



What's News in Tax

Transfer Pricing Methods Assist with Customs Arm's-Length Evolution in the United States, but CBP Rulings' Compliance Effect May Be Equivocal

Monday, August 9, 2010

by **Luis A. Abad, Washington National Tax**

Luis A. Abad is a senior manager in the Trade & Customs Services Group of WNT, operating out of the New York office.

For customs valuation purposes, the price paid for imported goods sold between related parties will be accepted only if arm's-length customs requirements are satisfied. Importers have been using tax transfer pricing methodologies to help support the customs valuation. This article analyzes a few recently published private ruling letters issued by the U.S. Customs and Border Protection agency ("CBP")¹ concerning related-party transactions and examines their potential impact from a compliance perspective.

Introduction

At the June 2010 annual conference of the American Association of Exporters and Importers, there was plenty of discussion concerning customs related-party issues amongst the estimated 500 members in attendance and plenty of varied interpretations regarding the potential compliance impact of several private ruling letters recently released by CBP Headquarters Office (the "HQ rulings"). This article analyzes HQ rulings H029658 (December 8, 2009), H037375 (December 11, 2009), and H032883 (March 31, 2010).² In these rulings, transfer pricing methods under Internal Revenue Code section 482 ("section 482") were used, along with other supporting evidence, to help support the customs arm's-length requirements.

Some customs compliance professionals view CBP's latest rulings as a significant departure from previous rulings and a welcome convergence with transfer pricing methods, while other professionals interpret the decisions as merely representing ad hoc applications of CBP's current amorphous arm's-length policy. Upon careful scrutiny, however, the truth would seem to stand somewhere in between.

¹ CBP is used in this article to also refer to its predecessor, the U.S. Customs Service.

² Reference is also made to recent HQ ruling W548419 (Dec. 27, 2009) for its consideration of section 482 methods, but, because CBP's analysis and application in that ruling is more straightforward than the other three referenced rulings, it is not a primary focus of this article.

CBP's "Related-Party" Policy

Under the "transaction value" method of customs valuation, the "price actually paid or payable" for imported goods sold between related parties will be accepted only if either of the two arm's-length conditions set forth in the customs valuation law, 19 U.S.C. section 1401a(b)(2)(B), is met.

The first condition accepts the transaction value "if an examination of the circumstances of the sale of the imported merchandise indicates that the relationship between the buyer and seller did not influence the price actually paid or payable" (the "*circumstances of sale*"). The second condition accepts the transaction value if it closely approximates certain "test values," which essentially are internal comparable import transactions that have been previously accepted by CBP as the basis for customs value. Because "test values" are generally not available to importers, the *circumstances of sale* condition is most frequently used to analyze the arm's-length nature of import transactions from a customs perspective.

Importers have in the past employed (with varied success) transfer pricing methods under section 482 to support the *circumstances of sale* condition, generally, under the auspices of Interpretative Note 2 of the customs regulations to demonstrate the transfer price "is consistent with the normal pricing practices of the industry in question."³ However, CBP has generally considered related-party prices that are based on prices published in a trade journal or posted in a public market index as representative of "objective" and acceptable "normal pricing practices of the industry" under Interpretative Note 2.⁴

CBP's view concerning the role of section 482's transfer pricing methods to determine the acceptability of transaction value is summarized in the 2007 informed compliance publication, *Determining the Acceptability of Transaction Value for Related Party Transactions* (the "ICP"):

Based on these considerations, CBP has ruled that the fact that the importer's transfer pricing methodology satisfies one of the IRS methods is not determinative of whether it is an acceptable transaction value for customs purposes. Rather a related party transaction value will be considered acceptable only if it satisfies either the *circumstances of sale*

³ 19 C.F.R. section 152.103(l)(1)(ii).

⁴ ICP, at page 8. See also HQ ruling W563467 (June 22, 2009).

test or closely approximates one of the test values as provided in the customs law.⁵

* * *

In summary, the mere fact that an importer provides CBP with an [advance pricing agreement (“APA”)] or transfer pricing study is not sufficient to establish that a related party transaction value is acceptable. The importer must provide information and evidence regarding the *circumstances of sale* and/or test values. If the importer believes that information in an APA or transfer pricing study and/or in the supporting documentation is relevant to the application of the *circumstances of sale* test, the importer should identify that information, explain why it is relevant, and submit the relevant documentation to CBP.⁶

In essence, the 2007 ICP represents a consolidated restatement of CBP's policies on various related-party issues, as already evidenced at that time by previously issued customs rulings.⁷

Thus, CBP's recently released related-party rulings should be measured in the context of the ICP and previous valuation decisions, which collectively and generally represent CBP's official or baseline position concerning the role of transfer pricing methods to evaluate the *circumstances of sale* condition.⁸

⁵ ICP, at page 15.

⁶ ICP, at page 16.

⁷ For example by 2000, it was CBP's position that financial information developed pursuant to section 482 is not *per se* sufficient to satisfy the related-party tests established in the customs law. In CBP's view, “the information submitted to the IRS, and the fact that there is a bilateral APA constitutes valuable information in applying the circumstances of the sale test.” HQ ruling 546979 (Aug. 30, 2000). In HQ ruling 548095 (Sept. 19, 2002), CBP also stated that “[a]lthough information contained in a transfer pricing study may be relevant to the application of the *circumstances of sale* test, the weight to be given to this information varies depending on the facts presented.”

⁸ 19 C.F.R. section 177.9(a) provides that the effect of a ruling letter is that it represents “the official position of [CBP] with respect to the particular transaction or issue described therein...” It also states that the “principle of the ruling,” absent revocation or modification, “may be cited as authority in the disposition of transactions involving the same circumstances.”

Recent CBP Ruling Letters

HQ Ruling H029658 - December 8, 2009 ("Ruling One")

In Ruling One, CBP determined that transaction value is the appropriate method of customs valuation with respect to import sales of automotive goods between the foreign seller/manufacturer and its related importer. The importer/distributor employed a "market driven" Manufacturer's Suggested Retail Price ("MSRP") policy, meaning that the dealer negotiates the actual retail price with the end customer, taking into account the importer's/distributor's expected economic return for its distribution function. The importer's/distributor's price and expected economic return is determined, on the basis of the comparable profits method ("CPM") pursuant to section 482, by comparing the importer's/distributor's operating margin to that of comparable importers/distributors. According to the transfer pricing policy, any remaining profit or loss (after the dealer and importer/distributor receive their targeted economic returns) belongs to the foreign seller/manufacturer.

