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Two caveats open this paper, one dealing with the scope of analysis, the other with the results we are expecting.

First, the scope of this inquiry needs to be broadened. Even though the topic asks that we limit ourselves to VAT/GST and direct taxes, in most jurisdictions there are three (not two) spheres of transfer pricing analysis – income tax, customs and VAT/GST. Although they share policy objectives, terminology and frequently borrow methodologies from one another, these domestic transfer pricing regimes rarely operate in complete harmony. In addition, compared with customs and income tax, VATs/GSTs are newcomers to transfer pricing. As a result, VAT/GST statutes tend to borrow in both directions (from income tax and customs).

Secondly, what do we hope to achieve? The short answer is we are looking for harmonization. The more difficult question is: are we looking for vertical harmonization (similar or identical transfer pricing rules among these taxes *within a single* jurisdiction); horizontal harmonization (similar or identical rules applied in each tax *among multiple* jurisdictions); or both? If the short term answer is the first (vertical harmonization), and the long term answer is the last (both vertical and horizontal harmonization), what we soon discover is that many of our most difficult problems stem from the success we have had in advancing the middle position (horizontal harmonization within each tax type).

The GATT Valuation Code (GVC)[1] provides a single set of valuation rules used in over 150 countries, but it is limited to goods. The OECD Transfer Pricing Guidelines[2] are considerably more detailed that the GVC, but they are not as widely followed.[3] The WCO and

[1] The GATT Valuation Code (GVC) sets out customs rules that govern valuation of related-party transactions. *Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994* included in THE FINAL ACT EMBODYING THE RESULTS OF THE URUGUAY ROUND OF MULTILATERAL TRADE NEGOTIATIONS, April 15, 1994.

[2] OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, looseleaf 1995. The influence of the OECD in establishing transfer price rules in global income tax regimes has been indirect, but comprehensive. The arm's length standard is included in Article 9 of the OECD's Model Tax Convention [OECD, Committee of Fiscal Affairs, MODEL TAX CONVENTIONS ON INCOME AND ON CAPITAL, June 1998].

[3] There are roughly 33 countries with developed transfer pricing regimes in income tax. They are Argentina, Australia, Austria, Azerbaijan, Belgium, Brazil, Canada, Chile, China (PRC), Colombia, Czech Republic, Denmark, Ecuador, Finland, France, Germany, Hungary, India, Indonesia, Italy, Ireland, Japan, Kazakhstan, Luxembourg, Malaysia, Mexico, Netherlands, New Zealand, Norway, Peru, Philippines, Poland, Portugal, Russia, Singapore, Slovak Republic, South Africa, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, Ukraine, United Kingdom, United States, and Venezuela. ERNST & YOUNG, TRANSFER PRICING GLOBAL REFERENCE GUIDE (February 2006) *available at* http://www.ey.com/global/download.nsf/Austria/transfer_pricing_guide_06/$file/GlobalTPGuide_Feb06.pdf. The Ernst and Young survey determines that a jurisdiction has a robust income tax transfer pricing system, if it is one with significant documentation requirements. In other jurisdictions rules may be in place, but they function more in an anti-avoidance context, not a regular compliance context. A more "liberal" counting of jurisdictions would increase the number to approximately fifty countries. CYM H. LOWELL, RICHARD HAMMER, & MARC LEVEY, INTERNATIONAL TRANSFER PRICING: OECD GUIDELINES ¶ 10.05 (2007).

OECD have long been aware that their transfer pricing rules are out of sync with one another: Conferences were held as recently as May 3-4, 2006,[4] May 22-23, 2007,[5] and October 20, 2008[6] on this issue.

This is the context within which we need to consider the harmonization of transfer pricing rules in VAT/GST and direct taxation. Some of the notable highpoints and the questions they raise are:

- **TRANSFER PRICING AT THE BORDER –** All countries with a VAT/GST apply customs transfer pricing rules to determine the value of imported goods. Are we anticipating two transfer pricing regimes in VAT/GST – one for goods (for the importer of record) at the border that will follow customs, and another for all other related party transactions (other goods transactions and all services) which would align with direct tax rules?
- **RELATIONSHIPS – ASSOCIATED ENTERPRISES –** Most VAT/GST jurisdictions determine "related parties" by borrowing (in detail) the definitions used by customs (from the GVC). A significant minority however, define "related parties" differently, harmonizing instead with rules borrowed from in their income tax statute. Both of these approaches are generally compatible with the broad description of "associated enterprises" referenced in the OECD Guidelines. However, general adoption of the OECD Guidelines will not resolve the deeper conflicts among specific approaches. Will the resolution of this issue necessarily include uncoupling VAT/GST transfer pricing from the GVC at the place where it is most commonly used today – the border?
- **METHODS –** Most VAT/GST jurisdictions do not specify transfer pricing methods, with the exception of near universally stated preference for a comparable uncontrolled price (CUP) method. Most jurisdictions that discuss pricing methods do so in very general terms and appear to limit acceptable methods to the "traditional," transaction-based methods. Very few VAT/GST jurisdictions mention profit methods, and those that do so have borrowed methods wholesale from the OECD Guidelines. Are we anticipating the general adoption of OECD methods in VAT/GST, or will new methods to determine prices be designed?
- **TIME** - There is a natural affinity between VAT/GST transfer pricing principles and those developed in customs law. Both of these taxes are transaction-based, and the tax base for both needs to be determined relatively soon after completing a transaction. Diect taxes are based on annual measures, and transfer pricing adjustments are frequently made much later in time. Are we anticipating a harmonization where direct tax adjustments in valuation are rolled back to prior VAT/GST determinations?

TRANSFER PRICING AT THE BORDER

[4] WCO/OECD CONFERENCE ON TRANSFER PRICING AND CUSTOMS VALUATION at http://www.oecd.org/document/39/0,2340,en_2649_201185_36541927_1_1_1_1,00.html
[5] INTERNATIONAL CONFERENCE ON TRANSFER PRICING AND CUSTOMS VALUATION at http://www.oecd.org/document/39/0,3343,en_2649_201185_36541927_1_1_1_1,00.html
[6] WCO TECHNICAL COMMITTEE ON CUSTOMS VALUATION, 27th Meeting (Oct. 20, 2008) powerpoint presentations on file with author.

VAT/GST valuations in all jurisdictions follow customs valuation when VAT/GST is imposed on importation of goods. As a result, because customs valuation under the GVC is not harmonized with the OECD Guidelines the VAT/GST base at the border is inconsistent with the valuation results for the same goods under direct taxation. In other words, the rule in the EU[7] that establishes this disharmony can be found in any of the world's VAT/GST jurisdictions. Take for example the rules in countries like Albania,[8] Armenia,[9] Bangladesh,[10] Japan, [11] and Russia.[12] Is there a solution?

Canada may offer a direction. Canada expressly ties GST valuation for goods at the border to the customs value,[13] but it goes one step further. It provides a mechanism for harmonizing the valuation measures of all three taxes at the border. The Canadian Revenue Authority (CRA) in Memorandum D13-4-5 indicates that it will accept an OECD-based valuation of goods (a direct tax measure of value) as the transaction value (a customs measure of

[7] SIXTH COUNCIL DIRECTIVE of 17 May 1977on the harmonization of the laws of the Member States relating to turnover tax – Common system of value added tax: uniform basis of assessment (77/388/EEC) 1977 O.J. (L 145) 1, Art. 11(B)(1). On November 28, 2006 the SIXTH COUNCIL DIRECTIVE was repealed and replaced with the RECAST VAT DIRECTIVE (RVD). The parallel citation is: Council Directive 2006/112/EC on the Common system of value added tax, O.J. (L 347) 1, Art. 85. Dual citations (to the old and recast versions of the Sixth Directive) will be used throughout this document.

[8] VALUE ADDED TAX, Law No. 7928, Art.26(1) & (2) (indicating that customs valuation methods apply in VAT with respect to imports) (1995) (Albania).

[9] LAW ON VALUE ADDED TAX, Art 8(2) (indicating that customs valuation methods apply in VAT with respect to imports) (1997) (Armenia).

[10] ADDED VALUE TAX, 1991, Act No. 22, Art 5(1) (indicating that customs valuation methods apply in VAT with respect to imports) (1991) (Bangladesh).

[11] JAPAN'S REVISED CONSUMPTION TAX LAW (SHOUHIZEIHOU), Art. 28(2) LAW NO. 108, 1988, AND APPENDIXES by approving the changes contained in LAW NO. 49, 2000; CABINET ORDER (SHOUHIZEIHOU SEKOUREI) NO. 360, 1988 (most recent amendment, ORDER NO. 147, 2000 *available at*: http://law.e-gov.go.jp/cgi-bin/idxsearch.cgi. (in Japanese). For an English translation of the Consumption Tax law based on Law No. 108, 1988 by approving changes contained in Law No. 49, 2000 see: *Consumption Tax Law*, tr. Vickie L. Beyer, 2000 WTD 247-20 (December 22, 2000). For a translation of the appendixes to Japan's revised consumption tax law, Law No. 108 see: *Translation of Exemptions to Japan's Revised Consumption Tax Law*, tr. Vickie L. Beyer, 2000 WTD 247-21 (December 22, 2000). For a translation of the final regulations, Cabinet Order No. 360, 1988 (most recent amendment, Order No. 147, 2000) see: *An Order for the Enforcement of the Consumption Tax Law*, tr. Vickie L. Beyer, 2001 WTD 36-24 (February 20, 2001).

[12] The Russian tax system is an example of a regime that has partially harmonized its transfer pricing rules, and roughly follows the OECD model. A single set of transfer pricing rules is applied to all taxes [Arts. 20 & 40, TAX CODE OF THE RUSSIAN FEDERATION, Part 1, Federal Law No. 147-FZ (July 31, 1998) with subsequent amendments and additions] except for customs and for the VAT imposed on goods crossing the customs border. The exception that ties the VAT base to the customs value at the border is at Art. 160(1)(1).

Customs valuation is governed by LAW OF THE RUSSIAN FEDERATION NO. 5003-I ON CUSTOMS TARIFFS (May 21, 1993) with subsequent amendments and additions. The amended version of this law is effective from 1 July 2006. On customs valuation it is consistent with the GATT Valuation Code, and has been since 1993. Thus, on transfer pricing matters Russian customs valuation methodology is not vertically harmonized with the rules in the Russian Federation Tax Code. (Translation assistance of Russian law provided by Alexei Ryabov. Originals and translations on file with author).

[13] EXCISE TAX ACT, R.S.C., ch. E-15, § 215(1)(a) (Can.) (valuation for GST purposes is determined under sections 46 through 55 of the Customs Act, plus all customs duties and additional duties imposed under the Customs Tariff, countervailing or anti-dumping duties imposed under the Special Import Measures Act, and any other taxes, other than the GST, imposed under the Excise Tax Act).

value). Thus, because customs valuation determines GST valuation, the OECD transfer pricing rules may control customs and GST valuation as well and income tax valuation.[14]

Some further observations are appropriate. First, the original draft of this memorandum was issued on March 30, 1989. It expressly referenced the OECD Report, *Transfer Pricing and Multinational Enterprises* (1979). When this memorandum was re-issued on April 9, 2001 the OECD reference was updated, and now cites the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1995) as acceptable authority for valuation. Thus, the CRA is following developments in direct taxation and is sweeping into the mix of acceptable methods the profit methods that were added by the 1995 *Guidelines*.

Secondly, the Canadian harmonization is limited. Not only is the harmonization limited to goods and import transactions, but it is further limited to specific taxpayers as a self-help measure. Taxpayers may use OECD methods to defend a declared price as a "price paid or payable," but the OECD methods are not generally the adopted standard. In other words, the OECD methods may be used *by the taxpayer* to prove that a transaction was "*not* influenced by the relationship" of the parties. This is not the same thing as saying that the OECD methods are accepted as the best way to determine customs value. Neither the tax authority nor the taxpayer can affirmatively rely on OECD methodologies; the taxpayer may defensively use them to support a declared price when questioned by customs.

The value of the Canadian solution is that it points to a workable solution; one that is self-help and one that is taxpayer-by-taxpayer based. It is only a border solution, and it is only applied to goods, but it is workable and has been in place for at least twenty years.

Final Canadian Caveat

A critical final caveat is needed. Although the GVC is concerned with related parties, and has defined methods to determine prices, customs methods are only applied as a last resort. Simply having related parties is not sufficient to require their use.[15] The circumstances surrounding the sale must be examined by customs first.[16] Pricing methods are only applied after this examination and only in cases where the examination leads customs to believe that the *stated transaction value* appears to have been *influenced by the relationship* of the parties.[17] Even at this point, customs must have "grounds" for this belief, and the GVC requires that the customs administration "communicate its grounds" to the importer, and give the importer "a reasonable opportunity to respond."[18]

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[14] MNR, Memorandum D13-4-5 *Transaction value method for related persons* ¶¶13-16 (Apr. 9, 2001 & Mar. 30, 1989) (setting out the position of Revenue Canada for customs valuation purposes and indicating that "The CCRA will accept, for valuation purposes, a price paid or payable which is derived from one of the methods set out in the OECD report [that is the OECD Report, 1979; later OECD Guidelines, 1995], unless there is information on prices available which is more directly related to the specific importations."

[15] GVC *supra* note 1, at Art. 1.2(a) (first sentence).

[16] GVC *supra* note 1, at Art. 1.2(a) (second sentence).

[17] GVC *supra* note 1, at Art. 1.2(a) (third sentence, first clause).

[18] GVC *supra* note 1, at Art. 1.2(a) (third sentence, second clause).

Thus, the GVC structures two points of contact between the importer and the customs administration before allowing customs to resort to GVC methods to determine value. They are:

- During the period up to and including the circumstances of the sale investigation, and
- During the period when the importer has a reasonable opportunity to respond to the "grounds" that customs has set out.

Memorandum D13-4-5 anticipates an OECD-based discussion at the second point – *after* customs has received the customs declaration, *after* it has examined the circumstances of the sale and *after* it has formulated "grounds." It is entirely possible that an importer could make its OECD-based case to customs well *before* the importation event – a direct tax advance pricing agreement (APA), or an advance customs agreement (ACA) for example could be the evidentiary vehicle. In doing so, the importer would pre-empt a major customs inquiry. The customs authority would not need to the point of "communicating its grounds," because the importer would have convinced the authorities in advance of the appropriateness of the stated transaction value.

Technically speaking, neither of these approaches (the Memorandum D13-4-5 or the APA option) actually harmonizes customs and direct tax valuation methodologies. Both of these approaches use direct tax valuation methods to convince customs (one *before* and the other *after* the import declaration) that customs does not need to resort to using "substitute values."[19]

This term "substitute values" suggests the reason that this approach is acceptable to Canadian customs. It is an important difference between valuation in customs and in direct taxation – customs valuation methods are deemed to be substitute measures and are designed as last resorts, whereas direct tax administrations (like the US IRS) believe that transfer pricing methods are the best way to find "<u>true</u> taxable income"[20] between related parties.

RELATIONSHIPS – ASSOCIATED ENTERPRISES

Normally, transfer pricing regimes assess the "closeness" of a buyer and a seller before proceeding to make adjustments to prices. Only closely "related parties" or "suspect" parties have transactions that are held up to price-scrutiny. However, when measuring relational closeness there are as many as five different yardsticks applied globally. These measures differ depending on the tax and the jurisdiction involved. Some define relationships economically; others measure it legally; while still others deem a relationship to exist based on whether a specific good or service is involved. Some systems apply a mix or a multiple of these tests. There are even instances where no relationship test is applied at all. This later situation results in either no formal pricing rules (the Commissioner's discretion determines all), or where pricing measures are applied to all transactions regardless of the relationship.[21]

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[19] GVC *supra* note 1, at Art. 1.2(c).

[20] Treas. Reg § 1.482-1(i)(9) (emphasis supplied).

