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CASE STUDY 14.1

**USE OF TRANSFER PRICING DOCUMENTATION WHEN EXAMINING RELATED PARTY
TRANSACTIONS UNDER ARTICLE 1.2 (a) OF THE AGREEMENT**

Introduction

1. This document describes a case where Customs took into account information provided in a company's transfer pricing study based on the Transactional Net Margin Method (TNMM) when examining whether or not the price of imported goods had been influenced by the relationship between buyer and seller in accordance with Article 1.2 (a).

This case study does not indicate, imply, or establish any obligation on Customs authorities to utilize the OECD Guidelines and the documentation resulting from the application of the OECD Guidelines in interpreting and applying the WTO Valuation Agreement.

Facts of Transaction

2. XCO, a manufacturer in country X sells relays to its wholly-owned subsidiary, ICO, a distributor of country I. ICO imports the relays and does not purchase any products from unrelated sellers. XCO does not sell relays or goods of the same class or kind to unrelated buyers.
3. In 2012, ICO entered its goods using the transaction value, based on the price stated on the commercial invoice, which was submitted to Customs of country I. There is no indication that special circumstances exist as set out in subparagraphs (a) to (c) of Article 1 of the Agreement that would prevent the use of transaction value.
4. After importation, Customs in country I decided to review the circumstances surrounding the sale of goods between ICO and XCO, pursuant to Article 1.2 (a) of the Agreement, because it had doubts about the acceptability of the price.
5. The importer did not provide test values in accordance with Article 1.2 (b) and (c), as a means of demonstrating that the relationship did not influence the price.
6. In response to Customs request for additional information, ICO presented a transfer pricing study for the period 2011, prepared by an independent firm on behalf of ICO.
7. The transfer pricing study used the Transactional Net Margin Method ("TNMM") that, in this case, compared ICO's operating margin with the operating margins of functionally comparable distributors of goods of the same class or kind, also located in Country I, that conducted comparable uncontrolled transactions in the same period of time. The transfer pricing study was prepared in order to comply with the requirements of Country I tax regulations and applied principles contained in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of the Organisation for Economic Cooperation and Development ("OECD Transfer Pricing Guidelines"). The transfer pricing study covered all relays purchased by ICO from XCO.
8. Relevant data for ICO, taken from the company's financial records :

- Sales	100.0
- Cost of Goods Sold (COGS)	82.0
- Gross profit	18.0

- Operating expenses	15.5
- Operating profit	2.5
- Operating profit margin (benchmarked)	2.5% of sales

9. The transfer pricing study, using data taken from ICO's company records, indicated that ICO's operating profit margin on the sale of relays purchased from XCO was 2.5 percent in 2011.
10. The study concludes that it is possible to find reliable comparables for ICO and, accordingly, ICO was selected as the tested party in the transfer pricing study.
11. ICO's transfer pricing study had been reviewed by the Tax authorities of countries I and X in the context of negotiating a bilateral Advance Pricing Agreement (APA). An APA was subsequently agreed between ICO, XCO and the Tax authorities of countries I and X with respect to all transactions between ICO and XCO. While in review by the Tax authorities of countries I and X, ICO provided information showing that the profit margins it earns on the sale of its relays are generally the same as those made by independent distributors in the electrical apparatus and electronic parts industries.
12. In the transfer pricing study, eight distributors, unrelated to their suppliers, were selected based on the substantial similarity of their functions, assets and risks, compared to ICO.
13. Information concerning these eight distributors was taken for fiscal year 2011 for purposes of the comparison. The range of operating profit margins earned by these unrelated distributors was 0.64 to 2.79 percent, with a median of 1.93 percent. In the context of the APA negotiations, this range was accepted by the Tax authorities as an arm's length range of operating profit margins for transactions comparable to ICO's transactions with XCO. This arm's length range was established using the operating profit margins of the eight comparable companies, using the financial records of these companies available in public databases. ICO's operating profit margin was 2.50 percent, thus falling within the range. The 2.50 percent margin achieved by the importer in the country of importation was a function of : a) the price actually paid or payable by ICO to XCO, b) ICO's own sales revenue, and c) ICO's own costs.
14. It was determined that no adjustments prescribed by Article 8 of the Agreement were required to be made to the price actually paid or payable. Additionally, ICO did not make compensating adjustments for tax purposes for the year 2011.
15. ICO sets its selling prices in order to allow the company to earn an operating profit that meets the target arm's length (interquartile) range as set out in the transfer pricing study. The price paid or payable to XCO has not undergone significant changes over the year.

