead to high profitability. However, implicit in bearing more risk is the possibility of that risk materializing, resulting in decreased profitability or even losses.

Undertaking a detailed functional analysis in practice will often involve significant research and analysis and is highly reliant on the collection of accurate and sufficiently detailed information obtained from a variety of sources. Typically, in an audit context, this will involve more than a desk review, and may require interviews of relevant personnel (operational personnel). Where informational deficiencies do exist, as is often the case when analyzing external comparables, professional judgment may be required as to whether or not those transactions are sufficiently comparable.

The identification and quantification of risks assumed can present a significant practical challenge when conducting a functional analysis. Consequently, the most recent revision to the OECD Transfer Pricing Guidelines provides expanded guidance on risk assumption in a transaction. In line with the general emphasis on economic substance and the accurate delineation of transactions, these revisions emphasize that contractual allocation of risks is only accepted when it corresponds to the performance of control functions in relation to the risk and capacity to assume the risk. With respect to financing, for instance, the revisions clarify that a legal entity that controls a funding risk is not entitled to the returns associated with operational risks, unless it exercises control over those operational risks.

Characteristics of the product or service

The characteristics of a particular product or service impact upon the value attributed to it in the open market. Therefore consideration of the characteristics of the products and/or services in the transactions being compared is required in order to determine whether or not there are any differences that materially impact the condition being examined, and where there is, whether appropriate adjustments can be made to eliminate the impact. Examples of characteristics that may be important to consider are set out in the table below.

Sample Characteristics of Tangible Property, Services, and Intangible Property

Tangible property	<ul style="list-style-type: none"> ▪ Physical features ▪ Quality and reliability ▪ Availability and volume of supply
Services	<ul style="list-style-type: none"> ▪ Nature of the services ▪ Extent of the services
Intangible property	<ul style="list-style-type: none"> ▪ Form of the transaction (for example, sale or license) ▪ Type of property (for example, patent, trademark, or know-how) ▪ The duration and degree of protection ▪ Anticipated benefits from use

Source: Based on OECD Transfer pricing Guidelines (2017)

Economic Circumstances

In transactions between independent parties, the economic circumstances (including the market within which a transaction takes place) surrounding a transaction can have a significant influence on its pricing. For example, the price paid for the same goods or services can differ significantly as between geographic locations or the industry (or sub-industry) in which they take place. Whether differences in economic circumstances have a

material impact on the condition being examined will depend on the particular facts and circumstances however. For example, for some products and services global markets have emerged, thus geographical location may have limited or no impact on the pricing.¹⁸ However for many products and services, differences in market size, competition and regulation for example can have a significant impact on pricing at the regional or country specific level.

Examples of economic circumstances that may be important to consider, include, but are not limited to:¹⁹

- Geographic location
- Market size
- Barriers to entry
- Level of the market (wholesale, retail etc.)
- Competition
- Existence and availability of substitute products
- Location specific costs
- Government regulation
- Economic condition of the industry
- Consumer purchasing power
- Economic, business or product cycles

Business Strategies

Adoption of particular business strategies by parties to a transaction (or group of transactions) can have a significant impact on pricing. Such strategies may include inter alia; market penetration; market expansion; market maintenance and diversification strategies.

Undertaking a Comparability Analysis in Practice

The goal of the comparability analysis, aside from identifying and analysing the economically significant elements of the controlled transaction(s), is to identify uncontrolled transactions that are sufficiently comparable to the controlled transaction(s) under examination so as to be able to apply a transfer pricing method and make a determination of the arm's length price or margin, or as is more common, a range of prices or margins (see below).

The actual process adopted in practice will depend on the particular facts and circumstances of the particular case and the resources available. The OECD Transfer Pricing Guidelines detail a typical 9-step process that is considered good practice in this regard. The chapter on 'comparability analysis' in the UN TP Manual details a similar process.

¹⁸ See for example: Commissioner of Taxation v SNF Australia Pty Ltd 2011 ATC 20-265 (Australia) where Ryan, Jessup and Perram JJ found that the evidence "...pointed to the existence of a global market" and that "standing back from the evidence that conclusion should hardly be surprising: the products in question were high volume industrial chemicals used in worldwide industries and inherently transportable. It is difficult to see how the market could not be a global one."

¹⁹ See further, Chapter 1 (D.1.) of the *OECD Transfer Pricing Guidelines* 2017 and chapter on comparability analysis in the *UN Manual*.

Comparability Analysis: the typical 9 step process in the OECD TPG

Step 1: *Determination of years to be covered*

Step 2: *Broad-based analysis of the taxpayer's circumstances*

Step 3: *Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate transfer pricing method to the circumstances of the case, the financial indicator that will be tested (in the case of a transactional profit method), and to identify the significant comparability factors that should be taken into account.*

Step 4: *Review of existing internal comparables, if any.*

Step 5: *Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.*

Step 6: *Selection of the most appropriate transfer pricing method and, depending on the method, determination of the relevant financial indicator (e.g. determination of the relevant net profit indicator in case of a transactional net margin method).*

Step 7: *Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors set forth at paragraphs 1.38-1.63.*

Step 8: *Determination of and making comparability adjustments where appropriate.*

Step 9: *Interpretation and use of data collected, determination of the arm's length remuneration.*

Sources of Comparable Information

Application of the arm's length principle is relatively flexible vis-a-vis the sources of information that can be relied upon, with the generally accepted qualifications that the information must be publically available (see below), concern transactions between unrelated parties and meet the standard of comparability (see above).

Generally speaking, broad distinction can be made between so-called 'internal comparables' and 'external comparables':

- **Internal comparables** - comparable transactions that have taken place between one party to the controlled transaction and an independent party
- **External comparables** - comparable transactions that have taken place between two independent parties, which are not associated with each other or either of the parties to the controlled transaction(s).

Internal comparables, where they exist, may have a more direct relationship to the transaction being examined. Furthermore it is likely that the necessary information to perform the comparability analysis will be more readily available and complete. As a result internal comparables can be easier and less expensive to identify and obtain information in relation thereto as opposed to external comparables. However, as most MNE groups are highly integrated, internal comparables are uncommon in practice. Often, where an entity does engage in potentially comparable uncontrolled transactions, these uncontrolled transactions do not, upon closer examination, meet the comparability standard. This is often

due to differences in comparability factors such as; market level; geographic market; contractual terms; and, quantities sold or purchased.

There are various sources of information that can be used to identify and obtain information on external comparables. The availability of such information however will be highly dependent on numerous factors, including; the type of transaction being examined, the methodology being applied and, where relevant, the country (or region) in which the tested party is located. Commonly used sources of information include commercial databases (which collate publically available information into a more user-friendly and easily searchable format, but often have limited coverage in developing countries as discussed further below), government bodies that collect and publish statutory financial accounts of local entities, company websites and the internet more generally (which can be used for example to obtain copies of annual reports and general information about the business activities and strategies of enterprises). These information sources are used by both taxpayers and tax administrations.²⁰

3.4.3. TRANSFER PRICING METHODS

The OECD Transfer Pricing Guidelines detail five transfer pricing methods that may be used to “establish or test the arm’s length principle”:

- Comparable uncontrolled price method
- Resale price method
- Cost plus method
- Transactional net margin method
- Transactional profit split method

The first three methods are commonly referred to as the ‘traditional transactional methods’ whilst the latter two are referred to as the ‘transactional profits methods’. These methods, or iterations thereof, are referred to in the UN Practical Manual and in the domestic legislation or administrative guidelines of almost all countries with established transfer pricing regimes. Reference is also made in the OECD TPG to the use of other methods to establish transfer prices, provided that the outcome is consistent with the arm’s length principle. The use of other methods may or may not be acceptable depending on the applicable domestic law.

A basic explanation of each of the methods is provided below.

Comparable uncontrolled price method (CUP method)

The **CUP method** compares the price charged in controlled transaction with the prices charged for comparable goods or services (including the provision of finance and intangibles) in uncontrolled transaction(s). Where the prices differ, this may be an indication that the conditions in the controlled transaction were not arm’s length.

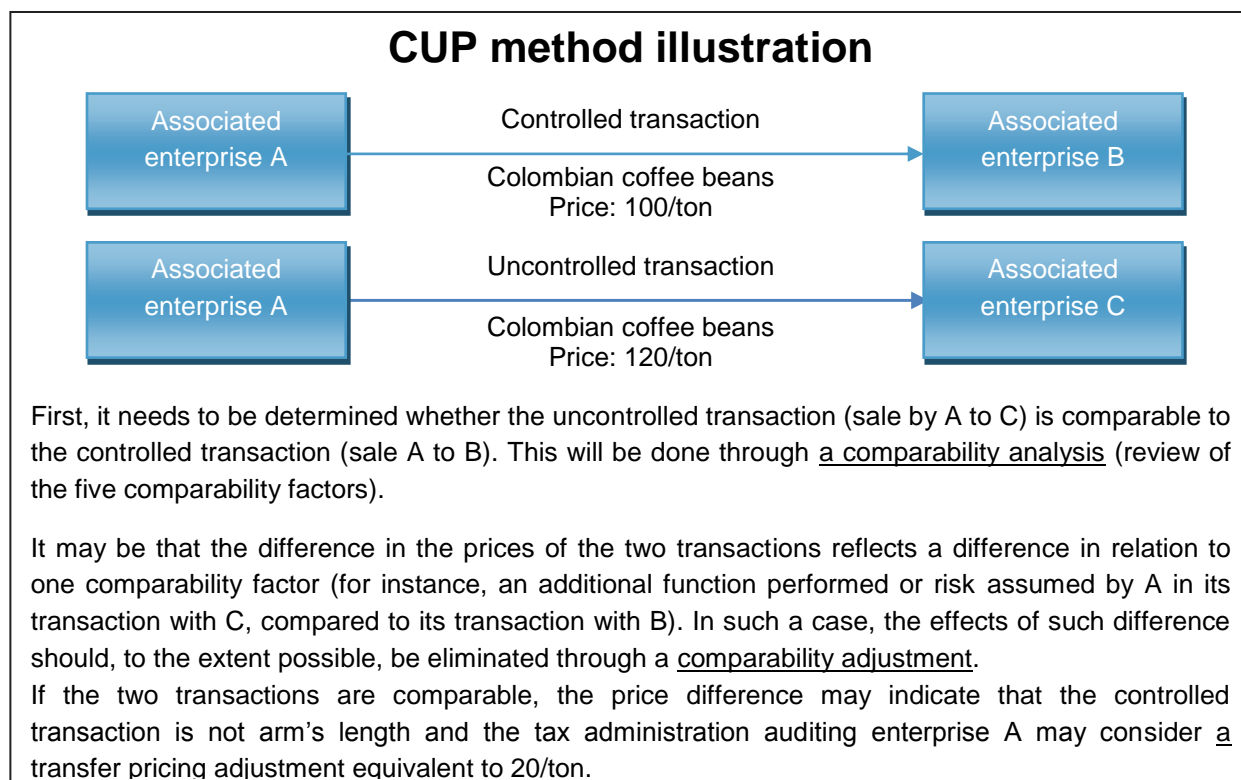
²⁰ For example, in its Announcement and Report concerning Advance Pricing Agreement (29 March 2011) the United States’ IRS disclosure that the following sources of comparable information were used (with varying degrees of frequency): Compustat, Disclosure; Mergent; Worldscope; Amadeus; Moody’s; Australian Business Who’s Who; Capital IO; Global Vantage; SEC; Osiris; Japan Accounts and Data on Enterprises (JADE); and “others”. - <http://www.irs.gov/pub/irs-utl/2010statutoryreport.pdf>

This price comparison may be made between internal uncontrolled transactions or external uncontrolled transactions (see above), depending on the existence of such transactions and availability of information in relation thereto. The condition being examined when applying the CUP method is the price of the products or services (including the provision of finance and/or intangibles). Accordingly, when assessing comparability it is important to consider that even minor comparability differences may have a material impact on the condition being examined. In this regard, the required standard of comparability for applying the CUP method is high relative to the other transfer pricing methods.

The main strengths of the CUP method are the fact that the actual price in the transaction is subject of the comparison/analysis and that it is not a one-sided analysis (there is no requirement to select a tested party – see below). However, the sensitivity of the CUP method to comparability differences means that this method is less likely to be the most appropriate method for more complex transactions or those involving non-commoditised goods, services or intangibles. .

Common examples of the CUP method being successfully applied in practice include, inter alia:

- Cases where internal comparables exist (tangible goods, services, royalty rates etc.)
- Commodities transactions, particularly where information on market prices for homogenous or standardised commodities exist
- Financial transactions (interest rates on loans etc.)
- Rights for the use of common intangibles (royalty rates, licence fees)



Source: OECD Secretariat, Transfer Pricing Methods (2010).

Resale price method

The **resale price method** starts with the price at which the product that is the object of the controlled transaction is resold to an independent enterprise (the “resale price”), which is then reduced by an appropriate gross profit margin (the “resale price margin”) in order to determine an arm’s length price. The appropriate resale price margin is determined by reference to the gross margins (see appendix 1) in comparable uncontrolled transactions. Accounting consistency is therefore paramount to the reliable application of the resale price method.

$$\text{Arm's length price} = \text{Resale Price} \times (1 - \text{Resale Price Margin})$$

Where Resale Price Margin = gross profit margin, defined as ratio of gross profit to revenues.

The condition being examined when applying the resale price method is the resale price margin earned by the reseller of the goods, hence it is a one-sided method that requires the selection of a tested party (see below). As the starting point for application of the resale price method is the resale price, the tested party must necessarily be the party that purchases the product in the controlled transaction which it then resells.

The resale price margin represents the margin that a reseller of the relevant products would seek to make in order to cover its operating expenses, taking into account the functions it performed, assets employed and risks assumed. The appropriate resale price margin may be determined by reference to the gross profit margins earned in internal comparable uncontrolled transactions or by reference to the gross profit margins earned by independent parties in external comparable uncontrolled transactions. Comparable resale price margins may be used as either a comparison to test compliance with the arm’s length principle or as a reference point for setting the prices in the controlled transactions.

When assessing comparability for the purposes of applying the resale price method it is important to consider that minor differences in the characteristics of the product may not materially affect the condition being examined – the resale price margin - as, for example, minor product differences are more likely to materially impact price as opposed to a profit margin. Functional comparability is very important however, as the main premise underlying the resale price method is that parties with comparable functional profiles (taking into account assets and risks) will be compensated similarly.

The main strengths of the resale price method are that as the condition being examined is at the gross margin level, there is less scope for variables unrelated to the transfer price in the controlled transaction to have an affect (vis-à-vis the TNMM – below), the fact that the starting point is an independent price (i.e. the resale price). The resale price method is however a one sided method, and thus requires the selection of a tested party. As only one party to the transaction is tested, there is the possibility that the arm’s length resale margin for one party may give rise to an extreme result for the other party to the controlled transaction(s) (i.e. a loss or extreme profitability) which may not be arm’s length. Furthermore, the resale price method is very sensitive to the classification of amounts to be

taken into account in calculating the gross profit margin or alternatively as selling and other operating expenses. As gross margin data may not be reported or where there are differences in accounting treatment that cannot be reliably adjusted for, such data may not be available or may be rendered unsuitable for the application of the resale price method (see below).

Common examples of the resale price method being successfully applied in practice include, inter alia:

- Situations where a reseller purchases products for resale from associated parties and independent parties, but due to product differences the CUP method cannot be applied
- Purchases of products from associated parties for resale by a reseller (e.g. a distributor) that does not add significant value by, for example, making physical modifications, contribution of valuable intangible property, significant marketing activities
- Commissionaires and agents (not undertaking significant marketing activities)

Resale price method (illustration):		
Sales price to independent customers	1,000	
Resale margin (i.e. gross margin) (e.g. 40%)	400	Tested in the resale price method; determined from uncontrolled comparables (i.e. purchase price from associated enterprise)
Cost of goods sold: transfer price	(600)	
Selling and other operating expenses	(300)	
Operating profit	100	

Source: OECD Secretariat, Transfer Pricing Methods (2010)

Cost plus method

The **cost plus method** starts with the costs incurred by the supplier of the property or services that are the object of the controlled transaction, which are then marked up by an appropriate mark-up in order to determine an arm's length price. The appropriate cost plus mark-up is determined by reference to the gross margins earned in comparable uncontrolled transactions. Accounting consistency, and in particular the composition of the relevant cost base, is therefore paramount to the reliable application of the cost plus method.

$$\text{Arm's length price} = \text{Cost base} \times (1 + \text{Cost Plus Markup})$$

Where *Cost Plus Markup* = gross profit margin, defined as ratio of gross profit to the relevant cost base

The cost plus mark-up represents the margin that a supplier of the relevant goods or services would seek to make in order to cover operating expenses, taking into account the functions it performed, assets employed and risks assumed. The appropriate cost plus margin may be determined by reference to the gross profit margins earned in internal uncontrolled comparable transactions or by reference to the margins earned by independent parties in external comparable uncontrolled transactions. Comparable cost plus margins may be used as either a comparison to test compliance with the arm's length principle or as a reference point for setting the prices in the controlled transactions.

The condition being examined when applying the cost plus method is the cost plus mark-up earned by the supplier of the products or services; hence it is a one-sided method that requires the selection of a tested party. As the starting point for application of the cost plus method is the costs incurred by the supplier of the goods or services, the tested party must necessarily be the party that supplies the product or service in the controlled transaction. The costs to be taken into account are the direct and indirect costs of producing the product or service, excluding operating costs. As these costs are the starting point, it is important that these costs are either incurred in transactions with independent parties, or otherwise determined to be consistent with the arm's length principle.

The main strengths of the cost plus method are that as the condition being examined is at the gross margin level, hence there is less scope for variables unrelated to the transfer price in the controlled transaction to have an effect (vis-à-vis the TNMM – see below), the fact that independent parties sometimes use costs as a reference point for determining prices and availability of comparable information vis-à-vis the CUP method (see above). However, as gross margin data may not be reported and where it is, differences in accounting treatment cannot be reliably adjusted for, this renders the cost plus method unsuitable in many cases. The availability of reliable gross margin data for the purposes of applying the cost plus method can be problematic in practice, particularly given the importance of ensuring that the cost base is comparable as between the transactions being compared (see below).

Common examples of the cost plus method being successfully applied in practice include, inter alia:

- Situations where a supplier of the goods or services in the controlled transaction(s) supplies similar goods or services to independent parties, but due to differences in the product or service the CUP method cannot be applied
- Sales of products where the manufacturer does not contribute valuable intangibles or assume substantial risks (e.g., contract manufacturers etc.)
- Intra-group services
- Contract research and development arrangements

Cost plus method (illustration):		
Cost of raw materials	200	
Other direct and indirect production costs	100	
Total cost base	300	
Mark-up on costs (e.g. 20%)	60	Tested in the cost plus method; determined from uncontrolled comparables (i.e. sale price to associated enterprise)
Transfer price	360	
Overheads and other operating expenses	(40)	
Operating profit	20	

Source: OECD Secretariat, Transfer Pricing Methods (2010).

