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IT-APAs – VERTICAL HARMONIZATION OF TRANSFER PRICING STANDARDS

Richard Thompson Ainsworth

There are three separate spheres of transfer pricing analysis – income tax, customs and VAT – and the rules among them are not harmonized. Could they be, and if so, how should they be?

The World Customs Organization (WCO) and the Organization of Economic Cooperation and Development (OECD) have begun considering these questions. Multinational enterprises (MNEs) would certainly be pleased if progress could be made. An ideal outcome for MNEs would be a single global set of transfer pricing rules (a monolithic standard) applied across all taxes and within all jurisdictions. A more limited outcome appears more reasonable, at least in the short and medium term. Three basic paths are being pursued at this point: (1) homogenization; (2) validation; and (3) vertical harmonization.

The primary forums within which the WCO/ OECD are assessing the current state of transfer pricing rules has been the First and Second Conferences on Transfer Pricing and Customs Valuation (May 3-4, 2006, and May 22-23, 2007). With an ultimate goal of determining if harmonized pricing methodologies can be forged, these conferences have concluded so far: (a) that more analysis is needed; (b) that harmonization will require adjustments on all sides; and (c) that pilot projects (real world statutory and administrative efforts to harmonize) or case studies in harmonization (hypothetical fact patterns) are needed to facilitate consideration. Although the first conference focused only on income tax and customs harmonization; the second conference complicated the inquiry by extending it to VAT.

At the present time, there is no comprehensive global assessment of the current state of transfer pricing rules across income tax, customs and VAT in the academic literature. This article serves as a first effort in that regard. It also introduces themes that are developed in a longer work that endeavors to fill in some gaps.¹

The Three Paths Considered

Homogenization, validation, and vertical harmonization are by no means the only ways forward. They simply represent current thinking. Additional approaches are likely to be brought forward over time. The three current paths can be summarized as follows:

Homogenization. This approach envisions a grand blending of differences among transfer pricing rules in income tax, customs and VAT. Homogenization seeks to derive a monolithic set of transfer pricing norms. It seeks a standardized approach to valuation

¹ See Richard T. Ainsworth, *IT-APAs: Harmonizing Inconsistent Transfer Pricing Rules in Income tax – Customs – VAT*, RUTGERS COMPUTER & TECH. L.J. (forthcoming, 2007).

that would be universally acceptable across all taxes, and across all jurisdictions. The other options are more limited.

Validation. This approach keeps current income tax, customs and VAT transfer pricing regimes in place. It focuses on building bridges between these systems (through interpretation or otherwise) so that the determination of an arm's length price under one regime could be accepted (validated) as an appropriate valuation under another tax. Validation, like homogenization, makes single valuation possible, but it does so without setting up a monolithic structure. Multiple systems remain in play, but they necessarily exist within an ordering scheme. Validation presumes a conflict among valuations, but it is a conflict that is resolved in an orderly manner.

Current discussions give precedence to OECD (income tax) valuation. This does not need to be the case. Theoretically, there is no reason why precedence could not be given to customs or VAT valuations, but those positions have not found an advocate. Thus, for example, a validation approach would say – if an arm's length price for the sale of property between related parties is determined to be 10 under the OECD Guidelines, then this amount (subject to adjustments) would form the basis of valuation for customs and VAT purposes.

Vertical harmonization. This is the narrowest of the three approaches. It advocates the use of an Information Technology Advance Pricing Agreement (IT-APA) to accomplish what validation accomplishes – but only for those situations where taxpayers have sought this result in advance. Vertical harmonization requires an agreement among income tax, customs and VAT authorities that resolves both theoretical inconsistencies and the timing problems that come with making harmonizing adjustments in advance.

As currently proposed, an IT-APA is unilateral – it harmonizes jurisdiction-by-jurisdiction (not across multiple jurisdictions). There is no reason however, why an IT-APA could not be multi-jurisdictional, but discussions have not progressed to this level yet.

An IT-APA requires granular valuations, and is implemented across all taxes in accordance with taxpayer-specific (taxpayer and multi-tax administration agreed) ordering rules. An IT-APA does not set up a global transfer pricing standard (as does homogenization), nor does it give automatic precedence to a particular valuation regime (as does validation). It is envisioned that IT-APAs would become the tax policy cauldrons of new ideas, places of experimentation within which presently undeveloped resolutions to the harmonization questions would be born.

Objective

This article provides a brief sketch of the diversity of approaches currently considered by the WCO and OECD, and suggests that (at least in the short term) these questions are leading us toward technological solutions – notably, to the *vertical*

harmonization, or the IT-APA option. Monolithic transfer pricing standards may be achievable, but the difficulty in designing globally effective or *homogenized* transfer pricing regimes necessarily relegates this approach to the long term.

In the medium term a *validation* system may be possible. One can imagine that we could move forward from country and taxpayer-specific IT-APAs to a multi-jurisdictional *validation* system. In other words, once prioritizing among regimes is found to be workable, and once specific ordering preferences are established, a validation system can be instituted. The difficulty in quickly doing this is in part political.

