Towards customs valuation compliance through corporate income tax

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Abstract

Customs valuation is based, primarily, on the price actually paid or payable for the goods. The customs administration is a third party to the price, and so needs to rely on the price declared by the parties. Nevertheless, Customs can cross-check the value declared with the cost declared for the purposes of the corporate income tax base determination. The need for coherence between these two values is an important control tool for the customs administration, if properly used. The relationship between customs valuation and the inventory cost of the goods is complex, and an adequate understanding of this issue is necessary to make correct use of this control tool. This article provides an overview of the possibilities available to customs administrations.

1. Introduction

This paper explores the possibilities of corporate income tax as a control tool for customs valuation. Since imported merchandise will constitute an input in the importing country, the value of imported goods will be relevant for the determination of the profits taxed by corporate income tax. The lower the customs value, the lower the inputs cost and, hence, the higher the profit taxed by corporate income tax. Therefore, in general the taxpayer will prefer a lower customs value and a high input value, since that way both customs duties and corporate income tax will be lower. Obviously, the interest of the authorities will be exactly the opposite, in order to maximise revenue.

The paper begins with an analysis of the respective valuation rules for customs and corporate income tax purposes, to identify their similarities and their differences (section 2). Then the legal connection established in United States (US) legislation between those two values is examined (section 3), followed by a connection found, in the absence of an explicit provision to that end, by the Courts in the Spanish system (section 4).

In this paper, the valuation of the imported goods for corporate income tax purposes is referred to as ‘inventory cost’ (US legislation uses the expression ‘basis or inventory cost’ in Sec. 1059A IRC).

2. Same concept, some differences

The relevance of corporate income tax as a tool to ensure compliance in customs valuation rests on the assumption that there is a relationship or connection between the valuation rules in both taxes. If that were not the case, it would not be possible to make an inference about one from the amount determined for the other.

Customs valuation methods are established in the World Trade Organization’s (WTO) Customs Valuation Code (CVC).[2] Member States have transposed that regulation in their internal law. The main valuation method is **Transaction Value** (TV). According to this method, valuation is based on the price in a sale for export to the importing country, with some adjustments. The CVC establishes some circumstances which preclude the use of transaction value, chief amongst which is that the existence of a relationship between the parties has had an influence on the price. Transaction value, as defined by customs valuation rules, **and an arm's length price** of the goods (which is the objective of transfer pricing rules in the Income Tax) should basically be the same thing. Of course, we are assuming that TV is based on a sale in which the buyer is the importer. But customs valuation rules allow that TV be based on an earlier sale, between a manufacturer and a middleman, where both parties might not be residents in the country of importation.[3] That is the case both in the US and European Union (EU) legal systems. In such cases, the link between customs valuation and the transfer price would be broken.

However, some differences must be highlighted: some elements of cost which are not included in transaction value but which, nevertheless, are part of the arm's length price of the goods for income tax purposes. It is interesting to note that some of these elements of cost not included in transaction value are included in the VAT tax base on imports by way of adjustments. In EU law this is the case, for example, as regards import duties and other duties and taxes paid on importation; transport and incidental costs incurred up to the first place of destination within the territory of the Member State of importation; and, in general, other costs incurred before goods reach their first place of destination (under this provision, customs agent fees and buying commissions might be included).

Depending on national legislation, there are also elements of cost that would be included in a transfer price which are not included either in the customs value or in the tax base of VAT on imports. That could be the case, for example, of:

- import quotas paid by the importer
- transport costs and incidental costs after goods reach their first destination in the Community
- charges for construction, erection, assembly, maintenance or technical assistance, undertaken after importation on imported goods such as industrial plant, machinery or equipment
- activities undertaken by the buyer on the buyer's own account
- payments for the right to distribute and re-sell the goods that were not included in the customs value because they weren't a condition of sale.

The point here is that transaction value and the transfer price will not be identical, but we can establish why and by how much they will differ and, therefore, we can make the necessary adjustments to go from one to the other. As long as we have clearly identified the elements requiring adjustment, that should not be too troublesome.

As for the **concept of related parties**, both customs valuation rules and the income tax share basically the same definition. The only substantial difference in this regard is that it seems that, in some jurisdictions, such as the US, relationship may be held to exist not only on the basis of legal relationship (that is, formal, legal ties between the parties) but also in terms of economic relationship (on what is called 'economic control').[4] This is not the case in all jurisdictions; for example, Spain adheres to the requirement of a traditional formal, legal relationship in order to determine that the parties are related for income tax purposes.

In any case, this difficulty should not be overstated because the concept of related parties in customs valuation could be interpreted to include cases of 'economic control' to accommodate the corresponding transfer pricing rules when necessary. Certainly customs valuation rules do not expressly include cases of strict 'economic control', but neither do they exclude them, so it would not entail much difficulty harmonising both sets of rules, perhaps by means of a Decision of the Committee on Custom Valuation, in order to avert any perception of a possible breach of the uniformity aspirations of the CVC. Therefore, with only one minor difficulty, we can agree that both customs valuation and the income tax share a common concept of related parties.

If the parties are related, we need to ascertain whether the existence of such relationship has had an influence on the price because if that were the case, the use of transaction value would be precluded. For that purpose, the CVC provides two tests: the 'circumstances of sale' test and the 'value test'.

Under the 'circumstances of sale' test, the relevant aspects of the transaction are analysed, including:

(1) the way in which the buyer and the seller organise their commercial relations, and

(2) the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price.

Under this test the price will be accepted provided that:

(a) the price was settled in a manner consistent with the normal pricing practices of the *industry in question* (that is, the industry that produces goods of the same class or kind. This test does not focus on the function performed by the parties, as transfer pricing rules do.)

