



# China Tax Alert

Issue 29, November 2017

## World Customs Organization (“WCO”) Issued a New Case Study on the Use of Transfer Pricing Documentation in Customs Valuation - First Case Contributed by the PRC Customs

### Regulations discussed in this issue:

- WCO issued its second Case Study 14.2 on the connection between transfer pricing and customs valuation

### Background

WCO issued the *Use of Transfer Pricing Documentation When Examining Related Party Transactions under Article 1.2 (a) of the Agreement* (hereinafter referred to as *Case Study 14.2*) end of October 2017. Following the issue of *Case Study 14.1* in April 2016, this is the second case study on transfer pricing and customs valuation issued by WCO, which draws extensive attention from the public. It is worth noting that this is the first time WCO has adopted a case from the PRC Customs and this particular “China Solution” has thus become part of the global customs valuation guidelines. It is a milestone which shows the PRC Customs’ active participation in formulating global customs valuation guidelines.

*Case Study 14.2* is significant to global customs valuation because it proposes to use transfer pricing documentation as the basis of customs valuation by comparing the gross margins of comparable companies to determine if the value of transactions with related parties is at arm’s length. In addition to the point raised in *Case Study 14.1* of using Advance Pricing Agreement (APA) transfer pricing analysis report as the basis to examine whether the transactions with related parties are at arm’s length through study and analysis on Transactional Net Margin Method (TNMM) and operation expenses, *Case Study 14.2* further enhances the reference value of transfer pricing documentation in customs valuation.

### Case facts

In *Case Study 14.2*, ICO, located in country I, is the distributor of XCO of country X. ICO is the sole agency of the luxury bags sold by XCO in

country I. XCO does not sell identical or similar luxury bags to unrelated buyers in country I. Thus, all luxury bags imported into country I by ICO are purchased from XCO. According to ICO's transfer pricing policy, the import price of all luxury bags was determined using Resale Price Method. ICO calculated the import price of luxury bags based on the resale price in country I and the targeted gross margin for the next year recommended by XCO, with the deduction of customs duties. The transfer pricing report indicated that the inter-quartile range of gross margins earned by the 8 selected comparable companies in 2012 was between 35% and 46%, with a median of 43 %. Therefore, gross margin at 64% earned by ICO did not fall within the inter-quartile range. When Customs of country I conducted valuation audit, they regarded that the import prices of ICO have been affected by special relationships and do not meet arm's length requirements.

Main facts of *Case Study 14.2* leading to the above conclusion:

- Since ICO, the exclusive distributor in country I, had failed to provide the test values, the Customs of country I examined the circumstances surrounding the sale on the basis of transfer pricing documentation;
- When examining the import price pricing method, the Customs in country I compared the gross margin of ICO with those of comparable companies to determine if the pricing method had been settled in a way that is consistent with the normal pricing practices in the industry;
- The research of benchmarking study is acceptable to the Customs. Based on functional analysis, there was no significant difference between ICO and all eight comparable companies. In addition, the products of the comparable companies are similar to those sold by ICO.
- The gross margin earned by ICO did not fall within the inter-quartile range and ICO did not make any transfer pricing adjustments in this regard.

#### **KPMG observations**

In recent years, transfer pricing of multinational companies has become a new challenge for customs authorities in many countries. It also becomes a hot topic when WCO conducts technical research on valuation matters. WCO issued the *WCO Guide to Customs Valuation and Transfer Pricing* in June 2015, followed by *Case Study 14.1* in April 2016 and *Case Study 14.2* in October 2017. The issuance of the documents reflects the attention of WCO Technical Committee on transfer pricing and indicates that related party transactions have drawn the attention of all countries (especially emerging countries such as China).

This Case study, conducted and drafted by the PRC Technical Committee on Customs Valuation (international team), aims to explain how the Customs applies transfer pricing documentation and other relevant information to ascertain whether the prices paid or payable of imported goods have been influenced by any special relationship between the buyers and the sellers (based on *Article 1.2(a) of the Agreement*).

With the Customs paying increasing attention to transfer pricing arrangements, we suggested that enterprises should consider doing the following: -

- The transfer pricing policy of most trading companies in China is modelled on Resale Price Method (“RPM”) or Transaction Net Margin Method (“TNMM”) and their testing indicator on operating margins or similar financial indexes. However, due to the significant attention of the Customs paid to gross margins, it is suggested that an analysis be conducted on gross margins when preparing transfer pricing documentation;
- Special factor analysis (e.g. industry analysis, financial analysis and adjustments) should be conducted if the profit is lower than the inter-quartile range in transfer pricing documentation. Considering the difference in a customs valuation review, it is recommended that special circumstances be analysed if the profit is higher than the inter-quartile range;
- When submitting the transfer pricing documentation to the Customs, companies should provide proper explanations regarding the applicability of the documentation to avoid any misunderstanding of the information disclosed and methods applied in the documentation by the Customs;
- It is recommended that a Customs valuation report be compiled with reference to the transfer pricing documentation prepared for tax purposes. Such a report should use customs valuation language and logically present a comprehensive study by consolidating the information and materials that are required to be submitted to the Customs.

#### **KPMG assistance**

- Assist enterprises in addressing inquiries raised by China Customs in respect of customs valuation, including the collection and review of information to be submitted and the preparation of explanation letters, as well as accompany enterprises to submit documents for explanations;
- Assist enterprises in conducting self-reviews to identify mistakes in a timely manner by analysing historical import data, and help enterprises prepare self-inspection reports and make voluntary disclosures to China Customs. KPMG can also provide recommendations for process improvement to mitigate future compliance risks;
- Assist enterprises in the implementation of trade management solutions to incorporate customs declarations/post-clearance reviews into automated processes, thereby reducing manual errors when handling customs declarations.

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