Resistance to establishing a uniform transfer price valuation hierarchy across multiple jurisdictions can be expected from two sources. Not only will (a) certain tax administrators resist (VAT administration may not want to defer to customs, and neither may want to yield to the income tax administration), but (b) jurisdictions as a whole may be reluctant to adopt solutions where the priority valuation methodologies (those in income tax, for example) are not well developed domestically. Thus, for example, customs administrators may be uncomfortable yielding to valuations determined under the OECD's income tax guidelines (because they are not familiar with these methodologies, or they do not feel they are sufficiently accurate, or they feel they cannot be applied in a timely manner). Similarly, developing countries may resist change because they collect a high percent of their revenue from border taxes and changing to a regime that would give priority to income tax valuations would mean moving to a poorly developed set of valuation techniques (as a domestic matter.)

Trade-Significance

The sheer magnitude of global cross-border (and domestic) related party trade makes harmonization a worthy endeavor. The world's largest multinational enterprises transfer significant volumes of goods, services and intangible property in cross-border (and domestic) related party transactions. In the international area, best estimates are that multinational entities engage in 60 percent of all cross-border *transactions*,² or stated in dollar volumes estimates are that more than one third of the *value* of cross-border trade is between related parties.³ US estimates are that approximately 40 percent of US cross-border trade involves related parties – an aggregate figure that includes, for example, roughly 70 percent of all Japanese imports and 60 percent of all exports by US multinationals.⁴

The amount of this trade has pressured governments to harmonize valuation rules. Income tax, customs and VAT authorities each demand an accurate valuation of related party supplies, and there is today considerable harmonization of pricing norms within a

² Liu Ping, *Transfer Pricing and Customs Valuation: Exploring Convergence*, 2 GLOBAL TRADE AND CUSTOMS JOURNAL 117 (2007).

³ OECD, *Press Statement – International Conference on Transfer Pricing and Customs Valuation, Brussels, (May 22-23, 2007)* TAX ANALYSTS, Doc 2007-12322 (May 22, 2007).

⁴ Erwin Diewert, William Alterman and Lorraine Eden, *Transfer Prices and Import and Export Price Indexes: Theory and Practice* in PRICE AND PRODUCTIVITY MEASUREMENT, 1 & 2 (W. Erwin Diewert, Bert M. Balk, Dennis Fixler, Kevin J. Fox & Alice O. Nakamura eds.)

single tax type across multiple jurisdictions. International and regional organizations like the OECD,⁵ WTO,⁶ and the EU Commission⁷ have brought about this harmonization (horizontal harmonization).

The business pressure for harmonization has not stopped on the horizontal threshold. The valuation results *within* jurisdictions differ *among* these taxes, so there is a need to go further. The present inquiry therefore has an “unfinished business” gloss to it. Stated another way, the WCO/ OECD are now asking – how can legitimate demands for *vertical* harmonization be advanced without disrupting the *horizontal* harmonies that have already been put in place?

The Involvement of Multi-national Organizations in Transfer Pricing and the Quest for Convergence

The OECD (in income tax), the WCO (in customs) and the EU Commission (in VAT) have each assumed leadership positions in the determination of transfer pricing rules. By framing the issue as the *convergence* of transfer pricing norms the WCO/OECD conferences suggest that this is a grand quest for tax symmetry. This framing of the issue makes the topic theoretically very appealing, as well as practically very relevant. Convergence in this context simply sounds right as a tax policy goal. It is difficult *not* to participate. Indeed, the OECD, WCO, EU Commission, as well as the private sector have been active at these forums

However, these *converging transfer pricing regimes* (if that is what they are) are different precisely because they respond (presently and historically) to very different sets of tax problems. There are very good reasons why the institutional advocates and the transfer pricing rules they sponsor look at the same problem differently. This is the context of the convergence problem.

OECD. OECD involvement in income tax transfer pricing is derivative of its oversight of Article 9 of the Double Taxation Model Convention on Income and Capital. Originally published in 1963, substantially revised in 1977, and reissued in 1995, the

⁵ See 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].

⁶ 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.

⁷ SIXTH COUNCIL DIRECTIVE of 17 May 1977 on 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. On November 28, 2006 the SIXTH COUNCIL DIRECTIVE was repealed and replaced with the RECAST VAT DIRECTIVE (RVD). Council Directive 2006/112/EC on the Common system of value added tax, O.J. (L 347) 1.

OECD Model Convention is the platform upon which the OECD has issued the *Guidelines* as well as a series of reports on transfer pricing.⁸

Thus, the OECD has an immediate interest in the horizontal harmonization of transfer pricing norms in direct taxes, but a tangential interest in the vertical harmonization of the same rules in customs and VAT. Not only is this a domestic tax issue, but it involves indirect taxes that are not within the ambit of the Model Convention.

If however, vertical harmonization was to threaten or disrupt existing horizontal harmonies, the OECD would have an immediate interest and a significant reason for involvement. For example, under a *validation* approach to convergence, if OECD methods are given priority there would be very little concern; but if customs or VAT methods were given priority, the OECD would need to consider this development as it impacts the Model Convention.

WCO. WCO involvement in customs transfer pricing flows from its responsibility to administer the technical aspects of the World Trade Organization's (WTO) Agreements on Customs Valuation and Rules of Origin.

The Tokyo Round Valuation Code, or the Agreement on Implementation of Article VII of the GATT, concluded in 1979, established a "positive system" of customs valuation, based on the "price actually paid or payable" for imported goods. This system replaced the Brussels Definition of Value (BVD), which had been in place since the 1950's, and was constructed around notional prices.⁹ Because the WTO legal system visualizes the WTO as a "single undertaking" all countries, that are members of the WTO, are bound by all the multilateral agreements constituting the WTO, including the Agreement on Customs Valuation.

