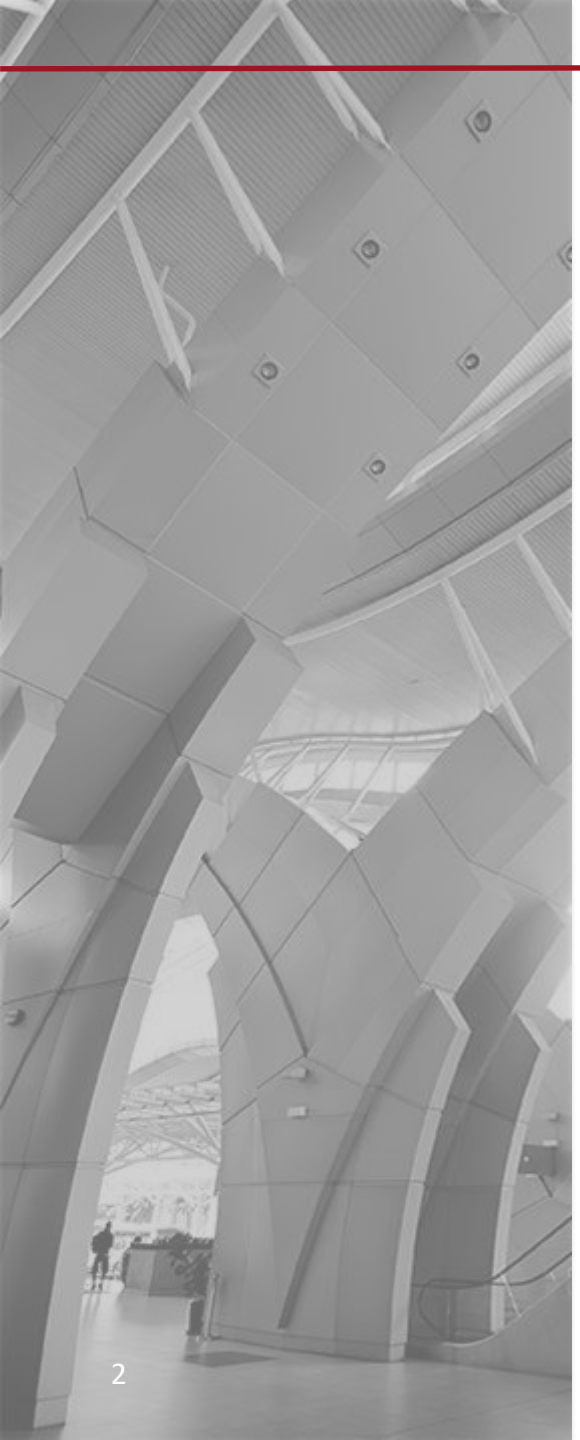
ANDERSEN

Transfer pricing and International Taxes Workshop

Theme: Transfer pricing considerations in uncertain times

DATE: 16th June 2021

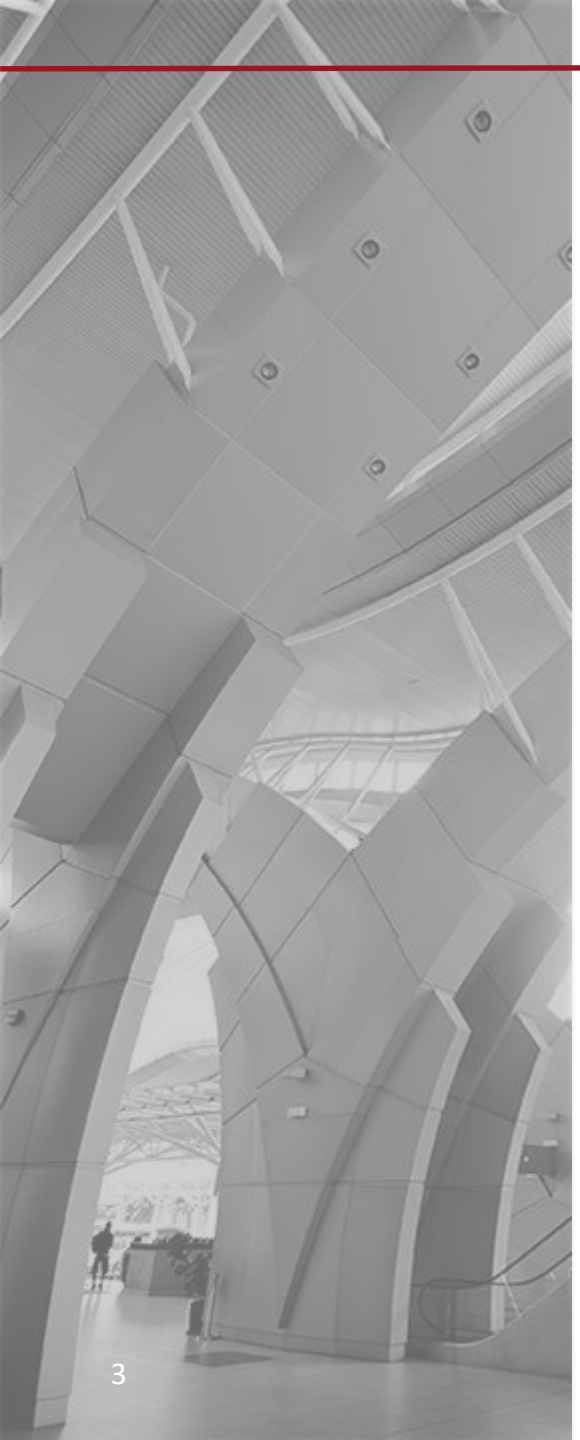
VENUE: Virtual



Nexus between Customs and TP in the context of uncertainty

Customs and tax authorities pursue different objectives in assessing the value of goods traded between related parties. Nonetheless, in pursuit of efficient global supply chains, there is a growing need for better alignment between TP and customs valuation.

1. Is it possible that two different authorities accept two different answers to the same question i.e. what is the arm's length price?
2. Considering a common departure point – the arm's length principle - what makes these two disciplines different? How deep are the existing differences?
3. How can these two disciplines align in order to find a common way of interpreting the arm's length principle?
4. Is the process of post importation adjustments to customs value in the event of a transfer pricing adjustment a source of tax inefficiency and double taxation for the importers?