[21] Although inefficient and cumbersome, diversity on this point is manageable for today's automated systems. During the installation and setup of an automated system the tax department of a multinational enterprise will input their analysis of the relationships among all the entities in a global trading family. When the relationship changes the system is updated. Automated systems have no difficulty switching back and forth among criteria and taxes to processes tax results. Parties can be related for VAT or customs, but unrelated for income tax without any difficulty. During the setup firms might even seek rulings, or offer their analysis as the subject of an APA to make

Vertically harmonizing transfer pricing regimes necessarily means harmonizing these relationship tests. Without this, adjustments in pricing between "related parties" could be deemed necessary for VAT/GST purposes whereas adjustments in prices for the same transfers would not be allowed for direct tax purposes. The reason – because the entities involved would be deemed related for the purposes of VAT/GST, and not related for income tax purposes.

Relationship/ associated enterprise definitions. This section considers the five major types of relationship/ associated enterprise definitions applied globally. Some jurisdictions (in some taxes) draw these rules very specifically, others do not. Some degree of specificity would seem to be essential here (and this is the case with the GVC), because the relationship/ associated enterprise test is the gateway to transfer pricing adjustment. *No* adjustment is appropriate if the parties are *not* initially "suspect."

The OECD does not provide this specificity. It provides nothing more than general guidance. The OECD's lack of concern about diversity-in-the-details is a function of its main objective, which is to get *potential* treaty partners close enough together so that they are able to resolve the details at the negotiation table. Determining exactly what constitutes an "associated enterprise" is a hand-crafted, bilateral outcome of a specific treaty.

Article 9 of the OECD Model Treaty provides a common (general) definition of "associated enterprises." It states:

> Where
> (a) and enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise in the other Contracting State, or
> (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State

The OECD Guidelines provide no more detail, and Klaus Vogel's analysis of the OECD Model is consistent with this result. He indicates that providing latitude for flexibility in local law was expressly intended in the drafting of Article 9:

> Whether there is a case of participation in the management, control, or capital of an enterprise is a matter to be decided by reference to (domestic) company law. … In paragraph 7 of the OECD Report on Transfer Pricing and Multinational Enterprises there is an express indication that it was not thought necessary to define such expressions as "associated enterprises" or "under common control." On the contrary it was assumed that there was a broad basis of common understanding of what was meant. Consequently, it should be left to the law of the contracting States to determine on the "broad basis of common understanding" those possibilities of influence being exercised under company law on which a re-writing of accounts should be based.[22]

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sure the setup conforms to local law. The fact that this complexity <u>can</u> be automated does <u>not</u> make this an optimal situation. This kind of complexity opens the door to planned arbitrage.

[22] KLAUS VOGEL, DOUBLE TAXATION CONVENTIONS, 3rd ed., (1996) 525, ¶23 (it should be noted that the "broad basis of common understanding" expression does not appear in the later OECD Guidelines, and that reference to a

Assuming that Klaus Vogel is correct, that there is a "broad basis of common understanding" of what constitutes "associated enterprises," and also assuming that an exact formulation of this understanding in direct taxation flows from the bilateral treaty, then we are faced with the possibility that when we arrive at this (direct tax) horizontal harmony we are at the same time disrupting domestic (vertical) harmonies with the other taxes that make transfer price adjustments in a jurisdiction.

The five basic ways of defining a suspect relationship or associated enterprises are:

(1) *Economic relationship*. The classic economic-based relationship test is found in the US income tax, IRC § 482. The statute requires affirmative proof that "… two or more organizations, trades or businesses [are] … owned or controlled directly or indirectly by the same interests …"[23] The regulations make it clear that the word "controlled" means:

> … any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the action of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.[24]

US litigation further emphasizes that the requirement is *not* to prove legal control, but to prove actual control of the economics of the relationship. The persons or entities involved must be shown to act together to achieve the common goal of shifting income – distorting the true economics of the marketplace.[25]

(2) *Legal relationship*. The classic application of tests based on legal relationships is found under the GVC, Article 15(4) and (5). In some of the over 150 countries where these tests are applied the GVC definitions (because they are part of an international convention) are directly applicable and binding on the government as a constitutional matter. In other countries

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"common understanding" in that document (found at ¶1.14) concern the "common understanding" the business community and tax administration have with respect to experience applying the arm's length principle).

[23] 26 U.S.C. § 482 reads in full:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

[24] Treas. Reg. § 1,482-1(i)(4).

[25] Grenada Industries, Inc. v. Commissioner, 17 TC 231, 253-254 (1951), aff'd 372 F2d 415 (4th Cir.), cert. denied, 389 US 841 (1953) (involving four families, none of whom held a majority interest in several corporations, but who acted in concert to direct corporate payments to a partnership for the benefit of two of the families).

(like the US) it is the *intent* – not the exact *wording* – that is followed. This leads to minor differences in expression, but not in meaning.[26] GVC, Article 15(4) and (5) provides:

> 4. For the purposes of this Agreement, persons shall be deemed to be related only if:
> (a) they are officers or directors of one another's businesses;
> (b) they are legally recognized partners in business;
> (c) they are employer and employee;
> (d) any person directly or indirectly owns, controls or holds 5 per cent or more of the outstanding voting stock or shares of both of them;
> (e) one of them directly or indirectly controls the other;
> (f) both of them are directly or indirectly controlled by a third person;
> (g) together they directly or indirectly control a third person; or
> (h) they are members of the same family.
> 5. Persons who are associated in business with one another in that one is the sole agent, sole distributor or sole concessionaire, however described, of the other shall be deemed to be related for the purposes of this Agreement if they fall within the criteria of paragraph 4.[27]

Conceptually, this is a dual-principled provision (legal and economic). There appears to be something very different happening in sections 4(a), (b), (c), (d), (h), and 5 where legal relationships are specified (interlocking officers and directors; legal partners; employer and employee relationships; shareholders with a 5 percent interest in voting shares; family members; sole agents), and sections 4(e), (f) and (g). Each of these latter provisions is built simply around the term "control" (one party controls the other party either directly or through third parties). This is strikingly like the economic tests of the US IRC §482 provisions. However, the Notes to the GVC will not permit such an expansive interpretation. The GVC's concept of "control" is not economic – it is legal. The Notes state:

> For the purposes of this Agreement, one person shall be deemed to control another when the former is legally or operationally in a position to exercise restraint or direction over the latter.[28]

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[26] For example, the companion US provisions are found at 19 USC § 1401a(g)(1) and provides:

> (g) Special Rules.
> (1) For purposes of this section, the persons specified in any of the following subparagraphs shall be treated as persons who are related:
> (A) Members of the same family, including brothers and sisters (whether by whole or half blood), spouse, ancestors, and lineal descendants.
> (B) Any officer or director of an organization and such organization.
> (C) An officer or director of an organization and an officer or director of another organization, if each such individual is also an officer or director in the other organization.
> (D) Partners.
> (E) Employer and employee.
> (F) Any person directly or indirectly owning, controlling, or holding with power to vote, 5 percent or more of the outstanding voting stock or shares of any organization and such organization.
> (G) Two or more persons directly or indirectly controlling, controlled by, or under common control with, any person.

[27] GVC *supra* note 1, at Art. 15(4) & (5).

[28] GVC *supra* note 1, at Notes to Article 15, paragraph 4(e).

Thus, GVC Art. 15(4) and (5) is *not* a set of five legal tests wrapped around three economic tests. It is a set of eight legal tests. This has not escaped the sharp eye of the commentators who accept the legal basis of the tests and generally find the language at (e), (f), and (g) (in the light of the Notes and customs practice) to be "vague," "sweeping," "obscure," "[im]precise." As a general matter, these provisions are something that "should have been deleted" from the GVC altogether.[29] Why draft general language that is open to an economic interpretation, if in fact what is intended are strictly legal tests?

(3) *Deemed relationships*. Russia has come very close to vertical harmonization of its transfer pricing rules.[30] The exception is customs. Customs transfer pricing is excluded from Article 40 of the Russian Tax Code, and this is the only thing that makes full harmonization incomplete (on paper at least). Although internally very consistent, the Russian rules are not entirely standard when considered from abroad. This creates a horizontal harmonization problem.

With respect to related parties (in the Russian Code they are called "interdependent parties"), the Russian Tax Code specifies five categories. Four of the five rely on the legal status of the parties involved. They are similar to the rules found in the GVC (and one suspects a conscious borrowing). The fifth category is an unusual three-part *deeming* provision. This fifth provision considers parties who are engaged in certain kinds of transactions to be related parties (regardless of their actual "relatedness") and subjects their transitions to pricing adjustment. The five categories are:

> (1) One party has a direct or indirect ownership interest in the other party of at least 20%,
>
> (2) One physical person is subordinate to another physical person in terms of official status.

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[29] SAUL L. SHERMAN & HINRICH GLASHOFF, CUSTOMS VALUATION: COMMENTARY ON THE GATT CUSTOMS VALUATION CODE 188 (1987). In a discussion of Art. 15(4)(e), Sherman and Glashoff reference and apply the critical language in:

> [t]he Note [that] explains that this test is met when one person 'is legally or operationally in a position to exercise restraint or direction over' the other. This [the term 'control'] is the most sweeping and least precise of the standards. This provision is as obscure as the employer-employee rule. … The same obscurity applies to the term 'operationally.' … The most serious defect is that this provision uses the concept of control to define the concept of control, and this is why the meaning is so unclear. The proviso as a whole should have been deleted. (emphasis added).

Discussing Art. 15(4)(f) and similarly for (g) where they further indicate that the control clauses in these provisions are:

> … set forth a sweeping and vague concept of 'control' unrelated to any defined type of relationship." (emphasis added).

[30] The pricing regime set out in Article 40 of the Russian Tax Code "… does not specify which taxes are covered by transfer pricing adjustments. [Nevertheless,] it is generally accepted that taxes other than profits tax are potentially covered by the new rules." Peter Arnett, *Russia*, TRANSFER PRICING INT'L: COUNTRY BY COUNTRY GUIDE at 29.9(h), 29.3 & 29.4 (Oct. 9, 2003) LexisNexis. Victor Matchekhin, *Russia: Transfer Pricing Rules, Practice and Potential Development*, INT'L TRANSFER PRICING J (May/June 2003) 124, 125 agrees with this assessment and references the use of these rules in two VAT cases (North-West District Court, decision A56-34965/01 of Sept. 20, 2002; North-West District Court, decision A56-21019/01 of Dec. 19, 2001).

(3) The persons concerned are married to one another, or related to one another by blood, or by marriage, or are connected by adoption.
(4) One person is the guardian of another.
(5) The parties are deemed to be interdependent if:

> (a) The transaction is by barter, and goods or services are exchanged.
> (b) The transaction is a foreign trade transaction. The term "foreign trade transaction" is not otherwise defined, but the term "foreign trade activity" is defined in the Tax Code to mean entrepreneurial activity in the area of international exchange of goods, work, services, information, and results of intellectual activity, including exclusive rights thereto, including intellectual property.
> (c) The transactions take place where the level of prices used for identical or similar goods fluctuates by more than 20% in either direction over a short period of time. The term "short period of time" is not otherwise defined.[31]

Thus, Russian definitions of "interdependent parties" lack horizontal harmony with companion definitions of "associated enterprises" or "related parties" in other jurisdictions. As a result, it is common for treaty negotiations to pull these Russian rules into horizontal harmony with those used by trading partners. This then pulls these definitions out of domestic (vertical) harmony. One of the reasons for the unique flavor to the Russian rules most likely has to do with the Russian Federation's status with international organizations: it is a "candidate country" of the OECD,[32] and an observer at the WTO.[33] It appears that the pull of internal (vertical) harmonies is somewhat stronger than the pull of external (horizontal) harmonies in Russia.

Assume for example that the deeming provisions are applied. A Russian entity and an entity of an OECD country engage in (a) an "international exchange" that involves (b) "goods, work, services, information, and results of intellectual activity." In this case, transactions between these parties would not be "suspect" under OECD rules – they are not associated enterprises. However, they could nevertheless be subjected to Russian transfer pricing adjustments – they are interdependent parties under Russian rules. If a Russian adjustment is made, it is very possible that the OECD country would refuse to make corresponding adjustments. When a problem like this causes significant business problems, tax treaty negotiations may not be far away.

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[31] Arnett, *supra* note 30.
[32] Adjustments in some of these rules might be expected as Russia has recently been invited to join the OECD. OECD, COUNCIL RESOLUTION ON ENLARGEMENT AND ENHANCED ENGAGEMENT (adopted by the OECD Council at Ministerial level on 16 May 2007) at ii, extract reported in OECD, CENTER FOR CO-OPERATION WITH NON-MEMBERS, THE OECD'S GLOBAL RELATIONS PROGRAMME 2007-1008, CCNM(2007)2 (May 22, 2007) at 14, *available at* http://www.oecd.org/dataoecd/46/25/38668215.pdf.

> The Council … (ii) Decides to open discussions with Chile, Estonia, Israel, the Russian Federation and Slovenia and invites the Secretary-General to set out the terms, conditions and process for the accession of each of these countries to the OECD for subsequent consideration and adoption by Council.

[33] The observer status of the Russian Federation is noted on the WTO web page *available at*: http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm.

(4) ***No relationship rules other than customs.*** Some countries pay no attention to the relationship of the parties (other than in customs) because there are no transfer pricing rules in income tax. The transfer pricing (and related party) rules in the customs area are used because (as a member of the WTO) the jurisdiction is required to adopt the GVC.

There are a large number of countries in this category. Without conducting a comprehensive survey, it appears that 137 countries could be in this group – if we take the 150 countries in the WTO[34] and reduce it by the 33 countries that are commonly identified as countries with significant income tax transfer pricing regimes. The only transfer pricing rules these countries apply are those prescribed by the GVC. These jurisdictions also tend to follow subjectively valuation principles in VAT,[35] and the relationship between the parties is never a factor.

(5) ***Relatedness ignored in transfer pricing application.*** Some jurisdictions have exceptionally robust transfer pricing rules in income tax and VAT, so robust in fact that they are applied even without proof of a suspect relationship. There is no need to even deem the parties to be related.[36] Prices are always held up to an arm's length standard. Essentially these jurisdictions use transfer pricing to enforce tax avoidance or tax evasion rules.

Australia provides the classic example. Australia reaches the same results (but not in the same way) as the Russian Federation does on this issue. The central concern is with

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[34] *Id.* (listing the 150 member countries of the WTO).

[35] Subjective and objective approaches to valuation are another major way to divide VAT/GST regimes. The difference is best explained with an example:

Consider a restaurant meal. If it is sold to the public for 50, costs 25 to prepare, but is supplied to employees for 10, what is the VAT base? Under subjective valuation, VAT is imposed on 10, because under this theory VAT is imposed on the consideration. This is the amount consumer actually paid, and the amount most readily available to the vendor to inscribed on the invoice. If goods or services are exchanged "in kind" or in addition to money, it is necessary to value this consideration in monetary terms. There may be a small amount of transfer price valuation for these transactions. Objective valuation is different. Under this theory tax would be imposed on the 50. Objective valuation VAT regimes measure the value of the supply, regardless of the amount of consideration actually paid. There will be considerably more transfer pricing valuation exercises under this system.

VAT jurisdictions can be placed along a continuum when the relative use of objective verses subjective valuation measures is isolated as a distinguishing criteria. Four types of jurisdictions are possible, but only three appear to be in common use. At one extreme there are jurisdictions that apply only subjective valuation methodologies (encompassing both arm's length and related party transactions). This is the case in Albania. [LAW ON VALUE-ADDED TAX , No. 7928, 1995 (Albania) at Art. 27] A second group of jurisdictions employ subjective valuations for the most part [1991 SA REVENUE 89; REVENUE, VALUE-ADDED TAX ACT No. 89 of 1991 at § 10(23) (South Africa)], but adopt objective measures of value when considering a small subset (some, but not all) of the related party transactions. This is the case in Canada. [EXCISE TAX ACT, R.S.C., ch. E-15, § 154(1) (Can.)] A third group of jurisdictions always shift to an objective measure of the tax base whenever the parties are related. Related party transactions are viewed as inherently suspect. Transactions among unrelated parties are trustworthy, and are valued subjectively. This is the case in Barbados. [VALUE ADDED TAX ACT, 1996 at § 18(1) (Barbados)]. A fourth approach to valuation is possible – valuing all transactions objectively. No jurisdiction has adopted it.

