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WCO releases 2018 "Guide to Customs Valuation and Transfer Pricing"

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In June 2018, The World Customs Organization (WCO) released an update to its *Guide to Customs Valuation and Transfer Pricing*, which was last updated in 2015. The guide is a primary source of reference for both customs authorities and businesses on tax and customs practices with respect to transfer pricing and customs valuation. The guide is available from the WCO website[1] (English and Spanish versions only).

The 2018 edition of the guide follows the framework of the previous version:

Chapter 1: Introduction, including "Who should read this Guide", "What is the issue" and "What are the benefits."

Chapter 2: Customs valuation and related party transactions provides a background to customs valuation methodology, "Test Values" and "Circumstances Surrounding the Sale" of related party transactions, transaction value and alternate valuation methods.

Chapter 3: An introduction to transfer pricing covers the definition of transfer pricing, history and current state of play, the legal framework, the arm's length principle and its application in practice, dispute avoidance and resolution, selected practical issues and transfer pricing compliance.

Chapter 4: Linkages between transfer pricing and customs valuation covers the background to the issue and the practical use of transfer pricing documentation. This chapter also introduces the joint WCO-OECD conferences/WCO focus group, and highlights the work of the technical committee on customs valuation, the WCO cooperation with OECD and World Bank Group, as well as private sector views.

[1] http://www.wcoomd.org/en/topics/valuation/instruments-and-tools/guide-to-customs-valuation-and-transfer-pricing.aspx

Chapter 5: Using transfer pricing information to examine related party transactions discusses the examination of circumstances surrounding the sale via the use of transfer pricing documentation and customs valuation treatment of adjustments to the declared customs value.

Chapter 6: Raising awareness and closer working primarily sets out good practices for customs valuation policy managers, business and tax administrations.

Appendices: There are 11 appendices, including national initiatives, commentary and case studies from the technical committee on customs valuation and examples of transfer pricing documentation structure.

Key changes in the 2018 edition of the guide

Although no major revisions were made, notable updates include the following:

- References to developments in the OECD base erosion and profit shifting (BEPS) initiative which aims to combat tax avoidance strategies utilizing low-tax jurisdictions. This includes references to OECD BEPS actions 8, 9 and 10 and updated guidance on the use of the transactional profit split method in Chapter 3.
- Specific references to the two case studies previously considered and issued by the WCO's technical committee on customs valuation in Chapter 4; case study 14.1, that applies the transactional net margin method (TNMM) and case study 14.2 that applies the resale price method.
- A contribution from Korea concerning its practice on the interaction of customs valuation and transfer pricing in Annex I, "National initiatives."

As with the previous version, the updated guide notes that it does not provide definitive approaches to dealing with customs valuation or transfer pricing issues, but rather provides only technical background and presents potential solutions that should be used in conjunction with domestic laws. However, the guide continues to serve as a main reference in the coordination of tax and customs practices with respect to related party pricing analyses.

Trends in customs valuation and transfer pricing in China

In recent years, both the Chinese tax and customs administrations have focused on transfer pricing, particularly of multinational enterprises (MNEs), and published a number of regulations. In 2016, the State Administration of Taxation (SAT) released "Announcement of the State Administration of Taxation on Relevant Matters relating to Improvement of the Filing of Related-Party Transactions and the Management of Contemporaneous Documentation" (SAT Announcement [2016] No. 42), that updated provisions for disclosure of related party transactions, country-by-country (CbC) reports and contemporaneous transfer pricing documentation, from an enterprise income tax (EIT) perspective. Since March 2016, China's General Administration of Customs (GAC) has announced several adjustments to the customs declaration form reporting requirements, requiring importers to disclose related party transactions and to confirm whether import prices have been influenced by the relationship between the buyer and seller.

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Both the tax and customs administrations are increasingly investigating potential tax avoidance by MNEs with respect to related party transactions. The tax authorities' scrutiny of related party transactions has been enhanced by the "Golden Tax Project Phase III" and they also have launched various special investigations. Customs authorities, by leveraging the newly established Customs National Supervision Center for Duty Collection for China customs' national all-in-one clearance reform, have increased the supervision and monitoring of import transactions between related parties, and instructed the Audit Division and Port Clearance Division to carry out focused inspections.

