



The Indian Journal for Research in Law and Management

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Editor-in-Chief – Prof. (Dr.) Muktai Deb Chavan; Publisher – Alden Vas; ISSN: 2583-9896

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Customs valuation and transfer pricing – different valuations for the same transaction?

Globalization has brought along with it various taxation issues, the most talked about being, transfer price of goods being traded amongst enterprises forming part of a same business group ('related entities').

The price at which related entities transact is of significance to both taxpayers as well as revenue authorities.

While the Customs Authorities monitor the transaction price between related entities to ensure that price is not understated so as to reduce the duty payable on importation of goods, the Income-tax Authorities, through their Transfer Pricing wing, examine the transaction price to ensure that the profit as well as the tax payable on the profit earned from the goods imported is not understated.

Similarities & differences between customs valuation and transfer pricing

Similarities

The similarity between customs valuation and transfer pricing methodologies is that the **objective** of both is to establish whether or not the price at which the transaction has been entered into has been **influenced by the relationship** between the parties entering into the transaction. Further, there are broad similarities in the methods laid down in the Customs Valuation Rules and the Income Tax Act.

For instance, the RPM under the Income Tax Act¹ can be correlated to the Deductive value method DVM² prescribed under the Customs Valuation Rules as both consider the

¹ Section 92C(1) of the Income Tax Act read with Rule 10B(1)(b) of the Income Tax Rules

² Rule 7 of the Customs Valuation Rules

sale price of the imported goods to unrelated party as the starting point and **work backwards** to arrive at the comparative price/ value.

Dissimilarities

However, there are **dissimilarities** between the customs and transfer pricing regulations. Some of the key differences are outlined below:

- While selecting CUT for carrying out the comparability analysis under the TP regulations, one of the essential parameter to be considered is the functions performed, assets employed and risks assumed ('**FAR**') by each of the parties in relation to the international transaction³. The arm's length price evaluation seeks to ascertain if the parties involved in the transactions are **compensated adequately** keeping in view the FAR analysis. However, FAR analysis is not a parameter under the Customs Valuation Rules while ascertaining the transaction value under any of the methods specified therein.
- The TP regulations permit carrying out **economic adjustments** such as working capital adjustments, capacity utilization adjustments etc⁴ between the transactions being compared. Customs Valuation Rules also permit adjustments but **specific adjustments** are permitted such as *commission/ brokerage, cost of containers, cost of packing etc.* Where there is more than one price, the TP provisions permit the use of **arithmetic mean⁵/ range** (35th and 65th percentile where six or more comparable prices are available)⁶ while determining the arm's length price. However, Customs Valuation Rules, permits use of **lowest value** under the transaction value of identical or similar goods methods⁷.
- TP provisions permit use of **multi-year data** of CUT where the data for the current year is unavailable⁸. The Customs Valuation Rules specify in respect of transaction value of identical goods and similar goods methods that use the transaction value of

³ Rule 10B(2) of the Income Tax Rules

⁴ Rule 10B(3) of the Income Tax Rules

⁵ Proviso to Section 92C(2) of the Income Tax Act

⁶ Rule 10CA(4) of the Income Tax Rules

⁷ Rule 4 and Rule 5 of the Customs Valuation Rules

⁸ Rule 10B(5) of the Income Tax Rules

identical or similar goods imported at or about the **same time** as the goods being valued can be considered.

The conflict

The fundamental difference that is observed to be arising between customs and income tax authorities is that on one hand the customs authorities seek to **increase the value of the imported goods** (as the higher the value of the goods imported the higher the customs duty liability) while on the other hand the income tax authorities are aggressive in **decreasing the value of imported goods** through transfer pricing adjustments (lower transfer price will result in higher taxable profits in India).

Indian perspective of the conflict

The conflict between Customs Valuation and Transfer Pricing regulations was subject matter of discussion in a few appeals before the Income-tax Appellate Tribunal. The facts giving raise to the appeals and the observations of the Tribunal have been summarized below;

(i) *Rayban Sun Optics India Ltd*⁹ ('Rayban')

Rayban was engaged in the business of importing and re-selling sunglasses and prescription frames in India. It had aggregated its international transactions under the Transactional Net Margin Method ('TNMM') and determined the same to be at arm's length.

During the assessment proceedings, the Transfer Pricing Officer ('TPO'), based on an order of the Assistant Commissioner of Customs, noticed that the raw materials purchased by the Rayban from its AEs in Italy were procured by the AEs from third parties in Italy.

The TPO observed from the order that the price at which Rayban purchased the goods from the AEs were **substantially higher** than the uncontrolled prices at which the raw materials were procured by the AEs from the third parties in Italy.

After considering an average margin of **11.75%** indicated to be earned by AE in the customs authority's order, the TPO determined the arm's length price of the raw materials

⁹ ITA No. 4203/Delhi/2010

imported by the Rayban by reducing the margin of 11.75% from the value of the international transaction.

On appeal, it was observed by the Tribunal that the assessee had taken **conflicting stands** before the customs authority and Income-tax Authorities. Given **the existence of trade in identical products**, the Delhi Tribunal upheld that Comparable Uncontrolled Price ('CUP') method would be the most appropriate method to determine arm's length price of the import of raw materials.