Transactional net margin method ²¹

The **transactional net margin method** (“TNMM”) examines an appropriate financial indicator (based on net profit) that the tested party realizes in controlled transactions, and compares it with that realized in comparable uncontrolled transactions. The appropriate financial indicator will differ depending on the facts and circumstances and the selection of the tested party (see below). The appropriate financial indicator is determined by reference to the net profit (operating margin) (see [Appendix 1](#)) earned in comparable uncontrolled transactions (as opposed to the gross margin, as used when applying the resale price or cost plus methods). Examples of financial indicators commonly used are set out in the table below.

Financial Indicators		Tested Party	Examples of use
Operating profit margin (also “EBIT/sales ratio”)	Operating profit*/sales *net margin excluding taxes and interest, also referred to as EBIT	Party earning sales income	Distribution enterprises
Return on total costs (also “full cost plus markup”)	operating profit/total costs	Party incurring costs	Service providers and manufacturers

²¹ In the some countries (namely the United States) a slightly different version of this method is applied, which is referred to as the **comparable profits method** (CPM). The CPM is very similar to the TNMM, the main difference is that in CPM is described in the United States’ regulations as providing for a comparison with the results of uncontrolled entities, whereas the TNMM, as described in the OECD TPG, refers to a comparison of the controlled transaction(s) with uncontrolled transactions. Whilst the distinction is relatively clear in theory, in practice the TNMM is, out of necessity, often applied using whole of entity or segmented data (provided the comparability requirements are still met).

Berry Ratio	Gross profit/operating expenses	Party incurring operating expenses	Distribution enterprises
ROA (return on assets)	Operating profit/assets* *generally tangible operating assets	Party holding and employing assets	Asset intensive activities
ROCE (return on capital employed)	Operating profit/capital employed* *for example, total assets less current liabilities or fixed assets plus working capital	Party with capital employed	Asset/capital intensive activities

Note: See Appendix 1 for example calculations of operating profit margin, return on total costs and berry ratio.

When assessing comparability for the purposes of applying the TNMM it is important to consider that minor differences in the characteristics of the product or service may not materially affect the condition being examined – the net profit margin – as, for example, minor differences as regards the product, services or industry are more likely to materially impact a price or a gross margin, as opposed to a net profit margin. Functional comparability is very important however, as the main premise underlying the TNMM is that parties with comparable functional profiles will be compensated similarly, however relatively minor differences in functionality may not have a material impact on the net margin, or may be able to be appropriately adjusted for, since such minor differences in functions may be reflected in variations in operating expenses.

An advantage of the TNMM is that since the condition being examined is at the net margin level there is a greater pool of potential comparable information available vis-à-vis the CUP, resale price and cost plus methods. Net margins are also being less likely to be materially affected by differences in the product/service or minor functional differences, and net margin information is commonly reported on (in financial accounts) and is less likely to be materially impacted by accounting differences. The TNMM is also very flexible in its application, in that the net margin can be compared to different bases depending on the financial indicator selected, allowing, for example, for the selection of the supplier or the purchaser in the controlled transaction(s) to be selected as the tested party. As a result of this flexibility and the relative availability of information, the TNMM is one of the most commonly applied methods in practice (Cooper & Agarwal 2011), in both developed and developing countries.

One major criticism of the TNMM is that net margins are affected by factors other than the transfer price(s), it is therefore important to ensure that during the comparability analysis that these other non-transfer pricing related factors are considered and that other controlled

transactions that may impact the net margin (such as services payments) are consistent with the arm's length principle.

Common examples of the TNMM method being successfully applied in practice include, *inter alia*:

- Sales of tangible products to distributors (not performing significant marketing functions or contributing valuable intangibles) where the data is not available to use the resale price method
- Sales of tangible products by manufacturers (performing routine manufacturing functions and not contributing valuable intangibles or bearing significant risk) where the data is not available to use the cost plus method
- Where gross margin data is available but is not reliable due to accounting differences
- Intra-group services, including contract research and development arrangements.

Difference between a resale price and a TNMM for a distributor (illustration):	
Sales revenue (sales to independent customers)	1,000
Cost of goods sold (purchases from associated enterprise)	(400)
Gross profit (e.g. 60% of sales)	600
Selling and other operating expenses	(400)
Operating profit (e.g. 20% of sales)	200
Financial items	+10
Exceptional items	(30)
Pre-tax profit (EBT, earnings before taxes)	180
Income tax	(60)
Net profit	120
Dividends/retained earnings	

Tested in a resale price method

Tested in a TNMM

Source: OECD Secretariat, Transfer Pricing Methods (2010).

Difference between a cost plus and a TNMM for a contact manufacturer (illustration):

Cost of raw materials	200	
Other direct and indirect production costs	100	
Total cost base	300	
Mark up on costs (e.g. 20% of costs)	60	Tested in a cost plus method
Transfer price	360	
Overheads and other operating expenses	(45)	
Operating profit (e.g. 5% of costs)	15	Tested in a TNMM

Source: OECD Secretariat, Transfer Pricing Methods (2010).

Transactional profit split method²²

The **transactional profit split method** begins with the relevant profits (or losses) arising from the controlled transaction(s) and then attempts to split those profits between the associated enterprises which are party to those transactions on an economically valid basis. Ideally, this economically valid basis should be supported by market data, however this is not always possible, and thus internal data, applied objectively using allocation keys for example, may be relied upon by necessity.

When applying the profit split method, different approaches may be used for determining the appropriate (arm's length) split of profits between the parties:

- *Comparable profit split* - Relevant profit (or loss) is split by reference to comparable splits of profits observed between independent enterprises in comparable transactions
- *Contribution analysis* - Relevant profits (or losses) from the controlled transaction(s) allocated between the associated parties on the basis of their relative contributions

²² Revised guidance on the application of the transactional profit split method is currently under development at the OECD as set out in the BEPS Actions 8-10, Final Report (2015).

- *Residual analysis* - A two-step approach that first allocates profits to non-unique (routine) activities of the associated parties and then splits the residual profit or loss (if any) on an economically valid basis, e.g. by applying a contribution analysis.

As the condition being examined when applying the profit split method is the split of the combined profits, the profit split is not a one-sided method – the results of all parties to the controlled transaction(s) are considered. The application of the profit split method may however, depending on the approach adopted, require the application of other one-sided methods (such as the resale price method, cost plus method or TNMM) as one of the steps in determining the appropriate split.

The profit split is used in practice in situations where the controlled transactions:

- where each party to the transaction makes unique and valuable contributions, e.g. in the form of valuable intangibles, which cannot be reliably measured by reference to comparable uncontrolled transactions; and/or
- are highly integrated and therefore cannot be reliably considered as a separate basis;
- Where the parties to the transaction share the economically significant risks associated with those transactions.

3.4.4. SELECTION OF TRANSFER PRICING METHOD

When determining which method to apply, reference must firstly be made to the relevant domestic law requirements (if any). In this regard, domestic law may dictate a hierarchy of methods²³; a ‘best method’ standard, or, as is more commonly the case, a standard of “most appropriate method to the circumstances of the case”. The latter approach is that which is provided for in the OECD Transfer Pricing Guidelines²⁴. In practice, it is practical realities and constraints such as the information available concerning comparable transactions, the functional profiles of the parties to the controlled transaction(s) and the type of transactions that typically dictate the method to be applied. In this regard, the guidance provided in the OECD TPG on the selection of the most appropriate method to the circumstances suggests that the following be taken into account:²⁵

- the respective strengths and weaknesses of the methods
- the appropriateness of the method considered in view of the nature of the controlled transaction
- determined in particular through a functional analysis
- the availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods
- the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them.²⁶

Despite the adoption of the most appropriate method standard, the OECD TPG 2017 do still express a preference for the CUP method where it and another method can be applied “in an equally reliable manner”. This same preference is also relevant as regards the other traditional methods (i.e. the cost plus method and the resale price method) when either can be applied in an equally reliable manner to the TNMM).

Illustration of the selection of the most appropriate method to the circumstances of the case	
If CUP and another method can be applied in an equally reliable manner	⇒ CUP
If not:	
Where one party to the transaction performs “benchmarkable” function (e.g. manufacturing, distribution, services for	⇒ One sided method ⇒ Choice of the tested party (seller or

²³ Prior to 2010 the OECD TPG contained a hierarchy of methods, with the TNMM and PSM specified as methods of last resort. This explicit hierarchy was removed in 2010, following an extensive public consultation process on the use of these methods.

²⁴ “The selection of a transfer pricing method always aims at finding the most appropriate method for a particular case.” (para 2.2 of the OECD TP Guidelines 2017)

²⁵ See further paragraphs 2.1 – 2.10 of the OECD Transfer Pricing Guidelines (2010)

²⁶ Paragraph 2.2 of the of the OECD Transfer Pricing Guidelines (2017)

which comparables exist) and does not make any unique and valuable contribution	purchaser): generally the one that has the less complex functional analysis.	
The tested party is the seller (e.g. contract manufacturing or provision of services)	<ul style="list-style-type: none"> ✓ Cost plus ✓ Cost-based TNMM (i.e. testing the net profit/costs) ✓ Asset-based TNMM (i.e. testing the net profit/assets) 	⇒ If cost plus and TNMM can be applied in an equally reliable manner: cost plus
*The tested party is the buyer (e.g. marketing /distribution)	<ul style="list-style-type: none"> ✓ Resale price ✓ Sales based TNMM (i.e. testing the net profit/sales) 	⇒ If resale price and TNMM can be applied in an equally reliable manner: resale price
Where each of the parties makes unique and valuable contributions to the controlled transaction; the transactions are so highly integrated that they cannot be reliably evaluated in isolation; and/or the parties share the economically significant risks in relation to the transaction	⇒ Two-sided method <ul style="list-style-type: none"> ✓ Transactional profit split 	
MNEs retain the freedom to use “other methods” not listed above, provided they satisfy the arm’s length principles. In such cases, the rejection of the above-described methods and selection of an “other method” should be justified.	⇒ Other methods	

Source: Adapted from OECD Secretariat, Transfer Pricing Methods (2010).

3.4.5. SELECTION OF TESTED PARTY

Application of a one-sided transfer pricing method (i.e. the resale price method, the cost plus method and the transactional net margin method – see above) requires the selection of a **tested party**. The tested party is the party for which the relevant condition being examined under the relevant method (i.e. gross profit margin, gross profit mark up, net margin etc.) is to be tested. The selection of the tested party is crucial to the selection of the transfer pricing method to be applied and, in the case of the transactional net margin method, the financial

indicator to be used. The OECD TPG provide the following guidance on the selection of the tested party:²⁷

The choice of the tested party should be consistent with the functional analysis of the transaction. As a general rule, the tested party is the one to which a transfer pricing method can be applied in the most reliable manner and for which the most reliable comparables can be found, i.e. it will most often be the one that has the less complex functional analysis.

In practice, the tested party will generally be the party to the transaction with the least complex functional profile and for which the most reliable information is available. For example, when examining the sale of products by a complex manufacturer that has developed and exploits unique and valuable intangibles (such as patents and trademarks) to a distributor that undertakes general routine functions, assumes minimal risks and that does not employ any unique and valuable intangibles, it is likely that the distributor would be the appropriate tested party, and the resale price method or the transactional net margin method would be applied accordingly. If, however, the factual situation is reversed, and the manufacturer undertakes general routine functions, and assumes minimal risks and the distributor undertakes high value added functions such as extensive marketing and has developed and exploits unique and valuable intangibles (e.g. a valuable trademark), it is likely that the manufacturer would be the appropriate tested party and the cost plus method or transactional net margin method would be applied accordingly.

The tested party may be the local party or the foreign party to the controlled transaction(s). However in practice, issues can arise in some countries regarding the acceptability of a tested party not located in that country, i.e. a so-called foreign tested party, largely due to concerns of availability and reliability of information concerning the foreign party.

3.4.6. ARM'S LENGTH RANGE

Although application of the most appropriate transfer pricing method(s) can give rise to a single arm's length price or margin, in practice it is commonly the case that application of the most appropriate method(s) will result in a range of acceptable arm's length results (i.e. an **arm's length range**). This range may come about because:²⁸

- in using a single method, the arm's length principle only produces an approximation of conditions that may be established between independent enterprises and for this reason the comparables examined may lead to different results
- when using more than one method, differences in the nature of the methods and data relevant to applying each method may produce different results

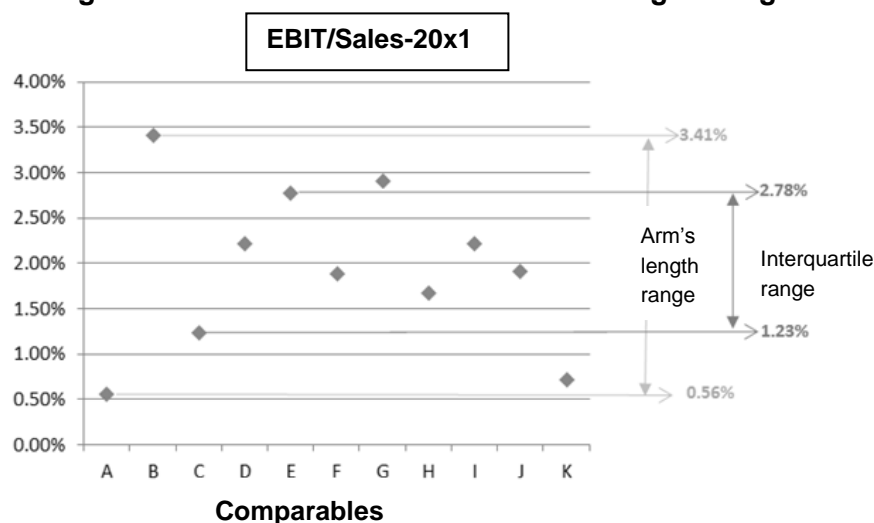
In practice, an arm's length range is more likely to arise as a result of the identification of multiple comparables (of equal reliability) that give rise to different arm's length prices or margins (see figure 1), as opposed to the use of more than one method, as it is not common that more than one method is applied.

²⁷ Paragraph 3.18 OECD TPG 2017

²⁸ Paragraph 2.83 of Australian Taxation Ruling TR 97/20

How the arm's length range is defined and used is a matter of domestic law and/or administrative practice. For instance, some countries typically adopt a 'full' range while in others, statistical measures, such as an interquartile range (see figure 1.5) may be used.

Figure 1.5 – Illustration of “Full” Arm’s Length Range and Interquartile Range



3.4.7. TRANSFER PRICING ADJUSTMENTS

The table below sets out the various types of adjustments that may be made for transfer pricing purposes, depending on the particular case, applicable domestic law and the applicability of a tax treaty.

Type of adjustment	Description
Primary	Adjustment made by the tax administration in order to increase (or decrease) the taxable income of a taxpayer in accordance with the arm's length principle.
Compensating adjustment (actual price adjustment)	Self-adjustment made by the taxpayer, whereby the actual transfer price is adjusted in order to be compliant with the arm's length principle. This would involve the price adjustment being recorded in the accounts of the taxpayer and a debit/credit note being issued.
Compensating adjustment (for tax purposes only)	Self-adjustment made by the taxpayer, whereby the taxpayer reports an (arm's length) transfer price for tax purposes that differs from the amount actually charged by the associated enterprises.
Corresponding adjustment	Adjustment to the tax liability of an associated enterprise corresponding to a primary adjustment made with respect to another associated enterprise in relation to a transaction with the first associated

enterprise so that the allocation of profits between the enterprises is consistent and no double taxation of the same income occurs.

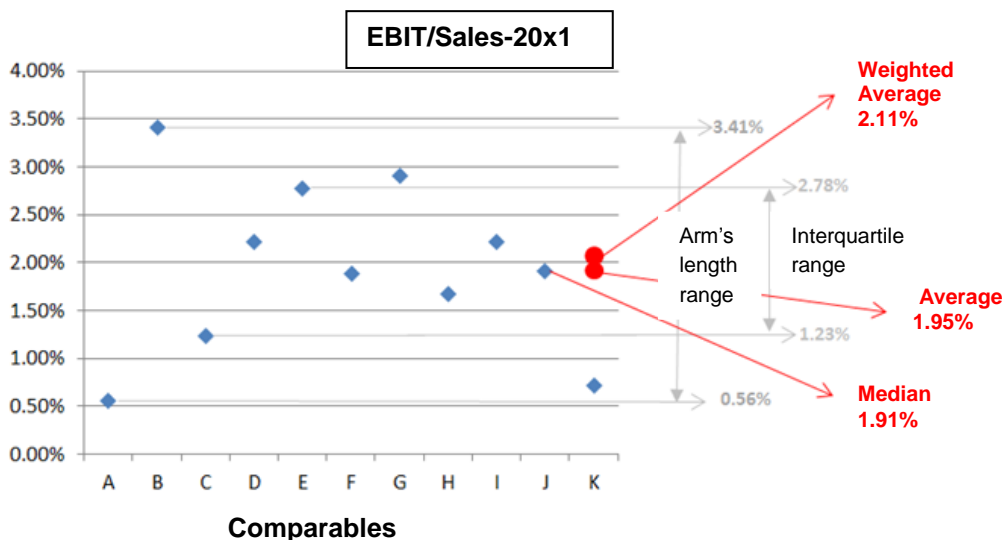
Secondary adjustment

Adjustment that arises from imposing a tax on a secondary transaction (that is, a constructive transaction asserted in order to make the actual allocation of profits consistent with the primary adjustment).

As regards primary adjustments, in most countries, where the price or margin used in the controlled transaction falls within the arm’s length range (see above), no transfer pricing adjustment will generally be made. However, where the price or margin falls outside of the arm’s length range, an appropriate point within the range will need to be selected.

In practice, various approaches are adopted to the selection of the appropriate point within the range. The OECD Transfer Pricing Guidelines state that “*In determining this point, where the range comprises results of relatively equal and high reliability, it could be argued that any point in the range satisfies the arm’s length principle*”²⁹. Therefore, in practice, the selection of the appropriate point in the range should be based on the facts and circumstances, weighing up various qualitative factors. However, in the absence of any factors or circumstances in favor of a particular point in the range, or where there are comparability defects (i.e. due to a lack of information or the use of “inexact” comparables) the use of measures of central tendency (such as the average (mean), median or weighted average) may be prescribed, or deferred to in practice (see figure 1.6).

Figure 1.6 – Illustration of Measures of Central Tendency



²⁹ Paragraph 3.62 OECD TPG 2017

3.5. DISPUTE AVOIDANCE AND RESOLUTION

In addition to the typical domestic tools available for the avoidance and resolution of tax disputes, there are two specific mechanisms available for avoiding and resolving transfer pricing disputes.

3.5.1. ADVANCE PRICING ARRANGEMENTS

Advance pricing arrangements (APAs) are arrangements that agree, in advance, an appropriate set of criteria for the transfer pricing treatment of a specific transaction or group of transactions, for a future period of time, generally for a specific taxpayer or group of taxpayers. The sorts of criteria agreed will generally be the transfer pricing method to be applied, comparables to be used (or the arm's length range to be applied from those comparables) and specific critical assumptions as regards the future situation. An APAs will typically cover a period of 3-5 years, but may be longer or shorter, depending on the particular case and the rules and practices of the country(ies) involved.

There are various types of APAs, categorized by the number of parties involved:

- *Unilateral* – APAs involving an arrangement between the taxpayer and the tax administration.
- *Bilateral* – APAs involving an arrangement between two tax administrations and the associated enterprises in those two countries
- *Multilateral* - APAs involving an arrangement between multiple tax administrations and the associated enterprises in each country

The number of countries with APA programs (i.e. offering APAs) has been increasing steadily and APAs, as a result, are becoming more commonplace. In addition to being used a dispute avoidance tool, APA's can play a role in resolving existing disputes through agreement on both historical and future treatment.

