

provision is dutiable at 2.5 percent *ad valorem* under the general column one rate of duty. Duty rates are provided for your convenience and are subject to change. The text of the most recent HTSUS and the accompanying duty rates are provided on the internet at www.usitc.gov.

EFFECT ON OTHER RULINGS:

NY K87306, dated June 28, 2004, is hereby revoked consistent with the foregoing analysis.

Sincerely,

MYLES B. HARMON,

Director

Commercial and Trade Facilitation Division

**PROPOSED REVOCATION OF A RULING LETTER HQ
547654 RELATING TO POST-IMPORTATION
ADJUSTMENTS; TRANSFER PRICING; RELATED PARTY
TRANSACTIONS; RECONCILIATION; REQUEST FOR
COMMENTS**

AGENCY: U.S. Customs and Border Protection; Department of Homeland Security.

ACTION: Notice of proposed revocation of a valuation ruling letter and treatment relating to post-importation adjustments made pursuant to a methodology specified in formal transfer pricing policies, reconciliation, and request for comments.

SUMMARY: Pursuant to Section 625(c), Tariff Act of 1930, (19 U.S.C. §1625(c)), as amended by Section 623 of Title VI (Customs Modernization) of the North American Free Trade Agreement Implementation Act (Pub. L. 103–182, 107 Stat. 2057), this notice advises interested parties that U.S. Customs and Border Protection (“CBP”) proposed to revoke Headquarters Ruling Letter (“HRL”) 547654, dated November 8, 2001 (set forth as Attachment A), relating to transfer pricing and the acceptability of post-importation adjustments, claimed pursuant to a formal transfer pricing policy. Similarly, CBP proposes to revoke any treatment previously accorded by it to substantially identical transactions.

On September 23, 2011, pursuant to the Commissioner Bersin’s initiative, CBP published the advance notice on this issue on cbp.gov and requested that the public provide comments on the broadening of CBP’s interpretation of what constitutes a “formula” for purposes of using transaction value, thereby allowing post-importation adjustments. Several comments were received in response to CBP’s request for advance comments. All of the comments received were in support

of CBP's proposed action. CBP has reviewed and taken these comments into account in issuing this proposed revocation of HRL 547654. Comments are invited once again on the correctness of the intended actions. However, persons who already provided comments in response to the advance notice need not resubmit them, unless there are additional points they would like CBP to consider.

EFFECTIVE DATE: Written comments should be received on or before January 27, 2012.

ADDRESSES: Written comments are to be addressed to U.S. Customs and Border Protection, Office of International Trade, Regulations and Rulings, Attention: Trade and Commercial Regulations Branch, 799 9th Street, N.W., Fifth Floor, Washington DC 20229-1177. Submitted comments may be inspected at the address stated above during regular business hours. Arrangements to inspect submitted comments should be made in advance by calling Mr. Joseph Clark, Trade and Commercial Regulations Branch, at (202) 325-0118.

FOR FURTHER INFORMATION CONTACT: Yuliya A. Gulis, Valuation and Special Programs Branch, Regulations and Rulings, Office of International Trade (202) 325-0042.

SUPPLEMENTARY INFORMATION:

BACKGROUND

On December 8, 1993, Title VI (Customs Modernization) of the North American Free Trade Agreement Implementation Act (Pub. L. 103-182, 107 Stat. 2057) (hereinafter "Title VI") became effective. Title VI amended many sections of the Tariff Act of 1930, as amended, and related laws. Two new concepts which emerge from the law are informed compliance and shared responsibility. These concepts are premised on the idea that in order to maximize voluntary compliance with customs laws and regulations, the trade community needs to be clearly and completely informed of its legal obligations. Accordingly, the law imposes a greater obligation on CBP to provide the public with improved information concerning the trade community's responsibilities and rights under the customs and related laws. In addition, both the trade and CBP share responsibility in carrying out import requirements. For example, under section 484 of the Tariff Act of 1930, as amended (19 U.S.C. §1484), the importer of record is responsible for using reasonable care to enter, classify and value imported merchandise, and to provide any other information necessary to en-

able CBP to properly assess duties, collect accurate statistics and determine whether any other applicable legal requirement is met.

Many importations into the U.S. involve trade between related parties. According to the U.S. Census Bureau, U.S. Department of Commerce, related-party trade in 2010 accounted for 40.8 percent (\$1, 295 billion) of total goods trade (\$3,176 billion). Related-party total goods trade is based on consumption imports and total exports. Related-party trade accounted for about 48.6 percent (\$922 billion) of consumption imports (\$1,899 billion) and about 29.2 percent (\$373 billion) of total exports (\$1,278 billion). In 2010, U.S. related-party trade increased by 23.6 percent (\$247 billion) while total trade increased by 21.9 percent (\$570 billion) from 2009.¹ Therefore, the related-party trade represents a fairly large percentage of U.S. trade. Related party transactions present various Customs appraisal issues. As explained below, these transactions are subject to rules to ensure that the relationship between the parties does not affect the price. For example, related parties often have formal intercompany policies in place for setting the price (i.e., the transfer price) and may provide for various adjustments to be made to the transfer price after importation.² This arrangement raises the issue of whether transaction value may be used, and, if so, how to treat the adjustments. As a result of pending requests claiming post-importation adjustments and the lack of consistent guidance on these issues, CBP has reviewed its current decisions regarding the use of transaction value to related party transactions and has determined that some changes are appropriate to properly address these transfer pricing concerns.

In HRL 547654, CBP determined that transaction value did not apply because the price was not considered to be fixed or determinable pursuant to an objective formula prior to importation. CBP found that at least one of the elements for determining the price was within the control of the buyer and/or the seller. After briefly considering the hierarchy of valuation methods set forth in 19 U.S.C. §1401a, CBP ultimately found that the goods could be appraised using the “fallback” method of valuation based on the related party price and that the adjustments could be reported (and claimed) to CBP through reconciliation, assuming that the related party price

¹ U.S. Census Bureau News, U.S. Department of Commerce, Washington, D.C. 20239, dated May 11, 2011. According to the report, “related party” trade includes trade by U.S. companies with their subsidiaries abroad as well as trade by U.S. subsidiaries of foreign companies with their parent companies. The definition of related parties for CBP appraisal purposes is even broader. See 19 U.S.C. §1401a(g) and Note 2.

