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CBP FINALIZES RULING ALLOWING POST-IMPORTATION PRICING ADJUSTMENTS

U.S. companies that purchase merchandise from related foreign sellers may potentially achieve significant duty savings by taking advantage of a recent ruling by U.S. Customs and Border Protection ("CBP"). In that ruling, CBP finalized a policy change that will make it easier to receive credit for "compensating adjustments" and other post-importation adjustments based on tax transfer pricing documentation and advance pricing agreements ("APAs"). This policy change, which will take effect July 30, 2012, could result in significant duty savings for parties that correctly structure their transfer pricing arrangements.

In the past, downward post-entry adjustments (price reductions) — which result in payments from the foreign seller to the U.S. buyer — generally could not be used to reduce duties declared at the time of entry, unless:

1. The importer participated in CBP's reconciliation protocol (a voluntary program that provides for adjustments to be reported up to 21 months after the date of importation), and
2. The adjustments in question were based on an "objective formula" established at the time of importation.

CBP interpreted the "objective formula" requirement to bar importers from declaring post-entry price reductions required by APAs or transfer pricing studies on the basis that the final prices were determined based on factors arguably within the parties' control, such as post-importation processing and/or distribution costs.

This presumption has been modified in Customs Ruling HQ W548314. Effective July 30, 2012, CBP will allow both upward[1] and downward post-importation adjustments to related-party sales prices made pursuant to a formal transfer pricing policy that meets the following five criteria:

1. A written "Intercompany Transfer Pricing Determination Policy" is in place prior to importation, and the policy is prepared taking Internal Revenue Code Section 482 into account;
2. The U.S. taxpayer uses its transfer pricing policy in filing its income tax return, and any adjustments resulting from the transfer pricing policy are reported by the taxpayer in filing its income tax return;
3. The transfer pricing policy specifies how the transfer price and any adjustments are determined with respect to all products for which the value is to be adjusted;
4. The company maintains and provides accounting details from its books and/or financial statements to support the claimed adjustments; and
5. No other conditions exist that may affect CBP's acceptance of the transfer price.

In addition to satisfying the five criteria set forth above, the transfer price must be acceptable under the "circumstances of sale" test, which allows related-party importers to use transaction value (*i.e.*, the price actually paid or payable for imported merchandise) for customs valuation purposes.

[1] CBP has always required importers to report upward post-entry adjustments (price increases).

A related-party importer may satisfy the "circumstances of sale" test by demonstrating that the price was established in a manner consistent with the normal pricing practices of the industry in question or the way the foreign seller sets prices for sales to unrelated buyers. In the alternative, the test is also satisfied if the price charged ensures recovery of all costs plus a profit in line with the seller's overall profit realized over a period of time (typically on an annual basis) in sales of goods of the same class or kind.[2]

CBP has repeatedly stated that an APA or a transfer pricing study by itself is not sufficient to support reported transaction values under the "circumstances of sale" test. More recent rulings, however, demonstrate an evolving willingness to consider transfer pricing studies and APAs when evaluating the "circumstances of sale" test. These rulings present an opportunity for taxpayers to structure transfer pricing studies and APAs so as to satisfy both their income tax and customs obligations.

The most recent ruling continues this trend by eliminating the onerous "objective formula" test. The new ruling strongly encourages importers to use the reconciliation program to alert CBP of anticipated post-importation adjustments. The use of reconciliation, however, is not mandatory. If an importer decides not to participate in the reconciliation program and wishes to make post-entry adjustments, it must demonstrate at the time of entry that prices are arm's length and provide supporting information for future price adjustments (a potentially arduous undertaking).

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Covington & Burling possesses significant expertise in assisting clients with international tax and customs valuation issues. Further information on these developments and potential opportunities for duty savings can be found in the latest issue (June 2012) of *International Tax Review* in an article co-authored by David Grace, Emin Toro, and Mateo Caballero, entitled "Transfer pricing documentation: An opportunity for multinationals and other related parties to support US customs valuations."

If you have any questions concerning the material discussed in this client alert, please contact the following members of our customs and international taxation practice groups:

David Grace	202.662.5368	dgrace@cov.com
Emin Toro	202.662.5481	etoro@cov.com
Reeves Westbrook	202.662.5150	rwestbrook@cov.com
Mateo Caballero	202.662.5365	mcaballero@cov.com

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[2] While importers may also potentially use "test values" to support related-party prices, the technical requirements of the "test values" approach cannot be satisfied in the vast majority of cases. Thus, importers almost always attempt to demonstrate the acceptability of reported transaction values using the "circumstances of sale" test.