New Year's resolution:

document my customs valuation compliance

In the second article in our mini-series on customs valuation, we bring you our thoughts on how to be better placed to survive an audit.

When it comes to customs valuation compliance, our customs specialist peers in industries often find themselves in a very difficult situation. Intercompany prices that are used for import declarations, as well as intangible payment arrangements, were never determined or reviewed by them. In many cases they would not even have been notified prior to their implementation or adjustment. Meanwhile, any documented evidence of the arms' length nature of such prices or charges is almost always exclusively based on transfer pricing principles. This - in a world lacking with significant differences between customs valuation and transfer pricing rules - understandably is unsatisfactory for Customs. As a result, most in-house customs specialists will be on the back-foot when challenged by the authorities, and scrambling to put together coherent and cohesive responses to such challenges.

What's wrong with Transfer Pricing?

Customs auditors often seek to speak directly with representatives from departments with pricing decision power, typically Finance or Tax. In such eventuality, the knowledge and experience of such representatives of their company's finance and transfer pricing may not only be 'not helpful', but even create more trouble as their views and comments could well be out of line with customs valuation rules and expectations. A commonly known and straightforward example would be that high margin retained by importer generally indicates a 'green light' from an in-country transfer pricing perspective, but very much a 'red light' from a customs valuation perspective. Unguarded comments around "assists", "pricing determination at HQ", "trademarks" and so on and so forth can be just as damaging.

Having spent the best part of two decades trying to convince the various international organisations and national authorities on both sides of the spectrum to converge, we are clear that there is little chance of a 'one solution for all' for managing transfer

pricing and customs valuation. This is not just a simple matter of a high profit versus low profit battle, which is often presented as the main underlying reason of the tension between transfer pricing and customs valuation. It is more to do with a completely different view of the commercial world: one which is concerned with who is entitled to how much of the profit that sits in a value chain (or should take on the required loss) and one which is concerned with how much the price of a(ny) specific product should be. In the former world, the entitlement to profit drives all decisions on intercompany pricing, both looking forward and looking back. In the latter, the price of a product is paramount, determined not by how much profit anyone in its value chain should make, but by how much the market is willing to pay for it. As we mentioned in the last lead article, the OECD is looking to award a greater share of the value chain profits to distributors which will cause more concern to customs administrations.

It should be obvious, therefore, that any documentation that explains the direct tax position will be of very limited use to explain correct customs position. Not only is the objective different, but the wording will usually not reflect the appropriate regulatory requirements. Increasingly, we even see the customs authorities take an approach where they try to use such shortcomings in transfer pricing documentation to challenge declared customs values. As a (blunt) example, use of the Transactional Net Margin Method is often interpreted by the customs authorities as a profit split approach that is covered by the "proceeds of a subsequent resale" provisions of customs legislation.

What I want for Christmas: clear customs valuation rules

All of this leads to the nearly inevitable conclusion that multinationals should go beyond relying on transfer pricing documentation to support the customs values declared by the importing affiliates. Creating some level of documentation that does just that, being cognizant of transfer pricing policies yet ensuring that they are framed within the requirements and language of customs value compliance.

To some extent that sounds much easier than it is. One of the major challenges is the often subjective and occasionally outdated wording of customs valuation regulations. This leads to ambiguous and constantly changing interpretations and implementation of the World Trade Organization's agreement on customs valuation (let's call it the 'CVA', although formally it is the "Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade") across territories or even among different ports in one territory. This however does not mean customs and other relevant authorities have not endeavoured to improve clarity. On the contrary, new guidance on interpretation arises very often.

A recent Supreme Court decision in South Korea (case number: 2018Du38697) stipulates that failure to consider the time when goods are imported when selecting comparable companies for purpose of determining profit and general expenses applicable in a Deductive Value Test, which is often the case for transfer pricing benchmarks using multiple year weighted average

financial results, is not compliant with customs valuation regulation requirements. The Supreme Court, however, did not provide a 'white list' guidance on how to factor in time of import consideration or how to select comparable companies. This is typical for such rulings – they determine whether a specific action or approach is ok, rather than opining on what would be ok in general. Oh, for some practical guidance!

