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IT-APAS: HARMONIZING INCONSISTENT TRANSFER PRICING RULES IN INCOME TAX – CUSTOMS - VAT

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HARMONIZING INCONSISTENT TRANSFER PRICING RULES IN INCOME TAX – CUSTOMS – VAT

Richard Thompson Ainsworth

INTRODUCTION

In most jurisdictions there are three separate spheres of transfer pricing analysis – income tax, customs and VAT. Although they share policy objectives, terminology and frequently borrowing methodologies from one another these domestic transfer pricing systems are not in harmony.

Businesses find this lack of harmony costly, problematical, but also a planning opportunity. The door is open for arbitrage. Related parties play a three dimensional game of chess with tax authorities whenever they structure cross-border transactions. Deft taxpayer planning through this complex maze of rules often leaves Treasury with a three-way transfer pricing problem, pitting uncoordinated, sometimes uncooperative revenue authorities against one another – Treasury, it seems, can be "foisted on its own petard."[1]

What if the transfer pricing rules within a jurisdiction were harmonized?

The World Customs Organization (WCO) and the Organization of Economic Cooperation and Development (OECD) are considering this question. It would ease domestic compliance if only one set of transfer pricing rules applied regardless of the tax involved. However, to avoid double taxation (or double non-taxation) the domestic rules also need to be harmonized internationally (among jurisdictions).

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[1] Consultants with international tax planning firms are very active in this area. Danny Beeton & Geof Hopkins, *An Integrated Approach to Transfer Pricing, VAT and Customs Duty Planning* TPI TRANSFER PLANNING (May 2005) (using six examples, two from each area – customs, VAT and income tax – Grant Thorton consultants explain how tax strategies backfire if the impact of the differing transfer pricing regimes in these three tax-types are not considered in an integrated planning manner); Pascal Luquet, Jerome Riorda & Stephanie Thomas *Overlap Between Transfer Pricing, Customs in France of Growing Importance to Multinationals* TAX NOTES INT'L (Apr. 28, 2006); Doc 2006-8061; 2006 WTD 82-2 (focusing on transfer pricing issues in income tax and customs these tax advisors from KPMG present additional case studies on the need for integrated planning); Folkert Idsinga, Bart-Jan Kalshoven & Monique van Herksen, *Let's Tango! The Dance Between VAT, Customs and Transfer Pricing* INT'L TRANSFER PRICING J. 199 (Sept./Oct. 2005) (focusing on recent developments in the EU these Baker & McKenzie transfer pricing advisors express concern that developments in the EU VAT are changing the tax landscape, suggesting that integrated transfer pricing planning is urgently needed by many firms); Robin Maxwell & Marc P. Schlaeger, *Typical Indirect Tax Issues in Supply Chain Structures* TAX NOTES INT'L 1135 (Mar. 19, 2997) (premised on the E&Y study of the perceived importance of income tax transfer price planning by tax managers of multinational trading companies, particularly when those firms set up modern supply chain structures, these consultants from Ernst & Young press for integrated transfer pricing tax planning, one that necessarily includes VAT and Customs analysis if firms are to avoid major pitfalls).

Therefore, a more accurate statement of the question considered by the WCO and OECD is: what if transfer pricing rules were harmonized within and between jurisdictions (vertical and horizontal harmonization)?

Through a series of conferences the WCO and OECD have embarked on a broad ranging assessment of current transfer pricing regimes to see if a harmonized pricing methodology can be forged. As expected, the jointly sponsored First and Second Conferences on Transfer Pricing and Customs Valuation (May 3-4, 2006,[2] and May 22-23, 2007[3]) concluded that more consideration is needed; that harmonization will require adjustment on all sides;[4] and that pilot projects or case studies in harmonization need to be identified.[5] The first WCO/ OECD conference focused on income tax and customs harmonization; the second conference extended the inquiry to VAT.

This article synthesizes the range of transfer pricing regimes currently in use, and argues that an affirmative answer to the WCO/ OECD's harmonization question can *only* be realized through technology.[6] Inherent differences embedded in the annual income tax are nearly impossible to harmonize with transaction taxes like customs and VAT if what

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[2] 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

[3] 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

[4] WCO/OECD CONFERENCE, *supra* note 2, Kunio Mikuriya, *Summary Remarks.* Summarizing the First WCO/OECD Conference on Transfer Pricing an Customs Valuation specific note was made of the following:

> At national level, we need to encourage more dialogue between customs and tax authorities, in close consultation with business, possibly establishing a mechanism for liaison. At international level, customs and tax administrations through the WCO and the OECD should create an appropriate joint forum for dialogue, study and possible liaison, with invitations being extended to the WTO, business and academics. The issues for dialogue and study might include a more thorough comparison between the two sets of rules, the identification of areas for possible convergence of rules and coordinated approaches, including possible development of guidelines or explanatory notes, the degree of acceptability by one agency of a value determination of the other, Advance Pricing Agreements, joint audits, the consequences of a re-adjustment of the value made by one agency on another, the exchange of information, and cooperation between customs and tax agencies.

Available at: http://events.wcoomd.org/cal2007_cal2006_valfactsheet_opening_speech_byrichard_hecklinger_closing_speech_bymikuriya.htm

[5] INTERNATIONAL CONFERENCE, *supra* note3, Kunio Mikuriya, *Summary Remarks.* Summarizing the Second Joint WCO/OECD Conference on Transfer Pricing an Customs Valuation specific note was made of the following:

> (5) At the global level the WCO and the OECD should continue their existing cooperation relating to the sharing of knowledge, the development of training materials, and the e-learning module initiative. This cooperation could be further enhanced by the suggestion to create a small focus group of customs and tax experts to dialogue on and study issues involving the WTO and the business community initially targeting practical and concrete case studies based on commercial realities.

Available at: http://www.wcoomd.org/ie/En/en.html

[6] To be clear, the argument is not that technology will determine transfer prices, but that technology will harmonize the results, and coordinate the application of transfer pricing rules among these taxes.

is envisioned is a single, monolithic transfer pricing standard. If instead one imagines a standard that employs flexible, integrated rules, where separately harmonized (vertical and horizontal) elements are brought together in a *certified automated system,* then a harmonized transfer pricing standard can be realized.

The direct harmonization of income tax and customs rules is a nearly impossible task. The income tax quest for *true taxable income* through transfer pricing fundamentally conflicts with the customs use of transfer pricing to determine *substitute values*. Thus, harmonization is only possible through the use of a permitted customs exception, a delay in customs valuation for *certified systems* that accurately ties later-in-time (income) valuations to the present transaction value.

This article argues that the keys to successful harmonization can be found in the assurances of certified automated systems. The operation of these systems tips the balance in favor of linking domestic transfer pricing rules in income tax, customs and VAT. A five-way negotiation is envisioned to establish these linkages. Income tax, customs and VAT administrations will need to negotiate with business groups and software providers.

Developing countries need to remember that most multinational corporations already have fully automated tax compliance systems in place that determine all tax compliance measures. By aligning transfer pricing rules, governments will be indirectly aligning these pre-existing automated systems. But alignment alone is not what businesses want in this exchange. The true simplicity and the bottom-line efficiency benefits that come from a harmonized transfer pricing regime flow from the *certified use* of these systems. Thus, this proposal is not one that requires a government investment in technology. It is one that requires an investment in the *capacity to certify* technology. Businesses want to know, and governments need to be assured that the automated systems that determine compliance are doing the calculations, making the adjustments, filing returns and making payments correctly.

That is why a rough alignment of transfer pricing regimes is not the end of the story. The real benefits of harmonization are delivered through an information technology advanced pricing agreement (IT-APA). An IT-APA, like a traditional APA, is a voluntary, taxpayer initiated agreement, but in this instance it is an integrated software program that is at the core of the agreement not just accounting procedures and agreed pricing formulas. The software program can be either *proprietary* or a *third-party* system.

Reaching an IT-APA agreement is in essence the certification of the software. Certification means – the determination by the tax administration that the software (absent fraudulent use): (a) accurately records the determination of transfer prices; (b) properly calculates VAT 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; and (e) adjusts all invoices, tax reports and returns for pricing decisions made later in time. 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 regimes) has been accomplished – short of a full blown three-tax audit.

Taxpayers that do not secure an IT-APA will benefit from the harmonization of income tax, customs, and VAT rules, a necessary activity that prepares the way for the IT-APA. However, these taxpayers will have no assurance that their returns will be accepted as accurate on all pricing issues (immediately on filing), and will certainly encounter a more highly cross-checked and comprehensively enforced tax system when they do file.

Adopting an IT-APA will be a matter of taxpayer choice. But if the model of the American Streamlined Sales Tax (SST)[7] 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. Perhaps, as is the case in the US, the government may pay for business adoption in certain circumstances.[8]

A Trade Barrier and the Reason for WCO/ OECD Cooperation

The world's largest multinational enterprises transfer significant volumes of goods, services and intangible property in cross-border (and domestic) related party transactions. Is the lack of vertical harmony in transfer pricing rules a trade barrier? The WCO and OECD believe it is.[9]

In the international arena, best estimates are that multinational entities are the source of 60 percent of all cross-border *transactions*,[10] or stated in dollar volumes, estimates are that more than one third of the *value* of cross-border trade is between

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[7] 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.

[8] *Id.* at §§601-03 (providing that the government may enter into contracts with a CSP to compensate the service provider directly based on taxable transactions processed, or a percentage of instances where sellers without nexus volunteer to collect sales taxes that they are not otherwise obligated to collect)

[9] In the Joint WCO/ OECD Press Release, *Second International Conference on Transfer Pricing and Customs Valuation* the OECD Deputy Secretary General, Thelma Askey summarized the reasons for the conference as:

> The existence of two sets of rules, and in many countries, two different administrative bodies to deal with direct taxes and customs duties, can make cross-border trade overly complicated and costly. This issue has been raised by the business community on several occasions. With this second joint WCO-OECD initiative, we want to continue encouraging global coordinated efforts among business and governments, tax experts and customs specialists.

Available at: http://www.wcoomd.org/ie/En/en.html.

[10] Liu Ping, *Transfer Pricing and Customs Valuation: Exploring Convergence*, 2 GLOBAL TRADE AND CUSTOMS JOURNAL 117 (2007) (referencing UNCTAD, WORLD INVESTMENT REPORT 1995 indicating that the best available evidence is that trade within multinational companies account for 60% of cross-border world trade).

related parties.[11] 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 total exports by US multinationals.[12] Why should this amount of trade be subject to three different and frequently conflicting transfer pricing regimes?

The simple answer is that income tax, customs and VAT authorities each demand an accurate valuation of cross-border supplies. But this answer begs the question of why these regimes should be *different.* The reality is (although a number of jurisdictions have managed to partially harmonization their systems[13]) that valuation results frequently

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

[12] Measuring the volume of trade potentially subject to transfer price manipulation is a major concern for statistical agencies, like the US Bureau of Labor Statistics. This is because tax-based strategic decisions of multinational enterprises taint the major databases that these agencies rely upon -- for example, the foreign sales figures gathered by the US Internal Revenue Service or the import figures gathered by the US Customs Service cannot be presumed accurate. This is precisely because tax planners have an incentive to distort related party transactions, and because they are successful in doing so on a statistically significant scale. As a result, "practical alternatives" to the direct application of these data sources are relied upon by government statistical agencies. A recent study explained the need for these "alternatives" and the significance of the transfer pricing distortions. 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.) (forthcoming 2007) (on file with author). It indicates (manuscript at 2-3) :

> In calendar year 2000, the latest year that the data are available, the Bureau of Economic Analysis reported that $241 billion (or 31 percent) of export goods and $452 billion (or 37 percent) of imports were between related parties. During the past 20 years these percentages have tended to fluctuate somewhat. The value of exports ranged from between 31 and 40 percent, while the comparable range for imports is between 37 and 44 percent. Regardless of the actual percentage, intra-firm shipments continue to represent a substantial portion of US trade.
>
> It should be noted that the characteristics of intra-firm trade could be different from trade between unrelated parties. For example, in 2001, only 13 of percent of exports to both China and Korea were intra-firm, while 41 percent of sales to Mexico were between related parties. On the import side, fully 74 percent of US imports from Japan were related party trade, while the comparable figure for China was just 18 percent. Similar differences crop up when looking at the data by industry, with especially high proportions of intra-firm trade in transportation equipment, computers and chemicals. Even within intra-firm trade there can be significant differences. For US multinationals, 65 percent of their exports in 1999 consisted of intermediate products exported to overseas affiliates for further processing or assembly. In contrast, for foreign multinationals 76 percent of their shipments to the US in 1998 were finished goods ready for resale.

[13] *See, e.g.,* Arts. 20 & 40, TAX CODE OF THE RUSSIAN FEDERATION, Part 1, Federal Law No. 147-FZ (July 31, 1998) with subsequent amendments and additions. The Russian tax system is an example of a regime that has partially harmonized. A single set of transfer pricing rules is applied to all taxes, except for customs. Vertical harmonization seems to be an attribute of Russian tax policy. This is evident from the design of the Code itself, which has two parts, with basic rules set out in the first part, followed by specific tax provisions in the second. Because transfer pricing rules are set out in Articles 20 and 40, both of which are located in the first part, rather than the second, they are applied broadly rather than in a limited, tax-specific manner. The common observation is that Russian transfer pricing rules are "… applicable not only to income tax, but also to other taxes such as VAT, excises and turnovers." Victor Matchekhin, *Russia:*

differ. It is an anomaly of transfer pricing practice that even though the rules *between* jurisdictions are reasonably harmonized within a single tax type (horizontal harmonization), the rules *within* a jurisdiction are not (vertically harmonization).

The horizontal harmonization we see today is largely attributable to the specialized influence of supra-national standard setting organizations: the Organization for Economic Cooperation and Development (OECD) in income tax,[14] the World Trade Organization (WTO) in customs,[15] and various regional economic unions, like the European Union (EU) in VAT.[16] Thus, it makes sense to ask, can a coordinated effort by these organizations facilitate vertical harmonization?

Organization of the Text

Transfer Pricing Rules, Practice and Potential Development, INT'L TRANSFER PRICING J (May/June 2003) 124, 125.

In particular note: Article 154.1 of the Russian Federation Tax Code referencing Article 40 for determination of the tax base for VAT purposes. It states: "The tax base of realization of goods (work, services)....is determined as a sales price calculated based on prices determined in accordance with Article 40 of the current Code...". Similarly, with respect to excises, Articles 187.2 and 187.2 (2) of the Russian Federation Tax Code says that, "The tax base of realization of... excisable goods...is determined as...a price of realized ... excisable goods, calculated based on prices determined on the basis of provisions of Article 40 of the current Code... ".

However, notice in contrast that customs valuation in Russia is governed by a different statute: 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, but on customs valuation issues it has been consistent with GATT Valuation Code 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).

Other countries that have partially harmonized transfer pricing regimes include Azerbaijan, Chile, Japan, Spain, and Turkmenistan.

[14] *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]. The OECD has become instrumental in interpreting this standard in income taxes not only between OECD countries but also among OECD and non-OECD countries. *See* RICHARD M. HAMMER, CYM H. LOWELL, MARIANNE BURGE & MARC M. LEVY, INTERNATIONAL TRANSFER PRICING – OECD GUIDELINES, on line at West Law WGL-ITPOECD.

[15] 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, online at http://www.wto.org:80/wto/english/docs_e/legal_e/final_e.htm.

[16] 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. 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. Dual citations (to the old and recast versions of the Sixth Directive) will be used throughout this document.

This paper proceeds in three parts. The first part describes the vertical context. It sets out problem areas that need to be addressed before full vertical harmonization can be achieved. It indicates that technology may be able to resolve these problems.

The second part is structured around the two primary questions of transfer pricing analysis: (1) Are the parties to the transaction sufficiently "related" so that their relationship *could be* affecting the price? (2) If so, how is the correct price to be measured? This part considers divergent answers to these questions across income tax, customs and VAT regimes, identifies patterns where harmonization has been partially achieved, and offers suggestions for further alignment.

The second part also considers examples where the vertical harmonization of transfer pricing norms was considered – even though harmonization was frequently brushed aside as a non-controlling principle of tax policy. In some instances taxpayers (and in other instances tax administrations) argue that courts should act to compel a vertical harmonization of transfer pricing norms that is not apparent in statute or regulations. For example, courts are asked to determine that parties are related, or that a pricing methodology is appropriate in one tax, based on rules set out in a different tax. Overall, this part raises the question – why has a tax policy of vertical harmonization sometimes been adopted, and sometimes passed over?

The final part makes the global tax policy argument, embeds it in the trend toward certified tax compliance technology in customs and VAT, and suggests that if the supra-national standard setting organizations that have achieved so much in horizontal harmonization of transfer pricing regimes, are willing to advocate *certified technological solutions*, then a vertical harmonization of pricing norms is also within reach.

PART ONE: THE VERTICLE CONTEXT

Superficial similarities, non-existent rules, and the impact of time. Three problems dominate the vertical context, and need to be addressed if vertical harmonization is to be successful: (a) the present similarities in transfer pricing methodologies in income tax and customs need to be seen as superficial (not profound) and in need of adjustment from both sides, (b) the different, incomplete, and sometimes non-existent transfer pricing methodologies applied in global VAT regimes need to be more fully developed, horizontally harmonized, and then brought into vertical alignment with customs and income tax rules, and finally (c) a bridge needs to be found at a fundamental level between the *transaction-specific* pricing issues in customs and VAT, and the *annualized* determinations of the income tax. This final concern is, in a sense, simply a complex timing issue, but it is probably the most difficult of the three problem areas to resolve – absent certified technology.

Problem One: Superficial similarities. There is a tempting, but superficial similarity between the methodologies advanced by the OECD Guidelines and those in the GATT Valuation Code (GVC). Theoretically, both income tax and customs regimes

share common objectives and principles on transfer pricing matters.[17] At a practical level however, the Guidelines and the GVC differ significantly. *When disputes arise*[18] it is highly unlikely that the same facts will produce comparable results under both income tax and customs law. In fact it is highly unlikely in a dispute-context that one transfer price can even be derived from the other. Very often the only way to get from one value to the other is to "begin all over again."

Problem Two: Inconsistent, incomplete or non-existent rules. The vertical harmonization of pricing rules is a more complex problem than inquiring simply into similarities in income tax and customs rules. Transfer pricing is a major concern of the VAT and (depending on the jurisdiction considered) the rules employed are inconsistent, incomplete, or non-existent. There are efforts at regional (horizontal) harmonization, but taken as a global matter transfer pricing in VAT is at a formative stage.

Thus, if vertical harmonization is indeed a goal of the international community, we have a present opportunity to suggest transfer pricing rules in VAT that align with companion rules in customs and income tax at their inception. It is certainly in the interest of the international community to resist the development of VAT rules that diverge from both the customs and income tax rules.

The one global constant in VAT pricing is that the value assigned to imported goods (related party or not) is determined under GVC rules. Other than this, few of the major VAT systems provide detailed regulations or administrative guidance on transfer pricing methodologies in VAT.[19] In addition to the general absence of valuation rules,

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[17] JUAN MARTIN JOVANOVICH, CUSTOMS VALUATION AND TRANSFER PRICING: IS IT POSSIBLE TO HARMONIZE CUSTOMS AND TAX RULES? (2002) at 6-7 (discussing two major objectives for customs and then for income tax systems, as well as five governing principles that underlie customs valuation and income tax transfer pricing regimes, and concluding that while there are rough similarities there is not full congruence). *See also* Mark K. Neville, Jr. *Customs Planning May Avoid Conflict with IRS Transfer Pricing Rules,* 4 J. INT'L TAX'N 70 (1993) (contending more than just being similar, "… the objectives of the [US] Customs Service and the [US] Internal Revenue Service are identical …").

[18] *Id.* at 121-26 (arguing that the OECD Guidelines should be use to determine the transaction value under GVC Article 1.2, a case which [if acceptable] would *eliminate* disputes at the outset, not *resolve* disputes once they arise).

[19] Guidance on methods for determining the "open market value" is provided in New Zealand and Australia. *See* N.Z. INLAND REV. DEPT., TAX INFO. BUL. Vol. 6, No. 14 (June 1995) *GST: The Meaning of "Open Market Value"* at 6-8 (reviewing the two statutory methods [1] the arm's length consideration paid for identical goods or services; [2] the arm's length consideration paid for similar goods or services; and explaining [3] that other methods may include a cost-plus method, but that the Commissioner will consider factors like (a) the "costs of production," (b) "likely profit margins," as well as (c) "the demand for the goods or services," and (d) "the amounts of consideration paid for similar or the same goods and services previously," but clearly rejecting [4] the "book value of an asset" method) *available at* http://www.ird.govt.nz/resources/file/ebdb0e4522c9369/tib6-14.pdf. *See also* AUST. GOODS AND SERVICES TAX RUL (GSTR 2001/6) *Goods and Services Tax: Non-Monetary Consideration* at ¶ 144-58 (indicating that reasonable methods would include [1] "the market value of an identical good, service or thing," [2] "the market value of a similar good, service or thing," [3] "the market value of the supply," [4] "a professional appraisal" and [5] other reasonable methods … for example, a cost plus margin method," but clearly rejecting [6] "historical cost or residual value" methods) *available at* http://law.ato.gov.au/atolaw/index.htm.

there are fundamental differences in the basic approach to VAT that impact transfer pricing applications.

Take for example the tax base. What is being valued under the VAT, the supply or the consideration for the supply? Until recently, the EU VAT had a reasonably clear and horizontally harmonized set of rules on this matter. This has begun to change.[20] Formerly, two uniform rules applied in the EU: (1) on importation the GVC applies;[21] (2) away from the border subjective valuation applies.[22] As of July 24, 2006 a third set of tax base rules became available to Member States on an elective basis: (3) objective valuation. This shift in the tax base is permitted in some (but not all) related party transactions.[23]

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[20] Michael Tumpel, *A Hybrid VAT System in the European Union*, 47 TAX NOTES INT'L 165 (July 9, 2007) (indicating that the EU VAT is more of a hybrid than a pure VAT as a result of changes brought about by carousel fraud – the major revision to date being Directive 2006/69/EC).

[21] SIXTH DIRECTIVE, *supra* note 16, Art. 11(A)(1)(a); RVD Art. 73.

[22] Case 230/87, Naturally Yours Cosmetics Ltd. v. Commissioners of Customs and Excises, 1988 E.C.R. 6365 at ¶ 16 (expressly holding that a subjective valuation, not an objective valuation applies in EU VAT, "… since the basis of assessment is the consideration actually received and not a value estimated according to objective criteria.").

[23] Pursuant to Article 27(1); RVD 395(1) it has always been possible for Member States to derogate from the subjective valuation rules and apply an open market valuation instead, but there were procedures and approvals needed to make this change. The Commission made it clear that it preferred open market valuation measures that were limited in scope and duration. As a result, prior to 2005 there was very selective application of the open market value in this context. This led to areas of complexity and confusion in the EU VAT – but in the whole scheme of things these transfer pricing concerns were relatively minor variances. Some of the complexity came from just ferreting out the source documentation for the derogation; other complexities came from the inconsistent scope of the derogations that were approved (on a country-by-country basis).

For example, *France* was authorized to "retain" the open market value in respect of supplies of buildings as a "special measure" under a Council Decision "deemed to have been adopted on 18 February 1997." Similarly, *Germany* (in an unpublished Council Decision from 1979) was authorized to apply the open market values somewhat broadly to all transactions between connected parties (associations and their members or near relations of those members, traders and their near relations, and traders and their employees or member of their family under a work contract). The *United Kingdom* had several derogations set in place: (1) one allowed the open market value to be applied to marketing structures of certain firms based on the sale of their products to unregistered resellers (initially a "retained" authorization like that of the French under Article 27(5); RVD 394) – extended under Council Decision 85/369/EEC, O.J. (L 199) 60, an unnumbered Council Decision of May 25 1987, O.J. (L 188) 52, and Council Decision 89/534/EEC, O.J. (L 280) 54); (2) another concerned imports or supplies of goods and supplies of services to totally or partially exempt persons with whom specified family, legal or business ties exist (unnumbered Council Decision of April 11, 1987. O.J. (L 132) 22); (3) another concerned the supply of a specific service – the use of motor cars – when the supplier and the recipient are connected persons in the motor trade (Council Decision 2004/736/EC, O.J. (L 325) 58); and finally (4) another derogation concerned the deemed supply of buildings or parts of buildings before first occupation and of the land on which they stood (Council Decision 89/466/EEC, O.J. (L 226) 23.

In 2005 things changed significantly. There was a large increase in number and scope of requests for open market value derogations in 2005. The increase coincides with an increase in fraud enforcement actions. The change began with a January 19, 2005 Proposal for a Council Decision authorizing the *Republic of Cyprus* to apply the open market value in all cases where (a) the consideration paid is less than the open market value, (b) the recipient does not have a right to deduct VAT in full, and (c) the parties are "connected … as defined in national legislation." COM(2005) 4 final. Council Decision 2005/259/EC, O.J. (L 78) 48. The Proposal indicates (at 3) that for Cyprus this was a request for the "authorization of a

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,[24] 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.[25] 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

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measure in existence prior to accession to the European Union." In other words, the EU was bringing into the Union a VAT system that fundamentally differed from the EU VAT with respect to the valuation principles of *Naturally Yours Cosmetics,* and rather than expecting Cyprus to yield to Union, the Union was prepared to yield to Cyprus. The reason for this concession was that Cyprus indicated that it had used transfer pricing principles in this manner very successfully to combat VAT fraud. The Commission received a very similar request from the Netherlands (one of the oldest members of the Union) soon after the Cypriot request was approved (March 14, 2005). On June 29, 2005 a Proposal for a Council Decision was published on behalf of the *Kingdom of the Netherlands*. This derogation requested the application of the open market value in cases where (a) capital goods and related services were supplied in "several economic sectors" (b) in tax avoidance schemes, that were (c) between "related parties" where (d) the recipient is not (fully or partially) entitled to deduct VAT. The Netherlands derogation, like the Cypriot derogation concerned undervalued supplies. COM(2005) 285 final. Council Decision 2006/181/EC, O.J. (L 65) 45. Before a favorable Council Decision was made in the Netherlands application (February 27, 2006) an even broader Proposal for a Council Decision was published (November 22, 2005). This time the request was to authorize the *Republic of Lithuania* to apply the open market value in all cases where the consideration paid is either greater (if the *supplier* does not have a full right of deduction) or lesser (if the *recipient* does not have a full right of deduction) than the open market value. In addition, the Lithuanian request specifically applied to both domestic and intra-community supplies. COM(2005)581 final. Council Decision 2006/389/EC, O.J. (L 150) 15. Finally, on December 23, 2005 a Proposal for a Council Decision on behalf of the *Kingdom of Spain* was published. Like the Lithuanian request, the Spanish request was broadly concerned with domestic and intra-Community supplies. Unlike the Netherlands, Spain was not willing to limit the application of the open market value to specific economic sectors. The Spanish request was also narrower than the Lithuanian request in one sense – Spain's request dealt only with undervaluation and made no mention of overvaluation. COM(2005) 697 final, Council Decision 2006/387/EC, O.J. (L 150) 11.