Importantly, among these four positions, there is no "majority position."

[36] Although the end result in most cases is no different than that under the "deemed relationship" rules of the Russian Federation, there is a slight difference. Because the Russian rule is based on an assumption that bartering, international and high price volatility transactions only take place between related parties, there is a slight opening through which to argue (in a specific case) that the parties involved are truly not related. However, if a jurisdiction decides to ignore the relationship element entirely this window is closed.

international transactions. The Explanatory Memorandum to the (Australian) Income Tax Amendment Bill of 1982 expresses this concern and clearly indicates that Australia intends to target *unrelated* parties with an expansion of transfer pricing rules:

> There can be cases where formally unrelated parties to an agreement do not deal with one another on an arm's length basis, viewed simply in relation to a particular supply or acquisition of property. This could be the case where the particular transaction which reduces a taxpayer's Australian income is offset by benefits under another seemingly unrelated agreement, which may accrue abroad and perhaps to an associate of the taxpayer.

This statutory provision gives the Commissioner sweeping powers. Essentially whenever he determines that property is supplied at less than arm's length, the Commissioner can adjust the price.

> Where –
>
> (a) a taxpayer has supplied property under an international agreement;
>
> (b) the Commissioner, having regard to *any connection* between any two or more of the parties to the agreement or to *any other relevant circumstances*, is satisfied that the parties to the agreement, or any two or more of those parties, were not dealing at arm's length with each other in relation to the supply;
>
> (c) consideration was received or receivable by the taxpayer in respect of the supply but the amount of that consideration was less than the arm's length consideration in respect of the supply; and
>
> (d) the Commissioner determines that this subsection should apply in relation to the taxpayer in relation to the supply,
>
> then, for all purposes of the application of this Act in relation to the taxpayer, consideration equal to the arm's length consideration in respect of the supply shall be deemed to be the consideration received or receivable by the taxpayer in respect of the supply.[37]

This provision is transaction-focused. It indicates that "any connection" or "any other relevant circumstance" is sufficient to allow a transfer pricing adjustment to be made. As was the case with the Russian provisions, it is very possible that after an Australian adjustment is made involving unrelated parties, compensating adjustments by the other jurisdiction could be denied – simply based on the fact that the parties were unrelated. This is a somewhat surprising outcome for an OECD member country that joined the organization in 1971. If the OECD has indeed brought about an international taxation regime one might expect this result in the case of the non-OECD member, Russia, but not in the case of Australia.[38]

If the definition of related parties/associated enterprises is the first filter, the screen through which all transfer pricing cases must pass before pricing adjustments are determined, it will be problematical if the pricing of same transaction, between the same parties is both suspect and not suspect at the same time. One would hope for some consistence (vertical harmony) in

[37] INCOME TAX ASSESSMENT ACT, 1936, § 136AD(1) (Australia) (emphasis supplied).

[38] The Australian provisions under ITAA 1936 § 136AD are not vertically harmonized. They apply only to the income tax. The "deemed relationship" provisions under Article 40 of the Russian Tax Code however are vertically integrated, and apply broadly to all taxes except in customs administration.

these rules. This appears to be what the Russian Federation has attempted to achieve, but this very success is leading to pressures to undo this harmony through treaty negotiation (horizontal harmonization).

Conclusion: Relationship/ associated enterprise definitions. Is there a better way forward? Could the Canadian solution – one that is self-help and taxpayer-by-taxpayer based be applied? Could the Canadian "border solution," to accept a determination in one tax to be an appropriate determination of value in another tax be extended? Specifically, would it be possible to deem parties to be related for customs and VAT/GST purposes in all instances where they are related for direct tax purposes? If so, how would this rule work? Which determination would be dominant? Could this rule be universal? Would the rule be elective and effective only after agreement with the tax administration?

METHODS

All tax regimes have an interest in determining the correct price on "suspect" related party transactions when the prices reported appear to impact the tax base. The degree of concern is not the same among all taxes. Income tax regimes are far and away the most concerned,[39] customs next[40] and VAT a distant third. [41]

[39] The income tax concern follows directly from the size of the cross-border related person trade. 60% of all cross-border trade is conducted by multinational entities, with roughly 40% of cross-border trade conducted within those entities. As a result, transfer pricing issues dominate international tax investigations. See generally the issue October 10, 1994 issue of Tax Notes International that focused on foreign government reactions to the new US transfer pricing regulations. 94 TAX NOTES INT'L 196-16 (Oct. 10, 1994) (indicating throughout that the US employs more international examination agents than any of our trading partners, and that about half of pending US tax cases involved transfer pricing issues).

[40] SHERMAN & GLASHOFF *supra* note29, at 199, n.140 (and related text). Referencing a 1982 GATT survey indicating that the transaction value had been the prevailing method applied, and concluding: "With Transaction Value so widely applied, it necessarily follows that most related-party transfer prices are being accepted, since such transactions are variously estimated to be in the range of 50 percent or more of total trade – something like 70 percent of US-Canada trade is informally estimated to fall in the related party categories." The GATT survey indicated that 95.4% of EC trade, 96.6% of Japanese trade 94.0% of US trade was processed with the transaction value, suggesting that the developed economies are not encountering significant transfer pricing problems in customs enforcement.

[41] In the EU VAT the open market re-valuation of supplies is only available in a small subset of all connected party transactions, and even in those cases it only applies to combat VAT avoidance or evasion. Only transactions where one of the parties is an exempt or partially exempt taxpayer are included within the rules. The proposal states (COM(2005) 89 final at 5):

> The Article therefore only allows re-valuation in the context of combating tax avoidance or evasion and in order to do so, a series of additional tests also need to be satisfied. The rule can be applied only when parties are connected … [and] only allowed in circumstances: (in the case of an undervaluation) where VAT has been charged and the recipient of the supply is not entitled to a full right of deduction of VAT; or (in the case of an overvaluation) VAT has been charged and the supplier is not entitled to a full right of deduction of VAT. Where VAT has not been charged, the revaluation is only applicable where an exempt supply has been undervalued by a partly exempt person.

In other word, the qualification in the opening sentence of this section that, "All the tax regimes considered in this study have an interest in determining that the correct price … <u>when those transactions impact their respective tax bases,</u>" applies directly to the VAT. As long as both parties to a transaction are fully taxable, the transfer price among related parties is not a concern, because ultimately VAT is collected from final consumption (not) intermediate transactions.

It is not surprising therefore that the most sophisticated transfer pricing methods are found in the thirty-three jurisdictions[42] that have serious income tax transfer pricing regimes (serious in the sense that they have well developed documentation and reporting requirements along with detailed standards set out in the law, not simply transfer pricing provisions that "could be" applied when the occasion arises). These jurisdictions are (by and large) the more developed economies. When there is vertical harmonization of methods in these countries it is income tax and VAT/GST harmonization – customs resists conformity.

The vast majority of jurisdictions (91%)[43] are different. In these jurisdictions there are no well-developed (or any) income tax transfer pricing rules. Transfer pricing theory in these jurisdictions is primarily a function of customs enforcement. When there is vertical harmonization of methods in these countries it is between customs and VAT/GST – income tax ignores the issue.

Thus, there is (limited) vertical harmonization of transfer pricing methods. It is a binary harmonization for the most part. It is either (a) *income tax and VAT/GST* harmonization, or (b) *customs and VAT/GST* harmonization. Other harmonies are rare.

It is exceptionally rare to find tripartite harmonization of methods – the use of a single method among *income tax, VAT/GST and customs*. However, there are some jurisdictions where the VAT/GST methods are drafted so vaguely that in a given instance the VAT/GST method employed could be found to be the same as that applied in either the income tax or a customs application.

An additional corollary is that frequently there is *not just one harmonization* per jurisdiction. It is reasonably common to find VAT/GST methods aligning with customs methods at the border, and then have other VAT/GST applications aligning with income tax methods away from the border.

The great problem then is the difficulty that domestic systems have in harmonizing income tax and customs rules. This is what makes the Canadian memorandum D13-4-5 most striking. Memorandum D13-4-5 is an effort to directly harmonize income tax and customs methods.

Five basic methodologies. There are five basic transfer pricing methodologies. Considering each method one-by-one it soon becomes apparent that some methods can have across the board appeal, whereas others are more suited to one tax or the other but will rarely be harmonized across all three.

There is a range of receptivity to these methods. For example, the US income tax finds all five approaches acceptable (depending on the facts and circumstances of the case).[44] The US

[42] *See supra* note 3 and accompanying text for commentary and a list of countries.
[43] *See supra* notes 34 & 3 and calculating 91% = 137/150.
[44] Treas. Reg. § 1.482-1(c)(1) (indicating that the arm's length result of a controlled transaction must be determined under the method "… that, under the facts and circumstances, provides the most reliable measure of an arm's length result.").

tries to find the "best" among all the method. In contrast, the VAT/GST in smaller or developing countries like Barbados, Fiji and Jamaica has a very basic design. These jurisdictions apply a single method (a one-size-fits-all approach) that is frequently borrowed from customs (commonly a TVI/ TVS aggregate).[45]

The section that follows examines the first three of the five major transfer pricing methods (the three traditional methods). The two profit-based methods are considered elsewhere,[46] and their usefulness in VAT/GST application is limited.

For the three traditional methods variances in their structure and application are identified (among income tax, customs and VAT/GST regimes). More emphasis is placed on VAT/GST than on income tax or customs, because (as a global matter) it is the VAT/GST that is reaching out (frequently in both directions) to forge harmonious methodologies. The effort will be to show where harmonies have been established, and where they have not.

(1) ***Comparable uncontrolled price (CUP) &Transaction value of Identical/ Transaction value of similar goods (TVI/ TVS) methods*****.** The comparable uncontrolled price method (CUP) is the preferred transfer pricing method of the US regulations,[47] as well as of the OECD Guidelines.[48] It is very similar to the combined effect of the first two substitute methods under the GVC – the transaction value of identical goods method (TVI), and the transaction value of similar goods method (TVS).[49] Rules that function similar to the CUP or TVI/ TVS methodologies can be found under most VAT regimes.

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[45] VALUE ADDED TAX ACT, 1996 at § 20 (Barbados) (simply indicating that the method is to determine the amount that the supply, "… would reasonably be expected to fetch on a supply in the open market to a recipient who is not connected to the supplier."). 1991 REPUBLIC OF FIJI 45; VALUE ADDED TAX DECREE No. 45 of 1991 at §§ 19(3) & 2(1) (simply indicating that the method is to determine "… the consideration in money that would be expected to be payable for that supply, being a supply at that date in Fiji, between a supplier and a recipient independent of each other."). It can of course be argued that these VAT regimes propose no method at all, and the referenced language only re-states the arm's length standard, in which case it becomes a matter of satisfying the tax authority that the correct result has been reached. This is the case in Jamaica. THE GENERAL CONSUMPTION TAX ACT, 1991 at § 2(1) (Jamaica) (indicating that the method is the demonstration that "satisfies the Commissioner," or "… the amount of consideration in money (excluding tax) which the Commissioner is satisfied would be payable in respect of a taxable supply by a person who is not a connected person in an arm's length transaction." Without regulations explaining how the Jamaican Commissioner is to be satisfied this is a standard that is searching for the "best method," and is most likely receptive to any of the methods specified under the domestic income tax or customs regime.

[46] Richard T. Ainsworth, *IT-APAs: Harmonizing Inconsistent Transfer Pricing Rules in Income Tax-Customs-VAT*, 34 RUTGERS COMP. & TECH. L.J. 1 (2007).

[47] CYM H. LOWELL, MARIANNE BURGE & PETER L. BRIGER, U.S. INTERNATIONAL TRANSFER PRICING ¶4.05[1] & [2](2[ND] ed.), on line at West Law WGL-ITP (indicating that "[t]he status of the CUP method as the highest priority means of satisfying the arm's length requirement in the case of tangible goods transactions remains unquestioned. This priority has, however, undergone a very careful reexamination … The 1992 Proposed Regulations would have severely restricted the scope of application of the CUP method, by requiring that an uncontrolled transaction involve the identical property and by not permitting the use of inexact comparables. … The 1994 Regulations, which affirmed the arm's length principle and set forth a best method rule to provide more flexibility in measuring arm's length requirements, has the effect of retaining the CUP method as the best method where its requirements can be satisfied.").

[48] OECD, GUIDELINES *supra* note 2, at ¶ 2.6 (stating, "where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable …")

[49] GVC *supra* note 1, at Art. 2 & 3.

Income tax (CUP). Under the CUP method the arm's length price of a related party transaction is considered to be equal to the price paid in a comparable uncontrolled sale. Assuming a comparable transaction can be found, the only significant issue under the CUP method is what should be done if there are differences between the controlled party transaction and those between the uncontrolled parties. Both US regulations[50] and OECD Guidelines[51] anticipate that minor adjustments can be made.

Customs (TVI/ TVS). The GVC takes a similar approach, but splits the CUP concept between two Articles. The transaction value of identical goods (TVI) is considered in Article 2, and the transaction value of similar goods (TVS) is considered in Article 3. They must be applied in sequence. Identical goods are:

> ... the same in all respects, including physical characteristics, quality and reputation. Minor differences in appearance would not preclude goods otherwise conforming to the definition from being regarded as identical.[52]

Similar goods are:

> … goods which, although not alike in all respects, have like characteristics and like component materials which enable them to perform the same functions and to be commercially interchangeable. The quality of the goods, their reputation and the existence of a trademark are among the factors to be considered in determining whether goods are similar.[53]

As under the CUP method, adjustments can be made to TVI and TVS values when precisely comparable transactions cannot be identified. However, the adjustments permitted under customs rules are significantly more limited than those allowed under the income tax. Custom adjustments are only for "differences attributable to commercial level and/or to quantity."[54]

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[50] Treas. Reg. § 1.482-3(b)(2)(B) list the following factors that can be adjusted, if they would affect the price:
(1) Quality of the product;
(2) Contract terms (e.g., scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);
(3) Level of the market (i.e., wholesale, retail, etc.);
(4) Geographic market in which the transition takes place;
(5) Date of the transaction;
(6) Intangible property associated with the sale;
(7) Foreign currency risks; and
(8) Alternatives realistically available to the buyer and the seller.

[51] OECD, GUIDELINES *supra* note 2, at ¶ 2.7 (indicating that, "… an uncontrolled transaction is comparable to a controlled transaction [i.e., it is a comparable uncontrolled transaction] for purposes of the CUP method if one of two conditions is met: (1) none of the differences [if any] between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price on the open market; or (2) reasonable accurate adjustments can be made to eliminate the material effects of such differences.).

[52] GVC *supra* note 1, at Art. 15(2)(a).

[53] GVC *supra* note 1, at Art. 15(2)(b). Compare with the list of adjustments under the income tax *supra* note 50.

[54] GVC *supra* note 1, at Art. 2(1)(b) & 3(1)(b) are identical except for the word "identical" used in Art. 2(1)(b) and the word "similar" in Art. 3(1)(b). They read as follows:

> In applying this Article, the transaction value of identical [*similar*] goods in a sale at the same commercial level and in substantially the same quantity as the goods being valued shall be used to determine the customs value. Where no such sale is found, the transaction value of identical [*similar*] goods sold at a different commercial level and/or in different quantities shall be used,

There are two additional differences between the income tax approach to a CUP and the GVC approach to TVI and TVS. First, under the GVC in order for the transaction being valued to be considered identical or similar to the transaction between related parties, the goods must have been produced in the same country.[55] There is no similar requirement under either the OECD or the US rules.

