Mexico: Transfer pricing and customs valuation

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While sharing the common goal of arm's-length valuation, due to their differing approaches and methodologies, transfer pricing and customs valuation may result in different values.

Differences in transfer pricing and customs valuation often result in expensive administrative and compliance costs for taxpayers, and may even give rise to important contingencies and expensive litigation against transfer pricing and customs administrations. Properly approaching this controversial subject and avoiding such contingencies is in the best interest of both taxpayers and governments. Recognising such needs, the International Chamber of Commerce (ICC)[1] has issued a policy statement on "Transfer pricing and customs value".[2]

Despite its increasing importance, the transfer pricing customs valuation conundrum has remained a pending issue in both the OECD and WTO agendas. Transfer pricing and customs administrations in most countries are still far from finding common ground that would provide a feasible solution for them both. That is why we found it interesting to summarise the six specific proposals that the ICC presents in its policy statement as an initial step for addressing this complex issue.

Proposal 1

"Concerning related parties, formal recognition by the customs administration of the arm's-length principle (as per Article 9 OECD Model Tax Convention) in order to determine the customs value."

In a transaction between independent parties, the most reliable basis for determining customs duties is the sales price of imported goods. Such a price will be adjusted in terms of Article 8 of the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994 (hereinafter, the Customs Valuation Agreement) in order to determine the correct basis: the transaction value.[3]

Between independent parties, the sales price is deemed to represent an arm's-length value. On the other hand, arm's-length pricing between the related seller and buyer may be questionable; however, the transaction value can still be used for customs valuation purposes,[4] as long as the importer can prove that (i) the relationship with the seller did not influence the price; or (ii) that the transaction value (determined with the controlled price) is close to the values resulting from the application of other customs valuation methods.

In the second hypothesis, the transaction value shall be accepted for customs valuation purposes, whenever the importer demonstrates that such value closely approximates to: (i) the transaction value declared 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 deductive value method set forth in Article 5; or (iii) the customs value of identical or similar goods as determined under computed value method under Article 6. For purposes of the comparison, the test values must have been declared at or about the same time of the importation of the goods being valued. Furthermore, customs administrations often require previously determined test values, pursuant to the valuation of imported goods. Thus, there may not be acceptable test values for the customs administration if there are no previous importations of identical or similar goods valued under the transaction, deductive or computed value methods.

Due to the practical problems and usually high costs of the test values clause, it is common (in a controlled transaction) to evaluate the circumstances surrounding the sale in order to demonstrate that the relationship between buyer and seller did not influence the price.

In determining whether the transaction value may be acceptable for customs valuation in a controlled transaction, the circumstances surrounding the sale shall be carefully examined, and only if the importer can prove that its relationship with the seller did not influence the price, the

transaction value can be accepted. Of course, the customs administration may have concerns regarding the possible influence that the relationship may have had on the price, in which case it must contact the importer, who shall be given a reasonable opportunity to respond before the administration decides to reject the transaction value.[5]

The Interpretative Notes to Article 1.2(a) of the Customs Valuation Agreement provide guidance on how to evaluate the circumstances of sales pursuant to demonstrating that the relationship of the parties did not influence the transaction value. In order to facilitate its reading, we offer a different presentation of paragraphs 2 and 3 of the Interpretive Note.

1. 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, such price should be accepted without requesting further information from the importer.[6]
     i. 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.
2. 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 organise 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.
     i. 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.
     ii. 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 realised 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.

Transfer pricing documentation may be very useful in cases where the customs administration requires further and detailed information from the importer in order to examine the circumstances surrounding the sale. Even the WCO Technical Committee on Customs Valuation (TCCV) has already recognised in its Commentary 23.1, that transfer pricing documentation may provide a solid basis on which customs administrations can evaluate the circumstances surrounding the sale in the case of importers who have related party pricing policies in accordance with the OECD Transfer Pricing Guidelines, and prepare, keep and provide the necessary transfer pricing documentation.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and the arm's-length principle, are based on sound underlying economic principles which have been internationally recognised and accepted as an adequate tool for evaluating if related parties have charged arm's-length prices in their controlled transactions.

It is therefore practically obvious that ICC recommends to importers who set prices in accordance with the OECD Transfer Pricing Guidelines, to demonstrate that the price paid to the seller was not influenced by their relationship.

The application of the arm's-length principle (as set forth in Article 9 of the OECD Model Tax Convention and further developed in the OECD Transfer Pricing Guidelines) may be aligned with the rules for determining the acceptability of transaction values in controlled transactions, especially under the circumstances of sale test. Although the analysis must be performed case-by-case where the customs administration cannot directly accept the declared transaction value, customs administrations should at least acknowledge this possible link between the OECD and WTO valuation rules.

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-transaction adjustments are possible under both sets of rules – the OECD Transfer Pricing Guidelines and the WTO-GATT customs valuation rules. Therefore, importers should be allowed to apply such adjustments for either transfer pricing purposes, customs valuation or both, as long as the respective requirements have been duly complied with. Furthermore, transfer pricing and customs administrations should promote, as much as possible, a simplification effort towards the application of such post-transaction adjustments, and even evaluate not to require a provisional customs valuation procedure, nor subject the importer to penalties due to valuation adjustments.