The "positive system" (favored by the US, Australia, Canada, New Zealand and eventually the EU) is a transfer-price-based system. The transaction value (free from the influence of the relationship between the parties) is the basis of assessment. Customs applies two tests to determine if the stated price can be accepted as the transaction value: (1) the "circumstances of sale" test determines if the relationship of the parties influenced the price, and (2) the "test values" test which is used to determine whether the transaction value closely approximates one of three types of "test" values. If neither test is passed (that is, if the transaction value of the imported goods is not accepted), then customs determines a substitute value by applying in hierarchical order a set of tests that resemble the traditional OECD pricing methods.¹⁰

⁸ OECD, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES 1979; OECD, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES – THREE TAXATION ISSUES, 1984; OECD, THIN CAPITALIZATION, 1987.

⁹ At the height of its popularity in the 1970's over 100 countries applied the BVD. The BVD was rejected by the US, Canada, Australia and New Zealand. These countries advocated the "positive system" that the EU was eventually persuaded to support, leading to the Tokyo Round agreement.

¹⁰ The transaction value of identical or similar goods resembles the comparable uncontrolled price Method (CUP); the deductive value method resembles the resale price method (RSP); and the computed value method resembles the cost plus method (C+). A final fall-back method resembles an "other method." For an in-depth discussion of similarities and differences among these methods see: Richard T. Ainsworth, *IT-*

Thus, the WCO's immediate commitment is to facilitating the horizontally harmonized GATT Valuation Code (GVC), a code that includes an embedded set of transfer pricing rules used in two places: (a) the "test values" criteria and more fully at (b) the determination of substitute values when relationships have influenced the price. As with the OECD, the WCO does not include within the immediate ambit of its mission a commitment to assuring the vertical harmonization of transfer pricing rules *within* domestic tax systems. However, the WCO does have a tangential interest if efforts at vertically harmonization impact its mission with respect to the interpretation (and the uniform application) of the GVC.

For example, under a *homogenized* approach to convergence a blending would be undertaken with respect to two sets of customs rules. *Homogenization* would blend (a) the "circumstances of sale" test with related party definitions (in income tax and VAT), and it would blend (b) the hierarchy of customs methods with OECD transfer pricing methodologies (and those used in VAT regimes where different). Because the GVC is a WTO document, sanctioning this kind of *convergence* is most likely well beyond its authority.

A *validation* approach would short-cut this analysis. A *validation* approach could more easily be accommodated by the WCO. If the validation is based on placing OECD methodologies in the superior position, then this approach would hold that any transaction by any taxpayer that satisfied OECD transfer pricing criteria, would (by definition) also satisfy the "circumstances of sale" test for customs purposes. In effect, satisfying OECD methodologies would indicate that the relationship of the parties did not affect the price between the parties. Reaching this result would only be a matter of interpreting the GVC, not fundamentally changing it.

Under the more limited *vertical harmonization* approach, an IT-APA would reach the same results, but the application would be more restricted (applying only to the taxpayer directly involved.) In addition, the analysis would be more detailed (because granular adjustments would be worked out in detail in preparation for automated implementation of the agreement.) Rather than cutting the traditional customs analysis short (as under the validation approach), an IT-APA extends it. The IT-APA would mandate conforming adjustments in tax and accounting records, and it would require invoice corrections in instances where facts or economic assumptions change during the tax year, after importation, or after the filing of returns.

EU Commission. EU Commission's involvement in transfer pricing is not confined to VAT, but extends to customs and income taxes. Unlike the OECD and the WCO, the EU Commission has a direct interest in vertical as well as horizontal harmonization of transfer pricing norms within the EU. Even though its jurisdictional scope is regional, not global, the EU Commission is positioned to offer a unique multinational perspective on the *convergence* of transfer pricing norms. As yet, the EU

APAs: *Harmonizing Inconsistent Transfer Pricing Rules in Income tax – Customs – VAT*, RUTGERS COMPUTER & TECH. L.J. (forthcoming, 2007).

Commission has not done so, confining itself to strengthening horizontal harmonies in income tax, customs and VAT transfer pricing norms.

Thus, for example, when the EU Joint Transfer Pricing Forum indicates that it is concerned with:

[t]he existence within the EU of different sets of national transfer pricing rules laying down that transactions between taxpayers under common shareholder control should be taxed as if they had taken place between independent taxpayers undermines the proper functioning of the internal market and represents a large administrative burden on taxpayers¹¹

it is speaking *only* of transfer pricing in an income tax context. There is no stated concern with *converging* income tax rules with companion transfer pricing rules embedded in the Community Customs Code,¹² or the Sixth VAT Directive.

Recently the EU Commission extended transfer pricing broadly into the VAT,¹³ allowing tax authorities to adjust the valuation of certain goods and service transactions if the declared value differs from the “open market value.” The EU is not the first to do this – Canada,¹⁴ South Africa,¹⁵ Singapore,¹⁶ Australia,¹⁷ and New Zealand¹⁸ have similar rules – but the EU has certainly attracted the most attention by doing so. However, from the perspective of transfer pricing *convergence*, the Rationalization Directive leaves a lot to be desired. It neither defines related parties (“connected parties”) nor does it prescribe pricing methodologies. By leaving these decisions up to the Member States the EU Commission is conforming to convention, focusing on horizontal rather than vertical harmonies, and avoiding (for the time being) the issues inherent in the convergence debate.