² When transfer prices are established based on certain “transaction-based methods” (resale price, cost plus) or “profit based” methods (Comparable Profits Method, or Profit Splits), it is often the case that the related parties will make year-end adjustments to the transfer price to achieve transfer pricing objectives for tax purposes.

was an acceptable arm's length transaction. Thus, while transaction value was not allowed, HRL 547654 nevertheless allowed the importer to use actual costs and take into account any downward adjustments. Upon review of this matter, CBP is proposing to rule that even though the parties are related and certain costs may be within the control of the parties, if the transfer pricing policy is set before importation and is used by the parties, subject to certain factors, it may be considered an objective formula, so that the merchandise is appraised under transaction value. Under such circumstances, post-importation adjustments may be recognized.

Thus, pursuant to section 625(c)(1), Tariff Act of 1930 (19 U.S.C. §1625(c)(1)), as amended by section 623 of Title VI, this notice advises interested parties that CBP proposes to revoke Headquarters Ruling Letter ("HRL") 547654, dated November 8, 2001 (set forth as Attachment A), relating to transfer pricing and the acceptability of post-importation adjustments claimed pursuant to a formal transfer pricing policy. CBP is proposing that subject to certain factors, the transaction value method of appraisal will not be precluded when a related party sales price is subject to post-importation adjustments that are made pursuant to formal transfer pricing policies and specifically related (directly or indirectly) to the declared value of the merchandise. CBP is proposing that these adjustments, whether upward or downward, may be taken into account in determining transaction value. Additionally, under this proposal, importers that have such post-importation adjustments affecting the value of the imported merchandise must report the adjustments to CBP using Reconciliation.

Similarly, pursuant to section 625(c)(2), Tariff Act of 1930 (19 U.S.C. §1625 (c)(2)), as amended by section 623 of Title VI, CBP proposes to revoke any treatment previously accorded by CBP to substantially identical transactions. Any person involved with substantially identical transactions should advise CBP during this notice period. An importer's failure to advise CBP of substantially identical transactions, or of a specific ruling not identified in this notice, may raise issues of reasonable care on the part of the importer or its agents for importations of merchandise subsequent to the effective date of the final decision on this notice.

Accordingly, pursuant to 19 U.S.C. §1625(c)(1), CBP proposes to revoke HRL 547654 and any other ruling not specifically identified, to reflect the proposed changes according to the analysis contained in proposed HRL 548314, set forth as Attachment B to this document. Additionally, pursuant to 19 U.S.C. §1625(c)(2), CBP proposes to revoke any treatment previously accorded by CBP to substantially

identical transactions. Before taking this action, consideration will be given to any written comments timely received.

Dated: November 29, 2011

Sincerely,

MYLES B. HARMON,

Director

Commercial and Trade Facilitation Division

Attachments

[ATTACHMENT A]

HQ 547654

November 8, 2001

RR:IT:VA:547654 KDW

CHRISTOPHER E. PEY
COUDERT BROTHERS
1114 AVENUE OF THE AMERICAS
NEW YORK, NY 10036-7703

RE: transfer pricing, transaction value, related parties, reconciliation, post importation price adjustments

DEAR MR. PEY:

This is in response to your letter dated February 10, 2000, filed on behalf of [****] (“E”) requesting a prospective ruling regarding transfer prices on imports from related vendors, [****] and [****] (collectively referred to herein as “S”). Per your letter dated April 19, 2001, we have reviewed your request for confidentiality pursuant to section 177.2(b)(7) of the Customs Regulations chapter 19, with respect to the information submitted. As that information constitutes privileged or confidential matters, it has been bracketed and will be deleted from any published versions.

FACTS:

E imports and distributes [****] products from its related vendors. Since the parties are related, E uses a transfer price to report its transaction value to Customs. E states that the prices for the imported goods are negotiated between it and S on an annual basis as set forth in its [*****] Policy. An English translation of the Policy was submitted for our review. The policy applies to all but two of the product lines imported by E, [*****]. E claims that the policy ensures it will earn enough to cover its costs and incur a reasonable profit, similar to a third-party distributor. Further, E states that the policy aims to result in a price similar to that of unrelated parties.

Currently, E’s transfer price and reported transaction value is calculated by subtracting the following from the anticipated resale price in the United States: transportation costs to the United States, U.S. customs duties, fixed costs of E’s U.S. operations, and E’s profit. E states that its current prices under the Policy provide a valid basis for appraisal using transaction value even though the parties are related. Further, E asks that we assume for purposes of this ruling, that the policy ensures that E earns a reasonable net profit comparable to other unrelated third-party distributors.

S wishes to change its billing system [*****]

*]. Under the current system, variations in sales prices and volumes require frequent management intervention in order to cover fixed costs and achieve the requisite profit. S proposes to change its calculations by deferring certain deductions from the resale price until after the actual resale in the United States. Under those circumstances, E will make entry at the resale price less freight costs, customs duties and E’s profit. The deduction for E’s U.S. fixed costs will occur after resale in the United States. Entries from all shipments to the United States between S and E would be flagged for reconciliation with

Customs. For those costs not known at the time of entry, i.e. E's fixed costs in the United States, E proposes to file reconciliation entries with Customs to adjust its prices for the actual costs quarterly. As part of the quarterly reconciliation filing, the sum of the fixed cost would be allocated by product group to individual shipments made during the quarter based on the ratio of fixed costs to sales for each product grouping.

E states that the new method would not amend or alter the current policy. Also, E states that the new method arrives at the same budgeted prices and profits, but in a more predictable way. E anticipates that the new method will require less managerial intervention, and will eliminate the need for price adjustments each time selling prices or sales volumes fluctuate. E believes that there will ultimately be no change in the overall amount of duties paid to Customs with the new method. Lastly, E claims that customs should consider the transfer price for the imported merchandise under the contemplated method an acceptable transaction value.