(b) the price was settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related to it (this test is equivalent to 'comparable uncontrolled price' in transfer pricing rules), or

(c) the price is adequate to ensure recovery of all costs plus a profit that is equivalent to the firm's overall profit realised over a representative period of time in sales of merchandise of the same class or kind (this test is equivalent to 'cost plus profit' method in transfer pricing rules, but focuses on merchandise of the same class or kind, and not the functions performed by the parties).

As for 'test value', it is met (and where met, the price declared accepted as a basis for transaction value) when the price declared closely approximates one of the following values:

(a) the transaction value in sales to unrelated buyers of identical or similar goods for export to the same country of importation

(b) the deductive value of identical or similar goods

(c) the computed value of identical or similar goods

occurring at or about the same time (in the US, at the time of exportation).

If the relationship is found to have had an influence on the price, we will have to resort to alternative valuation methods. The CVC methods are very similar to the transaction-based methods used for transfer pricing, as defined by the OECD Guidelines.[5] However, we must note that customs valuation rules establish a strict order in which the different methods have to be applied, while transfer pricing rules do not establish a preference for the methods to be used (in each case an assessment of the best available method will be made). Nevertheless, the preference established by customs valuation rules will also make sense for transfer pricing most of the time, that is, if a given customs valuation method can be applied, we can assume that the equivalent transfer pricing method will provide the most accurate results. So, again, this difference is not as important as it might seem at first sight, although it has to be taken into account.

However, when we compare **the alternative valuation methods** provided in the CVC with their equivalent methods in the OECD guidelines, we can observe some differences.[6]

Starting with the **Transaction Value of Identical goods and the Transaction Value of Similar goods** (TVI and TVS), in customs valuation, these methods are equivalent to **the Comparable Uncontrolled Price (the CUP)**, in transfer pricing. All of them take the value determined for a comparable transaction as a starting point, and then make some adjustments to arrive at the value for the transaction that is being appraised. Despite this basic similarity, we can find some differences:

- Customs rules have two different methods, one for 'identical' and the other for 'similar' goods, with a hierarchical preference for identical over similar goods. This difference is not established in the CUP method, although this difference is minor because it is obvious that identical goods are a better 'comparable' than similar goods, so the CUP method would yield more accurate results using identical goods as a 'comparable' when available.
- Adjustments for the TVI and TVS are strictly limited to those arising from differences in commercial level, quantity and transport costs. Meanwhile, in the context of the CUP, adjustments can have a broader scope and focus in the functions performed by the parties, taking into account assets used and risks assumed. Therefore, the resulting differences in adjustments can be important.
- The customs methods require that the goods in the comparable transaction must be produced in the same country as the goods being valued. The CUP method does not establish such a limitation, although we feel that goods produced in the same country will provide a more accurate comparable and, therefore, should also be preferred for transfer pricing purposes.
- Customs rules establish a preference for comparables in which the seller is the same person (referred to as 'internal comparables'). Transfer pricing rules do not establish this preference expressly, but there is no doubt that an internal comparable is preferable to an external comparable (which is where the transaction is undertaken by a different seller).
- In the case of the EU, the comparable transaction for customs valuation purposes could be the value determined for any importation that takes place in the Common Customs Territory, that is, in the whole of the EU. For CUP purposes, national jurisdictions will have a preference for transactions undertaken in their own jurisdictions, not in the whole of the EU.
- If payment is to be made in a foreign currency, the exchange rate for customs purposes will be that prevailing at the time of export or at the time of importation. In the case of the EU, for example, it will be the existing exchange rate at the time of the determination of the customs duties. For transfer pricing purposes, national legislation could establish a different moment to determine the applicable exchange rate (the date of delivery or the date of payment, for example).
- In the TVI and TVS, the time to establish the parameter transaction is the time of export, while for the CUP method it is the time of the sale, which can be different from the time of export.
- In the TVI and TVS, there is a rule establishing a preference for the lower value when more than one comparable transaction has been found. In the CUP method, we will have a range of acceptable values, and there is no preference for the lower value, rather the preference is for the average value.
- In the TVI and TVS, the parameter is a transaction value. This means that the differences between the transaction value and the arm's length price that we have referred to before will also be relevant here, and also we must bear in mind that the parameter transaction could be a related party sale. This is another difference with the comparable uncontrolled price method.

The next customs valuation method is the **Deductive Value Method (the DVM)**, which is similar to the **Resale Price Method (RPM)** in the transfer pricing rules. Both take a later sale as a starting point and subtract from the price of that sale some elements of cost incurred by the seller and a profit that approximates the acquisition value of such seller. So, basically, the DVM and the RSM start from a later point (a later sale) and then go backwards by means of adjustments (deductions) to the implicit acquisition value of the importer. The differences we can find between these two methods are as follows:

- In the DVM, the margin of the seller can only be determined from data obtained within the country of importation (or the Common Customs Territory in the case of the EU). In the RPM such limitation is not made expressly, although for obvious reasons the tax authorities will prefer to use data available and registered in operations in their own jurisdictions.

- The DVM establishes a limit of 90 days (before or after importation) for the acceptability of the sale prices. The RPM does not need such time limit because profit will be determined at year-end, and so there is no need to speed up the valuation of the goods.
- If there are several sales (that is, several parameters), the DVM directs us to take the price at which a greater amount of the goods has been sold, that is, not the average value but the value most repeated. In statistical terms, this value is known as the ‘statistical mode’. Instead, the RPM will determine a range of acceptable prices, with a preference for the average value.
- In order to determine the benefit of the importer-seller, the RPM directs us to make an analysis of the functions performed, taking into account assets used and risks assumed. Customs valuation rules do not direct us to make such an analysis, they simply require that we make a deduction of an amount equal to the ‘usual’ profit and general expenses.

