BEFORE THE CUSTOMS APPEAL AUTHORITY

Decision: [2019] NZCAA 013

UNDER	The Customs and Excise Act 1996
BETWEEN	**XXXX** Appellant
AND	**Chief Executive of the New Zealand Customs Service** Respondent

Hearing: 26 and 27 June 2019

Counsel: Ms V Sullivan and Ms K Keating, counsel for the appellant.

Ms P Courtney, counsel for Customs

Decision: 5 August 2019

DECISION

Representatives: EY Law Ltd, lawyers, Auckland, for the Appellant
Crown Law Office, Wellington, for Customs

The appellant

[1] The appellant is part of an international group of companies; it is identified with a nutritional product (the product), which has a strong brand identity. The appellant is incorporated in New Zealand, and wholly owned by an offshore parent company. This decision will not identify the appellant, and it will not contain specific financial details. I accordingly direct that no financial information in this proceeding is to be disclosed, beyond the parties and their advisers (and then only for this appeal). It is necessary to make these directions to protect the process of competition in the market for the product and its competitors.

[2] The product has a unique formula and brand identity. It is subject to competition from other brands of similar nutritional products, though each producer has a unique formula. The appellant's business model involves the supply of the product, which is manufactured offshore and imported into New Zealand. An offshore company that wholly owns the New Zealand company manufactures the product. In New Zealand, the appellant is responsible for the importation process, paying customs duty on importation, and it uses contractors to store and distribute the product. The appellant generally sells the product to retailers, including supermarkets, oil companies which have convenience stores in fuel outlets, and a range of other resellers of food.

The appeal concerns a valuation measure to determine the customs value

[3] The issue in this appeal arises from a routine circumstance in international commerce. Where a local company is owned by, or otherwise has common interests with, an offshore company, the pricing of supplies between the related parties may not be an arm's-length market price. Indeed, there may not be an arm's-length market price at all. That may occur due to intellectual property protection or unique technical advantages; in such cases, products and services may have only a single source, with no direct substitute available.

[4] One of the difficulties that flow from related party transactions across international borders in these circumstances concerns the work of revenue authorities. In the present case, the specific issue is the value of inbound goods and the effect on the quantification of customs duties. The value of the imported product raises issues both for Customs and Inland Revenue. However, the concerns are opposite for measuring profit for income tax, and for the imposition of Customs duty:

[4.1] The lower the price paid by the New Zealand company for goods, the higher its profit and the higher the tax on its profits.

[4.2] Whereas, the lower the value, the less customs duty payable when the product crosses the border.

[5] For income tax purposes, the Income Tax Act 2007[1] has a regime which identifies related party cross-border transactions as transfer pricing arrangements. Generally, it will address excess payments, insufficient receipts, and allow for adjustments to apply deemed prices, intended to equate to an arm's-length price. Inherent in the regime is an evaluative process intended to replicate the commercial terms of arm's-length parties trading as independent parties primarily concerned with their commercial interests.

[6] When determining the value of imported goods for Customs purposes, there are a range of mechanisms. They are set out in sch 2 of the Customs and Excise Act 1996[2] (all statutory references are to this Act, unless otherwise identified). The general structure is a cascade of approaches, where if one method does not produce an appropriate result, it is necessary to move to alternatives. Ultimately, there is an overriding obligation to be flexible, and use such techniques as may be required to produce a proper value that is not arbitrary or fictitious:

[6.1] The primary basis of determining the customs value (the value on which the Act imposes duty) is the transaction value. It is generally the price paid by the importer for the goods when the importer and its supplier are not related.[3]

[6.2] There are adjustments to the price paid to include offshore costs to procure the goods (such as the costs of procurement, logistics and modifications incurred in the country of export); but these exclude costs that relate to matters that occur after the goods leave the country of export.[4]

[6.3] Where Customs[5] consider the appropriate customs value is not reflected in the transaction value, then Customs can measure the value with reference to the transaction value of identical or similar goods,[6] imported in comparable circumstances. In short, if the price used for the importation is not reliable, the price of identical or similar importations by independent parties can be used. Adjustments can be made to reflect

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1 Sections GC 6 – GC 14 contain the principal elements of the provisions relating to transfer pricing provisions.

2 The Act has been replaced with the Customs and Excise Act 2018, but the 1996 Act applies to this case. The principles under the two Acts are similar.