ISSUE:

- 1) Is the proposed transfer price acceptable for purposes of transaction value?
- 2) If not, what is the appropriate method of appraisement?

LAW AND ANALYSIS:

As you are aware, merchandise imported into the United States is appraised in accordance with section 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 (19 U.S.C. 1401a; TAA). The preferred method of appraisement of imported merchandise for customs purposes is transaction value.

Transaction value is the price actually paid or payable for the merchandise when sold for export to the United States, plus certain enumerated additions. 19 U.S.C. 1401a(b)(1). The term 'price actually paid or payable' means the total payment (whether direct or indirect, and exclusive of any costs, charges, or expenses incurred for transportation, insurance, and related services incident to the international shipment of the merchandise from the country of exportation to the place of importation in the United States) made, or to be made, for imported merchandise by the buyer to, or for the benefit of, the seller. 19 U.S.C. §1401a(b)(4)(A).

In determining transaction value, the price actually paid or payable is considered without regard to its method of derivation. It may be the result of discounts, increases, or negotiations, or may be arrived at by the application of a formula, such as the price in effect on the date of export in the London Commodity Market. The word "payable" refers to a situation in which the price has been agreed upon, but the actual payment has not been made at the time of importation. 19 CFR § 152.103(a).

Pursuant to section 402(b)(2)(A)(iv), the transaction value of imported merchandise shall be acceptable *only if* the buyer and the seller are not related, or if the buyer and the seller are related, the transaction value is acceptable under section 402(b)(2)(B). In this case, we are asked to assume that the current transfer pricing method yields an acceptable transaction value. We note that the provisions of the Policy alone would not satisfy the tests in 402(b)(2)(B). Thus assuming you can otherwise substantiate the original transfer price consistent with one of the related party tests set forth

in 402(b)(2)(B), we turn our analysis to the proposed change in billing for adjustments to the price and whether those adjustments would alter the applicability of transaction value.

In this case, the proposed transfer price is ultimately contingent on the final costs incurred by E for sales in the United States, [*****]. E proposes that it make quarterly adjustments to Customs through the reconciliation program after it has finalized its fixed costs in the United States. No formula for the proposed adjustments is provided for in the Policy or in your description of the pricing structure. We have consistently held that where the price is not fixed at the time of importation or determinable by an objective formula agreed upon prior to importation, transaction value is not applicable.

In a case similar to this, Headquarters Ruling Letter (“HRL”) No. 545242, dated April 16, 1996, we found that a price, derived by factors controlled by the parties and determined after importation, was not “fixed” at the time of importation of the merchandise. In HRL 545242, as here, the price for the goods was arrived at pursuant to a methodology that included an initial sum subject to adjustments. Customs concluded that the parties to the agreement knew the pricing structure took into consideration possible, if not probable, price adjustments due to changing conditions and market pressures existing in the U.S. automobile industry. However, the control by the parties as to whether and to what degree the price was to be adjusted in response to changing competitive pricing conditions, could not be considered a “formula” within the meaning of 19 C.F.R. §152.103(a)(1). Accordingly, transaction value did not exist. *See also* HRL 545618, dated August 23, 1996.

Here, although the elements of the proposed transfer price appear to be the same as those in the current transfer price, the proposed price is not fixed or determinable by some formula at the time of importation. Accordingly, the use of transaction value is precluded for the proposed billing structure, and we move to the succeeding alternate methods of appraisement for the imported merchandise in the hierarchy provided under 19 U.S.C. § 1401a(b) through (e). However, we have insufficient information to determine whether the alternate methods set forth in those provisions would be acceptable. Therefore, we find that the merchandise may need to be appraised under 402(f) of the TAA (19 U.S.C. § 1401(a)(f)) using a modified transaction value approach. This will allow the use of the importer’s figures through reconciliation. Again, our finding is based on the assumption that the former transfer pricing structure as well as the proposed structure yields a price that meets one of the related party tests. We are not ruling on the acceptability of the price itself.

HOLDING:

As set forth above, the proposed method for the transfer price does not yield a transaction value. A modified transaction value based on the provisions of 402(f) of the TAA (19 U.S.C. § 1401a(f)) could be an acceptable method of appraisement. For information or clarification regarding the use of Customs Reconciliation Program you may contact the Reconciliation Team at 202–927-ext. 0915, 0032, or 2293.

Sincerely,
VIRGINIA L. BROWN
Chief,
Value Branch

[ATTACHMENT B]

HQ W548314

OT:RR:CTF:VS W548314 YAG

CATEGORY: Valuation

PORT DIRECTOR

PORT OF CHAMPLAIN

U.S. CUSTOMS AND BORDER PROTECTION

198 WEST SERVICE ROAD

CHAMPLAIN, NEW YORK 12919

RE: Transaction Value; Formulas; Post-Importation Adjustments; Revocation of HRL 547654

DEAR PORT DIRECTOR:

This is in reference to Headquarters Ruling Letter (“HRL”) 547654, dated November 9, 2001, regarding the valuation of certain bulk chemicals. The Importer requested reconsideration of HRL 547654 in an internal advice request forwarded by your office. We have reconsidered HRL 547654 and determined that the methodology for determining the transfer price at issue constitutes an objective formula for purposes of determining transaction value and claiming post-importation adjustments. For the reasons set forth below, we hereby revoke HRL 547654.

