Customs Risk Related to a Transfer Pricing Report

A TP report can and does contain valuable information for Customs to determine if the relationship between you [importer] and your related supplier has impacted the value for duty purposes as well as to identify other areas for further investigation.

Normally customs would only call for the TP report and financials when they have reason to doubt your import price and have issued you [the importer] with a price verification request, however sometimes customs could already have this information, e.g., if you have been subject to an industry inspection or previously submitted such documentation in support of your AEO application.

Customs will typically review the following information in the report:

- TP method adopted and tested party
- Function, risks, and assets analysis
- Inter-company transactions
- Inter-company service transactions
- Royalties
- Inter-company sales
- Benchmark studies
- Profit margins

From the information obtained in these reports Customs will determine if based on other pricing data available to them your price is acceptable. If Customs has reason to think that your price is too low or the relationship with your supplier impacted the price, they will issue you with a price verification request/or they could have previously issued you with such a request and have determined that the relationship between you and your supplier has impacted the price.

It is important to note that although the fact that the importer and seller are related is not in itself grounds for regarding transaction value as unacceptable, where Customs has doubts about the acceptability of the price and is unable to accept transaction value without further inquiry, the importer will be given an opportunity to supply such further detailed information as may be necessary to enable it to examine the circumstances surrounding the sale.

What detailed information should the importer provide to Customs?

According to the interpretative notes to the WTO Agreement on Customs Valuation [to which China is a signatory] there are two ways to determine whether the transaction value is acceptable.

1. Customs administrations should be prepared to examine relevant aspects of the transaction, including the way in which the buyer and seller organize their commercial relations and the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price.

The notes provide three examples of this:

a) The price has been settled in a manner consistent with the normal pricing practices of the industry in question, or
b) The way the seller settles prices for sales to buyers who are not related to the seller,
c) Where it can be shown that the prices are adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit in sales of the same class or kind.

This would demonstrate that the price had not been influenced.

2. The importer demonstrates that such a value closely approximates to one of the following test values:
   i. The transaction value 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 method.
   iii. The customs value of identical or similar goods as determined under the computed method.

The two methods as found in the Agreement have been incorporated in GAC valuation rules Order 213.

Test values has been incorporated in Article 17, however Method 1 which is incorporated in Article 18 does not contain the same wording as found in the Agreement rather it has been abbreviated as follows.

"Article 18 Having examined the circumstances surrounding the sale, where it can be shown that the price of the imported goods has been settled in a manner consistent with the normal business practice, Customs may determine that the price has not been influenced by the relationship."

In most cases importers cannot comply with the conditions under test value method and rely on their Transfer Pricing Report/Study to support the "circumstances surround the sale" under Method 1.

The OECD guidelines on establishing a transfer price are said to have no legal or direct relationship with customs valuation and as per guidance provided by the WCO "the use of a transfer pricing study for examining the circumstances surrounding the sale must be considered on a case-by-case basis,' by Customs.

China Customs is increasingly reviewing import prices of related party transactions based on the gross profit level of comparable companies. If the *gross margin of imported products is higher than the upper quartile of comparable companies, the customs valuation risk would be relatively high.*

It is important to keep in mind that for imports the taxable value for value added tax [VAT] and Consumption tax [CT] is determined by Customs valuation rules, as such any change in the Customs valuation will have an impact on your VAT/CT which could result in penalties or in a worst-case scenario deniability of VAT input tax credit or CT creditable for continuous production.

As Customs tend to have information available to them from different sources businesses may want to review their transfer pricing documents to understand the interdependencies of transfer pricing and customs valuation and to achieve positive outcomes, including

- Involve customs and indirect tax experts in transfer pricing-related processes early on. The tax strategy of a multinational entity may also need to include consideration of the integration of transfer pricing with other taxes, including customs, and proactively to address tax transparency initiatives and developments.
- Perform a transfer pricing and customs "health checks" to review existing intercompany transactions and manage potential risks and opportunities.
- Involve customs/indirect tax experts when defining or evaluating a transfer pricing policy (e.g., in conjunction with a supply chain reorganization) to review the overall structure and supporting documentation (including intra-group contracts) from a customs perspective.
- Prepare contemporaneous documentation that addresses customs/indirect tax rules and is aligned with transfer pricing-related economic analysis.
- Consider what information is available to tax and customs authorities (e.g., transfer pricing forms, documentation, etc.) and anticipate how authorities may approach that data to prepare for potential future price investigations/audits.

- Perform a risk assessment to understand how to best address year-end price adjustments.

PwC has an integrated supply chain team of tax experts that can help you conduct risk assessment/health checks to identify any areas of concern or where remedies are required.

Contact us for more information

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