Taken all together, by early 2006 it was apparent that transfer pricing theory was making significant, but very inconsistent inroads into the EU VAT. The result was far from the horizontally harmonized outcome the Commission wanted, and it was clear that there were more requests on their way. *See* Ivan Massin, *Introduction of the "Open Market Value" in Belgium* INT'L VAT MONITOR 335, at 337-38 (Sept./Oct. 2005) (discussing the Belgian law change in anticipation of the Commission acting on an open market value request from Belgium, a request that was never acted on by the Commission).

Perhaps sensing that a dam had broken in the resistance to transfer pricing in the EU VAT – the Commission adopted (July 24, 2006) the earlier proposed (May 24, 2005) "Rationalization Directive," a proposal that followed the Council Decision approving the Cypriot open market value derogation by a little more than two months. This Directive fundamentally changes the structure of the EU VAT with respect to transfer pricing. It makes the open market value an option (within defined limits) available to all Member States without prior Commission approval. The "Rationalization Directive" is found at: Council Directive 2006/69/EC, O.J. (L 221) 9. Its impact can be seen at: SIXTH DIRECTIVE, *supra* note 16, Art. 11(A)(5)-(7); RVD Arts. 72 & 80.

[24] These are essentially the facts of Case C-412/03, Hotel Scandic Gasaback AB v Riksskatteverket 2005 E.C.R. I-743, [2005] 1 CMLR 38 (2005).

[25] Naturally Yours Cosmetics*, supra* note 22 at ¶ 16 (indicating that, "… it is clear firstly that the consideration must be capable of being expressed in monetary terms and secondly, that it is a subjective value …").

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.

What the new EU rules mean (with twenty-seven Member States electing between objective and subjective valuation in defined related party situations) is that there will no longer be a horizontally harmonized outcome in the EU for certain transactions, *even if* the same transfer pricing methods are applied in each country – because the tax base being valued is not the same.

One further aspect should be noted. Suppose parent company "A" sells X to wholly owned subsidiary "B" (or to employee 'b") in a taxable transaction. Objective and subjective valuations will produce the most divergent results when X has an objective value, but "B" (or "b") pays nothing for it. In this case an objective measure of value will find a tax base, whereas a subjective measure of value will find no tax base at all.

Thus, in the VAT there is more going on in valuation than just the "relationship" and "methodology" questions that will be considered in Part Two. In VAT there is no global uniformity about what is being valued – the consideration received in some cases; the supply provided in others. As a result, it is important to keep in mind during the examination of transfer pricing in the next part of this study that not all VAT regimes have the same tax base, and as a result the relative importance of transfer pricing rules differs among them.

To summarize, 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.[26] A second group of jurisdictions employ subjective valuations for the most part,[27] but adopt objective measures of value when considering a

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[26] LAW ON VALUE-ADDED TAX , No. 7928, 1995 (Albania) at Art. 27 provides:

> The taxable value of a taxable supply is the total amount paid for such supply, except in cases defined otherwise in this law.

Among the "cases defined otherwise" the most notable is the valuations of imports according to the customs valuation regime [Art. 27]. There is no provision for changing valuation methodology in instances where the parties are associated or related.

This is also the rule in the EU prior to Directive 2006/69/EC, and is the rule currently in force in any Member State that has neither applied this Directive nor derogated under SIXTH DIRECTIVE Art. 27(1); RVD 395(1). *See supra* note 16.

[27] Because subjective valuation regimes focus attention on valuing the consideration, they frequently have an express statutory provision dealing with transactions where there is no consideration. These transactions are non-taxable. *See* 1991 SA REVENUE 89; REVENUE, VALUE-ADDED TAX ACT No. 89 of 1991 at § 10(23) (South Africa)

> Save as otherwise provided in this section, where any supply is made for no consideration the value of the supply shall be deemed nil.

small subset (some, but not all) of the related party transactions. This is the case in Canada.[28] A third group of jurisdictions always shift to an objective measure of the tax

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A nearly identical provision is found in 1991 REPUBLIC OF FIJI 45; VALUE ADDED TAX DECREE No. 45 of 1991 at § 19(14).

Other jurisdictions reach the same result by defining taxable supplies as a transaction that includes consideration as in Australia, A NEW TAX SYSTEM (GOODS AND SERVICES TAX) ACT, 1991 at Paragraph 9-5(a).

> 9-5 Taxable supplies
>
> You make a ***taxable supply*** if:
>
> (a) you make the supply for *consideration; and
> (b) the supply is made in the course or furtherance of an *enterprise that you *carry on; and
> (c) the supply is *connected with Australia; and
> (d) you are *registered, or *required to be registered.
>
> However, the supply is not a *taxable supply to the extent that it is *GST-free or *input taxed. (emphasis in original)

Regulatory guidance is then applied to make it clear that, "GST is not payable on a supply unless it is made for consideration …" AUST. GOODS AND SERVICES TAX RUL (GSTR 2001/6) *Goods and Services Tax: Non-Monetary Consideration* at ¶ 56. A similar approach can be seen in New Zealand law, GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at §2.

[28] EXCISE TAX ACT, R.S.C., ch. E-15, § 154(1) (Can.) sets out the main Canadian rule that:

> …every recipient of a taxable supply made in Canada shall pay … tax in respect of the supply calculated … on the value of the consideration for the supply.

And as § 153(1) further clarifies:

> … the value of the consideration, or any part thereof, for a supply shall, for the purposes of this Part, be deemed to be equal to
>
> (*a*) where the consideration or that part is expressed in money, the amount of the money; and
>
> (*b*) where the consideration or that part is other than money, the fair market value of the consideration or that part at the time the supply was made.

This is a subjective valuation. However, in cases where a supply is made between persons that are not dealing at arm's length the statute shifts from a subjective to objective valuation, but only in cases where the recipient does not qualify for a full input credit on the supply (consumers, small suppliers and persons engaged in exempt activities, such as financial institutions and universities). Thus, § 155(1) provides not that the value of the supply is the "value of the consideration," but that the value of the supply is instead "a value equal to the fair market value of the property or service."

> (1) For the purposes of this Part, where a supply of property or a service is made between persons not dealing with each other at arm's length for no consideration or for consideration less than the fair market value of the property or service at the time the supply is made, and the recipient of the supply is not a registrant who is acquiring the property or service for consumption, use or supply exclusively in the course of commercial activities of the recipient,
>
> (*a*) if no consideration is paid for the supply, the supply shall be deemed to be made for consideration, paid at that time, of a value equal to the fair market value of the property or service at that time; and
>
> (*b*) if consideration is paid for the supply, the value of the consideration shall be deemed to be equal to the fair market value of the property or service at that time. (emphasis supplied)

See also REVENUE CANADA, GST MEMORANDA G300-7 VALUE OF SUPPLY (GST 300-7) at ¶¶20-23, *available at* http://www.cra-arc.gc.ca/E/pub/gm/g300-7/README.html.

Similar rules limiting the applicability of objective valuation to related parties where the recipient is not entitled to take a full input deduction for the supply apply for example: (1) South African takes the same approach at: 1991 SA REVENUE 89; REVENUE, VALUE-ADDED TAX ACT No. 89 of 1991 at § 10(4)(b) & (c) (South Africa); (2) Singapore does the same at: GOODS AND

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.[29] A fourth approach to valuation is possible – valuing all transactions objectively. No jurisdiction has adopted it.

There is no majority position. The Albanian approach (very limited use of objective valuation) is favored by many developing countries, like Bangladesh.[30] It has the advantage of very infrequently requiring transfer pricing analysis. The exceptional instance is when consideration is paid "in kind." The Canadian approach[31] (expanded use of objective valuation in *some* related party contexts) is also favored by Singapore[32] and recently by the EU.[33] It has the advantage of adopting objective valuation measures only in cases where there is an immediate loss of revenue because either the buyer or seller is not entitled to full input tax credits. This reflects a tax policy decision of using transfer pricing analysis in the VAT, but doing so sparingly. The approach taken by Barbados (using objective valuation in all related party situations) is favored by countries like Australia[34] and Jamaica.[35] It demands a greater use of transfer pricing analysis in the VAT, but has the advantage of allowing a full vertical harmonization of the "relationship" question between income tax and VAT.

SERVICES TAX ACT, Cap 117A, at §17(3) & Third Schedule § 1(1)(c) (Sing.); (3) Australia is similar at: 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); and (4) New Zealand makes the same distinction at: GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at §10(3)(b) & (c). In addition, this is the approach favored by the EU SIXTH DIRECTIVE Art. 21(6)(a); RVD 80(1)(a) *supra* note 16.

[29] VALUE ADDED TAX ACT, 1996 at § 18(1) (Barbados) states the general rule (limited only with respect to supplies that are made to employees and are valued generally at the lower of cost or open market value) as:

> Where a supply is made to a person who is connected to the supplier, other than as an officer or employee of the supplier, the value of the supply is, for the purposes of this Act, equal to its open market value after deducting the tax payable in respect of the supply.

Similar rules can be found in Jamaican law, THE GENERAL CONSUMPTION TAX ACT, 1991 at § 7(2) (Jamaica) and in Botswana, THE VALUE ADDED TAX ACT, 2001 at §9(3)(b)(i) (Botswana).

[30] Added Value Tax Act. 1991 (Act No. 21) at § 5(2) (Bangladesh) (indicating that the tax is imposed simply on the "price receivable").

[31] EXCISE TAX ACT, R.S.C., ch. E-15, § 155(2)(b) (Can.) (excluding all sales except those to persons not entitled to a full input tax credit, sales to exempt entities, and other exempt supplies).

[32] GOODS AND SERVICES TAX ACT, Cap 117A, at §17(1) & Third Schedule § 1(1)(a)-(c) & 2(a)-(c) (Sing.) (excluding all related party sales except where the consideration is lower than the open market value and the recipient does not have a full right of deduction, as well as those where the consideration is higher than the open market vale and the supplier does not have a full right of deduction).

[33] SIXTH DIRECTIVE, *supra* note 16, Art. 11(A)(6); RVD Art. 80 (excluding all related party sales except where the consideration is lower than the open market value and the recipient does not have a full right of deduction, as well as those where the consideration is higher than the open market vale and the supplier does not have a full right of deduction).

[34] A NEW TAX SYSTEM (GOODS AND SERVICES TAX) ACT, 1991 at Division 72-A (indicating that all related party transactions are subject to pricing adjustments).

[35] THE GENERAL CONSUMPTION TAX ACT, 1991 at § 7(2) (Jamaica) (indicating that when consideration is paid by a connected person then the open market value will be applied).

Thus, where the GST in Canada[36] and Australia[37] both define related parties (suspect relationships) through a direct link to the same concept in the income tax, the Canadian rules are more complex. The Canadian GST excludes many of the relationships that are considered suspect under the Canadian income tax, whereas the Australian GST moves to an objective valuation in every case where the parties are considered related under the Australian income tax.

Problem Three: The impact of time. A true vertical harmonization of pricing conventions will never be achieved if the time-based sensitivities of *transaction-specific* indirect taxes (customs and VAT) cannot be merged with, or specifically linked to the *annualized* pricing determinations of the income tax. The two most important permutations of this issue concern tax point variances, and the impact of subsequent audit adjustments.

Tax point. Transaction-based indirect taxes (customs and VAT) 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 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. If customs and VAT regimes value X-1 at 10 on January 1, then a vertically harmonized pricing system should be able to confirm that when the purchase of X-1 is aggregated into other costs for income tax purposes the following March 15 the base amount included on that return is also 10 (adjustments may be necessary in VAT or customs to reflect the inclusion or exclusion of shipping costs and other discrete items in the base, just as certain costs may be capitalized into the inventory value for income tax purposes however, the base valuation figure for all three taxes should be a harmonized amount).

Audit adjustments. The audit cycle in direct taxes can yield pricing adjustments many years after the date of specific transactions. A vertically harmonized pricing regime would carry these adjustments back into prior customs and VAT filings.

For example, if three years after the income tax return is filed (in the previous example) the aggregate price for purchases of X is adjusted on audit from 100,000 to 150,000, then a harmonized pricing regime would require that the adjustment (50,000) be broken down transactionally (and not just reported in the aggregate). These amounts

[36] EXCISE TAX ACT, R.S.C., ch. E-15, § 126(2) (Can.) (defining related persons for purposes of the GST by cross-referencing subsections 251(2) to (6) of the Income Tax Act).
[37] A NEW TAX SYSTEM (GOODS AND SERVICES TAX) ACT, 1991 at Paragraph 195-1 (indicating that the term "associate" for the GST is defined by the Income Tax Act of Australia, at § 318).

would need to be carried back to the specific transactions involved. Appropriate *invoice adjustments* would be made and then amended customs and VAT returns filed.

There are various ways to solve the allocation problem embedded in this example. The jurisdiction could apply: (a) a ratable allocation rule (adjusting the January 1 purchase of X-1 proportionally from 10 to 15 along with each additional purchase of X), or (b) a specific tracing rule (where specific adjustments are made only to those transactions in X where an increase in purchase price is proven) or (c) a stacking rule (whereby adjustments are allocated first to one category of X and then to another according to a pre-set formula).

It would not be necessary for every jurisdiction to adopt the same allocation rule, but each jurisdiction would need to have an allocation rule. The important point is that with these transaction-level adjustments in hand (however they are determined) a certified automated system would then be able to immediately file amended VAT and customs returns. Penalties for filing late returns because of an adjustment carried over from another tax should be minimized.

The impact of inconsistent transfer pricing regimes on tax automation. Aside from the complexities and business uncertainties that this matrix of transfer pricing systems imposes on commerce, it has also become a matter of serious concern in another area – tax automation.

Globally comprehensive transaction tax software solutions are available today that interface seamlessly with the financial components of ERP (enterprise resource planning) systems. These software packages calculate all transaction taxes, and perform all compliance functions in all customs, VAT and retail sales tax (RST) jurisdictions globally.

As a result, the modern standard is for multinational companies to internally automate tax compliance to a degree that extends well beyond basic electronic invoicing, returns processing and the EDI remission of funds. In so doing, these companies are responding both to external pressures for global corporate governance reform,[38] and to internal pressures for corporate efficiencies.

Because Information Technology (IT) solutions meet these business needs[39] multinational corporations are stepping forward to work with tax administrations to

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[38] Richard T. Ainsworth, *Global Changes in Regulating Corporate Auditors: A Comparative Assessment*, 38 TNI 1029 (Dec. 20, 2004) (considering the global spread of post-Enron Sarbanes-Oxley-like corporate governance regulation in Australia ["Corporate Law Economic Reform Program 9"], Japan [*Kouninkaikeishihou no ichibu wo kaisei suru houritsu* 2004-4-1], France [*Loi de Sécurité Financière*], the EU [Eighth Corporate Directive], United Kingdom [APB Ethical Standard 5 – Non-audit Services Provided to Audit Clients], its impact on corporate IT systems and automated tax compliance generally.)

[39] In 2000 the University of California at Berkeley's School of Information Management Systems conducted the first study of newly created information, and demonstrated that 93 percent of the three billion gigabytes of data generated worldwide (using 1999 data) was computer generated. Updated in 2002, a new study reached much the same conclusions, and indicated (using 2001 and 2002 data) "… about 5 exabytes

certify software systems.[40] In exchange for an investment of time, energy and resources these companies expect to receive a significant degree of audit immunity when they use these systems properly – an IT-APA.

In the United States trusted third parties function as certified service providers (CSP) and transaction tax systems are independently certified as certified automated systems (CAS). These certified providers and software systems fully perform all tax determinations, return submissions, and record retention functions, in addition to facilitating money transfers in at least twenty-one states. Known as the Streamlined Sales Tax Initiative (SSTI),[41] this concept has inspired parallel proposals for CSP and CAS-type solutions in both developing[42] and developed countries[43] in the VAT.

The most significant difference between the American retail sales tax and the international transaction-based levies (VAT and customs) is that tax base adjustments under the retail sales tax are not common.[44] All retail sale taxes use subjective valuation

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of new information [was] created in 2002. Ninety-two percent of the new information was stored on magnetic media, mostly hard disks. … film represented 7% of the total, paper 0.01%, and optical media 0.002%." Thus, it may be presumed that almost all enterprise source data content for operations, accounting, audit, as well as tax filing, financial reporting, regulatory submissions, and almost all other purposes is digitized both in generation and in storage. Eric Woodman, *Information Generation: Berkeley Study measures gargantuan information boom,* EMC2, *at* http://www.emc.com (last visited Mar. 20, 2006) referencing SCHOOL OF INFORMATION MANAGEMENT AND SYSTEMS AT THE UNIVERSITY OF CALIFORNIA AT BERKELEY, HOW MUCH INFORMATION? (2000). Peter Lyman and Hal R. Varian, *Executive Summary,* SCHOOL OF INFORMATION MANAGEMENT AND SYSTEMS AT THE UNIVERSITY OF CALIFORNIA AT BERKELEY, HOW MUCH INFORMATION? (2003) (Oct. 27, 2003) *available at* http://www.sims.berkeley.edu (last visited Apr. 24, 2006).

[40] OECD, ELECTRONIC COMMERCE: FACILITATING COLLECTION OF CONSUMPTION TAXES ON BUSINESS-TO-CONSUMER CROSS-BORDER E-COMMERCE TRANSACTIONS (Feb. 11, 2005) 9 (indicating that "[t]he emergence of 'global intermediaries' is a possibility. A global intermediary may be based in one country and would undertake intermediary activities in as many countries as suppliers are required to collect and remit consumption taxes on behalf of e-commerce suppliers. In cases where satisfactory levels of approval or financial security are evident, countries could be more relaxed about imposing a residence requirement [for the intermediary]. … one way to safeguard revenue authority and taxpayer interests might be through mutually recognized international approval or certification of intermediaries."). For details on proposed certification systems see: OECD, GUIDANCE NOTE FOR THE STANDARD AUDIT FILE – TAX (May 2005) and OECD, GUIDANCE NOTE: GUIDANCE ON TAX COMPLIANCE FOR BUSINESS AND ACCOUNTING SOFTWARE (May 2005), *available at* http://www.oecd.org/topic/0,2686,en_2649_37427_1_1_1_1_37427,00.html.

[41] Although the agreement itself was the product of the combined effort of 44 states and the District of Columbia, the full-member states that are currently implementing the SST are: Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, New Jersey, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Vermont and West Virginia. Arkansas, Nevada, Ohio, Tennessee, Utah and Wyoming are in associate status and are expected to become full members within a year. Details, documentation and policy papers on the SST is *available at* http://www.streamlinedsalestax.org/

[42] Richard T. Ainsworth, *Digital VAT and Development: D-VAT and D-velopment,* 39 TNI 625 (Aug. 15, 2005) (proposing certified transaction tax solutions for developing and transitional countries with initial efforts focused on the large taxpayer groups, expanding eventually to smaller enterprises).

[43] Richard T. Ainsworth, *Carousel Fraud and Digital VAT in the EU,* 42 TNI 443 (May 1, 2006) (proposing a certified, fully automated mechanism to resolve carousel fraud in the E.U. by adopting CSP procedures in selected industry segments).

[44] The tax base adjustments we are concerned with are *not* the "additions to the base" for shipping, handling and incidental services about which the rules differ considerably among the jurisdictions, but an actual change in the basic price. For example, if an item priced at 100 has related shipping costs of 5, handling of

principles – tax is imposed on stated consideration, not on the objective value of the goods sold. In a sense then, the SSTI is being developed in a test tube environment – a tax world where the base is clear and exceptionally stable. Transposing the principles of certified software and audit immunity that the SSTI is based on to the international arena is a complex undertaking, but it is an endeavor well worth the effort.

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2 and incidental services of 4, some jurisdictions determine the tax on 100, others on 105, or 107, or even 111. With over 10,000 RST jurisdictions in the US, errors in determining whether these additions to the base are included or excluded are common. The transfer pricing concern is different. It concerns whether or not the price of 100 should be adjusted to 95 or 110 based on arm's length pricing considerations.

There are four ways in which transfer-pricing-like tax base adjustments might be expected to arise in the RST. (1) Direct sales tax audit. All states engage in sales tax audit but, "state audit officials unanimously agree that most underreporting of tax discovered in audit is not the result of deliberate evasion but of misunderstanding, simple mistakes, and negligence." (JOHN F. DUE & JOHN L. MIKESELL, SALES TAXATION: STATE AND LOCAL STRUCTURE AND ADMINISTRATION 207-44, 244 (2nd ed. 1994). Due and Mikesell list the major sources of sales tax audit adjustments. All are in the category of "errors of omission," not "errors in pricing" a supply. The errors identified are not errors that would result in an adjustment to the primary price compnant of the base. The major audit adjustments are made because of: (a) "… failure to report tax on taxable purchases … [in] out-of-state purchases … [and] purchases under certificate …" (DUE & MIKESELL at 227-28); (b) nontaxable sales where "… firms do not keep accurate records of such sales and tend to overstate them …" (DUE & MIKESELL at 228), (c) underreporting of gross sales "… but errors are relatively rare except in very small firms." (DUE & MIKESELL at 229). (2) Secondary sales tax audit. 17 states integrate income tax and sales tax audits, and the trend is toward more integration. If state income tax audits adjusted not only the profit on the return, but the prices charged or paid for goods and services, then state income tax audits could change the primary price used for sales tax calculations. However, "… many states do little [original] income tax auditing, [instead] relying primarily upon federal audits. Rather than maintain a full income tax audit operation, the state relies on federal income tax audit of entities within the state to maintain basic compliance and, from information in those audits, generates state liability associated with any federal findings. This is true of both the personal income tax and the corporate tax on firms doing business solely within the state. The auditing of corporations that *is* conducted is concerned primarily with interstate allocation of income, and issue of little concern for sales tax purposes." (DUE & MIKESELL at 210, emphasis n original). (3) Customs declarations. In instances where the RST is destination based, it is possible that information from customs audits could be useful in adjusting the reported sales tax base. However, state efforts in this area match those in direct audit. A few states use customs declarations to identify omissions in state use tax obligations, but Due and Mikesell find no use of customs pricing audits, and report no application of customs data to adjust a sale price. "At least four states make use of U.S. Customs offices … in the past there was not always complete willingness to cooperate on the part of U.S. Customs. … California exempts purchases below $400, matching the federal customs exemption; the New York threshold, administratively established, is not reported but apparently is much higher." (DUE & MIKESELL at 263). Once again, the states are not looking for pricing adjustments at customs; they are looking for omissions in sales and use tax reporting. (4) Federal audit. The most likely source for an adjustment to the sales tax base then should arise through a federal transfer pricing audit, the results of which would be carried through to the state returns, and then on further to taxable transactions under the sales tax. However, with respect to this aspect of transfer pricing the U.S. is an outlier. Most U.S. transfer pricing adjustments are made to profit amounts on the return, not to the underlying prices. Thus, there is no federal price adjustment carried through from the federal income tax, then to state income, and then to the state sales taxes. "At a broad level of generality, Reg. § 1.482-1(a)(3) sets the United States apart from virtually all of its trading partners. The regulation means that in many – not all, but many – instances we apply the arm's-length standard to amounts reported on the tax return irrespective of the amounts that may have been paid or received in transactions, or amounts that appear in the taxpayer's books." H. David Rosenbloom, *Self-Initiated Transfer Pricing Adjustments* 46 TAX NOTES INT'L 1019, 1020 (June 4, 2007).

Many of the critical elements for making this happen are already in place. Automated compliance software in VAT and customs already determines tax compliance for the largest multinational enterprises globally. The data-interface for a merged customs and VAT digital compliance system already exists, and it is operational in the world's most efficient commercial centers.[45] However, *neither* the automated tax compliance systems nor the interface *has been certified* – although they all could be if governments were willing to take this next step.

It goes without saying that certification of software systems, audit immunity for the taxpayers that use them, and vertical harmonization of transfer pricing norms are incompatible propositions if adjustments in one sphere (the income tax, for example) can call into question (or cannot be harmonized with) prior tax base determinations in other spheres (customs and VAT, for example). Thus, technology demands that this discussion of harmonization not only include *vertical harmonization of pricing rules* (among multiple tax-types within a jurisdiction), but also *end-of-the-day agreement* (among these tax regimes) that the ***results*** harmonize in a manner that makes them interchangeable (with adjustments) and valid within all these taxes. This alignment will clear the way for full certification of multi-functional tax software solutions – the IT-APA.

PART TWO: VERTICAL HARMONIZATION – A POLICY PASSED OVER

This part considers instances where policy-makers have had the opportunity to vertically harmonize transfer pricing norms among tax-types (income tax, customs and VAT). Examples are drawn from statute, regulation, and case law. Sometimes there have been outright rejections of harmonization, at other times acceptance has been partial (customs following income tax rules, but not the other way around), while at other times harmonization has been accepted as a last resort (the best available solution in a difficult situation).

This paper argues that given this history, the only effective way to advance vertical harmonization of pricing rules as a global norm is to find a supra-national organization (or group of organizations) that will become its advocate. The WCO, OECD and EU Commission are among the candidates. However, it is very clear that the advocate will need more than theory and a good argument; it will need a "liaison mechanism," something that when added to the mix will precipitate productive discussions among the vested interests in income tax, VAT and customs administrations,

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[45] OECD, TRADE FACILITATION REFORM IN THE SERVICE OF DEVELOPMENT 23 (July 30, 2003) TD/TC/WP(2003)11/FINAL (indicating that the TradeNet system of automated customs processing in Singapore reduced document processing costs in excess of 20%, reducing processing time from 2 to 3 days to 15 minutes, with overall cost savings measured by the government at approximately 1% of the Singapore GDP). A detailed discussion of Singapore's TradeNet, the taxes collected, as well as third-party studies conducted on the efficiency gains can be found on the Singapore Customs web site at http://www.tradenet.gov.sg/trdnet/index_home.jsp. *See* Luc DeWolf, *TradeNet in Ghana: Best Practice of the Use of Information Technology* (Jan. 28, 2004) (background paper for the World Development Report 2005 indicating that the automated TradeNet system in Singapore is a benchmark best practice that should be replicated in other countries).

along with business groups and the tax technology providers that provide businesses with compliance solutions and *push them collectively* toward the common goal.[46]

The "mechanism" proposed in this study is an offer of comprehensive technical assistance with software certification. If the income tax, customs and VAT administrations of a single jurisdiction were to step forward and express a collective desire to work together (through statutory and regulatory means) to vertically harmonize transfer pricing rules, then the advocate should respond with a contribution of talent, technical expertise and resources to help this jurisdiction certify software applications that implement these rules. Such an effort would put into place a regime similar to that currently in operation in the US states under the Streamlined Sales Tax. By streamlining the rules, certifying application software, and extending limited audit immunity to taxpayers that adopt these systems a jurisdiction will be offering efficiency gains that will attract businesses for long term development.