FACTS:

HRL 547654 determined that there were bona fide sales between the Importer and the Sellers. As discussed in HRL 547654, the related party Importer and Sellers used a transfer price to report the transaction value to U.S. Customs and Border Protection (“CBP”) which was calculated by subtracting: transportation costs to the U.S., U.S. Customs duties, fixed costs of the importer’s U.S. operations, and the importer’s profits from the anticipated resale price in the U.S. Because of variations in sales prices and volumes, frequent managerial intervention was needed to cover fixed costs and achieve the requisite profit amongst the related parties. Therefore, the related party Sellers proposed to change the calculation of the transfer price by deferring certain deductions from the resale price until after the actual resale in the U.S. Under those circumstances, the Importer made entry at the resale price less freight costs, customs duties, and the Importer’s profit. The deduction for the Importer’s U.S. fixed costs would occur after resale in the U.S. Entries from all shipments to the U.S. between the Seller and Importer were flagged for reconciliation with Customs. For those costs not known at the time of entry (*i.e.* the Importer’s fixed costs in the U.S.), the Importer proposed to file quarterly reconciliation entries with Customs to adjust its prices for the actual costs. As part of the quarterly reconciliation filing, the sum of the fixed costs would be allocated by product group to individual shipments made during the quarter based on the ratio of fixed costs to sales for each product grouping. In HRL 547654, CBP held that transaction value did not apply because the price was not fixed or determinable pursuant to an objective formula prior to importation. CBP found that the price was within the control of the buyer and/or the seller.

Subsequent to the receipt of the ruling, the Importer sought advice concerning the application of the ruling to its pending entries, and further

information was provided. The company's "Intercompany Transfer Pricing Determination Policy," dated February 11, 2000, translated into English, was submitted to show how its inter-company prices are determined. On April 18, 2006, the Importer provided CBP with its complete Transfer Pricing Determination Policy, prepared for tax purposes.¹ In this case, the company's Transfer Pricing Determination Policy was prepared by its tax department.

The company's Transfer Pricing Determination Policy established a system for the calculation of the transfer price and the distinction between the variable and fixed costs. In pertinent part, the transfer pricing calculation for directly delivered sales between the Importer and Seller is established as follows:

Transfer price for a sale between the Importer and Seller = Sales price to the U.S. customer (net of cash customer discount and forecasted rebates)² minus variable costs and a percentage of margin.

The transfer pricing policy states that the absorption of variable costs takes into account the following (which are deducted from line 01 of the Analytical Income Statement ("AIS"))³:

- Post invoice adjustments (including credit notes for quality, sale price adjustments, claims. . .), which will rarely occur,
- Customer discounts, and
- Variances between the rebates used to calculate the transfer prices and actual costs.

According to the policy, none of the variable costs and profits (including the unknown forecasted discounts and rebates, which may be subject to value manipulation of the parties), are subject to any post-importation price adjustments. Therefore, the transfer price declared to CBP upon importation is fixed with respect to the application of the variable costs. Any fluctuations to the variable costs are not re-invoiced or remitted back to the seller/exporter.⁴ The company's Transfer Pricing Determination Policy established that fixed expenses in the U.S., for example, structural costs, depreciation and interest

¹ The Internal Revenue Service ("IRS") regulates transfer pricing for tax purposes through Section 482 of the Internal Revenue Code, 26 U.S.C. §482 and the Section 482 regulations. The tax rules for transfer pricing are based on the premise that a taxpayer is dealing with another party at arm's length. A U.S. taxpayer may obtain approval in advance of its transfer pricing methodology through an Advance Pricing Agreement ("APA"). An APA is a prospective binding agreement between the taxpayer and the IRS regarding the correct transfer pricing methodology under section 482. However, more often, multinational companies prepare their own transfer pricing studies based on section 482 principles to support their transfer pricing practices. Although not approved by the IRS, these transfer-pricing studies are used to support the company's transfer pricing methodology in the event of an audit. These transfer pricing studies can be prepared by accounting firms, or they can be prepared internally by the companies.

² The Importer's Transfer Pricing Policy provides that discounts and rebates, if any, are forecasted and taken into account prior to the importation of the merchandise.

³ The Analytical Income Statement ("AIS") is the income statement used to reflect the profit/loss of the business units. It is generated by the general ledger system. The information is accumulated for each business unit for the year and makes up the audited financial statements.

⁴ If there are any post-importation adjustments for a variable expense (such as in the rare instance when there is a change in business practice), these adjustments are borne by the Importer, and, therefore, do not affect the transaction value or the price actually paid or payable to the Seller.

on working capital, would no longer be deducted from the invoice accompanying a shipment to the Importer, but rather, would be separately invoiced and paid to the Importer on a monthly basis after importation. In other words, via reconciliation, the Importer seeks to report the actual, final amount paid to the Seller for the imported goods by reducing the value originally declared at the time of entry by the amount of fixed expenses paid by the Seller to the Importer. With the exception of the fixed costs, all elements of the transfer price are declared to CBP upon the importation; these elements are known, included in the value of the merchandise, and not subject to change.

For products to be warehoused by the Importer before resale, the transfer price is calculated as follows:

Transfer price for a sale between the Importer and Seller = Forecasted sales price ("FSP") minus logistic variable costs ("LVC") of the Importer minus actual or forecasted variable costs and a percentage of margin.

The Importer calculated the FSP to customers for each article taking into account the amount of sales net of cash customer discount and forecasted rebates. The Importer calculated LVC for each article from all forecasts relating to all sales ex-storage taking into account: variable transport costs from the warehouse to the customer (transportation cost plus insurance, duty, customs duty brokerage, variable storage), and variable transport costs from the producer to the warehouse (particularly the duties) incurred by the Importer. According to the policy, the absorption of the variable costs took into account:

- Post invoice adjustments (including credit notes for quality, sale price adjustment claims . . .), which will rarely occur, deducted from line 01 of the AIS
- Customer discounts, deducted from line 01 of the AIS,
- Logistic costs: storage costs, rental and maintenance of trucks and containers (line 07 of the AIS), and
- Variances between the forecast (rebates and variable logistic costs) used to calculate the transfer price, and the actual costs.

Once again, pursuant to the company's Transfer Pricing Determination Policy, none of these variable costs are stated to be re-invoiced or remitted back to the seller/exporter.