3.5.2. MUTUAL AGREEMENT PROCEDURE

The **Mutual Agreement Procedure** (MAP) article of double tax agreements (see section 3.3.2) plays a crucial role in eliminating double taxation by providing a legal framework for the competent authority of one contracting state to the treaty to come together with the competent authority of the other contracting state to endeavour to remedy instances of "taxation not in accordance with the provisions of the Convention." Whilst the MAP is equally applicable to non-transfer pricing cases, such as disputes regarding the existence of and attribution of profits to a permanent establishment, residence, and withholding taxes, historically the majority of these cases have involved transfer pricing issues.

The outcome of a MAP may involve the contracting state that made the primary adjustment reducing or withdrawing the adjustment, or the other contracting state making the necessary corresponding adjustment in order to eliminate economic double taxation, or a combination thereof. However, the MAP articles of most of the comprehensive tax treaties currently in force do not require that the competent authorities reach an agreement, only that they endeavour to do so. Thus, under such agreements, there is no guarantee that any economic

double taxation arising from transfer pricing adjustments will be eliminated. Efforts to strengthen the effectiveness of the MAP process have, therefore, also been a key element of the OECD/G20 BEPS process, which resulted in the adoption of commitment to implement specific measures (a “minimum standard”) aimed at the timely, effective, and efficient resolution of treaty based disputes.³⁰

In recent years, an increasing number of MAP articles have been drafted to include binding arbitration provisions.³¹ In addition to this, countries signing the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS also had an option to adopt measures which could provide for binding arbitration. Where applicable, treaties containing such provisions may require that a solution be implemented by the contracting states in order to eliminate the double taxation. The European Arbitration Convention (1990), which deals specifically with the elimination of double taxation in connection with the adjustment of profits of associated enterprises, provides for compulsory binding arbitration as regards disputes between its contracting parties.

In addition to providing a mechanism for resolving disputes, MAP articles also provide a legal basis for competent authorities to negotiate bilateral and multilateral advance pricing agreements for specific taxpayers (see above) and, although much less common in practice, more general agreements covering a particular transaction type or industry.

3.6. SELECTED PRACTICAL ISSUES

Set out below are brief overviews of selected practical considerations of importance to understanding the interface of transfer pricing and Customs valuation.

3.6.1. DIFFICULTIES IN OBTAINING COMPARABLE INFORMATION

In practice, obtaining data that reflects transactions between unrelated parties, is public and meets the standard of comparability can be very difficult. Enterprises typically do not make information public unless they are required to, and, due to the size and number of MNE groups, transactions between unrelated parties are increasingly scarce. As a result, obtaining information concerning comparable transactions is one of the greatest difficulties faced in the practical application of transfer pricing. Practitioners make use of what information can be obtained within this rigid framework. Often, the information that is available is information concerning public filings by enterprises, namely financial accounts, but also, in some jurisdictions, details of licence agreements and finance transactions. Certain products may be publically traded (i.e. commodities), providing a potential source of transactional information, but can be limited in number.

³⁰ OECD/G20 Base Erosion and Profit Shifting (BEPS), Action 14 Final Report (2015): “Making Dispute Resolution Mechanisms More Effective.”

³¹ Example provisions are included in Article 25(5) of the OECD Model (2010) and Article 25B of the UN Model (2011)

However, solutions need to be found in practice and the recently published “Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analysis”³² presents practical tools to help with a search for potential comparables, common approaches to adjust imperfect comparables, and discusses policy options (use of safe harbours, reference to quoted prices for commodity sales, selective use of anti-avoidance approaches) that can be considered by countries to address problems of poor availability of accessibility of relevant data.

3.6.2. SECRET COMPARABLES

Tax administrations will generally have access to information regarding taxpayers and their transactions that is not publicly available and is the subject of tax secrecy laws. Use of such information (often generally referred to as the use of “secret comparables”) to determine and support transfer pricing adjustments is a contentious issue, and may or may not be possible under a country’s domestic law. In this regard, the OECD TPG recommend against the use of secret comparables:³³

Tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts.

In practice, countries have adopted a range of different approaches to the use of secret comparables. However, in the vast majority of cases the use of secret comparables is either explicitly disallowed in the legislation or administrative guidelines, or they are not relied upon in practice by the tax administration.

3.6.3. USE OF WHOLE OF ENTITY FINANCIALS AS COMPARABLES

One of the most commonly relied upon sources of comparable information in practice is commercial databases. Commercial databases are databases whereby accounts or details of transactions (that are otherwise publically available) are collated and presented in an easily searchable form. Although these databases require a paid subscription (which can be a particular constraint in developing countries with limited resources), they can generally provide a more cost effective way for identifying external comparables. Commercial databases typically present whole of entity financial data (i.e. company financial accounts) and data on specific transactions types (such as financial transactions (loans) and royalty agreements), depending on the particular database. One limitation of such databases is that

³² Platform for Collaboration on Tax (2017): A Toolkit for Addressing Difficulties in Accessing Comparables Data for Transfer Pricing Analyses. <http://documents.worldbank.org/curated/en/447901498066167863/pdf/116573-REVISED-PUBLIC-toolkit-on-comparability-and-mineral-pricing.pdf>

³³ Paragraph 3.36 OECD Transfer Pricing Guidelines 2017

the information they contain is based on publically available information, which may be limited or non-existent in many countries (see above).

As the most common source of publically available information is whole of entity financial accounts, it is this information that is often, out of necessity, relied upon for transfer pricing purposes. This does not however mean that a wholesale comparison of profit margins of entities is acceptable. Rather, an assessment of the comparability of the (independent) entity as a whole is undertaken vis-à-vis the controlled transaction(s) being analysed, taking into account all of the five comparability factors. Where the independent entity as a whole has differences vis-à-vis the controlled transactions(s) that materially impact the condition being examined under the transfer pricing method (for example, differences in functions performed, undertaking different types of transactions) it will not be considered comparable, unless such differences can be adjusted for. The OECD Transfer Pricing Guidelines provide the following guidance in this regard:³⁴

In practice, available third party data are often aggregated data, at a company-wide or segment level, depending on the applicable accounting standards. Whether such non-transactional third party data can provide reliable comparables for the taxpayer's controlled transaction or set of transactions aggregated consistently with the guidance at paragraphs 3.9-3.12 depends in particular on whether the third party performs a range of materially different transactions. Where segmented data are available, they can provide better comparables than company-wide, non-segmented data, because of a more transactional focus, although it is recognised that segmented data can raise issues in relation to the allocation of expenses to various segments. Similarly, company-wide third party data may provide better comparables than third party segmented data in certain circumstances, such as where the activities reflected in the comparables correspond to the set of controlled transactions of the taxpayer transactions.

3.6.4. USE OF THE PROFITS BASED TRANSFER PRICING METHODS

In practice, the transactional information necessary to apply the CUP method, and reliable gross margin level information for applying the resale price method or cost plus method can be scarce outside particular industries. Requirements that the information be in the public domain, and involve unrelated parties, and that the standard of comparability, taking into account the five comparability factors is met, substantially limit the pool of available information.

As financial accounts are the most readily available source of potential comparable information (see above), in practice the profits-based transfer pricing methods, in particular the TNMM are the most commonly relied upon methods). The TNMM, which draws upon net margin information presented in financial accounts, is widely used. Whilst financial accounts may also contain gross margin information, due to differences in accounting standards and elections the reliability of this information for applying the cost plus or resale price methods may be questionable.

³⁴ Para 3.37 OECD TPG 2017

Where profits-based methods are relied upon, the impact on profitability of other economic considerations unrelated to the controlled transactions (such as functional differences, inefficiencies and the level of operating costs) requires consideration. As part of the comparability analysis, any differences in the operating model and function profile will be considered, along with a whole range of other factors that may potentially impact the net margin. Information will only be considered comparable where it is determined that no differences exist that materially impact on the net margin, or, where such differences do exist, reliable adjustments can be made to eliminate the effect of the differences on the net margin.

Determining the relevant information concerning the controlled transaction(s) for comparison under the TNMM, often requires allocation of operating costs across different business segments, transaction or product types. Further, it must be ensured that any other controlled transactions that may impact the level of operating costs, such as services payments to associated parties, are consistent with the arm's length principle.

3.6.5. AGGREGATION OF CONTROLLED TRANSACTIONS

Although transfer pricing legislation is generally applicable on a transaction by transaction basis, in practice transactions are often aggregated for the purposes of application of the arm's length principle, with the analysis being undertaken on a product line or divisional basis. When aggregating however, caution is needed, particularly where the resale price method, cost plus method or transactional net margin method are being applied. In particular, the following require consideration:

- **Aggregation of controlled and uncontrolled transactions.** If controlled and uncontrolled transactions are aggregated, what may look like an arm's length result, may not be. For example, the margins achieved on the controlled transaction(s) may be being masked by those achieved on uncontrolled transactions.
- **Aggregation of controlled transactions that are not comparable.** Aggregation of controlled transactions that are not themselves comparable will not provide an appropriate basis for the application of the arm's length principle. For example, aggregation of revenues and expenses relating to the delivery of both specialized services and basic administrative services (the former generally attracting greater remuneration than the latter) may result in the administrative services being overpriced and/or the specialized services being underpriced.
- **Similar transactions with multiple associated parties.** Where similar transactions are entered into with multiple parties, this may not be appropriate. For example, if a distribution entity purchases similar products from two associated parties which it distributes into its local market, aggregation of these transactions could mask the fact that the distributor is paying greater than the arm's length price for products purchased from one associated party and less than the arm's length price for products purchased from the other.

3.6.6. BUSINESS RESTRUCTURINGS AND TYPICAL BUSINESS MODELS

Business restructurings typically involve the centralization of functions, assets (intangibles in particular), and risks, together with the related profit potential. The conversion of “fully fledged manufacturers” into contract or toll manufacturers and the conversion of fully fledged distributors into limited risk distributors or commissionaires are typical examples of business restructurings that have become increasingly common. As a result the way in which MNE groups operate has impacted significantly on international trade. In particular, the use of principal entities and stripped risk distribution and manufacturing models has resulted in a situation whereby the physical flows of goods often do not align with the flow of legal title in relation to those goods.

3.7. TRANSFER PRICING COMPLIANCE

3.7.1. ANNUAL REPORTING SCHEDULES

Tax administrations around the world have adopted various approaches to collecting the information needed to identify transfer pricing risks, ranging from requiring basic disclosures in the annual tax return to requiring taxpayers to complete specific schedules detailing related party transactions. Typically annual ‘transfer pricing schedules’ require taxpayers to disclose, on an annual basis, information such as:³⁵

- economic classification/business activities
- locations of related parties
- types and amounts of related party transactions
- transfer pricing methods applied
- loan balances
- existence of transfer pricing documentation

In addition to the general annual disclosure requirements, some tax administrations seek to collect more detailed information or information on selected topics and transaction types from specific taxpayers or categories of taxpayer. Targeted questionnaires are sometimes used for such purposes.

3.7.2. TRANSFER PRICING DOCUMENTATION

Transfer pricing documentation is specific documentation prepared by a taxpayer and or their advisors that is aimed at providing the tax administrations with the information they need to identify transfer pricing risks and assess the taxpayers’ compliance with the transfer pricing legislation. A lot of the information typically contained in transfer pricing documentation is aimed at describing the business activities of the taxpayers and the specifics of the related party transactions.³⁶

As part of the OECD/G20 BEPS project, transfer pricing documentation requirements were reviewed under Action 13 and it was agreed in October 2015 to introduce a uniform

³⁵ See further: OECD Draft Handbook on Transfer Pricing Risk Assessment (April 2013) - <http://www.oecd.org/ctp/transfer-pricing/Draft-Handbook-TP-Risk-Assessment-ENG.pdf>

³⁶ Appendix 2 sets out the typical content of transfer pricing documentation that may be relevant to Customs valuation.

documentation standard. The three-tiered approach now incorporated into Chapter V of the TPG is aimed at increasing global consistency and transparency, requiring a local file with information on all relevant intercompany transactions of a particular entity, a master file with high level global information on the MNE group activities, and a country-by-country report with aggregate information for all entities and tax jurisdictions. **Chapter C.2 of the UN Practical Manual** contains a useful summary of the different approaches and key issues.

A summary of the proposed three tiered approach for transfer pricing documentation structure is provided at Annex X.

APPENDIX 1 : EXAMPLES OF FINANCIAL INDICATORS CALCULATIONS

Income Statement

	Note	Year ended 31 December	
		2011	2010
Continuing operations			
Revenue	5	211,034	112,360
Cost of sales	6	77,366	46,682
Gross profit		133,668	65,678
Distribution costs		52,529	21,213
Administrative expenses		29,895	10,426
Other income	7	2,750	1,259
Other (losses)/gains-net	8	90	63
Operating profit		53,904	35,361
Finance income	11	1,730	1,609
Finance costs	11	8,173	12,197
Finance costs-net	11	6,443	10,588
Share of (loss)/profit of associates	12b	215	145
Profit before income tax		47,676	24,918
Income tax expense	13	14,611	8,670
Profit for the year from continuing operations		33,065	16,248
Discontinued operations			
Profit for the year from continued operations (attributable to equity holders of the company)	25	100	120
Profit for the year		33,165	16,368

Source: PWC, "Illustrative IFRS Consolidated Financial Statements For 2011 Year Ends"
<https://pwcinform.pwc.com/inform2/show?action=informContent&id=1148143710136176>

Set out below is a selection of example calculations of the financial indicators relevant when applying the transfer pricing methods discussed above:

Gross Profit Margin (Resale Price Margin):

$$\begin{aligned}
 &= [\text{Gross profit} / \text{Revenue}] \times 100\% \\
 &= [133,668 / 211,034] \times 100\% \\
 &= 63.34
 \end{aligned}$$

Cost Plus Margin:

$$\begin{aligned}
 &= [\text{Gross profit} / \text{cost of sales}] \times 100\% \\
 &= [133,668 / 77,366] \times 100\% \\
 &= 172.77\%
 \end{aligned}$$

Operating Profit Margin (also "EBIT/sales ratio") :

$$\begin{aligned}
 &= [\text{Operating profit} / \text{Revenue}] \times 100\% \\
 &= [53,904 / 211,034] \times 100\% \\
 &= 25.54\%
 \end{aligned}$$

Return on Total Costs (also “full cost plus markup”)

$$\begin{aligned} &= [\text{Operating profit} / \text{Total costs}] \times 100\% \\ &= [\text{Operating profit} / (\text{cost of sales} + \text{distribution costs} + \text{administrative expenses} - \text{other income} \\ &\quad + \text{other (losses)/gains} - \text{net})] \times 100\% \\ &= [53,904 / (77,366 + 52,529 + 29,895 - 2,750 + 90)] \times 100\% \\ &= [53,904 / 157,130] \times 100\% \\ &= 34.31\% \end{aligned}$$

Berry Ratio

$$\begin{aligned} &= [\text{Gross profit} / \text{Operating expenses}] \\ &= [\text{Gross profit} / (\text{distribution costs} + \text{administrative expenses} - \text{other income} + \text{other (losses)/} \\ &\quad \text{gains net})] \\ &= [133,668 / (52,529 + 29,895 - 2,750 + 90)] \\ &= [133,668 / 79,764] \\ &= 1.676 \end{aligned}$$

APPENDIX 2 : REFERENCES

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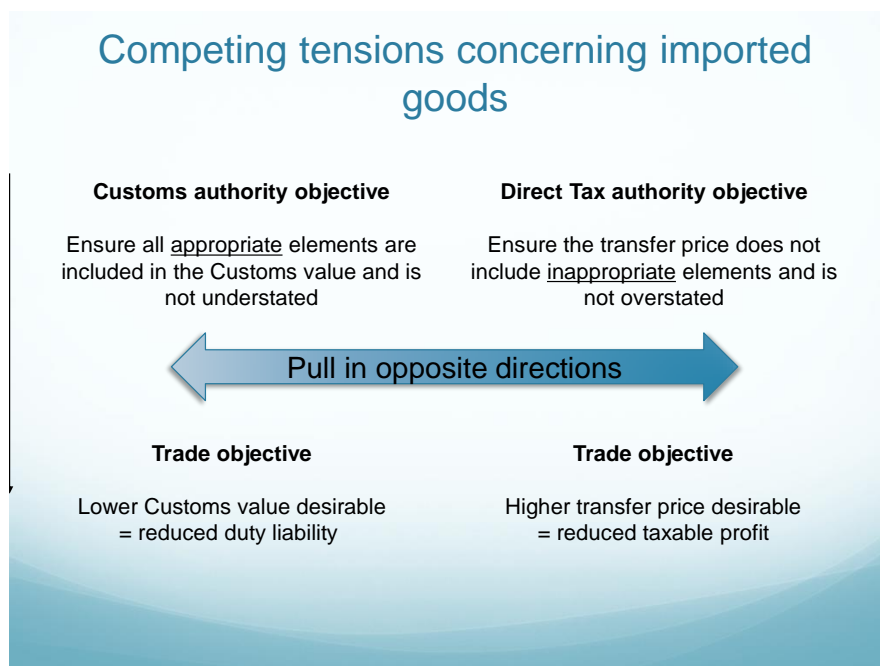
Chapter 4 : LINKAGES BETWEEN TRANSFER PRICING AND CUSTOMS VALUATION

4.1. BACKGROUND

Following the descriptions given in Chapters 2 and 3, it can be seen that the aim of both Customs valuation and transfer pricing methodologies is very similar: whereas Customs are establishing whether or not a price has been ‘influenced’ by the relationship between the parties, the tax objective is to seek an ‘arm’s length price’. Each is ensuring that the price is set as if the parties were not related and had been negotiated under normal business conditions.

It has been pointed out that there are marked similarities between the WTO and OECD methods for Customs valuation and transfer pricing respectively. For example, the WTO deductive method (Article 5) is based on the resale price of the goods as is the OECD resale price method; the WTO computed value method (Article 6) is based on a value built up from materials and manufacturing costs etc., plus profit, similar to the OECD cost plus method. However, although this is of interest, it is not directly relevant to the issue at hand. As explained in Chapter 2, Customs’ focus is on the transaction value method and whether or not the declared price has been influenced when buyer and seller are related. Customs therefore in the main will be examining transfer pricing data in this context and not in relation to the use of other WTO methods.

Having identified the similar concepts, it can be seen that the perspective and objective of each approach are a mirror image of the other:



There are also a number of differences in approach between Customs and tax which are explored in [Chapter 5](#).

The **OECD Transfer Pricing Guidelines** (2017) include the following text :

D.5 Use of Customs valuations

1.137. The arm's length principle is applied, broadly speaking, by many Customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises, which may be affected by the special relationship between them, and the value for similar goods imported by independent enterprises. Valuation methods for Customs purposes however may not be aligned with the OECD's recognised transfer pricing methods. That being said, Customs valuations may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price and vice versa. In particular, Customs officials may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction.