Secondly, the GVC has a distinct preference for internal comparables – goods produced by the same seller. It indicates that:

> Goods produced by a different person shall be taken into account only where there are no identical or similar goods, as the case may be, produced by the same person as the goods being valued.[56]

A related requirement also applies. Goods produced by the same person are valued only if they are: (a) actually imported, and they are either (b) actually valued under Article 1, or they provide (c) an acceptable basis for valuation under Articles 2 or 3.[57] There are no similar requirements under either US or OECD rules.

These customs rules can produce anomalous (economically inaccurate) results. For example, suppose Nigerian crude oil is imported into the same country, in the same volumes, on the same day, and under the same market conditions as is absolutely identical Venezuelan crude oil. Under OECD and US rules the price of the Venezuelan crude (subject to adjustments for differences in transportations costs) is a CUP for the Nigerian crude. Under the GVC the Venezuelan crude would be neither a TVI nor a TVS for the Nigerian crude. Adjusting for the difference in the origin of the goods is not possible under the GVC. In fact, similar (but not identical) crude produced by the same party (in Nigeria) would set the customs value, if the transaction value under Article 1 is rejected or cannot be applied.

Vertical Harmonization – Income Tax CUP & Customs TVI/ TVS. It is difficult to see how CUP and TVI/ TVS can be harmonized without making significant changes to one method or the other. This study has not found any examples where this has occurred. The CUP method searches broadly for comparable transactions and is willing to liberally adjust the data to align transactions. In contrast, the TVI/ TVS methods are narrow and rigid. They adjust only for commercial level and quantity, limit the comparable transactions to the same country of origin, and prefer internal comparables. Although it is possible that the same result can be reached under both systems, harmony is not assured.

VAT/GST. Most VAT/GST regimes adopt some form of a CUP or TVI/TVS valuation methodology. There are three general types of harmonized CUP or TVI/TVS valuation systems. They can be set along a sliding scale from:

- *fully harmonized with CUP* – VAT/GST rules are directly linked to income tax rules;

> adjusted to take account of differences attributable to commercial level and/or to quantity, provided that such adjustments can be made on the basis of demonstrable evidence which clearly establishes the reasonableness and accuracy of the adjustment, whether the adjustment leads to an increase or a decrease in the value.

[55] GVC *supra* note 1, at Art. 15(2)(d).
[56] GVC *supra* note 1, at Art. 15(2)(e).
[57] SHERMAN & GLASHOFF *supra* note 29, at 203, ¶ 634.

- *parallel harmonization with CUP or TVI/ TVS* – VAT/GST rules are independent, but ambiguously paraphrase companion provisions that can harmonize in either direction;
- *roughly harmonized with CUP or TVI/TVS* – VAT/GST rules contain very sparse methodology statements, but what is set down is patterned on either CUP or TVI/TVS methodologies; and
- *not harmonized at all* – these jurisdictions have neither CUP-like nor TVI/ TVS-like valuation rules.

Fully harmonized CUP – Japan, Spain, Russia, Azerbaijan, Turkmenistan, and Georgia, with further consideration of Uzbekistan, Chile and Ecuador. All of these jurisdictions (except Uzbekistan, Chile and Ecuador at the moment) apply exactly the same CUP method in income tax and VAT.[58] There are two ways this is accomplished, one is to put the CUP method in the income tax and then directly link the VAT to it; the other is to place the CUP method in a separate statute, and then indirectly link the income tax and VAT by linking both to this third statute. Spain and Japan take the first approach; Russia, Azerbaijan, Turkmenistan, and Georgia take the second.

Transfer pricing under the Japanese Consumption Tax, a credit subtraction VAT without invoices,[59] is handled by proxy. The Consumption Tax law specifically ties all Consumption Tax valuation issues to methods employed under the corporate income tax (except for valuation issues at the border which follow customs transfer pricing rules).[60] The Japanese corporate income tax follows the OECD Guideline, and the CUP method is given priority. Thus, exactly the same methods and priority apply in the Consumption Tax.[61]

A similarly harmonized transfer pricing methodology has been enacted in Spain. Spain, like Japan, places all transfer pricing methods into the Spanish Corporate Income Tax. Methods under the VAT are directly linked to the corporate income tax (except for valuation at the border

[58] It would be possible for a jurisdiction to apply exactly the same method in customs and VAT, but no examples of this approach to harmonization have been fond.

[59] ALAN Schenk & OLIVER Oldman, VALUE ADDED TAX: A COMPARATIVE APPROACH IN THEORY AND PRACTICE 38 Transnational Publishers 2001 (discussing the various types of VAT globally, distinguishing the annualized Japanese VAT from the invoice-based VAT common in most other countres).

[60] JAPAN'S REVISED CONSUMPTION TAX LAW (SHOUHIZEIHOU), Art. 28(2) LAW NO. 108, 1988, AND APPENDIXES by approving the changes contained in LAW NO. 49, 2000; CABINET ORDER (SHOUHIZEIHOU SEKOUREI) NO. 360, 1988 (most recent amendment, ORDER NO. 147, 2000 *available at*: http://law.e-gov.go.jp/cgi-bin/idxsearch.cgi. (in Japanese). For an English translation of the Consumption Tax law based on Law No. 108, 1988 by approving changes contained in Law No. 49, 2000 see: *Consumption Tax Law*, tr. Vickie L. Beyer, 2000 WTD 247-20 (December 22, 2000). For a translation of the appendixes to Japan's revised consumption tax law, Law No. 108 see: *Translation of Exemptions to Japan's Revised Consumption Tax Law*, tr. Vickie L. Beyer, 2000 WTD 247-21 (December 22, 2000). For a translation of the final regulations, Cabinet Order No. 360, 1988 (most recent amendment, Order No. 147, 2000) see: *An Order for the Enforcement of the Consumption Tax Law*, tr. Vickie L. Beyer, 2001 WTD 36-24 (February 20, 2001).

[61] The Japanese transfer pricing legislation is codified in the Special Taxation Measures Law (*Sozei-tokubetsu-sochihou*) (STML) Article 66-4. The legislation is supplemented by the SMTL Enforcement Order Article (*Sozei-tokubetsu-sochihou-sekourei*) 39-12 and the SMTL Ministerial Order Article 22-11. The National Tax Administration's interpretation of the transfer pricing laws and regulations is set out in the SMTL Basic Circular. Japan follows the OECD Guidelines. The CUP method is specified at SMTL Article 66-4(2).

where customs transfer pricing rules are followed).[62] Spain adopts the OECD Guidelines and makes the CUP a first priority method.[63]

The *Tax Code of the Russian Federation* accomplishes the same result as do the Japanese and Spanish laws, but it does so indirectly. The Russian approach is a classic example of full harmonization by indirect linkage. Part 1 of the Code sets out basic rules applicable to all taxes (excluding customs). Articles 20 and 40 of Part 1 concern transfer pricing.[64] The CUP method is the principal method.[65] Part 2 of the Russian Code contains a large number of tax laws, including the income tax and the VAT. Because each of the taxes in Part 2 relies on the harmonized definitions in Part 1, the same transfer pricing methods (with the same priority given to the CUP) are applied to the Russian VAT and the Russian income tax.[66]

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[62] Spain follows EU rules under the SIXTH DIRECTIVE, *supra* note 7, at Art. 11(A)(1)(a); RVD Art. 73.

[63] Spanish Act 36/2006 of Nov. 29, 2006 amends the VALUE ADDED TAX ACT 37/1992 (Dec. 28, 1992) Art. 79.5 (providing, "For purposes of the previous two paragraphs [concerning the definition of the open market value], Art. 16 CTA [Corporate Tax Act] will be applicable, when appropriate.") Royal Legislative decree 4/2004 (the Spanish Corporate Tax Act) was also modified by Act 36/2006 (Nov. 29, 2006) to amend the methodologies for Spanish transfer pricing to specifically adopt the five OECD methods.

[64] Peter Arnett, *supra* note 30, at ¶29.1 (indicating that Prior to the enactment of Part 1 of the Russian Tax Code in 1999 no transfer pricing rules applied in any taxes, and that there were only special rules dealing with sales below cost in the Russian VAT).

[65] The Russian Code has a hierarchy of methods, with proof of the impossibility of using the CUP method as a precondition of moving into other methods.

> The market price of a particular good or service under the CUP method is defined as the market price of identical (or homogeneous) goods, work, or services under comparable economic or commercial conditions (Article 40.4) Economic conditions are considered to be comparable if the difference between such conditions does not materially affect the price. Market price is determined on the basis transactions between unrelated parties.
>
> Article 40 of the Tax Code specifies various conditions as reasonable justification for a difference between the price of a transaction and a market price. The CUP can be established by making adjustments to a known benchmark market price where it is possible to quantify the effect of different economic conditions.

Id. at ¶29.4(a).

[66] The Russian system of harmonization is not unique. A similar tax code can be found in Georgia. A general definition of related persons (special persons) applies to income tax, VAT (and a series of other taxes except customs) at TAX CODE OF GEORGIA, 1997 (as amended) Pt. I, Ch. 1, Art. 24(2):

(a) persons are founders (participants) of the same enterprise, if their share is not less than 20 percent;
(b) one person has a direct or indirect interest in another person, which is an enterprise, where such an interest is not less than 20 percent;
(c) one person is subordinate to the other person in terms of his business, position or one person is under control (directly or indirectly) of the other person;
(d) persons are subsidiary enterprises or are under direct or indirect control of a third person;
(e) persons jointly (directly or indirectly) control third persons;
(f) persons are relatives.

This definition is followed with a uniform set of methods to be used to determine the "market price" for "goods, works or services" when these transactions are between related persons. TAX CODE OF GEORGIA, 1997 (as amended) Pt. I, Ch. 1, Art. 27. Article 27 follows a customs approach to valuation, following a TVI/TVS model rather than an income tax or CUP format. It has clear ordering rules (identical over similar), but with a further preference for transactions close in time to the suspect transaction (even to the extent of inverting the preference for identical over similar when the time of the transaction becomes a factor). It specifies that identical transactions by unrelated parties are considered first, and then similar transactions by unrelated parties [Art. 27(1)]. These transactions must occur close in time to the suspect transaction [Art. 27(2)]. If it is not possible to find acceptable comparables, then other (less proximate) identical (and then similar) transactions by unrelated parties are

A number of Former Soviet Republics follow the example of the two-part Russian tax code. Azerbaijan,[67] Turkmenistan,[68] and Georgia[69] follow the Russian example. Each country places transfer pricing rules in an opening part and associates a number of taxes (including the income tax and the VAT) with these rules in the second part. Although neither Russia nor any of the Former Soviet Republics fully adopt the OECD Guidelines (neither profit-split nor transactional net margin methods are included in any of these codes) each code adopts the CUP method and gives it priority over all other methods.

There are exceptions within the Russian sphere of influence. Uzbekistan,[70] for example, follows the Russian model of a two-part tax code but has no related party or transfer pricing methods included in the first part.

However, a two-part tax code design is not limited to Russia and the Former Soviet Republics. Chile and Ecuador have similar two-part codes, and currently reach non-harmonized results in the application of the transfer pricing rules they have in place. The outcome is different because both Chile and Ecuador actually implement their transfer pricing methods, but do so only in the income tax. Ecuador's two-part tax code includes both related party rules and transfer pricing methods, and the methods follow the OECD Guidelines.[71]

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considered, but only if they occur within 30 days of the suspect transaction [Art. 27(5)]. This provision is followed by authority to issue regulations that will further specify methods to be used at Art 27(6):

> If the provisions of parts 1-5 of this Article cannot be applied, the market price of goods (works, services) is determined according to the procedure prescribed by the Ministry of Economy in coordination with the Ministry of Finance. At the same time, account shall be taken of costs for the production and (or) sale (acquisition price or depreciated value) of the goods (woks, services) that are customary in such instances, and costs for transportation, storage, insurance and other similar costs that are customary in such instances, as well as additional charges or discounts that are customary for transactions between non-interdependent persons, considering factors of supply and demand on the market of goods (works, services). The aforementioned discounts are taken into account, in particular, in the case of quality deterioration or loss of other consumer qualities of the goods, or expiration (approaching expiration date) of the service life period or sale period of the goods.

The clear impression under the Georgia statute is that the same TVI/TVS or CUP type of analysis will solve most of the transfer pricing problems in income tax and VAT.

[67] TAX CODE OF THE REPUBLIC OF AZERBAIJAN, Law No. 905-IG at Arts. 14.6.3, (Jul. 11, 2000) (Azerbaijan) (indicating that comparable goods, services or works that are "identical and similar" have a first priority).

[68] TAX CODE OF TURKMENISTAN, 2005 at Pt. 1, Sec. IV, Ch. 2, Art. 36(3) (Turkmenistan) (indicating that comparables that are based on identical or similar goods, services or works have a first priority).

[69] TAX CODE OF GEORGIA, 1997 (as amended) Pt. I, Ch. 1, Art. 27(6) (setting out methods to determine the "market price" with a first priority given to identical and similar supplies).

[70] TAX CODE OF THE REPUBLIC OF UZBEKISTAN, Art. 18, Law No. 396-I (April 24, 1997) (although designed in a similar manner the Uzbekistan code does not contain a general provision in Part 1 dealing with related parties or with transfer pricing methods, however in the income tax alone the above provision allows the Commissioner to adjust taxable income of "correlated parties," but again without specified methods).

[71] The general rule authorizing transfer pricing adjustments in Chile is contained in Article 64 of the Tax Code. It is drafted broadly to cover all taxes:

> When the price or value assigned to tangible or intangible goods or services is the taxable base or one of the elements needed to determine a tax, the Administration, without any previous notice, could set their price or value when it is notoriously lesser than those used in the market or those which are normally charged in similar contracts, considering the circumstances of the transaction.

Tax Code, No. 830 (Dec. 1974), as amended Law No. 20,125 (Oct. 18, 2006) at Art. 64 (Chile). However this authority is affirmatively implemented only in income tax where CUP, RSP and C+ methods are

In the Ecuadorian case, a current tax reform is changing things. The new Ecuador law vertically harmonizes transfer pricing methods following the 1995 OECD Guidelines in income tax and VAT. Ecuador follows the Spanish result through indirect (rather than direct) linkage.[72]

Parallel harmonized CUP or TVI/ TVS – Australia & New Zealand. The Australian and New Zealand GST do not directly (or indirectly) link GST methodologies to income tax or customs rules. Three parallel systems are intended (income tax, customs and GST). However, it is not clear in either case (Australian or New Zealand) if the intent is to parallel the income tax, the customs rules, or both. This ambiguity stems from the drafting of the GST rules. Because the GST rules are set out in general terms, with an emphasis particularly in the Australian case on examples, not technical descriptions, the GST rules appear to reach out in both directions. The tax policy guiding the Australian and New Zealand GST rules appears to be to design a flexible, but GST-specific hybrid transfer pricing regime.

Australian Goods and Service Tax Ruling, GSTR 2001/6 indicates that identical or similar "goods, services or things" can be used to determine the market price. The rule resembles a CUP or a TVI/ TVS. However, the ruling neither indicates a firm priority between these methods as under the GVC (although one could assume that identical supplies would take priority over similar supplies), nor does it indicate that the taxpayer should find the "best

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referenced at: Income Tax Law, No. 824 (Dec. 1974), as amended (Feb. 21, 2007) at Art. 38 (Chile). There is nothing comparable in the Chilean VAT statute or regulations.

