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Publication of Guide to Customs Valuation and Transfer Pricing enhances the cooperation between WCO and OECD

To meet with requirements set out by both customs and tax authorities, interaction between customs valuation (CV) and transfer pricing (TP) regimes has long been the attention of companies with significant cross-border intercompany transactions. Multinational Enterprises (MNEs) are facing more and more audits from both tax and customs authorities. They therefore need to to establish transaction prices which satisfy the requirements of both authorities.

In June 2015, the World Customs Organization (WCO) released the *Guide to Customs Valuation and Transfer Pricing* ("the Guide"). The publication of the Guide shows the cooperation between the two organisations regarding the TP of MNEs has been enhanced continually. The Guide sets out the methodology for both CV and TP regimes and provides guidelines for customs to use TP information to examine CV of related party transactions. Although the Guide's content does not provide many new concepts, it encourages customs and tax administrations to work together and exchange information. Companies are encouraged to take customs requirements into account when preparing TP related documentation.

In this document, KPMG Trade and Customs practice provided an analysis in detail on the Guide in order to help companies with their business in China to understand how the Guide would affect them.

Main Content of the Guide

Overview of WTO valuation agreement

The methodology for determining the CV for imported goods is set out in the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 ("the Agreement"), which should be followed by all the World Trade Organization (WTO) member countries. The Agreement emphasizes that the transaction prices of related parties will be accepted by customs if the importer can demonstrate that the transaction price has not been influenced by the special relationship. Two approaches (i.e. circumstances surrounding the sale and test value) will be used by customs to examine whether or not the transaction price of related parties has been influenced by the special relationship. The Agreement also introduces the elements which should be included in the transaction value, in addition to the price actually paid or payable, known as commissions, royalties and assists.

However for some exceptional cases, when the transaction price is rejected by customs, alternate methods (i.e. the transaction value of identical or similar goods, the deductive value method, the computed value method, or the fallback option) will be used to determine a proper basis of dutiable value for customs purposes.

Introduction of the OECD's practice

The legal framework of TP consists of domestic legislation, tax treaty, OECD TP guidelines 2010 ("the guidelines") and United Nations (UN) TP manual 2013, which provide guidance on the arm's length principle. The five comparability factors (i.e. characteristics of the product or service, functional analysis, contractual terms, economic circumstances, and business strategies) are important to consider when determining whether or not there are any differences between the transactions being compared that materially impact the conditions being examined. Similar to alternative valuation methods set out in the Agreement, there are five TP methods which may be used to "establish whether the conditions imposed in the commercial or financial relationship between the associated enterprises are consistent with the arm's length principle". The guideline mentioned that two mechanisms – Advance Pricing Arrangements (APA) and the Mutual Agreement Procedure (MAP) – could avoid and resolve the disputes between the MNEs and the tax administrations.

How to use OECD documents for customs purpose

CV and TP are similar in that both ensure that the price is set as if the parties were not related and had been negotiated under normal business conditions. Customs administration focuses on whether or not a price has been 'influenced' by the relationship between the parties, while the tax administration is to seek an "arm's length transaction price", which ensures proper profit of different entities. For example, the WTO deductive value method is similar to the OECD resale price method, while the WTO computed value method is similar to the TP cost plus method.

Considering the above similarity, the Guide encourages customs to use TP documents when reviewing the transaction price of related parties which could save time and business cost for MNEs on the preparation of the specific documents submitted to customs. However the main challenges for customs when referring the TP documents will be single product verses company profitability product range, date range and so on.

How customs treats TP adjustment in practice

The guide offers possible solutions which could help the PRC customs in handling valuation cases in practice. Per the data from OECD, the number of countries with effective TP documentation rules increased from 4 to 80 during the period from 1994 to 2014.

If the TP adjustment is initiated by MNEs, recorded in the company's book, and a debit or credit note is issued, it is considered to have an impact on the price actually paid or payable for the imported goods for customs valuation purpose, so MNEs are recommended to voluntarily disclose it to customs.

Theoretically speaking, if an upward adjustment is made, MNEs will pay additional duty to customs; while if downward adjustment is made, duty will be refunded to MNEs. In reality, some countries' customs can approve both, while others only approve the upward adjustments and reject the downward. This inconsistency around the world concerns the business community.

KPMG Observation

Upon the publication of the Guide, there are critical points that MNEs should keep in mind when facing CV or TP controversial issues in the PRC:

- Increasing the certainty

  The Guide encourages customs authorities throughout the world to use OECD documents as useful information when determining whether the related party transaction has been influenced by the special relationship.

Per our experience and observations on real cases, the PRC customs has been relatively reluctant to refer to the TP documents. Upon the publication of the Guide, it could be easier to persuade the PRC customs officials to refer to TP documents (especially TP Contemporaneous Documentation for TP compliance purpose) for customs valuation purpose. This practice could benefit the solving of the controversial valuation issues.

- Improving efficiency

  As mentioned in the Guide, many countries' customs established communication channels (such as working groups or regular meetings) with their respective tax authorities with the aim to exchange information, share knowledge and skills between each other. This mechanism will also help to build a coordinated approach which could help MNEs to satisfy both TP and CV requirements when they face inquiries from either customs or tax authorities. Currently, the General Administration of Customs (GAC) and the State Administration of Taxation (SAT) in the PRC had yet built up such a communication channel.

  If tax authorities and customs in China adopt the opinions in the Guide, we expect to see further actions to be taken by these two authorities to improve the efficiency and benefit those MNEs which have controversial customs/TP issues in practice.

- Enhancing the compliance requirement

  As introduced in the Guide, interaction between the TP and customs practices in nature will lead to a higher compliance requirements. Therefore, the compliance requirements of customs should also be carefully considered by MNEs to achieve compliance in China from both CV and TP perspectives.

- Improving the practices on price adjustment

  As introduced above, the Guide shares various countries' practices on the upward/downward adjustments. In the PRC, the customs officials only consider the upward, while refund of import taxes paid for downward adjustments is generally not allowed.

  With the introduction of the Guide, we wait to see if the PRC customs authorities will change their position or carry out an innovative approach to handle the downward price adjustment issue.

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