1.138. Taxpayers may have competing incentives in setting values for Customs and tax purposes. In general, a taxpayer importing goods may be interested in setting a low price for the transaction for Customs purposes so that the Customs duty imposed will be low. (There could be similar considerations arising with respect to value added taxes, sales taxes, and excise taxes.) For tax purposes, however, a higher price paid for those same goods would increase the deductible costs in the importing country (although this would also increase the sales revenue of the seller in the country of export). Cooperation between income tax and Customs administrations within a country in evaluating transfer prices is becoming more common and this should help to reduce the number of cases where Customs valuations are found unacceptable for tax purposes or vice versa. Greater cooperation in the area of exchange of information would be particularly useful, and should not be difficult to achieve in countries that already have integrated administrations for income taxes and Customs duties. Countries that have separate administrations may wish to consider modifying the exchange of information rules so that the information can flow more easily between the different administrations.

The **United Nations transfer pricing manual**, approved in October 2012 and updated in 2017 with contributions from the WCO, aimed primarily at non-OECD developing countries (see further detail in [Chapter 3](#)), provides a similar methodology to the OECD Guidelines noting that:

“ ... both Models, which between them are the basis for nearly all bilateral treaties for avoiding double taxation, endorse the “arm's length standard” (essentially an approximation of market-based pricing) for pricing of transactions within MNEs.”

B.2.4.7. ‘Use of Customs Valuations’ states: *“...there may be perhaps an inherent conflict between the revenue implications and the motivation of the customs and direct tax authorities.”*

And, *“It is important to note here that both the methodologies set by the WTO and OECD aim at determining a price for related party transactions, as if the parties were not related; the approaches of the Customs authorities and direct tax authorities are, however, often different and incompatible due to different motivations, theoretical frameworks, documentation requirements and other factors. There is a need to achieve a convergence of transfer pricing and customs valuation through better coordination and exchange of information between these two authorities.”*

4.2. PRACTICAL USE OF TRANSFER PRICING DOCUMENTATION

The recommended way for both Customs and tax administrations to verify the duty/tax liability of MNEs is via compliance-based audit, selected on the basis of risk criteria. This involves the examination of companies' financial systems, accounts and payment records etc. and is recommended as the most effective means of Customs control. The WCO has provided guidance on post-clearance audit controls (PCA), available [here](#).

MNEs prepare transfer pricing studies and reports primarily to provide information on company activities and finances etc. for the purposes of tax auditing (both internal and external).

Over recent years, it had been proposed that transfer pricing studies may also be of use to Customs auditors on the basis that such studies can provide useful information regarding related party transactions of imported goods. This potentially reduces the burden on business in that this information is already available and does not need to be prepared specifically for Customs. This does not mean however that Customs must rely solely on transfer pricing documentation; additional evidence may be requested, as necessary, as part of an audit/verification enquiry.

The question which therefore arose is whether transfer pricing information may be of use to Customs in this regard and, if so, how can Customs interpret and use such data?

A second important question concerns the various types of adjustments which take place for transfer pricing purposes (see [Chapter 3](#)). To what extent, and in what circumstances, do transfer pricing adjustments have an impact on the Customs value?

4.3. JOINT WCO – OECD CONFERENCES / WCO FOCUS GROUP

The WCO and OECD held two joint conferences in 2006 and 2007 to help gain a better understanding of the topic. Specialists from Customs and tax administrations and the private sector presented and discussed various viewpoints and proposals regarding issues such as the scope for greater alignment and other technical aspects.

Following the second conference in 2007, a Focus Group was established (again comprising Customs and tax officials and business representatives) to consider the key themes which emerged during the conferences.

Some commentators have suggested that there should be some formal alignment or merger of the two methodologies. It became clear however, following the joint conferences and Focus Group meeting, that such harmonization was not a realistic proposition, particularly given the fact that application of the methodology contained in the WTO Valuation Agreement is an obligation for a WTO Member country and it is not expected to be amended/updated in the short to medium term. So the challenge is to consider what is possible within the constraints of the existing WTO Agreement provisions.

It was recognised that the “test values” option in Article 1.2 (b) and (c) for examining related party transactions was not likely to be useful for MNEs which typically sell unique goods. In other words, it is unlikely that such test values, based on the strict criteria of identical or similar goods provided in the Agreement, will be available. So the focus was on the analysis of the “circumstances surrounding the sale” provision outlined in Chapter 2.

The Focus Group recommended, *inter alia*, that the following technical points be taken up for examination and consideration by the Technical Committee on Customs Valuation (TCCV) :

- i. The phrase “circumstances of sale” in Article 1.2 (a) of the WTO Valuation Agreement in respect of its application to Transfer Pricing situations.*
- Consideration of the Customs valuation treatment of situations where a Transfer Pricing agreement indicates that the declared Customs value will be adjusted as necessary at a later date to achieve a pre-determined profit margin (known as price review clauses). This could be a development of earlier work of the Committee on Price Review Clauses.*

4.4. WORK OF THE TECHNICAL COMMITTEE ON CUSTOMS VALUATION (TCCV)

Following the Focus Group meeting in 2007, the topic “Related party transactions under the Agreement and Transfer Pricing“ was included in the agenda of the TCCV and has been a regular agenda item since the 26th Session (Spring 2008).

The key progress made to date has been the adoption of **Commentary 23.1**, an instrument of the TCCV which acknowledges that a transfer pricing study may be of use in the examination of related party transactions for Customs value purposes, on a case by case basis. This instrument (reproduced in [Annex III](#)) confirms the principle that transfer pricing studies are a source of information which can be considered by Customs and so provides an important first step.

The TCCV subsequently adopted its first Case Study, **Case Study 14.1** (reproduced in [Annex VI](#)) which is based on an example where a transfer price was established under the transactional net margin method (TNMM). Another case study, **Case Study 14.2** (reproduced in Annex VII) based on the resale price methodology has been approved by the TCCV during the 45th Session in October 2017 and will be submitted to the WCO Council for final approval in June 2018. These texts have been developed to illustrate specific situations where an analysis of transfer pricing studies has provided information which has enabled Customs to reach a conclusion regarding whether or not a price has been influenced by the relationship between buyer and seller.

4.5. WCO COOPERATION WITH OECD AND WORLD BANK GROUP (WBG)

The WCO has been working closely with both the OECD and WBG in furthering understanding of this issue in Customs and tax administrations.

At the technical level, the OECD has attended sessions of the TCCV as Observer to provide technical input to discussions on transfer pricing and Customs valuation. The WCO also has Observer status at the OECD’s Working Party no. 6, on taxation of multinational enterprises.

A programme of regional workshops is being conducted jointly by the three organizations which brings together Customs and tax officials specialising in Customs valuation and transfer pricing respectively to raise awareness and share experiences and good practices at the national, regional and international level.

4.6. PRIVATE SECTOR VIEWS - ICC POLICY STATEMENT

The International Chamber of Commerce (ICC), as the world business organization speaking with authority on behalf of enterprises from all sectors in every part of the world, has produced a policy statement (updated in 2015) outlining a series of comments and proposals reflecting the trade view on the relationship between transfer pricing and Customs value. The key points highlighted below underline the business interest in the two areas identified by the Focus Group, namely the use of transfer pricing data to demonstrate that a relationship has not influenced the price for Customs purposes and the treatment of transfer pricing adjustments. Firstly, it is advocated that where businesses establish prices for related party transactions in accordance with the arm's length principle, Customs should recognise that this generally demonstrates - based on transfer pricing documentation - that the relationship has not influenced the price for Customs valuation purposes. Secondly, the ICC proposes that Customs recognise the possible impact of post-transaction transfer pricing adjustments (both upwards and downwards) on the Customs value and agree to review the value, based on proposed simplified procedures.

ICC Policy Statement - Highlights³⁷

- Recognition by the customs administration that businesses which establish prices between related parties in accordance with the arm's length principle (as per Article 9 OECD Model Tax Convention) have generally demonstrated that the relationship of the parties has not influenced the price paid or payable under the transaction value basis of appraisal, and consequently the prices establish the basis for customs value.
- Recognition by the customs administration of post-transaction transfer pricing adjustments (upward or downward). This recognition should be applicable for adjustments made either as a result of a voluntary compensating adjustment – as agreed upon by the two related parties – or as a result of a tax audit
- It is recommended that in the event of post transaction transfer pricing adjustments (upward or downward), customs administrations accede to review the customs value according to either of the following methods as selected by the importer: application of a weighted average duty rate, or an allocation according to specific codes of the customs tariff nomenclature.
- It is recommended that in the case of post-transaction transfer pricing adjustments (upward or downward), companies be relieved from:
 - a) The obligation to submit an amended declaration for each initial customs declaration
 - b) The payment of penalties, as variations of the transfer price
- It is recommended that customs administrations recognize that the functions and risks undertaken by the parties as documented in a transfer pricing study following an OECD transfer pricing methodology are crucial to the economic assessment of the circumstances of the sale.
- Recognition of the acceptability of relevant transfer pricing documentation by the customs administration as evidence that the price paid for imported goods was not influenced by the relationship of the parties.

³⁷ The views and opinions expressed in the International Chamber of Commerce (ICC) Policy statement do not necessarily reflect those of the WCO or of the governments of its Members.

The full Policy Statement is reproduced in Annex VIII.

The ICC is also contributing to the discussions in the TCCV.

Chapter 5 : USING TRANSFER PRICING INFORMATION TO EXAMINE RELATED PARTY TRANSACTIONS

5.1. INTRODUCTION

This chapter explores the two key areas identified by the Focus Group, as outlined in Chapter 4. Following the principle established in Commentary 23.1, which acknowledged that information contained in a transfer pricing study may be useful to Customs, the next logical questions which arise are: what particular information typically found in a transfer pricing study may be useful to Customs in order to demonstrate that the price had not been influenced by the relationship and how should the Customs value be determined, taking into account relevant transfer pricing adjustments?

To this end, Customs officials require a sufficient level of knowledge to interpret transfer pricing documentation and derive relevant information. This is most effectively done via a post-clearance audit and in cooperation with the business concerned. It is also beneficial for Customs to consult with national tax officials responsible for transfer pricing to seek expert advice and any direct knowledge of the company concerned from the tax perspective, subject to legal constraints.

5.2. EXAMINATION OF THE PHRASE “CIRCUMSTANCES SURROUNDING THE SALE” IN ARTICLE 1.2 (A) OF THE AGREEMENT VIA USE OF TRANSFER PRICING DOCUMENTATION

5.2.1. BACKGROUND

As described in Chapter 2, the Interpretative Note to Article 1 provides guidance and examples for determining whether the price had not been influenced by the relationship when a related buyer and seller buy from and sell to each other. It is reiterated that such examination should only be conducted in situations where Customs has doubts about the acceptability of the price.

The Note states that Customs should be prepared to examine relevant aspects of the transaction, including :

- the way in which the buyer and seller organize their commercial relations and,
- the way in which the price in question was arrived at.

For example, where it can be shown that the buyer and seller, although related, buy from and sell to each other as if they were not related, then this would demonstrate that the price had not been influenced by the relationship.

There is much information contained in transfer pricing studies and documentation which can assist Customs in conducting such an analysis. Ultimately, Customs will make a decision based on the ‘totality of the evidence’ which may include various sources. However, in certain cases a decision may be reached based primarily on the transfer pricing data.

Information on functional analysis conducted by the tax authority (including examination of functions carried out by a party and their assets and risks) is typically contained in transfer pricing studies and can be informative for Customs in respect of examining the circumstances surrounding the sale.

5.2.2. KEY CHALLENGES

There are a number of differences in the approaches of tax and Customs that makes it difficult to compare 'like with like'.

i. Single product v. product range

Customs' aim is to gain assurance regarding the price of imported goods so one key challenge is to ensure that the transfer pricing data is relevant to the imported goods in question. Where the transfer pricing information covers a range of products it is important to consider whether the available information on costs, profit margins etc. gives assurance regarding the price of the imported goods.

If the business trades in only one product then the comparison should be fairly straightforward in that respect. On the other hand, if the transfer pricing study covers a range of products then the data may still be relevant to Customs.

Take, for example, the situation where the imported goods are branded electrical kettles and the range of goods covered by the study are various branded electrical household appliances (including microwaves, blenders, toasters and kettles).

In this case, the study confirms an acceptable arm's length range for those products, taken as a group. Customs may take into account the criteria given in the third example given for examining circumstances surrounding the sale, namely all the costs plus a profit realised "in sales of goods of the same class or kind". Article 15.3 of the Agreement states that: '*... "goods of the same class or kind" means goods which fall within a group or range of goods produced by a particular industry or industry sector, and includes identical or similar goods.*'

The transfer pricing study and additional research may give Customs assurance that in this case the kettles and other electrical appliances can be considered as goods of the same class or kind. Therefore, details of costings and profits for the range of products may be relevant for each individual product within that group, including the kettle.

ii. Date range

Typically, Customs and tax are examining different time periods when conducting audits. Customs will conduct an audit perhaps up to three or four years after importation of the goods in question (this will vary depending on national law which sets a time limit after importation for collecting underpaid duty or repaying overpaid duty³⁸). Tax audits may take place several years after the event (following completion and auditing of annual accounts etc.). Customs should therefore ensure that the transfer pricing data relates to the period

³⁸ For example, in the European Union this period is three years.

which is being scrutinised during the Customs audit. So, for example, if Customs are auditing consignments imported in 2013, the relevant information to be considered in transfer pricing studies must also relate to transactions in 2013.

Comments on the three examples provided in the Interpretative Note are given below:

1. *Has the price been settled in a manner consistent with the normal pricing practices of the industry in question?*

Such information may be available, for example either in the transfer pricing study or via independent studies of a particular industry sector. It is suggested that Customs consider, at least initially, the information contained in available transfer pricing documentation. It is noted that the Agreement does not define the term “normal pricing practices of the industry”; this may take into account the nature of the goods and role and functions of the parties to the sale.

2. *Has the price been settled in a manner consistent with ... the way the seller settles prices for sales to buyers who are not related to the seller?*

This option is likely to be limited in scope as for many related party transactions the importer is the exclusive distributor of the merchandise in that jurisdiction, i.e. there are no sales to unrelated parties by which a comparison can be made to the import value. Nevertheless, if such sales exist they can be used as a means of examining the circumstances of sale.

3. *Can it be demonstrated that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time (e.g. on an annual basis) in sales of goods of the same class or kind?*

This example focuses on an examination of how a price was set in terms of the elements included, and in particular the profit.

Customs may seek information regarding the exporter's/seller's profit via the importer, although it may be the case that the related company is not willing to share profit information with its distributors/importers so this could prove fruitless. As a first step, it is recommended that Customs consider information already available in the country of importation, in particular transfer pricing documentation, in order to examine the circumstances surrounding the sale.

The example does not define whether “profit” is “gross” or “operating” profit, but this gives Customs the flexibility to review both kinds of profit, depending on what is considered to be useful. Normally, operating profit is a better measure of real profitability because it shows what is earned after all expenses have been paid. Also, it is the measure for which information concerning independent parties will most often be available. Operating profit is also the most common Profit Level Indicator when the transactional net margin method is used.

It has been pointed out that an apparent inconsistency exists with regard to the “tested party” considered for tax and Customs purposes. When applying profit-based transfer pricing methods such as TNMM, the tested party is often the importer (since it is often the less functionally complex of the parties, and due to the availability of comparable data) which

places the focus on the MNE's profit in the country of importation (i.e. sales made by the taxable person). This can be tested against comparable uncontrolled transactions, as explained in Chapter 4, so that a decision can be made regarding whether or not the price in question is arm's length.

The example makes reference to the **firm's** overall profit which is assumed to refer to the seller's (i.e. exporter's) profit. The transfer pricing data, however, relates only to the profit made by the importer and not the seller, so is this still relevant to Customs?

It can be argued that as the import value is the starting point for the importer's profit calculation, information derived from the importer's profit can potentially give Customs assurance that the exporter/seller's profit is acceptable, which in turn may confirm that the price of the imported goods is adequate to ensure recovery of all costs plus a profit and hence not influenced by the relationship.

The following example from Case Study 14.1 illustrates this point :

1. Relevant data for the importer, ICO :

- Sales	100.0
- COGS/ cost of sales (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 (benchmarked)	2.5% of sales

2. Based on this information :

- the Sales figure can be taken to be reliable since ICO is selling only to independent parties (and it is assumed ICO is rationally seeking to maximise its profits in its dealings with arm's length parties)
- the Operating expenses amount can be accepted as reliable since it is determined that these expenses are paid by ICO only to independent parties, with ICO seeking to minimize its costs and no evidence has been found that any of these expenses have been paid at the request of the seller
- the comparability study in the example establishes 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
- the Cost of Goods Sold of ICO (being the price paid or payable to XCO) is not at arm's length (and therefore may not be reliable). However, by working back from the arm's length net margin of 2.5%, the arm's length COGS amount can be deduced.

Thus, if the deduced COGS is equal to the relevant declared transaction value it could be inferred that the price has not been influenced by the relationship.

Another example that is relevant is contained in Case Study 14.2, which describes a situation where a transfer pricing report was submitted based on the Resale Price Method (RPM) by the importer ICO to Customs. The RPM is used in this case as ICO is a simple and routine distributor who does not add substantially to the value of the goods. ICO's targeted gross margin is compared against comparable companies in the country of importation which performed similar functions, assumed similar risks and did not employ any valuable intangible assets, just like ICO.

Bases on the information provided:

- the comparison of the gross margin of ICO with the gross margin of comparable companies could indicate whether or not the declared price had been settled in a manner consistent with the normal pricing practices of the industry
- There is no significant difference between ICO and the selected comparable companies because these comparable companies:
 - are all located in the country of importation;
 - perform similar distribution functions, assume similar risks and do not employ any valuable intangible assets, which are similar to ICO;
 - import comparable products similarly manufactured in country of export.
- In addition, an adequate of product comparability was observed and these comparable companies are deemed to be suitable for Customs valuation purposes

According to the transfer pricing report, the targeted gross margin for ICO was determined at 40%. However, ICO's actual gross margin in the year of examination was 64% which is higher than the targeted gross margin stated in ICO's transfer pricing policy. The arm's length (inter-quartile) range of gross margins earned by the selected comparable companies in the year under examination was between 35 %-46 %, with a median of 43 %.

Thus, as the gross margin was not within the arm's length range of gross margin of the comparable companies, it could be inferred that the import price was not settled in a manner consistent with the normal pricing practices of the industry.

In summary, the examples provided in the Interpretative Notes to the Agreement are not exhaustive; Customs may consider other means of examining the circumstances surrounding the sale and request and take into account the totality of the evidence available and relevant to the sales in question.

Furthermore, as stated in Commentary 23.1:

“the use of a transfer pricing study as a possible basis for examining the circumstances of the sale should be considered on a case by case basis. As a conclusion, any relevant information and documents provided by an importer may be utilized for examining the circumstances of the sale. A transfer pricing study could be one source of such information”.

5.2.3. USE OF ADVANCE PRICING ARRANGEMENTS (APAs) AND ADVANCE RULINGS FOR CUSTOMS VALUATION

Advance Pricing Arrangements (sometimes referred to as advance pricing agreements), give tax administrations and businesses the opportunity to confirm and agree in advance the transfer pricing treatment of a specific transaction or group of transactions and hence

demonstrate the arm's length price (see [Chapter 3](#) for more details). Some Customs administrations have identified that APAs can provide useful information for Customs when examining related party transactions. It may also be the case that Customs valuation needs can be considered in the context of preparing an APA.