In similar fashion, the general rule authorizing transfer pricing adjustments in Ecuador is contained in Article 91 of the Tax Code. It too is drafted broadly to cover all taxes:

> The Government, while assessing taxes, could establish the necessary rules to regulate the transfer pricing of goods or services for tax purposes. The exercise of this competence is applicable exclusively in the following situations:
>
> > a) If sales are made at cost or less, unless the taxpayer can demonstrate with the proper documents, that there were circumstances that made the goods deteriorate or that the negotiated conditions were necessary (…)
> >
> > b) When exports are made at prices inferior to those used in international markets at the time of sale, at the first buyer level, unless the taxpayer can demonstrate with the proper documents, that there were circumstances that made the goods to deteriorate or that the negotiated conditions were necessary (…)
> >
> > c) Costs will be regulated when imports are made at prices higher to those used in international markets.

Tax Code, No. 1016-A (Dec. 1975), as amended (Oct. 1, 2005), at Art. 91 (Ecuador). As was the case with Chile, transfer pricing authority is extended only to the income tax through regulations, *see* Regulations to the Internal Tax Regime Law, Executive Decree No. 2209 (Dec. 2001), as amended Executive Decree 2430 (Dec. 31, 2004) at Arts. 4 (Ecuador). However, in the case of Ecuador it is clear that the methods adopted by the tax administration are the same as those set down in the OECD Guidelines:

> For technical reference to this chapter, the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations approved by the Organization for Economic Co-Operation and Development (OECD) in 1995 shall be used, to the extent they are congruent with article 91 of the Tax Code, these Rulings and tax treaties signed by Ecuador.

Regulations to the Internal Tax Regime Law, Executive Decree No. 2209 (Dec. 2001), as amended Executive Decree 2430 (Dec. 31, 2004) at Arts. 66.6 (Ecuador).

[72] Roberto M. Silva Legarda, *Tax Fairness Bill Released for Public Comment*, 46 Tax Notes Int'l 1301 (June 25, 2007) (discussing in detail the Ecuadorian Tax Reform in income tax, VAT and excise taxes).

method."[73] In addition, there are neither geographic preferences (similar to a place of origin rule in the GVC) nor are there preferences for an internal over external comparables (as in GVC Art. 15(2)(e)).

A New Zealand Tax Information Bulletin explains the IRD Commissioner's policy on applying the open market value concept.[74] Methods for determining the open market value are provided in Section 4 of the Goods and Services Tax Act of 1985. Unlike the Australian rules which are set out through ATO rulings, it is Section 4 of the Goods and Services Tax Act that is the relevant instrument in New Zealand. The New Zealand statute prioritizes valuation methods. It sets down a strict order in the use of methods (identical, then similar, and then unspecified methods reserved for the Commissioner's discretion). The approach of the New Zealand GST is therefore closer to a customs, than to an income tax approach.[75]

The first New Zealand method is to use an identical supply (Section 4(2)). If not successful, then a similar supply (Section 4(3)) can be used. Only then can either the taxpayer or the government use further methods, or "… a method approved by the Commissioner which provides a sufficiently objective approximation of the consideration in money which could be obtained for that supply of those goods and services." (Section 4(4)). New Zealand distinguishes between identical and similar supplies in Section 4(1)(a).[76]

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[73] Goods and Service Tax Ruling, *Goods and Services Tax: Non-Monetary Consideration*, ¶¶ 144, 145 & 148-49, GSTR 2001/6 (Nov. 28, 2001) indicates:

> 144. You may determine the GST inclusive market value of non-monetary consideration for a taxable supply by applying a method that produces a reasonable GST inclusive market value of the consideration. There will be situations where the methods used by parties differ according to their particular circumstances. Examples of reasonable methods include:
>
> - the market value of an identical good, service or thing;
> - the market value of a similar good, service or thing; …
>
> 145. If an identical good, service or thing exists in the market, then the market value can be the actual price of that identical good, service or thing in that market. The price of the goods, services or things being compared needs to be representative of the market in which you are dealing. …
>
> 148. You may seek to identify a similar good, service or thing from which the GST inclusive market value can be obtained.
>
> 149. A similar good, service or thing needs to closely resemble the good, service or thing that is required to be valued in the first instance. It needs to be able to take the place of the original good, service or thing and perform in a similar way. Matters that are relevant in considering the degree of similarity include the nature of the good, service or thing, the use to which it is put, its cost, location, size, quality and composition.

available at: http://law.ato.gov.au/atolaw/index.htm

[74] New Zealand, IRD Tax Information Bulletin, Vol. 6 No. 14 at 6-8 (Jun. 1995) *available at* http://www.ird.govt.nz/resources/file/ebdb0e4522c9369/tib6-14.pdf

[75] The New Zealand approach could be considered as one that follows the 1979 OECD Guidelines where a similar priority of methods can be found. If so, then the VAT transfer pricing rules are out of harmony with the income tax rules, which follow the OECD 1995 Guidelines. This is not unusual in this area as the Canadian guidelines do the same. *See infra* note 104 (discussing Canadian Customs & Revenue Agency, *Transaction Value Method for Related Persons*, Memorandum D13-4-5 (April 9, 2001)).

[76] A similar supply is one that, "… in respect of the characteristics, quality, quantity, functional components, materials, and reputation of the goods and services first mentioned, is the same as, or closely or substantially resembles, that supply of goods and services." GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at § 4(1)(a).

Roughly harmonized – Botswana & Lesotho. A third category of harmonized VAT statutes adopts customs methodologies, but does so without great attention to methodological detail. The TVI/ TVS methods are copied, but other GVC-based methods are frequently ignored.[77] This pattern is common in developing economies where income tax transfer pricing rules have not been adopted, but where customs rules are well understood and revenue from customs is significant.

Botswana is a classic example of a jurisdiction taking a customs-based approach to harmonization. Botswana requires the use of "fair market" valuation[78] when supplies are made to related parties. There is a very extensive definition of related parties, one that is nearly identical to that under the GVC.[79] Botswana determines the fair market value of a supply first by comparing identical supplies,[80] and if identical supplies are not available then through similar supplies.[81] This priority follows the TVI/ TVS distinction. In cases where neither of these methods works, the statute provides that "…the fair market value shall be determined in accordance with any method approved by the Director which provides a sufficiently objective

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[77] The other methods could be adopted in regulations or could simply be followed unofficially in audit practice.

[78] VALUE ADDED TAX ACT, 2000 at 9(3)(a) & (b)(i) (Botswana).

[79] VALUE ADDED TAX ACT, 2000 at Pt. 1, Art. 2. (Botswana) states:

"related persons" means -

(a) an individual and -

(i) any relative of that individual; or

(ii) a trust in respect of which such relative is or may be a beneficiary; or

(b) a trust and a person who is or may be a beneficiary in respect of that trust; or

(c) a partnership, or unincorporated association or body or close corporation and -

(i) any member thereof; or

(ii) any other person where that person and a member of such partnership, or unincorporated association or body, or close corporation as the case may be, are related persons in terms of this definition; or

(d) an incorporated company, other than a close corporation and -

(i) a person, other than an incorporated company, where that person or that person and a person related to the first mentioned person in terms of this definition controls 10 percent or more of -

(A) the voting power in the company;

(B) the rights to distributions of capital or profits of the company, either directly or through one or more interposed companies, partnerships, or trusts; or

(ii) any other incorporated company in which the first mentioned person referred to in sub-paragraph (i) or that person and a person related to that first mentioned person in terms of this definition controls 10 percent or more of -

(A) the voting power in the first-mentioned company; or

(B) the rights to distributions of capital or profits of the first-mentioned company, either directly or through one or more interposed companies, partnerships, or trusts; or

(iii) any person where that person and the person referred to in subparagraph (i) or the other incorporated company referred to in subparagraph (ii) are related persons in terms of this definition; or

(iv) any person related to the person referred to in sub-paragraph (iii) in terms of this definition;

(e) a registered person and a branch or division of that registered person which is separately registered under section 46(3) as a registered person; or

(f) any branches or divisions of a registered person which are separately registered under section 46(3) as registered persons;

[80] VALUE ADDED TAX ACT, 2000 at 3(2) (Botswana).

[81] VALUE ADDED TAX ACT, 2000 at 3(3) (Botswana).

approximation of the consideration in money …"[82] In Botswana, the Director has issued no regulations specifying these other methods, and one assumes that this provision refers to an audit discretion. However, the parallel construction of the statute assures that this discretion will most likely be exercised in a manner that keeps VAT and customs valuation in harmony.

The most striking aspect of the Botswana VAT is the express link that is made between import and non-import transactions. VAT valuation expressly parallels customs valuation. Not only does the opening section of the definition of "fair market value" present parallel concepts of "similar imports" and "similar supplies."[83] but the whole definition of fair market value is also drafted in parallel form.[84]

The rules in the Lesotho VAT are similar, but they are set out in less detail than in Botswana. Lesotho uses the expression "associate" to define related parties.[85] Lesotho adjusts prices between associates to "fair market value." Like Botswana, when defining "fair market

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[82] VALUE ADDED TAX ACT, 2000 at 3(4) (Botswana).

[83] VALUE ADDED TAX ACT, 2000 at 3(1) (Botswana).

> In this section -
>
> "**similar import**", in relation to an import of goods or services, means any other import of goods or services that, in respect of the characteristics, quality, quantity, functional components, materials, and reputation of the first-mentioned goods or services, is the same as, or closely or substantially resembles, that import of goods or services;
>
> "**similar supply**", in relation to a supply of goods or services, means any other supply of goods or services that, in respect of the characteristics, quality, quantity, functional components, materials, and reputation of the first-mentioned goods or services, is the same as, or closely or substantially resembles, that supply of goods or services. (emphasis in original)

[84] VALUE ADDED TAX ACT, 2000 at 3(2) – (6) (Botswana).

> (2) For the purposes of this Act, the fair market value of a <u>supply or import</u> of goods or services at any date shall be the consideration in money which the <u>supply or import</u>, as the case may be, would generally fetch if <u>supplied or imported</u> in similar circumstances at that date in Botswana, being a <u>supply or import</u> freely offered and made between persons who are not related persons.
>
> (3) Where the fair market value of a <u>supply or import</u> of goods or services at any date cannot be determined under subsection (2), the fair market value shall be the consideration in money which a <u>similar supply or similar import</u>, as the case may be, would generally fetch if <u>supplied or imported</u> in similar circumstances at that date in Botswana, being a <u>supply or import</u> freely offered and made between persons who are not related persons.
>
> (4) Where the fair market value of a <u>supply or import</u> of goods or services cannot be determined under subsection (2) or (3), the fair market value shall be determined in accordance with any method approved by the Director which provides a sufficiently objective approximation of the consideration in money which could be obtained for that <u>supply or import</u> had the supply or import been freely offered and made between persons who are not related persons.
>
> (5) For the purposes of this Act, the fair market value of any consideration, not being consideration in money, for a <u>supply or import</u> of goods or services shall be ascertained in the same manner, with any necessary modifications, as the fair market value of a <u>supply or import</u>, as the case may be, of goods or services ascertained pursuant to the foregoing provisions of this section.
>
> (6) The fair market value of a <u>supply or import</u> is determined at the time of the <u>supply or import</u> as determined under this Act. (emphasis supplied).

[85] SALES TAX ACT, 1995 at Art. 3 (Lesotho) states:

> "associate", in relation to a person, means any other person who acts or is likely to act in accordance with the directions, requests, suggestions, **or** wishes of the first-mentioned person whether or not they are communicated to that other person;

value," Lesotho aggregates the definition of similar import with the definition of similar supply.[86]

Lesotho adopts the customs priority of TVI/ TVS, and in cases where neither of these methods works, the statute provides that, "… the fair market value of the supply or import shall be such amount that, in the opinion of the Commissioner having regard to all the circumstances of the supply or import, is the fair market value …"[87] The definition of taxable value of imports expressly references the Customs and Excise Act, 1982.[88] Like Botswana, the general structure of the Lesotho statute parallels import and non-import transactions.[89]

No CUP or TVI/ TVS methods – Croatia & Albania. Some VAT jurisdictions do not make adjustments for transfer prices. In these jurisdictions there is no expectation that the tax base will conform either to CUP or TVI/ TVS valuation methodologies. As members of the GATT these jurisdictions will adjust import prices according to GVC principles, and as a result, an exception is included in the VAT to allow these revaluations.

The Albanian VAT strictly follows subjective valuation criteria.[90] The value of a supply is adjusted only for self supplies,[91] and customs valuation on import.[92] The same is true under the Croatian VAT – subjective valuation criteria are followed[93] with variation only for customs

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[86] SALES TAX ACT, 1995 at Art. 4(1) (Lesotho) states:
In this section, "similar supply or import", in relation to a taxable supply or import, means a supply or import that is identical to, or closely or substantially resembles, the first-mentioned supply or import, having regard to the characteristics, quality, quantity supplied, functional components and reputation of; and materials comprising, the goods or services the subject of that supply or import.

[87] SALES TAX ACT, 1995 at Art. 15(3) (Lesotho). As in Botswana, the Commissioner in Lesotho has issued no regulations specifying these methods, and one assumes that this provision refers to audit discretion.

[88] SALES TAX ACT, 1995 at Art.15(1) (Lesotho).

[89] SALES TAX ACT, 1995 at Art.15(2) & (3) (Lesotho).

> (2) For the purposes of this Act, the fair market value of a taxable supply or an import at any date is the consideration in money which a similar supply or import would generally fetch if supplied or imported in similar circumstances at that date, being a supply or import freely offered and made between persons who are not associates.
>
> (3) Where the fur market value of a taxable supply or an import cannot be determined under subsection (2), the fair market value of the supply or import shall be such amount that, in the opinion of the Commissioner having regard to all the circumstances of the supply or import, is the fair market value of the supply or import. (emphasis supplied).

[90] LAW FOR VALUE ADDED TAX, No. 7928, 1995 at Art. 27(1) & (2) (Albania) states.

> (1) The taxable value of a taxable supply is the total amount paid for such supply, except in cases defined otherwise in this law.
>
> (2) The taxable value of a supply of goods established in article 18, item 2 or item 3, is the total payment that would have been payable relating to that supply if the aim of the supplier were to receive a profit on that or either similar supplies.

[91] LAW FOR VALUE ADDED TAX, No. 7928, 1995 at Art. 18(2) & (3) (Albania).

[92] LAW FOR VALUE ADDED TAX, No. 7928, 1995 at Art. 26(3) (Albania) states:

> The taxable value of imported goods is defined under Law 7609, dated 22.09.1992 "On Customs Tariffs" despite the fact that imported goods are taxable or not with customs duties on the basis of that law.

[93] VALUE ADDED TAX ACT at Art. 8(1) (Croatia) states:

> The taxable base for value added tax shall be the consideration received for goods delivered or services performed. Consideration shall include anything that the recipient of goods or services is required to give or pay for the goods delivered or services performed, excluding the amount of

valuation for imported goods.[94] Neither the Albanian nor the Croatian VAT have provisions for revaluation of supplies between "related parties," connected parties," or "associates," and neither specifies any methodology for alternate valuations.

(2) ***Resale price method (RSP) & Deductive value method (DVM).*** The resale price method (RSP) or the deductive value method (DVM) is the pricing method that best fits cases where a reseller does not add substantial value to a supply. This is common with related-party distributors. The method (in a sense) moves backward. It starts with the (distributor's) resale price to a third party, and discounts this amount by the appropriate markup to arrive at the price for the sale between the related parties. The markup percentage is derived from an analysis of comparable transactions between unrelated parties.

Income tax (RSP). Under both US and OECD rules the resale price method emphasizes the comparability of functions performed, more than comparability of the products.[95] As a result, to find comparable transactions income tax methods require relatively complete information on the functions performed, the risks assumed, and the resale contract terms of the uncontrolled distributor.[96] Internal comparables are preferred (but external comparables are acceptable) under both US and OECD rules.[97] The method is most effectively applied when the reseller does not add valuable intangibles to the product before resale.[98] Under OECD rules the RSP is deemed more accurate when the subsequent resale of the product by the distributor occurs shortly after the acquisition of the good from the related party.[99]

Customs (DVM). The deductive valuation method (DVM) in Article 5 of the GVC takes a very similar approach, but there are differences.