The discussion in this part is patterned after the two steps that are taken in almost every transfer pricing inquiry. Each step is a question: (1) Are the parties to the transaction sufficiently "related" so that their relationship *could be* affecting the price? (2) If so, how is the correct price to be measured?[47] The analytical issue is how can the divergent answers to these questions be harmonized?

Relationship – The First Question

The norm is for transfer pricing regimes to first assess the "closeness" of a buyer and a seller. Only closely "related parties" need to have their transactions held up to transfer pricing scrutiny (and possible adjustment). In this first step – measuring relational closeness – there are as many as five different tests applied 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

[46] The expression "mechanism for liaison" is borrowed from the *Summary Remarks* of Kunio Mikuriya at the conclusion of the First Conference on Transfer Pricing and Customs Valuation, *supra* note 4.

[47] It is important to recognize that it is not necessary that these questions be answered the same way for all taxes (although harmonization would be limited by differences). Parties could be related for VAT or customs, but not for income tax, and a method adopted for determining the base valuation for income tax purposes need not be the same method employed for determining the base valuation for customs or VAT purposes (although harmonization would be made more difficult by differences). However the theoretical contours of the valuation method itself (what is the comparable uncontrolled price method, the resale minus method, or the cost plus method), and the evaluative evidence assembled (whether or not a transaction was comparable, whether or not a series of transactions reflected a legitimate market share strategy, whether or not valuable intangibles were transferred) would need to be uniform. In addition, the raw data elements of the transactions need to be broken down transactionally (if a royalty payment is due between related parties, then how much of that royalty is allocated to each transaction, if compensation needs to be included in the cost of goods transferred between related parties needs to be uniformly identified). In addition, when the time comes for an enterprise to finalize (for a specific period) all of its tax relationships with a jurisdiction, a uniform "base valuation" will be needed (not necessarily an agreement among the taxes on a pricing methodology, but an agreement on a number, a base value upon which each of the tax values will be constructed will be needed). These are matters taken up in the third part of this paper.

tests. There are even instances where no relationship test is applied at all, resulting in either no pricing rules, or pricing rules that are applied to all transactions regardless of the relationship.[48]

The horizontal aspect. There is a horizontal aspect to the relationship question. It is not the focus of this study, but it is closely related to it. With at least five different relationship tests in active operation globally, each of which is applied in one or more income tax or VAT regimes, it is very possible that there are multiple inconsistent pressures for very different vertical harmonization structures at play in any one system at any one time.

In horizontal terms, it is frequently observed that the OECD has been successful in bringing about harmonized rules in income tax – making a true international tax regime.[49] This observation is under scholarly debate. Some feel that the OECD has not succeeded in establishing even the most basic parameters of an international tax regime – everything is nation-based and arbitrage-susceptible.[50] OECD success is certainly difficult to validate with this study. Instead, the great success story in the establishment of an international tax regime has been in customs under the guidance of the WTO and WCO. This success can be validated. In over 150 jurisdictions a single set of related party definitions is used for customs purposes – they are discussed below under the *legal relationship* test.

Types of relationship rules. The six types of relationship texts uncovered in this study are considered below:

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[48] 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 sure the setup conformed to local requirements.

[49] Jose Calderon, *The OECD Transfer Pricing Guidelines as a Source of Tax Law: Is Globalization Reaching the Tax Law?* 35 Inter. Tax R. 4 (2007) (arguing that the tax policies underlying a large number of national tax regimes derive directly and indirectly from the OECD Guidelines).

[50] Reuven Avi-Yonah, *International Tax as International Law*, U. MICH. PUB. L. & LEGAL THEORY RES. SERIES No. 41; MICH. L & ECON. RES. PAPER No. 04-007 110 & 14 (Mar. 11, 2003) (indicating that the OECD MC and Transfer Pricing Guidelines have significantly advanced international tax law within the international legal arena); H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the International Tax System*, 53 TAX L. REV. 137 (2000) (asking the questions "Is therean international tax regime?" "Is it real?" "Does it still function?" and answering that the existence of such a system has not been proven, and in his mind is imaginary); Revuen S. Avi-Yonah, *Commentary to the Rosenbloom's International Tax Arbitrage Article,* 53 TAX L. REV. 167 (2000) (disagreeing with Rosenbloom on the "imaginary" quality of the international tax regime, but agreeing with him that international tax arbitrage is a serious problem that threatens the coherence of the system); Yariv Brauner, *An International Tax Regime in Crystallization* 53 TAX L. REV. 259 (2000). (proposing a new approach to the development of a global tax regime, one that responds to globalization and e-commerce and that is lead by the OECD in a gradual rule-harmonization effort).

(1) *Economic relationship*. The classic application of an economic 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 …"[51] 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.[52]

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.[53]

(2) *Legal relationship*. The classic application of a legal relationship test is found under the GVC, Article 15(4) and (5). These provisions are the basis upon which the 150 member states of the World Trade Organization draft their definitions of related parties under customs law. In some countries, because the GVC is part of an international convention, the GVC wording is directly applicable and binding on the government as a constitutional matter. In other countries, like the US, it is the *intent* not the *wording* that is followed. This leads to minor differences in expression, but not in meaning.[54] GVC, Article 15(4) and (5) provides:

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[51] 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.

[52] Treas. Reg. § 1,482-1(i)(4).

[53] 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).

[54] 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.

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.[55]

Conceptually, this is a dual-principled provision (legal and economic). There is 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) which are all built around the term "control" (one party controls the other party either directly or through third parties).

The potential for vertical harmonization of economic and legal relationship tests through a hybrid understanding of relationship in the GVC is critically important for this study.[56] If the GVC understands relationships in legal and economic terms, then the door is open for vertical harmonization. An income tax determination that parties were economically related would "fit" nicely with a customs determination that the same two parties were related.

(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.

[55] GVC *supra* note15, at Art. 15(4) & (5).

[56] Under the IT-APA proposed in this study legal and economic relationship tests are harmonized through the agreement. Essentially, reaching an IT-APA agreement constitutes an admission and a binding agreement among the parties (income tax, customs and VAT administrations and the taxpayers involved in the agreement) that the parties involved are related parties for purposes of all taxes. It is not a difficult leap in logic to move from an admission (in the context of one tax) that parties are so closely related that their relationship potentially distorts the prices in transactions between them for the purposes of one tax, to an understanding that the same relationship potentially distorts prices for the purposes of another tax regime involving the same transactions in the same jurisdiction.

An argument can be made for a hybrid reading of the GVC, based on the fact that these "control" provisions appear to echo language in the US income tax regulations. The "directly or indirectly controls" language in the GVC echoes "any kind of control, direct or indirect" in Treas. Reg. § 1,482-1(i)(4). The US regulation goes further when it adds the next clause, a clause not repeated in the GVC – "any kind of control, direct or indirect, *whether legally enforceable or not*." This clause catapults the US income tax rule into the realm of economics.

The question we are concerned with is, does the *absence* of a similar clause in the GVC allow the GVC to encompass both legal and economic tests? Could GVC Art. 15 (4) and (5) be hybrid provisions? Can GVC 15(4) and (5) be seen as five legal tests wrapped around three economic tests? Or, are there simply eight different legal tests here?

There is a real connection between the GVC and the US rule. History confirms that the US rule influenced the GVC (not the other way around). The US regulation was promulgated in 1935 and predates not only the GVC but both of the international regimes that were its immediate forbearers: (1) the 1947 General Agreement on Tariffs and Trade (GATT) that laid down basic guidelines for national legislation and customs valuation,[57] and (2) the 1950 convention that established the Brussels Definition of Value (BDV).[58] The US participated in the 1947 GATT, but did not participate in the BDV. The US developed an independent customs code, and was not brought into conformity with other trading nations until 1979 when a new Code (following an updated GVC) was presented to Congress.

One of the major criticisms of the US under its previous Customs Code was that the US was reluctant to accept at face value the validity of any transfer price between related parties. The GVC rejected this position. The US reversed its position in the process of agreeing to the GVC in GATT negotiations, and accepted a presumption of non-distortion between related parties – GVC Art. 2(a).[59] What did the US get in exchange?

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[57] The 1947 GATT indicated that rules should be fair, non-discriminatory, and consistent with commercial practice. The expression of principles was so general in nature, however that they created no meaningful uniformity (horizontal harmonization) among customs valuation methods. In addition the large presence of a "grandfathering provision" allowed many old practices which did not conform to the new standards. GENERAL AGREEMENT OF TARIFFS AND TRADE (GATT 1949) is *available at* http://www.wto.org/english/docs_e/legal_e/prewto_legal_e.htm

[58] The 1950 BDV, initiated by 30 countries, was eventually followed by about 100 countries (as parties to the convention or by actual customs practice). Not only did the US and Canada not participate in the BDV, but there remained considerable room for variation in application and interpretation. The Customs Cooperation Council (CCC) tried to promote uniformity, and the European Economic Community (EEC) issued regulations to promote harmony among the Member States.

[59] SAUL L. SHERMAN & HINRICH GLASHOFF, CUSTOMS VALUATION: COMMENTARY ON THE GATT CUSTOMS VALUATION CODE 53-54 (1987); GVC Art. 2(a) provides, "In determining whether the transaction value is acceptable for the purposes of paragraph 1, the fact that the buyer and the seller are related within the meaning of Article 15 shall not in itself be grounds for regarding the transaction value as unacceptable."

GVC Art. 15(4) is modeled on old section 402(g)(2) of the US Tariff Act, a clear accommodation to the US. The Tariff Act is where the "directly or indirectly controlled" language of GVC Art. 15(4)(d), (e) and (f) first appears – old section 402(g)(2) considered that "two or more persons directly or indirectly controlling, controlled by, or under common control with, any person"[60] were related parties.

Old section 402(g)(2) of the US Tariff Act in turn is drafted to echo the operative language of IRC § 482 which states that, "In any case of two or more organizations, … controlled directly or indirectly by the same interests, the Secretary may …" Thus, a line can be drawn from the GVC through the US Tariff Act back to IRC § 482 and the through to the original (and unchanged) 1935 regulations – the original economic test.

Therefore, an affirmative answer can be made to the question of whether the GVC definition of "related party" encompasses both legal <u>and</u> economic tests. However, a negative answer is provided by the Notes to the GVC. The Notes to Article 15, paragraph 4(e) explain:

> For the purposes of this Agreement, one person shall be deemed to control another when the former is <u>legally or operationally</u> in a position to exercise restraint or direction over the latter.[61]

As a result, even though the GVC language *looks like* the US regulations, and even though it *appears that* the language was borrowed, 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 purely legal tests. This is the case even though the commentators find that this reading makes the language at (e), (f), and (g) "vague," "sweeping," "obscure," "[im]precise," and as a general matter something that "should have been deleted" from the GVC altogether.[62]

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[60] (Former) 19 U.S.C. 1401a(g)(2), defines a 'related person' to be:

> (A) Members of a family, including brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants;
> (B) Any officer or director of an organization and such organization;
> (C) Partners;
> (D) Employer and employee;
> (E) Any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting stock or shares of any organization and such organization; and
> (F) Two or more persons directly or indirectly controlling, controlled by, or under common control with, any person.

[61] GVC *supra* note15, at Notes to Article 15, paragraph 4(e).

[62] SHERMAN & GLASHOFF *supra* note 59, at 188. 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 <u>sweeping</u> and <u>least precise</u> of the standards. This provision is as <u>obscure</u> as the employer-employee rule. … The same <u>obscurity</u> 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 <u>should have been deleted</u>. (emphasis added).

Clearly an opportunity for the vertical harmonization of the definition of "related parties" has been missed. The result in the US is most striking. The US income tax only uses an economic-based test for related parties, and the US customs only uses legal-based tests to determine the exact same thing – related parties.

In practical terms, this means that a particular buyer and seller may or may not be found to be related for both income tax and customs. It also means that getting to the right result will always require the application of two different sets of relationship rules.

(3) *Deemed relationships*. Russia has come very close to vertically harmonizing its transfer pricing rules.[63] Only the customs rules are excluded from Article 40 of the Russian Tax Code. This is the only thing that makes full harmonization incomplete.[64] The Russian rules however, are not entirely standard (and this is a horizontal harmonization problem for Russia).

With respect to related parties, the Russian Tax Code specifies five categories of "interdependent parties," four of which rely on the legal status of the parties involved. They are similar to the rules used in the GVC. The fifth category is an unusual three-part *deeming* provision. This provision considers parties 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.
(3) The persons concerned are married to one another, or related to one anther 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

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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).

[63] 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 *supra* note 13, at 125 & n.12 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).

[64] *See supra* note 13 (discussing the Russian system).

> 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.[65]

The difficulty with the Russian system is of course in its lack of horizontal harmonization. The Russian Federation is not a member of the OECD.[66] It is an observer at the WTO.[67] It is very possible (particularly with respect to the deeming provisions) that if unrelated parties (a Russian entity and an entity of an OECD country, for example) are engaged in (a) an "international exchange" that involves (b) "goods, work, services, information, and results of intellectual activity," that these transactions could be subjected to Russian transfer pricing adjustments. It is also very possible that the companion OECD country could refuse to make the necessary corresponding adjustments. The argument would be that the parties are not related, and that corresponding adjustments are not appropriate. This is a result that may easily lead to double taxation. A tax treaty between the jurisdictions involved should solve this problem, but no country has a tax treaty network that takes in all countries.

(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 or VAT. The transfer pricing (and related party) rules in the customs area are adopted 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 there could be as many as 137 countries in this group – take the 150 countries in the WTO[68] and reduce it by the 33 countries that are commonly identified as countries with significant income tax transfer pricing regimes to arrive at 137.[69] The only transfer pricing rules these countries apply are those prescribed

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[65] Arnett, *supra* note 63.

[66] 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.

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

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

[69] The 33 countries are Argentina, Australia, Austria, Azerbaijan, Belgium, Brazil, Canada, Chile, China (PRC), Colombia, Czech Republic, Denmark, Ecuador, Finland, France, Germany, Hungary, India,

by the GVC. This value will also be the import value for VAT. Other than in these situations, these jurisdictions tend to follow subjectively valuation principles. The relationship between the parties is never a factor.[70]

(5) *Relatedness ignored in transfer pricing application.* Some jurisdictions have exceptionally robust transfer pricing rules in income tax and VAT,[71] 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.[72] 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 on this issue (at least in some instances). The central concern is with 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

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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 lists jurisdictions with relatively robust income tax transfer pricing systems. It focuses on those jurisdictions 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).

[70] For example, this is the rule in Albania. There is no Albanian transfer pricing regime in income tax, and valuation in VAT is by subjective valuation methods. VALUE ADDED TAX, Law No. 7928, Art. 27(1) (indicating that subjective valuation applies generally) & Art. 26(1) & (2) (indicating that customs valuation methods apply in VAT with respect to imports) (1995) (Albania). The rule in Armenia is similar. There is no transfer pricing regime in income tax, and valuation in VAT is by subjective valuation methods. LAW ON VALUE ADDED TAX, Art 8(1) (indicating that subjective valuation applies generally) & Art. 8(2) (indicating that customs valuation methods apply in VAT with respect to imports) (1997) (Armenia). The also the rule in Bangladesh. There is no transfer pricing regime in income tax, and valuation in VAT is by subjective valuation methods. ADDED VALUE TAX, 1991, Act No. 22, Art 5(2), (4) & (5) (indicating that subjective valuation applies generally) & Art. 5(1) (indicating that customs valuation methods apply in VAT with respect to imports) (1991) (Bangladesh).

[71] In a VAT context a similar situation arises when a system adopts objective valuation of supplies. See the discussion at *supra* note 23 and accompanying text about the EU adoption of objective valuation and how it differs from subjective valuation measures. *See also supra* note 257 - 258 and accompanying text concerning the adoption of objective valuation measure in the Icelandic VAT.

[72] 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.

> 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.[73]

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 country that joined 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.[74]

Examples: Vertical Harmonization Passed Over – Relationship

This section considers two examples of where events have presented policy-makers with an opportunity to vertically harmonize the relationship aspect of transfer pricing rules, but where decisions were made against it. The first is the case of *Brittingham v. Commissioner*[75] (involving the non-harmonized US rules in income tax

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[73] INCOME TAX ASSESSMENT ACT, 1936, § 136AD(1) (Australia) (emphasis supplied).
[74] 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.
[75] 66 T.C. 373 (1976), aff'd., 98 F.2d 1375 (5th Cir. 1979)

and customs); the second is Directive 2006/69/EC[76] (involving rules adopted in the EU VAT that ignore the possibility of requiring harmonization with income tax or customs rules).

Brittingham v. Commissioner

Factual context. The *Brittingham* case presents the classic pattern of a taxpayer successfully exploiting differences in the way transfer prices are determined under customs and income tax rules. During the years at issue (1963-65) the Dallas Ceramic Company purchased ceramic tile from a Mexican corporation, Ceramica Regiomontana. The IRS asserted that the taxpayer (Dallas Ceramic) paid more than an arm's length price for tile, and that an allocation under Section 482 was necessary (reducing the taxpayer's cost of goods sold) to clearly reflect income. The correct arm's length price, according to the IRS, should be the same price that the taxpayer used with customs at importation.

Dallas Ceramic was the importer of record for the tiles from Ceramica Regiomontana, and was the exclusive distributor of Ceramica Regiomontana tiles in the United States.

Members of the Brittingham family held controlling interest in both Dallas Ceramic and Ceramica Regiomontana, but the way this ownership was distributed among the family is critical to the case.

> *Dallas Ceramic.* Robert and his brother Juan Brittingham were principal organizers of Dallas Ceramic. Robert and his immediate family owned 37% of Dallas Ceramic, and Juan and his immediate family owned an equal share. Uncles, an aunt and cousins of Robert and Juan owned the balance of the shares. Although Robert and Juan were both directors of Dallas Ceramic, Robert controlled the daily policies and actions of the taxpayer as its president.
>
> *Ceramica Regiomontana.* Juan organized Ceramica Regiomontana in 1955. Juan, his wife (Maria) and his mother (Roberta) owned all but three of over 1,000 shares (and the three shares were owned individually by three unrelated persons). Juan completely controlled the operations of Ceramica Regiomontana, and held power of attorney over the shares of his wife and mother. Importantly (for the income tax case, but not for the customs case), neither Robert nor any member of his immediate family held any interest in Ceramica Regiomontana.

In a series of letters, drafted in 1958 to the U.S. Bureau of Customs, Dallas Ceramic requested through its customs attorney that an agreement should be reached (in advance) on the customs value of the imported tiles. These letters disclosed the stock ownership of the two companies, demonstrated that the parties were related under the customs law, and argued that the customs value should be based on the sale of similar tiles manufactured in the same city and shipped into the United States under the same

[76] 2006 O.J. (L 221) 9.

sales terms.[77] The invoice price, in other words, was not an arm's length price.[78] The correct arm's length customs value should be determined through the use of the external comparables offered, because the relationship of the parties had influenced the price.

The attorney explained that the "real price" was set through later negotiations. It considered the current market demand generally as well as "…what price [Dallas Ceramic] can pay for the tile manufactured by Ceramica [Regiomontana] …"[79] Customs agreed with the taxpayer's analysis, and replaced the invoice price with a price derived from the comparables presented.

The IRS audit of Dallas Ceramic largely relied on the taxpayer's representations to Customs. The IRS contended: if the relationship between the parties made the invoice price inaccurate for customs purposes, then for the same reasons the invoice price should be rejected as part of the cost of goods sold. The IRS adjusted the cost of goods sold on the taxpayer's returns to reflect the agreed customs value for tiles. The resulting deficiency was (in aggregate) $1,108,182.50 along with additions to tax of $554,091.27 for fraud.

Decisions. The Tax Court decided against the IRS.[80] The IRS appealed[81] and lost again. The Fifth Circuit decision completely agrees with the Tax Court. The Appeals Court decision is a single paragraph in length.[82] The decision simply appends the full text of the Tax Court's transfer pricing analysis for its reasoning.[83] Although law

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[77] In a customs-centered transfer pricing analysis, this argument constitutes the application of a "transaction value for identical goods" (TVI) analysis. An income tax-centered transfer pricing analysis would see this as an application of a "comparable uncontrolled price" (CUP) using external comparables.

[78] The Court quoted from the attorney's letter, "Actually Ceramica … does not offer the tile for sale to Dallas Ceramic, and the price at which it is invoiced to Dallas Ceramic is arrived at in the following manner: Mr. Jack (Juan) Brittingham of Ceramica … and officials of Dallas Ceramic … get together, and the officials of Dallas Ceramic … decide on what price they can pay for the tile manufactured by Ceramica … taking into consideration that the sales price in the United States of such tile will be ten or fifteen percent less than the sales price of similar tile manufactured and sold by Dallas Ceramic …" *Id.* at 387.

[79] During the years under audit customs agents in fact erroneously imposed duties on Dallas Ceramic based on the invoice price, resulting in substantial overpayments. Dallas Ceramic applied for and received a refund based on the agreed valuation method. *Id.* at 389.

[80] There is a companion line of cases involving essentially the same facts that involve the 1966 tax year. In this companion litigation the taxpayer (Dallas Ceramic) paid the IRS deficiency and sued for refund in the District Court. Dallas Ceramic v. United States, 35 AFTR 2d 75-394, 74-1 USTC ¶ 9830 (N.D. Tex. 1974). At the District Court a finding of fact was entered at para. 9:

> Plaintiff and Ceramica during all times pertinent to this action were owned or controlled directly or indirectly by the same interest.

The Fifth Circuit took the appeal of the District Court case and reversed so as to harmonize its affirmation of the Tax Court decision dealing with the years 1963-65. Dallas Ceramic Co. v. U.S., 598 F.2d 1382, 44 A.F.T.R.2d 79-5367, 79-2 USTC P 9500 (5th Cir.1979).

[81] IRS, Action on Decision, In re: Robert M. Brittingham, et al. AOD 1977-15 (Dec. 22, 1976).

[82] This paragraph simply listed the arguments in the case and ended with the following sentence: "The taxpayer's brief meets these arguments head-on, and convinces us that the Tax Court dealt correctly with each argument made, and should be affirmed." Brittingham v. Commissioner, 598 F.2d 1375, 1377 (1979).

[83] *Id.* at 1377-82.

changes have occurred in both customs[84] and income tax[85] since the *Brittingham* case, the contour of the issues presented, particularly the issue of whether the parties are related is the same under current law.

Analysis. The heart of the Tax Court decision on the relationship issue is the refutation of a number of cases that the government offered in support of the assessment. The Court stated:

> … the families of Juan and Robert did not own proportionate interests in both corporations, and there was never a plan to shift income from Robert to Juan. Their fraternal relationship alone is not sufficient to infer that there existed any plan to shift income between them. … Robert and his family had no interest in Ceramica to which the Commissioner claims income was shifted. In view of Robert's lack of interest in Ceramica, we can find no reason for him to participate in a plan to shift income to that corporation, … (emphasis supplied)[86]

Of course, under customs rules a "fraternal relationship" is more than sufficient to establish that the parties are related.[87] This is what the customs lawyer argued to US Customs when is sought an advanced ruling on the customs value. The Tax Court quotes from this letter:

> Due to the control of the Brittingham families and relatives of the two companies, the law of supply and demand has no bearing on the price paid for the tile nor is there any opportunity of bargaining between seller and receiver, and the invoice price arrived at cannot be said to fairly reflect the market value of the merchandise.[88]

The customs and income tax outcomes in *Brittingham* differ precisely because customs and income tax analyze the relationship question differently. The customs approach is legal, and the income tax approach is economic. Because legal tests were

[84] With the adoption of the Trade Agreements Act of 1979, P.L. No. 96-39, section 201 (July 26, 1979) the United States joined the world's major trading nations in adopting the GVC – a common set of customs valuation principles.

[85] Major tax law changes that impacted transfer pricing included the Tax Equity and Fiscal Responsibility Act of 1982 (revising the § 936 scheme for possessions corporations), the Tax Reform Act of 1984 (revising the treatment of outbound property transfers under § 367), the Tax Reform Act of 1986 (adding commensurate with income language to § 482 and § 367(d)), the Omnibus Budget Reconciliation Act of 1989 (extending reporting requirements under § 6038A), the Revenue Reconciliation Act of 1990 (expanding the penalty provisions under § 6662); and completion new regulations in 1994.

[86] Brittingham, 66 T.C. at 399 (1976).

[87] Although under the GVC, Art. 2(a) this is not the end of the inquiry, because establishing that parties are related,

> … shall not in itself be grounds for regarding the transaction value as unacceptable. [But] in such case the circumstances surrounding the sale shall be examined and the transaction value shall be accepted provided the relationship did not influence the price.

[88] Brittingham, 66 T.C. at 388. The same sentence from the customs attorney letter is referenced by the Fifth Circuit Court of Appeals court in the reversal of the companion case dealing with the 1966 tax year from the US District Court. Dallas Ceramic, 598 F.2d 1186 (1979).

met customs proceeded to consider evidence on the arm's length price.[89] In contrast, because the economic test could not be met the income tax inquiry was terminated, and no consideration of the price was possible.

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[89] The relevant provisions of (former) 19 U.S.C. 1401a(g)(2) defining "related persons" (for customs purposes) that were applied in the *Brittingham* case are:

> (A) Members of a family, including brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants;
>
> (B) Any officer or director of an organization and such organization;
>
> (C) Partners;
>
> (D) Employer and employee;
>
> (E) Any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting stock or shares of any organization and such organization; and
>
> (F) Two or more persons directly or indirectly controlling, controlled by, or under common control with, any person.

There are some difficulties in going directly from the customs law applicable in the *Brittingham* case directly to present day customs rules (although the trail is reasonable clear). These problems however mostly concern valuation methodologies, not the determination of whether or not the parties are related.

Under the then applicable U.S. customs law the value of imported merchandise was first the "export value," then the "United States value," then the "constructed value," and finally the "American selling price" [(former) 19 U.S.C. § 1401a(a)(1), (2), (3) and (4)]. Because the tiles sold by Ceramica Regiomontana to Dallas Ceramic were exclusive purchases and only for wholesale (comparable tiles were not "freely sold" in the U.S. market) the law required use of the "constructed value." However, the "constructed value" method could be "disregarded" if the parties were related. Related party transactions were valued based on "… the best evidence available as to what the amounts would have been if the transaction had occurred between persons not specified in any one of the subdivisions in paragraph (2) [the (A) to (F) definition of a related party]."

The 1979 amendments [P.L. 96-39, Title II, Subtitle A, § 201(a)] – the rules that brought U.S. law was brought into global conformity with the world's major trading nations – elevated the 'related party' rules to their present place above all the valuation methods, as well as changed the formulation of the methods (from "export value," then the "United States value," then the "constructed value," and finally the "American selling price") to the familiar hierarchy of (1) "transaction value" of identical and then similar merchandise; (2) the "deductive value" of identical and then similar merchandise; and then (3) the "computed value" of identical and then similar merchandise.

The related party rules under current US law are found at 19 USC § 1401a(g)(1) and they provide as follows:

> (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.