The WCO encourages Customs administrations to provide advance rulings for Customs valuation. This is supported by Article 3 of the [WTO Trade Facilitation Agreement](#) which also requires Customs to provide advance rulings for classification and origin purposes. Where such a facility is offered, the business operator may seek a ruling from Customs on a related party transaction (or group of transactions) in advance of the importation of the goods concerned. Customs may then examine the relevant information provided (which could be derived from a transfer pricing study or APA) and make a decision which will apply in that particular set of circumstances. That decision could state whether or not the price in question is influenced by the relationship between buyer and seller and will apply to all future consignments where the facts remain the same as those on which the decision was based, subject to any conditions given in the ruling such as period of validity. Further information on advance rulings is available in the **WCO's Technical Guidelines on Advance Rulings for Classification, Origin and Valuation**.

5.3. CUSTOMS VALUATION TREATMENT WHERE A TRANSFER PRICING AGREEMENT INDICATES THAT THE DECLARED CUSTOMS VALUE WILL BE ADJUSTED AT A LATER DATE

5.3.1. BACKGROUND

As explained in [Chapter 3](#), transfer pricing adjustments³⁹ are a common feature of MNEs' pricing strategies. It is also explained that adjustments take place for different reasons, with different results. It is therefore necessary for Customs to gain an understanding of the different types of transfer pricing adjustment and then consider which may have an impact on the Customs value and how should this be dealt with.

It can be argued that given that the effect of a transfer pricing adjustment is to achieve an arm's length price, in some cases - depending on the type of transfer pricing adjustment - the adjusted price will be closer to the 'un-influenced' price actually paid or payable for Customs valuation purposes. In other cases, such as tax-only transfer pricing adjustments, it may demonstrate that the price was in fact influenced by the relationship. Put another way, Customs may not be able to make a final decision on the question of price influence until any adjustments have been made (or quantified). It is therefore in Customs' interest to study the impact of transfer pricing adjustments on the Customs value.

³⁹ *Note:* to avoid confusion, it is important to understand the distinction between different uses of the word 'adjustments'. It is used in the context of transfer pricing as described above and also in relation to Customs valuation where it refers to 'adjustments' made to the price actually paid or payable under Article 8 of the Agreement. The term is also used to describe a duty adjustment, i.e. when the duty paid at the time of import is varied subsequently by Customs, resulting in either an additional duty payment or refund of duty.

Customs' treatment of transfer pricing adjustments however is currently inconsistent around the world. Some Customs administrations consider both upwards and downwards price adjustments and make corresponding duty adjustments where appropriate, others do not, or only consider upwards adjustments (with additional duty payment) but do not consider downwards adjustments (duty refund). Some consider tax only adjustments, whilst others only consider actual price adjustments. This inconsistency has been one of the main concerns expressed by the business community.

It is desirable therefore that the Customs community strives to achieve a more consistent approach when considering the impact of transfer pricing adjustments on the Customs value.

An important principle is established in an instrument of the TCCV; **Commentary 4.1 - Price review clauses** (see [Annex IV](#)). This instrument considers the Customs value implications of goods contracts which include a "price review clause", whereby the price is only provisionally fixed at the time of importation; *"the final determination of the price payable being subject to certain factors which are set forth in the provisions of the contract itself"*. It concludes that such clauses: *"should not, of themselves, preclude valuation under Article 1 of the Agreement"*. This scenario can be compared to situations where the price declared to Customs at importation is based on a transfer price which may be subject to subsequent adjustment (for example to achieve a pre-determined profit margin). Hence, the possibility of a transfer pricing adjustment exists at the time of importation.

The basic principle of effecting a repayment of duties in the event of an overcharge by Customs is established in the Revised Kyoto Convention:

The Revised Kyoto Convention : International Convention On The Simplification And Harmonization Of Customs Procedures : General Annex, Chapter 4, Duties and Taxes

C. REPAYMENT OF DUTIES AND TAXES

4.18. Standard

Repayment shall be granted where it is established that duties and taxes have been overcharged as a result of an error in their assessment.

5.3.2. POSSIBLE CUSTOMS TREATMENT OF TRANSFER PRICING ADJUSTMENTS

As explained in [Chapter 3](#), there are a number of reasons why a transfer pricing adjustment may take place and different ways that it can be initiated.

Where the adjustment is initiated by the taxpayer and an adjustment is recorded in the accounts of the taxpayer and a debit or credit note issued, it could be, depending on the nature of the adjustment, considered to have an impact on the price actually paid or payable for the imported goods, for Customs valuation purposes. In other cases, particularly where the adjustment has been initiated by the tax administration the impact may be only on the tax liability and not on the price actually paid or payable for the goods.

Where such an adjustment takes place before the goods are imported then the price declared to Customs should take into account the adjustment.

If, on the other hand, the adjustment takes place after importation of the goods, (i.e. it is recorded in the accounts of the taxpayer and the debit/credit note issued after Customs clearance of the goods), then Customs may consider that the Customs value is to be determined on the basis of the adjusted price, applying the principles established in Commentary 4.1.

Regarding transfer pricing adjustments which affect only the tax liability (i.e. no actual change to the amount paid for the goods), Customs may consider whether this is an indication of price influence. In other words, there is an acknowledgement that the original price was not arm's length for transfer pricing purposes but the price actually paid has not been adjusted.

5.3.3. FINAL DETERMINATION OF THE CUSTOMS VALUE FOLLOWING TRANSFER PRICING ADJUSTMENTS

Assuming that Customs agree that the Customs value should be based on the price after the transfer pricing adjustment and consequent financial/accounting adjustment, it is then necessary to consider the appropriate Customs procedures for dealing with this.

Commentary 4.1 makes reference to Article 13 of the Agreement which provides for the possibility of delaying the final determination of Customs value. Article 13 requires Customs administrations to offer a facility to allow importers to clear their goods on provision of a security in cases where it becomes necessary to delay the final determination of the Customs value at the time of Customs clearance.

The question arises whether it is necessary to require importers to lodge Customs declarations on the basis of a provisional declaration of value, covered by a security for the potential duty due. This creates a major resource implication for both business and Customs in terms of accounting and reconciliation procedures, particularly where a large number of Customs declarations are involved.

This issue has been raised as a concern by business. As stated in the ICC's Policy Statement, Proposal 2:

*"Companies should be permitted to perform customs value adjustments without being required to set up a provisional valuation procedure or being subject to penalties due to valuation adjustments."*⁴⁰

Pending any international guidance on this point, it is for national Customs administrations to determine the Customs procedures required in these circumstances. As a basic requirement for Customs to consider an adjustment to the Customs value, it is clear that a transfer pricing policy should be in place prior to the importation or clearance of the goods concerned, which indicates the criteria (or 'formula') that will be applied to establish the final transfer price. Customs may require that the importer reports the existence of the transfer pricing policy in advance of importations. The policy may have been established in the context of an

⁴⁰ The views and opinions expressed in the International Chamber of Commerce (ICC) Policy statement do not necessarily reflect those of the WCO or of the governments of its Members.

Advance Pricing Arrangement. Customs would also typically require the business to report the final transfer price with details of the adjustment; this should be mandatory in the case of an upwards adjustment. Some examples of national practices in this respect are provided in Annex II.

Another important consideration for Customs in the post-importation environment is the treatment of adjustments under Article 8 of the Agreement. Typically, it is during the course of a Customs audit that such adjustments come to light and can be quantified. Customs should therefore take into account other payments made after importation to or for the benefit of the parent company (for example, contributions for design and development fees) or other payments based on subsequent resale, disposal, or use of imported goods that accrue to the vendor, in order to determine whether or not they should be included in the Customs value.

5.3.4. PRACTICAL CHALLENGES

Where Customs decide that an adjustment to the Customs value is appropriate, it is then necessary to determine the mechanism and calculation method. Customs' focus is on individual transactions whereas transfer pricing data is at the aggregate level. Hence it is necessary to find means to calculate and apportion to each consignment an appropriate value.

ICC provide this proposal:

ICC Proposal 3⁴⁰

Application of the weighted average customs duty rate: the weighted average customs duty rate is calculated by dividing the customs duties' total amount for the year by the respective customs value total amount for the same year. This may include the possibility of a lump-sum adjustment at the end of the year. For example, if at the end of the year, the transfer price adjustments result in an additional payment to the seller, then we recommend that the importer be able to report this lump-sum amount. That way customs will be able to allocate this to all entries declared within the year and the duty adjustment will be the weighted average duty rate.

Allocation of the transfer pricing adjustment, according to the nomenclature code, and to information provided by the importer or customs authorities disclosing all commodity codes and all relevant import data available in their national statistics.

Another issue is the timing of the Customs audit: what happens if a transfer pricing adjustment is anticipated but has not yet taken place at the time Customs are conducting an audit? Customs will need to decide whether to wait until the adjustment has been made or take a decision at that stage.

Chapter 6 : RAISING AWARENESS AND CLOSER WORKING

6.1. INTRODUCTION

It was mentioned at the beginning of this Guide that the TCCV has responsibility for interpreting and providing opinions on technical questions which arise in relation to the WTO Valuation Agreement.

It is noted that a number of the issues raised, particularly in relation to Customs' treatment of transfer pricing adjustments, concern Customs procedures and formalities rather than interpretation of the Agreement, (for example, means of notifying Customs of the possibility of adjustments and means of apportioning a duty adjustment to relevant importations).

For these reasons, until further guidance is available Customs administrations are encouraged to consider how they will deal with this issue at the national level. Some administrations may also consider bilateral or regional initiatives. As mentioned below, an important first step is to establish contact with counterparts in the tax administration.

It is acknowledged that developing countries have particular challenges:

- many Customs administrations lack capacity to conduct post-clearance audits and focus primarily on border controls which is ineffective for controlling MNEs;
- the UN Practical Manual (on Transfer Pricing) noted that the manual: *“should reflect the realities for developing countries at the relevant stages of their capacity development”*;
- many tax administrations are still developing their transfer pricing legislation and technical capacity;
- there is commonly a lack of comparable data from other companies which limits the use of certain transfer pricing methods and can add a further layer of complexity.

There are a number of good practices which can be promoted to encourage closer working and sharing of knowledge, skills and information:

6.2. GOOD PRACTICES FOR CUSTOMS VALUATION POLICY MANAGERS

- At the national level, assess the extent to which local MNEs who import are involved in transactions with foreign related parties. This will govern the need to invest resources in this topic;
- Ensure specialist staff working in Customs valuation (particularly in policy and audit teams) are given access to suitable training opportunities on this topic;
- Use of transfer pricing data: Following the principle established in Commentary 23.1, Customs administrations are encouraged to consider information derived from

transfer pricing studies, where available, when examining related party transactions. It is then to be decided, on a case by case basis, whether sufficient information is available to arrive at a decision or whether supplementary data is required;

- Monitor and participate in the discussions of the TCCV;
- Develop/strengthen links and co-operation with counterparts in national tax administrations:
 - Propose mutual awareness-raising/training seminars (i.e. Tax authorities provide training to Customs and vice versa)
 - Discuss options for exchange of information
 - Consider temporary or permanent staff exchanges or recruitment of staff with a tax background
 - Establish large business teams, focusing on MNEs. If Customs is part of a revenue authority, a single large business team may cover both tax and Customs issues. Joint Customs-tax audits can be considered however this may not be practicable given that Customs and tax are likely to be focusing on different time periods
 - Consider setting up an MOU with the tax department, covering above points
- Advise and discuss with the business community the good practices listed below

6.3. GOOD PRACTICES FOR BUSINESS

- MNEs who import are encouraged to ensure their Customs and tax advisors (either internal or external) communicate with each other regarding the mutual needs of Customs and tax authorities in respect of transfer pricing and Customs valuation
- Consider needs of Customs when preparing transfer pricing documentation
- Consider Customs needs in the development of APAs
- Depending on national procedures, ensure Customs are given advance notification where a post-importation adjustment may occur at a later date
- Consider requesting advance rulings from Customs, where available
- Work with Customs to provide and help interpret transfer pricing analyses and data related to imported goods.

6.4. GOOD PRACTICES FOR TAX ADMINISTRATIONS

- Develop/strengthen links and co-operation with counterparts in national Customs administrations:
 - Propose mutual awareness-raising/training seminars
 - Discuss options for exchange of information

- Establish large business teams, focusing on MNEs. If tax is part of a revenue authority, a single large business team may cover both tax and Customs issues
 - Consider setting up an MOU with the Customs department, covering above points
- Take account of how a business determined the Customs value of imported goods. *Note: ICC recommend in their Policy Statement that: “As a basic principle, tax administrations assess and appreciate how the enterprise has arrived at the declared customs value (and vice versa ...).”*⁴¹

⁴¹ The views and opinions expressed in the International Chamber of Commerce (ICC) Policy statement do not necessarily reflect those of the WCO or of the governments of its Members.

ANNEX I : NATIONAL INITIATIVES

Many Customs administrations are now considering how to approach this issue. In a number of countries, communication channels have been established between Customs and tax administrations; for example, working groups or regular meetings have been set up for the exchange of information and transfer of knowledge and skills, in respect of dealing with transfer pricing,

The following examples of national practice from Australia, Canada, Korea, United Kingdom and the United States provide examples of practices which will assist Customs administrations in the development of national policy :

1. Australia

In 2013, the then Australian Customs and Border Protection Service (now the Department of Immigration and Border Protection (DIBP)) issued a Practice Statement to assist industry understand DIBP's valuation legislative requirements and relevant transfer pricing policies. The Statement provides greater flexibility on how traders can show that the relationship between the related parties has not influenced the price of the goods sold between such parties. The Statement describes circumstance whereby information derived from transfer pricing studies may be considered by DIBP when examining related party transactions. This will be done on, a case-by-case basis. Importers may seek a Valuation Advice (VA – a type of advance ruling) from DIBP for this purpose. The VA also provides a basis for Customs to consider upwards and downwards adjustments to the Customs value, following a transfer pricing adjustment. It is emphasised that before any adjustment can be made to the Customs value, there must be an actual transfer of funds related to the transaction that flows into or out of Australia.

An extract is provided below and the full text is available via the link below⁴².

Australia Customs and Border Protection Notice No. 2013/19 (extract)
<p><i>Payment of Additional duty</i></p> <p>Where a transfer pricing VA has been issued and an adjustment results in the Customs value increasing, the proportionate amount of additional duty owed must be paid against the imported goods on the appropriate import declaration.</p>
<p><i>Refund of duty</i></p> <p>Where a transfer pricing VA has been issued and an adjustment results in the Customs value decreasing, the applicant/importer may be entitled to a refund of duty.</p>

⁴² <http://www.Customs.gov.au/webdata/resources/files/ACN2013TransferPricingPracticeStatementFINALFINAL.pdf>

http://www.customs.gov.au/practice_statements/border/ind.asp

2. Canada

The Canada Border Services Agency (CBSA) explains its policy relating to the treatment of transfer price adjustments in Memorandum D13-4-5.

An extract is provided below and the full text is available via the link below⁴³.

Canada Border Services Agency Memorandum D13-4-5 (extract)

Transfer Price Adjustments

20. When a transfer price agreement between a vendor and a related purchaser exists in writing and is in effect at time of importation, the transfer price is considered by the CBSA to be the "uninfluenced" price paid or payable for imported goods.

21. For the price to remain uninfluenced, payments made to the vendor and/or adjustments to the price after importation must be declared to the CBSA.

22. There are different types of adjustments that may be made to a transfer price. For example, a compensating adjustment occurs when the actual transfer price is adjusted in order to be compliant with the terms and conditions of the agreement. This involves the price being recorded in the accounts of the importer and a debit or credit note being issued to the importer depending on whether the adjustment is upward or downward. This may occur throughout the year, at year end, or after year end.

23. Corrections to the declared value for duty must be submitted to the CBSA when the net total of upward and downward transfer price adjustments occurring in a fiscal period is identified. It is at that moment that an importer has specific information giving reason to believe that corrections to declarations of value for duty are necessary.

...

28. The CBSA will examine any payment made directly or indirectly by the purchaser to or for the benefit of the vendor, or payment based on subsequent resale, disposal, or use of imported goods that accrues to the vendor, to verify whether the payment relates to reasonable identifiable services and whether that payment would normally be included in the selling price of a transaction between unrelated parties. All amounts not relating to reasonable identifiable services will be included in the value for duty of the goods. For more information on the treatment of payments or fees made after importation, refer to Memorandum D13-4-3, Customs Valuation: Price Paid or Payable, and Memorandum D13-4-13, Post-importation Payments or Fees (Subsequent Proceeds).

3. Korea

In order to develop a balanced approach between the Customs authority and taxpayers, Korea Customs Service (KCS) has introduced a number of cooperative schemes whereby it carries out stringent enforcement action against tax evasion of any form, while encouraging enterprises to be voluntarily tax-compliant. KCS is keen to narrow the gap between transfer

⁴³ <http://www.cbsa-asfc.gc.ca/publications/dm-md/d13/d13-4-5-eng.html>

pricing and Customs valuation and thus actively implements relevant, specific schemes as follows.

A. Advance Customs Valuation Arrangement (ACVA)

KCS put in place the ACVA scheme in 2008. This scheme is designed to reduce concerns regarding tax liability arising from post clearance audits and resulting appeals, thereby ensuring predictable and secure business management. The scheme is intended to determine in advance, upon request from taxpayers, the dutiable value of goods in related party transactions involving parent and subsidiary companies, through mutual consultation between Customs and taxpayers. Enterprises involved in related party transactions are encouraged by KCS to avail themselves of the ACVA scheme, which is of critical importance to advance tax-duty harmonization or provisional value declaration for compensating adjustments etc.

CUSTOMS ACT Article 37 (extract)

Prior Examination of Methods for Determining Dutiable Value

Where a person liable to file a duty return has inquiries about the following matters regarding the determination of the dutiable value, he/she may apply for a prior examination to the Commissioner of the Korea Customs Service before he/she files a value report.

...

3. Method for determining the dutiable value of goods being traded between persons in special relationships.

B. Advance Tax-Duty Harmonization Scheme

The Advance Tax-Duty Harmonization scheme, introduced in 2015, enables Tax and Customs authorities to coordinate the approval of the filed applications when taxpayers simultaneously file the application for ACVA with the Customs Authority and APA (unilateral only) with the Tax authority. Regardless of the methods used to determine dutiable value and for calculating arm's length price, taxpayers are allowed to apply for this scheme. Both authorities are required to inform the taxpayer and the Ministry of Strategy and Finance of the result of their review of the application.

CUSTOMS ACT Article 37-2 (extract)

Method for Determining Dutiable Value of Customs Duties and Advance Pricing Arrangement

A person, who files an application for advance pricing arrangement under Article 37 (1) 3 because of his/her inquiry about the matter prescribed in determining the dutiable value of goods being traded between persons in special relationships, may simultaneously file an application for the prior approval of the method of calculating the arm's length price (Unilateral APA) with the Commissioner of the Korea Customs Service. In such cases, the Commissioner of the Korea Customs Service shall arrange in advance the dutiable value of customs duties and the arm's length price for a national tax in consultation with the Commissioner of the National Tax Service.