3 Schedule 2, cl 2.

4 Schedule 2, cl 3.

5 The Chief Executive is the respondent; however, I will refer to Customs rather than the Chief Executive, unless necessary to personally identify the Chief Executive. Most of the actions relevant to this appeal are performed by Customs Officers under delegation.

6 Schedule 2, cl 4 (identical goods), and cl 5 (similar goods).

pricing differences that flow from the level of trade, quantities and circumstances affecting costs and charges.

[6.4] If there are no identical or similar goods sold for export to New Zealand available to determine a proper customs value, then the Act provides a further alternative. It is named the "deductive value". The name reflects that the starting point is not the goods, similar or identical goods priced for import into New Zealand. It only applies when Customs does not consider there are similar goods imported into New Zealand that provide a satisfactory comparison to determine the customs value.[7]

[6.5] The foundation for the deductive value is the first sale of the imported goods in New Zealand to an arm's-length party. Using that sale as the foundation for value, the profit and expenses incurred after importation are deducted from that price to infer the value at the time of importation. The profit and expenses may be calculated based on what is reasonable, and that judgment is informed by comparison with market values rather than necessarily accepting the importers' actual costs and profits.

[6.6] If the deductive value does not produce a satisfactory result, then a computed value may be used.[8] The concept underlying computed value is the cost of production. The evaluation is based, as necessary, on market values, not necessarily the actual costs of the importer and its supplier.

[6.7] If none of those alternatives produces a satisfactory result, the last of the alternatives to determine customs value is the residual basis of valuation.[9] It uses the principles used for the other methods of valuation applied flexibly.

[6.8] There is also a prohibition on using particular measures, the customs value may not be:[10]

[6.8.1] The selling price of goods produced in New Zealand.

[6.8.2] The higher of two alternative values.

7 Schedule 2, cl 6(1).

8 Schedule 2, cl 7.

9 Schedule 2, cl 8.

10 Schedule 2, cl 8(2).

[6.8.3] The price of the goods in the domestic market of the country of exportation.

[6.8.4] The cost of production, except as specifically provided in the computed value method.

[6.8.5] The price of goods for export to a country other than New Zealand (unless ultimately imported into New Zealand).

[6.8.6] Minimum customs values.

[6.8.7] Arbitrary or fictitious values.

[7] The parties have approached the valuation using the deductive value method (DVM). That is to say:

[7.1] The starting point is the sale from the appellant to retailers. They are arm's-length parties.

[7.2] It is then necessary to determine the appellant's profits and costs that are deducted to deduce the value of the product when imported into New Zealand.

The issues for the Authority to determine

[8] There is a series of details in the application of the DVM, little of the detail is contentious. At the risk of oversimplification, two critical points were in contention at the end of the hearing:

[8.1] The parties have different views on the price at which the appellant sells the product to retailers. This price is the arm's-length value used as the proxy from which the value at the point of importation is derived, by removing post-importation costs and profits. The difference is in the treatment of price adjustments the appellant makes to take account of the retailer's participation in marketing initiatives.

[8.2] The parties also have different views on the evaluation of costs and profits, but only in respect of a credit note from the appellant's parent company that New Zealand Inland Revenue approved for a transfer pricing mechanism (the transfer pricing credit). The credit reduces the cost of the product, so the appellant earns sufficient profit in New Zealand to meet its obligations under the Income Tax Act 2007's transfer pricing regime.

[9] There is a residual point in dispute regarding the calculation of profit, but the difference is a point of methodology rather than the principles, and the underlying objective of the calculation.

[10] Accordingly, the primary issues for the Authority are to determine the proper method of calculating the price at which the product is sold to retailers; then determine how the payments to meet transfer pricing obligations should be treated in the quantification of profits and costs when deriving the customs value.

[11] For reasons that will become evident in the following discussion, my view is that I must ensure that I do not reach conclusions which lead to arbitrary or fictitious values. It follows that, while I consider there is a satisfactory approach to reach a customs valuation under the DVM, if necessary, I would apply the residual value basis to avoid an unsound conclusion. However, my view is that DVM is an acceptable approach, if applied correctly.

[12] I note that at this point, I am required to address the methodology for applying DVM but will reserve the arithmetical calculations that follow. If necessary, I will deal with any aspects of calculation the parties cannot resolve by agreement.