Detailed Consideration of Current Positions – Homogenizing, Validating and Vertically Harmonizing Transfer Pricing Rules

¹¹ Commission of the European Communities, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, on the work of the EU Joint Transfer Pricing Forum in the field of dispute avoidance and resolution procedures and on Guidelines for Advance Pricing Agreements within the EU, COM (2007)71 final at 3.

¹² The European Community's basic customs legislation is contained in the Customs Code (Council Regulation (EEC) No 2913/92) and the Code's implementing provisions (Commission Regulation (EEC) No 2454/93). Implementing powers are conferred on the Commission which is assisted by a Customs Code Committee.

¹³ Known by the short hand expression, the “Rationalization Directive,” Council Directive 2006/69/EC, O.J. (L 221) 9.

¹⁴ EXCISE TAX ACT, R.S.C., ch. E-15, §§ 154(1), 153(1) & 155(1) (Can.)

¹⁵ 1991 SA REVENUE 89; REVENUE, VALUE-ADDED TAX ACT No. 89 of 1991 at § 10(4)(b) & (c) (South Africa).

¹⁶ GOODS AND SERVICES TAX ACT, Cap 117A, at §17(3) & Third Schedule § 1(1)(c) (Sing.).

¹⁷ A NEW TAX SYSTEM (GOODS AND SERVICES TAX) ACT, 1991 at ¶ 72-5(1)(a) & (b) (concerning supplies without consideration) and at ¶ 72-70(2)(a) & (b) (concerning supplies with inadequate consideration) (Australia).

¹⁸ GOODS AND SERVICES TAX ACT, 1985 at §10(3)(b) & (c) (N.Z.).

Homogenization. There are a number of examples of partially homogenized transfer pricing regimes, but full homogenization is elusive (at the present time). There are instances where domestic income tax rules have been adopted by the VAT administration in the same country, as well as instances where domestic customs-based transfer pricing methodologies are followed in that country's VAT. There are however, no examples where income tax and customs methodologies have been successfully homogenized, and only one instance where a national commitment has been publicly made to strive toward this degree of homogenization.

The Russian,¹⁹ Azerbaijan,²⁰ Turkmenistan,²¹ Georgian,²² Japanese²³ and most recently the Spanish²⁴ and possibly the Ecuadorian²⁵ tax systems approach transfer pricing issues for income tax and VAT purposes in a substantially *homogenized* manner. With the sole exception of a valuation question arising on the importation of goods, both the determination of whether or not parties are related, and if so what methods will be employed to determine transactional value are identical. Customs rules are not included.

In contrast, jurisdictions like Botswana,²⁶ Lesotho,²⁷ and New Zealand²⁸ adopt customs (not income tax) methodologies to determine value for VAT purposes. In this *homogenization* their rules reflect the only universal in this field – the fact that all jurisdictions *fully homogenize* VAT and customs valuation methodologies at the border for imported goods.²⁹ In these instances VAT valuation always follows customs. Income tax rules are different (or non-existent).

Although no jurisdiction has homogenized transfer pricing rules across customs and income tax, one country has made a commitment to move in this direction – South Korea. The Korean Customs Service has recently announced that:

We will ultimately establish a harmonized taxation system, agreeable by both tax authorities and tax payers through public hearings where all the parties concerned including transfer pricing experts participate. ...

¹⁹ TAX CODE OF THE RUSSIAN FEDERATION, Part 1, Arts. 20 & 40, Federal Law No. 147-FZ (July 31, 1998).

²⁰ TAX CODE OF THE REPUBLIC OF AZERBAIJAN, Law No. 905-IG at Arts. 14.6.3, (Jul. 11, 2000) .

²¹ TAX CODE OF TURKMENISTAN, 2005 at Pt. 1, Sec. IV, Ch. 2, Art. 36(3).

²² TAX CODE OF GEORGIA, 1997 (as amended) Pt. I, Ch. 1, Art. 27(6)

²³ Special Taxation Measures Law (*Sozei-tokubetsu-sochihou*) (STML) Article 66-4; STML Enforcement Order Article (*Sozei-tokubetsu-sochihou-sekourei*) 39-12 and the STML Ministerial Order Article 22-11.

²⁴ Spanish Act 36/2006 of Nov. 29, 2006 amending the VALUE ADDED TAX ACT 37/1992 (Dec. 28, 1992) Art. 79.5; 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.

²⁵ 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).

²⁶ VALUE ADDED TAX ACT, 2000 at Pt. 1, Arts. 2 & 3.

²⁷ SALES TAX ACT, 1995 at Arts. 3 & 4 (Lesotho).

²⁸ New Zealand, IRD Tax Information Bulletin, Vol. 6 No. 14 at 6-8 (Jun. 1995).

²⁹ See for example the rule in the EU at Art. 11(A)(1)(a) of the SIXTH COUNCIL DIRECTIVE; Art. 73 of the RECAST VAT DIRECTIVE (RVD).