C. Post Tax-Duty Harmonization Scheme

Under the post harmonization scheme, launched in 2012, taxpayers may file an application for rectification with the Head of Customs House in cases of divergence between transaction value and dutiable value; either because the National Tax Authority has adjusted the transaction value of the relevant imported goods, determined and imposed rectification of the taxable base and its amount, or because a prior approval of retroactive application has been granted. The Customs Authority may reject the claim if it finds that the principles of the WTO Valuation Agreement have not been followed. In such a case, taxpayers may file the request for adjustment with the Ministry of Strategy and Finance.

CUSTOMS ACT Article 38-4 (extract)

Rectification of Dutiable Value of Imported Goods after Adjustment

Where the transaction price of imported goods becomes different from the dutiable value that is a basis for calculating the amount of duty returned, paid and rectified pursuant to this Act as the Commissioner of the competent Regional Tax Office or the head of the competent tax office has adjusted the transaction value of the relevant imported goods and taken a disposition to determine or rectify the duty base and the amount of duty or as the Commissioner of the National Tax Administration has granted prior approval of retroactive application relating to the transaction price of the relevant imported goods, a person liable for duty payment may file an application for rectification of the amount of duty with the head of a customs office within three months from the date on which he/she is aware of such disposition or prior approval (where he/she has been notified of the imposition or prior approval, the date on which he/she has been notified) or within five years from the date on which the first duty return has been filed, as prescribed by Presidential Decree.

D. Provisional value declaration for a compensating adjustment

In 2017, KCS launched a scheme of 'compensating adjustment with provisional value declaration'. Multinational enterprises set the target operating profit margin in related party transactions, and if their operating margin has been over-achieved or underachieved at the end of year, the actual transfer price is adjusted in order to be compliant with the arm's length principle. Under the newly launched scheme, this adjusted price is allowed to be declared as the price actually paid or payable for Customs valuation purposes. Given that the compensating adjustment typically takes place after importation of the goods concerned, a provisional value declaration should be made by taxpayers at the time of the import declaration. For a provisional value declaration, taxpayers must meet specific requirements, such as having in place a plan to adjust the transaction value of the imported good(s). When taxpayers declare the final dutiable value after any compensating adjustment has been made, they are subject to either duty drawback or additional duties.

CUSTOMS ACT Article 28, ENFORCEMENT DECREE OF THE CUSTOMS ACT 16 (extract)

Declaration, etc. of Provisional Dutiable Value

A person liable for duty payment may declare a provisional dutiable value in case where a dutiable value is undetermined in filing a value declaration, such as when price of imported goods in related party transactions is to be adjusted to arm's length price after importation.

4. United Kingdom

HM Revenue and Customs provide the following guidance in respect of retrospective price adjustments:

30.3 Retrospective price adjustments (related or unrelated buyer & seller)

(Extract from Notice 252)⁴⁴

Situations may arise, whereby, for a variety of reasons, the price that you pay to the seller for the imported goods is revised or re-negotiated after the entry of the goods to free circulation. When this happens you must consider the customs valuation and customs duty implications.

Where, at the time of entry, there are contractual arrangements in place between you and the seller indicating the possibility of retrospective price adjustments, the invoice price for the goods concerned would, in effect, be provisional.

This means that you cannot arrive at a final value for customs duty at the time of entry. Therefore you should make security arrangements (see paragraph 2.5).

Alternatively you can ask us to agree to an arrangement whereby you can pay customs duty outright at the time of entry. Such an arrangement would involve you giving an undertaking to notify us of any price adjustments. Then we would both adjust the customs duty payable upwards or downwards as appropriate, according to any agreed price adjustments subsequently notified.

Where there has been a retrospective price increase, we will treat this as part of the total payment made by you to the seller for the imported goods. The fact that you agree to pay such a price increase is regarded as confirmation that the contractual arrangements implied or there was an implicit understanding between you and the seller that such an adjustment may occur, when the goods were ordered or purchased. Thus we will issue a demand (form C18) to you for the arrears of customs duty.

Where there has been a retrospective price decrease you may submit a claim for a refund of duty. Your claim must be accompanied by appropriate evidence including full details of the contractual arrangements as well as rebates received from and credits notes issued by the seller.

5. United States

In 2012, United States Customs and Border Protection (CBP) updated its policy on the treatment of related party transactions which involve adjustments to initial transfer prices after importation, in accordance with the company's formal transfer pricing policy or Advance Pricing Agreements ("APA"). It was noted that transfer pricing policies are used to examine whether a price between the related parties is at arm's length for tax purposes and to evaluate tax consequences among the parties.

Following a review, CBP proposed a broader interpretation of what is permitted under transaction value to allow a transfer pricing policy/APA to be considered a "formula" in the transfer pricing context provided certain criteria are met. It was noted that the transfer pricing policy would still need to be adjusted for Customs purposes since the arm's length test is different [(1) circumstances of the sale, or (2) test values] from the Internal Revenue Service analysis. In order to claim upward and downward post-importation adjustments

⁴⁴ Full version available here: <https://www.gov.uk/government/publications/notice-252-valuation-of-imported-goods-for-customs-purposes-vat-and-trade-statistics>

under the transaction value basis of appraisal, CBP strongly encourages importers to use the reconciliation program to make the final declaration of value.

An extract from the 2012 policy statement is provided below. The full statement is available via the link below⁴⁵.

United States Customs and Border Protection (CBP) policy statement (extract)

“It is now CBP’s position that subject to certain conditions, the transaction value method of appraisal will not be precluded when a related party sales price is subject to post-importation adjustments that are made pursuant to formal transfer pricing policies and specifically related (directly or indirectly) to the declared value of the merchandise. These adjustments, whether upward or downward, are to be taken into account in determining transaction value.”

⁴⁵ http://www.cbp.gov/bulletins/Vol_46_No_23_Index.pdf

ANNEX II : MEETING OF THE FOCUS GROUP ON TRANSFER PRICING BRUSSELS, 26 OCTOBER 2007 – RECOMMENDATIONS

The following recommendations were made by the Focus Group as a way forward :

- The summary of these recommendations to be presented to the Technical Committee on Customs Valuation (TCCV) at the 26th Session for the information of Members;
- Presentations and case studies presented to the Focus Group to be made available to the Members of the TCCV for their information;
- A proposal be made to the TCCV at their next session that the following technical points be taken up for examination and consideration of the need for further instruments:
 - The phrase “circumstances of sale” in Article 1.2 (a) of the WTO Valuation Agreement in respect of its application to Transfer Pricing situations.
 - Consideration of the Customs valuation treatment of situations where a Transfer Pricing agreement indicates that the declared Customs value will be adjusted as necessary at a later date to achieve a pre-determined profit margin (known as price review clauses). This could be a development of earlier work of the Committee on Price Review Clauses.
- Members of the Focus Group from the Private Sector could contribute to TCCV discussions on these issues, via the ICC or by the invitation of the Chairperson.
- Greater dialogue between the Customs and Tax administrations to be encouraged;
- The OECD to continue support.

ANNEX III : TECHNICAL COMMITTEE ON CUSTOMS VALUATION - 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

1. This Commentary seeks to provide guidance on the use of a transfer pricing study, prepared in accordance with the OECD Transfer Pricing Guidelines, and provided by importers as a basis for examining “the circumstances surrounding the sale” under Article 1.2 (a) of the Agreement.
2. Under Article 1 of the Agreement, a transaction value is acceptable as the Customs value when the buyer and the seller are not related, or if related, provided that the relationship did not influence the price.
3. Where the buyer and seller are related, Article 1.2 of the Agreement provides different means of establishing the acceptability of the transaction value:
 1. the circumstances surrounding the sale shall be examined to determine whether the relationship influenced the price (Article 1.2 (a));
 2. the importer has an opportunity to demonstrate that the price closely approximates to one of three test values (Article 1.2 (b)).
4. The Interpretative Note to Article 1.2 of the Agreement provides that: “It is not intended that there should be an examination of the circumstances in all cases where the buyer and the seller are related. Such examination will only be required where there are doubts about the acceptability of the price. Where the Customs administration has no doubts about the acceptability of the price, it should be accepted without requesting further information from the importer.”
5. In light of this, where the Customs administration has doubts about the acceptability of the price, the administration will examine the circumstances surrounding the sale, based on information provided by the importer.
6. The Interpretative Note to Article 1.2 states that where the Customs administration is unable to accept the transaction value without further enquiry, it should give the importer an opportunity to supply such further detailed information as may be necessary. The Note also sets forth illustrative examples of how to determine if the relationship between the buyer and the seller does not influence the price.
7. The question which then arises is whether a transfer pricing study prepared for tax purposes, and provided by the importer, can be utilized by the Customs administration as a basis for examining the circumstances surrounding the sale.
8. On one hand, a transfer pricing study submitted by an importer may be a good source of information, if it contains relevant information about the circumstances surrounding the sale. On the other hand, a transfer pricing study

might not be relevant or adequate in examining the circumstances surrounding the sale because of the substantial and significant differences which exist between the methods in the Agreement to determine the value of the imported goods and those of the OECD Transfer Pricing Guidelines.

9. Accordingly, the use of a transfer pricing study as a possible basis for examining the circumstances of the sale should be considered on a case by case basis. As a conclusion, any relevant information and documents provided by an importer may be utilized for examining the circumstances of the sale. A transfer pricing study could be one source of such information.

ANNEX IV: TECHNICAL COMMITTEE ON CUSTOMS VALUATION – COMMENTARY 4.1

PRICE REVIEW CLAUSES

1. In commercial practice some contracts may include a price review clause whereby the price is only provisionally fixed, the final determination of the price payable being subject to certain factors which are set forth in the provisions of the contract itself.

2. The situation can occur in a variety of ways. The first is where the goods are delivered some considerable time after the placing of the original order (e.g. plant and capital equipment made specially to order); the contract specifies that the final price will be determined on the basis of an agreed formula which recognizes increases or decreases of elements such as cost of labour, raw materials, overhead costs and other inputs incurred in the production of the goods.

3. The second situation is where the quantity of goods ordered is manufactured and delivered over a period of time; given the same type of contract specifications described in paragraph 2 above, the final price of the first unit is different from that of the last unit and all other units, notwithstanding that each price was derived from the same formula specified in the original contract.

4. Another situation is where the goods are provisionally priced but, again in accordance with the provisions of the sales contract, final settlement is predicated on examination or analysis at the time of delivery (e.g. the acidity level of vegetable oils, the metal content of ores, or the clean content of wool).

5. The transaction value of imported goods, defined in Article 1 of the Agreement, is based on the price actually paid or payable for the goods. In the Interpretative Note to that Article, the price actually paid or payable is the total payment made or to be made by the buyer to the seller for the imported goods. Hence, in contracts containing a price review clause, the transaction value of the imported goods must be based on the total final price paid or payable in accordance with the contractual stipulations. Since the price actually payable for the imported goods can be established on the basis of data specified in the contract, price review clauses of the type described in this commentary should not be regarded as constituting a condition or consideration for which a value cannot be determined (see Article 1.1 (b) of the Agreement).

6. As to the practical aspects of the matter, where the price review clauses have already produced their full effect by the time of valuation, no problems arise since the price actually paid or payable is known. The situation differs where price review clauses are linked to variables which come into play some time after the goods have been imported.

7. However given that the Agreement recommends that, as far as possible, the transaction value of the goods being valued should serve as a basis for Customs valuation,

and given that Article 13 provides for the possibility of delaying the final determination of Customs value, even though it is not always possible to determine the price payable at the time of importation, price review clauses should not, of themselves, preclude valuation under Article 1 of the Agreement.

ANNEX V : TECHNICAL COMMITTEE ON CUSTOMS VALUATION – CASE STUDY 10.1

APPLICATION OF ARTICLE 1.2.

Facts of transaction

1. ICO of country I purchased and imported two categories of ingredients used in the production of food flavourings from XCO of country X.

2. At the time of clearing the goods, ICO declared to Customs in country I that it was related to XCO as:

(a) XCO held 22 % of the shares of ICO; and

(b) officers and directors of XCO were also represented on the Board of Directors of ICO.

3. After importation, Customs in country I decided to conduct a review of the circumstances surrounding the sale of goods between XCO and ICO, pursuant to Article 1.2 of the Agreement, because it had doubts about the acceptability of the price. To this end, Customs forwarded a questionnaire to ICO which sought information regarding the sale of products by XCO to other buyers in country I and, if necessary, justification of any price difference as well as information relating to XCO's cost of production and profit. At the request of ICO, Customs also forwarded a questionnaire to XCO. From the responses received, facts as set out below were established.

4. ICO purchased many of the ingredients required for the production of food flavourings from XCO. The ingredients sold by XCO to ICO fall into two categories :

(a) ingredients manufactured by XCO; and

(b) ingredients stocked by XCO which have been acquired from other manufacturers and suppliers. Ingredients in this category are not manufactured or processed by XCO. Some of these ingredients may, however, be packaged for resale by XCO.

5. In terms of Article 15.2 of the Agreement, ingredients in category (a) are not identical or similar goods to the ingredients in category (b).

6. Ingredients in category (a) are also sold to other unrelated buyers in country I. The prices charged by XCO in respect of category (a) ingredients are :

(i) Sold to ICO 92 c.u. f.o.b.

(ii) Sold to unrelated buyers 100 c.u. f.o.b.

7. In respect of the ingredients in category (a) Customs found that :

(i) unrelated buyers purchased the ingredients at the same commercial level and in similar quantities as ICO and used the ingredients for the same purpose.

Importations of these ingredients by unrelated buyers were appraised with a transaction value of 100 c.u.; and

(ii) the costs incurred by XCO were the same in relation to sales to ICO and unrelated buyers in country I.

8. Customs also established that there was no seasonal influence on the price of ingredients which might explain the 8 % difference in prices set out in paragraph 6. Furthermore, after being asked to do so by Customs, ICO and XCO provided no additional information to explain the difference in prices.

9. Ingredients in category (b) are sold only to ICO in country I and there are no importations of identical or similar goods into country I.

10. In respect of the ingredients in category (b), Customs established that the prices charged to ICO were adequate to recover all XCO's costs, including the costs of acquisition plus the costs of repacking, handling and freight charges, as well as to recover a profit that was representative of the firm's overall profit over a representative period of time.

Determination of Customs value

11. ICO and XCO are related persons in terms of paragraphs (a) and (d) of Article 15.4. As provided by Article 1.1 (d), read with Article 1.2, the transaction value of sales between XCO and ICO will form the basis for the determination of Customs value only where it is established that the price was not influenced by the relationship.

12. Under Article 1.2 of the Agreement the responsibility for demonstrating that relationship has not influenced price lies with the importer. While the Agreement requires Customs to provide reasonable opportunity to the importer to provide information that would indicate that prices are not influenced by relationship, it does not require the Customs administration to conduct an exhaustive enquiry for the purpose of justifying the price difference. Thus, any decision in this regard must, to a significant degree, be based on the information provided by the importer.

Ingredients of category (a)

13. The information available in this case shows that the transactions between ICO and XCO are at prices lower than the prices at which the sales are effected to unrelated buyers. When asked to do so, XCO and ICO have failed to explain the different prices.

14. The information obtained by Customs shows that ICO and the unrelated buyers purchase similar quantities of ingredients at the same commercial level and for the same purpose and that XCO's selling costs are the same for sales to ICO and the unrelated buyers. Based on the foregoing and on the nature of industry and goods, there are insufficient grounds to take the view that the price differential is not significant.

15. In respect of ingredients in category (a), therefore, the transaction value method would not be applicable. Recourse to an alternative method for determining the Customs value of category (a) ingredients would be necessary. In this regard, the transaction value of either identical or similar goods imported by unrelated buyers may form the basis of determination of Customs value.

16. It should, however, be noted that the impact of the specific price differential is unique to the facts as presented in this case. This price differential should not be taken as a standard or benchmark for determining whether a price difference is commercially significant in other cases. The Agreement makes it clear that the significance of any price difference should be considered on the basis of the nature of the goods and industry in the case in question.

Ingredients of category (b)

17. In respect of ingredients in category (b) which are sold only to ICO, the examination of the circumstances of the sale shows that the price is adequate to ensure recovery of all costs plus a profit representative of XCO's overall profit on goods of the same class or kind. In accordance with paragraph 3 of the Interpretative Note to Article 1.2, transaction values in respect of this category of ingredients may be acceptable for Customs purposes.

ANNEX VI : TECHNICAL COMMITTEE ON CUSTOMS VALUATION – CASE STUDY 14.1

USE OF TRANSFER PRICING DOCUMENTATION WHEN EXAMINING RELATED PARTY TRANSACTIONS UNDER ARTICLE 1.2(a) OF THE AGREEMENT

Introduction

1. This document describes a case where Customs took into account information provided in a company's transfer pricing study based on the Transactional Net Margin Method (TNMM) when examining whether or not the price of imported goods had been influenced by the relationship between buyer and seller in accordance with Article 1.2 (a).

This case study does not indicate, imply or establish any obligation on Customs authorities to utilize the OECD Guidelines and the documentation resulting from the application of the OECD Guidelines in interpreting and applying the WTO Valuation Agreement.

Facts of Transaction

2. XCO, a manufacturer in 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.

3. In 2012, ICO entered its goods using the transaction value, based on the price stated on the commercial invoice, which was submitted to Customs of country I. There is no indication that special circumstances exist as set out in subparagraphs (a) to (c) of Article 1 of the Agreement that would prevent the use of transaction value.

4. After importation, Customs in country I decided to review the circumstances surrounding the sale of goods between ICO and XCO, pursuant to Article 1.2 (a) of the Agreement, because it had doubts about the acceptability of the price.

5. The importer did not provide test values in accordance with Article 1.2 (b) and (c), as a means of demonstrating that the relationship did not influence the price.

6. In response to Customs request for additional information, ICO presented a transfer pricing study for the period 2011, prepared by an independent firm on behalf of ICO.

7. The transfer pricing study used the Transactional Net Margin Method ("TNMM") that, in this case, compared ICO's operating margin with the operating margins of functionally comparable distributors of goods of the same class or kind, also located in country I, that conducted comparable uncontrolled transactions in the same period of time. The transfer pricing study was prepared in order to comply with the requirements of country I tax regulations and applied principles contained in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of the Organisation for Economic Cooperation and Development ("OECD Transfer Pricing Guidelines"). The transfer pricing study covered all relays purchased by ICO from XCO.

8. Relevant data for ICO, taken from the company's financial records :

- Sales	100.0
- Cost of Goods Sold (COGS)	82.0
- Gross profit	18.0
- Operating expenses	15.5
- Operating profit	2.5
- Operating profit margin (benchmarked)	2.5 % of sales

9. The transfer pricing study, using data taken from ICO's company records, indicated that ICO's operating profit margin on the sale of relays purchased from XCO was 2.5 percent in 2011.

10. The study concludes that it is possible to find reliable comparables for ICO and, accordingly, ICO was selected as the tested party in the transfer pricing study.

11. ICO's transfer pricing study had been reviewed by the Tax authorities of countries I and X in the context of negotiating a bilateral Advance Pricing Agreement (APA). An APA was subsequently agreed between ICO, XCO and the Tax authorities of countries I and X with respect to all transactions between ICO and XCO. While in review by the Tax authorities of countries I and X, ICO provided information showing that the profit margins it earns on the sale of its relays are generally the same as those made by independent distributors in the electrical apparatus and electronic parts industries.