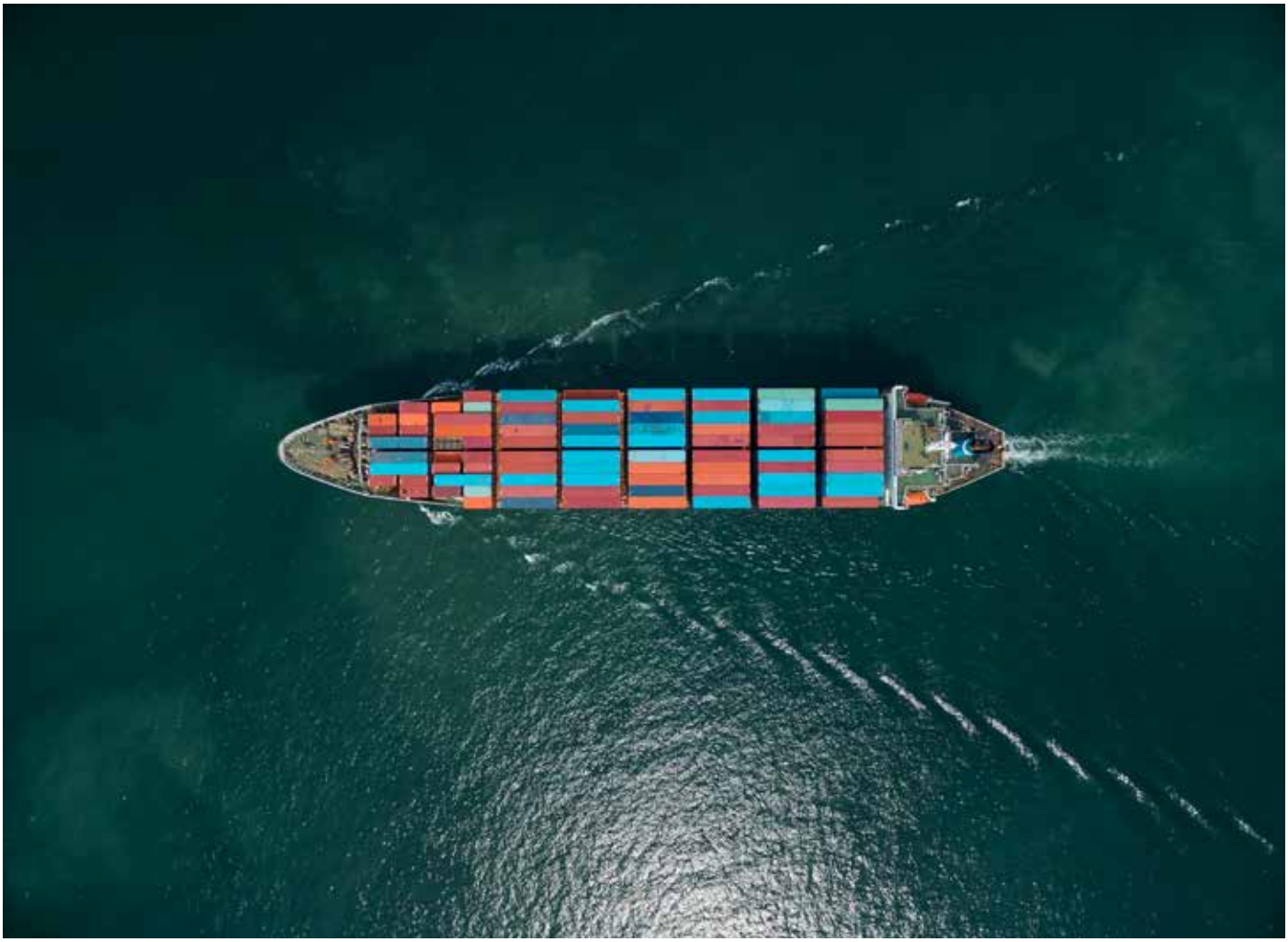
Many similar examples of guidance exist, even around Asia. Yet even that is not necessarily sufficient for importers to know where they stand. They may also conflict from territory to territory, which of course makes life harder for multinationals. Many matters tabled for discussion and resolution at the World Customs Organization's Technical Committee on Customs Valuation end up in Part III of the Conspectus of Technical Valuation Questions. In essence this means that territories can't agree and are left to decide on appropriate treatment for themselves. Exclusive distribution fees are considered dutiable in some territories, but not others. Certain buying commissions, which seem to be explicitly excluded form dutiable values by the CVA, are still considered dutiable by some territories, yet not by most others. Let alone the value of pre-loaded software that may be accessed long after importation by means of some kind of a digital key.

