International Trade Alert

January 11, 2018

Key Points

- A recent judgment of the European Court of Justice for bars the use of intercompany transfer prices for EU imports and EU customs duty purposes if (as is commonly the case) these are subject to retroactive adjustments.
- This means that EU importers who buy from related vendors may have to change the basis for valuation of their EU imports.
- The judgment increases uncertainty concerning past imports, and EU importers may want to review their customs valuation of past imports to assess their risks.

European Court of Justice: Intercompany Pricing Cannot Be Used For EU Import/Customs Purposes If Subject to Adjustments

On December 20, 2017, the European Court of Justice (ECJ) issued an important decision in respect of the use of intercompany transfer pricing for customs valuation for imports in the EU. The judgment bars the use of intercompany transfer prices for EU imports if (as is commonly the case) these are subject to retroactive adjustments. This means that EU importers who buy from related vendors may have to change the basis for valuation of their EU imports, as discussed in more detail below.

Transfer Pricing and Customs Valuation

The EU Union Customs Code (UCC) implements the World Trade Organization (WTO) Valuation Agreement. As such, the preferred (and default) method of customs valuation of EU imports is based on the price actually paid or payable ("transaction value"). Transaction value can also be applied in respect of EU imports in "intra-company" sales between related companies, provided that the price (or transaction value) is not influenced by the relationship between the parties to the transaction.

For corporate taxation purposes, many groups of companies rely on transfer pricing for their intracompany sales. By means of reference to comparable sales flows between unrelated companies (as documented in transfer-pricing documentation), groups confirm that the aggregated profit margins of their group companies resulting from such intracompany sales are "at arm's length" (i.e., not influenced by the relation between the companies engaged in the transactions). Contrary to corporate income taxation of aggregated profits, customs duties are levied over each individual sale/import and the transaction value of that sale/import. Nonetheless, some EU Customs authorities accept such transfer-pricing documentation to support, for customs valuation purposes, that the intragroup transfer prices are not influenced by the

© 2018 Akin Gump Strauss Hauer & Feld LLP. This document is distributed for informational use only; it does not constitute legal advice and should not be taken as such.

fact that buyers and sellers in transactions in which EU imports are made are related, and are thus acceptable as transaction value for EU customs duties.

In practice, such transfer-pricing strategies are often implemented by periodical monitoring of profit margins of group companies. Where a margin is outside the “at arm’s length” range as supported by transfer-pricing documentation, additional charges or repayments are made between group companies, so-called ‘transfer-pricing adjustments.” The amount of such transfer-pricing adjustments typically is determined by the desired profit margin of the group company to whom the adjustment is addressed.

For customs valuation purposes, the question is whether such transfer-pricing adjustments are part of the “price actually paid or payable” or transaction value. If so, this would require retroactive adjustment of the transaction value of goods previously imported.

Companies and customs specialists, as well as Customs authorities, struggle with the application of such retroactive adjustments in practice. EU customs rules do not offer a practical and comprehensive solution, other than reopening and amending previous individual import declarations. Where companies import frequently, this poses a massive administrative burden. In some EU countries, Customs authorities have been open to more practical solutions, such as consolidated periodical reconciliation where individual imports are made on the basis of a provisional transaction value. However, scholars and customs experts are divided about the justification of such approaches under EU customs legislation.

The Hamamatsu Judgment

The December 20, 2017 judgment of the ECJ in the Hamamatsu case confirms that, if such transfer-pricing adjustments are made (as is commonly the case), the intercompany sales price (i.e., sales price between related companies) can not be used for customs value.

Hamamatsu imported products acquired from a related supplier. In line with group transfer-pricing policies, a transfer-pricing adjustment was applied, which resulted in (retroactively) the transaction value of the imports being reduced. Hamamatsu applied to German Customs authorities for repayment of duties previously paid. The matter resulted in an appeal to a German court.

The German court considered that (par. 21 of the ECJ judgment) “The referring court considers that the final annual amount constitutes the final transfer pricing, established in accordance with the arm’s-length principle provided for by the OECD Guidelines. There was thus no point in basing the transfer-pricing exclusively on the provisional pricing in the context of an advance transfer-pricing agreement concluded with the tax authorities which does not reflect the real value of the goods. **Thus, the price declared to the customs authority was only a fictitious pricing and not the price payable for the imported goods pursuant to Article 29 of the Customs Code.**”

Based on that, the German court then raised the following question to the ECJ as the highest authority on interpretation of EU Customs regulations: “Do the provisions of (..) [the Customs Code] permit an agreed transfer price, which is composed of an amount initially invoiced and declared and a flat-rate adjustment

made after the end of the accounting period, to form the basis for the customs value, using an allocation key, regardless of whether a subsequent debit charge or credit is made to the declarant at the end of the accounting period?"