This is particularly relevant for (post-transaction) year-end adjustments aiming to get within a pre-agreed range or price at the end of a certain period. However, such adjustments are generally subject to different sets of rules, and often disregarded by customs administrations when the overall value is reduced.

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;**
- **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."**

In practice, this may be one of the most difficult issues in the application of post-transaction adjustments. For transfer pricing purposes, an adjustment that simply takes the taxpayer's taxable profit to the arm's-length value or range may be sufficient. However when the controlled transaction giving rise to the adjustment is the purchase of (imported) goods and the declared value for customs purposes also needs to be adjusted, important difficulties may arise in practice, as the adjustment needs to be properly allocated for customs purposes.

The transfer pricing adjustment is rarely determined for each specific (imported) good. Instead, it generally covers many products that may be classified in different tariff codes and even be subject to different import duty rates. Proper allocation among the different kinds of goods becomes an important challenge for both importers and customs administrations.

The first solution proposed by the ICC may not be feasible in many jurisdictions. In Mexico for example, it would not be possible to apply the adjustment for customs purposes by using a weighted average import duty rate, since import duties are taxes and, as such, the tax rate must be specifically and clearly established in a law (issued by the Congress), in order for the tax to comply with the applicable constitutional standards.

Importers must allocate the global adjustment among the different kind of imported goods, carefully observing and complying with applicable customs valuation provisions.

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;**
- **the payment of penalties, as variations of the transfer price."**

Post-transaction adjustments are becoming more common every day. Legislators and customs administrations should recognise the need for simplification in its application.

Importers should be relieved from the administrative burden and high costs of amending each and every initial customs declaration; as such cost does not derive benefits for neither the government nor the importer.

Also, spontaneous and voluntary compliance of customs valuation obligations deriving from post-transaction adjustments should not derive in penalties against the importer.

Unfortunately, Mexico has not issued sufficient regulation on the application of post-transaction adjustments. Initial efforts are still scarce and insufficient, but at least the need for such regulation has been acknowledged and the first steps have been taken. We certainly look forward to the next steps, as the issue is a growing concern.

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Proposal 5

"It is recommended that OECD methods be acceptable to customs administrations with an accommodation of the following elements:

- **identical or similar goods;**
- **recognition of corporate legal entities (performing specific functions and adding value within a group)."**

Despite the conceptual analogy between the transfer pricing and customs valuation methodologies, their application presents important discrepancies that may lead to different results. Although desirable, integration of the methodologies still seems to be far from possible. Therefore, documenting a proper analysis for each subject is certainly convenient in order to avoid undesired contingencies.

Recognition of the group's corporate structure and the value added by each entity is essential for purposes of both transfer pricing and customs valuation. In this sense, proper application of any adjustment under Article 8 of the value added by any entity within the group is of the essence.

Proposal 6

"Recognition of the acceptability of transfer pricing documentation by the customs administration."

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 analyse the circumstances of sale, the parties involved, the added value and the functions performed by each party. It is recommended that customs requirements, in addition to those of tax authorities, be defined so as to enable incorporation of those requirements into transfer pricing documentation to serve both purposes.

Transfer pricing documentation is generally a mandatory tax compliance requirement. Relevant information for analysing the circumstances of the sale, the parties involved, the value added and the functions performed by each party, is normally included in such documentation.

In such sense, training customs administrations on how to read the information contained in the transfer pricing documentation that may be relevant for customs valuation purposes is certainly recommendable. Furthermore, presenting such information in a manner that may be useful for both transfer pricing and customs administrations, may be worth exploring and, if possible, regulated.

Conclusion

Evidently, the ICC policy statement presented herein is far from offering a complete and definitive solution to the transfer pricing customs valuation conundrum. However, it should be recognised as a valuable effort for bringing transfer pricing and customs administrations together in finding solutions to a very complex and controversial issue, which does not appear to be a priority in the OECD and WTO current agendas.[7]

We hope that transfer pricing and customs administrations may find ICC's policy statement as a useful starting point for exploring the recommendations contained therein and any other possibilities they may find towards a practical and reasonable regulation and practice.

Notes:

1 Based on the conviction that trade is a powerful force for peace and prosperity, ICC was founded in 1919 with the fundamental mission of promoting trade and investment across frontiers, and helping business corporations meet the challenges and opportunities of globalisation. Today it groups hundreds of thousands of member companies and associations from over 120 countries. National committees work with their members to address the concerns of business in their countries and convey to their governments the business views formulated by ICC. ICC has three main activities: rules-setting, dispute resolution and policy. ICC also provides essential services, such as the ICC International Court of Arbitration, the world's leading arbitral institution, and the World Chambers Federation, ICC's worldwide network of chambers of commerce, fostering interaction and exchange of chamber best practice.

2 Document No. 180/103-6-521 (February 2012) of the ICC presenting this policy statement can be downloaded directly from ICC's website: www.iccwbo.org

3 Article 1 of the Customs Valuation Agreement states: "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 […]".

4 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. […]".

[5] Article I, paragraph 2(a) of the Rules on Customs Valuation of GATT Article VII.

[6] Interpretative Note to 2(a), paragraph 2.

[7] Despite the two joint WCO-OECD conferences on Transfer Pricing and Customs Valuation that took place in 2006 and 2007, the subject has not been recognised as a priority requiring immediate attention in the respective working groups.

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