The following circumstances were considered favorable in CBP's analysis to conclude that the price has not been influenced by the parties' relationship:

- The importer's transfer pricing analysis was reviewed and accepted by the IRS and the foreign tax authority pursuant to a bilateral APA;
- All of the importer's imported products are covered by the APA;
- Pricing throughout the supply chain—manufacturing, assembly, marketing and retail sales—is based on actual retail prices paid by consumers (rather than "any hypothetical or expected prices or costs used in the development stage");
- The price is adequate to ensure *the importer* recovered its costs plus a profit comparable to the profit realized by *functionally equivalent* companies;
- The importer provided a waiver that enabled CBP to access the documents submitted to the IRS in the APA process; and
- Evidence of "rigorous negotiations" between the related parties resulted in accurate free-on-board (FOB) prices that had not historically required subsequent compensating adjustments,

notwithstanding that the APA sets forth that compensating adjustments may be required.

Ruling One appears in some respects to be consistent with existing CBP policy, prior rulings, and the ICP. For instance, CBP has previously accepted related-party import transactions that have been the subject of bilateral APAs, and that are well documented from a customs perspective.⁹ Ruling One also does not represent the first time that CBP has examined the *importer's* profit for purposes of the *circumstances of sale* condition, although it is widely recognized that, generally, CBP examines the seller's/manufacture's profit. In HQ ruling 548233 (November 7, 2003), CBP considered a bilateral APA that compared the importer's/distributor's profitability to that of comparable companies, and found the transaction value acceptable. Thus, while uncommon, Ruling One does not appear to be unprecedented in this respect because, similar to HQ ruling 548233, the transfer pricing policy had the benefit of independent review and approval by the respective tax authorities during the APA process, which CBP generally favors.

What is distinguishing about Ruling One is that it may represent the first known instance when CBP has explicitly acknowledged what was seemingly implicit in HQ ruling 548233: "[T]he buyer's overall profit is one of the factors that may be considered to indicate that the relationship between the buyer and seller did not influence the price."¹⁰ This is reinforced in a separate ruling issued three days later (discussed below).

Another notable fact in Ruling One is that the final set of comparable companies used in the section 482 analysis included companies that sell a variety of products (e.g., air conditioners, heating equipment, tires, roofing products, etc.), and thus was not composed of companies in the automotive industry. This would seem to be contrary to CBP's general policy under Interpretative Note 2, as stated in the ICP:

⁹ In HQ rulings 546979 (Aug. 30, 2000) and 548233 (Nov. 7, 2003), CBP accepted transfer pricing methods that had been approved in a bilateral APA. Contrast the fact that, in these two rulings, compensating adjustments were considered possible and accepted by CBP, whereas in Ruling One the fact that the transfer pricing policies had not historically required compensating adjustments appears to be, in CBP's view, a favorable factor.

¹⁰ It is noted that although the ICP generally focuses on profitability of the seller in the transaction, neither the customs regulations nor the ICP explicitly precludes the examination of the buyer's/importer's profit when examining the *circumstances of sale*.

The pricing practices *must* relate to the “industry in question” which generally includes the industry that produces goods of the same class or kind as the imported merchandise. Same class or kind determinations necessarily take into account factors relating to the specific type of goods at issue. *CBP does not consider the industry in question to consist of other functionally equivalent companies if those companies do not sell goods of the same class or kind.*¹¹

* * *

The industry in question depends on the product that is imported and not the functions that the seller performs.¹²

Thus, Ruling One represents a noticeable departure from CBP’s general policy in respect to determining the “industry in question.”¹³ However, in Ruling One, CBP seemingly tempers the use of the “non-industry” comparables by restating the ICP position (*supra*), and indicating that the section 482 analysis is not conclusive to establish the pricing practices of the industry in question, but is merely insightful:

While this information does not definitely establish that the price was settled in a manner consistent with the normal pricing practices of the automotive industry, we find that the information presented *gives insight* on how the automotive industry determines the price, and therefore *provides some evidence* that the price was settled in a manner consistent with the normal pricing practices of the industry. (Emphasis added.)

Curiously, in Ruling One, CBP shifts its examination of the importer’s profitability from the “normal pricing practices of the industry” standard under Interpretative Note 2 to the alternative “all costs plus profit” standard under Interpretative Note 3 of the customs regulations.¹⁴ Interpretative Note 3 provides, among other things, that “if it is shown that the price is adequate to ensure recovery of all costs plus a profit which is equivalent to the firm’s overall profit realized over a representative time (e.g., on an annual basis) in sales of

¹¹ ICP, at page 8 (emphasis added).

¹² ICP, at page 15.

¹³ See also HQ ruling 547672 (May 21, 2002) where CBP rejected the importer’s section 482 analysis and stated that “Customs is of the view that the industry in question would consist of other manufacturers of comparable [products].”

¹⁴ 19 C.F.R. section 152.103(l)(1)(iii). The “all costs plus profit” standard (Interpretative Note 3) is an alternative standard to Interpretative Note 2’s “normal pricing practices of the industry” standard, commonly used by CBP to examine the *circumstances of sale* condition.

merchandise of the same class or kind, this would demonstrate that the price has not been influenced.”

In Ruling One, CBP states:

In other words, while CBP's review of the companies deemed to be *functionally comparable to the importer* may provide some evidence that *the price is adequate to ensure recovery of all costs plus a profit*, this information is less valuable since the companies are not engaged in the sale of the same class or kind of merchandise. (Emphasis added.)

However, this analytical nexus between functionally comparable distribution companies and the “all costs plus profit” standard appears to be a contortion of the standard, as previously applied by CBP. As an initial matter, the plain language of the “all costs plus profit” standard does not require or suggest comparisons to *external* comparable companies, but rather to the aggregated results of internal, or affiliated, comparable transactions. Moreover, the comparable companies to which the importer was compared did not sell goods of “the same class or kind,” which is a condition of the “all cost plus profit” standard.

Generally, the “all costs plus profit” standard requires an examination of the *seller's* price and economic results based on exports to the United States (i.e., “the price actually paid or payable” for imported goods), not the buyer's/importer's economic results, which are based on the domestic resale of the imported goods. Ruling One does not discuss whether the seller's price is sufficient to actually recover all costs plus a profit. The only mention of the seller's price, profitability, or economic results in Ruling One is that after the importer receives its targeted profit, “any remaining profit or loss goes back to the [seller/manufacturer].” It is unclear whether this suggests that CBP accepts that the “price actually paid or payable” for the imported goods may actually represent an amount below cost as long as the *distributor* makes its appropriate profit (e.g., in the event that the “market-driven MSRP policy” results in a residual loss for the manufacturer due to market conditions). If this is the case, this would represent a significant and more liberal recognition by CBP of the commercial and economic realities surrounding the *circumstances of sale*, under a standard that, generally, has been applied stringently by CBP.¹⁵

¹⁵ This would also be consistent with the economic tenet that expected return on a transaction should be commensurate with the functions, assets and risks contributed by the respective parties to the transaction. In other words, the greater the economic input and/or risk, the greater the potential financial reward