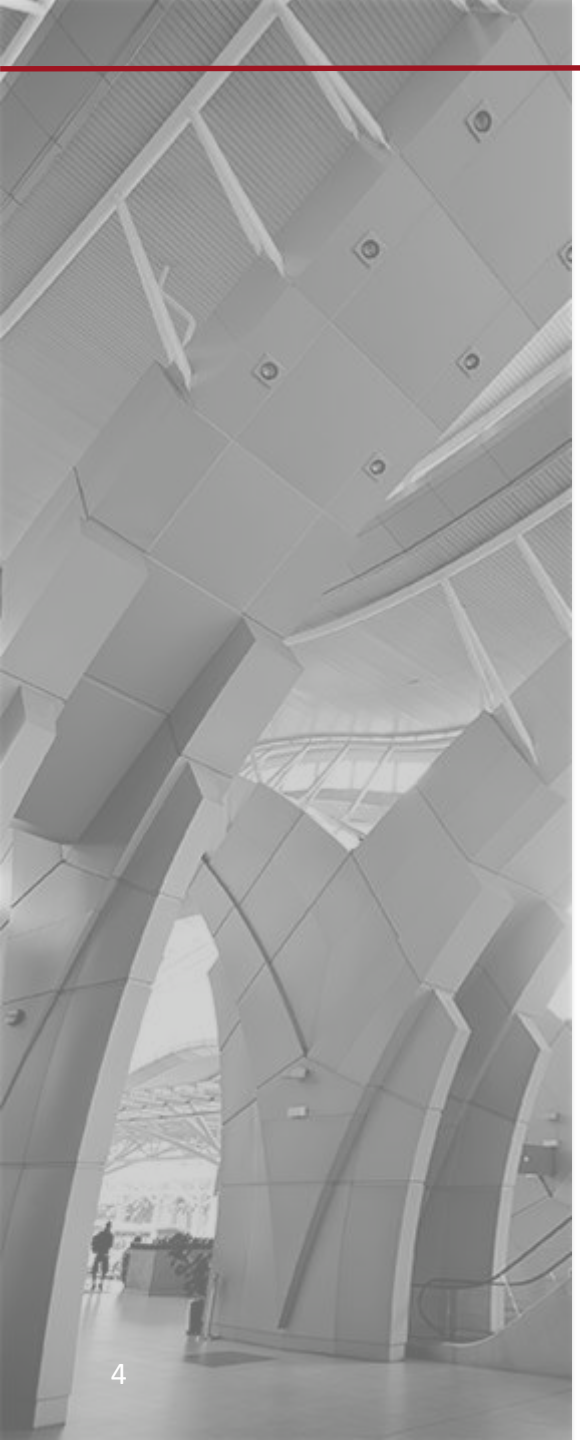


Inherent tension in objectives

On the **tax administrations' perspective** the goal is to minimize the cost of goods sold for imported goods and thus the import prices, resulting in higher taxable profits.

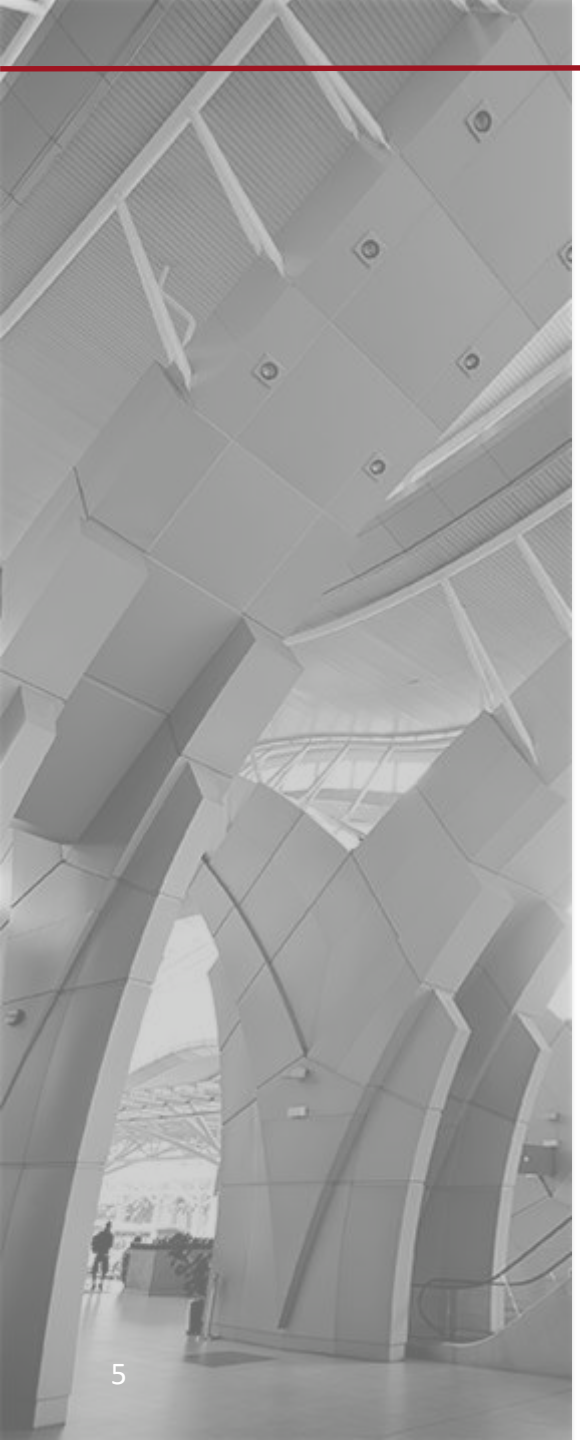
For **customs** purposes, the transfer price has a direct impact on the determination of the customs value of the imported goods, which constitute the base on which duties are charged. A lower transaction value means lower revenue collections. Therefore, a customs officer natural inclination would be to verify whether the value declared by an importer should be increased in order to collect more duties.

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 thereby reducing the income tax paid or payable (although this would also increase the sales revenue of the seller in the country of export).



What is Transfer Pricing?

- "*The amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization*" (Horngren and Sundem, 1993)
- The term is typically used to describe 'transfer pricing' for **direct taxation purposes**:
  - Associated parties
  - Arm's length principle
  - Comparability
  - Transfer pricing methods
- Transfer pricing is a 'neutral concept'



Arms Length principle

Transfer pricing and customs duties share a common founding principle:

The Arms Length principle

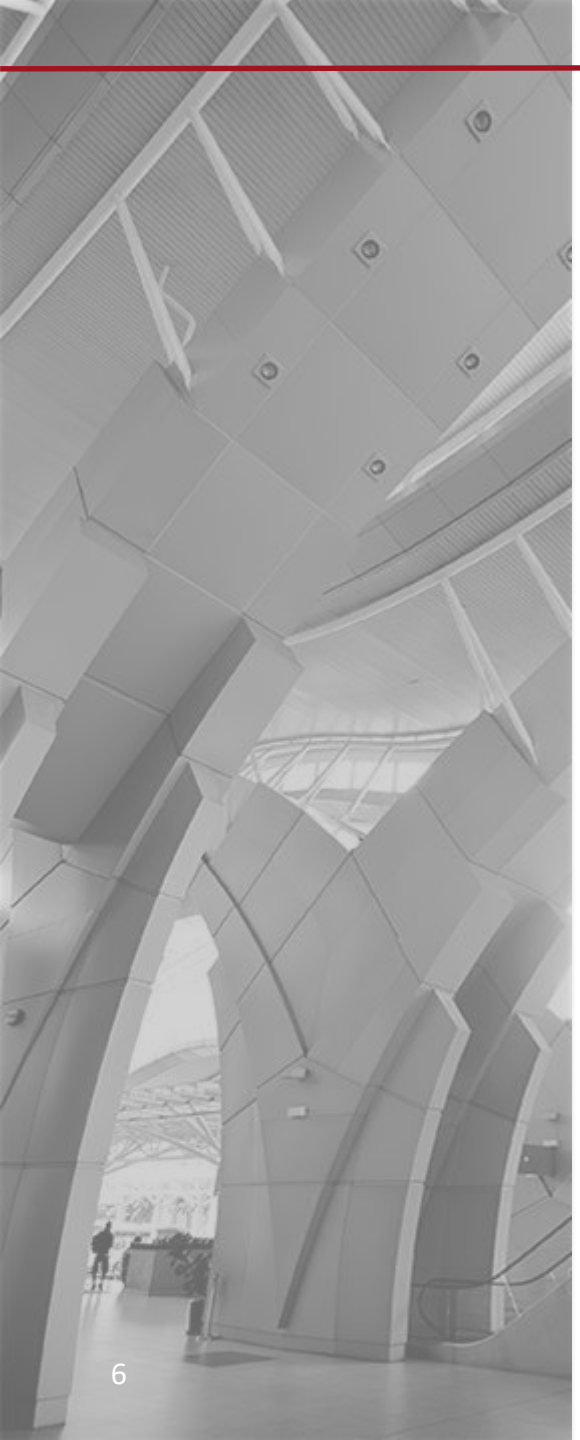
The price established for goods traded between related parties must be consistent with the verified price if the parties were unrelated and the transaction occurred under the same circumstances,

- Both disciplines strive to validate that the relationship did not influence the price.
- 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 fully 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.

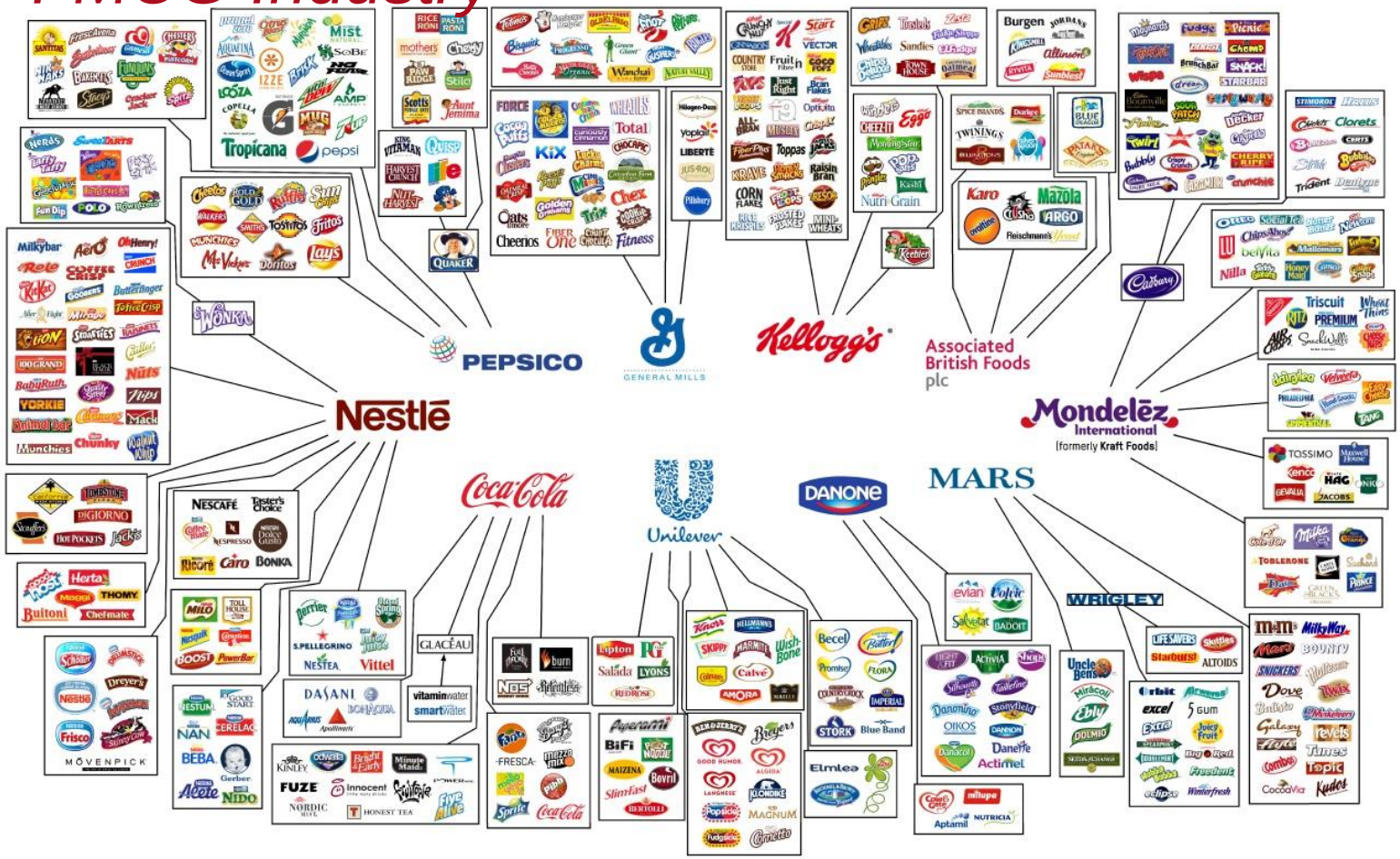
In particular, customs officials may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, while tax authorities may have transfer pricing documentation which provides detailed information on the circumstances of the transaction.



