Indirect Tax Alert

CJEU issues ruling on determining transaction value for customs valuation

Executive summary

On 20 December 2017, the Court of Justice of the European Union (CJEU) issued its decision in the Hamamatsu case (C-529/16) dealing with the question of whether a transfer price (TP) subject to retroactive price adjustments can be used as the basis for the “Transaction Value” (TV) method to determine the customs value. In this groundbreaking decision, the CJEU ruled that European Union (EU) customs law does not permit an agreed transaction value, composed of an amount initially invoiced and declared and a retroactive adjustment made after the end of the accounting period, to form the basis for the customs value, when it’s unknown at the time of import whether that adjustment would be made up or down at the end of the accounting period.

The ruling of the CJEU could have considerable impact for businesses with intercompany EU-import transactions as the CJEU seems to put the TV method under fire. It seems that the TV cannot be easily applied if the value of an intercompany EU-import transaction is based on a TP which is subject to a periodic adjustment. Further, year-end adjustments, both upwards and downwards, can no longer be taken into consideration for determining the customs value.

The ruling is subject to different interpretations as summarized in this Alert.
Detailed discussion

Background
For decades, the question regarding the impact of retroactive TP adjustments on determining the customs value has been debated. Given the lack of any EU legislation or case law there has been legal uncertainty on this issue and the EU Member States have taken divergent views. While some national courts denied the refund of import duties on account of a downward TP adjustment, others allowed this. However, across the EU, there was no doubt in the minds of customs authorities that upward adjustments should lead to additional payments of import duties.

The present case is about a customs duty refund application filed by Hamamatsu Photonics Deutschland GmbH (Hamamatsu Germany) which is a subsidiary of Hamamatsu Photonics Japan (Hamamatsu Japan). Hamamatsu concluded an Advance Pricing Agreement (APA) with the German and Japanese tax. The APA covers transactions between Hamamatsu Germany and Hamamatsu Japan of goods imported in the EU.

Under the APA, the transactions must meet the arm's-length standard. In other words, the pricing of such transactions must reflect the pricing that would have occurred between two non-related parties. At the end of the accounting period (year-end), the initially used TP is adjusted if the actual operating margin would fall outside that range a “year-end” adjustment would follow to the upper or lower limit of the range.

The customs value of the goods imported by Hamamatsu Germany is being based on this initially determined TP. The applicable import duty rate of the goods imported by Hamamatsu Germany varied between 0% and 6.7%. At 2010 year-end, the Hamamatsu group realized that the operating margin of Hamamatsu Germany was less than the benchmarked range. Therefore the TP was retroactively adjusted downwards so that the operating margin of Hamamatsu Germany for the year 2010 came within the benchmarked range. Following the adjustment, Hamamatsu Germany filed a request for repayment of overpaid import duties. The amount of the repayment was calculated as per the following method:

$$\text{Repayment amount} = \frac{(\text{initially used customs value} \times \text{average import duty}) - \text{corrected customs value} \times \text{average import duty}}{\text{corrected customs value} \times \text{average import duty}}$$

The German customs authorities rejected the request, based on the argument that the total amount of the repayment was not allocated by the type of goods.

Hamamatsu appealed against the decision of the customs authorities in the Finanzgericht München i.e., the Financial Court, Munich, Germany (the Court). The Court was of the view that the “final” TP between the parties is based on the arm's-length principle of the Organisation for Economic Co-operation and Development, however the price declared at the time of import is provisional and subject to final TP adjustment. Therefore such a price is fictitious and cannot be used as the TV for customs valuation purposes. In view of this, the Court stayed the proceedings and referred the following preliminary questions to the CJEU for a preliminary ruling:

1. Can a transfer price be used to determine the customs value if the transfer price is adjusted at the end of the year, regardless of whether the year-end adjustment leads to a refund or additional payment of import duties?
2. If so, may the customs value be reviewed and/or determined using simplified approaches where the effects of subsequent transfer pricing adjustments (both upwards and downwards) can be recognized?

The CJEU's decision in the Hamamatsu case
The CJEU referred to its case law to iterate that the customs value should primarily be based on the TV of the imported goods and only if such value cannot determined at the time of import, should alternative methods of valuation be used.

The CJEU further stated that the TV should reflect the economic value of the goods at the time the goods are being declared for free circulation and take into account all elements of that goods which have economic value (for example, selling commissions, transport costs and royalty and license fees).