From a methodological perspective, the “all costs plus profit” standard requires that the seller’s transactional profit should be compared *internally* to the “firm’s” aggregate profit in sales of goods of the same class or kind. CBP has generally interpreted the “firm’s overall profit” to be the consolidated profit of the corporate *parent* company, not the seller’s/manufacturer’s or the importer’s/distributor’s profit.¹⁶ The lack of substantive discussion of the records and documentation traditionally required by CBP, as discussed in the ICP, to satisfy the “all costs plus profit” standard suggests that under Ruling One such documentation was either not provided to or may not have been deemed relevant by CBP (e.g., financial statements, accounting records including general ledger account activity, bills of materials, inventory records, labor and overhead records, relevant SG&A expense records etc. . . .).¹⁷

Thus, Ruling One does not make clear how an examination of the importer’s/distributor’s profitability as the “tested party” demonstrates whether the seller’s/manufacturer’s price is “adequate to *ensure* recovery of *all costs* plus a *profit equivalent to the firm’s overall profit*,” and would appear to be a departure from prior CBP rulings.¹⁸ Arguably, the profit levels mandated by the bilateral APA for the importer/distributor, which would have been reviewed and approved by the foreign tax authority during the APA process, implies the tax authorities are satisfied the foreign seller/manufacturer is also operating at an arm’s length. However, this favorable fact still does not comport with the plain language of the “all costs plus profit” standard.

These disarrangements of the “all costs plus profit” standard (Interpretative Note 3) suggest an uncharacteristically liberal approach by CBP. Although the potential increased convergence with transfer pricing is a welcome development, it seems

or peril. In this case, it would appear the foreign seller/manufacturer is the “entrepreneur,” entitled to the residual profit or loss after the importer distributor has realized its “limited” risk return.

¹⁶ ICP, at page 9; HQ ruling 546998 (Jan. 19, 2000).

¹⁷ ICP, at page 9.

¹⁸ See HQ ruling 548482 (July 23, 2004), where CBP rejected the importer/buyer as the “tested party:”

[CBP] notes that the “tested party” in the submitted transfer pricing study is the buyer/importer. The focus of the [“all costs plus profit” standard] is the *seller’s costs and profits*. CBP regulations, in order to determine whether the transaction in issue was conducted at “arm’s length,” examines whether *the seller* received a price that enabled the recovery of all costs, plus a reasonable profit as described in detail in [Interpretative Note 3]. The transfer pricing study . . . does not, therefore, provide CBP with the information *necessary* to conclude that the relationship between the buyer/importer and the seller did not influence the price. (Emphasis added.)

unusual for CBP to utilize the “all costs plus profit” standard to achieve such convergence in this instance. CBP does not calculate the actual costs or measure the profit actually earned by the foreign seller/manufacturer in sales for exportation to the United States, which is generally considered indispensable to an “all costs plus profit” analysis. The comparison to an external set of comparable companies would, generally, seem to be more germane under the “normal pricing practices of the industry” standard. Thus, CBP appears to have fit the proverbial square peg into the round hole by comparing the *buyer's* economic results to *external comparables* from *outside the industry* under a standard that, historically, has been widely understood to require a comparison of the *seller's* economic results to *internal comparable transactions* of goods of the *same class or kind*.

Some observers may conjecture whether this labored “all costs plus profit” approach is merely indicative that, consistent with existing CBP policy, the “all costs plus profit” standard continues to represent “the most objective method of meeting the *circumstances of sale* test when there are no sales to an unrelated buyer.”¹⁹ However, it may also be indicative of unique facts or other unspecified positions held by CBP that are not set forth in the ruling, but which nonetheless are present in this particular case. For example, CBP may have agreed with the tax position in this case that it made sense to examine the least complex of the related parties to the import transaction (i.e., the importer/distributor), notwithstanding the interpretative note's focus on the seller/manufacturer.²⁰ Or, possibly, CBP may have not been entirely comfortable with relying solely upon an examination of the importer's/distributor's profitability and/or non-industry comparable companies to decide the matter on the basis of the “normal pricing practices of the industry” standard.

It is also worth mentioning that CBP considered the CPM notwithstanding that the ICP provides that “the comparable profits method (“CPM”) has little similarity to the customs methods” and “has the least relevance” for determining the acceptability of transaction value (i.e., the CPM does not generally measure profitability on a product-by-product basis, but rather does so on an aggregate basis).²¹

¹⁹ ICP, at page 9.

²⁰ Treasury regulation section 1.482-5(b)(2)(i) provides *inter alia* that for tax purposes, generally, the tested party will be the participant in the controlled transaction whose operating profit requires the fewest and most reliable adjustments, and is thus generally the least complex of the controlled taxpayers (e.g., the distributor).

²¹ ICP, at page 15-16.

Thus, from a planning and compliance perspective, the circuitous analytical means used in this particular case, while demonstrating a welcome flexibility, creates some uncertainty for other importers—an uncertainty that may be further exasperated by the following two rulings.

HQ Ruling H037375 - December 11, 2009 ("Ruling Two")

In Ruling Two, CBP determined that transaction value is the appropriate method of customs valuation in respect to import sales of medical products between the foreign seller/manufacturer and its related importer. The price charged by the foreign seller/manufacturer was based on the "actual resale price minus a discount," or resale price method ("RPM") pursuant to section 482. The foreign seller's/manufacturer's price was determined by subtracting an appropriate "distributor" gross margin from the importer's price on the resale of the imported goods to unrelated customers. The importer's gross margin (or discount) was determined by reference to internal and/or external comparables (i.e., by comparing the importer's distribution margins to the margins realized by an affiliated company and/or unaffiliated companies in comparable uncontrolled transactions). The transactions were *not* subject to an APA.

The following circumstances were considered favorable in CBP's analysis to conclude that the price has not been influenced by the parties' relationship:

- All the external comparable companies distributed goods of the same class or kind (medical products and supplies) and they are direct competitors of the importer;
- Adequate product comparability was observed;
- The gross margins on the *importer's* resale of the imported merchandise were shown to be generally the same as comparable distributors in the medical products industry; and
- Although the importer's gross profit margin was higher than the margins realized by an affiliated company in comparable sales to unrelated third parties, CBP nonetheless determined the margins to be "comparable" because it found it "persuasive" that the difference was due to additional marketing and distribution activities performed by the importer in respect to the related-party transactions.

Thus, “on the basis of the transfer pricing study,” CBP concluded:

Accordingly, since all [comparable companies] sell merchandise of the same class or kind, the transfer pricing study supports a finding that [the importer's] price was settled in a manner that was consistent with the normal pricing practices of the industry. (Emphasis added.)