Discussion

How the DVM functions

[13] As a preliminary step, I consider the purpose and elements used to apply the DVM. The DVM is one of the specific anti-avoidance mechanisms in the Act. Its purpose is to establish a realistic value of goods at the New Zealand border, so Customs can assess an appropriate level of duty. The method only applies when the price paid for the goods (the transaction value) is not the appropriate measure, and there are no identical or similar goods to use as a guide.

[14] The present case is typical of the circumstances where a DVM may be appropriate. The product is unique, it has a strong brand identity that likely affects the value, and it appears the importer's parent company controls the worldwide supply. It may be possible to measure the value of the product in various ways, the DVM does so by taking the first sale of the product to an arm's-length party. That is prescribed in the Act, by referring to "the unit price in respect of sales of the goods at the first trade level after their importation", where the sale is to a person who is not related to the seller.[11] In this case, the first trade level is the sale of goods from the appellant to the retailer, the only antecedent sale is from the parent company to the appellant.

[15] That establishes a foundation, measuring a sale on commercial terms, where the sale price is not affected by the relationship between the importer and the supplier. The mechanism then removes the commercial events between the importation and this arm's-length sale. The obvious intention is to infer the value at the border. However, the use of the first arm's-length sale is not a perfect

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11 Schedule 2, cl 6(5).

proxy from which the true value at the border can be inferred. The local New Zealand market may have influences that have little effect on the international market place, which is the true value of the imported item. In the present case, the appellant says there was a “price war” in the New Zealand market, triggered by parallel imports and aggressive competition. The appeal concerns the financial year ending in 2014. It appears that the year was not typical, due to the "price war" and other factors. However, if those factors applied only in the New Zealand market, they may have little relevance to the value of the product, which the appellant's parent company supplies to a worldwide market.

[16] One of the safeguards built into the legislation is the power for Customs to look at the value of the “goods being valued”, or identical or similar goods. Accordingly, if the sale price is affected by something peculiar to the particular goods, Customs may substitute other sales. An illustration would be an importer of specific goods, establishing market share with aggressive pricing. In such a case, Customs could ignore the goods in question, and look at the pricing of comparable products. Using comparable sales is a core technique in transfer pricing, and the methods in sch 2 of the Act.

[17] The legislation has other safeguards to ensure Customs calculates a realistic arm’s-length customs value. They include selecting an appropriate range of sales,[12] whether they are sales of the goods in question, or comparable sales.

[18] There is no doubt the legislation is predicated on first establishing an objectively justifiable measure of the commercial value of the first arm’s-length sale after importation.

[19] Stage two of the DVM is to measure the quantum of the commercial activities affecting the goods from their importation to the first arm’s-length sale. The purpose is so they can be deducted from the value of the arm’s-length sale to infer the value at the time of importation. It is necessary to adjust the price of the first arm’s-length sale.[13] Accordingly, Customs must deduct from the value of the arm's-length sale in the New Zealand market: [14]

[19.1] profit, and

[19.2] general expenses.

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12 Schedule 2, cl 6(2)–(4), by selecting the pricing for “the greatest number of goods”, and sales at “the earliest date after importation”, and, when necessary, allowing for post-import modifictions.

13 In some cases, goods are distributed under a commission-based distribution mechanism, schedule 2 Cl 6(6)(a)(i) provides for that. It does not apply in this case, so I discuss only the relevant provision.

14 Schedule 2, cl 6(6)(a)(ii).

[20] That will be profit and general expenses of all parties dealing with the goods from importation to that sale. The values for profits and general expenses may be those "in connection with sales in New Zealand of goods of the same class or kind as those goods".[15] Accordingly, the values need not be the importer's actual values. Like the methodology for transfer pricing, Customs may infer the values from comparable entities. Of course, as is the case here, Customs may accept the actual costs of an importer as consistent with normal costs. The amount of profit and general expenses are determined "in a manner consistent with generally accepted accounting principles".[16]

Aspects of the DVM that are not contentious

[21] In some cases, there are complexities relating to the identification of the sales used as the arm's-length reference. Schedule 2, cl 6 allows selection based on the time of importation, and a selection based on "the greatest number of units".[17] In some cases, the issues may be difficult; in the present case, both parties accept taking all the sales across a financial year is appropriate, there can be no criticism of that approach. I need not discuss it further.