The next valuation method for customs purposes is the **Computed Value Method (CVM)**. This method is very similar to the **Cost Plus Profit** method (C+) of the transfer pricing rules. Both methods use the costs of the exporter as a starting point and make the proper adjustments to obtain a value which can equal the exporter sale price. So basically, these methods go one step before the transaction we need to value and make the proper additions to reach the value of such transaction. The only – and quite unremarkable – difference between these two methods is that for the CVM one takes the profit and general expenses of the exporter as a unique amount, while the C+ method determines profit and general expenses separately. But this difference is unremarkable because we are not interested in the profit made by the exporter, so the disaggregation made in the transfer pricing method will be irrelevant in the importing country.

When none of the previous customs valuation methods can be applied, in customs valuation we come back to the valuation methods we have seen and apply them with some degree of flexibility. Instead, transfer pricing rules establish two additional methods which basically focus on the profit arising in the sale, the **Profit Split Method** and the **Transactional Net Margin Method**. Obviously the methodology differences here between customs valuation and transfer pricing rules can be huge and the reconciliation of both values could prove to be impossible.

3. The normative approach

Notwithstanding the differences in valuation that have been highlighted, the concept of value in customs valuation rules and in the corporate income tax remains basically coincident. This similarity has been noticed in the US legal system, where a provision was enacted that reflects the connection between these two values. Section 1059A of the Internal Revenue Code (IRC) provides:

> **Sec. 1059A. Limitation on taxpayer’s basis or inventory cost in property imported from related persons.**
>
> (a) In general
>
> If any property is imported into the United States in a transaction (directly or indirectly) between related persons (within the meaning of section 482), the amount of any costs –
>
> > **(1)** which are taken into account in computing the basis or inventory cost of such property by the purchaser, and
> >
> > **(2)** which are also taken into account in computing the customs value of such property,
>
> shall not, for purposes of computing such basis or inventory cost for purposes of this chapter, be greater than the amount of such costs taken into account in computing such customs value. …

It has to be noted that Section 1059A IRC establishes a limit only for related party transactions, so this rule will not apply when goods are imported by an unrelated importer. Besides, the rule does not apply in situations where no duty has to be paid (property not subject to customs duty; portion of an item that is a US good returned and not subject to duty; property subject to a zero rate of duty; property subject only to the user fee or the harbour maintenance tax) or when duties are not calculated on value. These exclusions probably aim to clear any possible intent to influence the inventory cost determination by means of an artificial customs valuation that does not result in duties to be paid.[7]

In essence, Section 1059A IRC provides that customs value sets a limit for the inventory cost on the part of related taxpayers in respect to the elements of cost which are included in such customs value.[8] That is, inasmuch as most of the components of the customs value will be relevant for the inventory cost of the goods, the importer is not allowed to claim a higher value for those components in the income tax than the value declared for customs valuation. The provision aims to prevent situations such as that in *Brittingham v. Comr*.[9] In that case, the plaintiff had customs value determined based on the price paid for products that Customs regarded as similar to those entered, resulting in a low customs value. When the IRS tried to determine the corporate income tax based on the value ascertained for customs purposes, the plaintiff argued that it was erroneous that both products were similar, since there was a relevant difference in quality, and stated that it had paid a higher price. The Tax Court concurred that the valuation by the Customs Service was not indicative of an arm's length price. That way Brittingham played both ways, obtaining a low customs value and a higher inventory cost for the same goods. The legislative history of the provision contains an express mention of this case:

> Congress understood that some importers could claim a transfer price for income tax purposes that was higher than would be consistent with the transfer price claimed for customs purposes. See *Robert M. Brittingham*, 66 T.C. 373 (1976), *aff'd*, 598 F.2d 1375 (5th Cir. 1979). Congress was particularly concerned that such practices between commonly controlled entities could improperly avoid U.S. tax or customs duties.[10]

Since the relationship between customs valuation and the inventory cost is not one of identity, Section 1059A IRC properly establishes the connection between the two values inasmuch as the same elements of cost are included in both. In this regard, Levine and Littman (1994) have stated that 'Section 1059A does not appear to act as an overall limitation on tax basis, but is instead a limitation upon each of the components of basis that are also components of customs value'.[11] Elaborating on this model, the regulations provide some upward adjustments to customs value to arrive at the inventory cost, such as freight charges, insurance charges, expenses incurred for the construction, erection, assembly or technical assistance provided with respect to the property after its importation into the US, differences in the allocation of the value of assists and 'any other amounts which are not taken into account in determining the customs value, which are not properly includible in customs value, and which are appropriately included in the cost basis or inventory cost for income tax purposes'.[12] It is important to stress that, in order to allow an adjustment, the element of cost could not be properly included in customs value. On the other hand, the regulations also provide for offsets to adjustments, when a rebate or reduction in the price is made after importation and, for that very reason, was not allowed for customs purposes but nevertheless has to be computed to determine the inventory cost, reducing it.[13] The elements explicitly enumerated suggest that the provision aims to allow the adjustments for differences in value that can be determined, that is, for elements of cost whose impact on valuation can be properly ascertained. As we have seen in the previous section of this paper, we can basically distinguish two types of differences between customs value and inventory cost; the first would be those for which an adjustment is possible (such as those referred to in the regulations of Section 1059A); the second would be those differences for which an adjustment might not be possible since we will not be in a position to quantify its impact on valuation.