One obvious observation from Ruling Two is that CBP's analysis placed a significant emphasis on the fact that the external comparable companies were of the same industry as the importer. This is a peculiar emphasis when juxtaposed against the relatively minor role that product and industry comparability played in Ruling One, issued only three days earlier. However, unlike Ruling One, CBP analyzed the *importer's* economic results in this instance solely under the “normal pricing practices of the industry” standard (Interpretative Note 2). CBP did not analyze the “all costs plus profit” standard (Interpretative Note 3) in Ruling Two.²²

Also notable is the fact that the transactions were not subject to an APA. Ruling Two, however, does not represent the first time that section 482 methods were successfully used by an importer without an APA. In HQ ruling 546998 (January 19, 2000) (the “Seiko ruling”), the CPM was used to successfully compare the “full cost markup” of the contract manufacturer to other comparable companies within the industry. CBP determined in that case:

Moreover, the markup comparison between [the seller/manufacturer to the parent company], as well as the other companies selling merchandise of the same class or kind, indicate that [the manufacturer's] cost and profit figures are consistent with the market as a whole. Such consistency demonstrates that the price between [the seller/manufacturer to the parent company] also has been settled in a manner consistent with the normal pricing practices of the industry. Accordingly, the evidence demonstrates that the price has not been influenced by the relationship. (Emphasis added.)

In the Seiko ruling, however, the importer's ability to satisfy the “all cost plus profit” standard was also necessary to establish the price was not influenced by the

²² Also consider HQ ruling W548419 (Dec. 27, 2009), where, because the comparable companies were of the “same general industry group as determined by four digit industrial classification (SIC) codes,” CBP considered the section 482 analysis under the “normal pricing practices of the industry” standard.

parties.²³ The internal profit comparison between the seller/manufacturer and its parent company was determined by CBP to be “most relevant for consideration” under the *circumstances of sales* condition (as opposed to the comparison to external comparable companies under the “normal pricing practices of the industry” standard):

Among the figures and analysis provided to Customs concerning the full cost markup between the various companies' figures, we find the comparison between [the seller's/manufacturer's] 2.1% markup to the [parent company's] 1.2% markup most relevant for consideration pursuant to the [Trade Agreements Act of 1979].

Thus, while uncommon, this is not the first instance where section 482 methods have been used, in conjunction with other supporting evidence, to successfully satisfy the *circumstances of sale* condition in the absence of the APA.²⁴

Another observation from Ruling Two is that, like Ruling One, CBP again focused on the *importer's* economic performance (i.e., the importer was the “tested party”). Thus, the “profitability” that was deemed pertinent was a direct function of domestic resale transactions, rather than the actual sales for exportation to the United States, which serves as the basis for transaction value.

However, it is important to note that, like the Seiko ruling, CBP did not rely solely on the section 482 analysis. Rather, according to Ruling Two, CBP also relied on favorable financial comparisons to internal comparable transactions in order to buttress its conclusion in this case (i.e., CBP compared the results of medical products manufactured by third parties that were distributed and resold by a company affiliated with the importer).

²³ Similarly, in HQ ruling W548419 (Dec. 27, 2009), in addition to the “normal pricing practices of the industry” standard, CBP performed an analysis under the “all costs plus profit” standard.

²⁴ In the years following the Seiko ruling there were several other rulings issued by CBP when importers were unsuccessful in establishing the arm's-length nature of transaction value *via* section 482 methods. In some rulings, CBP rejected the “evidence” provided by the importer to satisfy the *circumstances of sale* condition on the basis of transfer pricing documentation and information. In HQ ruling 547672 (May 21, 2002) CBP stated, “In conclusion, we find that the evidence presented is *insufficient* to establish that the [transfer price] is settled in a manner consistent with the normal pricing practices in the industry or that the [manufacturer's] price is adequate to ensure recovery of *all costs plus a profit* Therefore, the evidence does not establish that the [transfer price] is an arm's-length sale which can serve the basis for transaction value.” (Emphasis added.) In that ruling, and similar rulings, CBP found various grounds to reject the “evidence” and transfer pricing documentation submitted by the importer. See also HQ ruling 548482 (July 23, 2004).

Thus, while Ruling Two evidences CBP's flexibility to consider other objective arm's-length information beyond the "all costs plus profit" standard, it may also suggest that reliance *solely* on section 482 methods may not be sufficient to satisfy the *circumstance of sale* condition, particularly when the importer/distributor is the tested party.

HQ Ruling H032883 – March 31, 2010 ("Ruling Three")

In Ruling Three, CBP determined that transaction value is the appropriate method of customs valuation in respect to import sales of specialized textile fabrics between the foreign seller/manufacturer and its related distributor in the United States. The transfer prices for imported finished goods ("FGs") were based on a "customer-price-minus" formula, and semi-finished goods (works in progress or "WIPs") were based on a "cost-to-produce-plus" formula. Multiple transfer pricing studies were presented to CBP, which independently tested both the seller/manufacturer and the distributor, based on their respective functions vis-à-vis particular transactions. The CPM was used in the distributor's transfer pricing studies, while the foreign seller's/manufacturer's studies used the Transactional Net Margin Method ("TNMM").²⁵ The transactions were *not* subject to an APA.

The following circumstances were considered favorable in CBP's analysis to conclude that the price had not been influenced by the parties' relationship:

- The gross profit earned on the sample WIP and FG transactions were "healthy" and *exceeded* the seller's/manufacturer's aggregate gross profit realized on sales of goods of the same class or kind;
- The seller's/manufacturer's gross profit earned on WIP transactions comported to the operational "cost-to-produce-plus" formula for WIP transactions in the company's pricing model document (i.e., the company periodically reviewed and updated its transfer pricing policies annually in order to always remain within the interquartile range, and thus has not had any compensating adjustments);
- The seller's/manufacturer's gross margin earned on WIP transactions met and exceeded the median result realized by the comparable companies (in the seller's/manufacturer's transfer pricing study);

²⁵ The TNMM, a method with similarities to the CPM, is specified in the *OECD Guidelines*, and is applied by several countries throughout the world, but is not a specified method in the United States.

- All of the external comparable companies used in the *seller's/manufacture's transfer pricing study* produce goods of the same class or kind (i.e., in the industrial fabrics industry), and two companies were direct competitors; and
- The seller's/manufacture's gross margin in FG sales to related parties was higher than the gross margin in its sales to unrelated parties, and its net profit margin was similar to sales to unrelated parties.

In this case, the “all costs plus a profit” standard (Interpretative Note 3) was relied upon to satisfy the *circumstances of sale* condition. The gross profit margins of sample import transactions, based on bills of materials, were compared to the foreign seller's/manufacture's total gross profit margin on sales of merchandise of the same class of kind. Based on the results of this gross profit analysis, CBP concluded:

Therefore, based on the company's assertion that the *same results occur for every other FG and WIP transaction* because all [transactions] follow the respective [transfer pricing model] for the FG and WIP shipments, and *the gross profit for both WIP and FG sample transactions exceed the total gross profit of the [manufacturer]* in sales of the same class or kind, we find that it is likely that the purchase price is not artificially low for Customs purposes and the relationship of the parties did not influence the price. (Emphasis added.)