After the goods have been released for free circulation, the TV value may be adjusted only in certain specific circumstances such as an adjustment made by the seller with respect to defective goods. The CJEU therefore held that there is no legal basis to allow other adjustments (such as TP correction) to determine the customs TV.

The CJEU continued by stating that the EU customs law does not impose an obligation on the importer to take other types of corrections into consideration. In other words, the provisions of EU customs law do not require importers to revise the TV in the case of a downward adjustment and
neither does it provide an obligation on the importer to make an upward adjustment. Moreover, the CJEU ruled that the importer is not even allowed to take the downward or upward adjustment into consideration for determining the TV.

The CJEU ruled with regard to the first question that EU customs law does not permit an agreed TV, 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.

In other words, the TV cannot be based on a TP, which is partly based on an amount initially invoiced and declared, and partly on, at the time of import, an unknown year-end adjustment.

**Analysis: Multiple interpretations possible**

The ruling of the CJEU is short and does not include an in-depth analysis of the convergence between transfer pricing and customs valuation. It can be read as putting the TV method under fire in cases of a TP which can be adjusted retro-actively. However, it can also be read as a rejection of the view that there is a connection between customs valuation and transfer pricing.

This is notable as this ruling would appear to be contrary with the view that the World Customs Organisation (WCO) expressed in the WCO Guide to Customs Valuation and Transfer Pricing published in 2015. In this report, the WCO calls for further alignment between transfer pricing and customs valuation as the WCO found arguments to point out that the two may influence each other.

However, it should be noted that to apply the TV method in intercompany import transactions, it should be proven to the satisfaction of the customs authorities that the price is not influenced by the relationship between buyer and seller of the imported goods. The EU customs law requires importers to analyze whether the price has been influenced based on a so-called “test-values.” In practice, however, transfer pricing documentation is used to provide such evidence. In that respect, the ruling of the CJEU appears to run counter to conclusions adopted by the WCO in Case Studies 14.1 and 14.2.

WCO’s Case Studies 14.1 and 14.2 address the situation where an intercompany import transaction takes place and the importer takes into account transfer pricing information in the course of verifying the customs value.

In short, on the basis of Case Study 14.1, the importer may, in some cases, provide this evidence by handing over a transfer pricing study. The ruling of the CJEU, however, to disallow the use of a customs value that is based on a TP which can be retroactively adjusted after year-end.

Case Study 14.2 concludes that by not applying a compulsory compensating adjustment, the transfer pricing study demonstrates that an arm’s-length price did not result. Consequently, the importer is precluded from using TV. However, the CJEU rules in the Hamamatsu case that EU customs legislation does “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.”

There appears to be no conclusive interpretation of this judgment of the CJEU. However, in the situation where at import a TP is being used as the TV with retroactive year-end adjustments possibly taking place later, the two most likely interpretations are as follows:

- The CJEU is of the opinion that the initially reported customs value is the TV and that retroactive adjustments, be it downwards or upwards, cannot be applied.
- Or

  - The CJEU is of the opinion that the initially reported customs value should be rejected (because it possibly can be adjusted retroactively at year-end) and therefore Hamamatsu should avail itself of one of the other customs valuation methods (not being TV).

**Implications**

The ruling of the CJEU may have major impact on businesses with international supply chains to the EU and currently using a TP with possible retroactive adjustments. It creates uncertainty for these businesses, since it is not clear how the ruling should be interpreted. For that reason, businesses should review and assess their current transfer pricing policy and price adjustment mechanism to determine whether they are potentially affected by the ruling.
As mentioned, the ruling is unclear. However, at this point of time, businesses should take into account the following consequences of the decision:

- Customs authorities are no longer permitted to require the importer to adjust its customs value based on an upward transfer pricing adjustment.
- Businesses are no longer allowed to adjust their initially declared customs value based on a downward transfer pricing adjustment.
- Customs valuation rulings covering agreements about how retroactive transfer pricing adjustments should be taken into account, need to be assessed to see whether they remain valid.
- Customs authorities potentially will follow an interpretation of the ruling resulting in a demand that an alternative valuation methodology is used instead of the TV method.
- Business may explore the option of dynamic pricing based on continuous and prospective TP adjustments.

Endnote

1. Transaction value is defined as the price actually paid or payable for the goods when sold for export to the customs territory of the European Union, adjusted, where necessary.
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