The DVM has a reduced emphasis on product comparability, and a heightened concern with functional comparability when compared with the TVI/ TVS. This shift in emphasis is apparent when the DVM indicates that the value of "identical or similar goods" is reduced by a margin "for profit and general expenses in connection with the sale in such country of imported goods of the same class or kind." By further defining goods of the same class or kind as, "… goods which fall within a group or range of goods produced by a particular industry or industry sector …"[100] the GVC is shifting emphasis to functions. This produces a rough alignment with the income tax preference for a functional comparability in the RSP.

> value added tax. The taxable base also includes anything that any person other than the recipient of goods or services is required to give or pay to the entrepreneur for the goods delivered or services performed. The taxable base shall not include the amounts invoiced, received or given by the entrepreneur in the name and for the account of another person.

[94] VALUE ADDED TAX ACT at Art. 9(1) (Croatia) states:

> The taxable base of imports (Article 2, Paragraph 1 Item 4) shall be the customs base established in accordance with customs regulations, increased by the amount of customs duty, other charges and excises payable in the course of import customs clearance.

[95] Treas. Reg. § 1.482-2(c)(4), at Ex. (7) and OECD, GUIDELINES *supra* note 2, at ¶2.18.
[96] Treas. Reg. § 1.482-2(c)(3)(ii)(A) and OECD, GUIDELINES *supra* note 2, at ¶2.21.
[97] Treas. Reg. § 1.482-2(c)(3)(ii)(A) and OECD, GUIDELINES *supra* note 2, at ¶2.15.
[98] Treas. Reg. § 1.482-2(c)(4), at Ex. (7) and OECD, GUIDELINES *supra* note 2, at ¶2.22.
[99] OECD, GUIDELINES *supra* note 2, at ¶2.23 (there is no similar concern under the US rules).
[100] GVC *supra* note 1, at Art. 15(3).

Even though DVM and RSP share this emphasis, the customs rules remain more limited than the income tax rules. For example, the customs margin can only be determined from data obtained within the country of importation.[101] Like the OECD, the GVC has an express preference for a valuation based on "identical or similar goods [that] are sold in the condition as imported at the earliest date after the importation of the goods being valued…" [102] However, the GVC adds as a qualification, "… but before the expiration of ninety days after such importation."[103]

Vertical Harmonization – Income Tax RSP & Customs DVM. The harmonization of RSP and DVM methods is far easier to imagine than is the harmonization of the CUP and TVI/ TVS methods considered earlier. RSP/ DVM differences are comparatively minor.

The more important differences are: (1) the express customs preferences for comparables derived from the country of importation, (2) the customs requirement that comparable transactions occur within the ninety day period after the related party transaction, and (3) the customs preference to measure value against the normal pricing practices of an industry, or industry sector.

In spite of the similarities between RSP and DVM, none of the thirty-three jurisdictions with significant transfer pricing regimes in income tax directly link RSP and DVM methods in their statutes. Customs *practice* does vary, and there are jurisdictions that are receptive to an indirect linkage,[104] but this is not the general rule.[105] Even where indirect linking occurs, the

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[101] GVC *supra* note 1, at Art. 5(1)(a)(i), (ii), (iii), (iv), (1)(b) and (2) (each provision in Article 5 contains the "country of importation" limitation).
[102] GVC *supra* note 1, at Art. 5(1)(b).
[103] GVC *supra* note 1, at Art. 5(1)(b).
[104] Canadian Customs & Revenue Agency, *Transaction Value Method for Related Persons*, Memorandum D13-4-5 (April 9, 2001) at ¶ 15 & 16(g) *available at* http://www.cbsa-asfc.gc.ca/E/pub/cm/d13-4-5/d13-4-5-e.pdf. Indicating that the CCRA will follow the RSP method for determining the transaction value under Article 1(a) of the GVC, and as a corollary proposition roughly equating the RSP with the DVM:

> 15. The Organization for Economic Cooperation and Development (OECD) published a report entitled *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. This report sets out several methods of pricing goods in order to achieve a price which could reasonably have been expected in similar circumstances had the vendor and the purchaser not been related. These methods are illustrated in paragraph 16. The CCRA will accept, for valuation purposes, a price paid or payable which is derived from one of the methods set out in the OECD's report, unless there is information on prices available which is more directly related to the specific importations. …
> 16. The following methods are examples …
> (g) The Canadian purchaser's gross margin on sales in Canada of goods purchased from unrelated suppliers is not markedly different from the gross margin percentages realized on sales of comparable goods purchased from a related vendor. In this method, the importer may demonstrate that the percentage gross margin earned over the landed cost of goods purchased from a related supplier is very close to the percentage gross margin earned on comparable goods imported from unrelated suppliers. Care would have to be exercised when using this method to ensure that the gross margin percentage used is derived from sales where the terms of sale and marketing conditions are basically the same. For example, it would not be realistic to compare the gross margins realized on products advertised by the foreign vendor to the margins realized on products where the purchaser is responsible for the cost of advertising. In addition, the purchaser's gross margin would have to be compared to the industry margin. (emphasis added).

nature of this linkage is tentative, because additional customs tests must be met to align results.[106] The place where direct linkages can arise is with VAT statutes.

VAT/GST. Most VAT/GST regimes do not use either RSP or DVM methods to determine the open market value on related party transactions – the reason is structural. Neither of these methods takes direct aim at the VAT problem – what amount should the *seller* put on the invoice? In most transactions where VAT is due it is the seller (not the buyer) who needs to determine the tax base and record the VAT on an invoice.[107] The RSP and DVM are *buyer-centric* methods. They rely on data that is difficult for sellers to gather and analyze on a transactional basis.[108]

For example, if X sells goods to Y, under RSP or DVM methods **X** is obliged to determine the arm's length price through an examination of: (1) the price that **Y** charges for the resale of the goods, (2) the value that **Y** adds to the goods before they are resold, (3) the gross margin that **Y** has on the resale of identical or similar goods purchased from independent parties (internal comparables), and (4) the gross margin that a business comparable to **Y** would have on the resale of identical or similar goods to independent parties (external comparables). Even though X and Y are related parties, this is not easy for X. Using these methods, it is very difficult for X to determine the price that it should place on the invoice. It is much easier for X to determine a proper price through cost plus or constructed value methods. Under these methods most of the data X will need will be in X's accounting records.

Nevertheless, there are VAT/GST regimes that adopt RSP methodologies to determine the open market value of related party transactions. These VAT regimes are the same regimes that elected to *fully harmonize* with the CUP methodology considered earlier. However, there has been some selectivity in this linkage. Some of the jurisdictions that indirectly linked VAT and income tax CUP methods rejected a similar link with the RSP method.

This omission is replicated in the jurisdictions that adopted *parallel harmonization* structures in CUP and TVI/ TVS methods. The reason seems to be that when VAT/GST

It is important to note that this example involves an internal comparable, within the same industry segment, and within the 90 day window (probably even simultaneously with) the related party transaction.

105 US CUSTOMS & BORDER PROTECTION, WHAT EVERY MEMBER OF THE TRADE COMMUNITY SHOULD KNOW ABOUT: DETERMINING THE ACCEPTABILITY OF TRANSACTION VALUE FOR RELATED PARTY TRANSACTIONS 15-16 (Apr. 2007) *available at* http://www.cbp.gov/linkhandler/cgov/toolbox/legal/informed_compliance_pubs/icp089.ctt/icp089.pdf (indicating that the US recognizes similarities between income tax and customs methodologies, but also indicating that the US will not recognize any analytical links between methodologies, other than those which the importer can independently prove).

106 Canadian Customs & Revenue Agency, *supra* note 104 at ¶ 16(d) & Note (indicating that RSP-based analysis would not be sufficient for proof of the transaction value as there would "in addition" be a requirement to "compare to the industry margin" a requirement that derives from the definition of "goods of the same class or kind" in GVC, Article 15(3), which concerns "goods produced by a particular industry or industry sector").

107 Reverse charges are common in all VAT regimes, but they constitute only a small percentage of all transactions. Under a reverse charge the buyer self-assesses the VAT.

108 It should be noted that if a reverse charge applies, then this analysis should also be reversed. In the reverse charge instance it is the *buyer* not the seller who determined the VAT, and in this case the critical data on resale prices is very available to the buyer. This would make the RSP or DVM methods very appropriate.

jurisdictions engage in thoughtful crafting of transfer pricing rules (as opposed to borrowing them wholesale from another tax system), the difficulty of performing a RSP or DVM type of analysis in a VAT/GST context encourages them to omit the method.

Full harmonization – Japan, Spain, Russia, Azerbaijan & Turkmenistan. Because Japan[109] and Spain[110] harmonize directly, by simply linking the Consumption Tax and the VAT with the methods set out in the corporate income tax, the RSP method follows through into the VAT in both of these jurisdictions.

The same is true under the two-part design of the Russian tax code,[111] even though the linkage between the income tax and the VAT is indirect rather than direct. An indirect linkage with the RSP is in place in Azerbaijan,[112] and Turkmenistan.[113] However, Georgia,[114] a jurisdiction that follows the two-part Russian tax code model, and which applies the CUP method in both income tax and VAT, rejects the RSP method. The Georgian code remains fully harmonized, because the RSP method is rejected for all taxes.

Parallel harmonization regimes – RSP & DVM omitted – Australian & New Zealand. The VAT regimes that approach harmonization of transfer pricing methods through the careful design of parallel provisions within the VAT generally reject the RSP or the DVM method for the VAT. New Zealand[115] and Australia[116] lead in the parallel harmonization effort, and both omit the RSP and the DVM.

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[109] JAPAN'S REVISED CONSUMPTION TAX LAW (SHOUHIZEIHOU), Art. 28(2) *supra* note 11 (indicating that the Japanese Consumption Tax rules follow the results of the income tax) and SPECIAL TAXATION MEASURES LAW (SOZEI-TOKUBETSU-SOCHIHOU), Art. 66-4-2-1-b (defining the resale price method [*Saihanbai Kakaku Hou*] for income tax purposes).

[110] Spanish Act 36/2006 of Nov. 29, 2006 amends the VALUE ADDED TAX ACT 37/1992 (Dec. 28, 1992) Art. 79.5 (providing, "For purposes of the previous two paragraphs [concerning the definition of the open market value], Art. 16 CTA [Corporate Tax Act] will be applicable, when appropriate.") Royal Legislative decree 4/2004 (the Spanish Corporate Tax Act) was also modified by Act 36/2006 (Nov. 29, 2006) to amend the methodologies for Spanish transfer pricing to specifically adopt the five OECD methods.

[111] TAX CODE OF THE RUSSIAN FEDERATION, Part 1, Art. 40(10), Federal Law No. 147-FZ (July 31, 1998) (indicating that if identical or similar goods, services or works cannot be identified then a resale price method, translated as the "price of subsequent sale method" is to be used).

[112] TAX CODE OF THE REPUBLIC OF AZERBAIJAN, Law No. 905-IG at Arts. 14.6.3, 14.6.3.1 & 14.6.3.2 (Jul. 11, 2000) (Azerbaijan) (indicating that after identical and similar goods [Art. 14.6.3], services or works are considered, a resale price method [Arts. 14.6.3.1] or a cost plus method [Art. 14.6.3.2] is to be applied without a stated preference in the order of application of RSP and C+ methods).

[113] TAX CODE OF TURKMENISTAN, 2005 at Pt. 1, Sec. IV, Ch. 2, Art. 36(3) (Turkmenistan) (indicating that after identical and similar goods, services or works are considered, a resale price method is preferred to a cost plus method, however both resale price and cost plus methods are less preferred than an unusual/ unique "state statistics" method described as a, "… realistic market retail price of the goods (work, services) as received from the bodies of state statistics, …").

[114] TAX CODE OF GEORGIA, 1997 (as amended) Pt. I, Ch. 1, Art. 27(6) (setting out methods to determine the "market price" based on identical and similar supplies, but then indicating that "…If it is impossible to use the provisions of the 1-5 items of this Article, the market price of goods (work, service) is determined according to the rules agreed between the "Ministry of Economy" and "Ministry of Finances.").

[115] New Zealand, IRD Tax Information Bulletin, Vol. 6 No. 14 (Jun. 1995) *supra* note 74 at 6-8.

[116] Australian, Goods and Service Tax Ruling, *Goods and Services Tax: Non-Monetary Consideration*, *supra* note 73 at ¶¶ 144, 145 & 148-49.

No RSP or DVM methods. The vast majority of other VAT jurisdictions echo the decision of Australia and New Zealand with respect to the RSP/ DVM methods. The reason for this seems reasonably clear. RSP/ DVM methods are too difficult for sellers to apply in a VAT context.

(3) *Cost-plus method (C+) & Computed value method (CVM).* The cost-plus (C+) and computed value (CVM) methods seek to determine the transfer price as a multiple of the costs incurred by the seller. It is most accurate when the seller uses very little of its own intangible property, and assumes very little economic risk in the sale. The C+ method is a traditional method under the US regulations[117] and the OECD Guidelines.[118] It is very similar to the computed value method (CVM) under the GVC,[119] which is considered "… in some ways the simplest basis of valuation; in other ways it is the most complex and controversial."[120] Taken together, methods modeled on C+ and CVP are the second most popular method in VAT/GST regimes – following methods modeled after the CUP and TVI/TVS methods.

Income tax (C+). Under US and OECD rules the cost-plus method has not changed significantly over the past 30 to 40 years. The method has two parts: (1) calculating the cost of production, and (2) determining the gross profit percentage.[121]

In calculating the cost of production both US and OECD rules stress that costs need to be determined "in a consistent manner in accordance with sound accounting practices … neither favor[ing] nor burden[ing] controlled sales in comparison with uncontrolled sales."[122] The OECD indicates that, "[t]he cost plus method presents some difficulties in proper application, particularly in the determination of costs."[123]

The second part, the gross profit percentage, is determined through a comparison with comparable transactions. There is less concern with close physical product similarity when trying to find comparable transactions,[124] but there is concern with the relative value of products involved in the transactions being compared.[125] Internal comparables are preferred.[126] Adjustments may be needed for differences in cost structures, business experience and relative management efficiency.[127]

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[117] Treas. Reg. § 1.482-3(d).
[118] OECD, GUIDELINES *supra* note 2, at ¶¶ 2.32 – 2.49.
[119] GVC *supra* note 1, at Art. 6.
[120] SHERMAN & GLASHOFF *supra* note 29, at 227.
[121] Treas. Reg. § 1.482-3(d)(1); OECD, GUIDELINES *supra* note 2, at ¶ 2.32.
[122] Treas. Reg. § 1.482-2(e)(4)(ii) (1968). Essentially the same concept – following GAAP – is expressed in the 1994 regulations in cost accounting terms under the heading of "Data and assumptions – consistency in accounting" indicating that, "the degree of consistency in accounting practices between he controlled transaction and the uncontrolled comparables that materially affect the gross profit markup affects the reliability of the result." Treas. Reg. § 1.482-3(d)(3)(iii)(B) (1994).
[123] OECD, GUIDELINES *supra* note 2, at ¶ 2.36 & 2.39.
[124] Treas. Reg. § 1.482-3(d)(3)(ii)(B); OECD, GUIDELINES *supra* note 2, at ¶ 2.34.
[125] Treas. Reg. § 1.482-3(d)(3)(ii)(B).
[126] Treas. Reg. § 1.482-3(d)(3)(ii)(A); OECD, GUIDELINES *supra* note 2, at ¶ 2.33.
[127] Treas. Reg. § 1.482-3(d)(3)(ii)(B).