This distinction is relevant because it highlights the fact that it will not always be possible to maintain the connection between the two values. In such cases, the customs value should not set a ceiling on the inventory cost. The legislative history provides grounds for this understanding when it states that:

> Congress expected that the Secretary will provide rules for coordinating customs and tax valuation principles, including provisions for proper adjustments …[14]

This seems to take for granted that coordination rules include adjustments, but also need to encompass other types of rules. One of the circumstances in which coordination rules are required is that of multi-tiered sales, where the customs value is based on a price between a manufacturer and a foreign intermediary. In customs law this possibility was recognised by the Court of Appeals for the Federal Circuit (CAFC) in two relevant cases: *E.C.McAfee Co. v. U.S.* and *Nissho Iwai American Corp. v. U.S.*[15] where the Court rejected Customs' understanding that valuation should be based on the price registered in the sale that most directly caused that the goods were exported to the US, and decided instead that customs value could be based on any sale that could be properly regarded as a sale for export, that is, a sale resulting in the goods being clearly destined for export to the US. The Court further rejected any analysis requiring the weighing of the relative importance of two viable transactions. When the customs value is based on the price registered in a sale between a manufacturer and a foreign middleman, then the price paid by the importer will be different from the price used as a starting point for the customs valuation determination, and so the inventory cost should take into account this factor. In PLR 9406026 the IRS accepted that, if the correct value had been reported to Customs for duty purposes and that value was based on a sale to a foreign middleman, then the limitation in Section 1059A should be reviewed to take into account the higher price paid by the importer.[16] We note, however, that the so-called 'first-sale rule' is now challenged by *Commentary 22.1* of the Technical Committee on Customs Valuation, where the Committee expresses its view that:

> the underlying assumption of Article 1 is that normally the buyer would be located in the country of importation and that the price actually paid or payable would be based on the price paid by this buyer. The Technical Committee concludes that in a series of sales situation, the price actually paid or payable for the imported goods when sold for export to the country of importation is the price paid in the *last sale* occurring prior to the introduction of the goods into the country of importation, instead of the first (or earlier) sale.

This new understanding of the Valuation Code proposed by the Technical Committee, however, has not been introduced in US legislation or regulations so far,[17] or in the EU legal system.[18] Leaving aside the – well-grounded – merits of the interpretation on which the first sale rule is based, from the perspective of the relationship between customs valuation and inventory cost it has to be recognised that the understanding of the Technical Committee would approximate both values, since customs value would invariably be based on a sale to an importer located in the country of importation (and thus subject to corporate income tax in that country of importation). Therefore the connection between those two values would not be broken by the interposition of an earlier sale to a non-resident middleman who is not subject to income taxation in the country of importation.

The limit established in Section 1059A takes the form of a maximum amount for the elements of costs involved, which means that the value used for customs purposes will not necessarily be accepted to determine the inventory cost. Therefore, 'although customs value (as appropriately adjusted) provides a ceiling on transfer price valuation for income tax purposes, it does not provide a floor on that valuation'.[19] Hence, this limit does not apply to the tax authorities.

In this regard, it is especially troublesome for the trade community that, for Section 1059A purposes, the customs value is considered to be finally determined 90 days after notice of liquidation to the importer, unless a protest is filed.[20] The problem is that customs liquidation could be issued after that period and, in case of an increase in customs value, that increase would be disregarded for purposes of establishing a limit on the inventory cost, thus resulting in a high customs value and a low inventory cost. That situation can arise especially in cases where the importer participates in Customs' Automated Commercial System Reconciliation Prototype Program (Reconciliation Program). This program allows importers to file initial declarations with Customs at the time of importation providing the best available information at the time, using the ‘reasonable care’ standard. Entries where relevant elements are undetermined or unknown at the time of entry are flagged by the importer, to let the Customs Service know that further data will be provided when available. The entry information will be supplemented at a later date with more accurate data through a reconciliation declaration that has to be filed during the following 21 months. After the reconciliation is filed it is liquidated, resulting in duties, taxes and interest due (or in a refund, when the importer paid at the time of entry an amount in excess of the liquidation). This mechanism is very useful to defer the determination of the customs value to a later date when the price has finally been settled, both for Customs and income tax purposes, thus avoiding any inconsistency between those two values. The problem then is that the time limit set in the regulations of Section 1059A reduce the usefulness of this mechanism, since customs liquidations made after the expiry of the 90-day period since the entry liquidation might be deemed irrelevant to determine the ceiling for corporate income tax purposes. Probably ‘rules for coordinating customs and tax valuation principles’, as the legislative history indicated Congress expected from the Secretary, should be provided in order to avoid this type of situation (just as we have seen was made regarding multi-tiered sales) in order to avoid an importer being left paying more customs duties and denied the corresponding increase in the inventory cost.[21]

Another problem of coordination arises when the inventory cost is determined to be lower than initially declared – resulting in a higher income tax due – and the corresponding review of the customs value is denied. In this case we are outside the scope of Section 1059A, that only establishes a ceiling on the inventory cost. But fairness demands that customs value be reduced to maintain consistency. We are, in fact, in a reverse situation to the Brittingham case. The grounds on which Customs justifies its denial of a reduction of the customs value are in 19 U.S.C. § 1401a(b)(4)(B), that provides:

> Any rebate of, or other decrease in, the price actually paid or payable that is made or otherwise effected between the buyer and seller after the date of the importation of the merchandise into the United States shall be disregarded in determining the transaction value.[22]