What customs valuation documentation could look like

While some companies may rest with their fingers crossed, hoping Customs either don't knock on their door or – if they do – don't ask the difficult questions, others have started creating some kind of Customs Valuation Documentation ('CVD') in response to increasing attention from Customs on valuation matters. Customs officers across Asia are becoming much more aware of related party pricing issues. They are being trained by various developed nations as well as the World Customs Organization. It is becoming significantly riskier to rely on not being asked those questions.

Companies may still regard CVD as an alien idea, but in this case its counterpart in transfer pricing area, Transfer Pricing Documentation ('TPD'), may provide some very useful guidance. Prior to the existence of mandatory TPD requirements, many MNCs, with the help of transfer pricing specialists, started TPD preparation as a response to growing tax audits around the world. This followed in-country transfer pricing regulations and guidance from the Organisation for Economic Co-operation and Development ('OECD'). The lack of a standard format or unified regulatory requirements proved not to be an obstacle to TPD preparation. The documentation gradually matured with accumulating experiences. Regulatory TPD requirements developed subsequently, leveraging on and borrowing ideas from these early TPD versions. Tax officials also consulted experienced TP specialists' opinion on appropriate legislation.

Though customs valuation regulations have yet to develop a similarly comprehensive level of documentation requirements as transfer pricing, we do not see any reason why it would not follow a similar path. Therefore, we believe it is imperative for industry to be at forefront of these developments, if not ahead of the game, in order to shape and guide the evolution of inevitable regulatory requirements.



For now, being an "unofficial" document, the scope and format of CVD can be tailored depending on a company's supply chain arrangement and compliance needs. CVD can be created purely for the purpose of addressing the non-dutiable nature of an intangible payment. It can also be aimed purely or predominantly at justifying arms' length pricing with an overseas related party seller. Or it can look to support the import price review and adjustment process from a customs valuation perspective. Of course, it can also seek to comprehensively do all of the above and more.

The form of CVD can also vary, depending on a company's needs. It can be in the form of a Masterfile, applying CVA rules to demonstrate valuation compliance in multiple territories. It can also be in the form of a county-specific report, illustrating compliance under domestic valuation regulations and practices, possibly even using appropriate in-country comparables. Nevertheless, just as different industries and territories share similar TPD templates, the pattern for CVD would be more or less the same. A typical CVD starts with an introduction to the company's business from the perspective of cross-border trade in goods (e.g. characteristics of goods, supply chain flow, customs value determination policy). Customs valuation principles and methods will then be applied to test and demonstrate the reasonableness and compliance of the customs value declared or to be declared by the importer.

At this point, it would be worthwhile to dwell on some of the key components of CVD that vary from their equivalent in TPD, and would need special attention.

- "goods of the same class or kind": For customs purposes, any analysis that compares wildly different products on the basis that the roles, risk and responsibilities of their importer are similar are not going to be very relevant for customs purposes. The language, and as appropriate comparability, of the CVD needs to reflect this, focusing on the nature of products and what other companies that import similar products may be doing. If a company imports tractors and shoes, and makes most of its profits on the former, applying an average margin mark-up to the latter, which may be subject to much higher duties, is unlikely to fly. Instead, the importer should compartmentalize the two products and compare the latter with other shoe importers.
- "circumstances of sale": By and large, CVD will be looking to support the use of inter-company invoice values as a basis on which to declare customs values. A crucial component of demonstrating that such invoice values are appropriate is to demonstrate that they would be similar if the seller would be selling the products to unrelated buyers. Unrelated buyers would not simply accept any price determined by the seller or any other third party, but fight their own corner. Customs authorities will expect related party buyers to do the same. Hence the CVD needs to demonstrate the process of such negotiation happening. The average TP documentation is usually silent on this process, focusing instead on the outcome only. If anything, TPD will demonstrate that the seller or a global HQ determines intercompany prices, which are accepted by an importing Affiliate without so much as a whisper. That is not helpful for customs valuation support, to say the least.
- "Deductive and computed values": Where CVD goes as far as reflecting quantitative analysis, it is important that it recognises and reflects that the calculation of deductive and computed values is different to the calculation of its TP counterparts, "resale minus" and "cost plus". Even the way calculations are presented are different, with TP calculations looking to result in a target profit, and customs calculations looking to result in a target import price. In many TP calculations the Cost of Goods Sold (COGS) is inappropriately treated as if it were the import value, whereas in reality it may include or exclude components that from a customs perspective could be excluded or should be included in a customs value.

How to use customs valuation documentation

Regardless of how much thought and effort goes into the creation of CVD, as with TPD it would still be subject to questions and challenges from the authorities. They may not agree with the conclusions reached in the document, which by definition would be a status of compliance for the importer. This would beg the question of why a company would still put in efforts to prepare such documentation, given that it is not a regulatory requirement (yet!).