Customs (CVM). The computed value (CVM) method is difficult to apply in a customs context because it requires that a value be determined for imported goods (in the hands of the importer) based on an analysis of a foreign seller's confidential cost of production and profit data. It is an "…unpopular method of valuation with many businessmen and customs officials … [because] it involves the customs authorities of one country examining confidential data regarding a business or even an industry in another country."[128]

The GVC limits application of this method.[129] As with the C+ method there is less concern with comparable transactions involving identical or similar goods, or even goods of the same class or kind,[130] but there is concern with accounting consistency. The GVC avoids direct resolution of this issue, but underscores that acceptable comparisons must conform to domestic GAAP.[131]

Vertical Harmonization – Income tax C+ & Customs CVM. Vertical harmonization of C+ and CVM methodologies is a far more comfortable proposition than the harmonization of any of the other methodologies, although direct harmonization remains elusive. The GVC is less restrictive in its application of the CVM than it is of the TVI/ TVS and the DVM. There is a common concern between C+ and CVM with consistency of accounting records, reliance on GAAP, and a preference for internal comparables. With the CVM based on the willingness of a foreign related party to voluntarily disclose confidential cost and profit figures, it easy to see why two of the most significant customs/ income tax cases litigated by IRS (*Brittingham*[132] and *Ross Glove Co.*[133]) both involve applications of customs-based (CVM) valuations to income tax (C+) adjustments.

Once again, none of the thirty-three jurisdictions with significant transfer pricing regimes in income tax expressly link C+ and CVM methods in their statutes. Indirect linkage however, is evident through customs *practice* in several jurisdictions,[134] but once again this is not the general rule.[135]

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128 SHERMAN & GLASHOFF *supra* note 29, at 233.
129 GVC *supra* note1, at Art. 6, Notes 6(1) (indicating that the CVM method will generally be restricted to related party transactions, and not be resorted to widely to determine a substitute transaction value).
130 SHERMAN & GLASHOFF *supra* note 29, at 228.
131 GVC *supra* note1, at Art. 6, Notes 6(2).
132 Brittingham v. Commissioner, 66 T.C. 373 (1976), aff'd, 598 F.2d 1375 (5th Cir. 1979).
133 Ross Glove Co. v. Commissioner, 60 TC 569 (1973), acq. in part 1974-1 CB 2.
134 Canadian Customs & Revenue Agency, *supra* note at ¶¶ 15 & 16(h). Indicating in a further example that the CRA is willing to follow a C+ valuation method for determining the transaction value under Article 1(a) of the GVC, thereby equating the C+ with the CVM:

> The CCRA will accept, for valuation purposes, a price paid or payable which is derived from one of the methods set out in the OECD's report, unless there is information on prices available which is more directly related to the specific importations. …
> 16. The following methods are examples …
> (h) The vendor's percentage of net profit on sales to the related purchaser in Canada is comparable to the percentage of net profit realized on sales of comparable products to unrelated purchasers located in Canada or another country, if that country's free-market economy is comparable to the Canadian economy.
> NOTE: This method can be difficult to use and any profit comparison would have to be made with care. This method may be used principally in cases where semi-finished products are transferred between related companies. The use of the net profit rather than the gross profit allows a

VAT/GST. VAT/GST regimes are very receptive to C+/ CVM valuation methods. This is only to be expected. The central question in a VAT transfer pricing inquiry is: "What price should a vendor place on his invoice?" C+/ CVM methods answer this question with data that is in the vendor's accounting records. This makes these methods very VAT-friendly.

Vertical harmonization efforts that involve C+/ CVP methods can be found in jurisdictions that *fully harmonize* VAT methods with income tax methods in income tax, as well as in jurisdictions draft *parallel* VAT rules. There are a large number of additional VAT jurisdictions with rudimentary transfer pricing systems in place. These jurisdictions frequently identify only a CUP or a TVI/ TVS method, and then fall-back on a rule that relies upon the *Commissioner's (unspecified) judgment*. It is expected that (in practice) a C+/ CVM method would often be relied upon in these cases.

Fully harmonized with C+ – Japan, Spain, Russia, Turkmenistan, & Azerbaijan. The Japanese Consumption Tax[136] and Spanish VAT[137] directly borrow transfer pricing methods from the corporate income, and as a result the C+ method flows freely into the VAT in these jurisdictions.

The same is true under the two-part design of the Russian tax code,[138] and also under two of the tax codes that follow the Russian model, those in Turkmenistan,[139] and Azerbaijan.[140] The

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> comparison without the effect of different allocations of general, selling, and administrative expenses an of production costs in situations involving different trade levels, e.g., sales to co-manufacturers versus distributors. It is recognized that problems may prevail with regard to a fair an equitable assignment of total costs to different products. This method may well be used to confirm the conclusions reached by other means. Complete co-operation on the part of the foreign vendor is a pre-requisite to using this method as the documentation requirements would relate to the vendor's confidential costing, profit, and pricing records. Importers who are considering this method should contact Trade Policy and Interpretation Directorate … for assistance in deciding what documentary evidence is necessary to establish the acceptability of prices. (emphasis added).

[135] US CUSTOMS & BORDER PROTECTION, *supra* note 105, at 15-16 (indicating that the US recognizes similarities between income tax and customs methodologies, but also indicating that the US will not recognize any analytical links between methodologies, other than those which the importer can independently prove).

[136] JAPAN'S REVISED CONSUMPTION TAX LAW (SHOUHIZEIHOU), Art. 28(2) *supra* note 11 (indicating that the Japanese Consumption Tax rules follow the results of the income tax) and SPECIAL TAXATION MEASURES LAW (SOZEI-TOKUBETSU-SOCHIHOU), Art. 66-4-2-1-c (defining the cost plus method [*Genka Kasan Hou*] for income tax purposes).

[137] Spanish Act 36/2006 of Nov. 29, 2006 amends the VALUE ADDED TAX ACT 37/1992 (Dec. 28, 1992) Art. 79.5 (providing, "For purposes of the previous two paragraphs [concerning the definition of the open market value], Art. 16 CTA [Corporate Tax Act] will be applicable, when appropriate.") Royal Legislative decree 4/2004 (the Spanish Corporate Tax Act) was also modified by Act 36/2006 (Nov. 29, 2006) to amend the methodologies for Spanish transfer pricing to specifically adopt the five OECD methods.

[138] TAX CODE OF THE RUSSIAN FEDERATION, Part 1, Art. 40(10), Federal Law No. 147-FZ (July 31, 1998) (indicating that if identical or similar goods, services or works cannot be identified then a resale price method, translated as the "price of subsequent sale method" is to be used, and then a cost-plus method, translated simply as the "cost method").

[139] TAX CODE OF TURKMENISTAN, 2005 at Pt. 1, Sec. IV, Ch. 2, Art. 36(3) (Turkmenistan) (indicating that after identical and similar goods, services or works are considered, a resale price method is preferred to a cost plus method, however both resale price and cost plus methods are less preferred than an unusual/ unique "state statistics"

only difference between these jurisdictions and the Japanese and Spanish harmonization is that these countries accomplish this indirectly (through a third statute).

Parallel harmonization – Australia, New Zealand & Iceland. Rather than "borrowing" methodologies from an omnibus "part 1" of the tax code, or by linking directly to another tax statute to secure transfer pricing methodologies, Australia and New Zealand draft VAT regulations that are parallel (but are not identical with) methods in other taxes. Iceland accomplishes the same result through the VAT statute.[141]

The strength of the parallel harmonization approach is that it provides flexibility. Language can be drafted so that a VAT/GST method will harmonize with similar methods in both income tax and customs.[142] This flexible design also allows a jurisdiction to pick-and-choose among the methodologies that will be aligned – in the case of Australia, New Zealand and Iceland a C+ method has been selected, but not a RSP/ DVM method.[143] The weakness of this approach is that the VAT/GST valuation rules remain vague.

The Australian cost-plus method is set out in a Goods and Services Tax Ruling (GSTR 2001/6).[144] The general standard to "… appl[y] a method that produces a reasonable GST inclusive market value of the consideration." A series of examples are presented under the following headings:

- The market value of an identical good, service or thing;
- The market value of a similar good, service or thing;
- The market value of the supply;
- A professional appraisal.[145]

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method described as a, "… realistic market retail price of the goods (work, services) as received from the bodies of state statistics, …").

[140] TAX CODE OF THE REPUBLIC OF AZERBAIJAN, Law No. 905-IG at Arts. 14.6.3, 14.6.3.1 & 14.6.3.2 (Jul. 11, 2000) (Azerbaijan) (indicating that after identical and similar goods [Art. 14.6.3], services or works are considered, a resale price method [Arts. 14.6.3.1] or a cost plus method [Art. 14.6.3.2] is to be applied without a stated preference in the order of application of RSP and C+ methods).

[141] In each case (Australia, New Zealand and Iceland) the test is an objective measure of the value of the good or service sold, not the subjective measure of the worth of the item reflected in the value of the consideration exchanged. As a result, the rules are not applied only in a related party context. These are rules that apply as well when the consideration is not provided in money.

[142] Whether or not these VAT regimes actually do harmonize in both directions (with the income tax and customs) cannot be determined under current law. There is no express statutory or regulatory requirement or statement of policy that they should do so. Litigation may be necessary.

[143] Georgia presents an interesting hybrid approach to the harmonization issue considered here. Georgia has adopted a Russian-type of tax code, but has been selective in its choice of methods. It has adopted a cost plus method (like Australia and New Zealand) but it has applied it to only income tax and VAT (because of the "two part" design of the code). It has not adopted a resale price approach (again, like Australia and New Zealand) and thus differs from the other Russian-type codes. TAX CODE OF GEORGIA, 1997 (as amended) Pt. I, Ch. 1, Art. 27(6) (setting out methods to determine the "market price" based on identical and similar supplies in subsections (1) through (5), and suggesting that a cost-plus method could be "… determined according to the rules agreed between the Ministry of Economy and Ministry of Finances.").

[144] Goods and Service Tax Ruling, *Goods and Services Tax: Non-Monetary Consideration,* GSTR 2001/6 (Nov. 28, 2001).

[145] *Id.* at ¶144.

The next section of the GSTR is headed "Other Reasonable Methods" and indicates that a cost-plus method is also acceptable under the general "reasonableness" standard:

> Where you are making a taxable supply and you are dealing with another party at arm's length, you can use a reasonable valuation method as determined by you and the other party. Also, where both the supply and the consideration are difficult to value (for example, a forbearance may have no identifiable market), you can calculate a reasonable market value for the non-monetary consideration (for example, a "cost plus margin" method.[146]

The example that follows this description in the GSTR concludes with the following statement of the cost-plus method:

> The supply of the manufactured widgets by MegaMake is for the consideration provided by Gus of the right to produce and sell the widgets interstate. The widget is a new and unique item and there is no identical or similar good in the market. MegaMake can demonstrate that it is appropriate to use a cost plus margin method (that is, the sum of the cost of producing and a relevant profit margin) for the production of the widgets it supplies to determine the market value of the consideration provided by Gus.[147]

New Zealand sets out a cost-plus method in a Tax Information Bulletin.[148] According to the Bulletin there are three statutory methods: (1) identical supplies,[149] (2) similar supplies,[150] and then (3) "… a method determined by the Commissioner which provides a sufficiently objective approximation of the consideration in money which could be obtained for that supply of those goods."[151] The reason for the Information Bulletin is to set out the Commissioner's methods. It states:

> Section 4(4) enables the Commissioner to approve a method the taxpayer adopts to determine the open market value of that supply. … For example, the only similar supply available in New Zealand may be between persons who are associated. However, the associated persons may arrive at an open market value based on a cost-plus method which may be acceptable to the Commissioner.
>
> Some of the factors the Commissioner considers in approving a method to calculate the open market value are:
>
> - Cost of production and likely profit margin
> - The demand for the goods or services and the amount of consideration paid for similar or the same goods and services previously.[152]

The Icelandic VAT also relies on an objective valuation of supplies. Iceland's VAT is imposed on a tax base measured by the value of the good or service supplied, which includes

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[146] *Id.* at ¶155.
[147] *Id.* at ¶157.
[148] N.Z. INLAND REV. DEPT., TAX INFO. BUL. Vol. 6, No. 14 (June 1995).
[149] GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at § 4(2).
[150] GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at § 4(3).
[151] GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at § 4(4).
[152] N.Z. INLAND REV. DEPT. *supra* note 148, at 8.

even goods or services for which no consideration exchanged.[153] Iceland defines the "tax price" as follows:

> The tax price is the price on which a value added tax is calculated upon the sale of goods and valuables, taxable labor and services. The tax price refers to total remuneration or total sales value before value added tax.[154]

Iceland embeds both objective (total sales value) and subjective (total remuneration) valuation standards in its VAT statute. This allows Iceland to reach transactions where the nature of the consideration (or lack of consideration) makes a valuation based on what is received difficult. Related party transactions are easily brought into the Iceland VAT in this manner. The Icelandic VAT provides:

> When goods or services are exchanged or goods are handed over without charge, the tax price shall be based upon the general price in similar transactions. Should such a general price not be available the tax price shall be based on the calculated sales price where account is taken of all cost plus the markup generally used for goods and services in a similar category.[155]

Harmonization through the Commissioner's (unspecified) judgment – South Africa, Botswana, Lesotho & Uganda. There are a large number of jurisdictions that grant authority to the Commissioner to determine an appropriate valuation methodology either generally, or on a case-by-case basis. This authorization is normally a catch-all provision. It commonly follows both a general policy statement on valuation and very roughly specified methods based on identical and then similar supplies.

Given the difficulty of applying a resale price (RSP) or deductive valuation (DVM) method in a VAT/GST context, one would expect that a cost-plus (C+) or computed value (CVM) method would be favored in most instances, but this is not clearly stated. Jurisdictions where this approach is taken include South Africa,[156] Botswana,[157] Lesotho,[158] and Uganda.[159] Published regulations or rulings by the Commissioner are not available in any of these jurisdictions, suggesting that the Commissioner's discretion is exercised on audit.

TIME

The impact of time. One of the great dilemmas in the effort to vertically harmonize pricing conventions is how to accommodate the time-based sensitivities of the *transaction-*

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[153] Under the Australian rules transactions without consideration are not subject to GST [A NEW TAX SYSTEM (GOODS AND SERVICES TAX) ACT, 1991 at para. 9-5(a)]. Transactions among related parties are an exception to this rule, and are subject to GST based on objective valuation criteria. [A NEW TAX SYSTEM (GOODS AND SERVICES TAX) ACT, 1991 at para. 72-10] The New Zealand GST differs, and is more like the Iceland VAT in this respect. The New Zealand concept of supply is exceptionally broad and includes sales, gifts, leases and the provision of goods and services. [GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at §5] The New Zealand definition of consideration is similarly broad. [GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at §21)].

[154] VALUE ADDED TAX ACT, No. 50 at Art. 7 (1998) (Iceland).

[155] VALUE ADDED TAX ACT, No. 50 at Art. 8 (1998) (Iceland).

[156] REVENUE, VALUE-ADDED TAX ACT No. 89 of 1991 at § 3(4) (South Africa).

[157] THE VALUE ADDED TAX ACT, 2001 at §§ 3(4) & 9(5) (Botswana).

[158] SALES TAX ACT, 1995 at Art. 15(3) (Lesotho).

[159] VALUE ADDED TAX STATUTE, No. 8 at Art. 3(2) (1996) (Uganda).

specific indirect taxes (VAT/GST and customs) with the *annualized* pricing determinations of the income tax. In other words, even if we were to agree on the definition of related parties/associated enterprises across all taxes, and even if we were to agree completely on the precise methodologies to be applied to determine an appropriate price, how are annualized tax base adjustments to be synchronized with day-to-day tax base calculations? The two most important permutations of this question involve tax point variances, and the impact of audit adjustments.

Tax point. Transaction-based indirect taxes (VAT/GST and customs) have a time-specific tax point (for example, the moment of importation or the delivery date). Aggregation-based direct taxes (the income tax) have a time-deferred tax point (for example, the due date of the annual return). How reasonable is it to expect true price harmonization for a transaction that is subject to tax (or contributes to the determination of aggregate tax liability) under all three regimes?