First of all, it has to be stressed that this rule is nowhere to be found in the Agreement on the Implementation of Article VII of the GATT 1994 (the ‘Valuation Code’), although customs authorities in other countries also have a tendency to disregard discounts or rebates effected after importation. The provision seems to evolve from an understanding that when the Valuation Code establishes that transaction value is ‘the price actually paid or payable for the goods *when* sold for export to the country of importation adjusted …’ the term ‘when’ denotes a reference in time. That understanding clashes with the terms ‘price *actually* paid or payable’ and was rejected by the Technical Committee in its *Interpretative Note 1.1*. The US specificity in this case is the result of unduly transposing the Valuation Code provisions through the lens of the previous US valuation system. It is important to note that in the EU, the ECJ has decided that importers have a right to have their declaration reviewed even after the release of the goods unless the authorities can properly justify a denial.[23]

That said, it still remains unclear that a review of the transfer price might be regarded as a ‘rebate’ or as a ‘decrease’ in the price. As Pike (2006) highlights, transfer pricing adjustments ‘are made to bring the transaction value of imported merchandise into compliance with IRS’s arm’s length pricing regulations … Instead, the adjustment reflects what should have been reported upon entry, had such information been available at the time’.[24] These adjustments are part of the nature of transfer prices, that have an element of artificiality to them, and the Valuation Code clearly wanted that, inasmuch as possible, goods imported by related parties were valued according to the transaction value method, so the Valuation Code assumed this element as the lesser evil. Therefore it seems reasonable to agree with Pike (2006) when he states that ‘Customs’ apparent stance completely ignores fundamental concepts of logic and fairness. If importers are expected to report upward transfer pricing adjustments and tender any underpayment of duties, taxes and fees (as CBP has expressly indicated), why would a downward adjustment fail to result in a refund of any overpayments?’.[25]

Many authors have dedicated considerable effort to enhance the position of importers regarding the problems that arise in connection with the relationship between customs valuation and transfer pricing. One of the recommendations is to apply to the Customs Reconciliation Program that, as has already been said, will allow modification to the customs value when more accurate information is available. Another advice that is repeated is to plan customs aspects of international-related party transactions in advance. In particular, since Customs denies 'rebates' and 'decreases' in price effected after importation, importers are advised to prepare contracts and commercial documentation that thoroughly contemplate instances in which a price reduction will be granted by the seller, so that the reduction can be argued to pre-date importation. Therefore, it is important to carefully design price review formulas so that they take into account as many contingencies as possible.

The main focus of attention in this area has been on Advanced Price Agreements (APA), that is, formulas to calculate transfer prices that are acceptable to the IRS because they fall in a range of acceptable values. The aim is to make the most in terms of customs valuation relevance of the considerable effort that both tax authorities and taxpayers put in order to agree to a mutually satisfactory APA. In this regard, the US Customs and Border Protection has made several rulings recognising that prices agreed in an APA can be relevant for customs valuation purposes when the differences in methodology do not prevent this.[26] This relevance concerns mainly the determination about whether or not the relationship influenced the price (in the context of the 'circumstances of the sale' test, discussed above), which is a requisite to depart from transaction value.[27] So, if the prices declared to the customs authorities are consistent with an APA and no relevant differences in the methodology are detected, the customs authorities will accept the price declared.[28]

A Transfer Price study (the records and documents that companies must prepare and keep in relation to their related party transactions) is not considered sufficient grounds to establish the acceptability of the resulting price as a basis for transaction value. In a case in which the importer had been audited by the IRS and the Transfer Price study had been considered correct, Customs denied that such study could be regarded as sufficient evidence as to the acceptability for customs purposes of the prices derived from the application of the methodology contained in it.[29]

The US customs authorities have made clear some difficulties in this regard:

- Customs laws require that a customs value must be determined for every imported article. It is necessary to determine the correct customs value for each product, not for all the products as a whole. It should be borne in mind that transfer pricing rules allow for aggregation of transactions and offsetting adjustments in appropriate circumstances.

- There are differences in valuation methods. In order to establish the existence of a comparable transaction, transfer pricing rules look for companies that perform similar functions. In customs valuation, the 'circumstances of sale' test focuses on product similarity to identify comparable transactions.

Even with an APA price in hand, the importer is not guaranteed in every case the acceptance of the declared price for customs purposes as a basis for establishing the transaction value. In some rulings, however, the US customs authorities have stressed the importance of their participation in the discussions before an APA is made, and also of disclosure of the APA documentation to them. These two points should thus be considered when entering an APA with the US tax authorities, the IRS.

Other countries have followed a similar path on this issue. For example, the position of the Canadian Customs Administration is fundamentally similar to the US position.[30] The language of the Memorandums released by Canadian Customs could make us think that Canada is more ready to accept that when the price declared to Customs is consistent with an APA it can be concluded that the relationship did not influence the price. But a careful reading of Canada's statements reveals that they also maintain some reservations on this issue. They are committed to accept APA-consistent prices as an indication that the relationship did not influence the price, but that is subject to the relevance of such APA price for customs purposes. On their part, the Australian Customs Service stresses the importance of avoiding aggregate data and the need to offer detailed data for each product instead and highlights the importance of being provided all the supporting documentation prepared in the context of the APA.