[22] In respect of profit, the parties are both, in principle, content to accept the measure of profit Inland Revenue applied for its transfer pricing obligations. It is a formula derived from the net revenues. It was not contentious, it can be safely accepted Inland Revenue's approach considered industry norms for profits. Accordingly, the statutory criteria in the Act are met. There is, however, a relatively minor difference in application.

[23] Similarly, the parties accepted that actual general expenses were a reasonable and objective measure, and accordingly, they too are not contentious.

[24] As noted, that only leaves two contentious aspects:

[24.1] What was the price paid by purchasers for the arm's-length sales? The statutory wording is "the price per unit in respect of sales"[18] of the "goods being valued … at the first trade level" to an arm's-length party on standard terms.[19]

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15 Schedule 2, cl 6(6)(a).

16 Schedule 2, cl 6(7).

17 Schedule 2, cls 6(1) and (2)

18 Schedule 2, cl 6(2) which cross-references the sales in subclause (5).

19 The quoted elements of the definition are in sch 2, cl 6(5), that the sales selected meet the criteria of being to an unrelated person on appropriate terms, and are properly selected is not contentious.

[24.2] The second element is the proper treatment of a transfer pricing credit, where the appellant received money from its parent company. The function of this payment was to reduce the net value the appellant paid to its parent company for the product, thereby inflating its profits. The parties have different views regarding the proper treatment of this transaction. However, within the statutory scheme in sch 2, cl 6 the payment must be irrelevant,[20] or affect the quantum of profit or general expenses to be deducted under the DVM.[21]

[25] For clarification, I note the chartered accountant who gave evidence for Customs, Mr Apps, took a view that related the value of the arm's-length sales and the transfer pricing credit. He said the transfer pricing credit could be compensation for discounts the appellant provided to purchasers of the product. Accordingly, it is necessary not only to consider the two items, but their relationship with each other.

Customs' position

[26] Customs' position, on the evidence it produced, involved a composite effect:

[26.1] The arm's-length sales involved an initial price, and on the fulfilment of certain contingencies, the appellant would repay some money to the purchaser. Without placing any importance on the term, they can be identified as trade discounts.

[26.2] The supply of product from the parent company involved an initial price, and later the parent company issued a credit note to reduce the price of the product, under the transfer pricing agreement with Inland Revenue.

[26.3] Customs said through its witness that the correct approach is "offsetting the [transfer pricing credit] and the trade discounts", as that produces a true reflection of the unit cost of the imported product for Customs duty purposes.

[27] The essential concept is that the rebates, discounts, credits, or price adjustments both between the appellant with its customers, and the appellant and its parent company should be offset. Customs say the promotional discounts to its customers would not have been offered unless its parent company would reimburse it.

[28] Using purely illustrative figures, the respective positions taken by Customs are as follows:

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20 Subject to sch 2, cl 8(2)(g) if it creates arbitrary or fictitious values.

21 Schedule 2, cl 6(6)(a)(ii).

THE ELEMENTS FOR THE CALCULATION		
Cost of product		$ 500.00
Parent company credit		$ 100.00
Net cost of product		**$ 400.00**
General expenses		**$ 300.00**
Profit (nominal)		**$ 10.00**
Sales gross		$ 1,000.00
Rebates on sales		$ 105.00
Net return on sales		**$ 895.00**
CUSTOMS APPROACH		
Sales gross		$ 1,000.00
Less		
General expenses		$ 300.00
Profit (nominal)		$ 10.00
		$ 690.00
Add back netted off rebates		
Rebates on sales	$ 105.00	
Less		
Parent company credit	$ 100.00	
		$ 5.00
Cost of product at border		**$ 695.00**
THE APPELLANT'S APPROACH		
Net return on sales		$ 895.00
Less		
General expenses		$ 300.00
Profit (nominal)		$ 10.00
Cost of product at border		**$ 585.00**

[29] As can be seen, the difference between Customs and the appellant is:

[29.1] Customs take the gross sales figure ($1000), whereas the appellant takes the net sale figure ($895). That is a difference of $105 in the sales figures.

[29.2] Customs justifies using the gross figure and ignoring the trade rebate that gives a net figure by offsetting the parent company transfer pricing credit ($100 parent company credit). The claim being that the parent company is repaying the appellant for the trade discounts, when providing the transfer pricing credit required by Inland Revenue. The netting off produces an additional $5 to the cost of the product at the border, giving a difference of $110 in this illustration.