Since it is clear that despite the similarities of basic concepts and taxation principles, the two tax authorities still have differences in the specific standards and methods of approach, enactment of the integration of the two systems will proceed after reaching national and international consensus over the necessity of the integration.³⁰

These instances of *partial homogenization*, seen in conjunction with commitments to work toward the homogenization of the income tax and customs rules, gives hope that the grand convergence of transfer pricing regimes that the WCO/OECD is seeking may be achievable, but it may be some considerable distance over the horizon. As the Korean Customs Service indicates this will require both “national and international consensus.” It is a long term goal.³¹

Validation. Juan Martin Jovanovich has been one of the most consistent advocates for a validation approach to convergence, particularly in the difficult area of income tax and customs rules.³² This approach keeps current transfer pricing rules within each tax regime in place, but relies on ordering principles that allow one set of rules to override (or “interpret”) the other in certain circumstances. The harmony is real, but indirect. In particular, Jovanovich proposes interpreting Article 1.2(a) of the GVC (and its Note) in a manner that would accept and apply determinations of value under the OECD Guidelines for customs purposes.

Jovanovich’s approach to convergence is similar to the argument raised before the ECJ in *Ministero dell’Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc.*³³ If it had been decided in the government’s favor this case would have raised a valuation question under the Italian VAT. Because the Italian law is not clear on the valuation methods that should be applied in a VAT context, the Italian Court asked the ECJ if the OECD Guidelines could be applied.

The *FCE Bank* argument in the income tax-VAT context is stronger than Jovanovich’s argument in the income tax-customs context, because instead of an “interpretation” of VAT rules, the FCE Bank argument sought a full “override, or replacement” of VAT valuation methods with OECD methods. The substance of the argument was that because the OECD Guidelines underpin the UK-Italian Income Tax Treaty, then the Court could judicially extend these principles to the VAT. The question presented was:

Can the 'arm's length' standard laid down in Article 7(2) and (3) of the OECD model convention on double taxation and the Convention of 21

³⁰ KOREAN CUSTOMS SERVICE AUDIT POLICY BUREAU, ADVANCE CUSTOMS VALUATION AGREEMENT (ACVA) (Apr. 26, 2007) at 14-15.

³¹ Liu Ping & Caroline Silberstein, *Customs Valuation and Transfer Pricing*, Session 3, WCO/OECD CONFERENCE ON TRANSFER PRICING AND CUSTOMS VALUATION (May 3-4, 2006) at slides 21 & 22.

³² JUAN MARTIN JOVANOVIK, CUSTOMS VALUATION AND TRANSFER PRICING: IS IT POSSIBLE TO HARMONIZE CUSTOMS AND TAX RULES? (2002).

³³ C-210/04, *Ministero dell’Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc.* 2006 E.C.R. 00000. (March 23, 2006).

October 1988 between Italy and the United Kingdom of Great Britain and Northern Ireland be used to define that relationship?³⁴

The ECJ never reached this question (because the case was decided against the Italian government) however, if the ECJ had done so the Court indicates that the OECD Guidelines would be irrelevant. The Court observed:

It should be noted that the OECD Convention is irrelevant since it concerns direct taxation whereas VAT is an indirect tax.³⁵

Although analytically similar, there is a considerable difference between asking a court to judicially extend the OECD transfer pricing methodologies from the income tax into the VAT, and asking the Technical Committee on Customs Valuation (TCCV) to interpret the phrase “circumstances of sale” in Article 1.2 (a) of the WTO Valuation Agreement in a manner that allows the OECD Guidelines to set the arm’s length standard for customs.

Jovanovich’s approach is not only appropriate; it is an approach to convergence that has found some acceptance at the national level. As Jovanovich points out, Revenue Canada interprets the GVC in this manner (almost). Canadian Customs, “... will accept, for valuation purposes, a price paid or payable which is derived from one of the methods set out in the [1979] OECD report [Guidelines] unless there is information on prices available which is more directly related to the specific importation ...”³⁶ In Canada, in this context only, OECD Guidelines are given priority over customs rules, as envisioned under Jovanovich’s proposal.

The difficulty with the Canadian model however, is that the OECD Guidelines have been extended since 1979, most notably with the inclusion of profit based methods (profit splits and the transactional net margin method), but the harmonized Canadian model has not followed suit. Canadian Customs does not accept the 1995 OECD Guidelines, even though seventeen years have passed since they were issued and even though these Guidelines are followed for income tax purposes in Canada.

Vertical harmonization. Although *validation* overcomes many of the most visible barriers to the *homogenization* of transfer pricing rules – notably the fact that the present system is characterized by jurisdictions where inconsistent, partially convergent systems prevail. The dominant jurisdictions are those where there is (1) income tax – VAT convergence, and where there is (2) customs – VAT convergence. These approaches are in fundamental conflict. Canada presents a minor pattern (3) where there is some income tax – customs convergence.

However, set against this backdrop, it is difficult to see how a *homogenization* can be achieved in the short term. Homogenization is seeking a tripartite solution as in pattern (4) where income tax-customs-VAT rules converge. It is problematical for the

³⁴ *Id.*, at ¶ 20.

³⁵ FCE Bank, *supra* note 33, at ¶ 39.