Issues for Determination

16. Does the transfer pricing study supplied in this case, prepared on the basis of the OECD Transfer Pricing Guidelines and used as the basis of a bilateral APA, provide information which enables Customs to conclude whether or not the price actually paid or payable for the imported goods is influenced by the relationship of the parties under Article 1 of the Agreement ?

Analysis

17. Under Article 1 of the Agreement, a transaction value is acceptable as the Customs value when the buyer and the seller are not related, or if related, the relationship does not influence the price. Where the buyer and seller are related, Article 1.2 of the Agreement provides two ways of establishing the acceptability of the transaction value when Customs have doubts concerning the price : (1) the circumstances surrounding the sale shall be examined to determine whether the relationship influenced the price (Article 1.2 (a)); or (2) the importer demonstrates that the value closely approximates one of three test values (Article 1.2 (b)). In this case, as indicated in paragraph 5, the importer did not provide test values therefore Customs examined the circumstances surrounding the sale.
18. The Interpretative Note to Article 1.2 of the Agreement provides that in examining the circumstances surrounding the sale, “the customs administrations should be prepared to examine relevant aspects of the transaction, including the way in which the buyer and the seller organize their commercial relations and the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price.”
19. Based on the information obtained from ICO, XCO does not sell the merchandise to unrelated buyers. Therefore, ICO is unable to demonstrate that the price was settled in the same manner as in sales to unrelated parties, specified in Note 1 to Article 1.2 (a) of the Agreement.
20. During its review of the circumstances surrounding the sale, Customs took into account the examination of information discussed in the transfer pricing study when determining whether the price had been settled in a manner consistent with the normal industry pricing practices under the Note to Article 1.2 (a). In this regard, the term “industry” includes the industry or industry sector that contains goods of the same class or kind (including identical or similar goods) as the imported goods.
21. Based on the information provided in Paragraph 8:
 - The Sales figure can be accepted since ICO is selling only to unrelated parties (and it is assumed ICO is rationally seeking to maximize its profits in its dealings with unrelated parties)
 - The Operating expenses amount has been examined and accepted as reliable since it is determined that these expenses are paid by ICO to unrelated parties, with ICO seeking to minimize its costs and these expenses have not been paid for the benefit of the seller
 - The transfer pricing study confirms that ICO’s operating profit margin is within the arm’s length range (i.e. based on a study of comparable, but independent (unrelated) distributors)
 - The Cost of Goods Sold of ICO reflects the price paid or payable to XCO and represents the transaction between ICO and its related party, XCO. This is the transfer price in question.

By working back from the arm’s length range of operating profit margins and the other accepted information set out above, it could be deduced that the transfer price is an arm’s length amount. This demonstrates that information relating to the transaction between ICO and unrelated distributors can be helpful and relevant to Customs when examining the circumstances surrounding the sale between XCO and ICO.
22. The functional analysis showed that there were no significant differences in functions, risks, and assets between ICO and the eight unrelated distributors. In addition, an adequate level of product comparability was observed. The comparable companies were chosen from the electrical apparatus, and electronic parts industries (companies that sell goods of the same class or kind as the imported goods). Thus, the operating profit margin on the resale of the

imported goods was shown to be generally the same as in the electrical apparatus and electronic parts industries.¹ Specifically, the transfer pricing study found that the arm's length range of the comparable companies' operating profit margins was 0.64 % to 2.79 %. As previously noted, ICO's operating profit margin was 2.50 %. Accordingly, since all the comparable companies sell goods of the same class or kind, the transfer pricing study supports a finding that the price between ICO and XCO was settled in a manner consistent with the normal pricing practices of the industry.

Conclusion

23. After examination of the circumstances surrounding the sale in respect of related party transactions between ICO and XCO, Customs concluded, including by analysis of a transfer pricing study based on the TNMM and additional information concerning operating expenses as deemed necessary, that under the provisions of Article 1.2 (a) of the Agreement, the relationship between the parties did not influence the price.
24. As indicated in Commentary 23.1, the use of a transfer pricing study for examining the circumstances surrounding the sale must be considered on a case-by-case basis.

¹ In this case, Customs accepted the operating profit margin as a more accurate measure of ICO's real profitability because it revealed what ICO actually earned on its sales once all associated expenses have been paid. Nevertheless, in certain circumstances, gross profit may be considered by Customs to illustrate the appropriately deducted associated expenses and the establishment of the accurate transfer price.