[30] If the appellant and its parent company used pricing that conformed to Inland Revenue's determination during the year without the need for a credit, using the illustrative figures Customs' approach results in costs at the border that are $210 higher at $795. Whereas, if the appellant and its parent company agreed to pay $800 for the product, and a credit of $400 was issued, then Customs would have a cost of product at the border of $395, compared with the appellant at $585. Customs' netting off approach would leave the appellant and its parent company free to adjust the customs value lower by increasing the cost of product and using larger credits to meet transfer pricing obligations.

[31] Customs supported its view not only with the offsetting analysis presented by Mr Apps, an experienced chartered accountant, in submissions counsel added an interpretative argument regarding sch 2, cl 6 of the Act. The interpretive argument was that the reference in sch 2, cl 6(5) to "the first trade level" identified only the initial pricing of sale from the appellant to its customers, and excluded the promotional payments the appellant made back to its customers. On that basis, the arm's-length sale price on which the DVM depends would be the higher value, and excludes the repayments made by the appellant to its customers.

[32] As noted, there is some difference between the parties in respect of the calculation of profit. Customs would adopt the figure Inland Revenue used for the year.

The appellant's position

[33] The appellant says the net price its customers paid is the true value of the transaction, so that is the starting point giving the arm's-length value on which the DVM operates.

[34] The appellant says the credit from its parent company is simply a transfer pricing process, it has no nexus with the pricing of sales. Accordingly, it is not part of the DVM, the value of the product at the border is the outcome of the calculation. It is not appropriate to introduce any of the pricing.

[35] In respect of profit, the appellant says the profit should be calculated using the percentage Inland Revenue applied to transfer pricing calculations, using the net return on sales. It says that produces the most objective measure.

The value of the product when sold at the first level of trade

[36] I cannot find factual support for Customs' view that trade or promotional discounts provided to its customers link with the transfer pricing credit. The evidence relating to the arm's-length sales was partly provided in an agreed statement of fact, and otherwise from the appellant's general manager. The essential facts are:

[36.1] The sales are from the appellant, which is a subsidiary of the worldwide producer and distributor of a nutritional product. The first sales to an independent party are the sales under consideration. Generally, retailers make purchases from the appellant.

[36.2] While the product is a unique formulation, it is subject to competition from substitutes. The pricing model is to charge the retailers a standard price and invoice them for that price. However, there is an understanding, at least for many of the retailers, that there will be promotional activities that affect the net cost to the retailer.

[36.3] The essential method is to encourage the retailer to offer discounts on retail sales, and the appellant accesses the sales records and makes a payment back to the retailer reflecting the volume of promotional sales.

[36.4] In the 2014 year, which is the year in issue, there was a "price war" with the dominant competitors for competing products in New Zealand, and substantial competition from parallel imports of the identical product. The appellant's general manager said there was a discount on total sales of approximately 14 per cent due to the marketing strategy of offering trade discounts.

[36.5] The appellant called these discounts off-invoice promotional discounts and characterised them in financial statements as "marketing expenses" labelled as "Trade Fairs".

[36.6] From year to year, there was some variability in the discounting.

[37] I am satisfied the discounting model was usual industry practice, and there was no evidence of manipulation to distort results. To the extent atypical factors occurred in 2014, I accept they arose from the initiatives of competitors, and they related to the New Zealand market. There was no evidence of any unusual events in the New Zealand market resulting from international market pressures (except to the extent the parallel importing, potentially, implied a surplus of product in some location offshore).

[38] I was unable to find any link between the discounting and the amount of the transfer pricing credit. The amount of the transfer pricing credit is the product of

the appellant and its parent company setting a price for the product, trading for the year and then making a payment to adjust the net cost of supplies to increase profits. The amount of the payment depends on arrangements between related parties. They could readily manipulate it. The pricing of the product is subject to the transfer pricing agreement with Inland Revenue, but Inland Revenue would achieve the same outcome whether the appellant overpaid and then received a credit, or the product was priced throughout the year so no credit was required.