³⁶ MNR, Memorandum D13-4-5 *Transaction value method for related persons* ¶¶13-16 (Mar. 30 1989).

advocates of *homogenization* that no jurisdiction presents a workable example of this model. The *validation* option is strengthened precisely because it does not try to make a single set of pricing rules applicable in all instances in all taxes. *Validation* accepts the status quo and focuses instead on building bridges among existing pricing regimes.

However, *validation* presents its own difficulties – problems of ordering, granularity and timing. These are all problems that can be solved, but the way to see their resolution (under the present system) is to work through them on a case-by-case basis – that is, through an APA procedure.

We are being led to a narrower first step than *validation*. An IT-APA approach to convergence has the advantage that it can *vertically harmonize* transfer pricing norms within a single jurisdiction for a specific taxpayer, without disrupting the business processes of the rest of the taxpaying community. The IT-APA fits very well as a first step. Its workability (and usefulness for this purpose) can be demonstrated if it is considered alongside an assessment of the ordering, granularity and timing problems that hinder a *validation* approach.

Ordering. *Validation* presumes a hierarchical ordering of methodologies. Jovanovich prefers OECD rules over the ambiguous GVC at Article 1.2(a). Canada agrees with this approach, but resists importing post-1979 OECD developments into customs. The ECJ see no similar place (priority) for OECD methodologies in VAT valuation rules.

An APA would approach this ordering problem differently. In the first instance it would be doing things by agreement, not by generally applicable rules. Thus, an APA could establish multiple ordering regimes. It could preference customs valuation methods for certain imported goods, but OECD methodologies when goods are associated with significant intangible values. The VAT could follow customs at the border and income tax domestically. Issues with services might be handled one way if they are closely connected to imported goods, but another way when they are independent of goods transactions. The specific ordering rules would be developed from the facts of the specific taxpayer's business dealings with related parties.

Granularity. Granularity is a different concern. It is most likely the underlying reason for Canadian hesitancy to bring OECD profit methodologies into customs valuation. Profit methods are by nature aggregate, annual adjustments, and they fit poorly with transactional tax regimes, like customs and VAT. But this fit is a poor one only if there is no agreed mechanism to associate annual profit adjustments with the discrete transactions that form the tax base for customs duties or VAT. *Validation* convergence proposals ignore granularity. A solution is needed to this problem before *validation* convergence can be seriously considered.

An APA could resolve this concern by establishing allocation or apportionment formulas that would specify (in advance) how aggregate transfer pricing adjustment would flow through to the transactional level. All-purpose formulary allocations of

valuation adjustments could burden businesses if they are imposed widely, but less so if they are produced out of the business-facts of a specific company. Special concerns will arise when granularity rules impact invoices. However, in the context of an APA this burden becomes more manageable because the rules are tailored. The most workable rules developed under APAs could eventually be adopted more widely, but they would need to stand-up in practice first.

Timing. Timing is the third concern. It arises predominantly when income tax pricing adjustments are made long after customs or VAT liability has been liquidated. Reflecting annualized price adjustments in transactional tax bases has been a long standing problem in this area. It shows up when compensating adjustments are made pursuant to a traditional APA; under self-initiated pricing adjustments (allowed under the US system where “prices different from those actually charged”³⁷ can be used on returns); with adjustments made in conformance with a “commensurate with income” standard; with ordinary audit adjustments; and with measures taken as a result of competent authority agreements. The timing concern is directly related to the ordering problem.

Suppose for example a cost-plus method is determined appropriate for pricing transactions between two related parties. If the arm’s length “plus” is determined to be 10%, the estimated costs at the time of the transaction are 100, but the “full costs” are determined to be 130 at the end of the year, but are still further adjusted to 150 pursuant to an income tax audit two years later, should the tax base be 110,³⁸ 143,³⁹ or 165⁴⁰? If OECD pricing rules take precedence, then the tax base for customs and VAT needs to be 165, even though at the time of the transaction the best estimate of cost is 110.

Under present rules the GVC might allow customs to adjust the price to 143. This would occur under a price review clause.⁴¹ However, it is unlikely that the audit adjustment result (165) could be accommodated. This adjustment probably takes place too long after importation to be recognized.⁴² Most VAT systems would impose significant penalties if either of these adjustments (143 or 165) were actually made to related party invoices.⁴³

The practice of making price adjustments very late in time is resisted by transaction tax administrations because it directs audit resources away from core

³⁷ Treas. Reg. §1.482-1(a)(3). See also H. David Rosenbloom, *Self-initiated Transfer Pricing Adjustments*, 46 TNI 1019 (June 4, 2007).

³⁸ $100 + (100 \times 10\%) = 110$.

³⁹ $130 + (130 \times 10\%) = 143$.

⁴⁰ $150 + (150 \times 10\%) = 165$.

⁴¹ GVC at Commentary 4.1/1 (Commentary 4.1 of the Technical Committee on Customs Valuation)

⁴² For example 15 months was the limit established for adjustments by US Customs in: *Notice to test the use of reconciliation for adjustments made to the price of imported merchandise by related-party companies under 26 U.S.C. 482*, US Customs Service, Department of Treasury, Vol. 60 Federal Register Bo. 128 (July 5, 1995) 35105.

⁴³ Under an IT-APA penalties (but not interest) for late-in-time adjustments to the tax base (that were made consistent with the IT-APA) would need to be minimized (or eliminated).

oversight functions. VAT and particularly customs administration in its border control responsibilities are focused on today's transfers (not yesterday's prices.) The premise of the IT-APA proposal is to meet this concern through technology, and achieve a *vertical harmonization* of pricing methods on a case-by-case basis.