The Tribunal however rejected the TPO's action of applying the margin of 11.75% for computing arm's length and stated that the TPO had not compared price charged in a CUP with price paid by the assessee. Therefore, the Tribunal restored the matter to the file of the TPO to re-determine arm's length price under CUP method as per the TP provisions.

From the above decision, one may observe that the price at which the AE purchased the raw material may not be comparable to the price at which the raw materials were procured by the Indian entity. This is because, the AE would be performing **functions of a distributor** such as identifying appropriate suppliers, verifying quality of the raw materials based on Indian entity's requirements, negotiating with the suppliers on the price, placing orders with the suppliers and ensuring timely delivery of the raw materials to the assessee.

Under TP regulations, **FAR analysis is critical** as it aids in ascertaining the functions performed and risks assumed and accordingly evaluating if the remuneration earned by the AE is commensurate with the functions performed and risks assumed.

Therefore, in this case, the AE would be incurring expenses in relation to its functions and these would be factored in the selling price to the assessee along with a reasonable markup to compensate for its business operations.

In view of this, a comparison of the AE's purchase price to the Indian entity's purchase price would not hold true due to the functions performed by the AE in relation to the purchase of raw materials.

However, as mentioned earlier, under the Customs Valuation Rules, FAR analysis is not recognized as a parameter for the comparability analysis. Therefore, there would arise circumstances wherein a comparable uncontrolled price which may be acceptable under the Customs Valuation Rules which may not hold good as an appropriate comparable uncontrolled price under the TP regulations.

(ii) *Panasonic India (P) Ltd*¹⁰ ('Panasonic')

Panasonic contended that the import of raw materials from AEs were based on valuation accepted by Special Valuation Bench **SVB** of Customs department and therefore the valuation made by the customs authorities should be **guiding factor** for TPO while making adjustment on account of arm's length price. The Delhi Tribunal was of the view that where specific rules of law exist in the Statute on a particular subject, then they would hold the field. The Delhi Tribunal also held that **Chapter X and Rules** made thereunder are a self-contained code and answers to all questions must be found in the written law contained in the Act and Statute. Thus, the Delhi Tribunal held that Customs valuation is for **different purposes** and Chapter X of the Income Tax purposes are for different purposes and different criteria are being used.

Similarly, in the case of *Serdia Pharamaceuticals (India) Private Limited*¹¹, *Mobis India Limited*¹² and *Fuchs Lubricants (India) Pvt Ltd*¹³, the Mumbai and Chennai Tribunals have held that the valuations made by Customs authority cannot be considered for transfer pricing purposes as the valuation as per the Customs Rules are not relevant for transfer pricing under the Income Tax Rules.

However, the Chennai Tribunal in the case of *Coastal Energy Pvt Ltd*¹⁴ chose to depart from the above views. The taxpayer in this case had imported 1,000 MT of coal from its AEs at a price of 46.51 USD per MT.

¹⁰ ITA No. 1417/Del/2008

¹¹ ITA Nos. 2469/Mum/06, 3032/Mum/07 and 2531/Mum/08

¹² ITA No. 2112/Mds/2011

¹³ ITA No. 6339/Mds/2011

¹⁴ ITA No. 2099/Mds/2011

The TPO, based on information from customs authorities found that another company had imported 1440 MT of coal at 43 USD per MT.

Therefore, the TPO concluded that the taxpayer had overstated its purchase price and accordingly made an adjustment for the difference in price. This was also upheld by the Dispute Resolution Panel.

On appeal before the Tribunal, the taxpayer contended that the valuation of the customs authorities was **not realistic**. In this regard, the Tribunal held that the customs authorities are assigning values to the imported goods on the basis of **scientifically formulated methods** and they are responsible for making a **fair assessment value** of the imported goods. The valuation made by the customs authorities is **not an arbitrary** exercise. The Tribunal proceeded to observe that the assessee could also establish its case for a different price other than the customs price provided **acceptable materials were furnished** to support its contentions.

Accordingly, the Tribunal upheld the TPO's action of considering the customs valuation as the arm's length price for TP purposes.

It may be observed in the decision of *Coastal Energy Pvt Ltd (supra)* that the quantity imported from AEs is 1000 MT while the quantity imported in the comparable uncontrolled transaction was 1440 MT. There may be **quantity related discounts** on account of which there would have been a lesser price paid in the comparable uncontrolled transaction and adjustments for the same could be made under TP regulations in order to render the price comparable. This aspect has not been argued by the assessee in the case before the Tribunal.

Based on above judicial precedents, it may be noted that predominantly all the Tribunals have upheld the view that the methodology specified under the TP regulations and the Customs valuations are **different and specific** in their own way. Therefore, the valuation under both the regulations may not be interchangeable.

Conclusion

The conflict between the customs valuation and the TP regulations is yet to be settled and guidance at both national and international levels are awaited. On a practical level, taxpayers while setting the transfer price should consider both the transfer price and customs valuation aspects in order to avoid conflict between the two at a later stage.

Also, as mentioned by the OECD guidelines and WCO guide, **greater coordination and exchange of information** between the customs and tax authorities would aid in resolving conflicts. The use of TP study by the customs as a preliminary information to evaluate existence of influence of relationship between the buyer and seller is an important aspect which is a step towards resolving conflicts.