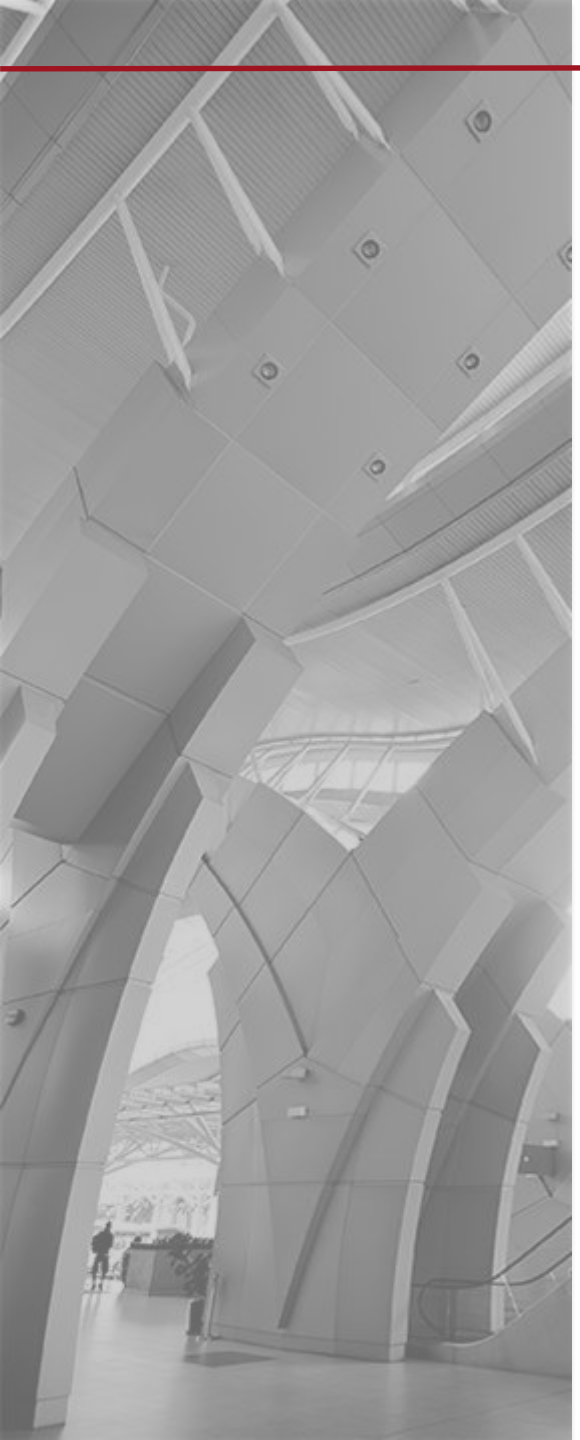
Significance of MNE Groups

- Number of foreign affiliate firms has increased 6 fold over the last 2 decades (UNCTAD WIRs)
- Of the world's 100 largest economic entities in 2012, 40 (40%) are corporations (Global Trends, 2013)
- A substantial portion of international trade takes place within MNE Groups. Various figures are often quoted:
  - Global trade is increasingly dominated by the complex and circuitous routes followed by goods and services as they are upgraded into finished products.
  - 80 per cent of the $20 trillion in trade each year consists of value chains administered in various ways by MNEs. UNCTAD 2013
  - 60% (OECD, 2013)
- Significant portion of value of international trade is on intangible assets such as intellectual property rights.

Intangibles, MNE Groups and Trade: *FMCG Industry*



- **Intellectual property accounts for more than 50% of the value of many public companies (brandchannel.com)**



AGREEMENT ON IMPLEMENTATION OF ARTICLE VII OF THE GENERAL AGREEMENT ON TARIFFS AND TRADE 1994- Customs valuation Agreement (CVA)

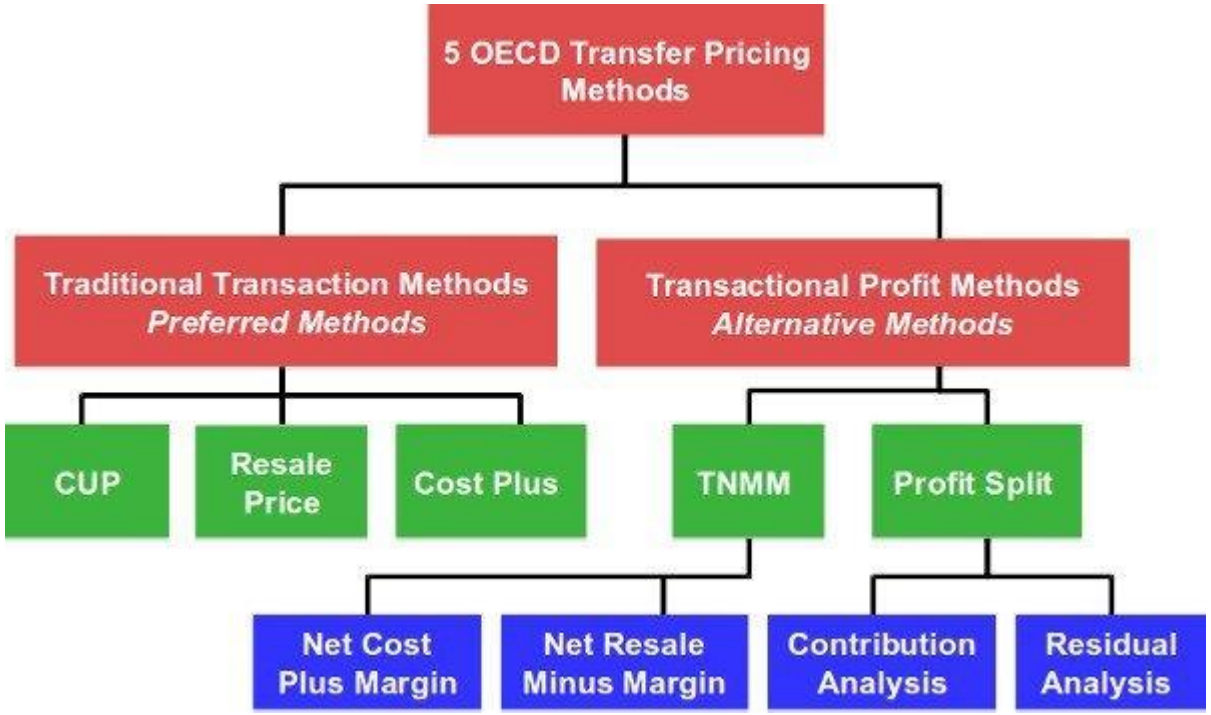
The primary basis for customs value is "transaction value" The transaction value ought to factor for adjustments to the price actually paid or payable in cases where certain **specific elements which are considered to form a part of the value for customs purposes are incurred by the buyer but are not included in the price actually paid or payable for the imported goods** e.g Assists, commissions, royalties and licence fees.