While this approach to the “all costs plus profit” standard generally may make sense from an economic perspective, it deviates in several respects from the approach generally taken, and the principles previously set, by CBP under this standard. For instance, CBP compared the profit from the selected sample transactions to the foreign seller's/manufacture's total profit instead of the corporate *parent's* consolidated profit (i.e., the “firm's” overall profit).²⁶

From an economic perspective, this is a welcome departure from CBP's general interpretation because the expected return on a transaction should be commensurate with the functions, assets, and risks contributed by the respective

²⁶ While uncommon, this is not the first time that CBP has considered the manufacturer's overall profit as the baseline benchmark instead of the corporate *parent's* profit. See HQ ruling W563326 (Nov. 3, 2006) (CBP compared the profit margin on the manufacturer's sales to the United States to the profit margin realized on its total global sales).

parties involved with the particular transaction. An abstract comparison to the corporate *parent's* consolidated overall profit may not be appropriate without adjustment, notwithstanding that the parent may also sell goods of the same class or kind. The corporate parent may be functionally different than the foreign seller/manufacturer, or may operate at a different commercial level, and/or may hold different assets or risks.²⁷ Thus, a comparison between transactional profit and the actual foreign seller's/manufacturer's overall profit in comparable sales (assuming the foreign seller's/manufacturer's overall aggregated result is at arm's length) is theoretically a sounder approach to detect unusual pricing practices between the parties that may suggest tariff manipulation with respect to particular transactions.

Also notable is the fact that CBP examined the foreign seller's/manufacturer's "gross profit" margin as the basis for comparison. Generally, "gross profit" on its own would not necessarily demonstrate that "all costs" are recovered in the price (i.e., a positive gross profit margin does not necessarily indicate that a company is profitable after *all costs* are taken into account, including operating expenses). Previous customs valuation rulings have indicated that the price shall ensure "all costs," including direct manufacturing costs *and* indirect operating expenses, are recovered under the "all cost plus profit" standard.²⁸

Thus, generally speaking, "operating profit" is considered to be a more appropriate profit metric under the "all cost plus profit" standard in the absence of any unusual or extraordinary expenses (e.g., one-off extraordinary expenses, depending on their accounting classification, may affect comparative operating profits disproportionately).²⁹ However, no such reason was provided in Ruling Three to disqualify "operating profit" as the comparative profit metric in this instance, nor was there any indication that "all costs," including operating expenses, were actually recovered in the seller's/manufacturer's price vis-à-vis the gross profit margin.

²⁷ See HQ ruling W548419 (Dec. 27, 2009). Although the data submitted in that case indicated that the consolidated return for the corporate parent was higher than the manufacturer's markup, CBP considered the fact that one company bore greater risk in the transaction to be a reasonable basis for adjustment under the "all costs plus profit" standard.

²⁸ See HQ rulings H016585 (Dec. 30, 2008), W563326 (Nov. 3, 2006) and 544336 (July 11, 1989).

²⁹ See HQ ruling W548419 (Dec. 27, 2009). Due to differences in the manner in which the certain costs are classified for accounting purposes, the gross margins were not considered comparable. Thus, the markup at the operating margin level was used to eliminate the impact of any differences arising from cost classifications.

CBP viewed favorably the fact that the profit margins of the sample transactions “exceed” the seller’s/manufacturer’s total, or average, profit. While CBP’s concern with “artificially low” profits or prices may be understandable from a tariff-manipulation or revenue perspective, it may be difficult to reconcile CBP’s seemingly favorable view of the higher profit or price, or to find authority for this criterion from a regulatory perspective, since the customs valuation law is neutral in this respect. The customs valuation statute has a preference for accurate values (as opposed to higher), and the customs regulations has a preference for “equivalent” profits (not necessarily higher).³⁰

The Court of International Trade (“CIT”) has stated, citing the legislative history of the customs valuation statute, that “the same [arm’s-length] considerations apply whether the transaction value is higher or lower.”³¹ In that case, CBP had argued that under the “closely approximates” standard for test values, “a transfer price that is too high would not be any more acceptable than one that is too low.” The CIT concurred that CBP’s position “was consistent with congressional intent.” This would suggest that when testing a transaction for arm’s-length purposes, whether it be a comparison under the “closely approximates” standard, or the more stringent “equivalent” standard, the law does not create a presumption that higher transaction values will be *per se* more acceptable than transaction values that may, for various legitimate economic or commercial reasons, fall below the “objective” or uncontrolled benchmark.³² Thus, an acceptable range above and below the baseline profit benchmark should be considered by CBP. Ruling Three, however, correctly or incorrectly, gives the impression that CBP

³⁰ Under the “all costs plus profit” standard, the transactional profit must be “equivalent” to the firm’s overall profit. Previous CBP rulings have indicated that profits need not be precisely “equivalent” to satisfy the “all costs plus profit” standard. See, for example, HQ ruling W563326 (Nov. 3, 2006) and the Seiko ruling. In Ruling Three, CBP did not find that the profit margins were “equivalent,” but instead found that the manufacturer “earns a healthy margin on the sale of WIP products.” (Emphasis added.) This is illustrative of the evolution from older customs rulings where CBP strictly interpreted that “[equivalent] is not the same as ‘usual,’ ‘reasonable,’ ‘adequate’ or ‘healthy’ profit” HQ ruling 543144 (November 17, 1983) (emphasis added).

³¹ *VWP of America, Inc. v. United States*, 27 C.I.T. 434, 440-441 (2003), *aff’d in part, and vacated in part (on other grounds)*, 117 Fed. Appx. 113 (2004).

³² Both the “closely approximates” and “equivalent” standards should be consistent with the statute’s neutral intent for accurate valuation results (as opposed to favoring higher valuation results), notwithstanding that the “closely approximates” standard is derived directly from statute, but the “equivalent” standard is derived merely from “interpretative notes.” 19 C.F.R. section 152.100 provides that “interpretative notes” set forth in the CBP regulations “will have the force and effect of regulations,” and regulations should be consistent with the customs valuation statute.

may have preferred a higher profit/price in order to help satisfy the *circumstances of sale* condition.

Moreover, mathematically speaking, it is axiomatic that if some transactions exceed the total profit margin, or average profit, other transactions must be lower than the average. In other words, the same results (profit margins that exceed the average) cannot statistically occur for every other transaction, as suggested by Ruling Three. Thus, it may be appropriate for importers to consider how CBP's favorable view of this circumstance, in the absence of generally accepted statistical sampling techniques, could objectively translate into customs enforcement and compliance efforts. In the real commercial, world some randomly selected sample transactions will inevitably fall below its constituent average or below any other comparative benchmark, yet this does not necessarily indicate that the relationship has influenced the price.

CBP also examined multiple transfer pricing studies submitted by the importer in order to assess the *circumstances of sale*. However, unlike Ruling Two, CBP does not consider the section 482 analysis under the "normal pricing practices of the industry" standard (Interpretative Note 2), but rather considers them under the "all costs plus profit" standard (Interpretative Note 3), similar to the approach in Ruling One:

Additionally, in order to show that the *circumstances of the sale* did not influence the price and to substantiate *the all costs plus a profit test*, the Company submitted multiple transfer pricing studies pertaining to the buyer, the Company, for our review and consideration. (Emphasis added.)