The company's Transfer Pricing Determination Policy directs that only monthly budgeted fixed costs, incurred in the U.S., are to be analyzed quarterly and adjusted prospectively, if needed. In other words, the transfer pricing policy included a procedure to quarterly verify the actual versus budgeted fixed cost amounts as well as an explanation for any possible variances. The policy defines fixed costs as the following items of the income statement:

- Selling expenses,
- Commissions received/paid (only the commissions paid to the sub-agents),
- General and administrative expenses,
- Miscellaneous income and expenses (except the income allocated to this item corresponding to fixed costs invoicing),
- Interest on working capital, and
- Depreciation of assets not directly attributable to manufacturing.

These fixed costs are allocated to the resale activity. On the other hand, as is stated above, variable costs and profits are not subject to any post-importation price adjustments, as fluctuations in variable costs are not remitted to the seller. Additionally, the Importer books its adjustments for the fixed cost reimbursement as "Other Income." The Importer applied for and was approved to participate in the Reconciliation Prototype Program.

The company also provided CBP with a copy of an inter-company memorandum, dated December 20, 1999, which sets out the following method to calculate the fixed costs: budgeted fixed costs (structural costs + depreciation + interest on working capital). The budgeted fixed costs are directly invoiced by 1/12 (based on the approved budget amount) and the income is allocated to line 31 of the AIS (miscellaneous income and expenses).⁵ This method is set in advance, and according to the new information submitted by the Importer, the amount of the fixed costs is known at the beginning of each year. The element that is not known at the time of importation is the level of total imports across which the fixed costs are allocated in a particular month. Therefore, the fixed costs paid are set; it is merely the allocation of those fixed costs to the individual import entries that cannot be fixed until after the month has passed.

The specified percentage of margin, referenced in the Company's Transfer Pricing Determination Policy, is calculated based on a study of comparable and available data, concerning sales in the uncontrolled market to allow a reasonable profit to be earned. The margin is confirmed as often as required by the U.S. transfer pricing regulations, by a joint external study of the importer's and exporter's finance departments. The Importer also submitted a transfer pricing study, dated September 20, 2001, prepared by PricewaterhouseCoopers, LLP, for CBP review, which was not provided to CBP at the time HRL 547654 was decided. This transfer pricing study further confirms the margin the Importer utilizes in establishing its transfer price. The Importer's transfer pricing study also determines the range of profit margins the Importer's profit must fall within in order for the transfer price to be at arm's length. If, depending on the level of imports across which the fixed costs are allocated, the allocation of fixed costs causes the Importer's profit to fall outside of the range, the Importer must make the necessary adjustments to bring its transfer price within the range to be at arm's length.

Although certain post-importation price adjustments may occur pursuant to the Policy, the Importer is of the view that transaction value may be applied because the price is determined pursuant to an objective formula in place prior to importation. The Importer is also of the view that annual price adjustments made pursuant to the Policy should be taken into account and that reconciliation should be used as the vehicle to make the adjustment. Finally, the Importer provided information and documentation in an attempt to establish that the related party price was acceptable under the circumstances of sale test, and to clarify the company's transfer pricing policy.

As indicated, the original ruling issued to the Importer determined that transaction value could not be applied because there was no fixed price or objective formula in place for determining the price prior to importation. In view of this finding, the ruling did not analyze the circumstances of the sale

⁵ This method is implemented by dividing the value of the particular import by the total "fixed costs" as reported on the Importer's income statement. The resulting ratio is multiplied by 1/12 of the total annual fixed costs to derive the amount of fixed costs allocated to a particular entry.

to determine whether the related party transaction value was acceptable or whether post-importation price decreases were precluded under 19 U.S.C. §1401a(b)(2)(2). Instead, after finding that the alternate methods of appraisal under 19 U.S.C. §1401a(b) through (e) were not applicable due to the unavailability of information, CBP appraised the merchandise under section 402(f) of the TAA (19 U.S.C. §1401a(f)), using a modified transaction value approach and permitted the Importer to use its figures through reconciliation.

ISSUES:

1. Does the related party price, determinable pursuant to the transfer pricing policy, constitute a formula at the time of importation for purposes of determining transaction value, and if so, is it acceptable to take post-importation price adjustments (upward and downward) into account in determining transaction value?
2. Do the circumstances of sale establish that the price actually paid or payable by the Importer/Buyer to the Exporter/Seller was not influenced by the relationship of the parties and is acceptable for the purposes of using transaction value?

LAW AND ANALYSIS:

Merchandise imported into the United States is appraised for customs purposes in accordance with Section 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 (TAA; 19 U.S.C. §1401a). The primary method of appraisal is transaction value, which is defined as “the price actually paid or payable for the merchandise when sold for exportation to the United States,” plus amounts for certain statutorily enumerated additions to the extent not otherwise included in the price actually paid or payable. *See* 19 U.S.C. §1401a(b)(1).

As provided in 19 U.S.C. §1401a(b)(4):

(A) The term “price actually paid or payable” means the total payment (whether direct or indirect, and exclusive of any costs, charges, or expenses incurred for transportation, insurance, and related services incident to the international shipment of the merchandise from the country of exportation to the place of importation in the United States) made, or to be made, for imported merchandise by the buyer to, or for the benefit of, the seller.

Section 152.103(a)(1), CBP Regulations (19 CFR §152.103(a)(1)) provides, in pertinent part, as follows:

In determining transaction value, the price actually paid or payable will be considered without regard to its method of derivation. It may be the result of discounts, increases, or negotiations, or may be arrived at by the application of a formula, such as the price in effect on the date of export in the London Commodity Market.

However, rebates, or any other decrease in the price actually paid or payable made or effected after the date of importation are to be disregarded for the purposes of determining transaction value. 19 U.S.C. §1401a(b)(4)(B).

1. Does the related party price, determinable pursuant to the transfer pricing policy, constitute a formula at the time of importation for purposes of determining transaction value, and if so, is it acceptable to take post-importation price adjustments (upward and downward) into account in determining transaction value?