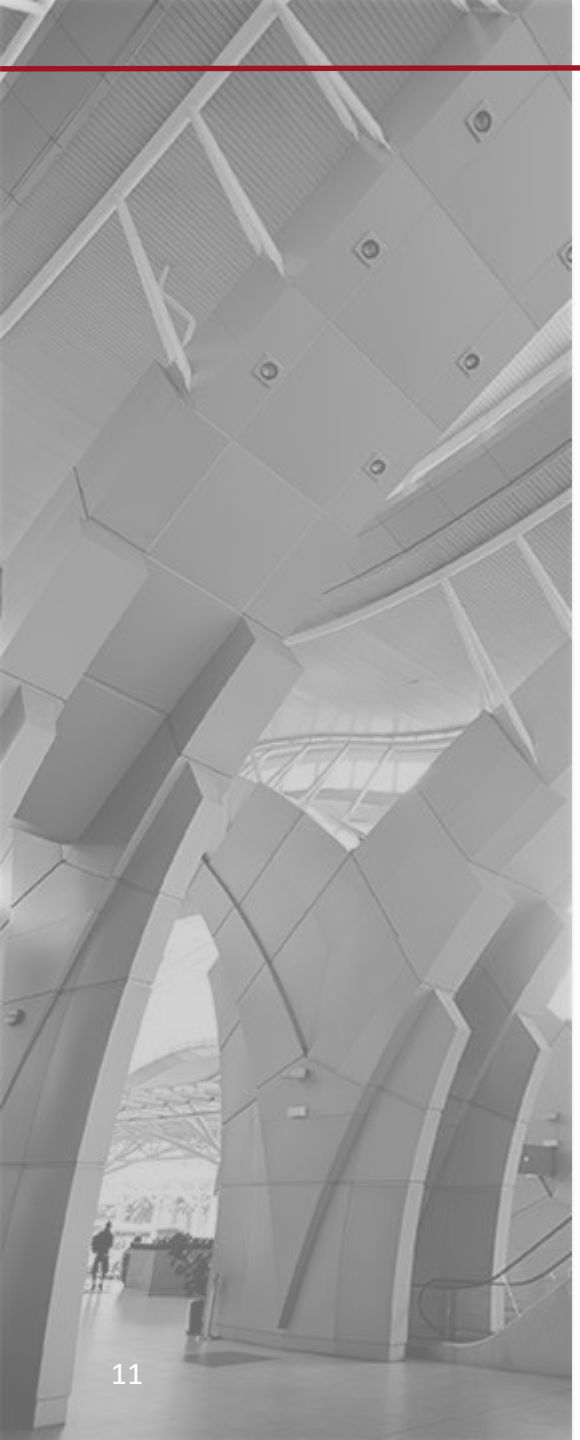
Method 1 The customs value of imported goods shall be the transaction value, that is the price actually paid or payable for the goods when sold for export to the country of importation …**provided that the buyer and seller are not related, or where the buyer and seller are related, that the transaction value is acceptable for customs purposes under the provisions of paragraph 2**

Broad differences between customs and transfer pricing

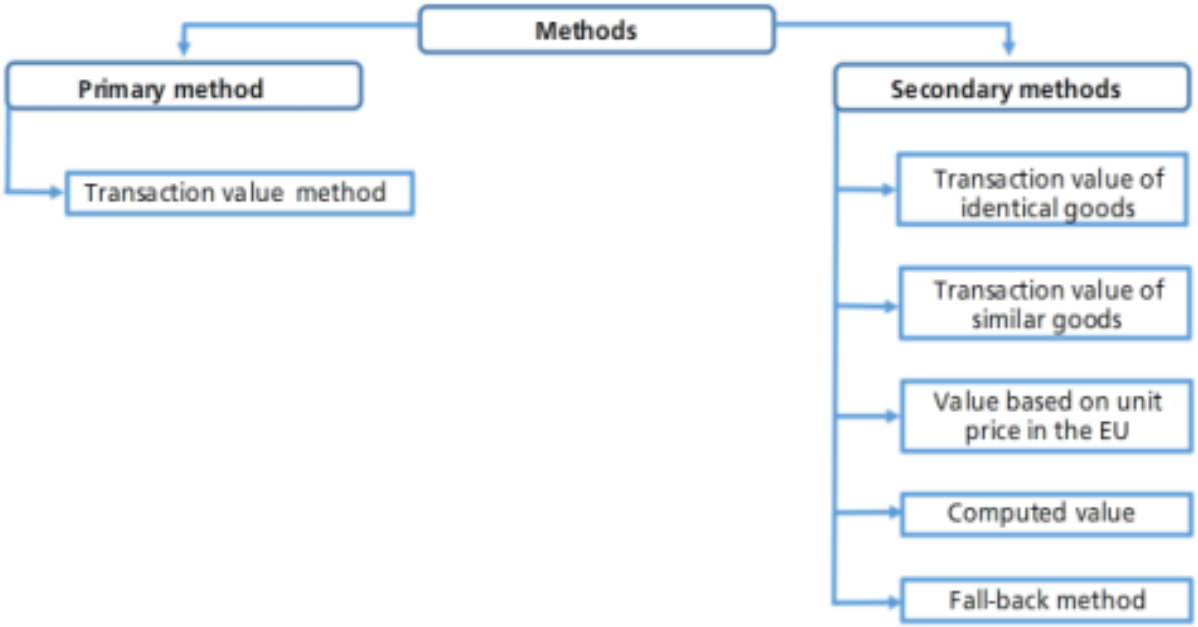
	Customs value	Transfer pricing
Legal basis	• WTO Agreement • National legislation	• OECD Model Tax Convention, OECD Transfer Pricing Guidelines ("soft law") • Bilateral Double Taxation Conventions • National legislation
Objectives, principles and operational functioning	• Examination based on simple and equitable criteria • Customs administration • At the border • At import or post-clearance • Review of products and import transactions • Determine Customs duties	• Depending on the applicable domestic rules, determination by the taxpayer upon or before the transaction is entered into; or when the tax return is filed or tax assessed. • Assessment by the tax administration when the tax return is filed or retrospectively audited. • Review of all aspects of the commercial and financial relationship between parties. • "Fair" allocation of taxable profits between tax jurisdictions.
Scope	Physical commercial transactions between related parties.	Cross-border commercial and financial transactions between associated enterprises (transfer of tangible or intangible assets and provision of services).