[39] The relevant legislative provision that determines the value of the arm's-length sales in the DVM is set out above at [24.1]. Ms Courtney contended the “first trade level” identified the price initially charged, and necessarily excluded subsequent rebates related to that sale. The parties could not identify any authority dealing with the issue of discounting, relating to the arm's-length sales used for DVM calculations. In my view, the provisions in sch 2 are practical legislation, and expressly exclude a slavish adherence to labels and descriptions. Clause 8 of sch 2 is important. Throughout the various alternatives in sch 2, Customs must determine an appropriate “Customs value”. That value is intended to be, as far as possible, a true value of goods at the border. For the reasons already discussed, that is not always readily determined. Clause 8 requires that, to the extent necessary to determine an adequate customs value, the methods in sch 2 must be applied “in a flexible manner”, and the Customs value must not be “arbitrary or fictitious”.

[40] The essential feature of the DVM is to start with an arm's-length sale in New Zealand. That sale may or may not be an adequate foundation to use as the starting point, but it is the foundation if the DVM is used. What is certain is that if the values taken from those sales do not reflect unrelated parties dealing transparently on commercial terms for the sale of the goods only, then the exercise of eliminating the costs and profits since importation will not reliably produce an objective measure of value at the border.

[41] In my view, if an interpretative approach to the words “first level of trade” is taken, or for any other reason, Customs does not capture the real exchange of value between the parties in that transaction, then the DVM cannot apply. The methodology in sch 2, cl 6 of the Act relates to either “the goods being valued” or “identical or similar goods”. The plain implication is that the measure must be an objective measure of value between independent parties. If it were otherwise, manipulation is inevitable.

[42] For example, an importer could offer non-exclusive agreements, where a purchaser makes a lump sum payment for the right to distribute the product for a period of time. It would not be sensible to ignore the lump-sum payment when quantifying the sale price of the goods. If not accounted for, the arm's-length

sale price would be lower than the real exchange of value. In principle, it is no different to the rebating system used in this case, the true value of what was paid by purchasers must fully account for the exchange of value.

[43] There was some discussion between the parties regarding the characterisation of the rebate. The appellant had characterised the payments as marketing expenses, which are included in sch 2, cl 6(6)(a)(ii) in the phrase "general expenses, including all costs of marketing the goods". In my view, for present purposes that is not the appropriate characterisation. In the present case, the parties agreed they should use the DVM, and do so for all sales; the essential first step is to find out what the appellant received for the product.

[44] All the retailers got from the appellant was the product, and what the appellant got from the retailers was the net payments. There were general marketing expenses, which the appellant bore, and that would have helped the sales. There was also marketing the retailer's bore, and that too would have helped sales. However, that does not detrimentally affect the application of the formula:

[44.1] New Zealand marketing costs must be taken out by the DVM equation.

[44.2] If the appellant undertakes them to achieve sales, they come out as general expenses.

[44.3] If the retailers have to spend more on marketing, they will expect to get the product at a lower cost to maintain their margin after incurring a higher cost of sales. The costs come out as a lower price.

[45] In this case, provided the discounts come out as general expenses or a lower price, that preserves the integrity of the formula. In my view, failing to take account of discounts in pricing will lead to distortions because it is an invitation to create a legal structure where value is passed from a purchaser in a different form to lower the sale price of goods. That destroys the efficacy of the DVM.

[46] Accordingly, in my view, if the DVM is to apply, the net cost of goods derived by the appellant is the correct figure to use for the calculation. If it is not used, then the DVM will produce an arbitrary or fictitious value.

The transfer pricing credit and whether it can offset the sales discounts

[47] The transfer pricing credit is arbitrary, in that the importer and the related party supplier can manipulate the value. In the case of the appellant, the amount of the transfer pricing credit and the trade discounts were similar. However, that correlation did not apply in all years. That is not surprising:

[47.1] The discounting reflects the appellant's marketing strategy and the demands of retailers who sell the product to consumers.

[47.2] The transfer pricing credit is compulsory, and must precisely adjust the appellant's profit to meet Inland Revenue's view of what its profits should be for transfer pricing purposes.

[48] The only evidence that favours linking trade discounts and the transfer pricing credit was from Mr Apps, he said "even though the presumptive test is one against offsetting [discounts and transfer pricing credits], it would appear that [the discounts] have been offered … on the basis [the appellant] would be reimbursed for such expenses", by the transfer pricing credit. Mr Apps did not point to any evidence to support his view there was a factual link in this case. The appellant's general manager disagreed, and said there was no link. There is an absence of evidence to support the linkage.

