

Transfer Pricing: IRS vs. CBP

By Alan Goggins, Esq., CPA

Related party transactions subject to scrutiny by both the IRS and U.S. Customs and Border Protection (CBP) typically arise whenever a U.S. importer purchases from a related overseas exporter. The requirements imposed by CBP and IRS both seek to establish that the transfer prices are conducted at arm's length, but these requirements sometimes differ drastically in the details of their application. Each agency requires that its own regulations be met. In addition to regulation in the United States by both CBP and the IRS, transfer prices may also be regulated overseas by the exporting country's tax authority.

To determine whether the parties are related, the IRS employs a control test, whereas CBP has a statutory definition under [U.S. Code \(USC\) 19 section 1401a\(g\)\(1\)](#). Under the valuation statute administered by CBP, the value declared for imported merchandise is almost always determined under the transaction value standard—that is, “the price actually paid or payable for the merchandise when sold for exportation to the United States” plus certain additions. The statute requires secondary methods of appraisement (transaction value of identical or similar merchandise, deductive value or computed value) only after the primary transaction value method is rejected. If such prices are between unrelated parties, the inquiry ends. If related parties are involved, however, CBP may inquire whether such prices are acceptable for determining transaction value.

One way to avoid this CBP inquiry is through first sale appraisement. The possibility of first sale appraisement exists if the related exporter purchases the merchandise from an unrelated factory; such transactions otherwise qualify as sales for exportation to the United States. The basic requirements are that the factory knows the goods are destined for the United States and that the transactions are established as sales.

Once these requirements are met, CBP is faced with a transaction value based on prices in sales between unrelated parties, and thus the inquiry ends. The advantages to this method are that the exporter's mark-up is not included in the values declared to CBP, resulting in lower duties, and that the sometimes onerous documentation requirements for meeting CBP's related party pricing tests can be avoided.

CBP Related Party Pricing Tests

Absent the availability of first sale appraisement, related party prices are acceptable for transaction value purposes if they meet either the circumstances of sales test or a test value—that is, a previous Customs value determined pursuant to actual appraisements of imported merchandise. While evidence sufficient to meet only one test is required, reliance on only one test is not recommended.

The circumstances of sales test is met if the analysis reveals that the relationship between the buyer and the seller did not influence the prices paid, which can be demonstrated in the following three ways:

- *Variation one:* the related party prices are settled in a manner consistent with the normal pricing practices in the industry—for example, when the related party prices are tied to quoted public market prices, such as for traded commodities.
- *Variation two:* the related party prices are settled in a manner consistent with the way the seller settles prices in sales to unrelated buyers. For example, if the exporter sells the same merchandise to unrelated buyers in the U.S. or in other countries and uses the same pricing formulas, or if the prices are comparable at the same level of trade, then the related party prices are acceptable for CBP purposes. The documentation necessary to satisfy CBP would include a comparative analysis of the related and unrelated prices converted into a common currency, along with sales invoices from the exporter demonstrating such prices. CBP prefers a comparison using prices in sales to unrelated parties in the United States, but will accept comparisons to to

unrelated parties outside the United States if such sales do not exist in the country and an adequate explanation of such sales is provided. This test is very similar to the IRS's comparable uncontrolled price (CUP) test and could possibly be met with the same type of documentation: an analysis comparing such related and unrelated prices and the sales invoices demonstrating such prices.

- *Variation three:* the related party price is adequate to ensure recovery of all the exporter's costs plus a profit equal to its overall profit, realized over a representative period of time, such as a year in sales of merchandise of the same class or kind. When this variation is undertaken, the amount of documentation necessary to satisfy CBP as to the accuracy of such costs is enormous; thus, this test is only recommended as a back-up method or if the first two variations do not apply. This third variation is similar to the cost plus method employed by the IRS, but the IRS method would possibly have to undergo significant adjustments before it was acceptable to CBP.

But CBP will often reject circumstances of sales analyses because they contain conclusory statements unsupported by evidence. Thorough documentation is needed for any circumstances of sales analysis.

The second method of establishing the acceptability of related party prices is determining whether such prices closely approximate the appraised value of the merchandise if a secondary method of appraisement was used. The three following variations exist:

- The transaction value of identical or similar merchandise in sales to unrelated buyers in the United States requires the exporter to sell to unrelated buyers in the United States or to have access to and documentation of its competitors' prices in sales to unrelated buyers in the United States.
- Deductive value starts with the U.S. importer's resale prices to unrelated buyers in the United States and then backs out the duties and freight, the importer's selling, general and administrative costs and the profits in the United States. This test is somewhat similar to the IRS's resale price method.
- Computed value looks at the exporter's cost of production, general overhead and profits. It is very similar to circumstances of sales variation three.

Unfortunately, CBP has a policy of not accepting any test values unless one of the secondary appraisement methods was actually used in a previous importation and accepted by CBP. This policy effectively rewrites the statute and eliminates test values. Few court cases have addressed related party pricing under the Customs laws and although those that do raise this policy, the court decisions have not discussed it. Therefore, test values should only be used as a back-up method.

IRS Transfer Pricing Tests

Unlike CBP, which only has the option of accepting or rejecting related party prices for transaction value appraisement purposes, the IRS can adjust transfer prices for tax purposes if they do not meet one of the IRS tests. The IRS has several profit-based methods and three transaction-based methods for reviewing transfer prices. It also requires a taxpayer to demonstrate that the method used provides the best and most reliable measure of the arm's length nature of the transfer prices.

The profit-based methods include the comparable profits, comparable profit split and residual profit split methods, all of which focus on overall profits and not on specific transactions. Profit comparisons are made either between the related parties or between the related parties and competitors. Because a Customs value must be ascertained for each imported article, these IRS methods will generally not establish the acceptability of such transfer prices for CBP purposes.

The IRS's transaction-based methods include the CUP method, the resale price method and the cost plus method. The CUP test compares the transfer prices to the prices in sales to unrelated parties.

The IRS's resale price method compares the gross margin earned in related party sales to the gross margin earned in sales to unrelated parties and is typically used for a reseller. The IRS's cost plus method is ordinarily used in the context of a manufacturer and also compares the gross margins earned in related and unrelated party sales.

A Comparison

Proactive U.S. taxpayers can obtain an advance pricing agreement (APA) with either the IRS or with the IRS and the overseas taxing authorities. Absent an APA, many multinational companies prepare their own transfer pricing studies based on the IRS methods to support their transfer prices. CBP has said that the existence of an APA or a transfer pricing study by itself [will not satisfy](#) their inquiries into the acceptability of related party prices for transaction value appraisal purposes. The importer must demonstrate how the IRS transfer pricing method used also satisfies one of the CBP tests. Similar in effect to an APA, a proactive importer can apply for a CBP ruling approving its related party pricing.

The only IRS method that would appear to readily satisfy a CBP test is the CUP test. Information found in the other IRS transaction-based methods may help support one or more CBP tests, but significant adjustments would have to be made.

Under [U.S. Code \(USC\) 26 section 1059A](#), the inventory costs of imported merchandise taken into account by a related party importer for IRS purposes shall not exceed the value declared to CBP. This statute does not apply to first sale appraisements but applies a double penalty when, for example, a related party importer does not declare an assist (material supplied free of charge or at a reduced cost by the buyer of imported merchandise to the overseas parties), one of the required additions to the price paid or payable. Not only is the importer subject to CBP penalties for undervaluing its imported merchandise, but the IRS can disallow the tax deduction for the cost of that assist.

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