Transfer Pricing Methods





Customs Valuation methods



Summary Comparison of Customs and TP methods

Customs valuation	Transfer pricing
Transaction value	No equivalent
Transaction value of identical or similar goods	Comparable Uncontrolled Price Method
Deductive value	Resale Price Method
Computed value	Cost Plus Method
Fall-back	Transactional Net Margin Method, Transactional Profit Split Method

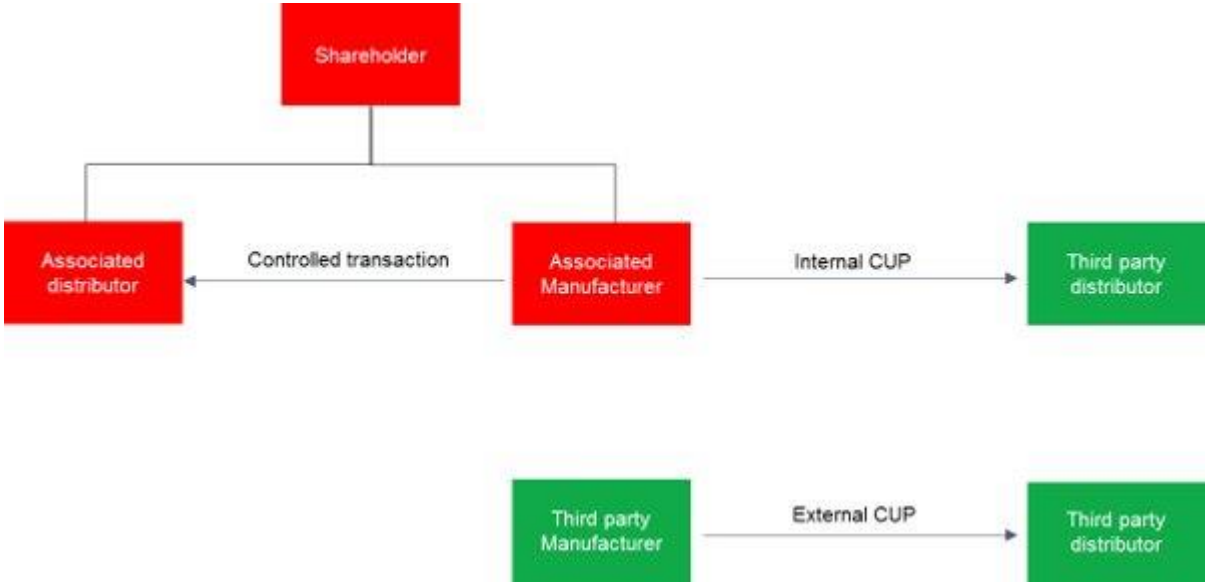
Fall Back method: “profit methods” such as TNMM and transactional profit split method can be used to examine arms length profits in the event that suitable comparables can be found and other methods do not apply

CUP method

Similar to transaction value of identical or similar goods in customs

Identical goods are the same in all respects including physical characteristics, quality and reputation. They are produced in the same country by the same producer.

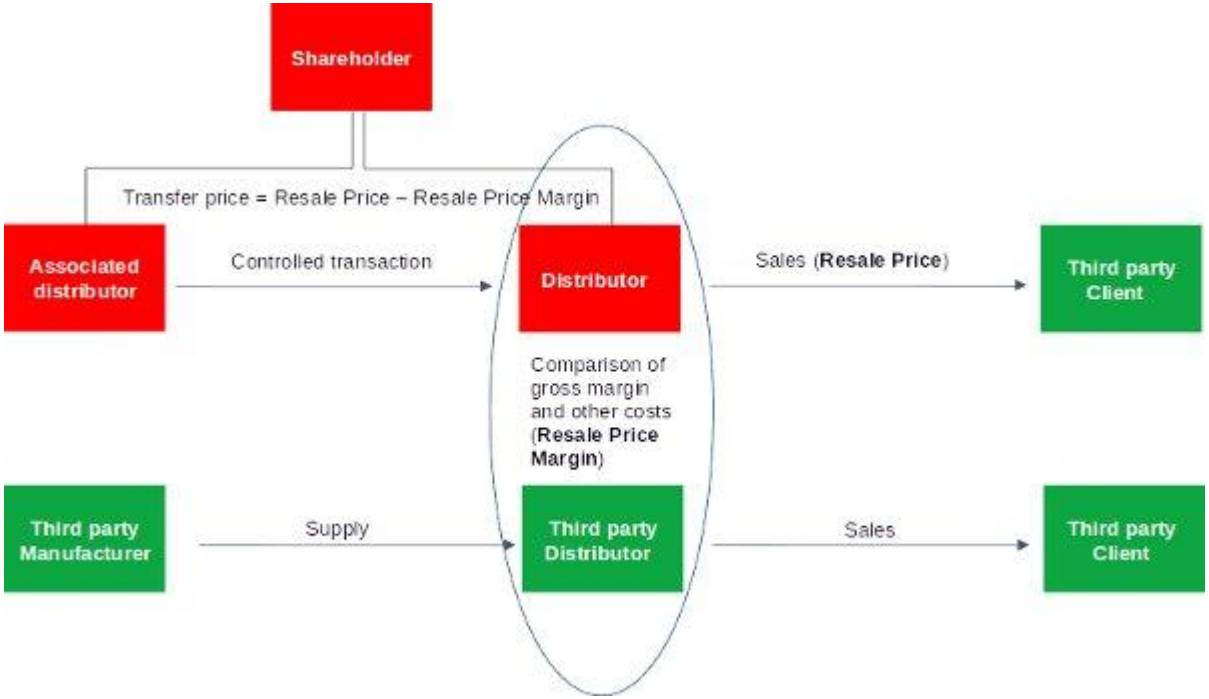
Similar goods closely resemble the goods being valued in terms of component materials and characteristics. They have been produced in the same country of the imported goods. They must be commercially interchangeable.



Resale Price Method-

Similar to Deductive method in customs

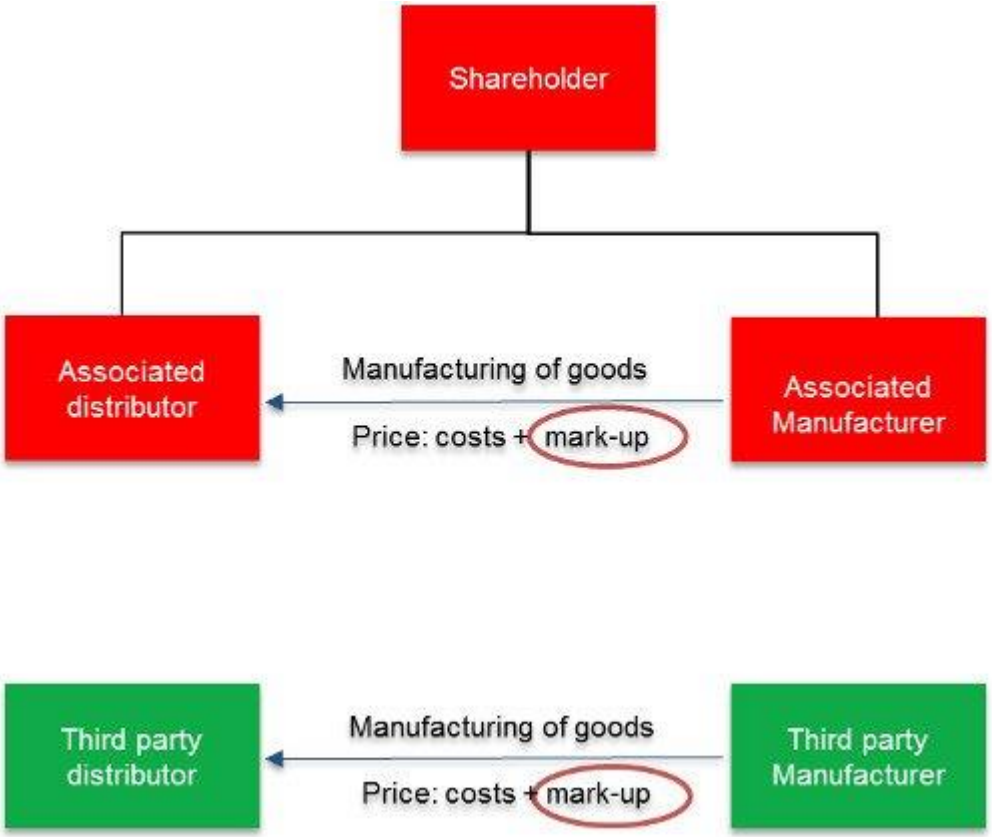
The customs value is calculated on the basis of the unit price at which the imported goods, or identical or similar goods, are sold in the local market to an unrelated buyer…[with] various deductions, mainly concerning costs incurred in the local market, are necessary to reduce that price to the relevant customs value.