In fact, the ruling does not provide an analysis of the transfer pricing studies under the "normal pricing practices of the industry" standard. In contrast, in Ruling Two, CBP considered the section 482 analysis solely under the "normal pricing practices of the industry" standard.

For similar reasons to those discussed earlier under Ruling One, the consideration of external comparable companies under the "all costs plus profit" standard appears to be a novel approach to the standard.

Moreover, it is unusual to evaluate the importer's/distributor's economic results under a standard that traditionally focuses on the seller's/manufacturer's results. In this respect, CBP makes the seemingly contradictory statements that, on one hand, "the comparison in the transfer pricing study between an *importer's profitability*

and that of other companies may provide some evidence that the price is adequate to ensure recovery of all costs plus a profit . . .” but, on the other hand, “we do not consider *the distribution analysis* of the [distributor] under the TNMM methodology to test the [manufacturer] *to be pertinent* to the examination of the *all costs plus a profit* test method...” (Emphasis added).

Is CBP potentially having it both ways by stating that, consistent with its traditional focus on the seller, an analysis of the buyer's/distributor's profitability is not pertinent under the “all cost plus profit” standard in one instance, but it “provides some evidence” in another?³³ Or is the fact that the foreign TNMM is not a specified transfer pricing method in the United States, under the IRC, the reason why the U.S. distributor's study is not considered pertinent in this case? This latter explanation may have been more plausible had CBP not accepted the foreign manufacturer's transfer pricing study “despite the use of the TNMM methodology” in the same ruling, discussed *infra*.

Thus, importers may find it difficult to reconcile the seemingly inconsistent approaches between the rulings, and between statements within the same ruling. It is unclear whether other unspecified circumstances were relevant to consider the buyer's/distributor's profit to be pertinent in one instance, but not in other instances, notwithstanding that in neither case does the buyer's/distributor's profitability intuitively reveal whether the seller's/manufacturer's price was adequate to “ensure recovery of all costs plus a profit that is *equivalent to the firm's overall profit*.”

CBP's paradox may be partially explained from the fact that, similar to Ruling One, CBP granted less weight to the *distributor's* transfer pricing study because the comparable companies did not engage in the sale of the same class or kind of merchandise:

[W]e find the information to be *less valuable* since the comparable companies chosen for the distribution analysis are not engaged in the sale of the same class or kind of merchandise. Therefore, under the circumstances of this particular case, we are *reluctant to solely rely* on the analysis of the *distribution activities* of the [distributor] and [seller/manufacturer]...

³³ In Ruling One, CBP also stated that the section 482 comparative analysis of the importer's profit to that of functionally comparable distribution companies “provides some evidence” and “may be relevant” under the “all costs plus profit” standard.

Consequently, like in Ruling One, given the limited value of the distributor's analysis, CBP considered other *circumstances of sale*.³⁴

With respect to WIP transactions, CBP looked to the manufacturer's transfer pricing studies because the comparable companies used therein produce goods of the same class or kind ("despite the use of the TNMM methodology to evaluate the manufacturing activities"). CBP found the "transfer pricing study supports a finding that the [manufacturer's price] for WIP products was adequate to ensure recovery of *all costs plus a profit . . .*"³⁵ But, again, it would be appropriate for importers to question why the analysis was not conducted under the "normal pricing practices of the industry standard," since, like in Ruling Two, the comparable companies used in the manufacturer's transfer pricing study were determined to be from the same industry. Thus, the rulings on the surface appear to demonstrate a lack of consistency.

With respect to FG transactions, CBP also considered internal uncontrolled comparable transactions between the seller/manufacturer and unrelated customers. CBP determined that "since the net profit margin of the [manufacturer's] sales to unrelated third parties is similar (or higher) to the net profit margin of the [manufacturer's] sale the related parties . . . the related party prices with respect to FG transactions in this instance are settled in a manner consistent with the way the seller settles prices in sales to unrelated buyers."

Thus, CBP, in similar fashion to the earlier two rulings, relied on several forms of evidence and analysis, some of which were seemingly inconsistent at times, to buttress its finding that the relationship did not influence the price actually paid or payable for the imported merchandise (i.e., CBP did not rely solely on section 482 methods, but also relied on evidence from internal comparable unrelated transactions).

³⁴ In Ruling One, the fact that the comparable companies did not engage in the sale of the same class or kind of merchandise was also viewed as problematic, however, CBP overcame the analytical imperfection by considering the results under a modified version of the "all costs plus profit" standard instead of the "normal pricing practices of the industry" standard. In that case the existence of a bilateral APA, and its corollary safeguards, is viewed to be a significant *circumstance of sale* to help support the arm's-length result despite the use of non-industry comparables in the distributor's analysis.

³⁵ The transfer pricing study assisted to demonstrate that the "[manufacturer's] gross margin meets and exceeds the median [margin percentage], thus, satisfying the transfer pricing formula for WIP transactions."

An Equivocal Compliance Landscape

The effect of the latest related-party developments discussed above is subject to various interpretations. However, the ambiguity raised by these rulings can be particularly problematic given that importers must prospectively self-assess what compliance actions may be necessary in order to exercise *reasonable care* over their import operations, or face potential customs penalties.³⁶

Importers generally rely on the regulations and interpretative notes as a basis for their related-party analysis, and on published private letter rulings as persuasive precedent. The interpretative notes, although generally referred to as mere “examples,” nonetheless “have the force and effect of regulations.”³⁷ The importance of the interpretative notes is also evidenced by CBP’s consistent and traditional reliance on at least one of the interpretative notes to help satisfy the *circumstances of sale* condition. Thus, CBP’s recent applications of the interpretative notes may create a potentially precarious legal situation for importers going forward, and could be disconcerting to importers who, in hindsight, may believe they previously failed on the basis of similar transfer pricing analysis, arguments, and/or evidence that CBP may now find acceptable in these latest rulings.

For example, in HQ ruling 547672 (May 21, 2002), CBP rejected the section 482 documentation, *inter alia*, on grounds that the transfer pricing report takes into account the profit on an “aggregate, rather than product-by-product, basis,” and that “absent a determination that the other companies manufacture *only* merchandise of the same class or kind, *these companies are not particularly relevant for purposes of applying the circumstances of sale test* set forth in the customs regulations.” (Emphasis added.) Also, in HQ ruling 548482 (July 23, 2004), the importer/buyer was rejected as the “tested party” because the “focus of [the “all costs plus profit” standard] is the *seller’s costs and profit*.” (Emphasis added.)

Will CBP auditors follow the more stringent constructions of the arm’s-length standards of the past or might CBP auditors apply the nuanced, and, arguably, tenuous, approaches set forth in these latest rulings? Or could the latest rulings spark potentially contentious audits concerning related-party matters that will require resolution *via* CBP’s “internal advice” procedures in many instances?