Because IRC § 482 affirmatively burdens the IRS to demonstrate that parties use their control over the transaction to alter prices, it is the reality of control that is decisive, not the form or mode of its exercise. Thus, where customs rules turn on formalities – five easily identifiable 'legal status' criteria based on familial relations or ownership interests[90] – the US income tax demands proof of actual economic control.[91] Only at this point has the relationship been established for the income tax. As the Tax Court in *Brittingham* indicated, "… it is not necessary that the same person or persons own or controls each business before section 482 can be applied, but there must be an actual use of common control, a design to shift the income in order for different individuals to constitute the 'same interests.'"[92]

Vertical harmonization (customs and income tax) in the US – related parties. The *Brittingham* case stands for the proposition that related parties for customs purposes are not (necessarily) related parties for purposes of IRC § 482. This rule is not absolute. Harmonization is partial in two respects. However, much of the vertical harmonization already in the system could use clear regulatory support.

First, in instances where a customs determination (that parties are related) is made under 19 USC § 1401a(g)(1)(G) there should be a harmonized result.[93] This section defines related parties for customs purposes as, "[t]wo or more persons directly or indirectly controlling, controlled by, or under common control with, any person." It is very easy to associate this provision with the IRC § 482 requirement that there be "… two or more organizations, trades or businesses [that are] … owned or controlled directly or indirectly by the same interests …" Both tests should be satisfied, although it might be helpful to make this clear in a regulation.[94]

Secondly, in a reverse *Brittingham* situation, where an income tax determination that the parties are related precedes the customs inquiry, it seems reasonably clear that customs would frequently follow the income tax determination. This would most commonly occur when a taxpayer secures an Advanced Pricing Agreement (APA), and submits either the APA or the underlying studies in support of the transaction value. Although these studies may not always be determinative of customs value,[95] they would

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[90] In addition to a sixth test that echoes the direct and indirect control test of IRC § 482, but which is not applied as an economic-based test like those in IRC §482. *See supra* notes 55 - 62 and accompanying text.
[91] Pauline W. Ach v. Commissioner, 42 T.C. 114, 125 (1964); Grenada Industries, Inc. v. Commissioner, 17 T.C. 231, 254 (1971), aff'd, 202 F.2d 873 (5th Cir. 1953), cert. denied 346 U.S. 819 (1953); Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part and rev'd in part, 856 F.2d 855 (7th Cir. 1988).
[92] Brittingham 66 T.C. at 398 (1976).
[93] In *Brittingham* the parties were deemed related under 19 USC § 1401a(g)(1)(A):

> Members of a family, including brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants;

[94] *But see* the discussion *supra* notes 60 - 62 and accompanying text (concerning the possibility that the GVC requires the customs rules to be read as legal and not economic tests of relationship).
[95] US CUSTOMS & BORDER PROTECTION, WHAT EVERY MEMBER OF THE TRADE COMMUNITY SHOULD KNOW ABOUT: DETERMINING THE ACCEPTABILITY OF TRANSACTION VALUE FOR RELATED PARTY TRANSACTIONS 16 (Apr. 2007) *available at* http://www.cbp.gov/linkhandler/cgov/toolbox/legal/informed_compliance_pubs/icp089.ctt/icp089.pdf

almost surely be a concession of the related party issue. Again, a customs regulation stating this would be helpful.

There are a large number of other fact patterns, and it would have been helpful if Congress had dealt with at least some of them after the *Brittingham* case. However, the Congressional response to *Brittingham* was *not* to vertically harmonize the related party definition in income tax and customs. Instead, Congress took steps to preserve the tax base (in the income tax) and drafted rules controlling the basis of imported assets and the cost basis of inventory. IRC § 1059A[96] was added in the Tax Reform Act of 1986. It was accompanied by a single regulation in 1989.[97] These provisions establish income tax ceilings (not floors) that are tied to the customs valuation (as adjusted). This solution is not considered adequate.[98]

A very simple solution, one tailored narrowly to fit the facts in the *Brittingham* case, would be to attach income tax consequences to the issuance of an advance customs determination that the value of imports differed from the stated invoice price. Such a provision could be added to the "presumption of control" language in the income tax regulations. For example, language like the following (in italics) could be added to the definition of control:

> … any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted, *or if representations are made to US Customs that the importer is related so closely to the supplier that the invoice price does not reflect an arm's length price.*[99]

This presumption of control language would essentially function as an estoppel. The taxpayer would not be allowed to argue in the customs forum that its invoice prices are so inaccurate that the government needs to determine values by analogy, and then deny the government the opportunity to verify prices on these same transactions for income tax purposes through similar means.

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[96] IRC § 1059A(a) states:

> If any property is imported into the United States in a transaction (directly or indirectly) between related persons (within the meaning of section 482), the amount of any costs:
>
> (1) which are taken into account in computing the basis or inventory cost of such property by the purchaser, and
>
> (2) which are also taken into account in computing the customs value of such property,
>
> shall not, for purposes of computing such basis or inventory cost for purposes of this chapter, be greater than the amount of such costs taken into account in computing such customs value.

[97] 26 CFR §1.1059A-1.

[98] Mayra O. Lucas Mas, *The Existence of Section 1059[a]: An Obstacle to Achieve A Consistent Legislation?* (Spring 2006) (unpublished LLM thesis, NYU, on file with author) (indicating that § 1059A allows for tax arbitrage as well as significantly increases compliance burdens on taxpayers).

[99] Treas. Reg. § 1.482-1(i)(2) (except for the material in italics).

Alternately, an administrative provision could be added to the customs code that would condition the issuance of an advanced customs determination on the taxpayer's declaration of their status for income tax purposes. Such a declaration should be required to be attached, along with a full record of the customs petition to the income tax return. A stronger version of this approach might be to deem the parties to be related for income tax purposes on the issuance of a favorable customs determination.

None of these approaches would achieve full vertical harmonization, although taken together they would go a long way to making the rules in this area clear. Full vertical harmonization can not be achieved without something akin to a statutory deeming provision, one that would extend the definition of a related party under IRC § 482 to include all related parties under customs rules. The reverse (changing US customs rules to conform to IRC § 482) is not necessary, if 19 USC § 1401a(g)(1)(G) is interpreted as an economic relationship test.

Directive 2006/69/EC[100] -- the Rationalization Directive

On March 16, 2005 the Commission proposed[101] changes in the Sixth Directive that would allow Member States to re-value certain supplies between "closely connected persons."[102] The tax base would be the "open market value" of the supply. Re-valuation was previously allowed as a special measure and required the unanimous approval of the Council. A number of derogations had been permitted over the years, but this proposal was to grant blanket permission (within limitations) to all Member States. The proposal was adopted (with some modifications) as Directive 2006/69/EC on July 24, 2006 (also known as the Rationalization Directive).

Background. Prior to Directive 2006/69/EC, derogations[103] allowing re-valuation of supplies using "open market value" criteria[104] had been approved for France,

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[100] O.J. (L 221) 9.

[101] Commission Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations, COM(2005) 89 final (Mar. 16, 2005).

[102] "Closely connected persons" is used at SIXTH DIRECTIVE, *supra* note 16, Art. 11(A)(6); RVD Art. 80(1), and this expression or cognate phrasings like "… when the parties are connected and that connection rather than demonstrable commercial reasons, has led to a value other than the usual market value being placed on the supply,…" in the Proposal (COM(2005) 89 final at 5) make it clear that "connected persons" is intended to be used in EU VAT in the same manner as "related parties" is used in the income tax.

[103] Pursuant to Article 27(1); RVD 395(1).

[104] "Open market value" is a defined term in the Sixth Directive, and has traditionally been used in the case of self-supplies (commonly instances where an exempt or partially exempt taxpayer – a bank for instance – decides not to purchase business inputs from third parties and incur VAT, and instead decides to provide this service to itself – printing bank forms for example). In this case the supply is deemed to be a taxable supply, and the consideration is deemed to be the open market value. SIXTH DIRECTIVE, *supra* note 16, Art. 11(A)(1)(d) referencing Art. 6(3); RVD Art. 77 referencing Art. 27. The definition is:

> 'Open market value' of services shall mean the amount which a customer at the marketing stage at which the supply takes place would have to pay to a supplier at arm's length within the territory of the country at the time of the supply under conditions of fair competition to obtain the services in question.

Germany, the United Kingdom, Cyprus, the Netherlands, Lithuania and Spain.[105] In each case the Council limited the use of an open market value to transactions between "connected persons."[106]

Connected persons. Although both the Council and the Commission rely on the "connected persons" expression, neither has provided a detailed definition. Derogations use "connected persons" in three different ways: (1) some derogations have simply used the expression and ignored defining it,[107] (2) some derogations expressly indicate that national legislation will provide a definition,[108] and (3) other derogations provide a rough outline of what areas the defining national legislation could include, but they do not provide detail.[109] This third approach was taken in both the proposal for the Rationalization Directive, and in the Council Directive itself.

The proposal was narrower than the Directive. Both set outer limits on what would be permissible in national legislation. The language is permissive not prescriptive, and falls far short of a vertically or horizontally harmonized standard. The passage below reproduces the Rationalization Directive with italicized sections that indicate (a) where the Council expanded the Commission's proposal, and (b) where alternate wording in the Commission's proposal was rejected by the Council. The Rationalization Directive states:

> The option [to use an open market valuation] shall be applied only in respect of supplies of goods and services involving family *or other close*

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[105] *See supra* note 23.

[106] The *German* derogation is unpublished, but the title indicates that it is directed at "connected persons." It states: "An unpublished Council Decision from 1979 regarding the valuation of supplies of goods and services effected by certain connected persons requested by the Federal Republic of Germany" (Commission Proposal, *supra* note 101, at 10 emphasis supplied). The *Netherlands* derogation which is concerned with capital goods transactions (and related services) indicates that the "supplier and the recipient are directly or indirectly connected persons according to national legislation" and "facts make it possible to conclude from the circumstances of the case that the relationship between those connected persons has influenced the taxable amount," (Council Decision 2006/181/EC, O.J. (L 65) 45 at Art. 1(2) & (3) emphasis supplied). The *Lithuanian* derogation indicates that the authorization is limited situations where the government intends to, "… counter avoidance or evasion of VAT through the valuation of supplies between connected persons, …" (Council Decision 2006/389/EC, O.J. (L 150) 15 at Art. 2 emphasis supplied). The *Cyprus* derogation contains the same expression (as the Lithuanian), "… counter avoidance or evasion of VAT through the valuation of supplies between connected persons, …" as well as a limitation that "the person making the supply and the recipient are connected by family, business or legal ties, as defined in national legislation." (Council Decision 2005/259/EC, O.J. (L 78) 48 at Arts. 3 & 2(3) emphasis supplied). The *Spanish* derogation is also similar to the Lithuanian indicating that the derogation is limited to situations where the government intends to, "… counter avoidance or evasion of VAT through the valuation of supplies between connected persons, …" (Council Decision 2006/387/EC, O.J. (L 150) 11 at Art. 2 emphasis supplied). The *United Kingdom's* most recent derogation applies to situations, "… where the supplier and the recipient are connected persons in the motor trade, …" (Council Decision 2004/736/EC, O.J. (L 325) 58 at Art. 1).

[107] This is the case with the derogations for Lithuania (O.J. (L 150) 16) and Spain (O.J. (L 150) 12)

[108] This is the case with the derogation for the Netherlands which states, "2. the supplier and the recipient are directly or indirectly connected persons according to national legislation;" O.J. (l 65) 46 at Art. 1(2)

[109] This is the case with the Cyprus derogation, which states, "3. The person making the supply and he recipient are connected by family, business or legal ties, as defined in national legislation;" (O.J. (L 78) 48 at Art. 2(3).

personal ties [italic material added by the Council], management, ownership, *membership* [italic material added by the Council], financial or legal ties as defined by the Member State. For these purposes legal ties may include [Commission used *shall include*] the [Commission specifies *formal*] relationship between an employer and employee *or employee's family, or any other closely connected person* [italic material added by the Council].[110]

The three most notable aspects of this language are: (1) the absence of any reference to a test based in economic control, (2) the fact that each category appears based in legal criteria that align closely with the definition of "related persons" in Article 15(4) of the GVC[111] without stating as much, and that (3) national VAT definitions of connected persons can be broader or narrower than the related persons rules in customs. Thus, both the Council and the Commission appear to have implicitly considered vertical harmonization of the VAT rules (most notably with customs), but neither was willing to explicitly mandate harmonization. Neither was willing to be a strong advocate of a regional policy for harmonization. However, flexibility in the design of the Rationalization Directive does allow vertical harmonization as a national policy – and this may have been the unexpressed intent of the Council and the Commission. This study however, would prefer a supra-national advocate of vertical harmonization.

National definitions – connected persons. When national definitions of "connected persons" in VAT statutes are examined a national policy to vertically harmonize with customs appears very clear. The Lithuanian[112] VAT even adopts the

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[110] Council Directive 2006/69/EC, O.J. (L 221) 9 at Article 1(3)(b); SIXTH DIRECTIVE, *supra* note 16, Art. 11(A)(6); RVD Art. 80, and contrasted with COM(2005) 89 final at 16.

[111] This correspondence can be presented graphically as follows with significant differences in italics:

GVC, Art 15(4) & (5)	SIXTH DIRECTIVE Art. 11(A)(6); RVD Art. 80
Officers or directors of one another's businesses	Management
Legally recognized partners in business	Financial or legal ties
Employer and employee	Employer and employee, *or employee's family, or any other closely connected person*
Any person directly or indirectly owns, *controls or holds 5% or more of the outstanding voting stock or shares of both of them*	Ownership
One of them directly or indirectly controls the other	Legal ties
Both of them are directly or indirectly controlled by a third person	Legal ties
Together they directly or indirectly control a third person	Legal ties
They are members of the same family	Family *or other close personal ties*
	Membership
Sole agent, sole distributor, or sole concessionaire	Legal ties

[112] LAW ON VALUE ADDED TAX, No. IX-751 (Mar. 2002), as amended Law No. IX-1960 (Jan. 15, 2004) at Art. 2.31 (Lith.) states:

"Related persons" shall mean:

1) a natural person and his spouse, fiancé or cohabitant;

customs expression "related persons," instead of "connected persons." Nevertheless, there are aspects of Lithuanian VAT usage of "related persons" that are not harmonized with customs usage – the VAT usage is broader.[113] The situation in Cyprus[114] is similar.

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2) a natural person and persons connected to him by blood relationship (up to the fourth degree) or by marriage (a natural person and the relatives of his spouse (up to the fourth degree), also natural person and the relatives (up to the second degree) of the relatives of his spouse (up to the second degree);

3) a natural person and the person connected to him by guardianship relations;

4) a taxable person and a person who holds an interest in the latter (shareholder, holder of member share, etc.);

5) a taxable person and a member of its management body;

6) a taxable person and its employees;

7) a taxable person and a natural person who is related to the person holding an interest in the taxable entity or is a member of the taxable entity's management body by the links or relationship specified in subparagraphs 1, 2 or 3 of this paragraph;

8) taxable persons that are subsidiaries of the same taxable parent entity;

9) a taxable parent entity and a person holding an interest in its taxable subsidiary;

10) a taxable subsidiary and a person holding an interest in its taxable parent entity;

11) a taxable parent entity and a member of the management body of its taxable subsidiary;

12) a taxable subsidiary and a member of the management body of the taxable parent entity;

13) a taxable parent entity and a natural person connected to a person holding an interest in its taxable subsidiary or to a member of the management body of its taxable subsidiary company by the links or relationship specified in subparagraphs 1, 2 or 3 of this paragraph;

14) a taxable subsidiary and a natural person connected to a person holding an interest in its taxable parent entity or to a member of its management body by the links or relationship specified in subparagraphs 1, 2 or 3 of this paragraph;

15) two taxable persons if one of them directly or indirectly (through one or several intermediaries) controls over 25% of shares (interest, member shares) or has a right to over 25% of decisive votes in the other person or has undertaken to co-ordinate his business decisions with that other person or has assumed liability for the performance of obligations of that other person to third persons or has undertaken to transfer to that other person all or part of the profit or has granted that other person the right to use over 25% of its assets;

16) two taxable persons if the same persons holding an interest in them (alone or together with persons connected with them by the links or relationship specified in subparagraphs 1, 2 or 3 of this paragraph) directly or indirectly hold over 25% of shares (interest, member shares) in each one of them;

17) two taxable persons if one of them has the right to elect (appoint) the majority of members of that other person's management bodies and/or actually controls the decision making of that other person.

[113] For example, where the GVC Art. 15(4)(h) considers "members of the same family" to be related persons, the Rationalization Directive allows considers "family or other close personal ties" to be considered "connected persons" in national legislation. The Lithuanian VAT considers "a natural person and his spouse, fiancé or cohabitant" to be related persons. Extending the rule to "fiancé or cohabitant" is an example of this difference.

[114] LAW ON THE APPLICATION AND COLLECTION OF VALUE ADDED TAX, (L 95(1)/2000) at APPENDIX FOUR to Art. 14 & 14A, Value – Special Cases Arts. 1(4) & (5) & 7 (Cyprus)

1 (4) For the purposes of the present paragraph, any issue as to whether a person is associated to another person is regulated pursuant to the following provisions:

(a) a person is associated to another person if the first person is the spouse or relative of the second person or is the spouse of a relative of the second person, or is a relative of the spouse of the second person

(b) a person is associated to any person with whom he/she has a partnership, and with the spouse or relative of any person with whom he/she has a partnership

(c) a company is associated to another company –

(i) if the same person has control of both, or if one person has control of one company and persons associated with such person or the same person and persons associated with him/her have control of the other company or

The Cypriot VAT uses the expression "associated person," rather than "related person" or "connected person." Once again, the VAT rules are substantially the same as the customs rules – but the VAT rules are a little bit broader.[115]

This near *vertical harmonization* of VAT and customs definitions of related persons (connected persons, or associated persons) in Lithuania and Cyprus is not surprising. VAT completely follows customs valuation on goods imported into the EU, so whenever VAT and customs duties are imposed on the same transaction there is *vertical harmonization*.[116] But in addition, Council Regulation (EEC) No 2454/93 requires *horizontal harmonization* of customs rules in each Member State, including the

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(ii) if a group of two or more persons have control of each company and these groups consist of the same persons or could be considered as consisting of the same persons considering (in one or more cases) that one member of either company is replaced by another person with whom he/she is associated

(d) a company is associated to another person if this person has control of such company or this person and persons associated with him/her have control of the company

(e) any two or more persons acting together to gain or exercise control of a company are considered in relation to the said company as associated between them if any other person is acting under the instructions of any of those persons to gain or exercise control of the company

(f) in the present paragraph –

a "company" can be any legal entity or union of persons not constituting legal entities, but it can not be a partnership

"control," in relation to a legal entity, is the power of a person to ensure that –

(i) through possession of shares or right to vote in the legal entity or in relation to it, or in relation to any other legal entity, or

(ii) by virtue of any powers granted by the Articles of Association or any other document regulating the operation of the said legal entity or any other legal entity,

the affairs of the first legal entity are operated to the will of such person and, in relation to a partnership, this is the right to a share exceeding half of the assets or exceeding half of the income of the partnership

"relative" is a sibling, younger or older or a spouse.

(5) The present paragraph is not applicable to a transaction for which paragraph 7 below is applicable. …

7 (1) The present paragraph is applicable in case of the delivery of goods or provision of services, either in exchange for a valuable consideration or not, which is taking place by an employer and consists of

(a) the delivery, within the framework of providing food and beverages to his/her employees, or

(b) the provision of accommodation to his/her employees in hotels, motels or similar facilities.

(2) The value of the transaction for which the present paragraph is applicable is considered to be zero, unless the transaction is taking place in exchange for a monetary, in full or in part, valuable consideration and in such case the value will be determined disregarding any non monetary valuable consideration.

[115] For further example, where the GVC Art. 15(4)(h) considers "members of the same family" to be related persons, the Rationalization Directive allows considers "family or other close personal ties" to be considered "connected persons" in national legislation. The Cyprus VAT considers "a person is associated to another person if the first person is the spouse or relative of the second person or is the spouse of a relative of the second person, or is a relative of the spouse of the second person" to be associated. Extending the rule to "the spouse of a relative of the second person" and to "a relative of the spouse of the second person" is an example of this difference.

[116] SIXTH DIRECTIVE, *supra* note 16, Art. 11(B)(1); RVD Art. 85.

definition of related persons,[117] so there is a considerable body of harmonized customs law on this point throughout the community, which makes it very easy for the VAT to piggyback on customs.

The situation in the UK is similar to that in Lithuania and Cyprus, but it is also more complex than either of them. The UK uses the expression "connected persons."[118]

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[117] 1. For the purposes of Title II, Chapter 3 of the Code and of this Title, 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 % 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. Persons shall be deemed to be members of the same family only if they stand in any of the following relationships to one another:
— husband and wife,
— parent and child,
— brother and sister (whether by whole or half blood),
— grandparent and grandchild,
— uncle or aunt and nephew or niece,
— parent-in-law and son-in-law or daughter-in-law,
— brother-in-law and sister-in-law.

2. For the purposes of this title, 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 only if they fall within the criteria of paragraph 1.

[118] Income and Corporate Tax Act (ICTA) 1988, §839, defines "connected persons" as follows:

(1) For the purposes of, and subject to, the provisions of the Tax Acts which apply this section, any question whether a person is connected with another shall be determined in accordance with the following provisions of this section (any provision that one person is connected with another being taken to mean that they are connected with one another).

(2) A person is connected with an individual if that person is the individual's wife or husband, or is a relative, or the wife or husband of a relative, of the individual or of the individual's wife or husband.

(3) A person, in his capacity as trustee of a settlement, is connected with any individual who in relation to the settlement is a settlor, with any person who is connected with such an individual and with a body corporate which, under section 681 is deemed to be connected with that settlement ("settlement" and "settlor" having for the purposes of this subsection the meanings given by subsection (4) of that section).

(4) Except in relation to acquisitions or disposals of partnership assets pursuant to bona fide commercial arrangements, a person is connected with any person with whom he is in partnership, and with the wife or husband or relative of any individual with whom he is in partnership.

(5) A company is connected with another company—

(a) if the same person has control of both, or a person has control of one and persons connected with him, or he and persons connected with him, have control of the other; or

(b) if a group of two or more persons has control of each company, and the groups either consist of the same persons or could be regarded as consisting of the same persons by treating (in one or more cases) a member of either group as replaced by a person with whom he is connected.

(6) A company is connected with another person if that person has control of it or if that person and persons connected with him together have control of it.

(7) Any two or more persons acting together to secure or exercise control of a company shall be treated in relation to that company as connected with one another and with any person acting on the directions of

Just as with the Lithuanian VAT ("related person") and the Cypriot VAT ("associated person") the contours of the UK definition of "connected persons" harmonizes with the GVC – and is a little broader.

However, there is an additional difference – the UK definition is also harmonized with the income tax definition. This brings exceptional administrative simplicity to this area of the law, but adds some complexity as three (not just two) tax regimes are coordinated. For example, an income tax court decision on "connected persons" will impact income tax, VAT and possibly customs, making arguments based on legislative intent more complex.

The UK rule derives from a national policy decision *not* to set out independent definitions in the VAT Act, but to satisfy the need for them through statutory cross-references. This is conscious decision to *vertically harmonize*, and to do so in all three taxes.[119] Schedule 6 of the UK VAT Act is captioned "Valuation: special cases." It indicates that "… the Commissioner may direct that the value of the supply shall be taken to be its open market value,"[120] if the parties are "connected." Schedule 6 then defines "connected persons" by referencing § 839 of the Income and Corporation Taxes Act (ICTA):

> For the purposes of this paragraph any question whether a person is connected with another shall be determined in accordance with section 839 of the Taxes Act.[121]

Furthermore, when looking for the definition of "control" (because connected persons are ones that directly or indirectly control one another, ICTA § 839(5), (6) & (7)), ICTA § 839 cross-references another income tax provision, ICTA § 416.[122] In ICTA § 416 it becomes apparent that the UK extends the concept of control beyond legal control, and includes actual or economic control within the definition.[123]

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any of them to secure or exercise control of the company.

(8) In this section—

"company" includes any body corporate or unincorporated association, but does not include a partnership, and this section shall apply in relation to any unit trust scheme as if the scheme were a company and as if the rights of the unit holders were shares in the company;

"control" shall be construed in accordance with section 416; and

"relative" means brother, sister, ancestor or lineal descendant.

In relation to any period during which section 470(2) has effect the reference above to a unit trust scheme shall be construed as a reference to a unit trust scheme within the meaning of the [1958 c. 45.] Prevention of Fraud (Investments) Act 1958 or the [1940 c. 9 (N.I.).] Prevention of Fraud (Investments) Act (Northern Ireland) 1940.

[119] It should be noted however, the customs law does not cross-reference the income tax law, so the vertical harmonization is not absolute. Harmonization with customs in the UK comes the same way as it does in Lithuania and Cyprus – the statutes are simply close parallels of one another.

[120] Value Added Tax Act, 1994, Sch. 6, para. 1(1) (UK).

[121] Value Added Tax Act, 1994, Sch. 6, para. 1(4) (UK).

[122] ICTA 1988, s 839(8) (UK).

[123] ICTA 1988, s 416 (UK) provides:

Meaning of "associated company" and "control".

The ICTA § 416(2) definition of control, "… approaches the question of control of a company from two angels."[124] Lord Scott of Foscote in the House of Lords judgment, *Regina v. Commissioners of Inland Revenue ex parte. Newfields Developments Ltd.* indicates that the first is an actual control test:

> Subsection (2) of section 416 provides that: "a person shall be taken to have control of a company if he exercises, or is able to exercise, or is entitled to acquire, direct of indirect control over the company's affairs …" The words I have cited prescribe a test of *actual control*. But section 416 goes on, in the remaining part of subsection (2) and in subsections (4), (5) and (6), to describe circumstances in which, whether or not a person has *actual control*, the person "shall be taken to have control." (emphasis supplied)[125]

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(1) For the purposes of this Part, a company is to be treated as another's "associated company" at a given time if, at that time or at any other time within one year previously, one of the two has control of the other, or both are under the control of the same person or persons.
(2) For the purposes of this Part, a person shall be taken to have control of a company if he exercises, or is able to exercise or is entitled to acquire, direct or indirect control over the company's affairs, and in particular, but without prejudice to the generality of the preceding words, if he possesses or is entitled to acquire--
(a) 50 per cent. of the share capital or issued share capital of the company or of the voting power in the company; or
(b) such part of the issued share capital of the company as would, if the whole of the income of the company were in fact distributed among the participators (without regard to any rights which he or any other person has as a loan creditor), entitle him to receive the greater part of the amount so distributed; or
(c) such rights as would, in the event of the winding-up of the company or in any other circumstances, entitle him to receive the greater part of the assets of the company which would then be available for distribution among the participators.
(3) Where two or more persons together satisfy any of the conditions in subsection (2) above and do so by reason of having acted together to put themselves in a position where they will in fact satisfy the condition in question, each of those persons shall be treated as having control of the company.
(4) For the purposes of subsection (2) above a person shall be treated as entitled to acquire anything which he is entitled to acquire at a future date, or will at a future date be entitled to acquire.
(5) For the purposes of subsections (2) and (3) above, there shall be attributed to any person any rights or powers of a nominee for him, that is to say, any rights or powers which another person possesses on his behalf or may be required to exercise on his direction or behalf.
(6) For the purposes of subsections (2) and (3) above, there may also be attributed to any person all the rights and powers of any company of which he has, or he and associates of his have, control or any two or more such companies, or of any associate of his or of any two or more associates of his, including those attributed to a company or associate under subsection (5) above, but not those attributed to an associate under this subsection; and such attributions shall be made under this subsection as will result in the company being treated as under the control of five or fewer participators if it can be so treated Definition of "associated company" employed for purposes of …

[124] HMRC, *Close Companies: tests: control: over the company's affairs*, CTM60220 *available at* http://www.hmrc.gov.uk/manuals/ctmanual/CTM60220.htm.