4. The interpretative approach

The Judgment of the Spanish *Tribunal Supremo* (Supreme Court) of 30 November 2009 provides an interesting case to illustrate an alternative approach regarding the connection between the customs value and the inventory cost, one we can refer to as the 'interpretative approach'.[31] Some aspects of the case are noteworthy. Coca Cola Spain, the plaintiff, imported some components to prepare refreshments. In previous years, Coca Cola Spain had manufactured those components itself. When the goods were imported, the customs authorities examined the value and determined a higher value than that declared. Years later, Coca Cola Spain was subject to a corporate income tax audit. In the course of the audit, the authorities contested the inventory cost that Coca Cola Spain had used to determine the taxable profit, and considered that such value was too high. It has to be noted, in this regard, that in previous years Coca Cola Spain manufactured at a lower cost the components they later decided to import and that the value determined for customs purposes was higher than the market value of the components. Besides, Coca Cola Spain imported those components from related parties that benefited in their jurisdiction from a ten-year tax exemption in corporate income tax, so a higher value determined a global lower taxation for the group of entities, since it lowered the Spanish corporate income tax without incurring any foreign tax as a result. The higher value determined by Customs seemed made to fit with a tax planning opportunity.

In the audit the authorities applied the RPM that resulted in a lower value for income tax purposes. Coca Cola Spain appealed the corporate income tax determination, alleging that the authorities were bound by the previously determined customs value in establishing the taxable profit. The Court of First Appeal (*Audiencia Nacional*) decided that the decision of the authorities was correct since customs valuation rules and transfer pricing rules are two different sets of rules, so the value established for the purposes of one of them is not binding when determining the other. The authorities, reasoned this Court, had correctly applied corporate income tax rules.

On appeal, the *Tribunal Supremo* disagreed with this finding. First, it concluded that the concept of value in both customs duties and corporate income tax is based on an open market sale price (an arm's length price). The Court found that there is an essential coincidence between the two sets of valuation rules. According to corporate income tax legislation in force at the relevant time, the authorities had discretionary powers regarding the valuation method to be used among the various methods provided in the regulations, one of them being to resort to a value previously determined for the purposes of another tax.[32] In this context, the Tribunal Supremo argued that where the legislation bestows a discretionary power on the authorities, the exercise of such powers is subject to adequate justification. And in the case judged, the Court concluded that such power was not properly exercised because the authorities ignored their previous customs duties determination, and therefore acted in clear contradiction of their previous action, thus violating the good faith standard (*estoppel*).

One can wonder whether such doctrine can be applied under the current legislation in force, since it no longer provides for a valuation method based in a value previously determined for another tax for transfer pricing.[33] Nevertheless, two basic elements taken into account by the Court remain unchanged: (1) Both Customs and corporate income tax valuation methods are essentially equivalent and, (2) therefore, establishing a different value would contradict the previous determination of value unless a proper justification for such difference is provided, detailing the facts on which that difference is based (*estoppel*).

In the cases decided by the Court, the authorities had verified the customs declaration and determined a higher customs value than the value declared. But such situations will not be the most typical. Typically, the authorities will accept the value declared. In order to decide the relevance of the doctrine established by the Court, it has to be determined if in these cases it can also be held that the authorities are in contradiction of a previous value determination. In this regard, it is relevant to take into account that customs duties in the EU are always assessed by the authorities, based on the data provided by the declarant unless the declaration is verified.[34] The assessment can be implicit, when the release of the goods is provided without an express assessment, and in that case the duties due will be those entered, 'for guidance', in the customs declaration.[35] Being the assessment of duties generally based in the data filed by the declarant, it could be questioned whether such assessments create an estoppel situation, since in these cases the authorities are simply accepting the data provided by the declarant without further scrutiny. At the same time, denying any relevance to the fact that the authorities issue an assessment (even if they do so implicitly by allowing the release of the goods) would seem unsatisfactory, since this act on the part of the authorities has the legal effect of creating an obligation on the declarant, and an act of such legal effect should also produce legal effects on the issuer, the authorities. To conclude otherwise would be tantamount to saying that the authorities claim debts they know nothing about, and that they do not even check if the information provided by the importer in their declaration is consistent with their value determination.

For the aforementioned reasons, probably a middle ground solution would be to consider that the authorities would be in contradiction of a previous valuation inasmuch as they do not justify that they have had access to relevant information which was not made available to them when the previous valuation was made. That is, the authorities could claim that *estoppel* does not apply inasmuch as they can base their new finding on information they did not have previously. This means, for example, that when the importer filed incomplete or inaccurate data at entry, the authorities would be able later to depart from the customs value determined inasmuch as such incompleteness or inaccuracy have an impact on value.

But the *estoppel* doctrine that the judgments of the *Tribunal Supremo* project on the authorities can also be applied to the importers. Importers would contradict their customs declaration if, afterwards, they try to claim an inventory cost that is not consistent with the customs value declared. Interestingly, the *estoppel* would enter into play in respect of importers in every case, since they should be fully aware and be made responsible for the value declared. Only when customs value and inventory cost essentially differ due to one of the factors that have been identified in section 2 of this paper (for example, when the Profit Split Method or the Transactional Net Margin Method are applied for transfer pricing purposes) and it is not possible to make an adjustment to bridge that difference, the importer could claim that the connection between those two values does not apply. This idea leads us to conclude that, although the judgments of the *Tribunal Supremo* mentioned find in favour of the taxpayer, potentially their doctrine is more beneficial to the authorities than it is to taxpayers. More so when one takes into account that the statute of limitations for customs purposes is only three years from the date of entry of the declaration, while the statute of limitations for corporate income tax will usually be longer than that, so the importer might be caught with a reviewed inventory cost that does not result in a symmetrical reduction of the customs value.[36]