³⁶ 19 U.S.C. section 1484(a)(1) (discussing the “reasonable care” requirement); 19 U.S.C. section 1592 (customs penalties). *See also* 19 C.F.R. Appendix B to Part 171, paragraph (C)(6).

³⁷ 19 C.F.R. section 152.100.

Unfortunately, private letter rulings are not generally designed or intended to adequately address the broader compliance implications in all instances. Nonetheless, CBP's rulings have come to represent a form of informal administrative rulemaking with respect to related-party issues, which importers and CBP auditors frequently consider as authoritative guidance.

These latest interpretations, employed to converge section 482 methods in particular cases, can make it difficult for importers to distill and fashion workable guidelines. Thus, the lessons learned may not be easily transferable and applied to specific compliance efforts and factual circumstances going forward—without seeking a specific binding ruling in certain cases.

Nonetheless, the following broad observations or trends can be distilled from CBP's own analysis in these latest rulings:

- CBP's related-party analysis still gravitates around one or more of the interpretative notes.
- CBP may consider section 482 methods notwithstanding that it may have previously rejected potentially similar forms of analysis in previous rulings on what may have been similar grounds.
- An analysis of the importer's/distributor's profitability may be considered to indicate that the relationship between the buyer and seller did not influence the price.
- The "normal pricing practices of the industry" may be evidenced by objective section 482 methods (i.e., not merely by prices posted in trade journals, etc. . . .).
- Acceptable section 482 methods should include functionally comparable companies that operate in the *same industry* as the importer.
- Section 482 methods that include only functionally equivalent comparables (not from the same industry) may, nonetheless, be relevant under the "all costs plus a profit" standard, even though it may not establish the "normal pricing practices of the industry."
- Bilateral APAs provide "arm's-length" safeguards that CBP may favor.
- The use of "market driven" pricing methods appears to be, in CBP's view, a potentially favorable factor (i.e., transfer prices for import

transactions that start by working backwards, or are adjusted, from subsequent sale prices to unrelated customers).

- Plausible explanations of legitimate differences, or adjustments, in profitability or pricing may be persuasive if properly documented.³⁸
- Section 482 methods, on their own, may not be sufficient to satisfy the *circumstances of sale* condition without additional related-party evidence to significantly buttress the claim from a customs perspective (e.g., if the transactions are also subject to a bilateral APA or the economic results are also consistent with the results of internal comparable unrelated transactions, etc. . . .).³⁹

These broad observations, however, do not represent concrete rules as they must be reconciled with the various permutations and potential inconsistencies identified in this article on a case-by-case basis. In some respects, the rulings raise a few fundamental questions. For instance, in all three rulings, CBP appears to prefer “market driven” pricing policies that are derived from post-importation resale transactions to unrelated customers, the prices to which are then discounted or adjusted to take into account the distributor’s targeted profit.⁴⁰ However, the rulings do not specifically address whether these “market driven” methods satisfy CBP’s long standing requirement for “formula pricing”: A price determined or adjusted post-importation is acceptable under the transaction value method *only if* it is based on a fixed formula that is in place prior to importation of the merchandise, *and* that is based on a future event or occurrence over which neither

³⁸ This was evident in Ruling Two, HQ rulings W548419 (Dec. 27, 2009), H062635 (Nov. 30, 2009) and 54098 (May 20, 2002). In HQ ruling H062635, CBP accepted “plausible explanations as to why the importer may purchase generic product [from a related seller] at prices that are substantially lower than those charged for branded products.” Heavy advertising and marketing expenses associated with the sale of branded pharmaceutical products, and competitive market conditions were cited as the acceptable reasons for price and profit disparity although the generic and branded products were “chemically identical.” In HQ ruling W548419, CBP considered the fact that one entity bore greater risk than the other to be a plausible basis for adjustment under the “all costs plus profit” standard. In HQ ruling 548098, CBP found that the difference between the profit margins of the seller and buyer was due to differences in the commercial conditions of the respective countries—not the relationship between the seller and buyer.

³⁹ For example, in HQ ruling W548419 (Dec. 27, 2009), similar to in the Seiko ruling, CBP considered evidence under both the “normal pricing practices of the industry” standard and the “all costs plus profit” standard.

⁴⁰ In another recent ruling, HQ ruling W563467 (June 22, 2009), CBP also expressed that “arguably, this ‘market driven’ method could show that related-party prices are settled in a manner consistent with the normal pricing practices of the industry.”

the seller nor the buyer has any control.⁴¹ Prima facie, these “market-driven” approaches would seem more akin to the alternative “deductive value” customs method, not transaction value.⁴²

Implicitly, if CBP accepted that *transaction value* exists on the basis of post-importation “market driven” resale-minus methods notwithstanding that retroactive compensating adjustments may be necessary, then it could follow that CBP may have been satisfied that the transfer pricing methods constitute “fixed formulas.” This could also imply that downward compensating adjustments to the transaction value may be eligible for duty refunds. Explicitly, however, CBP has generally held that transfer pricing methods are not fixed formulas, and downward adjustments to price do not merit duty refunds pursuant to the “rebate provision,” 19 U.S.C. section 1401a(b)(40(B), which disregards decreases to the price actually paid or payable that are “effected” after the date of importation. Thus, the potential contradiction with CBP’s long standing policy in this respect deserves a more adequate resolution by CBP going forward.⁴³

⁴¹ See HQ rulings 547493 (Mar. 14, 2002), 545242 (Apr. 16, 1995) and 542701 (Apr. 28, 1982).

⁴² 19 U.S.C. section 1401a(d) provides that, if the “transaction value” method cannot be used, then the “deductive value” method should be used as the basis for customs valuation (i.e., generally speaking, the unit price at which imported merchandise is then resold post-importation is reduced by certain post-importation costs and profits of the importer).

⁴³ CBP has previously ruled that transfer prices that contemplated adjustments to the price actually paid or payable are “within the control of the parties” as to whether and what degree the price will be adjusted, and, thus, are not “fixed formulas.” In HQ ruling 545242 (Apr. 16, 1995), similar to Ruling One, the related parties contractually anticipated retroactive transfer price adjustments “due to competitive, economic and other factors” including “changing conditions and market pressures existing in the U.S. automobile industry.” The contracts indicated “target pricing” was employed, but CBP ruled that because the “parties exercise control over whether and to what degree the price will be adjusted,” the control “eliminates consideration for the pricing methodology as an acceptable ‘formula’ within the meaning of the [customs regulations].” Similarly, in HQ rulings 547493 (Mar. 14, 2002), the transfer price was calculated on a resale-minus basis whereby the “standard” import prices were subsequently reconciled and adjusted retroactively based on “actual” revenue and costs (which is frequently the case to ensure that parties achieve targeted profits from an arm’s-length perspective). However, CBP determined that “the amounts of the actual revenues and costs incurred are within the control of one of the parties,” and thus “no element in the formula was based on a future event over which neither the seller or the buyer has any control.” In Ruling One, the “market driven” circumstances necessitating adjustment would seem to be similar to those in HQ rulings 545242 and 547493, except that in Ruling One there was a bilateral APA in place. If external “market driven” conditions, affecting sales and costs, play a significant role in triggering the compensating adjustment (to achieve the arm’s-length mandated profit), then this would seem to constitute an event or occurrence outside the control of the parties. Arguably,

In addition, the rulings provide little, if any, guidance as to what criteria should be considered to determine whether a particular section 482 method is appropriate from a customs perspective (e.g., if the particular transfer pricing method aggregates profit on an entity-wide basis, rather than accounting for profit on a “product-by-product” basis).⁴⁴ For instance, Ruling Three suggests that transfer pricing methods that are not specified in the United States, such as the TNMM, may be acceptable in some cases;⁴⁵ and, in other rulings, the CPM is used despite the fact that the ICP provides that the method has “little similarity” and has the “least relevance” with the customs methods because it does not account for profit on a product-by-product basis.