12. In the transfer pricing study, eight distributors, unrelated to their suppliers, were selected based on the substantial similarity of their functions, assets and risks, compared to ICO.

13. Information concerning these eight distributors was taken for fiscal year 2011 for purposes of the comparison. The range of operating profit margins earned by these unrelated distributors was 0.64 to 2.79 percent, with a median of 1.93 percent. In the context of the APA negotiations, this range was accepted by the Tax authorities as an arm's length range of operating profit margins for transactions comparable to ICO's transactions with XCO. This arm's length range was established using the operating profit margins of the eight comparable companies, using the financial records of these companies available in public databases. ICO's operating profit margin was 2.50 percent, thus falling within the range. The 2.50 percent margin achieved by the importer in the country of importation was a function of : (a) the price actually paid or payable by ICO to XCO, (b) ICO's own sales revenue, and (c) ICO's own costs.

14. It was determined that no adjustments prescribed by Article 8 of the Agreement were required to be made to the price actually paid or payable. Additionally, ICO did not make compensating adjustments for tax purposes for the year 2011.

15. ICO sets its selling prices in order to allow the company to earn an operating profit that meets the target arm's length (interquartile) range as set out in the transfer pricing study. The price paid or payable to XCO has not undergone significant changes over the year.

Issues for Determination

16. Does the transfer pricing study supplied in this case, prepared on the basis of the OECD Transfer Pricing Guidelines and used as the basis of a bilateral APA, provide information which enables Customs to conclude whether or not the price actually paid or payable for the imported goods is influenced by the relationship of the parties under Article 1 of the Agreement ?

Analysis

17. Under Article 1 of the Agreement, a transaction value is acceptable as the Customs value when the buyer and the seller are not related, or if related, the relationship does not influence the price. Where the buyer and seller are related, Article 1.2 of the Agreement provides two ways of establishing the acceptability of the transaction value when Customs have doubts concerning the price : (1) the circumstances surrounding the sale shall be examined to determine whether the relationship influenced the price (Article 1.2 (a)); or (2) the importer demonstrates that the value closely approximates one of three test values (Article 1.2 (b)). In this case, as indicated in paragraph 5, the importer did not provide test values therefore Customs examined the circumstances surrounding the sale.

18. The Interpretative Note to Article 1.2 of the Agreement provides that in examining the circumstances surrounding the sale, “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.”.

19. Based on the information obtained from ICO, XCO does not sell the merchandise to unrelated buyers. Therefore, ICO is unable to demonstrate that the price was settled in the same manner as in sales to unrelated parties, specified in Note 1 to Article 1.2 (a) of the Agreement.

20. During its review of the circumstances surrounding the sale, Customs took into account the examination of information discussed in the transfer pricing study when determining whether the price had been settled in a manner consistent with the normal industry pricing practices under the Note to Article 1.2 (a). In this regard, the term “industry” includes the industry or industry sector that contains goods of the same class or kind (including identical or similar goods) as the imported goods.

21. Based on the information provided in Paragraph 8 :

- The Sales figure can be accepted since ICO is selling only to unrelated parties (and it is assumed ICO is rationally seeking to maximize its profits in its dealings with unrelated parties).

- The Operating expenses amount has been examined and accepted as reliable since it is determined that these expenses are paid by ICO to unrelated parties, with ICO seeking to minimize its costs and these expenses have not been paid for the benefit of the seller.

- The transfer pricing study confirms that ICO's operating profit margin is within the arm's length range (i.e. based on a study of comparable, but independent (unrelated) distributors).
- The Cost of Goods Sold of ICO reflects the price paid or payable to XCO and represents the transaction between ICO and its related party, XCO. This is the transfer price in question.

By working back from the arm's length range of operating profit margins and the other accepted information set out above, it could be deduced that the transfer price is an arm's length amount. This demonstrates that information relating to the transaction between ICO and unrelated distributors can be helpful and relevant to Customs when examining the circumstances surrounding the sale between XCO and ICO.

22. The functional analysis showed that there were no significant differences in functions, risks and assets between ICO and the eight unrelated distributors. In addition, an adequate level of product comparability was observed. The comparable companies were chosen from the electrical apparatus and electronic parts industries (companies that sell goods of the same class or kind as the imported goods). Thus, the operating profit margin on the resale of the imported goods was shown to be generally the same as in the electrical apparatus and electronic parts industries⁴⁶. Specifically, the transfer pricing study found that the arm's length range of the comparable companies' operating profit margins was 0.64 % to 2.79 %. As previously noted, ICO's operating profit margin was 2.50 %. Accordingly, since all the comparable companies sell goods of the same class or kind, the transfer pricing 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.

Conclusion

23. After examination of the circumstances surrounding the sale in respect of related party transactions between ICO and XCO, Customs concluded, including by analysis of a transfer pricing study based on the TNMM and additional information concerning operating expenses as deemed necessary, that under the provisions of Article 1.2 (a) of the Agreement, the relationship between the parties did not influence the price.

24. As indicated in Commentary 23.1, the use of a transfer pricing study for examining the circumstances surrounding the sale must be considered on a case-by-case basis.

⁴⁶ In this case, Customs accepted the operating profit margin as a more accurate measure of ICO's real profitability because it revealed what ICO actually earned on its sales once all associated expenses have been paid. Nevertheless, in certain circumstances, gross profit may be considered by Customs to illustrate the appropriately deducted associated expenses and the establishment of the accurate transfer price.

ANNEX VII : TECHNICAL COMMITTEE ON CUSTOMS VALUATION – CASE STUDY 14.2⁴⁷

USE OF TRANSFER PRICING DOCUMENTATION WHEN EXAMINING RELATED PARTY TRANSACTIONS UNDER ARTICLE 1.2(a) OF THE AGREEMENT

Introduction

1. This document describes a case where Customs took into account information provided in a company's transfer pricing report, as well as additional information, when determining whether or not the price actually paid or payable for imported goods had been influenced by the relationship between buyer and seller under Article 1.2 (a) of the Agreement.

This case study does not indicate, imply, or establish any obligation on Customs authorities to utilize the OECD Guidelines and the documentation resulting from the application of the OECD Guidelines in interpreting and applying the WTO Valuation Agreement.

Facts of Transaction

2. XCO of country X sells luxury bags to ICO, a distributor of country I. Both XCO and ICO are wholly-owned subsidiaries of ACO, the headquarters of a multinational enterprise and the brand-owner of the luxury bags. Neither XCO nor other companies related to ACO sell the identical or similar luxury bags to unrelated buyers in country I. ICO is the only importer of the luxury bags sold by XCO to country I. Thus, all luxury bags imported into country I by ICO are purchased from XCO.

3. In 2012, ICO declared the price of imported luxury bags based on the value on the invoice issued by XCO. The commercial documents submitted to Customs of country I indicated that there was no special circumstances or additional payments which would prevent the use of the transaction value as set out in subparagraphs (a) to (c) of Article 1 of the Agreement or require an additional adjustment prescribed by Article 8 to the import price.

4. In 2013, Customs in country I conducted a Post-Clearance Audit to verify ICO's declared import price, because it had doubts about the acceptability of the price. ICO's transfer pricing policy showed that the import price of all luxury bags was determined using the Resale Price Method (in accordance with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of the Organisation for Economic Co-operation and Development). At the end of each year, ICO calculated the import price of luxury bags based on the resale price and the targeted gross margin for the next year as recommended by XCO. After the targeted gross margin for 2012 was determined at 40%, ICO then calculated the import price of luxury bags to be imported in 2012 by using the

⁴⁷ **DISCLAIMER: THIS TEXT HAS BEEN ADOPTED BY THE TECHNICAL COMMITTEE ON CUSTOMS VALUATION AND IS SUBJECT TO APPROVAL BY WCO COUNCIL**

Resale Price Method according to the formula: $Import\ Price = \frac{recommended\ Resale\ Price \times (1 - Targeted\ Gross\ Margin)}{(1 + Duty\ Rate)}$.

5. ICO is a simple or routine distributor. The marketing strategy for the sales of bags in country I is in fact established by XCO. XCO also advises on the levels of inventory to be maintained, and establishes the recommended sales price of the bags sold by ICO, including the discounting policy to be used by ICO. XCO has also invested heavily in developing valuable intangible assets associated with the bags. As a result, XCO assumes the market risk and price risk in relation to the sales of the bags in country I.

6. The luxury bag market of country I where the imported goods were resold has been very competitive. However, in 2012, the actual sales income of ICO far exceeded the estimated income since more bags were sold at full price, and fewer at a discounted price, than anticipated. Consequently, ICO's gross margin in 2012 was 64 % which was higher than the targeted gross margin stated in ICO's transfer pricing policy. During the audit, Customs asked ICO to provide further information in order to review the acceptability of its declared import price.

7. ICO did not provide test values required for the application of Article 1.2 (b) and (c), as a means of demonstrating that the relationship did not influence the price. However, ICO submitted a transfer pricing report, which used the Resale Price Method that compared ICO's gross margin with the gross margins earned by comparable companies in their transactions with unrelated parties (i.e. comparable uncontrolled transactions). The transfer pricing report was prepared by an independent firm following the process set out in accordance with the OECD Transfer Pricing Guidelines.

8. According to the transfer pricing report, ICO does not employ any valuable, unique intangible assets or assumed any significant risk. The transfer pricing report submitted by ICO selected eight comparable companies located in country I. The functional analysis indicated that the eight selected comparable companies imported comparable products from country X, performed similar functions, assumed similar risks and did not employ any valuable intangible assets, just as ICO.

9. The transfer pricing report indicated that the arm's length (inter-quartile) range of gross margins earned by the selected comparable companies in 2012 was between 35 %-46 %, with a median of 43 %. Therefore, the 64 % gross margin earned by ICO did not fall within the arm's length inter-quartile range. At the time Customs conducted its valuation audit, it was established that, in this particular case, ICO had not made any transfer pricing adjustments in this regard.

Issue for Determination

10. Does the transfer pricing report, supplied in this case, provide information which enables Customs to conclude whether or not the price actually paid or payable for the imported goods is influenced by the relationship of the parties under Article 1 of the Agreement.

Analysis

11. Under Article 1 of the Agreement, a transaction value is acceptable as the Customs value when the buyer and the seller are not related, or if related, the relationship does not

influence the price. Where the buyer and seller are related, Article 1.2 of the Agreement provides two ways of establishing the acceptability of the transaction value when Customs have doubts concerning the price: (1) the circumstances surrounding the sale shall be examined to determine whether the relationship influenced the price (Article 1.2 (a)); or (2) the importer demonstrates that the value closely approximates one of three test values (Article 1.2 (b)).

12. In this case, as indicated in paragraph 7, the importer did not provide test values therefore Customs examined the circumstances surrounding the sale.

13. The Interpretative Note to Article 1.2 of the Agreement provides that in examining the circumstances surrounding the sale, “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.”

14. When examining the circumstances surrounding the sale concerning companies using Resale Price Method, a comparison of the gross margin of the company in question with the gross margin of comparable companies could indicate whether or not the declared price had been settled in a manner consistent with the normal pricing practices of the industry.

15. Based on the functional analysis, there was no significant difference between ICO and all eight comparable companies because these comparable companies:

- are all located in country I;
- perform similar distribution functions, assume similar risks and do not employ any valuable intangible assets, which are similar to ICO;
- import comparable products similarly manufactured in country X.

In addition, an adequate level of product comparability was observed and these comparable companies are deemed to be suitable for Customs valuation purposes.

16. According to the transfer pricing report, the arm’s length inter-quartile range of the gross margin earned by the comparable companies was between 35 %-46 % with a median of 43 %. However, in 2012, ICO earned a gross margin of 64 % which was much higher than the normal gross margins of comparable companies in this industry. It should also be noted that the luxury bag market of importing country I was competitive, so that the operating profit and expenses of ICO should be similar to those of the comparable companies given that there was no substantial difference between ICO and the eight comparable companies. Therefore ICO’s high gross margin in 2012 was not commensurate with its functions, assets and risks.

17. Thus, by virtue of ICO earning a higher margin, and considering ICO has not made any compensating adjustments, Customs arrived at the conclusion that the import price was not settled in a manner consistent with the normal pricing practices of the industry in question. The Customs value of goods imported in 2012 had been declared at a lower price and should be re-determined accordingly by application of the alternative methods of valuation in a sequential order.

Conclusion

18. In examining the circumstances surrounding the sale between ICO and XCO under the provisions of Article 1.2 (a) of the Agreement through the review of the transfer pricing report, Customs concluded that the declared import price was not settled in a manner consistent with the normal pricing practices of the industry and thus had been influenced by the relationship between the buyer and seller. Therefore, the Customs value should be determined by application of the alternative methods of appraisal in a sequential order.

19. It should be noted that the use of a transfer pricing report as a possible basis for examining the circumstances surrounding the sale should be considered on a case by case basis as specified in Commentary 23.1.

ANNEX VIII : ICC POLICY STATEMENT

International Chamber of Commerce
Policy and Business Practices

TRANSFER PRICING AND CUSTOMS VALUATION – 2015



POLICY STATEMENT

Prepared by the ICC Commission on Taxation and the
ICC Commission on Customs and Trade Facilitation

Summary

International businesses face difficulties regarding the valuation of goods due to diverging customs and tax rules regulating transactions between related parties. ICC calls for more alignment and puts forward concrete proposals to secure harmonized tax and customs valuation of transactions between related parties in an international context.

Highlights

- Recognition by the customs administration that businesses which establish prices between related parties in accordance with the arm's length principle (as per Article 9 OECD Model Tax Convention) have generally demonstrated that the relationship of the parties has not influenced the price paid or payable under the transaction value basis of appraisal and consequently that the prices establish the basis for customs value.
- Recognition by the customs administration of post-transaction transfer pricing adjustments (upward or downward). This recognition should be applicable for adjustments made either as a result of a voluntary compensating adjustment – as agreed upon by the two related parties – or as a result of a tax audit
- It is recommended that in the event of post transaction transfer pricing adjustments (upward or downward), customs administrations accede to review the customs value according to either of the following methods as selected by the importer: application of a weighted average duty rate, or an allocation according to specific codes of the customs tariff nomenclature.
- It is recommended that in the case of post-transaction transfer pricing adjustments (upward or downward), companies be relieved from:
 - a) The obligation to submit an amended declaration for each initial customs declaration
 - b) The payment of penalties, as variations of the transfer price
- It is recommended that customs administrations recognize that the functions and risks undertaken by the parties as documented in a transfer pricing study following an OECD transfer pricing methodology are crucial to the economic assessment of the circumstances of the sale.

Recognition of the acceptability of relevant transfer pricing documentation by the customs administration as evidence that the price paid for imported goods was not influenced by the relationship of the parties.

Introduction

As the world business organization, the International Chamber of Commerce (ICC) confirms that multinational companies, from all sectors and in every part of the world, face difficulties with respect to the valuation of goods. These difficulties arise because transactions between related parties are subject to both customs and fiscal examinations and are thereby bound by differing rules and contradictory interests. ICC believes these examinations should yield the same value and that a resolution to the problem is in the interests of all concerned.

There are two reasons for this problem:

1. Tax and customs administrations, even within one country and sometimes within the same government department, have different approaches: tax administration focuses on

intra- group sales' prices that may be perceived as higher than they should be; whereas customs authorities control imported goods for which prices may be perceived as lower than the market price. While both administrations seek to achieve the same goal, which is arm's length pricing, revenue interests in the transaction still remain at odds with each other.

2. Tax and customs administrations often set rules independently for the same transaction/good. Tax authorities seek conformity with the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines which have been largely codified in many countries. This set of rules provides guidance on the application of the arm's length principle for the valuation of cross-border transactions between associated enterprises, whereas customs authorities conform to Article VII of the General Agreement on Tariffs and Trade (GATT) Valuation Code.

This dichotomy, present in both developed and developing countries, creates a climate of uncertainty and complexity compounded by economic globalization. It also leads to increases in implementation and compliance costs, absence of flexibility in the conduct of business operations, and furthermore creates a significant risk of penalties. Indeed, even when a company complies with both the OECD guidelines/principles and the World Trade Organization (WTO) Valuation Agreement, there is no guarantee that there will not be a dispute between two countries or two administrations in the same country on the determination of the arm's length price. This means that valuation conflicts can arise not only prior to but also after an audit.

Given that intercompany transactions account for more than 60% of global trade in terms of value, the divergence of customs and transfer pricing valuation presents an obstacle to the liberalization of trade and inhibits international development for companies of all sizes.

Key features

Although numerous points of divergence can be listed between customs and tax approaches, it is important to stress that points of convergence also exist. Therefore, while it may not be necessary to change WTO rules or the OECD guidelines we believe that the two can and should be aligned by finding a common way of interpreting the arm's length principle. As a basic principle, we recommend that tax administrations assess and appreciate how the enterprise has arrived at the declared customs value (and vice versa – as the case may be - the customs administration assess and appreciate how the enterprise has arrived at the transfer price) prior to issuing a formal tax or duty assessment. If the conflict between the enterprise and the relevant fiscal administration cannot be resolved, then the tax administration and the customs administration of the respective country should work in concert and attempt to harmonize valuation determinations.

A recommended method to accomplish harmonization of customs and income tax requirements is for customs administrations to use information contained in transfer pricing studies. It will help determine whether the price between related parties is acceptable for customs valuation. Indeed, ICC notes that the World Customs Organization (WCO) has already considered the appropriateness of transfer pricing documentation in Commentary 23.1 of the Technical Committee on Customs Valuation (TCCV). To the extent a customs administration believes it needs additional data that is readily available in the normal course

of business to supplement standard transfer pricing study data sets, those data elements should be clearly defined and published (see Proposal 6).

This approach considers that it is not currently conceivable to try to find solutions outside existing and well-recognized principles, nor is it realistic to seek a total harmonization of customs and tax rules or even to impose one's view onto another. Furthermore, the business community believes that creating yet another set of rules will not solve these problems. ICC therefore recommends a focus on how these principles can be more closely aligned and made acceptable to both governmental authorities and the private sector. This document is offered as an input from the business sector to international organizations working on these issues.

The goals of the proposals that follow are to:

- Secure harmonized tax and customs valuation of transactions between related parties in an international context
- Clarify rules for both companies and administrations
- Suppress or at least reduce financial impact linked to divergent valuation
- Simplify regulations

And thereby:

- Reduce compliance costs to companies
- Eliminate the risk of penalties resulting from disputes arising from divergent views taken by customs and tax authorities
- Streamline intercompany operations and facilitate international business

Proposals

Although Advance Pricing Agreements (APAs) can resolve tax valuation concerns, APAs are often very rigid, time- and cost-consuming, and not appropriate for businesses that continually evolve. Often, APA's are also not a viable option for small and medium sized enterprises or for transactions that are not material in size.

Accordingly, in order to enable more documentation supportive of valuation validation, ICC proposes the following additional options to derive customs value:

Proposal 1

Recognition by the customs administration that businesses which establish prices between related parties in accordance with the arm's length principle (as per Article 9 OECD Model Tax Convention) have generally demonstrated that the relationship of the parties has not influenced the price paid or payable under the transaction value basis of appraisal, and consequently that the prices establish the basis for customs value.

The customs value is normally based on Article VII of the GATT agreement 1994 which states that, in article I, Rules on Customs Valuation:

1. The customs value of imported goods shall be the transaction value, that is the price actually paid or payable for the goods when sold for export to the country of importation adjusted in accordance with the provisions of Article 8 (...)