[125] Regina v. Commissioners of Inland Revneue ex parte. Newfields Developments Ltd. [2001] UKHL 27, [2001] B.T.C. 196, 73 T.C. 532 (May 23, 2001) at para. 41.

Lord Hoffman agrees with Lord Scott, and indicates that the test involves, "… a concept of control which reflects its meaning in ordinary speech … [it is a] fairly simple notion that is enormously widened by subsequent subsections."[126] The concern from an income tax perspective is most likely *horizontal harmonization* with the US, a major trading partner.[127] The US has long used actual control as a test of whether parties are related for purposes of IRC § 482,[128] a concept considered earlier in this study under the *economic relationship* heading.[129]

Harmonizing in this manner makes considerable (income) tax policy sense when the US is a major trading partners. It would not do for the US to make adjustments on a cross-border business and not have a UK statute flexible enough to accommodate the other side of the change. But the UK has achieved more than simply facilitating US-UK transfer pricing adjustments in the income tax. The UK definition has simultaneously *harmonized vertically* the relationship test in the income tax with the companion rules in VAT and customs.

Thus, unlike *Brittingham* where non-harmonized definitions of "related person" in the US income tax and customs law created a "whipsaw" (where prices *could be* adjusted for customs but *could not be* adjusted for income tax), in the UK it is common practice for income tax and VAT auditors to coordinate their examination of "connected persons," precisely because the definition of "connected persons" is *vertically harmonized*. Field guidance on coordinated income tax and VAT audits was issued December 5, 2005,[130] and soon thereafter KPMG advised its clients:

> When transfer pricing adjustments or compensating adjustments are made, HM Revenue & Customs now requires the involvement of VAT officers and consideration of VAT issues because, according to the guidance, any

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[126] *Id.* at para. 10.

[127] The UK is sixth in the ranking of the top US trading partners in 2006 with trade of $98.83 billion. US Census Bureau, Foreign Trade Statistics, *available at*: http://www.census.gov/foreign-trade/top/index.html (other major trading partners include Canada at $533.67 billion, China at $343.00 billion, Mexico at $ 332.43 billion, Japan at $207.74 billion, and Germany at $130.39 billion).

[128] *Grenada Industries*, 17 TC at 254. Treas. Reg. § 1.482-1(i)(4).

[129] *See supra* notes 51 - 53 and accompanying text.

[130] H.M. Revenue & Customs, *Draft Guidance: Transfer Pricing – VAT Implications: the interaction of ICTA88/Sch. 28AA with VAT*, (Aug. 12, 2005):

> [1.] … [W]here a business undertakes a transaction with an associated business other than on an arm's length basis, then there may be a question about whether the value of the underlying supply for VAT purposes is less than the open market value. If so, then, depending on whether the conditions specified in VATA94/SCH6 are met, there may be scope for making a direction that the open market value is used for VAT purposes. This is most likely to be an issue if the two parties to the transaction are not in the same VAT group, or if a member of the VAT group is involved in making supplies that are exempt for VAT purposes (as then the value of supplies to other members of the VAT group may affect the amount of input tax that can be recovered.)
>
> [2.] Officers considering making an Open Market Direction for VAT purposes are encouraged to discuss their proposals with those responsible for the direct tax affairs of the associated businesses, as (depending on the particular facts and circumstances) there could be some read across to the application of transfer pricing rules.

Available at: http://www.hmrc.gov.uk/international/vat-balancing-payments.pdf

> adjustment may be evidence of an under-value of supplies for VAT purposes. … Similarly, when a VAT officer makes a valuation adjustment for VAT purposes, the draft guidance provides that this should be discussed with the direct tax inspector as this VAT adjustment could have implications for the transfer pricing valuation.[131]

Methods – The Second Question

All tax regimes have an interest in determining the correct price on related party transactions when those transactions impact the tax base. The degree of concern is not the same among the taxes considered in this study. Income tax regimes are far and away the most concerned,[132] customs next[133] and VAT a distant third. [134] It is not surprising therefore that the most sophisticated transfer pricing methods are found in the thirty-three jurisdictions[135] that have serious income tax transfer pricing regimes (serious in the sense that they have well developed documentation and reporting requirements along with statutory rules, not simply transfer pricing provisions in the law that "could be" applied

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[131] KPMG, *Tax New Flash – Transfer Pricing* (Jan. 4, 2006) No. 2006-01.

[132] 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 supra* notes 12 - 14 and accompanying text for statistical supports. 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).

[133] SHERMAN & GLASHOFF *supra* note 59, 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.

[134] In 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 … when those transactions impact their respective tax bases," 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.

[135] *See supra* note 69 and accompanying text for commentary and a list of countries.

when the occasion arises). These jurisdictions are (by and large) the more developed economies. When there is vertical harmonization in these countries it is most frequently between income tax and VAT, and follows an income tax design – customs resists conformity.

In the vast majority of jurisdictions (91%)[136] there are no well-developed (or any) income tax transfer pricing rules. In these countries transfer pricing theory is primarily a function of customs enforcement. When there is vertical harmonization in these jurisdictions it is between customs and VAT, and follows customs principles – income tax ignores the issue.

Thus, the places where vertical harmonization of transfer pricing methods is at work today – the harmony we find is binary. Transfer pricing methods are harmonized between (a) *income tax and VAT* as well as between (b) *customs and VAT*. It is rare to find harmonization between (c) *income tax and customs*.

As a corollary observation, it is exceptionally rare to find tripartite harmonization of methods, that is, a single set of methods used among (d) *income tax, VAT and customs*. However, there are some jurisdictions where the VAT methods are somewhat vague, and seem to assimilate characteristics of the income tax and customs. An additional corollary is that frequently there is *not just one harmonization* per jurisdiction. It is reasonably common to find VAT methods matching customs methods at the border, and then in domestic transactions (or non-border transactions) VAT methods harmonizing with income tax methods.

Once again (in a negative sense), the underlying reason for this clustering of binary systems, rather than a variety of tripartite harmonized systems, are the competing global standards set in place through the OECD's treaty network,[137] and the GATT convention.[138] These systems are horizontally harmonized, and not easy to adjust. They have not been matched by a global network or convention in VAT. As a result, the horizontal flexibility in the VAT has been used to advantage and this use has greatly facilitated the limited, but effective vertical harmonization of some transfer pricing methods in many countries.

The great problem then is the difficulty that domestic systems have in harmonizing income tax and customs rules. There are a number of hard-to-change differences between income tax and customs. The two most significant differences are in tax policy and valuation methods.

Tax policy differences – exact justice v. rough justice. At a policy level, the income tax transfer pricing tries to determine "<u>true</u> taxable income."[139] It has tried to do this by making "… an <u>accurate</u> distribution or apportionment of gains, profits, income,

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[136] *See supra* notes 68 & 69 and calculating 91% = 137/150.
[137] *See supra* note 14 and accompanying text on the OECD Model Tax Convention.
[138] *See supra* note 15 and accompanying text on the GATT and the GVC.
[139] Treas. Reg § 1.482-1(i)(9) (emphasis supplied).

deductions, or capital between or among related trades or businesses."[140] The income tax goal is to determine the "… profits which would, … have accrued to one of the enterprises …"[141]

Recently, this emphasis has mellowed on the part of both the US and the OECD. It is becoming clear to all involved that the arm's length standard does not necessarily identify the exact price or consideration, but rather identifies a range of arm's length prices or considerations within which a given inter-company transaction may fall.[142] However, even with this mellowing, the income tax emphasis on profit and pricing accuracy is not exactly the customs emphasis.

The policy objective of customs transfer pricing is to find *substitute values*[143] – values that are used in place of rejected (transaction) values. In an enforcement setting, the primary customs concern is not to determine the economically correct price. Customs primary concern is to facilitate the free flow of trade. There is a premium on clarity. This is rough justice, not precise justice.

Thus, customs is not concerned (or at least "not as concerned" as the income tax) if its valuation does not reflect a marketplace-accurate value for a rejected transaction value.[144] It would be good if the number was pin-point-accurate, but this is not necessary. When applying transfer pricing methods customs follows a rigid set of tests, and uses a limited set of factors to determine a price that may or may not correspond to a true arm's length price. The value is a substitute.

VAT regimes that harmonize with income tax systems reflect the tax policy goal of trying to find a true, correct or accurate price. Those that harmonize with customs seek the rough justice of a substituted value. Said another way, a VAT system that harmonizes transfer pricing rules with the income tax encourages a search (by the taxpayer and the tax authority) among multiple methods to try to find the method that produces the most accurate valuation – the best method. VAT systems that harmonize their transfer pricing rules with customs tend to emphasize the Commissioner's best judgment if the "same or simil46ar" supply cannot be easily identified.

Valuation methods – traditional v. profit methods. The most notable structural difference is that customs does not recognize profit-based methods, and the income tax

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[140] Rev. Act of 1921, ch. 136, s240(d), 42 Stat. 260 (1921) (emphasis supplied) (phrasing of the original IRC § 482, the initial enactment of an allocation mechanism for income tax purposes in the US).
[141] OECD, MODEL TAX CONVENTION, Art. 9 (emphasis supplied).
[142] OECD, GUIDELINES *supra* note 14, at ¶¶1.45 –1.48; .Treas. Reg. § 1.482-1(e).
[143] GVC *supra* note15, at Art. 1(2)(c).
[144] JOVANOVICH, *supra* note 17, at 43 indicates:

> The methods set forth in GVC Articles 2, 3, 5, and 6 are not equivalent to those recommended by the OECD Guidelines. The former are not designed to provide the importer with guidance as to how its transfer prices should be set. Rather they must be used where the transaction value (transfer rice), if any, is not acceptable because there is no sale for export or the conditions of paragraphs (a), (b), (c), and (d) of Article 1.1 are not met. These methods must be used by Customs authorities to determine substitute values. (emphasis supplied).

has two of them. Profit-based methods are frequently the most relied upon income tax methods. As a result, it is very possible for profit methods to be used on the income tax side of a pricing dispute between related parties, and have the same goods between the same parties valued for customs purposes through an entirely different method.

VAT jurisdictions reflect this difference. The jurisdictions most inclined to follow an income tax approach to transfer pricing will recognize profit-based methods. Those inclined toward a customs approach never do.

Self-help harmonization. Direct income tax/ customs harmonization is not impossible. It is just that under the current OECD-based treaty network and the GATT convention in place, it is not very likely as a direct statutory matter. It is much more likely to find income tax/ VAT harmonization or customs/ VAT harmonization.

Recent proposals for income tax/ customs harmonization have instead focused on indirect harmonization, or self-help harmonization. Two approaches are commonly mentioned: (1) joint income tax and customs APA's[145] and (2) express commitments by customs to accept income tax transfer pricing documentation under Article 1.2(a) of the GVC as a measure of the transaction value.[146] Both of these approaches produce harmonized transfer pricing results (on a case-by-case basis).

This paper proposes to merge (and extend) these remedies in an IT-APA. It proposes a self-help remedy (the APA component) that relies on *certified transaction tax software* (the IT component) operating within an aligned (linked, or harmonized) income tax, customs and VAT regimes. The most difficult alignment issues are not within the five definitions of related parties, they are within the five methodologies commonly used to determining values (and how they are defined, applied and accepted among these taxes) that present the most difficult problems.

Five basic methodologies. There are five basic methods in transfer pricing analysis. Three are transaction-based; two are profit-based. There is a range of receptivity to these methods. Receptivity varies by jurisdiction and by tax-type. For example, the US income tax finds all five approaches acceptable (depending on the facts and circumstances of the case).[147] The US tries to find the "best" among all the method. In contrast, the VAT 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

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[145] MNR, Memorandum D13-4-5 *Transaction value method for related persons* ¶¶13-16 (Mar. 30 1989) (setting out the position of Revenue Canada for customs valuation purposes and indicating that "Customs 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 Guidelines, 1979]."

[146] JOVANOVICH, *supra* note 17 (contending that Article 1(a) in the GVC contains all the flexibility needed to harmonize income and customs rules, provided customs administrations are willing to accept income tax pricing methods as transactional value determinants).

[147] 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.").

approach). This method is frequently borrowed from customs (commonly a TVI/ TVS aggregate).[148]

The sections that follow examine each of the five major transfer pricing methods (three traditional methods and two profit-based methods). Variances in their structure and application are identified (among income tax, customs and VAT regimes). More emphasis is placed on VAT than on income tax or customs in these sections, because (as a global matter) it is the VAT that is reaching out in both directions (to the income tax and to the VAT) to forge vertical harmonizations of methods. The effort will be to show where harmonies (income tax/VAT or customs/VAT) have been established, and where they have not. The three traditional methods are considered first, followed by the two profit methods.

Three Traditional Methods

(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,[149] as well as of the OECD Guidelines.[150] 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).[151] Rules that function similar to the CUP or TVI/ TVS methodologies can be found under most VAT regimes.

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[148] 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.

[149] CYM H. LOWELL, MARIANNE BURGE & PETER L. BRIGER, U.S. INTERNATIONAL TRANSFER PRICING ¶4.05[1] & [2](2ND 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.").

[150] OECD, GUIDELINES *supra* note 14, at ¶ 2.6 (stating, "where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable …")

[151] GVC *supra* note15, 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[152] and OECD Guidelines[153] 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.[154]

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.[155]

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."[156]

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[152] 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.

[153] OECD, GUIDELINES *supra* note 14, 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.).

[154] GVC *supra* note15, at Art. 15(2)(a).

[155] GVC *supra* note15, at Art. 15(2)(b). Compare with the list of adjustments under the income tax *supra* note 152.

[156] GVC *supra* note15, 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:

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.[157] 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.[158]

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.[159] 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

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> 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, 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.

[157] GVC *supra* note15, at Art. 15(2)(d).
[158] GVC *supra* note15, at Art. 15(2)(e).
[159] SHERMAN & GLASHOFF *supra* note 59, at 203, ¶ 634.

is possible that the same result can be reached under both systems, harmony is not assured.

VAT. Most VAT 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 rules are directly linked to income tax rules;
- *parallel harmonization with CUP or TVI/ TVS* – VAT rules are independent, but ambiguously paraphrase companion provisions in either the income tax or customs;
- *roughly harmonized with CUP or TVI/TVS* – VAT 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.[160] 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,[161] 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).[162]

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[160] 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.

[161] 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).

[162] 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).

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.[163]

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 where customs transfer pricing rules are followed).[164] Spain adopts the OECD Guidelines and makes the CUP a first priority method.[165]

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).[166] Articles 20 and 40 of Part 1 concern transfer pricing.[167] The CUP method is the principal method.[168] 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.[169]

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[163] 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).

[164] Spain follows EU rules under the SIXTH DIRECTIVE, *supra* note 16, at Art. 11(A)(1)(a); RVD Art. 73.

[165] 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.

[166] *See supra* note 13 and accompanying text.

[167] Peter Arnett, *supra* note 63, 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).

[168] 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).

[169] 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;

A number of Former Soviet Republics follow the example of the two-part Russian tax code. Azerbaijan,[170] Turkmenistan,[171] and Georgia[172] 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.

(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 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.

[170] 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).

[171] 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).

[172] 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).

There are exceptions within the Russian sphere of influence. Uzbekistan,[173] 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.[174]

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[173] 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).

[174] 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 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. 1,7 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.

In the Ecuadorian case, a current tax reform effort promises to change things. If successful, the Ecuador law will soon have vertically harmonized transfer pricing methods following the 1995 OECD Guidelines in income tax and VAT. Ecuador will thus achieve a Spanish result through indirect (rather than direct) linkage.[175]

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 VAT). However, it is not clear in either case (Australian or New Zealand) if there is an intent to parallel the income tax, customs, 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.[176]

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 method."[177] In addition, there are neither geographic preferences

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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).

[175] 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).

[176] *See supra* text accompanying notes **Error! Bookmark not defined.** to **Error! Bookmark not defined.**.

[177] 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

(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.[178] 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.[179]

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).[180]

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.[181] 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[182] 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.[183] Botswana determines the fair market

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[178] 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
[179] 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 208 (discussing Canadian Customs & Revenue Agency, *Transaction Value Method for Related Persons*, Memorandum D13-4-5 (April 9, 2001)).
[180] 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).
[181] The other methods could be adopted in regulations or could simply be followed unofficially in audit practice.
[182] VALUE ADDED TAX ACT, 2000 at 9(3)(a) & (b)(i) (Botswana).
[183] VALUE ADDED TAX ACT, 2000 at Pt. 1, Art. 2. (Botswana) states:
"related persons" means -

value of a supply first by comparing identical supplies,[184] and if identical supplies are not available then through similar supplies.[185] 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 approximation of the consideration in money …"[186] 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."[187] but the whole definition of fair market value is also drafted in parallel form.[188]

(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;

[184] VALUE ADDED TAX ACT, 2000 at 3(2) (Botswana).
[185] VALUE ADDED TAX ACT, 2000 at 3(3) (Botswana).
[186] VALUE ADDED TAX ACT, 2000 at 3(4) (Botswana).
[187] VALUE ADDED TAX ACT, 2000 at 3(1) (Botswana).

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.[189] Lesotho adjusts prices between associates to "fair market value." Like Botswana, when defining "fair market value," Lesotho aggregates the definition of similar import with the definition of similar supply.[190]

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

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> 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)

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

> (2) For the purposes of this Act, the fair market value of a supply or import of goods or services at any date shall be the consideration in money which the supply or import, as the case may be, would generally fetch if supplied or imported in similar circumstances at that date in Botswana, being a supply or import freely offered and made between persons who are not related persons.
> (3) Where the fair market value of a supply or import 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 similar supply or similar import, as the case may be, would generally fetch if supplied or imported in similar circumstances at that date in Botswana, being a supply or import freely offered and made between persons who are not related persons.
> (4) Where the fair market value of a supply or import 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 supply or import 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 supply or import of goods or services shall be ascertained in the same manner, with any necessary modifications, as the fair market value of a supply or import, 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 supply or import is determined at the time of the supply or import as determined under this Act. (emphasis supplied).

[189] 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;

[190] 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.

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 …"[191] The definition of taxable value of imports expressly references the Customs and Excise Act, 1982.[192] Like Botswana, the general structure of the Lesotho statute parallels import and non-import transactions.[193]

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.[194] The value of a supply is adjusted only for self supplies,[195] and customs valuation on import.[196] The same is true under the Croatian VAT – subjective valuation criteria are followed[197] with variation only for customs valuation for imported goods.[198] Neither the Albanian nor the

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[191] 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.

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

[193] 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).

[194] 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.

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

[196] 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.

[197] 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 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.

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

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.[199] 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.[200] Internal comparables are preferred (but external comparables are acceptable) under both US and OECD rules.[201] The method is most effectively applied when the reseller does not add valuable intangibles to the product before resale.[202] 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.[203]

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 …"[204] the GVC is shifting emphasis to functions. This produces a rough alignment with the income tax preference for a functional comparability in the RSP.

> 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.

[199] Treas. Reg. § 1.482-2(c)(4), at Ex. (7) and OECD, GUIDELINES *supra* note 14, at ¶2.18.
[200] Treas. Reg. § 1.482-2(c)(3)(ii)(A) and OECD, GUIDELINES *supra* note 14, at ¶2.21.
[201] Treas. Reg. § 1.482-2(c)(3)(ii)(A) and OECD, GUIDELINES *supra* note 14, at ¶2.15.
[202] Treas. Reg. § 1.482-2(c)(4), at Ex. (7) and OECD, GUIDELINES *supra* note 14, at ¶2.22.
[203] OECD, GUIDELINES *supra* note 14, at ¶2.23 (there is no similar concern under the US rules).
[204] GVC *supra* note15, 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.[205] 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…"[206] However, the GVC adds as a qualification, "… but before the expiration of ninety days after such importation."[207]

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,[208] but this is not the general rule.[209] Even where

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[205] GVC *supra* note15, at Art. 5(1)(a)(i), (ii), (iii), (iv), (1)(b) and (2) (each provision in Article 5 contains the "country of importation" limitation).
[206] GVC *supra* note15, at Art. 5(1)(b).
[207] GVC *supra* note15, at Art. 5(1)(b).
[208] 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

indirect linking occurs, the nature of this linkage is tentative, because additional customs tests must be met to align results.[210] The place where direct linkages can arise is with VAT statutes.

VAT. Most VAT 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.[211] 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.

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 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.

> 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).

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.

[209] US CUSTOMS & BORDER PROTECTION, *supra* note 95, 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).

[210] Canadian Customs & Revenue Agency, *supra* note 208 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 form 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").

[211] 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.

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 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 context encourages them to omit the method from the VAT.

Full harmonization – Japan, Spain, Russia, Azerbaijan & Turkmenistan. Because Japan[212] and Spain[213] 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,[214] 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,[215] and Turkmenistan.[216] However, Georgia,[217] 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

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[212] JAPAN'S REVISED CONSUMPTION TAX LAW (SHOUHIZEIHOU), Art. 28(2) *supra* note 162 (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).

[213] 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.

[214] 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).

[215] 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).

[216] 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, …").

[217] 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.").

or the DVM method for the VAT. New Zealand[218] and Australia[219] lead in the parallel harmonization effort, and both omit the RSP and the DVM.

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[220] and the OECD Guidelines.[221] It is very similar to the computed value method (CVM) under the GVC,[222] which is considered "… in some ways the simplest basis of valuation; in other ways it is the most complex and controversial."[223] Taken together, methods modeled on C+ and CVP are the second most popular method in VAT 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.[224]

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."[225] The OECD indicates that, "[t]he cost plus method presents some difficulties in proper application, particularly in the determination of costs."[226]

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,[227] but there is concern with the

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[218] New Zealand, IRD Tax Information Bulletin, Vol. 6 No. 14 (Jun. 1995) *supra* note 178 at 6-8.
[219] Australian, Goods and Service Tax Ruling, *Goods and Services Tax: Non-Monetary Consideration*, *supra* note 177 at ¶¶ 144, 145 & 148-49.
[220] Treas. Reg. § 1.482-3(d).
[221] OECD, GUIDELINES *supra* note 14, at ¶¶ 2.32 – 2.49.
[222] GVC *supra* note15, at Art. 6.
[223] SHERMAN & GLASHOFF *supra* note 59, at 227.
[224] Treas. Reg. § 1.482-3(d)(1); OECD, GUIDELINES *supra* note 14, at ¶ 2.32.
[225] 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).
[226] OECD, GUIDELINES *supra* note 14, at ¶ 2.36 & 2.39.
[227] Treas. Reg. § 1.482-3(d)(3)(ii)(B); OECD, GUIDELINES *supra* note 14, at ¶ 2.34.

relative value of products involved in the transactions being compared.[228] Internal comparables are preferred.[229] Adjustments may be needed for differences in cost structures, business experience and relative management efficiency.[230]

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."[231]

The GVC limits application of this method.[232] 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,[233] 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.[234]

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*[235] and *Ross Glove Co.*[236]) 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

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[228] Treas. Reg. § 1.482-3(d)(3)(ii)(B).
[229] Treas. Reg. § 1.482-3(d)(3)(ii)(A); OECD, GUIDELINES *supra* note 14, at ¶ 2.33.
[230] Treas. Reg. § 1.482-3(d)(3)(ii)(B).
[231] SHERMAN & GLASHOFF *supra* note 59, at 233.
[232] GVC *supra* note15, 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).
[233] SHERMAN & GLASHOFF *supra* note 59, at 228.
[234] GVC *supra* note15, at Art. 6, Notes 6(2).
[235] Brittingham v. Commissioner, 66 T.C. 373 (1976), aff'd, 598 F.2d 1375 (5th Cir. 1979); *see supra* text at notes 75 to 99.
[236] Ross Glove Co. v. Commissioner, 60 TC 569 (1973), acq. in part 1974-1 CB 2; *see infra* text at notes 304 - 313 and accompanying text.

linkage however, is evident through customs *practice* in several jurisdictions,[237] but once again this is not the general rule.[238]

VAT. VAT 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[239] and Spanish VAT[240] directly borrow transfer pricing

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[237] 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 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).

[238] US CUSTOMS & BORDER PROTECTION, *supra* note 95, 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).

[239] JAPAN'S REVISED CONSUMPTION TAX LAW (SHOUHIZEIHOU), Art. 28(2) *supra* note 162 (indicating that the Japanese Consumption Tax rules follow the results of the income tax) and SPECIAL TAXATION

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,[241] and also under two of the tax codes that follow the Russian model, those in Turkmenistan,[242] and Azerbaijan.[243] The 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.[244]

The strength of the parallel harmonization approach is that it provides flexibility. Language can be drafted so that a VAT method will harmonize with similar methods in <u>both</u> income tax and customs.[245] 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.[246] The weakness of this approach is that the VAT valuation rules remain vague.

MEASURES LAW (SOZEI-TOKUBETSU-SOCHIHOU), Art. 66-4-2-1-c (defining the cost plus method [*Genka Kasan Hou*] for income tax purposes).

[240] 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.

[241] 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").

[242] 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, …").

[243] 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).

[244] 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.

[245] 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.

[246] 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

The Australian cost-plus method is set out in a Goods and Services Tax Ruling (GSTR 2001/6).[247] 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.[248]

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.[249]

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.[250]

New Zealand sets out a cost-plus method in a Tax Information Bulletin.[251] According to the Bulletin there are three statutory methods: (1) identical supplies,[252] (2)

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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.").

[247] Goods and Service Tax Ruling, *Goods and Services Tax: Non-Monetary Consideration*, *supra* note 19.

[248] *Id,* at ¶144.

[249] *Id,* at ¶155

[250] *Id,* at ¶157

[251] N.Z. INLAND REV. DEPT., TAX INFO. BUL. Vol. 6, No. 14 (June 1995)

[252] GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at § 4(2).

similar supplies,[253] 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."[254] 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.[255]

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 even goods or services for which no consideration exchanged.[256] 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.[257]

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

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[253] GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at § 4(3).
[254] GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at § 4(4).
[255] N.Z. INLAND REV. DEPT. *supra* note 251, at 8.
[256] 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)].
[257] VALUE ADDED TAX ACT, No. 50 at Art. 7 (1998) (Iceland).

cost plus the markup generally used for goods and services in a similar category.[258]

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 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,[259] Botswana,[260] Lesotho,[261] and Uganda.[262] 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.