[49] It is appropriate to have full regard to the accounting evidence for each party. For Customs, Ms Courtney contended sch 2, cl 6(7) of the Act said the amount of profit and general expenses must be evaluated "in a manner consistent with generally accepted accounting principles". That was a foundation for evidence respectively from Mr Apps and Ms Hodgkins relating to accounting standards.

[50] I accept of course that accounting principles are important, and should be applied when applying the DVM. However, in my view, the reference to accounting principles in sch 2 relates to ensuring the DVM calculation produces a realistic result. It does not allow the substitution of financial reporting standards for the proper application of the method. The DVM must provide a realistic customs value for goods imported into New Zealand. Ms Courtney for Customs suggested that audited accounts where an importer had its profit calculations determined by Inland Revenue under a transfer pricing methodology might produce a reliable and expedient way to determine Customs values. However, in my view, that approach cannot be used reliably. First, this particular case is somewhat unusual, as there is essentially only one product and a simple process of supplying it to retailers. Typically, there are multiple product lines, and a need to apportion and allocate costs, and potentially complexities from additional processing in New Zealand. However, even in a simple case like the present one, financial reporting standards are not designed to produce customs values. Reporting standards are concerned primarily with presenting a true and fair picture of financial performance, and the capital structure of a business. The evidence in this case further demonstrated that opinions may vary regarding reporting standards. When it comes to a transfer pricing credit, which is both a related party transaction and made to comply with a regulatory demand from Inland Revenue, reporting standards are particularly problematic. Regardless, the evidence from Mr Apps and Ms Hodgkins does not undermine the approach that:

[50.1] the trade or promotional discounts should be taken into account to set the value of the arm's-length sales; and

[50.2] the transfer pricing credit should not be taken into account.

[51] Mr Apps, while recognising there were complexities, in my view, correctly identified in his evidence that:

> Ascertaining sales at the first trade level after importation to unrelated parties on an arms-length basis. I assume that this definition implies net sale after allowing for trade discounts and rebates.

[52] Ms Hodgkins in her evidence said:

> I agree that the off-invoice promotional discounts … were a customer incentive and therefore should be netted off revenue …

[53] Their evidence was more extensive. They both carefully explored a range of factors; however, both agree the best measure of the first level of trade is the net revenue. For the reasons I have discussed, the need to establish the true quantum of receipts[22] is critical in the context of a DVM.

[54] Accordingly, the extent of any disagreement focuses on the transfer pricing credit. When turning to this element, Mr Apps said:

[54.1] A variety of treatments was open, it could be "other income" outside of the DVM, a reduction in marketing costs, a deduction to the cost of goods sold, or a deduction to trade discounts and rebates.

[54.2] He said if the transfer pricing credit was to pay for "abnormal marketing costs", referring to the discounting in the promotional campaigns, the two should be offset.

[55] As I have noted, Mr Apps did not provide any convincing explanation for regarding the transfer pricing credit as being related to the promotional discounting. He couched his evidence as dependent on evidence that there was a factual link.

[56] Ms Hodgkins questioned linking the transfer pricing credit and the sales discounts. First, she identified the credit was apparently a transfer pricing transaction, not a reimbursement of promotional discounting. She did not agree with the netting off that Mr Apps supported. In her view, the credit should be deducted from the cost of inventories/cost of sales. She thought it would be potentially misleading to offset in the way Mr Apps advocated. The effect would

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22 Rather than taking gross revenue, and deducting the discount as a marketing expense.

be to use a related party transaction to inflate revenue, and thereby distort the financial statements.

[57] In short, Ms Hodgkins was pointing out that money from a related party should not artificially inflate sales figures, it should bring down the value of stock and gross profit to reflect a market-based[23] cost/value of the product. From the point of view of a person interested in the business' financial performance and stock levels, Ms Hodgkins' observations are understandable and consistent with reporting standards, as she said. Mr Apps did acknowledge those points.

[58] In my view, for similar, but distinct reasons, the net value of the sales of product to purchasers for the DVM and reporting standards should stand alone. An offset using a payment from a related party undermines the integrity of the measure of income. The reasons Ms Hodgkins advanced are consistent with that view, and indeed, in the absence of evidence to link the transfer pricing credit and the trade discounts, Mr App's evidence is also to the same effect.