Under an IT-APA adjustments (and amended returns) will be processed automatically:

- in conformity with an agreed pricing hierarchy (the ordering issue);
- in accordance with price-adjustment-allocation formulas (the granularity issue);
- at the time a relevant pricing adjustment is made in another tax regime (the timing issue).

The key to the IT-APA is the certification of the tax technology within a businesses ERP (enterprise resource planning) system. Software systems are currently being certified to perform some of these functions under the Streamlined Sales Tax in the US.⁴⁴ A similar, but far more comprehensive certification process would be expected under an IT-APA, but the essential elements of tax calculation, in-time adjustments and automated return submission based on these systems is already operational.

The Current Blueprint for Change

Based on current discussions have we seen a blueprint for change? Have the WCO/OECD conferences roughly hewn a way forward? An affirmative answer is possible, if the current proposals are aligned as short-term, medium-term, and long-term solutions. Seen in this way, a path forward is visible.

There is some evidence (and agreement) that working with APAs is a good first step.⁴⁵ APAs have functioned as incubators – places where new solutions to difficult problems have been born – in the past. There is evidence that robust and very persuasive APA solutions can become international norms.

Seen in this manner the way forward might be to use IT-APAs (a taxpayer-specific *vertical harmonization* solution) to develop the persuasive national solutions to the ordering, granularity and timing problems that stand in the way of *validation* convergence. With this experience as background the international community might then see the way to devise a unitary transfer pricing regime – a single set of principles and mechanisms that would *homogenize* transfer pricing rules across income tax, customs and VAT. A new international standard could then arise.

⁴⁴ 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>.

⁴⁵ Both Juan Martin Jovanovich, the leading advocate of a *validation* approach, and the Korean Customs Service, the only government agency on record advocating a broad *homogenization* of transfer pricing rules concede that APAs may be the best place to start this process. See JUAN MARTIN JOVANOVIK, *supra* note 32, at 17-18 & 122; KOREAN CUSTOMS SERVICE *supra* note 30, at 15.

*Example – Global Dealing.*⁴⁶ The treatment of global dealing operations is the classic example of where APAs have transformed solutions to a tax problem faced by the international community.

The global dealing issue reached the public eye in 1990 when the US indicated that guidance had been requested on how the income from global dealing operations should be divided among the countries where the dealers operated.⁴⁷ When the APA program began the following year a number of taxpayers petitioned for APAs in this area, because official guidance remained limited, audit risk remained high, and penalties were severe.⁴⁸

In the initial wave of global trading APAs a formulary apportionment methodology was applied.⁴⁹ Although nominally a profit split, most commentators identified this approach as formulary apportionment. One of the difficulties for the IRS in these APAs was trying to achieve a consistent result whether the global trading

⁴⁶ Global dealing (or the OECD expression “global trading” generally refers to the activities of a corporation such as an investment bank, that has many offices throughout the world that engage in buying and selling securities and financial instruments. Different offices may perform different functions, such as hedging for the entire group or handling a particular set of securities or instruments. Often exchanges occur between the branches, especially if the operate like independent units. Serious tax problems arise if tax treatment does not recognize these transactions.

⁴⁷ IRS, Announcement 90-106, 1990-38 IRB 29 (September 17, 1990) (no regulations were issued in response to the comments received).

⁴⁸ Diane M. Ring, *Risk-shifting within a Multinational Corporation: The Incoherence of the U.S. Tax Regime*, 38 B.C.L. Rev. 667, 722 (1997) indicating that:

Under the current tax regime, APAs are the only framework for recognizing inter-branch transactions, and even then only in a limited context. The taxpayer must be engaged in cross-border transactions in a treaty country, and the Service (and the other countries) must agree to the methodology proposed by the taxpayer.

⁴⁹ The Service, in IRS, Notice 94-40, 1994-1 C.B. 351, 360 - 61 (January 1994), described the method as follows:

The method was intended to measure the economic activity of each trading location and its contribution to the overall profitability of the worldwide business. Three critical factors were identified: (1) the relative value of the trading location (the “value factor”), (2) the risks associated with the trading location (the “risk factor”), and (3) the extent of the activity of each trading location (the “activity factor”). Each of these factors was weighted to reflect its relative contribution to the overall profitability of a taxpayer’s worldwide business. ... The first step in applying the agreed upon method is to determine the amount of trading profits or losses to which the method will apply. Typically this includes worldwide profits and losses from trading the class of commodities or derivative financial products and related hedges ... the worldwide net income or loss. ... The second step in applying the method is to calculate the ratio that results from each factor. For example, to determine the ratio for the value factor, the total US trader compensation is divided by the total worldwide trader compensation. ... Once the three ratios are determined, the percentage of worldwide net income or loss attributed to the US is determined by taking the sum of the three factors and dividing them by the sum of the weights given to each factor. ... to determine the amount of worldwide net income or loss attributable to the US, the worldwide profit or loss is multiplied by the percentage described above.