Two Profit-based Methods

(4) *Profit split methods (PS) & Comparable profits (CPM)/ transactional net margin method (TNMM)*. This section will consider the two profit-based methods. They are considered together because these methods came into use relatively recently as dual responses to the problems posed by the valuation of intangibles.

Both methods were developed in the income tax, and even though the problem posed by intangible valuation is a growing concern in both customs and VAT regimes they have not been widely adopted outside the income tax. Customs is most resistant to them. However, VAT jurisdictions that harmonize transfer pricing methods with the income tax sometimes include companion methods.

Income tax - US. Prominent US transfer pricing cases in the mid-1980's focused attention on the impact of intangible valuation on transfer prices.[263] The inadequacy of the 1968 regulations in dealing with intangibles was clear.[264]

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[258] VALUE ADDED TAX ACT, No. 50 at Art. 8 (1998) (Iceland).
[259] REVENUE, VALUE-ADDED TAX ACT No. 89 of 1991 at § 3(4) (South Africa).
[260] THE VALUE ADDED TAX ACT, 2001 at §§ 3(4) & 9(5) (Botswana).
[261] SALES TAX ACT, 1995 at Art. 15(3) (Lesotho).
[262] VALUE ADDED TAX STATUTE, No. 8 at Art. 3(2) (1996) (Uganda).
[263] *See* Eli Lilly & Co. v. Commissioner, 84 TC 996 (1985), aff'd in part and rev'd in part, 856 F2d 855 97th Cir. 1988) (concerning the pricing impact of the transfer of a valuable intangible from the US parent company to a Puerto Rican subsidiary); Ciba-Geigy Corp. v. Commissioner, 85 TC 172 (1985) (concerning the pricing impact of the transfer of an intangible from a Swiss parent company to a US subsidiary and subsequent testing of the intangible for the US market).
[264] US Treas. Reg. § 1.482-2(e) (1968) (generally indicating that taxpayers should apply "other methods" when the CUP, resale price and cost-plus methods are not sufficient).

As a result, the Tax Reform Act of 1984 considered the impact of outbound transfers of intangibles.[265] The Tax Reform Act of 1986 went further. It added the "commensurate with income" language to IRC § 482, and then directed the US Treasury to study this issue broadly and consider further regulations.[266] The immediate result was the 1988 White Paper.[267] A series of regulation projects followed the White Paper and new regulations were finalized in 1994 that dealt specifically with intangibles. Essentially, these regulations indicate that if there is no CUP[268] for the intangible, then two new methods designed specifically for intangibles (profit splits and comparable profits) should be utilized.

Two kinds of profit splits are contemplated; the residual profit-split, and the comparable profit-split. The residual profit split method is derived from the approach of the court in the *Eli Lilly & Co.* case. The combined profit or loss of the relevant business activity is allocated among the controlled taxpayers in two steps. First operating income is allocated to each party to provide a market return for contributions to the business activity (other than for non-routine intangibles). Secondly, the residual amount is divided among the controlled parties based on their relative contributions to the non-routine intangibles.[269]

The comparable profit split method combines the profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers. After determining the percentage of operating profit or loss of each uncontrolled taxpayer within the relevant business activity, a comparable percentage is applied to the controlled taxpayers to determine the profit level of each entity.[270]

Income tax – OECD. The initial 1979 OECD report on transfer pricing did not consider intangibles.[271] The methods considered were traditional and hierarchically arranged. They included the CUP, RSP, C+, and unspecified "other methods." In 1993 the OECD reviewed the implications of the US Tax Reform Act of 1986, the 1988 White Paper, and the proposed (but soon to be finalized) US regulations. The result of this review was the 1995 Guidelines.[272]

An early draft of the 1995 Guidelines contained both of the new American methods – profit splits[273] and the comparable profits method.[274] However, ongoing

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[265] Changes were made to IRC § 367, and the transfer of intangible property to a foreign corporation ws treated as a sale under IRC § 367(d).
[266] Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 1013-14.
[267] 1988 White Paper, Notice 88-123, 1988-2 CB 458.
[268] US Treas. Reg. § 1.482-4(c) (indicating that the method is called the comparable uncontrolled transaction (CUT) method, and in effect is really the CUP method applied to intangible property that is "the same intangible property or comparable intangible property" as further explained at Treas. Reg. § 1.482-4(c)(2)(iii)(A)).
[269] US Treas. Reg. § 1.482-6(3).
[270] US Treas. Reg. § 1.482-6(2).
[271] OECD COMMITTEE ON FISCAL AFFAIRS, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES (1979)
[272] OECD, GUIDELINES *supra* note 14.
[273] OECD, GUIDELINES *supra* note 14, at 3.5 – 3.25.

debates within the OECD eventually changed the OECD's comparable profits method. A new method, called the transactional net margin method (TNMM), was adopted. It is a variant of the CPM. The essential difference is that the TNMM is narrower. It focuses on transactional profit rather than the profit of a business segment.[275]

Customs – no applicable methods. There are no transfer pricing methods under the GVC that deal specifically with intangibles. However, the development of transfer pricing in the income tax clearly underscores the impact that intangibles have on arm's length prices between related party prices. Intangibles are problematical because if they are non-routine they have few (if any) comparables, and they are frequently subject to adjustment based on future events and commercial practice. The customs impact of intangibles is no less significant than the income tax impact, but the valuation system is not designed to easily accommodate either voluntary or audit-based intangible adjustments.

For example, assume X is related to Y and sells goods to Y for a transfer price of 100 on January 15. A voluntary adjustment could be made on the last day of the tax year for a related royalty payment of 15. The reason for making the adjustment could be (a) a required year end compensating adjustment pursuant to an APA, (b) a Sarbanes-Oxley internal control audit, (c) an offset, or perhaps (d) the commercial contract involved has a cost-plus design and final royalty figures are based on annual sales. Increasing the transfer price by 15 would mean that the transaction value must be rejected, the test values will not be available, and a substitute value will need to be found under TVI, TVS, DVM or CVM methods, none of which are receptive to the valuation of intangibles. There are two reasons why this occurs under the GVC:

- The invoice price was subject to a condition for which value could not be determined on import.[276]
- The circumstances of the sale indicate that the relationship influenced the price paid or payable.[277]

The same result (rejection of the transaction value and sequential search for a substitute value) would follow from an income tax audit where the royalty payment[278] was adjusted.[279]

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[274] *See* H. Becker, *An analysis of the Comparable Profits Method in OECD's Transfer Pricing Draft Guidelines, Part I,* 5 TAX MGMT. TRANSFER PRICING REP. 923 (Apr. 26, 1995)
[275] OECD, GUIDELINES *supra* note 14, at 3.26 – 3.48.
[276] GVC *supra* note15, at Art. 1.1(b).
[277] GVC *supra* note15, at Art. 1.2(a).
[278] This fact pattern is not dependent on royalties. An income tax audit could adjust any on the GVC Art. 8 adjustments to the "price actually paid or payable" that GVC Art. 1.1 makes part of the transaction value. Those amounts include under GVC Art. 8(1)(a) amounts paid by the buyer for: commissions and brokerage fees, the cost of containers, the cost of packing; under GVC Art. 8(1)(b) the value of goods and services supplied directly or indirectly to the buyer for: materials, components, and parts incorporated in the imported goods, tools dies, moulds and similar items used in the production of the imported goods, materials consumed in the production of the imported goods, and engineering, development, artwork, design work, and plans sketches undertaken elsewhere than in the country of the imported goods; under GVC Art. 8(1)(c) royalties and license fees related to the goods that the buyer must pay directly or indirectly as a condition of sale; and under GVC Art. 8(1)(d) the value of the proceeds of any subsequent resale that accrues directly or indirectly to the seller.

VAT. The VAT interfaces with intangible transfers very differently than does customs. [280] VAT is imposed on *all transfers* of intangible assets. But this does not mean that *all transfers* of intangible assets between related parties are potentially subject to VAT-based transfer pricing adjustments. The scope of suspect transactions is more limited, and among these only some of them are difficult to value with traditional methods.

Most VATs[281] are only concerned about transfer prices when the parties are related *and* when one of those parties cannot take full input credits.[282] This means that all related party B2C transactions are a concern (because C's by definition cannot take an input credit). However, B2C intangible valuation issues are almost always for minor amounts and reasonably easy to value (because they are rarely unique intangibles).[283]

The situation is different for related party B2B transactions. In concrete terms the businesses involved are banks, financial institutions, insurance companies, hospitals, schools, or similar enterprises. Aside from the fact that unique intangibles are difficult to value, when intangibles are transferred in B2B transactions VAT is not imposed by the vendor on his invoice, it is self-assessed through a reverse charge procedures.[284]

This complicating factor makes applying traditional transfer pricing methods problematical. For example: (a) if the intangible is truly unique[285] – CUP/ CUT methods (by definition) are not available (the intangible would not be unique if there were comparables), (b) if the intangible asset is not resold (and this would be the normal case with an intangible asset purchased by a bank, financial or insurance company)[286] – RSP

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[279] The problem presented is more than academic. In the US case, for example, the inappropriate use of transaction value, due to a condition for which a firm price was not established prior to export, is a violation under USC § 1592 and 19 CFR Part 171, Appendix B. This is an event that may subject the importer to penalties.

[280] GVC *supra* note15, at Art. 8.1(c) (indicating that intangibles are included in the customs base *only if* they are, "… related to the goods being valued [and] that the buyer must pay [for the royalties or licenses], either directly or indirectly, as a condition of sale of the goods being valued …").

[281] SIXTH DIRECTIVE, *supra* note 16, Art. 11(A)(6)(a), (b) & (c); RVD Art. 80; *see supra* note 28 (discussing the most common exception to this rule, which is when a jurisdiction uses objective valuation criteria [like Australia or Canada], and where a transaction is engaged in that is not an exchange entirely in money).

[282] If an intangible asset is transferred in a B2B transaction where the purchasing business can claim a full input credit (because the intangible is being used to produce fully taxable supplies) then transfer pricing issues are really cash flow issues. Any adjustment increasing the price of the intangible would produce no net revenue (other than cash flow related gains or losses).

[283] However, unlike the B2B transactions, transactions that are B2C should be relatively easy to value with traditional methods. The likelihood that an internal CUP could be identified are stronger (similar sales to non-employees for example), and the costs incurred along with standard markups for similar sales would be data available within the entity (B) that would be responsible for issuing the invoice to the related party (C).

[284] SIXTH DIRECTIVE, *supra* note 16, Art. 21(1)(b); RVD Art. 196.

[285] For example, customized software developed by a related party for use only handling the customer accounts of a particular bank.

[286] For example, valuable management or marketing expertise customized to particular hospital systems. *See* Hospital Corp of America v. Commissioner, 81 TC 520 (1980) (concerning the correct royalty on the transfer of intangibles of personnel and hospital management systems).

valuations cannot be performed (there are no resales), and (c) if the cost of producing the intangible asset are not controlled by the purchaser – C+ methods are difficult to perform (because the data needed to perform is analysis is under the seller's control, not the buyer's control).[287] Of all the traditional methods, only the C+ method can be realistically applied, and this would be a difficult application.

Given these problems, one would expect: (a) that some VAT regimes would be receptive to adopting profit-based methods, (b) that the most receptive would be found among the thirty-three jurisdictions that have significant income tax transfer pricing regimes, and (c) the resistance of customs to adopting profit methods would keep the vast majority of jurisdictions away profit methods.

This study has found vertical harmonization of profit-based methods in only two systems – both of which established transfer pricing rules in VAT by directly linking the VAT rules to those in the income tax. The only other plausible avenues for bringing profit-split or transactional net margin methods into the VAT are through regulations allowing valuation through professional appraisal, and systems that have a broad "Commissioner's-best-judgment" provision.

Fully harmonized profit-splits and transactional net margin methods – Spain & Japan. Spain fully harmonized all of its VAT transfer pricing methods with its income tax transfer pricing methods, including the application of both of the profit methods (profit-splits and the transactional net margin method) when it transposed the Rationalization Directive[288] into Spanish law.[289] The new law amends Article 79.5 of the VAT to expressly adopt the methodologies of the corporate income tax, which in turn follow the OECD Guidelines in full.[290]

Japan has reached the same result by expressly linking valuation under the Consumption Tax to determinations under the income tax. The Japanese income tax accepts both the OECD profit split and the transactional net margin method, and as a consequence so does the Consumption Tax.[291]

Professional appraisal – Australia & Azerbaijan. Australian GST regulations and the Azerbaijan[292] tax code provide for professional appraisals to resolve valuation problems.

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[287] In jurisdictions where only traditional transfer pricing methods are applied in VAT, and because the cost-plus method it might be advisable tow

[288] O.J. (L 221) 9; *see supra* text following note 100.

[289] Law on Measures to Prevent Tax Fraud, Act 36/2006 (Nov. 29, 2006).

[290] *See supra* note 207 and related text.

[291] JAPAN'S REVISED CONSUMPTION TAX LAW [SHOUHIZEIHOU], Art. 28(2) *supra* note 162 (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(4)-1 (defining the profit-split method [RIEKI-BUNKATSU-HOU] and Art. 66-4(5)-1 defining the transactional net margin method [TORIHIKI-TAN-I-EIGYOU-RIEKI-HOU] both for income tax purposes).

[292] TAX CODE OF THE REPUBLIC OF AZERBAIJAN, Law No. 905-IG at Arts. 14.6.3.3 (Jul. 11, 2000) (Azerbaijan) (indicating that if CUP, RSP and C+ methods do not work, then value may be determined by a "contractor expert").

The Australian regulation is the most detailed. The fourth "example of [a] reasonable method" for determining the market value of a supply is a professional appraisal. The regulation provides in full:

> A professional appraisal directed at determining the market value of the consideration for your supply will be a reasonable method where it:
>
> - Is done by a person who is recognized in the particular field in which the appraisal is being given as having the requisite skills and knowledge for the task; and
> - Uses valuation methodologies that are consistent with professional guidelines.[293]

Under this provision it would seem to be appropriate to secure the services of an economist with an expertise in valuing intangibles of the kind in question, perhaps someone who was also engaged in producing documentation for an income tax APA, and submit this report in support of the value. The workability of this rule in the VAT context might be more difficult in instances where the VAT is self-assessed (under a reverse charge procedure), because most of the data the expert would need is most likely in the confidential business records of the seller, not those of the buyer.

Examples: Vertical Harmonization Passed Over – Can Methods be Harmonized through Case Law?

Although statutory harmonization of transfer pricing methodologies is the preferred way to align transfer pricing rules in income tax, VAT and customs, it is not the only way. The Spanish alignment of income tax and VAT methodologies with the OECD Guidelines[294] may well be replicated in Ecuador under the current tax reform,[295] but for those who cannot wait, there is always litigation. The difficulty with litigating vertical harmonization is that it frequently solves only the case at hand.

This section considers court cases where the core argument was that valuation methods among tax regimes *should be* vertically harmonized (even though statutes may not have directly provided for it). Two of the more common fact patterns are considered.

The first pattern argues that a transfer pricing result (methodology and analysis) should be borrowed from another tax regime. The argument is: because both taxes employ similar methodologies what works for one should work for the other. Tax administrations as well as taxpayers have argued (because the CUP is like the TVI/ TVS or because the RSP is like the DVM or because the C+ is like the CVM) that the outcome of a customs dispute (for example) should (without much more analysis) resolve the

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[293] Australian, Goods and Service Tax Ruling, *Goods and Services Tax: Non-Monetary Consideration*, *supra* note 177 at ¶ 154.
[294] Ramon Lopez de Haro & Mario Ortega Calle, *Spain: Major Amendments to Transfer Pricing Legislation*, INT'L TRANSFER PRICING J 72 (Jan./ Feb. 2007) (discussing the recent Spanish law changes in income tax and VAT).
[295] Roberto M. Silva Legarda, *supra* note 175.

related income tax dispute. This is a request for judicially mandated vertical harmonization. It is not often a successful argument, but the fact that the argument is made with some frequency manifests a shared belief that transfer pricing methodologies should be harmonized.

The context is frequently a customs-income tax situation. Two cases are considered here – one is where the customs administration argues that the customs result should follow a previous income tax outcome; another is where the income tax administration argues that an income tax result should follow a previous customs outcome.

The second pattern addresses the question of what do you do when there are no methods? In other words, the case requires the determination of a transfer price, but the statute involved only declares the arm's length principle – without detailing methodologies. Should methods be borrowed from another tax? Should methods be crafted *ad hoc* to fit the specific case? Could methods be based simply on expert witness reports?

First Pattern – Income tax-customs litigation – Procureur de la République v. René Chatin[296] *& Ross Glove Co. v Commissioner*.[297] These cases, European and American, approach the same issue from different directions. In *René Chatin* French Customs sought to adjust declared customs value to accord with prices finally determined for income tax purposes. The customs adjustment is denied. In *Ross Glove* the IRS sought to adjust income tax results based on a contract manufacturing theory. The taxpayer resisted. The taxpayer justified the transfer prices on its income tax return based on a final customs determination for the same goods. The taxpayer's theory is allowed, with adjustments. The judgment of the court carries over the customs methodology (CVM) to the income tax (C+).

Procureur de la République v. René Chatin

In *René Chatin* a criminal investigation was instituted against the manager of the wholly owned company Laboratories Sandoz (Sandoz-France). He was accused of making a false customs declaration with respect to goods purchased from the Swiss-established parent company, Sandoz A.G. (Sandoz-Switzerland).

The stated transaction value (GVC, Art. 1.1) was higher than the "normal price" (arm's length price, or fair market value, or open market value) for the goods purchased. Citing from the EU regulations then in effect the court states:

> According to [Article 1(1) of Regulation No. 803/68] the value for customs purposes of imported goods is "the normal price, that is to say the price which they would fetch … on a sale in the open market between a buyer and a seller independent of each other." According to Article 9, the

[296] Case 65/79, 1980 E.C.R. 1345 (1980).
[297] Ross Glove Co. v. Commissioner, 60 TC 569 (1973), acq. in part 1974-1 CB 2.

> price actually paid or payable may be regarded as being the basis to be used in determining the normal price.[298]

Over the period from January 4, 1971 to November 9, 1973 the French and Swiss competent authorities determined that the price declared to French customs was overstated by FF 36,786,081.[299] The reason for the intra-company overstatement seemed obvious: "The [French] customs authorities inferred from their assessment that the declared price was increased by comparison with the normal price in order to allow Sandoz-France irregularly to transfer capital to the parent company in Switzerland."[300]

The higher prices were in fact the invoice prices used. The base customs value is the invoice price, and this inflated amount was declared on the relevant customs forms by the Sandoz-France manager. The base amount can be adjusted up or down by "extrinsic items" specified in the regulations. The issue for the court was whether or not an invoice price which is known to be overstated can be adjusted *down*,[301] when the adjustment is the same adjustment made in the related income tax case, and which has been agreed to by French and Swiss competent authorities. The answer, and the holding of the case is "no."

> Regulation No. 803/68 of the Council of 27 June 1968 on the valuation of goods for customs purposes, in particular Articles 1 to 10 of that regulation, and Regulation No. 375/69 of 27 February 1969 must be interpreted as meaning that the reduction by the competent authorities of a Member State of the invoice price of goods imported from a non-member country does not accord with the aims and rules relating to the determination of the value of goods for customs purposes. However, the determination of the value for customs purposes in accordance with those regulations cannot have the effect of requiring the fiscal and financial authorities of the Member States to accept that valuation for purposes of other than the application of the common customs tariff.[302]

René Chatin remains good law in the EU.[303] This decision essentially sets customs valuation apart from other valuations of the same goods. It clearly holds that customs value is not (necessarily) equivalent to an economically-accurate measure of fair market value. Furthermore, fiscal and financial authorities cannot be required to accept customs valuations for other tax or regulatory purposes.

Ross Glove Co. v Commissioner

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[298] René Chatin *supra* note 296, at ¶ 11.
[299] *Id.* at Grounds ¶2 (indicating that the declared value for goods was FF 89,929,024, where the price should have been FF 53,142,943).
[300] *Id.* at Grounds ¶2.
[301] *Id.* at Grounds ¶14 (indicating that it is clear to the court, based on the regulations that the invoice price can be adjusted downwards).
[302] *Id.* at Operative Part ¶1 4.
[303] BEN TERRA & JULIE KAJUS, A GUIDE TO THE EUROPEAN VAT DIRECTIVES 676 (2007) (indicating that *René Chatin* remains the rule in the EU and indicating that this decision creates some difficulties for the harmonization of VAT ad customs rules with respect to the "open market value" concept).

Ross Glove essentially approaches the *René Chatin* case from the other side, and reaches the opposite outcome. In this case the IRS questions the inter-company pricing of gloves imported by a US reseller. The gloves were manufactured by Carla Trading, a sibling (Panamanian) company, from facilities operated by that company in the Philippines. Glove manufacturing had generally become unprofitable in the US.[304]

Ross Glove justified its margins by relying on the cost-plus (C+) method, and used the margins developed by US Customs examiners. These margins were in the range of 21 to 27 percent, and were determined under the constructed value method (CVM).[305] The court stated:

> Importations into the United States are entered with, and appraised by, Customs. 19 U.S.C. 1488-1490. Because Ross Glove and Carla Trading were related parties, the Ross Glove importations were appraised at 'constructed value.' 19 U.S.C. 1401a. …
>
> During the period from 1963 through 1969, Ross Glove periodically furnished U.S. Customs with cost-of-production statements which were intended to reflect Carla Trading's direct cost. Customs determined the markup to be added to such costs to cover the allowable profit and overhead. For importations during 1963 and the first 4 months of 1964, the markup was 27 percent of direct production and material costs, and thereafter, 21 percent.

The IRS contended that Carla Trading was no more than a contract manufacturer, and as such deserved "… a profit of 5 percent over costs."[306] All the rest of the combined profit should be attributed to the US company – Ross Glove. The court rejected the IRS approach, largely because it could not support the 5% mark-up with reliable comparable transactions, thereby failing to meet its burden of proof.[307] However, the court also

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[304] Ross Glove *supra* note 297, at 606.
[305] The constructed value method is an earlier version of the computed value method [CVM] that was used in US Customs prior to adoption of the GVC. The court in *Ross Glove* explains (*Id.*,at 584):

> Constructed value is defined as the sum of:
> (1) the cost of materials … and of fabrication or other processing of any kind employed in producing such or similar merchandise … which would ordinarily permit the production of that particular merchandise in the ordinary course of business;
> (2) an amount for general expenses and profit equal to that usually reflected in sales of merchandise of the same general class or kind as the merchandise undergoing appraisement which are made by producers in the country of exportation, in the usual wholesale quantities and in the ordinary course of trade, for shipment to the United States; and
> (3) the cost of all containers … and all other expenses incidental to placing the merchandise undergoing appraisement in condition, packed ready for shipment to the United States. (19 U.S.C. 1401a(d).)

[306] *Id.* at 587.
[307] *Id.* at 598-601.

rejected the taxpayer's direct use of customs margins because the customs examiners had not consistently based their results on the total costs of Carla Trading.[308]

Thus, the court was "… presented with a situation in which neither the respondent's determination nor the petitioner's price accurately reflects an arm's-length price."[309] Nevertheless, the Tax Court found that the customs valuation method was an appropriate basis for determining the arm's length price, and the "… markups used by Customs in computing the value of gloves imported … may serve as a basis for determining an arm's length price under § 482."[310] The court also found that the customs valuation was the "… best evidence available as to the amount that a seller would receive to cover overhead and profit in an arm's length sale."[311]

Thus, in Ross Glove the customs *method* flows through into the income tax, even though the customs calculation of the cost base is rejected as inaccurate. After tending to this detail, the Tax Court accepts both the method and the result.

The *Brittingham* decision (1976)[312] followed soon after *Ross Glove* (1973). The IRS argued in *Brittingham* that the customs value (determined under the constructed value method (CVM)) should be the value for income tax purposes (determined on a cost-plus basis (C+)). The IRS lost because the parties were not "related" for income tax purposes, even though they were related for customs purposes.

We are never told whether the customs method would carry over into the income tax in *Brittingham,* because the court never reached the issue of the appropriate method. The statutory response that followed close on the heals of *Brittingham* was IRC § 1059A.[313] This section partially harmonized income tax and customs transfer pricing results (not the definition of related parties, or the methods used to determine value) by setting income tax ceilings (not floors) that are tied to the customs valuation (as adjusted).

Second Pattern – Income tax-VAT litigation – Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc[314] *& Between: Southpark Estates Inc., S.A.M. (Colorado) Inc., Villa Beliveau Inc., Virden Kin Place Inc, and Her Majesty the Queen [Indexed as: Southpark Estates Inc. v. Canada]*[315] These cases, European and Canadian present the problem of what to do in a VAT case where the valuation of a supply is at issue, but the controlling statute sets out no methods explaining how to determine value. Both cases present the question: should income tax methods be used?

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[308] *See infra*. notes 225 - 226 & 234 and accompanying text (concerning the importance of using a consistent cost base when applying C+ and CVM methods).
[309] Ross Glove *supra* note 297, at 602.
[310] *Id.* at 605.
[311] *Id.* at 605.
[312] *See supra* notes 64 to 81, and accompanying text.
[313] *See supra* note 96, and accompanying text.
[314] C-210/04, Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc. 2006 E.C.R. 00000. (March 23, 2006).
[315] 2006 ACWSJ 98; 148 ACWS (3rd) 333; 2006 FCA 153 (Apr. 27, 2006).

Although the holding of the ECJ in the *FCE Bank* case never reached the question of which methods should be used in a VAT valuation case, the court is very clearly against using income tax methods to determine open market value in the VAT. In the *Southpark Estates* case the court makes a choice. The court decides not to determine GST value with income tax methods, and instead follows the *ad hoc* methods developed through the professional expertise of the witnesses. Although this direction is not set out in Canadian regulations, this approach is consistent with the treatment accorded similar transactions in the Australian regulations.

Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc

FCE bank is established in the UK and performs VAT exempt financial services. It charges its branches for services including management, advice, personnel training, data processing development and software-related supplies. The costs of these services are divided among the branches.

FCE IT, the Italian branch of FCE Bank, applied the reverse charge with respect to the charge made by FCE Bank. After FCE IT paid in the VAT it claimed back the VAT arguing that because it lacked a separate legal personality no VAT was properly due. The Italian government denied the refund, resulting in the lower court case, and this referral to the European Court of Justice.

If these services were taxable, there was a question about the method to be applied to determine the open market value of these services under the Sixth Directive.[316] The Italian Court asked the ECJ if the proper approach would be to apply the rules set out under the OECD Guidelines, because these principles underpin the UK-Italian Income Tax Treaty. The question raised 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 October 1988 between Italy and the United Kingdom of Great Britain and Northern Ireland be used to define that relationship?[317]

The ECJ never reached this question, because it agreed with the FCE Bank's contention that the services were not taxable – there was one party not two related parties involved. However, if the ECJ had decided this question differently, if it had decided that there was a sale between related parties (the head office and the branch), then it would

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[316] SIXTH DIRECTIVE, *supra* note 16, Art. 11(A)(1)(d); RVD Art. 77 provides:

> In respect of the supply by a taxable person of a service for the purposes of his business, as referred to in Article 27 [Article 6(3)], the taxable amount shall be the open market value of the service supplied.