It is expected that CBP will continue to make these informed determinations on a case-by-case basis upon careful consideration of all relevant factors. While “flexibility” seems to characterize CBP’s current approach to the related-party landscape, unfortunately, the ambiguities do not create the predictable compliance environment that importers seek, absent a binding ruling in applicable instances. This landscape would also seem to be at issue with respect to importers who, in hindsight, believe they may have travelled a similar “transfer pricing” course in the past, but were denied the use of transaction value on the basis of the *circumstances of sale* condition (e.g., importers who sought to use the “first sale” price for the purpose of minimizing duty costs). A more equitable approach to customs related-party compliance going forward is necessary.

Conclusion

There appears to be a nuanced evolution of CBP’s application of its related-party rules. CBP’s latest *circumstances of sale* rulings include several technical departures from previously held positions and general policy, although some deviations are not entirely unprecedented. The rulings represent a continuation of the seemingly *ad hoc* approach that has been a part of CBP’s arm’s-length

the existence of an APA does not, or should not, be determinative as long as there is a contractual agreement, entered into prior to importation, mandating specific targeted arm’s-length results and automatically triggering adjustments should the actual results fall outside the acceptable arm’s-length profit range. Under these conditions, the pricing method or formula would be in place prior to importations, and the future event(s) triggering the price adjustment would seem to be outside the control of the parties in both instances (i.e., market driven circumstances would dictate the final “results,” notwithstanding whether or not there is an APA in place).

⁴⁴ See HQ ruling 547672 (May 21, 2002).

⁴⁵ See also HQ ruling W548419 (Dec. 27, 2009). In this ruling, CBP considered a transfer pricing methodology that “factors in an appropriate operating margin in accordance with the [TNMM].”

determinations over the past decades. Thus, the evolution would appear to be occurring through administrative adjudication on a case-by-case basis, rather than by formal rulemaking or through clear administrative directives.

Nonetheless, there is a common theme running through each of the latest rulings discussed herein. CBP's latest rulings suggest that the approach presently taken by CBP is based on something more fundamental than the quality of the transfer pricing evidence or customs documentation submitted by the importer. The recent approaches taken by CBP evidence a renewed willingness by the agency to find points of convergence between transfer pricing methods under section 482 and the *circumstances of sale* condition, even when the "circumstances" do not fit perfectly within the existing customs regulatory framework.

In one respect, this is a welcome trend.

The convergence with section 482's approach is welcome because the analysis appears to comport with genuine commercial *circumstances of sale* and universal economic principles, rather than strict adherence to abstract customs standards or interpretative notes.

In another respect, however, the trend is problematic.

CBP's seeming lack of consistency with established regulatory interpretative notes and/or ruling precedents, as detailed herein, may create uncertainty in a compliance landscape where predictability is essential. Thus, this evolution (or informal rulemaking through administrative adjudication) is, arguably, inefficient from a compliance perspective.

CBP's current embrace of transfer pricing methods *via* private letter rulings is reminiscent of the challenging arm's-length environment a decade ago. At the time, the Seiko ruling was seen as the seminal case signaling the convergence of transfer pricing methods and customs valuation. Many importers enthusiastically, and some hastily, attempted to duplicate the Seiko approach in their compliance efforts notwithstanding that the ruling had potentially raised as many questions as it had purportedly answered. As the compliance community soon learned, CBP sought to close the "Pandora's box" that the Seiko ruling had opened. Rather than transform or liberalize the customs rules to converge with transfer pricing methods, CBP moved towards a more stringent application of the customs arm's-length standards, an approach that viewed section 482 methods warily.

Similarly, the latest rulings create significant technical ambiguity concerning the application of section 482 methods under either the “normal pricing practices of the industry” standard and/or the latest modified version of the “all costs plus profit” standard. These particular rulings fall short of explicitly sanctioning transfer pricing methods, on their own, to satisfy the *circumstance of sale* condition in all instances, and business realities may not create identical circumstances to those facts present in the latest rulings. Without broader or more formal guidance from CBP, importers may be left guessing at the potential enforcement consequences of their transfer pricing policies and customs compliance efforts.⁴⁶ This uncertainty can be relieved if the customs related-party regulations and/or directives are revised to comport the rules with the analytical approaches presently taken by CBP. While CBP's current flexibility in these latest rulings bends the regulatory customs “arm's-length” requirements toward practical commercial and economic realities on a case-by-case basis, more concrete and definitive “informed compliance” action would be welcome from CBP. Rather than evolve through ruling adjudication, it would seem preferable for all intents and purposes if CBP liberated the *circumstances of sales* analysis entirely from the abstract interpretative notes. CBP should consider fashioning and implementing a new set of pragmatic related-party regulations rather than continue with the seemingly labored, and at times contradictory, adherence to the customs regulations' “examples.”

CBP's regulatory “arm's-length” framework needs to catch up with the times and its own rulings.

In the meantime, importers must continue to exercise sound judgment to explain, from a customs perspective, why specific transfer pricing methods are relevant; to identify additional commercial evidence and financial data to support the claim that the parties' relationship has not influenced the price; and to prepare the necessary contemporaneous documentation for customs purposes. The uncertainty raised by CBP's latest rulings makes it more imperative than ever that these complex arm's-length issues must be determined on a case-by-case basis with careful consideration of all pertinent economic, regulatory, transfer pricing and accounting issues.

⁴⁶ The issuance of formal guidance by CBP would be consistent with the goal of the customs valuation statute. According to the statute's legislative history, the new valuation code was enacted “to ensure that these new rules are fair and simple, conform to commercial reality, and allow traders to predict, with a reasonable degree of accuracy, the duty that will be assessed in their products.” See H.R. Rep. No. 96-317, at 79 (1979).

ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY KPMG TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

Unless otherwise indicated, references to section or sections in this article are to the Internal Revenue Code of 1986 (the "Code"), as most recently amended, or to the U.S. Treasury Department regulations, as most recently adopted or amended.