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Transfer Pricing Changes May Result in Potential Customs Tariff Opportunities in a COVID-19 Environment

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The seismic economic shock caused by COVID-19, including both demand and supply disruptions, is causing multinational corporations ("MNCs") to reassess existing transfer pricing ("TP") policies and consider making retrospective inter-company TP adjustments or additional payments. Different customs risks and opportunities exist depending on the direction of the TP adjustments or classification of any additional payments. In the current high-tariff environment—i.e., with tariffs as high as 25 percent on many imported goods—the customs duty cost implications can be significant.[1] This article highlights pertinent compliance and planning issues involved with these opportunities, which often require advance customs, accounting, and TP coordination and planning.

Impact on Related-Party Transactions and Transfer Pricing

COVID-19 has led to severe disruptions in MNCs' global supply chains and the demand for their products. A result of these disruptions is that many companies are experiencing unusual profit outcomes. A question that is arising in light of these unusual profit outcomes: Are the MNC's transfer prices still appropriate or should they be revised? This question comes up with particularly high

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[1] The terms "tariffs" and customs "duties" are used interchangeably in this article.

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frequency in the context of routine entities that earn profit margins or markups within target ranges (e.g., distributors, manufacturers, or service providers). The focus of this article is on routine distributors and manufacturers. However, it should be noted that the ideas discussed in this article may also be relevant for other types of entities, depending on the facts and circumstances.

Routine distributors within an MNC typically buy products from a related party (e.g., a principal company or manufacturer) for resale in a specific market. The terms of the intercompany relationship are established so the distributor performs a narrow range of functions and incurs limited operating risks. The related party seller, accordingly, performs the more high-value functions, manages the economically significant risks, and typically owns and exploits valuable intangible assets. Intercompany prices paid by the distributor are then set so that the distributor earns an expected profit margin within a targeted range. Because many local markets were severely disrupted by the COVID-19 crisis, many distributors are unable to maintain local sales volumes and/or incurred significant increases in operating costs. MNCs are considering whether they should institute retroactive price reductions for these distributors, thereby reducing their product costs (i.e., COGS) to bring the profits of these entities back in-line with the target margin ranges. The retroactive nature of the price reductions means that the importer (the distributor in this example) perhaps overpaid duties on the subject goods.

Routine manufacturers within an MNC's supply chain generally produce goods under contract for related parties. The intercompany pricing for the products manufactured and sold by the routine manufacturer is typically set so the manufacturer earns a markup over its total costs based on benchmarks established by comparable independent manufacturers. The TP policy may be implemented in different ways; a common approach is to sell the manufactured products at standard cost plus a markup and to true-up the result periodically or at year-end to equal the total actual cost of manufacturing plus the target markup. As a result of COVID-19 disruptions, many companies are finding that their actual costs per unit are significantly higher than their standard costs per unit due to underutilized capacity.

A question MNCs are facing is whether routine manufacturing entities should continue earning the target markups over total costs that were established before the downturn or if their prices should be revised. Companies are considering various approaches (e.g., continuing to true-up manufacturer profits as before, adjusting prices within existing benchmark ranges, changing benchmarks, or renegotiating prices). Depending on the approach chosen, the payment received by the manufacturer during the downturn could be in excess of the price it would have received solely from selling the manufactured goods in the market. While for TP purposes the entire intercompany payment is often loosely called payment for the manufactured product, it may be useful for customs purposes to be more precise in the classification of the payment received by the manufacturer. It may be possible to bifurcate the payment made to the manufacturer between the payment for manufactured product and the payment not related to the product that was actually manufactured and delivered (e.g., payment for unutilized capacity or extraordinary expenses).

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Simple Contract Manufacturing Example

Assume the standard cost of a product is $10 based on an expected production volume of 10 units. Further assume for simplicity that the entire $10 of standard costs are fixed costs. Also assume the arm's-length pricing policy is standard cost plus five percent. At full production, the contract manufacturer would be paid $105 ($10 x 10 units x 1.05) against costs of $100, earning $5 of profit.

Due to the COVID-19 crisis, however, the principal orders only six units from the contract manufacturer. The manufacturer would receive a payment of $63 ($10 x 6 units x 1.05) but would have unabsorbed costs of $40 ($10 per unit x 4 units), leaving it with a loss of $37. If the principal increased the price of the products actually produced and delivered to restore the contract manufacturer to full profitability, the per-unit price would rise to $17.50 ($105 / 6 units), a $7 per unit increase from the original price of $10.50 per unit—a substantial increase in the dutiable value of the manufactured product. But what if the unabsorbed costs could be reimbursed separately from an adjustment in the price of the products that were actually produced and delivered?

U.S. Customs Opportunity

Duty Refund Opportunity

From a customs perspective, retrospective compensating TP adjustments are generally considered to be part of the customs value of previously imported goods. The most common method of customs valuation ''transaction value'' is defined as ''the price actually paid or payable" for goods when sold for exportation to the United States, plus certain additional statutorily mandated costs. Thus, depending on the nature of the compensating TP adjustment, it may form part of the ''price actually paid or payable'' for previously imported goods.