[59] Ms Hodgkins appropriately discussed the various ways in which the transfer pricing credit could be treated, as of course he credit must be recognised in financial statements. However, the costs of goods in a DVM is not part of the equation, deriving a figure for the cost of goods is the objective of the equation. In my view, aside from what I have already said, introducing a credit from a related party that supplies goods has no place in the formula (except as reflected in transfer pricing to determine the level of profit).

[60] To put this significant point regarding including the credit as a component of the formula as simply as possible:

[60.1] The formula, which is, sale price less profit and expenses[24] has the purpose of determining the value at the New Zealand border.

[60.2] Customs' position involves introducing into the formula a component of the price the related parties agreed on at the border. Given that the purpose of the formula is to determine a substitute for the price the related parties agreed on, the approach would require directed and clear reasoning to justify it.

[60.3] I can discern no directed and clear reasoning to justify the approach, it inevitably introduces into the calculation a component of the price that is adjustable at the election to the two related parties. The approach accordingly means the DVM formula only partially replaces the pricing

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23 At least as adjusted by tranfer pricing principles.

24 They are the three components of the formula, though of course the full statutory definition determines what is included in those components.

decisions of the related parties, their decisions wll influence the value the DVM determines. That is not justifiable as a standard application of the DVM, and the facts of this case do not extablish an exception, where related party pricing decisions should be taken into account.

Measurement of profit

[61] There is a limited dispute regarding the measure of profit. Both parties agree on the transfer pricing measure, but Customs want to take the figure declared to Inland Revenue, and the appellant wants to apply the method to the unit price determination.

[62] My view is:

[62.1] The objective measure of profit under the transfer pricing methodology is appropriate, given that the parties do not seek to conduct that exercise afresh. Furthermore, as discussed in the present case, the financial results for the whole tax year can be used, without apportionment.

[62.2] Accordingly, it would be pragmatic simply to use that actual profit figure, which Inland Revenue accepted.

[63] The difference between the parties is that the appellant wants to conduct the exercise using the unit price derived after discounting. I would readily accept that would be appropriate if we were not dealing with all of the results for the year, say it involved one product line and not others. However, my tentative view is that when considering all of the transactions in the DVM calculation, the transfer pricing profit result will be the most accurate measure. However, the evidence does not appear to go further than I have identified; accordingly, I will reserve this issue as well as the calculation.

Conclusion

[64] I have reached a view on the issues in contention:

[64.1] the DVM calculation must use the net sales; and

[64.2] the transfer pricing credit is not relevant (except as it relates to the amount of profit).

[65] I am conscious that there is some evidence the DVM may not have been the ideal method for the year in question. Local market prices potentially influenced the outcome of the DVM, and if those prices related to unique factors in the New Zealand market, it made the DVM less accurate as a measure of the correct customs value. However, I do not reject the approach as wrong. Local market conditions will inevitably affect the appropriateness and accuracy of the DVM, that is an inherent limitation of the method. Furthermore, sch 2, cl 8(2) excludes

a range of measures that Customs could use as a cross-reference, such as the selling price of goods produced in New Zealand, choosing the higher of two values, the domestic price in the country of origin, and also prohibits arbitrary values. In a different year, the local market could inflate values. Indeed, I have no foundation to say whether the local market in New Zealand is high by world standards. I could infer from the parallel importing that is possible, but know nothing of the circumstances, so could reach no firm conclusion.

[66] In my view, provided the DVM is applied in the manner described, it is an appropriate method and will not, on the evidence I have heard, produce an arbitrary or fictitious value. Customs chose the DVM, and the appellant accepted it, I lack an evidential foundation to reject it.

[67] I reserve leave for either party to require me to:

[67.1] provide further directions regarding the measure, and/or calculation of profits; and

[67.2] make any determinations necessary to calculate the customs values of the goods in issue.

[68] Costs are reserved, the parties should submit memoranda when the proceedings have been finalised.

Decision

[69] The Authority will allow the appeal in the respects identified. That will occur when the parties have resolved the outstanding issues by agreement or through a further decision of the Authority.

[70] The parties should request a telephone conference to determine the process to complete the appeal or submit a joint memorandum setting out an order they agree reflects the terms of this decision (it would not be a consent order beyond agreement that it implements the computational implications of this decision).

[71] The parties are requested to take further steps or give an indication of progress within two months.

Dated at Wellington 5 August 2019.

G D Pearson
Customs Appeal Authority