Although both administrations are examining related party transactions more closely, the tax and customs authorities have different areas of focus and requirements concerning imported goods. Their objectives, perspectives and approaches are different, as illustrated in the following table:

	Customs valuation	Transfer pricing
Legal basis	Customs law, Regulations on import and export tariffs, Provisions for assessing the dutiable value for customs on import and export goods, WTO valuation agreement, etc.	EIT law and its implementation rules, Tax administration and collection law and its implementation rules, OECD transfer pricing guidelines, etc.
Focus and requirement	To examine tangible assets (import/export prices) and related intangible asset transfers (such as royalty payments) and services, with a focus on whether each transaction is affected by the special relationship between the parties	To examine transactions involving tangible assets, financial assets, intangible assets, capital financing, services, etc., with a focus on whether the transactions are at arm's length
Risk indicators	• Low import prices; • High local profits	• High import prices and low export prices; • Declining local profitability

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	Customs valuation	Transfer pricing
Methods	i. Transaction value method; ii. Transaction value of identical or similar goods; iii. Deductive value method; iv. Computed value method; and v. Fallback method The above methods are used in a sequential order. The order of application of the deductive value method and computed value method may be reversed at the taxpayer's request, subject to the approval of the customs administration.	i. Comparable uncontrolled price method; ii. Resale price method; iii. Cost plus method; iv. Transaction net margin method; v. Profit split method; and vi. Other methods that conform to the arm's length principle (e.g., cost method, market method, income method)
Frequency of review	Usually upon declaration of each transaction, or post-declaration audit/investigation	Annual review of corporate profits, the specific transaction types are tracked when necessary
Mandatory documentations	• Import declaration forms; and • Price declaration forms for imported goods	• Transfer pricing documentations; and • Annual related party transactions reporting forms
Database	Price database (from the national customs declaration database)	Database of listed companies

As China's tax and customs administrations are legally empowered to perform adjustments retroactively, subject to the assessment of the transfer price, significant amounts of additional duty/taxes may be imposed on companies. There also may be surcharges, administrative penalties or potentially even a downgrade in an enterprise's credit rating, with associated negative consequences.

Deloitte comments

Given the increasing scrutiny of related party transactions, MNEs with significant imports from related parties may wish to consider taking the following measures:

- Closely monitor changes of policies and business trends - The arm's length principle is the basic foundation for customs valuation and transfer pricing, as well as a focus of both authorities when examining the rationale underlying related party transactions. Since the concept is relatively broad, its technical aspects have been evolving. Authorities around the world, including those in China, have been adjusting relevant regulatory methods and MNEs should closely monitor policy changes to ensure they are compliant with the regulatory requirements. MNEs also should be aware of common industry practice and determine their transfer pricing policies on a reasonable basis.

- **When preparing transfer pricing documentation, MNEs may wish to consider the perspectives both of the tax and customs authorities, and in this context examine not only the group pricing policy but also the status of implementation of the policy. Transfer pricing documentation is one of the key records for tax and customs authorities to assess the reasonableness of the pricing of related party transactions. As the documentation generally is prepared in accordance with tax regulations, the potential impact from the customs valuation perspective may be overlooked, particularly with respect to function/risk profile and the comparable research. When preparing transfer pricing documentation, MNEs also may wish to involve the trade compliance team and consider including analysis from the customs valuation perspectives, in particular, for the analysis of tangible goods transactions and benchmarking on the gross margin.**

  SAT Announcement No. 42 requires companies to disclose in their local file "different types of business and product revenues, costs, expenses and profits," explain the rationale for profit allocation between the members of the group and the results in the global value chain. The local file also should reflect specific factors, such as local cost savings and market premium. This information enables customs authorities greater access to the data relating to imported goods, as well as the costs and profit associated with the supply chain outside China and companies need to understand the potential customs impact of the disclosure of such information.

- **The actual transfer price may be influenced by a number of factors, such as the tax rate, foreign exchange fluctuations, capital and market conditions, which could result in deviations from the target margin set in accordance with the transfer pricing policies. MNEs may wish to explore the feasibility of self-adjustment, for example, retroactive adjustment of the imported prices, or a lump-sum year-end transfer pricing adjustment to satisfy the target margin. In the context of China's complicated regulatory environment, aspects such as foreign exchange, the EIT impact and customs valuation should be thoroughly evaluated to properly implement the transfer pricing self-adjustment.**

- **MNEs also may wish to consider available mechanisms such as advance pricing agreements (APAs) and customs advance rulings for valuation that can reduce potential risks that may arise in transfer pricing and customs valuation. The binding nature of APAs and the customs advance ruling mechanism can mitigate uncertainty and help manage the potential risks of post-transaction adjustments by the tax or customs administrations.**

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

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