Related party transactions involve initial transfer prices that may be subject to adjustment after importation. It is common for the transfer price to be determined in accordance with the company's transfer pricing policy/formula. The term transfer pricing policy refers to Advance Pricing Agreements ("APA"s), transfer pricing studies prepared in accordance with 26 U.S.C. §482 (the IRS transfer pricing statute) or its foreign equivalent, and/or legally binding inter-company agreements/memoranda. Oftentimes such policies provide the method for determining the transfer price, which may include the setting of an initial price and then making various adjustments to the price after the importation based on specified criteria. For example, the transfer pricing policy may provide for the transfer price to be initially set based on certain estimated costs and for adjustments to be made at the end of the year based on the actual costs incurred. Further, adjustments may be made to account for certain additional expenses that may be incurred by the parties. In some cases, the transfer pricing policy may provide for year-end "compensating adjustments" to the transfer price to comply with the requirements of an APA entered into by the U.S. party and the IRS. In other words, the adjustments are taken to bring the profit margins of the companies within the range of profit margins established on the basis of a study of comparable data from the uncontrolled market, in order for the transfer price to be at arm's length for tax purposes. Depending on the circumstances presented, such adjustments could similarly affect whether the price is considered fixed or determinable by an objective formula at the time of importation.

CBP determined that where the price is not fixed at the time of importation, transaction value is not applicable. *See e.g.*, HRL 545618, dated August 23, 1996; HRL 545242, dated April 16, 1995; HRL 545798, dated October 28, 1994; HRL 546231, dated February 10, 1997; and HRL 546421, dated March 27, 1998. CBP has determined that the fixed price rule is satisfied when the price is determinable by an objective formula agreed upon prior to importation. In applying this provision, CBP ruled in HRL 542701, dated April 28, 1982, TAA No. 47, and subsequent rulings, that in situations in which the price paid or payable is determined pursuant to a formula, a firm price need not be known or ascertainable at the time of importation, although it is necessary for the formula to be fixed at that time so that a final sales price can be determined at a later time on the basis of some event or occurrence over which neither the seller nor the buyer has any control. *See also* HRL 545622, dated April 28, 1994.

CBP has previously determined that if a transfer price is subject to post-importation adjustments and those adjustments are within the control of either the buyer or the seller, the formula exception to the fixed price rule would not apply. *See* HRL 544680, dated June 26, 1992 (CBP did not consider the parties' arrangement to be a "formula" because the final determination to make additional payments depended on a subjective factor within the control

of the importer, i.e., importer's inspection of the imported merchandise). *See* HRL 545388, dated October 21, 1994 (the parties entered into a supplemental agreement after the importation decreasing certain royalty payments; CBP found that this was a decrease in the price that was "made or otherwise effected...after the date of importation..." and should be disregarded).

In many cases, the events in the transfer pricing formula that trigger the post-importation price adjustments (for example, the costs incurred or the profit earned) are to some extent within the control of the buyer and/or the seller. Accordingly, based on these prior decisions, many transfer pricing policies would not qualify as formulas within the meaning of 19 CFR §152.103(a)(1). In those cases, transaction value determined under 19 U.S.C. §1401a(b) may not be applied, even if the relationship between the parties did not affect the price. This is not consistent with transaction value's being the preferred method of appraisal.

Further, when transaction value cannot be applied, the merchandise must be appraised using one of the other valuation methods in 19 U.S.C. §1401a. In a few cases, CBP has determined that when transaction value could not be applied because the transfer price was not "fixed," the merchandise should be appraised using a modified transaction value under the fallback method, e.g., HRL 545618, dated August 23, 1996; HRL 547654, dated November 8, 2001; and, HRL 544845, dated November 9, 1993. However, under the customs value law, the fallback method may only be used when all previous valuation methods cannot be applied. In HRL 545618, HRL 547654, and HRL 544845, CBP applied the fallback method of appraisal and permitted the importers to claim upward and downward post-importation adjustments because the information about the applicability of other methods was not available.

In HRL 547654, the price for the goods was arrived at pursuant to a methodology that included an initial sum subject to adjustments. The Importer provided CBP with limited details of the transaction and little documentation explaining the relevant transfer pricing policies. Thus, although there was a formula in HRL 547654 that determined the price prior to importation and allowed for certain post-importation adjustments, CBP found that the transfer pricing policy was not fixed and could not be considered an objective "formula" within the meaning of 19 CFR §152.103(a)(1) because the parties could control whether and to what degree the price would be adjusted. Accordingly, the use of transaction value was precluded for the proposed billing structure. However, CBP appraised the merchandise under section 402(f) of the TAA (19 U.S.C. §1401a(f)), using a modified transaction value approach and permitted the Importer to claim downward post-importation adjustments through reconciliation. While this analysis was consistent with CBP's interpretation at the time, we now conclude that notwithstanding that there may be some element of control, additional considerations should be taken into account in evaluating whether an intercompany transfer pricing formula is an objective formula when it provides for post-importation adjustments to the price.

After examining the additional submissions which have clarified the Importer's transfer pricing policy, CBP finds that the Importer's transfer pricing policy constitutes an objective formula. It is CBP's view that when analyzing whether transaction value may be used in a related party transaction, certain factors should be examined to determine whether there is a fixed price, pursuant to a formula. CBP is considering that since the following criteria were met, the company may use the transaction value method of appraisal.

ment: (1) a written “Intercompany Transfer Pricing Determination Policy,” which sets out how the transfer price is to be determined prior to the importation; (2) the importer/buyer is the U.S. taxpayer, and it uses its transfer pricing methodology in filing its corporate income tax returns; (3) the company’s transfer pricing policy specifically covers the products for which the value is to be adjusted; (4) the policy specifies what adjustments must be made to the transfer price, and the company provides detailed explanations and calculations of the adjustments incurred and claimed in the United States; and, (5) there is an absence of other conditions which may indicate that the compensating adjustments do not result in an arm’s length price between the parties.