In any case, what these judgments make clear is that, even in the absence of an explicit provision in the legislation establishing a connection between customs value and inventory cost, both authorities and taxpayers should be well aware that such connection can nevertheless be relevant in a valuation dispute. That conclusion could well be relevant in other legal systems whose transfer pricing rules are aligned with the OECD guidelines. In this regard, it is interesting to note that in the US system, before Section 1059A IRC was enacted, the Tax Court decided in the *Ross Glove Co. v. Commissioner* that the methods adopted by the Customs Service and the IRS were quite similar, and so the markups used by the Customs Service to determine the value of the goods purchased from a related party were adequate to determine the arm's length price for corporate income tax purposes. The Court found that the customs value was the ‘best evidence available as to amounts that a seller would receive to cover overhead and profit in an arm’s length sale’.[37]

The ‘interpretative approach’ has the advantage of providing the necessary flexibility to avoid inconsistent or unfair results that we have seen in the ‘normative approach’ of the US system. Besides, the connection between customs value and inventory cost travels both ways and is not only a control tool in the hands of the authorities but also a protection for importers, since it prevents the authorities from making inconsistent value determinations.

In each case the Judge will decide, based on the merits of the facts and supporting evidence provided, whether or not a relationship between the customs value and the inventory cost exists, and in case it does (which can be expected to be the most common situation), the adjustments necessary and their amount. But in this advantage lies also the weakness of the ‘interpretative approach’, since it assumes that the Judge will have, in the absence of any guidance from the law, the complex knowledge required to ascertain the intricate details of the relationship between two sets of complicated valuation rules. At the very least this is clearly not the best approach to provide legal certainty.

5. Conclusions

The relationship between customs value and inventory cost is not one of identity but one of proximity. In most cases, the differences can be bridged with proper adjustments, to take into account elements of cost that are not included in the customs value that, nevertheless, are part of the inventory cost. In some cases, though, an adjustment will not be possible because the difference in methodology will not allow it. Customs and tax authorities, as well as the trade community, must be prepared to face both scenarios as possibilities.

When the differences between those two values can be bridged with adjustments, consistency should be the guiding principle, both for the authorities and taxpayers. This principle has several consequences:

- An importer should not be allowed to claim a low customs value and a high inventory cost unless the adjustments for the differences in the elements included in the inventory cost that are not properly includable in the customs value allow for such difference. Therefore, the principle of consistency reveals that corporate income tax is a relevant tool to control the value entered for customs purposes.
- If there is an upward adjustment to the customs value, the importer should be allowed to claim a higher inventory cost as well. Also, if the inventory cost is lowered, then the customs value should be reduced correspondingly.
- Procedural difficulties or excuses should not be put in the way of consistency. Time limits or non-allowance of certain adjustments that result in unfair results should be removed to favour a healthy relationship between the taxpayer and the authorities based on mutual trust.

The relationship between the two values can be expressly stated in legislation or it can be found by the Courts. Although the latter option has the advantage of flexibility, it also has the burden of a more complicated implementation and legal uncertainty. Therefore, legislation carefully drafted, that takes consistency as the guiding principle and not just the maximisation of revenue collection, seems a more desirable option.

The trade community also has some tools at their disposal in this matter. It is important to plan ahead in respect of customs issues, to prepare contracts and commercial documentation taking into account possible contingencies that might arise regarding the determination of the customs value, to prepare detailed price formulas and, when available, to apply for a deferment of the final determination of the customs value. If the importer is planning to conclude an APA with the tax authorities, it seems advisable to invite Customs to participate, so that they too have the opportunity to acquire a deep knowledge of, and trust in, the methodology agreed in the APA.

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Endnotes

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2 Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (Customs Valuation Code, 'CVC'), www.wto.org/english/docs_e/legal_e/20-val.doc.

3 We will come back to this topic in the next section of this paper.

4 See Ainsworth 2007.

5 OECD 2010.

6 An extended comparison between customs valuation methods and their equivalent transfer pricing methods can be found at Martín Jovanovich (2002), and also in Ibáñez Marsilla (2002). A more concise comparison is offered by Maisto (2001).

7 As we explain below, though, Section 1059A IRC sets a ceiling for the importer, but not a floor for the tax authorities. Therefore, one should think that the results absent this rule would be the same anyway.

8 The implementing provisions can be found in 26CFR1.1059A-1. The implementing provisions include useful examples to illustrate its application. Commentaries on these provisions can be found in Dorn & Dorris (1989); Weigel (1993); Neville (1993); Cody (1993-94); Mavridis (1994); Levine & Littman (1994); Sheldrick, Lowell & Briger (1996).

9 66 T.C. 373 (1976).

10 Staff of the Joint Committee on Taxation, at 1062.

11 Levine & Littman 1994, p. 238. In fact, the regulations provide as an 'alternative method of demonstrating compliance' that the taxpayer 'may demonstrate compliance with this section and section 1059A by comparing costs taken into account in computing basis or inventory costs of the property and the costs taken into account in computing customs value at any time after importation, provided that in any such comparison the same costs are included both in basis or inventory costs and in customs value. If, on the basis of such comparison, the basis or inventory cost is equal to or less than the customs value, the taxpayer shall be deemed to have met the requirements of this section and section 1059A' (26CFR1.1059A-1 (c) 6).

12 26CFR1.1059A-1 (c) 2. To allow an adjustment, the regulations require that, when the amounts are paid to a related party, they reflect an arm's length charge within the meaning of Section 1.482-1(d)(3).

13 US legislation, in determining transaction value, disregards rebates of, or other decrease in, the price actually paid or payable that is made or otherwise effected after the date of the importation of the merchandise (19 U.S.C. § 1401a(b)(4)(B); the regulations also include this rule at 19 C.F.R. § 152.103(a)(4)). See further discussion on this topic below.