Thus, customs authorities prefer to determine customs duties on the sales price of imported goods, which is deemed to represent an arm's length value. When the seller and the buyer are related, and arm's length pricing comes into question, transaction value can still be used for customs valuation purposes if the importer can demonstrate that the declared transaction value: 1) meets the circumstances of sale test or 2) by comparison with test values.

As explained below in article I, Rules on Customs Valuation of GATT Article VII:

1. The customs value of imported goods shall be the transaction value (...) provided (...) 3 (d) that the buyer and seller are not related, or where the buyer and seller are related, that the transaction value is acceptable for customs purposes under the provisions of paragraph 2.

2. (a) In determining whether the transaction value is acceptable for the purposes of paragraph 1, the fact that the buyer and the seller are related within the meaning of Article 15 shall not in itself be grounds for regarding the transaction value as unacceptable. In such a case the circumstances surrounding the sale shall be examined and the transaction value shall be accepted provided that the relationship did not influence the price. If, in the light of information provided by the importer or otherwise, the customs administration has grounds for considering that the relationship influenced the price, it shall communicate its grounds to the importer and the importer shall be given a reasonable opportunity to respond. If the importer so requests, the communication of the grounds shall be in writing.

(b) In a sale between related persons, the transaction value shall be accepted and the goods valued in accordance with the provisions of paragraph 1 whenever the importer demonstrates that such value closely approximates to one of the following occurring at or about the same time:

(i) the transaction value in sales to unrelated buyers of identical or similar goods for export to the same country of importation; (ii) the customs value of identical or similar goods as determined under the provisions of Article 5;

(iii) the customs value of identical or similar goods as determined under the provisions of Article 6;

With regard to 2(b), the Agreement at 2(c) requires that an inquiry under 2(b) must be undertaken only at the request of the importer and that the tests are only for comparison purposes. The Interpretative Notes to 2(b) require that the test values must be previously determined, pursuant to an actual appraisal of imported merchandise. If there are no previous importations of identical or similar merchandise that were appraised by customs authorities under the transaction, deductive or computed value methods, there may not exist any test values that will be accepted by the customs administration. Therefore, it is common practice to evaluate the circumstances surrounding the sale in relation to the above 2(a).

The Interpretative Notes to 2(a) provide examples of how to evaluate the circumstances of sales in order to satisfy the customs administrations that the relationship of the parties did

not influence the transaction value. The Interpretive Note to Article 1, 2(a) of GATT Article VII reads as follows:

2. Paragraph 2(a) provides that where the buyer and the seller are related, the circumstances surrounding the sale shall be examined and the transaction value shall be accepted as the customs value provided that the relationship did not influence the price. It is not intended that there should be an examination of the circumstances in all cases where the buyer and the seller are related.

Such examination will only be required where there are doubts about the acceptability of the price. Where the customs administration has no doubts about the acceptability of the price, it should be accepted without requesting further information from the importer. For example, the customs administration may have previously examined the relationship, or it may already have detailed information concerning the buyer and the seller, and may already be satisfied from such examination or information that the relationship did not influence the price.

3. Where the customs administration is unable to accept the transaction value without further inquiry, it should give the importer an opportunity to supply such further detailed information as may be necessary to enable it to examine the circumstances surrounding the sale. In this context, the customs administration should be prepared to examine relevant aspects of the transaction, including the way in which the buyer and 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. Where it can be shown that the buyer and seller, although related under the provisions of Article 15, buy from and sell to each other as if they were not related, this would demonstrate that the price had not been influenced by the relationship. As an example of this, if the price had been settled in a manner consistent with the normal pricing practices of the industry in question or with the way the seller settles prices for sales to buyers who are not related to the seller, this would demonstrate that the price had not been influenced by the relationship. As a further example, where it is shown that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time (e.g. on an annual basis) in sales of goods of the same class or kind, this would demonstrate that the price had not been influenced.

Consistent with Commentary 23.1 of the WCO Technical Committee on Customs Valuation (TCCV), for importers that establish related party pricing policies in accordance with the OECD Transfer Pricing Guidelines and provide the necessary transfer price documentation, such documentation should be considered a solid basis on which customs administrations can evaluate the circumstances surrounding the sale. The OECD Guidelines are based on sound underlying economic principles designed to result in arm's length prices being charged the same result sought by customs administrations when determining that prices have not been influenced by the relationship.

Consequently, consistent with Commentary 23.1, in certain instances ICC recommends that importers who set prices in accordance with the OECD Transfer Pricing Guidelines have demonstrated that the relationship between the buyer and the seller did not influence the price.

Accordingly, the arm's length principle (Article 9 OECD Model Tax Convention) may be directly aligned with the rules for determining the acceptability of transaction value under the

circumstances of sale test. This alignment should be recognized by customs administrations and doing so will set up a convergence between the OECD and WTO rules with regard to the value of transactions between related parties.

Moreover, there are many situations where voluntary or a fortiori imposed adjustments were not foreseeable at the time the import declaration had been made. The propositions 2 and 3 concern cases where the customs implications of any such transfer pricing adjustment need to be duly dealt with.

Proposal 2

Recognition by the customs administration of post-transaction transfer pricing adjustments (upward or downward). This recognition should be applicable for adjustments made either as a result of a voluntary compensating adjustment – as agreed upon by the two related parties – or as a result of a tax audit.

Post-transactions adjustments that affect product price are permitted by both the OECD guidelines and WTO customs valuation rules. These post-transaction adjustments can be done for a variety of reasons, including voluntary adjustments, but also for year-end adjustments when trying to achieve a pre-agreed profit range at the end of a year or period. However, the procedures to report such adjustments to customs administrations are determined by local rules, and adjustments are often disregarded by customs when the importer adjusts the purchase price downwards.

When such post-transaction adjustments that affect price – i.e. compensating adjustments – are made pursuant to an OECD transfer pricing methodology, these adjustments should be recognized by customs administrations as part of the price paid for the goods, and consequently as an element of the transaction value of the goods.

Companies should be permitted to perform customs value adjustments without being required to set up a provisional valuation procedure or being subject to penalties due to valuation adjustments.

Proposal 3

It is recommended that in the event of post-transaction transfer pricing adjustments (upward or downward), customs administrations accede to review the customs value according to one of the following methods as selected by the importer. These methods being applicable to the value of the goods impacted by the adjustment:

- ✓ Application of the weighted average customs duty rate: the weighted average customs duty rate is calculated by dividing the customs duties' total amount for the year by the respective customs value total amount for the same year. This may include the possibility of a lump-sum adjustment at the end of the year. For example, if at the end of the year, the transfer price adjustments result in an additional payment to the seller, then we recommend that the importer be able to report this lump-sum amount. That way customs will be able to allocate this to all entries declared within the year and the duty adjustment will be the weighted average duty rate.
- ✓ Allocation of the transfer pricing adjustment, according to the nomenclature code, and to information provided by the importer or customs authorities disclosing all commodity codes and all relevant import data available in their national statistics.

Proposal 4

It is recommended that in the case of post-transaction transfer pricing adjustments (upward or downward), companies be relieved from:

- ✓ The obligation to submit an amended declaration for each initial customs declaration. Instead, a single recapitulative return referring to all the initial customs declarations would be lodged.
- ✓ The payment of penalties, provided the amended declaration is voluntarily timely filed with customs. In fact, these variations depend on various factors which have absolutely nothing to do with an intention to evade customs duties.

Proposal 5

It is recommended that OECD transfer pricing methods are recognised as an acceptable framework for evaluation of the circumstances of sale by customs administrations with an acknowledgement of the following elements:

- ✓ Identical or similar goods: Many transfer pricing studies apply comparable pricing methods. In most cases such methods rely on the similarity of the functions performed, assets used, and risks assumed as well as similarities between the imported goods. Transfer Pricing studies also require geographic and temporal comparability, although it may be necessary to use regional and multi-year comparables if more precise comparables are unavailable. Customs administrations should recognize the use of comparable profits methods and regional and multi-year comparables where appropriate.
- ✓ Corporate legal entities (performing specific functions and adding value within a group): Transfer pricing studies evaluate the functions of each company in the related party group, and the risks undertaken by each party to make an economic assessment of arm's length prices between related parties. Customs administrations should similarly recognize that understanding the functions and risks undertaken by each entity provides valuable information for evaluation of the circumstances of the sale following sound underlying economic principles.

Proposal 6

Recognition of the acceptability of transfer pricing documentation by the customs administration as evidence that the price paid for imported goods was not influenced by the relationship of the parties.

Tax transfer pricing documentation is a tax legal requirement almost all over the world. Its content is largely aligned across the countries and can hence be considered fairly standard. It normally includes all of the information required to analyze the circumstances of sale, the parties involved, the added value, and the functions performed by each party. Should a customs administration believe that additional data – readily available in the normal course of business – beyond that commonly found in transfer pricing documentation is necessary to assess whether or not the prices are influenced by the relationship of the parties, ICC recommends that the additional customs data requirements be clearly defined and published

in advance by the customs administration to enable incorporation of those requirements into transfer pricing documentation to serve both purposes.

Conclusion

This policy statement is an update of the 2012 ICC Policy Statement on Transfer Pricing and Customs Value, prepared by the ICC Commission on Taxation and the ICC Committee on Customs and Trade Regulations. A comprehensive approach on the nexus between transfer pricing and customs value is becoming of increasing importance for cross-border trade. It is to be expected that many around the world will contribute to this topic in the foreseeable future and ICC is ready to work with intergovernmental organizations such as the Organisation of Economic Co-operation and Development (OECD) and the World Customs Organization (WCO) on this highly complex and contentious area within the global tax and customs world.

ICC will continue to monitor developments in this important area and will issue an update of this policy statement if needed.

The views and opinions expressed in the International Chamber of Commerce (ICC) Policy statement do not necessarily reflect those of the WCO or of the governments of its Members.

ANNEX IX : A GLOSSARY OF COMMON TRANSFER PRICING TERMS

<p>Adjustments</p>	<p>Adjustments are made in a number of transfer pricing contexts. The terminology used to describe each may vary, however the following are the standard terms used in the OECD TP Guidelines:</p> <p><i>Compensating adjustment</i> (sometimes referred to as a ‘ year-end adjustment’ or a ‘true-up’ adjustment): an adjustment made by a taxpayer to reconcile, for income tax purposes, their actual transfer price(s) to what they consider to be an arm’s length price. These can be actual price adjustments or tax only.</p> <p><i>Primary adjustment</i>: an adjustment made by a tax administration to a taxpayer’s taxable profits as a result of applying the arm’s length principle. (<i>i.e.</i> generally an audit adjustment)</p> <p><i>Corresponding adjustment</i> (sometimes called ‘correlative adjustment’): an adjustment made by the competent authority of a second tax jurisdiction to the tax liability of the associated enterprise in that jurisdiction, corresponding to a primary adjustment, so that the allocation of profits by the two jurisdictions is consistent</p> <p><i>Secondary adjustment</i>: an adjustment made by a tax authority that arises from a constructive transaction that may be asserted in some countries after making a primary adjustment, in order to make the actual allocation of profits consistent with the result of the primary adjustment. The secondary transaction may take the form of constructive dividends, equity contributions, or loans.</p>
<p>Advance pricing arrangements (APA)</p>	<p>Arrangements that agree, in advance, an appropriate set of criteria for the transfer pricing treatment of a specific transaction or group of transactions, for a future period of time, generally for a specific taxpayer or group of taxpayers.</p>
<p>Arm’s length principle</p>	<p>The arm’s length principle requires that the conditions (prices, profit margins etc.) in transactions between related parties should be the same as those that would have prevailed between two independent parties in a similar transaction under similar conditions.</p>

Arm's length range	A range of figures that is acceptable for establishing whether the conditions of a controlled transaction are arm's length. Each of the figures in the range should be equally reliable.
Associated parties	Transactions between parties whose relationship may allow them to influence the conditions of the transaction (commonly referred to as " related parties ") - can involve the provision of property or services, the use of assets (including intangibles), and the provision of finance, all of which need to be priced.
Berry ratio	A net profit indicator Generally, Gross profit / Operating expenses Many adjusted Berry ratios are also used, e.g. excluding accounting depreciation, etc. from Opex
Comparability	The application of the arm's length principle is typically based on a comparison of the conditions in the controlled transaction with the conditions in 'comparable' transactions between independent parties.
Comparability adjustments	Comparability requires that none of the differences between the transactions being compared materially impact on the condition being examined in the transfer pricing methodology that is to be applied (i.e. the price or the profit margin); or, that where such differences do exist, that reasonably accurate adjustments (comparability adjustments) can be made in order to eliminate the impact of any such differences on the condition being examined.
Comparable uncontrolled transaction	A transaction between independent parties that is comparable to the controlled transaction under examination. It can be either a comparable transaction between one party to the controlled transaction and an independent party (" <i>internal comparable</i> ") or between two independent parties, neither of which is a party to the controlled transaction (" <i>external comparable</i> "). To be "comparable" means that none of the differences (if any) between the transactions could materially affect the factor being examined in the methodology (e.g. price or margin), or, reasonably accurate adjustments can be made to eliminate the material effects

	of any such differences.
Comparability factors	<p>Attributes of the controlled and uncontrolled transactions that may be important when determining comparability, including:</p> <ul style="list-style-type: none"> - the characteristics of the property or services transferred; - the functions performed by the parties (taking into account assets used and risks assumed); - the contractual terms; - the economic circumstances of the parties; and - the business strategies pursued by the parties.
Controlled transaction	A transaction between enterprises that are associated enterprises with respect to each other (<i>i.e.</i> related parties)
Cost of Goods Sold (COGS) or Cost of Sales	Direct costs attributable to the production of the goods sold by the entity. The composition of COGS will depend on the nature of the business .
Double taxation	Double taxation is generally recognized as a hindrance to international trade and investment. Thus, in order to promote trade and investment, countries have largely sought to avoid and or eliminate cases of double taxation by entering into tax treaties .
Functional analysis	The functional analysis, which involves an analysis of functions performed, risks assumed and assets employed, may be considered as a cornerstone of the comparability analysis. When independent parties transact, the prices that they agree upon will generally reflect the functions performed by the respective parties, the risks they bear and the assets that they employ.
Gross margin	Gross profit / net sales
Gross profit	Broadly, gross receipts (<i>i.e.</i> generally Net Sales) less COGS
Multinational enterprise (MNE)	An MNE group establishes itself in a new market by incorporating or acquiring a local subsidiary or establishing a branch, the local

group	subsidiary or branch generally engages in transactions with other members of the group.
Mutual agreement procedure (MAP)	A means through which tax administrations consult to resolve disputes regarding the application of double tax conventions. This procedure, described and authorised by Article 25 of the OECD Model Tax Convention, can be used to eliminate double taxation that could arise from a transfer pricing adjustment.
Net profit indicator or Profit level indicator (PLI)	The ratio of net profit to an appropriate base (e.g. costs, sales, assets). The transactional net margin method (TNMM) relies on a comparison of an appropriate net profit indicator for the controlled transactions with the same net profit indicator in comparable uncontrolled transactions
Operating margin/ Operating Profit Margin	A net profit indicator (<i>expressed in percentage terms</i>) Operating profit / Net sales
Related parties	Transactions between parties whose relationship may allow them to influence the conditions of the transaction - (also commonly referred to as “ associated parties ”) - can involve the provision of property or services, the use of assets (including intangibles), and the provision of finance, all of which need to be priced.
Operating profit (also known as operating income)	Broadly, Gross profit <i>less</i> Operating expenses (<i>expressed in monetary terms</i>) Broadly equivalent to earnings before interest and tax (EBIT)
Return on assets (ROA)	A net profit indicator Operating profit / Assets (NB: Often tangible operating assets only)
Return on sales (ROS)	A net profit indicator. Generally equivalent to Operating margin Operating profit / Net sales
Tax treaties	Tax treaties are agreements between the contracting parties (the states) concerning the allocation of taxing rights (i.e. extent to

	which each state may level tax in specific cases), amongst other things (such as exchange of information and other administrative procedures).
Tested party	The tested party is the party for which the relevant condition being examined under the relevant method (i.e. gross profit margin, gross profit mark up, net margin etc.) is to be tested.
Transfer pricing methods	<p>The OECD Transfer Pricing Guidelines detail five transfer pricing methods that may be used to “establish whether the conditions imposed in the commercial or financial relations between associated enterprises are consistent with the arm’s length principle” (OECD 2010):</p> <ul style="list-style-type: none"> ▪ Comparable uncontrolled price method ▪ Resale price method ▪ Cost plus method ▪ Transactional net margin method ▪ Transactional profit split method
Uncontrolled transactions	Transactions between independent parties that have been found to be comparable.

ANNEX X : TRANSFER PRICING DOCUMENTATION : EXAMPLE OF STRUCTURE

Note: This is not intended to be a prescriptive or exhaustive list of content for transfer pricing documentation, rather it is intended as an overview of the key elements of transfer pricing documentation that may be found in transfer pricing documentation and that may be relevant for Customs valuation.

1. Description of the MNE Group, its Business Activities and the Industry in which it operates

A description of the MNE group, including the types of business activities it is engaged in, its organizational structure and management structure and an overview of the key characteristics of the relevant industry in which the related party transactions take place.

2. Financial information

Key financial information relevant to the controlled transactions, including financial statements (profit and loss and balance sheet) for the parties to the transactions, and, where applicable, segmented financial information.

3. Transfer Pricing Policy

Details of the relevant aspects of the group's transfer pricing policy, including details of how prices are set and reviewed and whether the group has any relevant APAs.

4. Description of the related party transactions, including functional analyses

A detailed description of the transactions, including:

- listing of related party transactions by type, amount and related party
- analysis of the characteristics of the product or service, the contractual terms and any relevant business strategies for each transaction type
- analysis of the economically significant functions performed, assets employed and risks assumed by each of the parties to the transactions
- analysis of relevant economic circumstances (such as market conditions etc.)

5. Selection of Transfer Pricing Method

Explanation as to why the transfer pricing method selected was selected, with reference to local legislative requirements (where applicable).

6. Comparability Analysis and Data

Explanation of the process undertaken to try and identify comparable uncontrolled transactions, including details of sources of information and search criteria used.

Comparability analysis of selected comparable uncontrolled transactions, including analysis with respect to the 5 comparability factors and details of any further research conducted.

7. Conclusion

A conclusion, based on application of the selected transfer pricing method, as to whether the related party transactions are consistent with the domestic transfer pricing legislation.

ANNEX XI : ACKNOWLEDGEMENTS AND THANKS

- The WCO would like to thank the Customs administrations of Australia, Canada, Korea, United Kingdom, United States, the Organisation for Economic Cooperation and Development (OECD) and World Bank Group (WBG) who have provided invaluable input to this Guide's development.
- Chapter 3 is based on text kindly supplied by the World Bank Group.
- The WCO would also like to thank the International Chamber of Commerce (ICC) and representatives of the business community who have shared their views and provided suggestions for this Guide.

Publisher:

World Customs Organization
Rue du Marché 30 - B-1210 Brussels
Belgium
Tel.: +32 (0)2 209 92 11
Fax: +32 (0)2 209 92 62
www.wcoomd.org

Date of publication: June 2018

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D/2018/0448/4