The battle continues

The war between transfer pricing and customs is far from over

“Are transfer pricing adjustments or changes acceptable for customs purposes?” is one of the most frequent questions we have received over the past decade. Our loyal readers may recall that exactly ten years ago we published a groundbreaking document in the sidelines of PwC’s Global Transfer Pricing Conference entitled "The cold war between Transfer Pricing and customs valuation", which has been much referred to, elaborated on and even copied.

The battle, or perhaps conflict of interest is a better phrase to use, between transfer pricing and customs valuation is therefore nothing new. The value declared for customs valuation purposes has always been top of mind of customs authorities and this will not change anytime soon. Not only because there are very specific rules and compliance requirements on how a value should be declared and determined upon import, but also because the value declared determines the import duty and taxes collected by customs authorities. In our experience, customs valuation, and particularly related party transactions, is the area that consistently over the years has resulted in the most frequent challenges during customs audits (closely followed by tariff classification and preferential origin issues, in case your experience suggests otherwise).

Again, this is nothing new, but we are noticing some interesting trends on this topic. When gazing into our crystal ball, we expect many companies to run into (in some cases big!) trouble with customs authorities as a result of not appropriately assessing and addressing the risks that their transfer pricing approach, policies and documentation is creating in their customs compliance.

What we are seeing from the customs authorities

With almost daily interactions with customs authorities around the region over a long period of time has allowed us to make some interesting observations. One of which is that there has been a shift in how customs authorities look at and assess related party transactions.

Up until just a couple of years ago we would see a number of customs officials in Asia struggling to understand the link between customs valuation and transfer pricing. This was followed by a lot of companies experiencing customs authorities challenging their intra-company pricing simply on the basis that it was a related-party transaction and therefore the relationship must have influenced the price, despite customs valuation rules clearly stating otherwise. In some extreme cases customs officials genuinely believed the use of a transfer price was equivalent to fraud, which in many cases would result in a not so pleasant penalty assessment. This still happens today, but fortunately less frequently.

The good news is that more recently we see that most customs authorities have realised they need to learn more about how companies within a group transact with one another. As a result, customs officials across Asia have become more aware of related party pricing issues, what transfer pricing is and what impact it can have on customs valuation. We have also seen them being trained by various developed nations as well as the World Customs Organization on this topic (for example, the WCO Train-the-Trainer Workshop on Customs Valuation for the benefit of ASEAN Members in 2020). While this is positive in the sense that customs authorities are more broadly starting to understand and accept how multinationals operate, we are also seeing an upward trend in challenges. Recent examples we have seen include customs authorities using TP documentation to proactively challenge declared customs values on the basis that the TP documentation fails to demonstrate fundamental customs valuation principles have been considered.
For us customs professionals that have been in the game for some time, this is actually quite refreshing. A customs authority showing signs of applying the underlying rules and fundamentals of customs valuation more consistently beats a challenge for the sake of a challenge any day. This change in mindset is also reflected in many of the interactions we are having with customs officials across the region on a daily basis.

Having said that, there is no doubt that this shift in mindset and uptick in scrutiny is also driven by revenue shortfalls, making additional duty and penalty collection a top priority for the authorities. We know many authorities are significantly behind on their revenue targets on the back of COVID-19. In fact we have been told by one authority that they came in 90% behind budget in 2020 and are expected to recover the shortfall as borders open up more and more.

These are of course only some generic observations, but they do touch on very real and practical issues companies are facing or will have to deal with in the near future if it hasn’t hit their radar screen yet. For example, economic difficulties putting pressure on margins, TP benchmarks changing, overcapacity leading to products being sold at much lower margins or losses, changes to global tax regimes leading to product price changes - all of these have an impact on customs valuation and customs value testing that we can expect the authorities to be applying in upcoming audits. What may be acceptable for TP purposes may well increasingly not be for customs purposes.

So, what can we make of all this? To us it is pretty clear. Customs authorities will continue to focus a lot of their attention in the coming years on related party transactions and the lack of support companies have in place to justify a price from a customs perspective. Based on what we are seeing at the moment, we can almost assure you that if you are operating in Asia and most of your cross border trade transactions are between related parties, at some point soon you will likely receive difficult questions or an audit notice somewhere in the region.

What are companies doing in response?

Nothing.

Well, that may be a little harsh. Very little, then.

Based on what we are seeing, most companies are unfortunately continuing to be reactive in this space. They underestimate the potential risk of not assessing and documenting why their related party transactions reflect an appropriate import value based on solid customs valuation fundamentals and rules.

Of course there are companies that do take this seriously and develop robust support documentation to complement their transfer pricing policy. But they represent a small minority of importers. Oftentimes these companies learnt the consequence the hard way, i.e. experienced an audit that resulted in large financial exposure and/or disruptions to operations.