We note that since the Importer claimed adjustments for the fiscal years 2001 and 2002, and the written transfer pricing policy was executed by relevant parties on February 11, 2000, the agreement, and thus, the formula was in effect prior to the importations subject to this internal advice request. We also note that the formula had an impact on the reported Customs values. Since the downward adjustments are reported in the Importer’s accounting books as adjustments to “Other Income” and are made quarterly,⁶ these adjustments specifically result in lower declared values for the merchandise. Such transfer pricing adjustments indirectly relate to the originally-reported price actually paid by the Importer to the related Seller (adjustments must, directly or indirectly, relate to the value of the merchandise). Changes must be declared to the value of the imported merchandise and be reported on a product-by-product, entry-by-entry basis. In this case, based on the information provided by the Importer, the related party price (and the adjustments thereto) is determined pursuant to their transfer pricing policy. The Importer provided CBP with documentation that showed what adjustments are made on an entry-by-entry basis; therefore, adjustments are related to specific entries upon importation. The transactions in question are not subject to antidumping/countervailing duty proceedings or type 03 entries. Also, the Importer does not allocate the compensating adjustments and claim such adjustments for merchandise partially damaged at the time of importation. Finally, the documents submitted by the Importer show how the adjustments are calculated and claimed. Specifically, only the budgeted fixed costs (and not the variable costs, absorbed by the Importer), incurred in the United States are adjusted after importation. None of the variable costs are stated to be re-invoiced or remitted back to the Seller/Exporter. On the other hand, the amount of the fixed costs is known at the beginning of each year and is set in advance, pursuant to the inter-company memorandum, dated December 20, 1999. The element that is not known at the time of importation is the level of total imports across which the fixed costs are allocated in a particular month. Therefore, the costs paid are set; it is merely the allocation of those costs to the individual import entries that cannot be fixed until after the month has passed. Taking into account the adjustments based on the fixed costs, the analysis undertaken by PricewaterhouseCoopers, LLP concluded that the Importer’s average profit ratio was within the range for comparable

⁶ The frequency of adjustments is one of the important factors that need to be examined in order to determine whether there is a fixed price, pursuant to a formula. Adjustments made on the yearly or quarterly basis are more acceptable than adjustments booked in lump sum at the end of the multi-year APA term (if applicable), for example. If the adjustments are made at the end of the term, the importers must show that such adjustments would not result in the importers being out of the transaction value for Customs purposes).

transactions by similarly situated companies and that the Importer's implementation of its transfer pricing policy conformed to the applicable U.S. laws and regulations.

While some of the provisions of the transfer pricing policy in this particular case might be considered to be within the "control" of the parties under the prior understanding of "control" in CBP's previous decisions, such as the initial determination of the budgeted fixed costs by the company, the factors set out above (and especially the fact that the amount of fixed costs is set in advance and later simply allocated to the individual imports) reduces the possibility of price manipulation and subjectivity in claiming post-importation adjustments. Further, the transfer pricing policy includes a procedure to quarterly verify the actual versus budgeted fixed cost amounts as well as an explanation as to any possible variances. Therefore, it is our opinion that in this particular case and based on the above referenced factors, the Importer's transfer pricing policy may be considered an objective formula in place prior to importation for purposes of determining the price within the meaning of 19 CFR §152.103(a)(1). Of course, no single factor is determinative, and CBP's finding with respect to whether an objective formula exists will be made on a case-by-case basis.

Therefore, CBP is of the view that post-importation adjustments (both downward and upward), to the extent they occur, may be taken into account in determining the transaction value under 19 U.S.C. §1401a(b). We find the downward adjustments in the transfer price made pursuant to the valid transfer pricing study are not rebates of, or other decreases in, the price actually paid or payable that are made or otherwise effected between the buyer and seller after the date of importation of the merchandise into the United States (*see* 19 U.S.C. §1401a(b)(4)(B)). Instead, the post-importation adjustments represent an element of the determination of the price actually paid or payable in accordance with 19 CFR §152.103(a)(1). Therefore, the post-importation adjustments made pursuant to the transfer pricing policy in this case simply reflect what should have been reported as the invoice price upon entry, had the exact price information of the imported merchandise been available at the time. Any such changes in the transfer price should be immediately reported to CBP.

In this particular case, the Importer uses reconciliation to report downward and upward post-importation adjustments to the value initially declared upon the importation of the merchandise. We find that the reconciliation program must be used to properly apply transaction value and account for the total value for the imported merchandise where a formal transfer pricing study, policy, or an APA allows for upward or downward post-importation adjustments that directly (or indirectly) relate to the value of the merchandise. Reconciliation allows companies to provide CBP with information not available at the time of entry summary filing and which is necessary to ascertain the final appraisement of imported merchandise. Furthermore, the reconciliation can be filed as late as 21 months from the date of the first entry summary filed under that reconciliation with extensions of time as available to importers. This flexibility makes reconciliation an ideal vehicle to declare all adjustments (upward and downward) within the timeframe allowed by in the APA or a transfer pricing study or policy. Thus, the

Importer should continue to report all of its adjustments to CBP via reconciliation. However, if circumstances change, the decision issued by CBP may no longer be valid.

Finally, we note that, in general, in order to claim adjustments, the Importer must be prepared to furnish its complete transfer pricing documentation to CBP upon request, including but not limited to documentation concerning the proposed adjustments.

2. Do the circumstances of sale establish that the price actually paid or payable by the Importer/buyer to the exporter/seller was not influenced by the relationship of the parties and is acceptable for the purposes of using transaction value?

Having established under the new approach that the Importer's transfer pricing policy constitutes a formula, despite the post-importation adjustments being within some control of the buyer and/or the seller, we must determine whether the imported merchandise can be appraised under transaction value. In order to use transaction value, there must be a bona fide sale for exportation to the United States. Several factors are relied on to determine whether a bona fide sale exists. See HRL 546067, dated October 31, 1996. In HRL 547654, the question whether there was a bona fide sale was not at issue. So, it is assumed that bona fide sales occurred. Furthermore, there are special rules that apply when the buyer and seller are related parties, as defined in 19 U.S.C. §1401a(g). Specifically, transaction value between a related buyer and seller is acceptable only if the transaction satisfies one of the two tests: (1) circumstances of the sale or (2) test values. See 19 U.S.C. §1401a(b)(2)(B); 19 CFR §152.103(l). While the fact that the buyer and seller are related is not in itself grounds for regarding transaction value as unacceptable, where Customs has doubts about the acceptability of the price and is unable to accept transaction value without further inquiry, the parties will be given the opportunity to supply such further detailed information as may be necessary to support the use of transaction value pursuant to the methods outlined above.