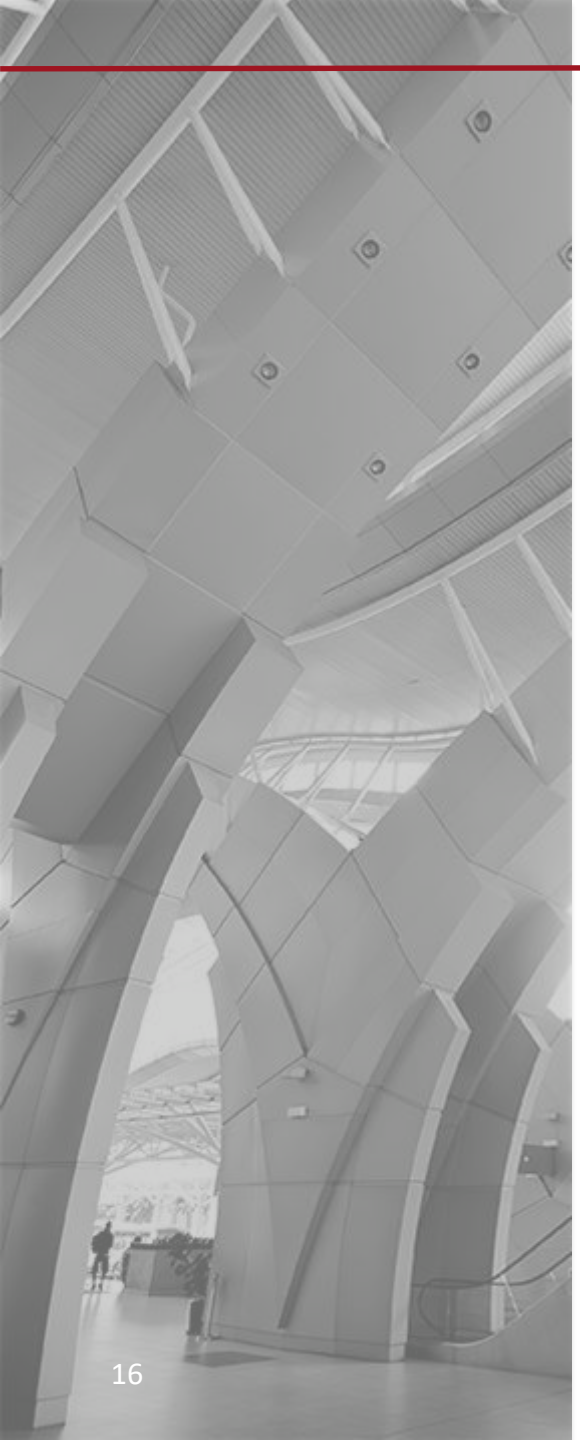


Cost Plus Method

Similar to computed value in customs

Costs or value of material and production costs + Profit and general expenses equal to those usually reflected in the sale of goods of the same class or kind + + Cost of transport, loading, handling and insurance up to the point of entry into the customs territory.





Legal basis for use of TP studies in Customs

The Technical Committee on Customs Valuation (TCCV) Commentary (WCO, 2018) recognises that transfer pricing documentation may be used as a basis for examining the circumstances of the sale (CoS) of related party transactions.

23. 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…

Commentary 23.1

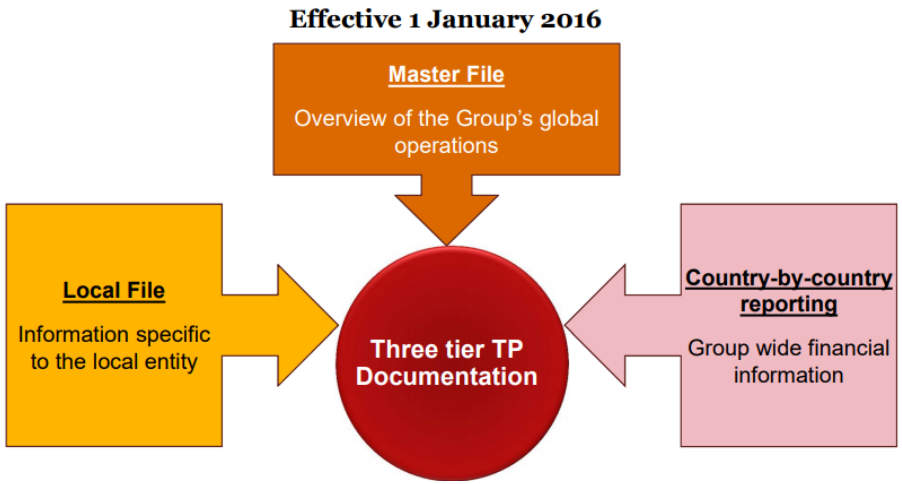
*Examination of the expression "**Circumstances surrounding the sale**" under article 1.2 (A) in relation to the use of transfer pricing studies*