The answer lies in the usage of CVD. CVD does not only serve to prove compliant and accurate customs value declaration, though this remains the primary purpose for most companies to have it. By putting in place a dedicated document prepared with efforts from customs valuation specialists, an importer can demonstrate its reasonable care and diligence with regards to customs valuation compliance management. This echoes with the increasing expectations from customs authorities in the region for companies to take proactive initiatives in managing customs valuation compliance and maintaining corresponding records.

A circular issued by the Vietnam Ministry of Finance in late 2019 (Circular 60/2019/TT-BTC) puts a regulatory requirement in place on having supporting documents when applying the transaction value method. Some other countries, while not specifically requiring supporting documents on customs value declared, indicate an importers' responsibility for compliant value declaration and burden of proof via declaration or penalty treatments. For example, in 2016 China amended its customs declaration form, requiring importers' declaration on existence of any special relationship between buyer and seller, confirmation of any influence on the transaction price, and the existence of any dutiable royalty fees. Incorrect declaration can lead to not only import tax claw-back but also charges on false declaration and therefore financial penalties. This follows the principles of similar guidance that has been around in places like the EU and Australia for a long time.

As supply chain arrangements change over time, CVD needs to be reviewed and updated on a regular basis to reflect any changes. An obvious frequency would be once a year, with additional updates to be considered whenever there is a change in supply chain or pricing methodology. This of course does not mean CVD needs to be amended whenever there is an import price adjustment. Although customs valuation assessment goes down to the level of individual import transactions, testing the import price of each SKU against customs valuation rules is both impossible and unnecessary for most MNCs, considering the efforts needed. It is also impractical for Customs to review all related party transactions of an importer. As such, CVD provides an alternative approach that is generally acceptable and commonly used by Customs themselves is assessing risk of

non-compliance. Specifically, instead of proving the arms' length nature of each transaction price, it tests and demonstrates the reasonableness of price determination and review methodology. This in turn proves the customs arms' length nature of transaction prices calculated following such methodology.

Because of this, CVD can also be leveraged by companies to support the customs treatment of transfer pricing adjustments ('TPA'). TPA, particularly retrospective TPA, have only recently hit the radar screen of many customs authorities. Taiwan has regulated the procedures for one-time retrospective TPA late last year, requesting companies to declare a provisional customs value upon the import of goods, and apply for final customs value assessments within one month after the fiscal year end. Documents requested by Taiwan Customs include not only import declaration information (e.g. final commercial invoice), but also an explanation on the reasonableness of the final customs value to be declared. Having a document ready that clearly outlines the company's price setting and review methodology and its approach to compliance with customs valuation rules will surely be a strong contributor to this, especially if such document has been put in place prior to and independent of any TPA. Taiwan is not the only territory adopting such practice. Australia is one territory that has had a similar regulatory system allowing for provisional value declaration and year-end adjustment for quite a while. Many other territories, though having no equivalent legislation as yet, are open for TPA discussions in practice. In such discussions, an explanation on the reasonableness of amended customs values is always expected.

Pandora's box?

The rationale for preparing CVD will always be to prove customs valuation compliance. However, in practice the outcome may not always be thus. Many companies, especially those that never have been subject to a customs valuation review or challenge before, are concerned about potential non-compliance being uncovered during CVD preparation.

However, such concerns have by and large proved to be unnecessary. Bear in mind that the main objective of CVD is to support the approach taken by a company to enable it to declare supportable customs values. It does not determine any specific import value to be declared. The outcome of CVD preparation usually goes beyond the expectations most people have upon commencement of the work. The involvement of multiple departments during the preparation process tends to bring a comprehensive understanding of the company's pricing policy and how it affects customs valuation determination and declaration. Its preparation process also typically includes the identification of practical improvement and optimisation opportunities to enhance compliance levels. It forms the basis for argumentation for customs valuation specialists, and in most cases leads to a better and clearer formulation of why current practices are compliant. Time and time again we have seen customs officers draw adverse conclusions from a company's inability to answer questions quickly and comprehensively. Sometimes the answers are difficult to explain, which is even more reason to spend an appropriate amount of time and resources preparing to do exactly that. The scrambling for answers to questions from assertive customs officers often is more problematic than the answers themselves.

It is never a good idea to go into battle without the appropriate arms in your possession. So if you have yet to make your new year resolutions list, now is the perfect time to consider having your own customs valuation documentation!