SIXTH DIRECTIVE, *supra* note 16, Art. 6(3); RVD Art. 27 provides:

> In order to prevent distortion of competition and after consulting the VAT Committee, Member States may treat as a supply of services for consideration the supply by a taxable person of a service for the purpose of his business, where the VAT on such a service, were it supplied by anther taxable person, would not be wholly deductible.

[317] FCE Bank, *supra* note 314, at ¶ 20.

need to determine if the OECD transfer pricing methods would apply to the open market value of the supply. The Court answers this (hypothetical) question clearly. It observes:

> It should be noted that the OECD Convention is irrelevant since it concerns direct taxation whereas VAT is an indirect tax.[318]

The way the *FCE Bank* case approaches income tax-VAT harmonization is reminiscent of the why it handled income tax-customs harmonization in *René Chatin* twenty-six years earlier. Just as customs valuation is distinct from income tax valuation, so too are the VAT rules distinct from the income tax rules. Thus, for the ECJ there are three distinct transfer pricing regimes.

Southpark Estates Inc. v. Canada

In *Southpark Estates Inc. v. Canada* developers built four apartment complexes as "life lease apartment complexes" and upon turning over the first unit were required to pay GST on the fair market value of the entire complex.[319] Soon after construction, rent controls were imposed in the communities where these units were built. As a result, no further building was planned. Developers projected that they would not be able to recover their costs and a reasonable profit.

In each case the developers declared the fair market value to be significantly lower than the cost of construction, and the question for the court was could a below cost valuation be the GST fair market value? The GST definition of fair market value is simply:

> "fair market value" of property or a service supplied to a person means the fair market value of the property or service without reference to any tax excluded by section 154 from the consideration for the supply.[320]

The Canadian GST has no further discussion of how to determine fair market value. There are no GST regulations or rulings that explain this concept in any further detail. Although the Canadian income tax and customs both have rules for determining tax values, the court resorted to the testimony of expert witnesses. The court preferred the analysis of professionals who were in the business of valuing commercial real estate.

The methods considered by the Tax Court were (1) The Cost Approach, (2) The Direct Sales Approach, and (3) The Income Approach.[321] The court was convinced that the Cost Approach best determined value in this case, and ruled in favor of the government. The taxpayers appealed, and the government won on appeal. Relying on professional appraisers, and the methods developed by those professions to determine

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[318] FCE Bank, *supra* note 314, at ¶ 39.
[319] EXCISE TAX ACT, R.S.C., ch. E-15, § 191(3) (Can.).
[320] EXCISE TAX ACT, R.S.C., ch. E-15, § 123(1) and Sch. V to X (Can.).
[321] Between: Southpark Estates Inc., S.A.M. (Colorado) Inc., Villa Beliveau Inc., Virden Kin Place Inc, and Her Majesty the Queen, 2004 TCC 701; 2004 Can. Tax Ct. 1590, at ¶22 (Nov. 1, 2004)

value is one of the primary methods set out in the Australian GST regulations and the Azerbaijan code.[322]

CONCLUSION PART II: EFFICIENCY AND THE PRESSURE TO VERTICALLY HARMONIZE TRANSFER PRICING NORMS

There is an intuitive expectation that transfer pricing rules should be harmonized within a jurisdiction across the major tax types. When tax regimes intersect (income tax, customs and VAT) at the valuation of the same supply, between the same related parties, business efficiency considerations also press for harmonized measurement. The case law tells a global story of governments and businesses seeking harmonized answers to transfer pricing questions where statutes or regulations are inconsistent or incomplete.

The reality is however, that no jurisdiction has vertically harmonized transfer pricing norms across all of its major taxes, even though there is considerable evidence that efforts have been made (almost everywhere) to harmonize them. The ways and means of reaching a harmonized outcome may differ from jurisdiction to jurisdiction, but prior to the WCO/ OECD First and Second Conferences on Transfer Pricing and Customs Valuation[323] there had been almost no systematic consideration of this issue. There is therefore, a lot to learn from the comparative assessment that has just begun.

Two questions follow from these WCO/OECD conferences. What have we learned so far? Where are we going? A summery is important at this point.

What have we leaned so far (the relationship aspect)? Under the relationship test harmonization problems arise when definitions are drawn exclusively (that is, when definitions in one regime do not include presumptive links to analysis under other standards). This is very difficult income tax/ customs harmonization issue. When taken head-on (as was the case in the First WCO/OECD Conference) it is much more difficult to see a resolution, than it is when the income tax/ customs issue is viewed obliquely from the vantage point of the VAT. This was one of the lessons learned as we moved forward to the Second WCO/OECD Conference.

Four examples are considered.

(1) For example under the income tax, we considered the case of the US where an "economic control" standard is used to determine if parties are related. In this case, it was suggested that if taxpayers had made prior representations to *customs* that the invoice price had been influenced by a close relationship, then the relationship question under the *income tax* should also be settled.[324] These parties are related, presumptively. In other words, the presumption of control should be extended.

[322] *See supra* notes 292 to 293 and accompanying text.
[323] *See supra* notes 2 & 3 and accompanying text.
[324] *See supra* text at note 99.

(2) An additional presumption should also apply. If, for example, *customs* duties are finally liquidated on a basis different from the transaction value (because of a determination by *customs* that the relationship had influenced the price[325]), then it should be presumed that these parties are related for *income tax* purposes.

Such a rule should be conditioned on there being a "final determination," so that (for example) under US rules (1) the 90 day period for a protest with the port director has expired, (2) administrative remedies have been exhausted, and (3) judicial review has been completed (including, if utilized, an appeal to the US Court of International Trade). Thus, if we include both of these suggestions in the US income tax regulations we would have a provision that looked like the following. (The first suggestion is in italics; the second suggestion is underlined). The definition of control would read as follows:

> … any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted, *or if representations are made to US Customs that the importer is related so closely to the supplier that the invoice price does not reflect an arm's length price,* <u>or if a final US Customs determination has been reached supporting a revaluation of imported goods on a basis different than a proposed transaction value because the relationship of the importer and the vendor has influenced the price</u>.[326]

This is the issue in *Brittingham*. The language above would harmonize the definition of related parties across income tax and customs in the US, so that a case like *Brittingham* could move forward to a consideration of the appropriate income tax method.

(3) Similar presumptions can work in reverse. There is room within the definition of related parties under GVC Art. 15(4)(e), (f), and (g) to allow harmonization of the relationship definition in the other direction (from the *income tax* back to *customs*). The operative language in the GVC – "directly or indirectly controlled" – is similar to the operative language in the income tax (under the economic relationship test). Given this symmetry one could specifically link the issuance of an *advanced income tax ruling* (an APA) back to the GVC. Taxpayers should not be allowed to avoid customs scrutiny of prices that are associated with an income tax APA negotiated on the same goods.[327]

(4) The previous three examples arise in reasonably fluid situations. However, a different difficulty arises when customs has liquidated the duty, and then *subsequently* there is an income tax determination that the relationship of the parties impacted the

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[325] Robert T. Cole & Ralph H. Sheppard, *Customs Issues Arising Out of Transfer Pricing Compliance,* in Practical Guide to US Transfer Pricing 25-27 (1999).

[326] Treas. Reg. § 1.482-1(i)(2) (except for the material in italics and underlined).

[327] This may be customs <u>practice</u> in a select number of jurisdictions however it should be elevated to a customs practice generally through WCO interpretive guidance.

price. Re-opening a liquidated customs case at this point in time is difficult. Time and the goods have long left the port.

There is an easy way to deal with this fourth situation. It requires income tax adjustments to be *granular*. Income tax adjustments must be made not *to the tax return as a whole*; instead income tax adjustments must be carried back to the company's accounts and ledgers. Audit changes (or compensating adjustments) need to be recorded at the invoice level.[328] With these adjustments in place customs and VAT returns can be re-determined. Such a system would need to be a fully automated tax compliance system. It could be/ should be certified for accuracy. The certification process would constitute an Information Technology Advanced Pricing Agreement (IT-APA).[329]

Is the linking discussed in the four examples above workable? Can relationship definitions (among different taxes) be effectively linked? The workability of expressly linking the relationship definition is one of the critical lessons learned between the First[330] and Second[331] WCO/OECD Conference on Transfer Pricing and Customs Valuation. We learned of the difficulties in the First Conference and some light of its resolution in the Second Conference through the inclusion of VAT. It is very clear (when the global reach of the VAT is scanned) that there is very wide acceptance for statutorily linking relationship definitions. The linkage is frequently binary (income tax/VAT or in other cases VAT/Customs).

The most obvious examples of the linkage came from jurisdictions that directly linked income tax and VAT transfer pricing regimes. Spain,[332] Japan,[333] UK,[334] Jamaica,[335] Australia,[336] and Canada[337] are among the jurisdictions that have a direct

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[328] A example of this process would be an income tax adjustment of 100 for the sale between related parties of 10 items each originally invoiced at 15 would be changed so new, revised invoices would issue at a price of 25. VAT and customs duties would be due on the revised amounts.
[329] *See supra* text at note 40.
[330] *See supra* note 2 and accompanying text.
[331] *See supra* note 3 and accompanying text.
[332]Spanish Act 36/2006 of Nov. 29, 2006 amending VALUE ADDED TAX ACT 37/1992 (Dec. 28, 1992) Art. 79.5 (expressly linking the VAT definition of "related parties" to that under the Corporate Income Tax, and further enlarging it to include related parties under (a) the Personal Income Tax and the Non-resident Income Tax, (b) non-profit entities under Act 49/2002, and (c) partners, associates or members of a professional enterprise, and the enterprise itself).
[333] JAPAN'S REVISED CONSUMPTION TAX LAW (SHOUHIZEIHOU), Art. 28(2) *supra* note 162 (indicating that the Japanese Consumption Tax rules follow the results of the income tax) and CABINET ORDER TO THE SPECIAL TAXATION MEASURES LAW (SOZEI-TOKUBETSU-SOCHIHOU-SEKOUREI), Art. 39-12 (indicating that the definition of related parties is (1) where one party owned fifty percent or more of the other party, (2) where two entities have the same parent company, and (3) or where one entity has substantial control over the other party).
[334] Value Added Tax Act, 1994, Sch. 6, para. 1(4) (UK) (defining the term "connected persons" by directly cross-referencing the definition under the Income and Corporate Tax Act (ICTA) 1988, §839); See supra Note 123.
[335] THE GENERAL CONSUMPTION TAX ACT, 1991 at § 2(1) (Jamaica) (defining "connected person" under the GCT as the "same meaning" as "connected person" under the income tax).
[336] A NEW TAX SYSTEM (GOODS AND SERVICES TAX) ACT, 1991 at Pt. 6-3, Div. 195-1 (Australia) (simply indicating that the term "associate has the meaning given by section 318 of the INCOME TAX ACT OF AUSTRALIA, 1936").

linkage. Other jurisdictions reach the same result indirectly. These countries follow a statutory construction model that places transfer pricing rules, including the definition of related parties, in the "first part" of an omnibus Tax Code, followed by the application of these rules in specific taxes listed in the second part. Russia,[338] Azerbaijan,[339] Turkmenistan,[340] and Georgia[341] have codes that function in this manner.

Ecuador[342] and Chile[343] both follow similar statutory constructions, and place a definition of related parties in the first part. At the present time, both of these countries selectively apply this definition *only* to the income tax. However, seen from a developing law perspective, the Ecuadorian situation is interesting. A business-friendly tax reform is underway in Ecuador, and one of its elements is the vertical harmonization of transfer pricing rules between the income tax and VAT. If enacted, the current definition of related parties will be extended to the VAT, and both VAT and income tax methodologies will be in full harmony with the 1995 OECD Guidelines.

The other binary alignment is VAT/Customs. There are a large number of jurisdictions that harmonize the relationship element among transfer pricing regimes along this other axis. When this pattern is observed, harmonization is achieved by duplicating customs definitions in the VAT statute. This study uncovered no countries where the VAT definitions linked were linked directly or indirectly to the customs statute (as the income tax/VAT definitions were linked). The pattern that was always observed

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[337] EXCISE TAX ACT, R.S.C., ch. E-15, §§ 126(2) & 127(1) (Can.) (equating "related persons" for GST purposes with the same definition under § 251(2) through (6) under the Canadian INCOME TAX ACT; and "associated persons" for GST purposes with the same definition under § 256(1) through (6) under the Canadian INCOME TAX ACT.

[338] TAX CODE OF THE RUSSIAN FEDERATION, Part 1, Federal Law No. 147-FZ Art. 20 (July 31, 1998) (indicating that "interdependent persons" are physical persons or organizations where (1) ownership is 20% or more (2) there is a subordinate relationship, (3) various marital relationships apply, and (4) otherwise determined to be related by a court).

[339] TAX CODE OF THE REPUBLIC OF AZERBAIJAN, Law No. 905-IG at Art. 18 (Jul. 11, 2000) (Azerbaijan) (specifying rules similar to the Russian rules, and also under the caption of "interrelated parties").

[340] TAX CODE OF TURKMENISTAN, 2005 at Pt. 1, Sec. IV, Ch. 2, Art. 36.2 (Turkmenistan) (indicating generally that "interdependent parties" are subject to the valuation methods and setting a standard that is broad and economic based, "…physical persons and (or) legal entities the relations between which may render influence upon the conditions or economic results of their activity shall be recognized as interdependent entities.").

[341] TAX CODE OF GEORGIA, 1997 (as amended) Pt. I, Ch. 1, Art. 24 (setting out "interdependent parties" in an manner that includes both economic relationship as well as standard legal tests that are applicable to income tax and VAT).

[342] Tax Code, No. 1016-A (Dec. 1975), as amended (Oct. 1,7 2005), at Art. 4 (Ecuador) (setting out an economic standard "…in which one of [the parties] participates, directly or indirectly in the direction, management, control or capital of the other, or those in which a third party individual or business, domiciled or not in Ecuador participates, directly or indirectly in the direction, management, control or capital of them."

[343] Tax Code, No. 830 (Dec. 1974), as amended Law No. 20,125 (Oct. 18, 2006) at Art. 38 (Chile) (setting out relationship rules that have a business, not individual, focus in large part because Chile will apply these rules in the Corporate Income Tax and not the VAT at the current time, and specifically linking to the OECD Tax Havens list at Art. 41D, No. 2).

was to duplicate the customs definitions in the VAT statute. Countries in this category include Botswana,[344] Lesotho,[345] Singapore,[346] Barbados,[347] and Lithuania.[348]

What have we learned so far (the methodology aspect)? Looking at transfer pricing methodologies (and only at the income tax/ customs interface for the moment) we have recorded similarities (but no alignment) of methods. A policy difference was also apparent. Where the income tax uses transfer pricing to determine true/accurate taxable income, customs uses it as a substitute valuation method. There is also a significant omission. Customs applies no profit methods, even when intangibles are involved; the income tax has two profit methods.

The prospect for full and direct harmonization of income tax/customs methodologies is not encouraging. No jurisdiction does it today, and there appears to be none on the horizon. There are suggestions that (1) self-help options like multi-tax-type APAs be employed,[349] and proposals for use of (2) OECD methodologies in the customs context to prove that the transaction value is correct under GVC Art. 1.2(a).[350]

These are both self-help, taxpayer-centric remedies, and government involvement in them has been light. The government's attitude could be attributable to one of two factors: (1) long-term, but inconsistent (conflicting) horizontal harmonization regimes have developed under the OECD (income tax) and the WCO (customs) – these regimes

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[344] THE VALUE ADDED TAX ACT, 2001 at Pt.1, Art 2 (Botswana) (listing related parties in detailed categories that track the GVC rules).
[345] SALES TAX ACT, 1995 at Art. 3 (Lesotho) (establishing a general economic relationship test of, "…any other person who acts or is likely to act in accordance with the directions, requests, suggestions, **or** wishes of the first-mentioned person…"); *see supra* note 189 and accompanying text.
[346] GOODS AND SERVICES TAX ACT, Cap 117A, at §17(3) & Third Schedule §§ 3 & 4 (Sing.) (listing under the definition of "connected persons" a series of relationships that trace those in the GVC, followed by a definition of "control" that is limited to legal, not economic control).
[347] VALUE ADDED TAX ACT, 1996 at § 5 (Barbados) (listing in subsection (1) legal categories of relationships that define a "connected person" followed by a deeming provision that could possibly extend the meaning to economic control, "… one person shall be deemed to control another person where he is legally or operationally in a position to exercise restraint or direction over that other person.").
[348] LAW ON VALUE ADDED TAX, No. IX-751 (Mar. 2002), as amended Law No. IX-1960 (Jan. 15, 2004) at Art. 2.31 (Lith.)
[349] Pascal Luquet, *supra* note 1, at (indicating that French Customs and Bureau CF3, the income tax counterpart to discuss possibilities of issuing joint APAs); Mayra O. Lucas Mas *supra* note 98, at 19-21 (indicating that the establishment of a system of joint customs/ income tax APAs would "definitely constitute a step forward in achieving a more cohesive and consistent regime for all transfer pricing purposes"); Sean Foley, Todd R. Smith & Vanessa Francisco, *Tax versus Customs Arm's Length Pricing,* 8:4 Tax Planning International Transfer Pricing (indicating in the concluding section that, "In short, complying with IRS and Customs transfer pricing requirements creates multifaceted risk exposure. In all cases involving [US] inbound tangible goods, the decision on whether to apply for an APA or make a compensating adjustment should include an analysis of the Customs implications. The proposed formula pricing offers an approach that may enable MNCs to use transaction value appraisement and mitigate the risk that a transfer pricing adjustment may trigger IRC § 1059A complications.").
[350] JOVANOVICH, *supra* note 17, at 112 (indicating that, "… uniformity in applying the notion of customs value and its adjustments would be recommendable in order to undertake a process of harmonization between tax and customs valuation regimes. … use of OECD Guidelines in the context of GVC Article 1.2(a) aims at a uniform application of the GVC among the WTO members, as required by its Preamble."

resist vertical harmonization efforts by governments; and (2) the distinct agencies that enforce income tax, VAT and customs see "very little in it for themselves." In fact the vertical alignment of pricing norms may be seen as disruptive to the horizontal alignments that have successfully promoted trade, and minimized international double taxation. Is a close alignment of transfer pricing methodologies unlikely? This was where the First WCO/OECD Conference left off.

VAT made a significant contribution to this analysis at the Second WCO/OECD Conference. Rather than the "no harmonization" answer of income tax/customs, once again the VAT perspective allowed us to see a number of VAT jurisdictions where transfer pricing methodologies have been harmonized (some of which even include profit methods). As before, there are patterns in this fabric when we look broadly.

The Spanish[351] and Japanese[352] have aligned income tax/ VAT methodologies directly. Spain and Japan have both adopted the 1995 OECD Guidelines, and all five OECD methods are applied in them. Ecuador appears ready to follow suit. The two-part codes in Russia,[353] Azerbaijan,[354] Turkmenistan,[355] and Georgia[356] have also harmonized across income tax and VAT, but they have done so without including profit methods.

Other countries have harmonized differently. A customs/ VAT harmonization of methodologies can be identified in Botswana,[357] Lesotho,[358] Barbados,[359] Fiji,[360] New

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[351] Spanish Act 36/2006 of Nov. 29, 2006 amends the VALUE ADDED TAX ACT 37/1992 (Dec. 28, 1992) Art. 79.5 (indicating that the methods for determining value are those under the Corporate Tax Act, Art. 16).

[352] JAPAN'S REVISED CONSUMPTION TAX LAW (SHOUHIZEIHOU), Art. 28(2) *supra* note 162 (indicating that the Japanese Consumption Tax resuts follow the results of the income tax, and by extension all the income tax methods apply to the Consumption Tax as well).

[353] TAX CODE OF THE RUSSIAN FEDERATION, Part 1, Federal Law No. 147-FZ Art. 40 (July 31, 1998) (basing value on the "market price" a series of methods are set down for both income tax and VAT); *see supra* note 13.

[354] TAX CODE OF THE REPUBLIC OF AZERBAIJAN, Law No. 905-IG at Arts. 14.1 through 14.4 (Jul. 11, 2000) (Azerbaijan) *available at*: http://www.taxes.gov.az/eng/qanun/mecelle.html (indicating the price is the market price set by the laws of supply and demand within 30 days of the transaction).

[355] TAX CODE OF TURKMENISTAN, 2005 at Pt. 1, Sec. IV, Ch. 2, Art. 36 (Turkmenistan) (setting out the market value as the measure of the tax base and providing the basic methods for its determination primarily through the use of similar and identical transactions).

[356] TAX CODE OF GEORGIA, 1997 (as amended) Pt. I, Ch. 1, Art. 27 (setting out the determination of the market price through the use of identical and similar transactions).

[357] THE VALUE ADDED TAX ACT, 2001 at §§ 3 & 9 (Botswana) (indicating that the fair market value of similar and identical goods are used to measure the value of the consideration).

[358] SALES TAX ACT, 1995 at Arts. 4 & 13(3) (Lesotho) (indicating that the tax base is the consideration, and consideration is the fair market value or the amount actually exchanged with a standard set at the fair market value of similar or identical supplies in instances where consideration is not in money).

[359] VALUE ADDED TAX ACT, 1996 at §§ 20 & 17 (Barbados) (providing a general definition of arm's length valuation, with a series of fall-back provisions setting a lower limit at the sellers costs).

[360] 1991 REPUBLIC OF FIJI 45; VALUE ADDED TAX DECREE No. 45 of 1991 at §§ 2(1) & 19 (generally defining the open market value as the arm's length price, and applying the terms generally in the valuation section, but with no further methodological analysis).

Zealand,[361] and Jamaica,[362] among other countries. In these cases the harmonization is limited to the adoption in the VAT statute of a rough approximation of customs TVI/ TVS methods. The VAT is clearly aligning with Customs (not with the income tax) because: (1) there is a distinct ordering of a TVI-like method over a TVS-like method as under Customs, but not what one would call general CUP methodology; (2) there is also a strong Customs-like deference to the Commissioner's good judgment when these methods do not provide a good answer; and (3) some of these jurisdictions have not developed income tax transfer pricing methodologies, thus the customs regime is highly influential at policy and practical levels. However, the customs orientation to find "rough justice," rather than the "exact justice" that dominates income tax policy.

Seen from the VAT perspective then, there are important patterns in the fabric. Why is the harmonization partial (binary)? Why is the harmonization different from country-to-country? Why is there only limited acceptance of the profit based methods? The last question deserves some attention. Only Japan, Spain and possibly Ecuador extend profit methods into the VAT.

The question is important because intangibles are notoriously responsible for large year-end compensating adjustments through APAs (adjustments that are not known until well after the transaction is completed). They are also subject to much later in time audit adjustments (of both a voluntary and an involuntary nature). Thus, if the amounts involved are significant, and if the traditional approach to finding a workable methodologies for the VAT (borrowing the method from income tax or customs) is not workable, then is there a *third way* to adjust transaction values for intangibles?

Making changes that will allow (income tax) intangible adjustments to harmonize with and "flow through" (to VAT and customs returns) will likely result in a revenue boon to developing countries. These are countries that presently have very little capacity to perform intangible transfer pricing adjustments (in their income tax) but that are increasingly seeing developed countries pull back significant royalty amounts associated with sales of goods into their countries.

Take for example a related party transaction between a developed and developing country. The normal case would find high value goods flowing from the developed to the developing country with the bulk of the developing country's revenue from these transactions collected at the border through VAT and customs. Aside from the direct price of the product, related royalty payments will flow to the developed country.

If, subsequent to the importation, an adjustment is made in the developed country requiring additional royalty payments (related to the goods), or if a unilateral APA requires a royalty-based year-end compensating adjustment (also related to the goods), how is the appropriate additional VAT and customs duty collected? Certainly there will

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[361] GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at § 4; New Zealand, IRD Tax Information Bulletin, Vol. 6 No. 14 at 6-8 (Jun. 1995); *see supra* note 178 to 180 and accompanying text.
[362] THE GENERAL CONSUMPTION TAX ACT, 1991 at §§ 2(1) & 7 (Jamaica) (providing a general definition of arm's length valuation, with a fall-back provision of the seller's cost at § 7(d)).

be enterprises that will volunteer the additional payments. Certainly exchange of tax information agreements will help at a government-to-government level. Certainly standard audit and enforcement techniques will be helpful. However, as the time for making adjustments to the dutiable value and the VAT base expires revenue losses will increase.

The *third way* (one that neither borrows methodologies directly from the income tax, nor one that assumes that the GVC adequately deals with intangible adjustments) might be found in the *parallel harmonization* approach adopted by the Australian GST, and the Azerbaijan code. Both of these jurisdictions effectively align their consumption taxes with income tax, and do so in a manner that includes intangible adjustments. They simply rely on professional appraisals, and adopt valuation methodologies on an *ad hoc* basis that are "consistent with professional guidelines."[363] An Australian rule would allow VATs to incorporate intangible adjustments in most jurisdictions, and would be an easy statutory change. This is the approach under the Canadian GST in the *Southpark Estates* case.[364]

Accomplishing the same thing in customs would be a matter of the Technical Committee on Customs Valuation drafting an Advisory Opinion that would associate professional appraisals that are made consistent with professional guidelines as appropriate valuations of royalties that should be an "addition" to the customs value under GVC Article 8(c).

Where are we going? This study suggest that we are going toward technological solutions to the timing problems embedded in the harmonization of income tax, customs and VAT transfer pricing regimes. The technology that does this should be *certified*.

Once the valuation issue is settled, both VAT and customs are faced with a timing issue to get adjustments reliably added to the tax base. Large multinational companies already automate these transactions. If rules were adopted to allow VAT and customs adjustments to be made "out of time," but only through *certified tax compliance systems*, then the adjustments and the remission of additional taxes due would be automatic and accurate. Full consideration of this issue is the topic of the next part.

PART THREE: VERTICLE HARMONIZATION & CERTIFICATION – IT-APAs

There are two patterns in the current alignment of transfer pricing regimes: (a) a rough[365] (but very effective) horizontal alignment of transfer pricing rules within a single tax type across multiple jurisdictions combined with (b) instances where some transfer

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[363] Goods and Service Tax Ruling, *Goods and Services Tax: Non-Monetary Consideration*, *supra* note 19, at ¶154.
[364] *See supra* text at notes 319 to 322
[365] "Rough" in the sense that the customs rules are globally binding and uniform through the GVC, but the income tax rules are uniform through non-binding OECD guidelines interpreting a suggested model treaty, and the VAT rules are uniform only in some regions.

pricing rules are vertically aligned among several (but not all) tax types within a single jurisdiction.

Vertical alignment of transfer pricing norms meets resistance whenever it is disruptive to pre-existing horizontal harmonies. This resistance is an effective barrier to full harmonization, and produces the binary patterns seen widely (income tax and VAT are harmonized without customs, or customs and VAT are harmonized without income tax). Thus, the question for policy makers is: Can domestic (vertical) harmonization be achieved without disrupting international (horizontal) alignments?