In this case, the Importer provided information regarding the circumstances of the sale. Under this approach, the transaction value between a related buyer and seller is acceptable if an examination of the circumstances of the sale indicates that although related, their relationship did not influence the price actually paid or payable. The Customs Regulations specified in 19 CFR Part 152 set forth illustrative examples of how to determine if the relationship between the buyer and the seller influences the price. In this respect, Customs will examine the manner in which the buyer and seller organize their commercial relations and the way in which the price in question was derived in order to determine whether the relationship influenced the price. If it can be shown that the price was settled in a manner consistent with the normal pricing practices of the industry in question, or with the way in which the seller settles prices with unrelated buyers, this will demonstrate that the price has not been influenced by the relationship. See 19 CFR §152.103(l)(1)(i)-(ii). In addition, Customs will consider the price not to have been influenced if the price was adequate to ensure recovery of all costs plus a profit equivalent to the firm's overall profit realized over a representative

period of time. 19 CFR §152.103(l)(1)(iii). These are examples to illustrate that the relationship has not influenced the price, but other factors may be relevant as well.⁷

Detailed information has been confidentially provided by the Importer's counsel regarding the Seller's sale price data for the imported products. In lieu of this information submitted by the Importer concerning the prices of the merchandise sold to the related and unrelated buyers around the world, which are established pursuant to the company's Transfer Pricing Determination Policy and further supported by the transfer pricing study, prepared by PricewaterhouseCoopers, LLP, CBP finds the examination of whether the transfer pricing study itself, prepared for tax purposes, satisfied the circumstances of the sale test, to be unnecessary. Counsel has submitted detailed charts including data from 2000 and 2001 pertaining to the Seller's global sales of the imported products. The charts show the name of the customer, the country, the material number and name, the quantity, and unit prices. In addition, the charts include the total volumes and value as well as the average per unit sales price. They also include a weighted average per unit sale price. The charts allow a comparable product-by-product comparison of export sales to the U.S. (both related and unrelated customers) with export sales to third countries. There are numerous examples of sales of identical products (identified by either material name or material number) at comparable unit prices to unrelated customers both in the U.S. and abroad. An examination of the data reveals that the price for a particular product can vary throughout the year even to the same customer. Counsel states that the reason for this is that sales prices are driven by market conditions of supply and demand. In particular, most of the imported products are price sensitive depending upon numerous factors such as the quantity of product purchased, the timing of the demand, and availability as to alternative sources. Other factors supporting the variance in pricing include whether the customer has a long term purchase agreement or whether a sale is merely a "spot purchase." The customers for such products are often in industries that are cyclical in nature and very sensitive to changes in general economic conditions. These fluctuating market conditions are reflected in the varying sales prices for these products. Notably, these price differences occur equally for sales to unrelated parties as well as to related parties. That is at times, the prices can be lower for sales to parties that are not related than the prices for sales to related parties.

Based on the Importer's explanation of the differences in prices between related and unrelated parties and detailed documentation submitted to CBP, we find that the related party prices are settled in a manner consistent with the way the seller settles prices in sales to unrelated buyers. Although CBP generally requires that the comparison sales to unrelated buyers be sales to buyers in the U.S., CBP will consider evidence regarding sales to unrelated buyers in other countries, provided the Importer presents an adequate explanation as to why it is relevant to the transactions at issue. In this instance, the Importer presented an adequate explanation as to why it is relevant to the transactions at issue and accounted for the differences in unit

⁷ The fact that the "fixed price" requirement has been satisfied based on the acceptance of the Importer's transfer pricing policy, prepared for tax purposes, as formula, does not mean that the circumstances of the sale test is satisfied. The Importer must show that the relationship has not influenced the price.

prices. The Importer also submitted price lists for the merchandise sold by the Seller to the unrelated parties in the United States. Thus, the Importer satisfied the circumstances of the sale test. Accordingly, transaction value is acceptable method of appraisalment in the instant case.

HOLDING:

Based on the above referenced factors, in this case the Importer's transfer pricing policy may be considered a formula in place prior to importation for purposes of determining the price within the meaning of 19 CFR §152.103(a)(1). Therefore, all adjustments (both upward and downward) made to the price pursuant to the Importer's transfer pricing policy and subject to certain considerations are to be reported to CBP to be taken into account in determining transaction value. Lastly, we find that the related party prices are settled in a manner consistent with the way the seller settles prices in sales to unrelated buyers.

Please note that this ruling is issued on the assumption that all of the information furnished in connection with the consideration of this matter, including the internal advice and reconsideration requests, is accurate and complete in every material respect. Further, the application of this decision is subject to the verification by the Office of Regulatory Audit should an audit be conducted.

This decision should be mailed by your office to the party requesting Internal Advice no later than 60 days from the date of this letter. On that date, the Office of Regulations and Rulings will make the decision available to CPB personnel, and to the public on the CPB Home Page on the World Wide Web at www.cbp.gov, by means of the Freedom of Information Act, and other methods of public distribution.

EFFECT ON OTHER RULINGS:

Headquarters Ruling Letter ("HRL") 547654, dated November 9, 2001, is hereby revoked.

Sincerely,

MYLES B. HARMON,
Director

Commercial and Trade Facilitation Division

**PROPOSED MODIFICATIONS AND REVOCATION OF
RULING LETTERS AND PROPOSED REVOCATION OF
TREATMENT RELATING TO THE TARIFF
CLASSIFICATION OF AIR FRESHENERS**

AGENCY: U.S. Customs and Border Protection, Department of Homeland Security.

ACTION: Notice of proposed modification of four ruling letters and revocation of one ruling letter and proposed revocation of treatment relating to the tariff classification of air fresheners.