Based on the factual decision by the referring German court, the ECJ considers (paragraph 23) "whether Articles 28 to 31 of the Customs Code must be interpreted as meaning that they permit the adoption, as the customs value, of an agreed transaction value which consists partly of an amount initially invoiced and declared and partly of a flat-rate adjustment made after the end of the accounting period, without it being possible to know at the end of the accounting period whether that adjustment would be made up or down."

In answering the question, the ECJ emphasizes (paragraph 28), "The transaction value must reflect the real economic value of imported goods and take into account all the elements of those goods that have economic value." The ECJ then considers (in paragraphs 30 to 35) that, for customs valuation, the only permissible post-import adjustments are those in relation to hidden defects or damages to the goods imported. This is also set out in Article 145 Paragraph 2 of the (old) Implementing Regulation 2454/93 to the (old) Community Customs Code, as applied to the case decided by the ECJ.

The ECJ then concludes that:

a. there is no obligation on importers to retroactively adjust transaction value in case of transfer pricing adjustments
b. the applicable provisions of the Community Customs Code "do not permit an agreed transaction value, composed of an amount initially invoiced and declared and a flat-rate adjustment made after the end of the accounting period, to form the basis for the customs value, without it being possible to know at the end of the accounting period whether that adjustment would be made up or down."

Consequences of the Judgment

In summary: If retroactive transfer-pricing adjustments are made, they need not be disclosed to Customs authorities for prior imports, but the fact that they are made does mean that the intercompany transfer price cannot be used as transaction value for customs purposes.

If the intercompany transfer price cannot be used as transaction value, the taxable base for customs duties must be determined by another method. These alternative methods are, in mandatory order of application:

2. Transaction value of identical goods (sold between unrelated parties)
3. Transaction value of similar goods (sold between unrelated parties)
4. Deductive value ("re-sale minus")
5. Computed value.

where Methods 4 and 5 are interchangeable.

In practice, Methods 2 and 3 will be difficult to apply, since individual transactions in which identical or similar goods are sold between unrelated parties in the same economic, commercial and factual

circumstances will be difficult to find. From an audit perspective, such comparable individual transactions will be difficult to find and demonstrate to Customs authorities in a verifiable and auditable manner.

The most likely method to be applied would either be method 4 or 5. Method 4 is based on the price of sale after importation, from which elements that need not be included in the taxable base for customs duties (i.e., profits and costs incurred after importation) are deducted. Method 5 requires that an importer demonstrate that the overall cost of production, including materials, design, royalties, general sales and administration cost, adds up to the price as declared for import. In other words, the cost of all individual inputs for the products as set out in the bill of materials, as well as additional costs of transport (up to the EU border) and intangible assists related to the product must be justified on an item-by-item basis. This poses a challenge to importers, as well as to Customs authorities, since this requires extensive (internal) audit and verification.

With this judgment, the ECJ has essentially cut off the connection between transfer pricing for corporate tax purposes and the transactional taxable base for customs duties. Reliance on the transfer-pricing documentation as prepared for corporate tax purposes to justify customs valuation is, at least according to the judgment, not sufficient. Importers should consider building a separate justification of their intercompany transfer prices on a cost basis or on a resale minus basis, if only as an audit defense for future audits by Customs authorities.

Our EU international trade specialists are ready to assist and advise on the consequences of this decision for your trade flows and EU customs compliance.

Contact Information

If you have any questions regarding this alert, please contact:

Jasper Helder
jasper.helder@akingump.com
+44 20.7661.5308
London

Chiara Klaui
chiara.klaui@akingump.com
+44 20.7661.5342
London

Daniel Lund
daniel.lund@akingump.com
+44 20.7012.9653
London

Lars-Erik A. Hjelm
lhjelm@akingump.com
+1 202.887.4175
Washington, D.C.

Suzanne Kane
skane@akingump.com
+1 202.887.4037
Washington, D.C.