Transfer pricing methods in customs valuation (3/5/17)

According to Latvian legislation, transfer pricing methods must be used in determining the value of goods for corporate income tax purposes because a reference to those methods is made in Cabinet Regulation No. 556, *Application of Provisions of the Corporate Income Tax Act*. However, when Latvian taxpayers buy goods from related suppliers incorporated outside EU/EEA countries, transfer pricing (TP) can also affect customs values and customs duties.

Pricing issues

When analysing the value of goods to be imported into Latvia, Latvian customs officers mainly use their own statistics, paying attention to cases where the price of imports substantially differs from the statistical average. However, customs officers are also permitted to use TP rules for checking whether imports are priced at arm's length.

A study that involves a customs valuation scenario based on TP methods was accepted as a customs valuation tool in Brussels last year at session 42 of the Technical Committee on Customs Valuation of the World Customs Organisation (WCO), which Latvia joined back in 1992.

The customs valuation scenario

Xco, a manufacturer established in X country, sells relays to its subsidiary Yco, a wholesaler in Y country. Xco is Yco's sole supplier and sells its products only to its subsidiaries. Country Y's customs authority decided to examine the value of Yco's imports after doubts arose about whether the declared value of goods is acceptable. In response to an information request, the customs authority received Yco's TP documentation, which supported arm's length pricing with the transactional net margin method. In the TP documentation, Yco's operating margin was compared with those earned by functionally similar wholesalers that distributed comparable goods through transactions with unrelated companies in Y country during the same period.

Here are Yco's financials for the year:

1	Net revenue	100
2	Cost of goods sold	82
3	Gross profit	18
4	Operating cost	15.5
5	Operating profit	2.5
6	Operating margin (6=5/1x100%)	2.5%

A benchmarking study included in Yco's TP documentation selected eight comparable independent wholesalers whose operating margins ranged from 0.64% to 2.79%, with a median of 1.93%. This range was approved by X and Y countries' tax authorities as they entered into a bilateral advance pricing agreement (APA). Since Yco's 2.5% operating margin comes within the approved range, it follows in the context of the APA that the relays Yco purchased from Xco are priced at arm's length.

WCO findings

The WCO analysis was based on the customs valuation rules of the General Agreement on Tariffs and Trade (GATT), which Latvia has also joined. GATT article 1 provides that the customs value of goods corresponds to the transaction value only if the parties are not related to each other. If they are, this relationship does not affect the transaction value. Since Yco and Xco are related parties, in order to determine whether the transaction value is acceptable as a customs value, the WCO should establish whether this relationship has affected the transaction value. Having examined the analysis in the TP documentation, whose compliance with the legislation of X and Y countries is confirmed by the APA, the WCO found that the TP documentation and the APA prove that Xco sold goods to Yco at a price that would have been agreed between two unrelated companies. So the WCO found that the relationship between Yco and Xco has not affected the price of goods in their mutual transaction, which means that the transaction value is acceptable as a customs value.

How the WCO study affects Latvian taxpayers

The WCO recommends that in certain cases customs officers should use TP methods for customs valuation purposes. Customs valuation in the EU, including Latvia, is governed by Regulation (EU) No. 952/2013 of the European Parliament and of the Council of 9 October 2013 laying down the Union Customs Code, articles 69–74. Similar to GATT, under these clauses the customs value of goods corresponds to the transaction value if there are no restrictions affecting the transaction, including a relationship between the parties. If there are any restrictions, the regulation defines auxiliary customs valuation methods, one of which provides that the customs value is the sum of the following amounts:

- the price of materials used in the manufacture of the imported goods and the value of production or other processing activities;
- the sum of profits and general expenses, equal to an amount that normally arises when selling the same type of goods as those under review, which are produced for export to the EU by manufacturers in the country from which they are exported.

Although this is the last method in the hierarchy of customs valuation methods, this practice can change in the light of the WCO study. Also, the study recognises TP documentation as a way of determining whether the relationship between the parties has affected the transaction value, which is the main task of customs officers, and not as a tool for calculating the customs value of goods.

In a market, related-party transactions can be affected by circumstances that cause the prices of goods to differ from average prices in the industry, yet those circumstances do not cover a relationship between the parties (e.g. market penetration strategy etc). In such cases a professionally prepared and well-argued TP documentation file can help taxpayers defend a disputed customs value and prevent customs officers from unreasonably increasing the amount of customs duty. Where the amount of imports from related foreign companies is substantial (and so is the tax risk) it is advisable to consider the option of entering into an APA with the State Revenue Service to avoid the risk of extra assessments of customs duty and corporate income tax.

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[1]http://www.wcoomd.org/en/topics/valuation/instruments-and-tools/case-study-14-1.aspx