14 Staff of the Joint Committee on Taxation 1987, *General explanation of the Tax Reform Act of 1986*, at 1062.

15 Decisions of the Court of Appeals for the Federal Circuit *E.C.McAfee Co. v. U.S.,* 842 F.2d 314 (Fed. Cir. 1988) and *Nissho Iwai American Corp. v. U.S,* 982 F.2d 505 (Fed. Cir. 1992).

16 See an analysis of the impact of the CAFC interpretation on Section 1059A limitation in Levine & Littman 1994.

17 The Bureau of Customs and Border Protection (CBP) tried to introduce this interpretation in 'Proposed interpretation of the expression "Sold for Exportation to the United States" for purposes of applying the transaction value method of valuation in a series of sales' (USCBP-2007-0083, published in 73 Fed. Reg. 4254), but the *Food, Conservation and Energy Act* subjected this new approach to a 'sense of Congress provision' that no change be made before 1 January 2011. In response, CBP retired

his proposal (73 Fed. Reg. 49939). See a discussion on this topic in Neville 2008; Ruesmann & Willems 2009; Desiderio & Desiderio 2010.

18 See art. 147.1 Commission Regulation EEC 2454/93 (implementing provisions of the Community Customs Code) and Commentary No. 7 of the 'Compendium of customs valuation texts of the Customs Code Committee' (TAXUD/800/2002-EN).

19 Staff of the Joint Committee on Taxation 1987, *General explanation of the Tax Reform Act of 1986*, at 1062. The text goes on to state that 'in no event does a customs declaration or customs valuation constrain the ability of the Commissioner to adjust transfer prices under section 482' (the provision that deals with transfer pricing in the US legal system). The aim of Section 1059A is to avoid that importers might benefit from a low customs value and a high inventory cost. This idea is again present when the report states that 'In enacting the new provision, Congress did not express the view that valuation of property for customs purposes should always determine valuation of property for U.S. income tax purposes. Instead, Congress was concerned only with establishing a limit on the price an importer could claim for income tax purposes'.

20 26CFR1.1059A-1 (d).

21 This is the core argument made by Offerman 1999.

22 The regulations also include this rule at 19 C.F.R. § 152.103(a)(4).

23 See ECJ Judgment of 20 October 2005, case C-468/03, *Overland Footwear*. In this case, the importer had failed to report and distinguish from the price a buying commission. The importer provided at a later time the documents and evidence to support that part of their payment was in fact a non-dutiable buying commission. The authorities denied a review of the customs value, but the ECJ decided that such denial was not compatible with the Community Customs Code, art. 78. See also ECJ Judgment of 19 March 2009, case C-256/07, *Mitsui*. In this case, the parties agreed that the seller would reimburse the importer of any costs derived from a three-year guarantee provided to final customers. The ECJ decided that the amounts reimbursed by the manufacturer should be properly deducted from the customs value declared at entry.

24 Pike 2006, p. 9. The author offers an extended explanation on the difference between transfer pricing adjustments and 'rebates' or 'decreases' in price.

25 Pike 2006, p. 10.

26 US Customs and Border Protection 2007. See also HQ 548095.

27 When discussing the 'circumstances of sale' test above we have noted in parenthesis some problematic issues stressed by USCBP that arise from differences between that test and the transfer pricing methodology.

28 For a discussion of the differences in methodology, see section 2. As explained above, the situation will be especially troublesome if the method used for the APA is a profits-based one (the Profit Split Method or the Transactional Net Margin Method).

29 HQ 548482 (23 July 2004). An examination of the circumstances of the case and a criticism of Customs' position can be seen in Pike 2006, pp. 7-8.

30 The position of the Canadian Administration is stated in Memorandum D-13-3-6 'Income tax transfer pricing and customs valuation' (2006) and Memorandum D-13-4-5 'Transaction value method for related persons' (2001).

31 Appeal No. 3582/2003. Another Judgment of the *Tribunal Supremo*, of 11 December 2009 (Appeal No. 4113/2003), applies the same doctrine. This is relevant because two judgments of the *Tribunal Supremo* establishing the same doctrine are regarded as setting guiding jurisprudence for the rest of the Spanish Courts.

32 The legislation in force at the time was *Ley* 61/1978 (article 16) and the regulatory provisions were established in RD 2631/1982. The alternative valuation methods were provided in article 169 of the regulations.

33 For transfer pricing, article 16.4 of *RDLeg*. 4/2004 provides the valuation methods elaborated by the OECD (Comparable Uncontrolled Price; Cost Plus Profit and Resale Price; when due to their complexity or lack of information those methods cannot be applied, the law provides the application of the Profit Split Method and the Transactional Net Margin Method). Interestingly, article 57 of the General Tax Act (Ley 58/2003) provides as an administrative valuation method, for the whole tax system, the price or value declared for purposes of another transfer of the goods made in a period of one year.

34 Art. 217.1 and art. 71.2 Community Customs Code (Reg. 2913/1992; 'CCC'). The Modernized Customs Code (Reg. 450/2008, MCC) opens the door to self-assessment of customs duties in art. 116.2(d). The MCC is not yet applicable.

35 Art. 221.2 CCC.

36 The statute of limitations for customs duties is established in art. 221.3 CCC. In the case of Spain, the statute of limitations is four years after the date when the tax has to be filed, and the computation of that period is re-started every time the authorities act on that tax providing notice to the taxpayer or when the taxpayer lodges an appeal or a claim on that tax (see arts. 66 to 68 General Tax Act, *Ley 58/2003*).

37 *Ross Glove Co. v. Commissioner*, 60 T.C. 569 (1973). This judgment predates the legislation implementing the GATT Valuation Code.

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