The majority of importers are however reactive. Some believe their transfer pricing policy is sufficient. Others are not aware of the customs risk. Yet others, like in so many aspects of our lives, tend to make decisions based on recent history and experiences only. For example, if you have not had any customs valuation issues or challenges in the recent past, and your products are routinely cleared by Customs, it is easy to make the assumption that what you are doing today must be good enough. Other common barriers we encounter is that it is not always clear who within an organisation should take on the responsibility to assess or manage the risk. Therefore it is “somebody else’s problem”. The fact that there is no regulatory requirement to maintain adequate support is another barrier that tends to result in a “wait and see” approach.

There is also a category of companies that claim they review customs values on a periodic basis, identify no issues and therefore conclude there is unlikely to be any risk. However, in most such cases when we dig deeper we find that these are quite perfunctory checks which are not documented and therefore unlikely to be very helpful against a future Customs challenge.

Our conclusion of all this, which is very much based on what we see in practice, is that there are many companies out there that will regret not taking action earlier to mitigate risk.

So what can and should you as a company do? We are glad you asked!

A best practice approach

While some companies may rest with their fingers crossed, hoping Customs either don’t knock on their door or – if they do – don’t ask the difficult questions, others, as we mentioned above, take a more proactive approach. What we are seeing being extremely effective when dealing with customs authorities is companies that create some kind of Customs Valuation Documentation ("CVD") in response to increasing attention from Customs on valuation matters.
Companies may still regard CVD as an alien idea, but in this case its counterpart in transfer pricing, Transfer Pricing Documentation (‘TPD’), may provide some very useful guidance. Prior to the existence of mandatory TPD requirements, many MNCs, with the help of transfer pricing specialists, started TPD preparation as a response to growing tax audits around the world. The lack of a standard format or unified regulatory requirements proved not to be an obstacle to TPD preparation. The documentation gradually matured with accumulating experiences. Regulatory TPD requirements developed subsequently.

Though customs valuation regulations have yet to develop a similarly comprehensive level of documentation requirements as transfer pricing, our recent experiences suggest that over time challenges will become more sophisticated, and that being prepared will mean significantly less time defending pricing and a substantially reduced risk of penalties. The companies that have already taken these proactive steps will know that it makes a massive difference when Customs start asking difficult questions or send a notice for an audit.

If you are still not convinced there is sufficient value in creating robust support documentation, the minimum you should do is to make sure you take the time to review how your company sets its transfer prices and assess what risks this created from a customs valuation perspective. For example, if all intercompany pricing is determined at a central level without active involvement from and decisions by importing affiliates, a key customs “arm’s length” requirement will not be met, and the door is open for an easy challenge by a customs authority.

Performing a risk assessment - a great first step

We recognise that for many companies and professionals out there, the sound of creating customs valuation documentation may seem a bit over the top. Especially if you are convinced what you are doing is sufficient.

In our experience, doing a holistic risk assessment does not have to be complex or require too much effort, despite what you may think. And to illustrate how this can be done, we want to share more about a ‘Customs Valuation Scorecard Assessment’ that we have developed and are implementing for companies on the back of receiving more and more questions on how to proactively manage transfer pricing risks on customs valuation compliance.

What is a customs valuation scorecard assessment?

| Objective | to take a holistic look at how transfer prices are set to help companies assess what the risks are and get a better sense of potential exposure. |
| Purpose | to provide management an overview on potential customs valuation risks and available compliance management measures for the purpose of deciding the most efficient approach in maintaining customs valuation compliance. |
| Approach | taken to complete the scorecard includes a review of Transfer Pricing Documentation information and interviews with key personnel to understand knowledge and consideration taken of customs valuation. |
| Content | of the scorecard covers preliminary evaluation of common customs valuation risks and exposures against a pre-agreed set of criteria, as well as recommendations for next steps. Based on our experience, we know that this type of assessment needs to be created and graded not just based on solid knowledge of customs valuation rules and regulations, but perhaps more importantly on a good understanding of customs valuation declaration practices. Our assessment therefore take into consideration: |

- what are the usual challenges from the authorities?; 
- what are companies likely to overlook?; and 
- how are written policies implemented?
Why should you be interested?

This is quite simple. A risk assessment will give you an indication of how your company is doing. More specifically it will give you the following:

- Quick understanding of the weak points in your customs valuation management;
- An independent view from customs specialists on your customs valuation compliance status.
- Clear indication of risk levels to help you prioritise your action points.
- Best practice benchmarking and recommendations on available tools and approaches for managing customs valuation risks.
- Robust basis to determine whether customs valuation support documentation or other risk mitigation measures are needed.

Takeaways

At some point you will receive questions from a customs authority or be audited, and when that happens, you want to make sure you have your house in order, or at least you know and are prepared for what Customs may challenge when they come knocking. Companies that do this properly will more likely than not win this battle in the war between transfer pricing and customs valuation. It will likely also make you sleep better at night if this happens to be your responsibility within an organisation.

At the very least you should have a clear and documented assessment of risk, which is also shared with the relevant higher echelons in your company. That in itself will make it clear whether and where further customs valuation support documentation should be created, to mitigate the risk of successful challenges by Customs, as well as probably reducing the resources and time needed to deal with the next audit.