For example, assume a specific related party transaction is entered into on January 1 (Foreign Parent Company sells X-1 to its Wholly Owned Domestic Subsidiary for 10). This purchase is then aggregated with other inventory purchases of X (for a total value of 100,000) and reported (as cost of goods sold) on the annual income return filed March 15 the following year. Assume also that customs and VAT/GST also value X-1 at 10 on January 1. If this tax system is harmonized, then it should be possible to confirm that X-1 was purchased at 10: (a) on the customs forms submitted to the border agents; (b) on the VAT/GST invoice, and (c) as a discrete inventory item in the cost of goods sold. Audit programs should be able to tie these figures regardless of the starting point (income tax; VAT/GST; customs).

Audit adjustments. The audit cycle in direct taxes produces pricing adjustments many years after specific transactions have been completed. A harmonized tax system should be able to carry these adjustments back into prior VAT/GST and customs filings.

For example, assume that three years after the income tax return in the previous example is filed the aggregate price for purchases of X is adjusted on audit from 100,000 to 150,000. A harmonized tax system would require this aggregate adjustment (50,000) to be broken down transactionally. Discrete amounts would be carried back and associated with the specific transactions that were part of the aggregate inventory adjustment. Appropriate adjustments should be made to *invoices* and amended VAT/GST and customs returns should be filed.

There are various ways to solve the allocation problem in this example. The jurisdiction could apply: (a) a ratable allocation rule (adjusting the January 1 purchase of X-1 from 10 to 15), or (b) a specific tracing rule (a specific adjustments could be made for the specific transactions the price increase has been proven) or (c) a stacking rule (a formula is applied to allocated adjustments to one category of X and then to another).

PROPOSED SOLUTION – APAs & CERTIFIED SYSTEMS

There are two aspects to the harmonization problem: (1) how to get agreement on the valuation across all taxes, and (2) once this agreement is reached, how to adjust for harmonized outcomes across all the taxes. This paper argues that the best way to achieve the first objective is through multi-tax APAs, and the best way to achieve the second is through certification of automated systems.

It is always possible to legislate a single (vertical) solution, but this is not likely. There are too many (horizontal) difficulties with treaties and conventions in place that have had as their goal the horizontal harmonization of valuation rules in customs and direct taxes to make this a workable solution in the short term.[160] Although, the Canadian harmonization of direct tax, customs and GST valuations at the border through Memorandum D13-4-5 works, it indicates only that governments are willing to let taxpayers make an affirmative case for harmonization of pricing formulas. The Canadian solution was both *after the fact* and taxpayer-specific.[161]

SOLUTION – THE APA PART

Could this kind of harmonization be achieved *before the fact*? Welcoming such a solution would increase business certainty. Australia has in fact done this, but is waiting for business volunteers.[162] Commentary suggests that joint APA-ACR agreements should work.[163]

However, the tax literature does not record a large number of joint APA-ACRs. There is one recorded instance in the US (Private Ruling HQ 546979),[164] a further suggestion that French authorities may be considering joint agreements,[165] and a number of jurisdictions where multi-tax advance rulings on transfer pricing are "possible," but none have been reported.[166]

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[160] There is currently a proposal to do this in South Korea. Korea Customs Service Audit Policy Bureau, *Advance Customs Valuation Agreement (ACVA)* (Apr. 26, 2007).

[161] It should be noted however that the Canadian approach has remained unique for twenty years. Even though governments "should" be willing to follow the Canadian example, it does not seem like that have done so. The reason for this is not apparent.

[162] The Australian customs administration has offered to enter into joint customs-income tax-GST APAs with any trader willing to volunteer to go through the process. In the past year no trader has stepped forward. The reason for this is also not apparent, but may have to do with the uncertainty of being the first. "The discussions took place at the Australian Taxation Office forum: National Taxation Liaison Group – Transfer Pricing Sub-Group, which includes representation of relevant government agencies, peak representative groups and industry members." Personal e-mail communication Matthew Bannon, Acting National Manager, Maritime Operations Support, Australian Customs Service (Dec. 22, 2008, on file with author).

[163] JUAN MARTIN JOVANOVICH, CUSTOMS VALUATION AND TRANSFER PRICING: IS IT POSSIBLE TO HARMONIZE CUSTOMS AND TAX RULES? 18 (2002).

[164] Private Ruling HQ 546979 (Aug.30, 2000). *See* JOVANOVICH, *supra* note 163, at 17; *Baker & Mckenzie Transfer Pricing Annual Update--Part 2,* 14 J. INT. TAX'N 26, 34 (Nov. 2003).

[165] Pascal Luquet, *Transfer Pricing and Customs: Two Closely Related Tax Issues* 5 in a paper presented at the WCO/OECD CONFERENCE ON TRANSFER PRICING AND CUSTOMS VALUATION, *supra* note 4 (and on file with author)

> A question still pending is whether it would be useful or, to say the least, possible to benefit from a certain convergence between customs and tax rules that would, in particular, include taking the customs declaration aspect into account in any discussions that tax authorities undertake with taxpayers in the framework of APAs. It must be noted that the French customs authorities met with Bureau CF3 in charge of APAs in France for the first time a few weeks ago.

[166] Silvain Niekel & Danny Oosterhoff, *Netherlands: Compliance Agreements*, 13 INT. TRANSFER PRICING J. 291 (Nov./ Dec. 2006) (discussing the new tax compliance process for large corporate taxpayers involving "compliance agreement" (*handhavingsconvenanten*) that has been initiated in a pilot program with 20 large Netherlands multinational taxpayers that has a scope broad enough to include transfer pricing issues in income tax, customs and

This makes the decision of Thomas L. Lobred, Chief of the Value Branch of the US Customs Service, in Private Ruling HQ 546979 the best fact-based analytical tool we have on joint APA-ACRs. Interestingly, HQ 546979 not only identifies the problems with joint APA-ACRs, it resolves them in a way that is fully consistent with solution proposed in this study. Even more interestingly, HQ 546979 demonstrates how inconsistent *horizontal harmonization* of transfer pricing rules (between countries) puts pressure on businesses to find *vertical harmonization* solutions (within a country). Although the US does not have a VAT/GST, if it did one could easily imagine in this case that the VAT/GST result would be folded into the direct tax and customs results.

Private Ruling HQ 546979

At the time of this ruling request the US's CPM method was not accepted by the Japanese National Tax Administration, although a Japanese Profit Split method reached similar results. The taxpayer/ importer (Importer) in HQ 546979 seems to have been concerned that by concluding a bilateral APA using different (US and Japanese) methods for valuing the same goods, would create the possibility that US Customs would use this "dual methodology" to reject the Importer's transaction value. The APA would make the "price actually paid or payable" appear to be ambiguous. As a result the Importer sought vertical harmonization of the US transfer pricing rules through an ACR that was specifically related to the APA.

Facts – HQ 546979

HQ 546979 involved merchandise imported to the US from related-party suppliers. The Importer was a US corporation that acted as a wholesale distributor of products for household and commercial use in the US market. Products were imported from two related suppliers.

The Importer filed a request for an APA with the IRS and the Japanese tax authorities. The APA request contained an analysis of two different transfer pricing methodologies: (1) the CPM and (2) the Japanese profit-split method.

The Importer subsequently attended an APA pre-filing conference with the IRS and requested that a member from Customs participate in it. The Importer provided Customs with access to information regarding the application of the CPM, and enabled Customs to review: the selection of the tested party under the APA;

- how the comparable companies were selected;

VAT); Stephan Schnorberger, *Germany: Same Procedure as Last year? Competent Authority Procedures and Advance Pricing Agreements Revisited*,14 INT. TRANSFER PRICING J. 109, 113 (Mar./Apr. 2007)

> Whereas a competent authority agreement is immediately implemented in domestic tax assessments, the implementation of an APA, from a German perspective, relies on a binding advance ruling which is issued by the local tax office in accordance with the principles of the intergovernmental agreement. This binding advance ruling obligates the competent tax office to assess tax in line with the content of the international agreement. The binding ruling may cover subjects other than transfer pricing and permanent establishments, such as capital gains taxation, the tax treatment of restructuring transactions, and the VAT treatment of a particular transaction.

- the determination of financial results related to the controlled or tested transactions;
- the selection of the years for comparison;
- the accounting adjustments made to the comparable companies' and the Importer's financial data;
- the selection of the most reliable profit-level indicator for use under the CPM; and
- capital adjustments and the use of the interquartile range.

The APA was signed by the IRS in March 2000, and the competent authorities of the US and Japan executed a mutual agreement that was consistent with the APA. As is usually the case, the APA contained a compensating adjustment clause. The ACR noted this as follows:

> Further, pursuant to paragraph 7 of the APA, if the Importer's actual transactions are not in compliance with the TPM described above, the Importer's taxable income must nevertheless be reported in an amount consistent with the TPM and the requirements of the APA. Thus, the Importer may make what are referred to in the IRS revenue procedures as "compensating adjustments." Compensating adjustments are a means of allowing a taxpayer to retroactively account for any differences between actual transactional results and true arm's length results, in this case arm's length results that are defined in the APA.[167]

Importer's Argument & Custom's Rejection – HQ 546979

The Importer argued that it was not necessary for US Customs to analyze the transaction value because the APA (and the information made available to Customs through the APA proceedings) demonstrated that the relationship of the buyer and seller did not influence the price.

Customs rejected the Importer's argument. The ACR stated that the APA's analysis was *not sufficiently granular* for Customs purposes. This is a position the US has not modified.[168] The ACR states:

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[167] Private Ruling HQ 546979 (Aug.30, 2000) at 2.

[168] US CUSTOMS & BORDER PROTECTION 16 (2007) *supra* note 105 indicates:

> CBP recognizes that in some cases, the underlying facts and the conclusions reached in an APA or transfer pricing study may contain some relevant information about the circumstances of sale and thus may be considered in applying the circumstances of sale test. For example, they may contain pertinent information about how the related parties transact business and may include information about sales of similar products to unrelated purchasers. The weight given to the facts and conclusions in an APA or transfer pricing study depends in large part on the particular circumstances presented and the transfer pricing methodology used. For example, an APA that is based on the comparable uncontrolled price method (CUP) has the most relevance for customs valuation purposes and would be given much more weight than an APA that is based on the comparable profits method (CPM), which generally has the least relevance for customs valuation purposes.
>
> In addition to the methodology used, other relevant considerations are whether the transfer pricing study has been considered by the IRS, whether the APA is bilateral or unilateral, and whether the products covered by the study are comparable to the imported products at issue. *See*, HRL 548095, September 19, 2002; HRL 547672, May 21, 2002; and, HRL 546979, August 30, 2000. If an importer believes that any information or finding contained in an APA or transfer pricing study is relevant to the application of the circumstances of sale test, it is up to the importer

[The] Customs approach to related party transactions differs from the IRS approach. Specifically, the methods [CPM and Japanese profit split] review profitability on an aggregate basis, not a product by product basis. … in the Prefiling Submission to the IRS, the Importer stated that to establish a range at a less aggregate level, allocations of its profit and loss statement and balance sheet would have to be undertaken to analyze each product division individually … (emphasis added)[169]

Custom's Solution: Resolving the Granularity & Timing Issues – HQ 546979

But HQ 546979 does not end with a simple rejection of the Importer's petition. Because Customs did not view a product-by-product analysis to be a difficult hurtle to overcome, Mr. Lobred went on to explain how the facts of the present case were sufficient to satisfy the "circumstances-of-the-sale" test.[170] Mr. Lobred indicated that the required product-by-product analysis was something that could be done within the confines of the current APA.

> … all the Importer's imported products are covered by the APA. Thus, [Customs] will not require the Importer to provide Customs with a further breakdown of product line profitability for comparability purpose. However, Customs expects that in any future verification, the Importer will be able to show Customs that the profit earned by product line falls within the agreed upon range specified in the APA.[171]

In other words, all that is needed as a general matter is a reasonable formula that allocates profit among the product lines. It may not be necessary for an APA to be granular, but it is necessary for an ACR to be granular. Customs and an ACR are concerned with a transactional (not an aggregate) tax base.

The final concern of the ACR was the compensating adjustment required by the APA. Because these adjustments have a direct bearing on customs value the ACR indicated,

> … if the importer must make compensating adjustments to comply with paragraph 7 of the APA, the adjustment must be reported to Customs immediately, and any additional duties resulting from the adjustments must be tendered to Customs.[172]

In other words, under the ACR the Importer would have to agree to make adjustments to the transaction value as and when those adjustments were being made on the income tax side.

SOLUTION – THE CERTIFIED SYSTEMS PART

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to identify that information, explain why it is relevant, and submit supporting documentation to CBP. If the importer simply submits a copy of an APA or transfer pricing study without further explanation and documentation, the circumstances of sale claim will be rejected.

[169] *Id.* at 10-11.

[170] §402(b)(2)(B) of the Tariff Act (1930), as amended by the Trade Agreements Act of 1979 (19 U.S.C. 1401a); GVC *supra* note1, at Art. 2(a).

[171] Private Ruling HQ 546979 (Aug.30, 2000) at 11-12.

[172] *Id.* at 12-13.

The full solution is not simply a multi-tax APA. More is needed. It is reasonably clear that a serious barrier to vertical harmonization of transfer pricing rules in direct taxes and VAT/GST (and customs) has to do with timing as well as granularity.

Direct tax valuations are completed much later in time than VAT/GST and customs regimes are comfortable with. Transaction taxes are designed around having either a *set number* or a *fixed formula* that will objectively determine the tax base. Certified systems, software programs that are certified as part of the APA process, have the *fixed formula* that provides the adjusted tax base numbers that transaction taxes need. The formula, embedded in the taxpayer's VAT and customs software, linked through the ERP to the financial statements and the direct tax return can be designed to determine the granular adjustments that transaction tax auditors need. A certified system would go one step further. It would file amended VAT/GST and customs returns based on this formula.

Thus, what is proposed is for an IT-APA (Information Technology – Advance Pricing Agreement). Reaching an IT-APA agreement is in essence the certification of the tax software of an enterprise. Certification means – the determination by the tax administration that the software (absent fraudulent use): (a) accurately records the determination of transfer prices [based on the application of methods agreed to elsewhere in the APA]; (b) properly calculates VAT/GST and customs duties based on these values; (c) automatically files all tax documentation; (d) authoritatively interfaces with financial reporting systems and the pricing elements of the income tax; (e) adjusts all invoices, tax reports and returns for pricing decisions made later in time; and (f) file the related returns, reports and schedules based on these adjustments along with remission of additional taxes due, plus interest an applicable penalties.

It is expected that concessions on penalties, the kinds of adjustments possible, later filing of amended returns, and even some linkages among transfer pricing regimes will only be available to businesses that enter into an IT-APA. Only these enterprises will be able to assure governments that the necessary balancing of compliance obligations (among income tax, customs and VAT/GST regimes) has been accomplished – short of a full blown three-tax audit.

Taxpayers that do not secure an IT-APA will benefit from the conscious efforts of the tax administration to further harmonize income tax, customs, and VAT rules – a necessary activity when tax administrations are actively engaged in negotiating IT-APAs. However, these taxpayers will have no assurance that their returns will be accepted as accurate on all pricing issues (immediately on filing), and will likely encounter a more highly cross-checked audits.

Adopting an IT-APA will be a matter of taxpayer choice. But if the model of the American Streamlined Sales Tax (SST)[173] is considered, and if third party certified service providers (CSPs) enter the tax compliance market as they have in the US, then certified solutions, and the IT-APA, will be readily available, at low cost, and with on-line access.

[173] Streamlined Sales and Use Tax Agreement (SSUTA) (adopted November 12, 2002, amended November 19, 2003 and further amended November 16, 2004) *available at* http://www.streamlinedsalestax.org.