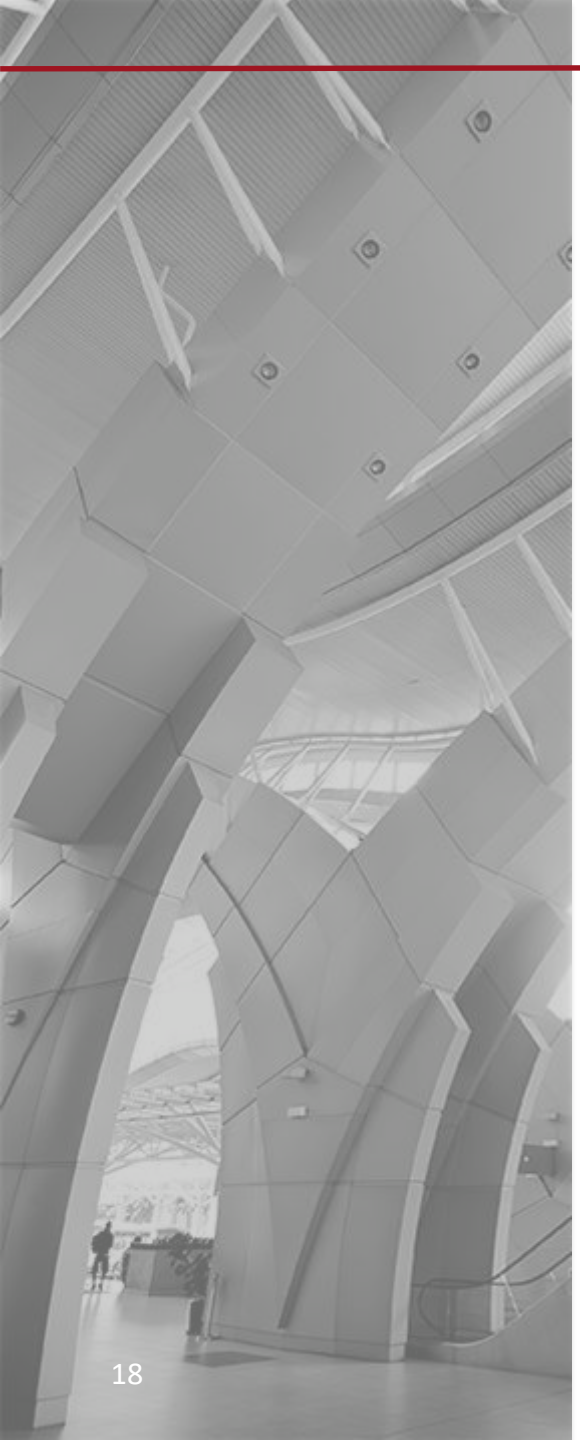
8. On one hand, a transfer pricing study submitted by an importer may be a good source of information, if it contains relevant information about the circumstances surrounding the sale. On the other hand, a transfer pricing study might not be relevant or adequate in examining the circumstances surrounding 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.

Impact of changing international tax landscape

OECD/G20 Base Erosion and Profit Shifting (BEPS) project is targeted at tax planning strategies that exploit gaps and mismatches in tax rules, to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid.

Enhanced transparency requirements under exchange of information instruments including on financial information of the global entity and previously unknown valuation information, e.g. CBCR documents on overseas Gross Margins.





Observations and conclusions

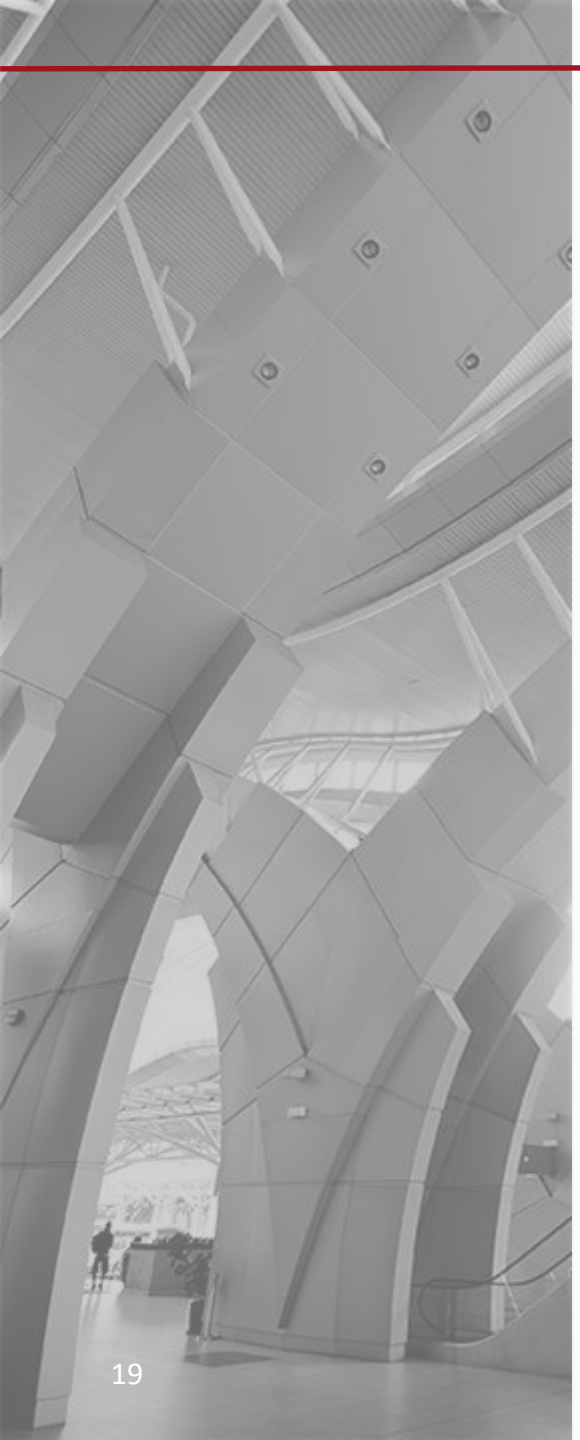
1. Need for clarification of the process of reflecting post importation transfer pricing adjustment at the customs level.

2. Need for harmonization between TP and customs valuation to avoid double taxation and enhance uniformity in approach across all taxes. Joint working groups of TP and customs in tax administration.

3. Some Customs administrations have identified that Advance Pricing Agreements/Rulings can provide useful information when examining related party transactions. It may also be the case that Customs valuation needs can be considered in the context of reviewing TP compliance or when preparing an APA. Advance Customs Valuation Arrangements (ACVA) can also be prepared with good working knowledge of TP

4. TP can provide excellent basis for Post clearance audit risk assessments and audits and for provide opportunities for efficient trade facilitation of low risk importers already pre-assessed.

5. The impact of the OECD BEPS project which seeks to closely align profits to value creation likely to impact on customs valuation. E.g Adjustment of royalties and licence fees, rechacterisation of transactions to match substance and economic reality.



GOOD PRACTICES FOR BUSINESS

MNEs who import are encouraged to ensure their Customs and tax advisors 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
- Consider requesting advance rulings/ACVAs with customs authorities based on approved TP documentation to avoid risks of post clearance audit queries.
- Inform Customs of outcomes of a post-importation price adjustment where this is likely to reduce import tax burden
- Work with Customs to provide documentation and help interpret transfer pricing analyses and data related to imported goods.

Andersen Kenya

7th Floor, Rhapta Heights

Rhapta Road Westlands Nairobi

ANDERSEN TAX