With regard to downward compensating TP adjustments (i.e., payments from the exporter/seller to the importer/buyer), under U.S. Customs and Border Protection ("CBP") policy, importers must satisfy the following five criteria in order to be able to avail themselves of a duty refund for any corresponding decrease in customs value:

— A written ''Intercompany Transfer Pricing Determination Policy'' is in place prior to importation and the policy is prepared taking section 482[2] into account

— The U.S. taxpayer uses its TP policy when filing its income tax return, and any adjustments resulting from the TP policy are reported or used by the taxpayer in filing its income tax return

— The company's TP policy specifies how the TP and any adjustments are determined with respect to all products covered by the TP policy for which the value is to be adjusted

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[2] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

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— The company maintains and provides accounting details from its books and financial statements to support the claimed adjustments in the United States, and

— No other conditions exist that may affect the acceptance of the transfer price by CBP (e.g., the adjusted price must be at arm's length under the customs rules).

Alternatively, if upward-compensating TP adjustments are made (i.e., payments from the importer/buyer to the exporter/seller), generally there is an additional duty liability for the corresponding increase to the customs value of the imported good. However, depending on the facts and circumstances, it is possible that underlying supply-side losses or operating "shortfalls" can be more aptly addressed through an additional payment unrelated to imported goods, rather than via an adjustment to the price of goods (e.g., payments by the importer to compensate the seller/manufacturer for the importer's failure to purchase anticipated quantities, cancelled future purchase orders or contracts, and/or the manufacturer's underutilized production capacity). Thus, if the additional payment is for a purpose unrelated to goods actually imported, there may be an opportunity to potentially exclude the "shortfall" payment from the dutiable customs basis of imported goods, thereby avoiding unnecessary duty costs.

"Shortfall" or "Maintenance" Payment Exclusion

Based on the court's decision in *Generra Sportswear Co. v. United States*,[3] it is CBP's position that there is a rebuttable presumption that all payments made by the buyer to the seller (or to a party related to the seller) are part of the "price actually paid or payable" for imported goods. The importer thus bears the burden to establish that these payments are unrelated to the imported goods.

In *Chrysler Corp. v. United States*,[4] the importer did just that. The court determined that "shortfall" payments made by the importer to the manufacturer for failure to purchase the contracted number of engines, for the purpose of allowing the manufacturer to recover certain fixed costs related to production underutilization, did not relate to the purchase of imported goods but rather to goods *not purchased*.

The *Chrysler* decision is in-line with other U.S. customs letter rulings finding that certain payments to the seller/manufacturer for goods not purchased are not part of the "price actually paid or payable" or the "transaction value" of the imported goods. Examples of excluded payments include:

— Compensation for out-of-pocket expenses incurred due to the foreign seller's excess capacity, caused by a reduction in customer purchases

— Compensation for maintenance costs incurred by the seller for reserved but underutilized production capacity

— Payments for termination of supply contracts or cancellation of future purchase orders

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[3] 905 F.2d 377 (CAFC 1990).

[4] 17 C.I.T. 1049 (1993).

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A key attribute of these non-dutiable payments is that the compensation is *not* for imported goods, but rather is paid as a result of goods not being produced by, or purchased from, the seller. For instance, "shortfall" or "maintenance" payments are typically made to compensate the foreign seller for setting aside a certain amount of production capacity or making investments in order to properly satisfy the buyer's estimated or anticipated, but ultimately unfulfilled, purchase requirements. It is important to note that pricing formulas that change the base price of imported goods depending on the number of units purchased are distinguishable from excludable "shortfall" or "maintenance" arrangements. Generally, "shortfall" or "maintenance" arrangements are established through written agreements, accounting records, and the actions of the parties, indicating the payment is a form of penalty for goods not purchased, to be determined on a case-by-case basis. The more specific the terms of the agreement regarding the payment, the greater the likelihood the payment is excludable from customs value. Importers should be careful and precise in drafting the agreements because prices that are structured to be a function of the number of units purchased could end up resulting in dutiable payments. Where contractual terms are vague or non-existent, the importer may nonetheless seek a binding ruling from CBP with respect to prior imports, and should prospectively consider revising existing agreements to include explicit contractual terms that are favorable from a customs perspective.

The internal accounting methodology should also support the treatment of "shortfall" or "maintenance" payments as unrelated to the initial price of imported goods (e.g., payments are accounted for separately from the price of goods, as expenses, and not charged to the cost of goods in inventory accounts). "Shortfall" or "maintenance" payments that are booked on financial statements as cost of goods sold are unlikely to qualify as non-dutiable.

Additionally, the tax accounting classification of "shortfall" or "maintenance" payments made by U.S. entities as cost of goods sold or below-the-line deductions may have implications for the base-erosion and anti-abuse tax (BEAT), which should be evaluated. The applicability of recently issued regulations under section 263A concerning capitalization of costs to inventory for U.S. federal income tax purposes should likewise be evaluated in the context of the relevant facts and circumstances. Furthermore, one must establish that the payments are not capital contributions or similar non-deductible amounts.

It is also important to consider that payments made by the importer to the foreign seller for tooling or materials used in production of imported goods may, for customs value purposes, be apportioned over the anticipated production quantity rather than the actual quantity imported, thereby avoiding the potential overvaluation of imported goods and overpayment of duties. For example, in *Chrysler*, the court determined that tooling payments made by the importer to the manufacturer should be properly apportioned over the 181,423 engines that were anticipated to be produced rather than over the 28,577 engines that were actually imported.

These opportunities are important to keep in mind where there is a significant shortfall between anticipated and actual production quantities (e.g., due to economic COVID-19 disruptions).

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