This description is remarkably similar to the three-factor formula used by the US states to allocate income under state income tax systems.

operation was organized through subsidiaries or through branches. When the Service came to understand that they had authority to issue APAs to branch structures under the mutual agreement provisions of the tax treaties, in the same manner as they did when an organization operated through subsidiaries, activity on the global dealing APAs accelerated.⁵⁰ The first APA covering inter-branch transactions of a foreign bank (a breakthrough APA) was completed in 1995, and at the time of its completion approximately ten other APA applications were pending on the same issue.⁵¹

As these APAs moved forward the OECD began work on a Discussion Draft dealing with global trading that was released in 1998.⁵² The draft resolved the global trading problem in a manner that was fully consistent with that of the US APAs. Formulary apportionment under the rubric of a profit split was the preferred methodology.

Almost immediately after the OECD Discussion Draft was released the US issued proposed regulations on global dealing (Prop. Reg. § 1.482-8(e)). The proposed regulations, like the OECD Discussion Draft before them followed the formulary apportionment approach of the US APAs. These regulations are not final.⁵³

⁵⁰ Kathleen Matthews, *Non-US Bank Gets APA for Interbranch Foreign Exchange Transactions*, TAX ANALYSTS, 95 TNI 47-4 reporting on an announcement by Michael Durst, Director of the IRS Advance Pricing Agreement program on March 7, 1995 before the Institute of International Bankers, and observing:

The [APA] solution is dependent on using the competent authority process in the mutual agreement article of tax treaties. Thus, banks located in jurisdictions that do not have a tax treaty with the United States will not be eligible for this type of APA.

⁵¹ *Id.*

⁵² On April 20, 1988 TAX ANALYSTS 98 TNI 75-5; Doc 98-12743 published, *The Taxation of Global Trading of Financial Instruments: A Discussion Draft* which constituted;

... a partial text of a revised and updated version, published on March 17, 1998, of the OECD's discussion draft, released on February 14, 1997, on taxation of global trading of financial instruments. The report was prepared by the Special Sessions on Innovative Financial Transactions, a group of tax experts established by the OECD Committee on Fiscal Affairs, and is *intended to stimulate a global debate*, between tax authorities and tax authorities and taxpayers, as to whether a multilateral consensus on how global trading should be taxed can be reached.

The final version of this Discussion Draft was incorporated in a later document: OECD, DISCUSSION DRAFT ON ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (PES), at Pt. III *Enterprises Carrying on Global Trading of Financial Instruments* (Mar 4, 2003).

⁵³ Steve Musher, IRS Associate Chief Council (International) at an Institute of Bankers tax meeting in New York on June 18, 2007 indicated that the global dealing regulations are expected to be re-proposed this summer. "Hopefully you'll be happy" with the re-proposed regulations, which contain "no big surprises." Lee A. Sheppard, *IRS Report Progress on Banking Issues*, TAX ANALYSTS Doc. 2007-14555, 2007 TNT 118-2 (June 19, 2007). Lisa M. Nadal, *IRS, Treasury Officials Preview Global Dealing Regulations*, TAX ANALYSTS Doc 2007-5807, 2007 TNT 45-3 (Mar. 7, 2007) reported that at a meeting of the Institute of International Bankers annual conference in Washington DC on March 6, 2007 that,

Jesse Eggert, an attorney-adviser in Treasury's Office of Tax Policy, said the global dealing guidance is "a top priority for us." Taxpayers can expect the proposed regulations "not in the next few weeks, but by the end of the plan year" on June 30, Eggert said. He said the guidance "will work in harmony" with the OECD project on attribution of profits to permanent establishments. The global dealing regulations and the OECD project "grew up together in the last 10 years," he added.

Even more extraordinary than the scope of the APA program's influence on global policy positions, is the nature of the policy choice made by APA program. The formulary apportionment methodology selected by the APA program to resolve global trading had previously been strongly rejected by both the OECD⁵⁴ and the US.⁵⁵

Could the IT-APA to do exactly the same thing for the harmonization of transfer pricing norms among income tax, customs and VAT regimes? Could IT-APAs begin a process that would lead to workable *validation* solutions, and then onward to a *homogenized* result?

This seems to be where we are after the conclusion of the Second WCO/OECD Conference on Transfer Pricing and Customs Valuation.

⁵⁴ OECD, GUIDELINES *supra* note5, at ¶ 1.14 indicates:

In sum, OECD Member countries continue to support strongly the arm's length principle.

In fact, no legitimate or realistic alternative to the arm's length principle has emerged.

The global formulary apportionment approach, sometimes mentioned as a possible alternative, would not be acceptable in theory, implementation, or practice.

Similar declarations of principle and a detailed defense of this position can be found at ¶¶ 3.1 & 3.58 – 3.74.

⁵⁵ The US Congress has considered but never accepted formulary apportionment. As far back as 1962 the House Ways and Means Committee proposed that formulary apportionment be used in all instances where the taxpayer could not demonstrate an arm's length price under the comparable uncontrolled price (CUP) method. HR Rep. No. 10650, 87th Cong., 2d Sess. §6 (1962). The House provision was not included in the final Revenue Act of 1962. Assistant Secretary of the Treasury for Tax Policy Leslie B. Samuels in a speech relating to the 1994 Draft OECD Report [that became the 1995 OECD Guidelines] rejects formulary apportionment. *See, US Treasury Assistant Secretary Stresses Support for OECD Guidelines, Rejects Calls for Formulary Apportionment*, 9 TAX NOTES INT'L 1951 (Dec. 26, 1994).