Simple answers – drafting a single transfer pricing statute and applying it universally – do not work. An answer that does work is the IT-APA. This is a self-help (taxpayer-initiated) remedy that relies on the certification of taxpayer-technology.

The IT-APA approaches the policy problem of transfer pricing harmonization from two directions. It blends two of the strongest tends in modern tax compliance – certification of transaction tax software and APAs. From the transaction tax side (VAT and customs) this solution relies on the growing willingness of revenue authorities to certify taxpayer software. From the income tax side this solution relies on a similar willingness to engage in taxpayer-initiated APAs.

This part explores the IT-APA. It considers in detail the IT part of the IT-APA as a solution in customs, then in VAT, and income tax. It concludes with a consideration of the APA part of the IT-APA and why this vehicle is uniquely qualified as an *incubator of ideas and solutions* for the specific vertical harmonization model that will "fit" a specific domestic tax system. Simple answers and a monolithic transfer pricing standard[366] is not the way.

The IT-APA – IT/Customs

Automated systems are regularly used to calculate customs tariffs, duties, fees and the other border taxes of international trade. In modern practice the programs that make these calculations are stand-alone software products that are integrated into either the enterprise resource planning (ERP) system of private sector traders,[367] or the parallel system used by customs administration to regulate trade.[368]

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[366] *See supra* text after note 6.

[367] JITENDRA SINGH, IMPLEMENTING AND CONFIGURING SAP GLOBAL TRADE SERVICES 17-18; 149-53 (2007) (indicating how the Global Trading Services standalone software application manages global customs calculations in conjunction with the SAP enterprise resource planning (ERP) system that is used by the majority of multinational corporations). Similar software products are marketed as SAP add-on applications, and are marketed at a lower cost. One such add-on software application is "smallToll/3®." This software and descriptive materials are available only in German. It is described in English by VAT plus GmbH, a trade consultancy, *available at* http://www.vatplus.ch/services/sap_ecustoms_en.html. Other third party systems specialize in automated customs compliance for specific countries. For example: Icarus is an Irish company that specializes in customs clearance software solutions for traders dealing with Ireland, *available at* www.icarus.ie. Impatex Computer Systems Ltd is a UK company that supplies import and export customs and duty management software to traders and freight forwarders, *available at* www.impatex.com. Misrya is an Egyptian technology company that supplies import and manifest

Automated systems commonly engage in the digital check-and-balance of all taxes due on cross-border trade. On many occasions it is functionally the same software product (sold to both taxpayer and tax administration) that is performing these cross-checked calculations.[369] Taxpayer-systems are on the verge of being certification by customs authorities. The reason is clear – they are critical elements in the global customs movement to develop Single Window Trade Portals.

The Single Window Trade Portal Movement

Through its Center for Trade Facilitation and Electronic Business (UN/CEFACT) the United Nations is taking the lead in promoting the development of Single Window Trade Portals as a key to economic development through trade facilitation.[370] A Single Window (SW) is "… a facility that allows parties involved in trade and transport to lodge standardized documents at a single entry point to fulfill all import, export, and transit-related regulatory requirements. If information is electronic, then individual data elements should only be submitted once."[371] Taxes are at the heart of the SW.

As a result of UN/CEFACT involvement and real business pressures for cost reduction efficiencies, SWs are evolving quickly and globally. They bring enormous

solutions to traders, *available at* www.misryasys.com. Conex is a French supplier of customs related technology solutions to traders, *available at* www.conex.fr. In each case these programs determine tariffs, duties, fees and related border taxes along with necessary trade document.

[368] CUSTOMS MODERNIZATION HANDBOOK 299-03 (Luc De Wulf & José B. Sokol eds., 2005) (indicating that the ASYCUDA [Automated System for Customs Data] program developed by the UNCTAD Technical Assistance program in the 1980's determines customs duties and is the most widely used automated system, as it is presently installed in 84 countries). *See* UNCTAD, *ASYCUDA++: Description of Application Software (Functional Overview)* at 2.2.5 *available at* http://www.asycuda.org/programme.asp Although the largest, ASYCUDA is not alone on the customs side. French customs developed the Solutions Francais Informatiques (SOFI) in 1974 which became SOFIX when it adopted the use of the UNIX operating system. The SOFI/SOFIX solution is no longer supported by French customs, and instead a consultancy firm, Solutions Informatiques Francaises, implements this solution, *available at* http://www.sifamerica.com/html/inicio.asp. Hewlett-Packard, Pricewaterhouse Coopers, and Societiete Generale de Surveillance, as business partners, developed TATIS to offer automated solutions for customs administrations globally. TATIS has recently formed a partnership with SAP. As a result, traders using the SAP ERP system with SAP's Global Trading Services software application frequently pass tax calculations across to customs administrations that use a the companion SAP product in TATIS to confirm customs determinations, *available at* http://www.tatis.com/about/index.html.

[369] Consider for example the TATIS system used by customs, a software partner of SAP, and the Global Trading Service software application of SAP that integrates with the SAP ERP system used by many multinational enterprises. *See supra* note 368.

[370] UNITED NATIONS ECONOMIC COMMISSION FOR EUROPE, RECOMMENDATION AND GUIDELINES ON ESTABLISHING A SINGLE WINDOW TO ENHANCE THE EFFICIENT EXCHANGE OF INFORMATION BETWEEN TRADE AND GOVERNMENT, RECOMMENDATION NO. 33 (2005) (recommending that simplification and harmonization of global trade processes and procedures is needed to reduce trade barriers to development, and indicating that even though the Single Window concept is not dependent on technology it is greatly enhanced by it) *available at* http://www.unece.org/cefact/recommendations/rec33/rec33_trd352e.pdf.

[371] *Id*. at 3

efficiency gain with them.[372] McMaster and Nowak[373] assess the evolutionary development of SW. They see thee progressive stages: (1) pre-SW portals (the eighty-nine countries that have adopted UNCTAD's ASYCUDA platform);[374] (2) national SW portals (seventeen countries where one-stop trade facilitation systems are currently in place);[375] (3) regional SW portals (two examples of regional commitments to develop multi-national SW portals);[376] and (4) global SW portals (one example of a global SW developed in the private sector).[377] Fully functioning global SWs are expected by McMaster and Nowak in the 2010's.

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[372] The fundamental economic argument behind the global trade facilitation effort is that the current trade regime is inefficient, costly, and a barrier to economic development. Jayanta Roy & Shweta Bagai, *Key Issues in Trade Facilitation: Summary of World Bank/ EU Workshops in Dhaka and Shanghai in 2004*, WORLD BANK POLICY RESEARCH PAPER NO. 3703 (September 2005) at 5 (indicating that an international trade transaction normally involves 27-30 different parties, about 200 data elements, 40 documents and costs that range between 2.5 – 1.5% of the goods value) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=803644. UNECE, *A Roadmap Toward Paperless Trade*, ECE/Trade/371 (2006) at 4 (indicating that shifting from paper to electronic solutions in airway bills in the US alone would save in excess of $1 billion per year) *available at* http://www.unece.org/cefact/publica/ece_trd_371e.pdf.

[373] Jim McMaster & Jan Nowak, *The Evolution of Electronic Trade Facilitation: Towards a Global Single Window Trade Portal,* 26 ELECTRONIC JOURNAL ON INFORMATION SYSTEMS IN DEVELOPING COUNTRIES 1 (2006) (assessing the current trend and predicting the emergence of a SWGTP by in the 2010's) *available at*: http://www.ejisdc.org/ojs2/index.php/ejisdc

[374] The eighty-nine ASYCUDA countries listed on their web site (http://www.asycuda.org/countrydb.asp) are: Afghanistan, Albania, Aruba, Anguilla, Antigua & Barbuda, Armenia, Bangladesh, Barbados, Belize, Benin, Bolivia, Bosnia & Herzegovina, Botswana, Burkina Faso, Burundi, Cambodia, Cameroon, Cape Verdi, Central African Republic, Chad, Colombia, Comoros, Congo, Cote d'Ivory, Cuba, Democratic Republic of the Congo, Dominica, East Timor, El Salvador, Estonia, Ethiopia, Fiji, Gabon, Gambia, Georgia, Ghana, Gibraltar, Grenada, Guatemala, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, Iran, Jordan, Latvia, Lebanon, Lithuania, Macedonia, Madagascar, Malawi, Maldives, Mali, Malta, Mauritania, Moldova, Mongolia, Montserrat, Namibia, Nepal, Netherlands Antilles, New Caledonia, Nicaragua, Niger, Nigeria, Palestine, Panama, Papua New Guinea, Philippines, Romania, Rwanda, Saint Kitts & Nevis, Saint Lucia, Saint Vincent & the Grenadines, Samoa, Sao Tome & Principe, Slovakia, Sri Lanka, Sudan, Suriname, Syria, Tanzania, Togo, Trinidad & Tobago, Turks & Caicos Islands, Uganda, Vanuatu, Venezuela, Vietnam, Yemen, Zambia, and Zimbabwe.

[375] The seventeen countries listed by McMaster & Nowak *supra* note **Error! Bookmark not defined.**, at 7 & 8-10 are: Australia (Tradegate); Finland (PortNet); Germany (DAKOSY); Ghana (GCNet); Guatemala (SEADEX); Hong Kong (DTTN); Jamaica (TradePoint); Japan (NACCS); Korea (KTNet); Malaysia (VIPPROG system); Singapore (TradeNet); Sweden (VCO); Thailand (TradeSiam); Tunisia (TTN); and United States (ITDS).

[376] The two multi-national SW portals (regional SW portals) listed by McMaster & Nowak *supra* note **Error! Bookmark not defined.**, at 7 & 10-13 are: the ASEAN Single Window initiative, and the European Commission's Single Window initiative expected to be operational in 2012 and 2010 respectively.

[377] The single example of a global SW portal is the private sector company Bolero.net (Bolero International Ltd.) http://www.bolero.net/ . [Bill of Lading Electronic Registry Organization]. Bolero was initiated in 1994 by a consortium of carriers, traders, banks and telecommunications companies in conjunction with the European Commission. Bolero.net specializes in paperless international trade facilitation, but concentrated in trade documentation. There is no present functionality in the Bolero.net system to determine taxes at the border (personal communication Arthur Vonchek, Chief Executive Officer, Bolero International Ltd. Aug. 13, 2007, on file with author). *See* Emmanuel T. Laryea, *Bolero Electronic Trade System – An Australian Perspective,* 16 J. Int. Banking L. 4 (2001) (examining the creation of Bolero.net as a successor organization to prior failed efforts at applying e-commerce to trade facilitation and concluding that Bolero.net has a good chance of surviving because (a) it learned from predecessor's errors, (b) it has

Customs Certification

Certification of tax compliance software used by importers would assure those who use it that their goods will pass unimpeded by a tax audit. There will be requirements for surety bonds, and automated adjustments to declarations and returns along with automated payments (or requests for refunds).

Three elements are needed for customs certification: (a) customs needs to be sure that the trader's system is always applying the correct rate; (b) customs needs to be sure that the system is always applying these rates to the correct goods, and (c) customs needs to be sure that the system is always using the correct tax base (the valuation of the goods). The first and second issues can be met with technology alone; the third requires technology, a law change (related to the local adoption of GVC Art. 13[378]), and an APA.

Customs certification – The Correct Rates

Swedish customs has answered the first question. In 2000 Swedish customs initiated construction of The Virtual Customs Office (VCO), which was "open for business 24/7" in February 2002. It has not been closed since.[379] The long term objective of the VCO is to provide seamless electronic processing over the whole value chain. Sophisticated e-services and total mobility is presumed. The system is fully financed by the government, and all services are free of charge.[380] The VCO is a success story. It processes 90% of all declarations electronically and deals through automated clearance with 70% of the declarations within three minutes.[381]

One of the most striking attributes of the VCO (aside from the fact that it is one of the first seventeen national SWs) is that the VCO actively interacts with the automated systems of traders. The VCO is not simply an extension of the passive ASYCUDA model that McMaster and Nowak describe as a pre-SW type of portal.

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survived early trials, (c) it is functioning in a more technology receptive environment and (d) it is dealing with governments that are far more receptive to e-commerce than had previously been the case).

[378] It is anticipated that penalties will apply in local legislation whenever customs declarations and amounts of tariff are re-determined. A similar problem is encountered in VAT, *see infra* note 443.

[379] Mats Wicktor, *The Virtual Customs Office – eServices for Traders, Citizens, Students,Press and Media*, 8 INT. J. COMM. L & POL'Y. 1, at 1 & 4 (2003) (the Director of the Swedish Customs Future Center explaining the background, development and implementation of the VCO, a project under his direct supervision) *available at* http://www.digital-law.net/IJCLP/8_2004/pdf/wicktor-paper-ijclp.pdf. *See also* Mats Wicktor, *Single Window Development and Implementation: Experience of Sweden,*UNECE CAPACITY BUILDING WORKSHOP ON TRADE FACILITATION IMPLEMENTATION: TOOLS, TECHNIQUES AND METHODOLOGIES, *available at:* http://www.unece.org/cefact/single_window/sweden/mats_wicktor.ppt

[380] UNECE *supra* note 370, at 19

[381] *Role of e-Government in Europe's Future,* 28 I-WAYS: DIG. ELECTRONIC COM. POL'Y & REG. 59, 60 (2005) (assessing the current state of e-government in Europe after the Communication from the Commission to the Council on the Role of e-Government for Europe's Future (COM(2003) 567 final)).

Recommendation 33 the UN/ECE, which is the primary UN document recommending global adoption of SWs for trade facilitation, describes the Swedish Virtual Customs Office as follows (emphasis supplied):

> The Virtual Customs Office (VCO) allows the submission, by electronic means, of customs declarations and of applications for import and export licenses, for licenses for strategic products and for both the import and export licenses. It can further be integrated into the business system of traders and can then automatically update changes in exchange rates, tariff codes and duty rates. The Single Window also includes all trade-related regulations and can provide traders with automated updates on changes via the internet and/or SMS-services…the VCO supports ten different languages.[382]

Thus, for example, a trader using a SAP ERP system with the SAP Global Trade Services software application[383] can integrate the Swedish VCO into their business system. This trader will receive automatic updates of exchange rates, tariff codes and duty rates along with related regulation and form changes. The accuracy of the trader's system (on the issue of rates and their application) should be easy to certify, provided it can be shown that all VCO updates are received and installed properly. This could be confirmed remotely.

Customs certification – The Correct Goods

The second concern is a mapping issue. Customs needs to be sure that the trader's product codes are correctly associated with customs codes. This could be a relatively easy matter for a company with a short list of goods being sold, or a more complex matter for a firm with a wide range of products. However, the automation of this function is a standard attribute of all ERP packages that incorporate add-on specialty software programs like SAP Global Trade Services.[384] It is standard functionality in these programs to blend custom code lists with product classification lists.

Mapping can be tested directly or remotely. The test involves the construction of a product matrix that can be run through an ERP system along with all related tax packages. The output will be checked against an "answer grid" much like a standardized test.

Customs certification – The Correct Valuation

The third concern is the tax base. How can customs be sure that a trader's system always uses the correct valuation for the imported goods, particularly in cases where the parties are related? Even though the vast majority of transaction values assigned by

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[382] *Id*. at 19 (emphasis added).
[383] JITENDRA SINGH, *supra* note 367 (discussing the SAP ERP system and the add-on SAP Global Trading Services program).
[384] *Id.* at 115-160, and specifically 116-19 for product classification and numbering schemes.

traders to their goods are accepted by customs,[385] the number of related party transactions involved in cross-border trade makes the determination of accurate values very important.[386]

Automated systems[387] are set up to specifically identify the invoice price based on the terms of sale[388] as well as (a) the statutory *additions* (commissions and brokerage,[389] containers and packing,[390] the four categories of assists,[391] royalties and license fees,[392] proceeds of resale,[393] transportation and related charges [CIF and FOB],[394] as well as warehousing between manufacture and clearance[395]) and (b) the statutory *deductions* (costs accruing in the country of importation in the categories of construction and maintenance, transportation after importation, and duties or taxes in the country of importation[396]).

Two elements of this price matrix are commonly subject to income tax transfer pricing adjustments: (1) the invoice price set out in the terms of sale may be undetermined (or inaccurate) at the time of import due to year end compensating adjustments made pursuant to an income tax APA, and (2) the royalty or license fees associated with the imported goods may be the target of a transfer pricing audit, resulting in changes to an important *addition* to customs value.

The problem in both cases is timing.[397] When income tax adjustments are being made to core financial elements of a transaction for income tax purposes, changes are being made to the financial accounts that are the basis of customs value. The problem is that these adjustments are recognized long after customs has liquidated the duty. In

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[385] SHERMAN & GLASHOFF *supra* note 59, at 199 (reporting on a GATT survey from 1982 indicating that the transaction value was accepted by customs 98.5% of the time in Norway; 94.0 % of the time in the US; 99+% of the time in Sweden; 100% of the time in Romania; 96.6% of the time in Japan; 86.8% of the time in Hungary; 93.1% of the time in Finland; and 96.4% of the time in the EU as a whole).
[386] There is an unstated issue in the "acceptance" of the vast majority of transaction values by Customs. A significant number of these related party "accepted values" could very easily be inaccurate, but the inaccuracy is not apparent until after Customs has liquidated the account. The examples considered further in this study include compensating adjustment pursuant to an APA and adjustments to related royalty payments pursuant to a income tax transfer pricing audit.
[387] JITENDRA SINGH, *supra* note 367, at 149-54.
[388] GVC *supra* note15, at Art. 1
[389] GVC *supra* note15, at Art. 8(1)(a)(i).
[390] GVC *supra* note15, at Art. 8(1)(a)(ii) & (iii).
[391] GVC *supra* note15, at Arts. 8(1)(b)(i) (materials, components, parts and similar items incorporated in the imported goods); 8(1)(b)(ii) (tools, dies, moulds, and similar items used in the production of the imported goods); 8(1)(b)(iii) (materials consumed in the production of the imported goods); 8(1)(b)(iv) (engineering, development, artwork, design work, and plans and sketches undertaken elsewhere than in the country of importation and necessary for the production of the imported goods).
[392] GVC *supra* note15, at Art. 8(1)(c).
[393] GVC *supra* note15, at Art. 8(1)(d).
[394] GVC *supra* note15, at Art. 8(1)(d).
[395] GVC *supra* note15, at Art. 8(2) and Commentary 7.1 in Annex III/B.
[396] GVC *supra* note15, at Annex I (Interpretive Notes to Article 1).
[397] Stated another way, the problem is the price. Even though both parties may know that a correct (arm's length) price will be paid, that numerical value is not known at the time that customs needs to know the price that was "actually agreed or payable."

effect, making either of these adjustments is a concession that the relationship of the parties has influenced the price.[398] These adjustments prevent acceptance of the transaction value. They compel the use of substitute valuation methods.[399] Can this be avoided?

A narrow exception to this timing problem is provided for in Article 13 of the GVC.[400] Article 13 "… provides for the possibility of delaying the final determination of Customs value, even though it is not always possible to determine the price at the time of importation."[401]

The mechanism that facilitates this exception is the placement of a price review clause or formula in the sales contract. Details on this mechanism are sparse, and the exception does not appear to be uniformly understood. The GVC is only directly concerned that when customs allows this delay that a "sufficient guarantee in the form of a surety" is provided by the trader. Details are specifically left to the "legislation of each party." There are a range of approaches as is evident when the understandings of the commentators, the Technical Committee on Customs Valuation, and US Customs and Border Protection are contrasted.

Commentators. Commentators suggest that a cost-plus contract would be acceptable under Article 13 even if "… the cost figures are not yet available at the time of importation. Where the formula is declared at entry and the figures are available not too long afterward, it seems clear that the formula will be accepted."[402]

Some commentators go further, and suggest that any income tax APA (not just a C+ formula) would satisfy the Article 13 criteria because, "[t]he TPM (transfer pricing methodology) of an APA is, for all intents and purposes, a method in existence prior to the date of export which should form the basis upon which adjustments can be made, either up or down."[403]

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[398] GVC *supra* note15, at Art. 2(a).
[399] GVC *supra* note15, at Arts. 2, 3, 5, 6, and 7. In fact, when US Customs attempted to solve this problem through a "reconciliation for adjustments made to the price of imported merchandise by related-party companies under 26 U.S.C.482" it required the use of methods equivalent to GVC Art. 7. "Each participant agrees that appraisement is under section 402(f) of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979, if, in fact, an upward section 482 adjustment is made for tax purposes." US Customs Notice, 60 Fed. Reg. 35105 (July 5, 1995).
[400] GVC *supra* note15, at Article 13 states:

> If, in the course of determining the customs value of imported goods, it becomes necessary to delay the final determination of such customs value, the importer shall nevertheless be able to withdraw his goods from customs if, where so required, he provides sufficient guarantee in the form of a surety, a deposit or some other appropriate instrument, covering the ultimate payment of customs duties for which the goods may be liable. The legislation of each party shall make provision for such circumstance.

[401] World Customs Organization, Technical Committee on Customs Valuation, Customs Valuation Compendium (CVC) at Com. 4.1 (1) (1997).
[402] Sherman & Glashoff *supra* note 59, at 83.
[403] Dennis I Meyer & William D. Outman, *US Tax and Customs Consequences of Dealing with a Related Foreign Supplier*, 12 J. Int'l Tax 30, 36 (2001) *available at*: http://www.bakernet.com/NR/rdonlyres/2D3F9B0F-F2CA-4C0F-B88F-

Technical Committee on Customs Valuation. The Technical Committee on Customs Valuation does not go as far as the commentators. It reasons from commercial practice where contracts "… include a price review clause whereby the price is only provisionally fixed, [and] the final determination of the price payable being subject to certain factors which are *set forth in the provisions of the contract itself*."[404] It would be uncommon for the pricing regimen of an APA to be set forth in a standard contract for the sale of goods between related parties, although it could be.

Three examples are provided by the Technical Committee on Customs Valuation. The first is based on the sale of "specially to order" goods where the final price is determined by an agreed formula that "… recognizes increases or decreases of elements such as cost of labor, raw materials, overhead costs and other inputs incurred in the production of the goods."[405] The second situation is the same as the first except multiple pieces are delivered over time, with the same formula applied in all cases, but the "final price of the first unit is different from that of the last unit."[406] In the third situation the contract determines the price based on an "… examination or analysis at the time of delivery (e.g., the acidity level of vegetable oils …)."[407]

Basing the import price on the production costs of the supplier produces two possible outcomes. The first is where the price review clause "… produces their full effect by the time of valuation…"[408] The second is when the "price review clause is linked to variables which come into play some time after the goods have been imported."[409] *Both* outcomes are acceptable to the Technical Committee on Customs Valuation.

US Customs and Border Protection. The US interprets price review clauses and formula more narrowly than either the commentators or the Technical Committee on Customs Valuation. The US requires not only that the formula be (1) *set forth in the provisions of the contract itself,* but that it be based on (2) *some future event or occurrence over which neither the seller nor the buyer have any control*.

This second condition conflicts with the first two examples used by the Technical Committee on Customs Valuation. The cost of labor, raw materials, overhead costs and other inputs incurred in the production of the goods are factors clearly *under the control* of the seller, and would not produce an acceptable result under US rules. The US approach is a direct consequence of a very different understanding of an acceptable formula in US regulations. The example provided is critically important:

392CCCF28798/28355/USTaxandCustomsConsequences2.pdf. *See also* JOVANOVICH, *supra* note 17, at 114-19.

[404] CVC *supra* note 401 at Com. 4.1 (1) (emphasis added).

[405] *Id.* at Com. 4.1 (2).

[406] *Id.* at Com. 4.1 (3).

[407] *Id.* at Com. 4.1 (4).

[408] *Id.* at Com. 4.1 (6) (emphasis supplied).

[409] *Id.* at Com. 4.1 (6) (emphasis supplied).

> In determining transaction value, the price actually paid or payable will be considered without regard to its method of derivation. It may be the result of discounts, increases, or negotiations, or may be arrived at by the application of a formula, such as *the price in effect on the date of export in the London Commodity Market*.[410]

The *price in effect on the date of export in the London Commodity Market* is clearly an event outside the control of the buyer and the seller. This example is read by USCBP *not* as one-of-many possible understandings of how a formula would work, but as the only understanding of a formula under US rules.[411]

This interpretation is consistently re-affirmed in Customs rulings. Thus, not only is the US regulatory example narrower than the examples used by the Technical Committee on Customs Valuation, but its use by Customs makes it a firm limitation on the application of formulas. For example, a common expression of the US Customs policy is presented as follows:

> … if the price paid or payable is determined pursuant to a formula, a firm price need not be known or ascertainable at the time of importation, although it is necessary for the formula to be fixed at that time so that a final sales price can be determined at a later time on the basis of some future event of occurrence *over which neither the seller nor the buyer have any control*.[412]

Customs certification and the IT-APA

Customs certification in the context of an IT-APA is a two-part process: (1) a comprehensive assessment of the taxpayer's tax software is undertaken, followed by (2) a pricing agreement that not only specifies the methods used to determine prices, but also a detailed explication of how pricing adjustments are carried through to the invoice level. In the IT-APA the taxpayer will agree to operate its *certified* system as specified in the certification assessment, without change. If changes in the system are necessary, a re-certification will be performed. In addition, the taxpayer will agree to carry all pricing adjustments to the invoice-level and, if necessary, re-invoice goods, services or intangible transactions to accommodate changes made.

Because a tax software program is no more than a very complex formula, which is used to determine the price paid or payable, "… by the time of valuation … [or] some time after the goods have been imported,"[413] an IT-APA fits squarely within the Technical Committee on Customs Valuation's understanding of GVC Article 13, provided that it is "… *set forth in the provisions of the contract itself*."[414] If an IT-APA is

[410] 19 CFR 152.103(a)(1).
[411] Although 19 CFR 152.103(a)(1) is followed by five more detailed examples of how to determine the price actually paid or payable, none of them deal with the application of a formula
[412] 16 Cust. B. & Dec. 905, HQ 542701 (Apr. 28, 1982). *See* Sean Foley, Todd R. Smith & Vanessa Francisco *supra* note 349 at n.11 (also referencing 17 Cust. B. & Dec. 837, HQ 542975 (Mar. 9, 1983).
[413] CVC *supra* note 401 at Com. 4.1 (6)
[414] *Id.* at Com. 4.1 (1) (emphasis added); *see supra* text at note 404.

referenced in the contract, then the Customs Administration will have already undertaken a comprehensive assessment of the taxpayer's software. Referencing an IT-APA in the contract for sale will mean that Customs has examined the trader's software and has certified that the software (a) always uses the correct rate, (b) always maps transactions to the correct goods, and (c) always applies tax to the correct valuation of the goods.

Certification of the rates. Customs administrations that adopt the Swedish VCO model can easily certify that the rates used in a taxpayer's system are the correct rates if the VCO is "…integrated into the business system of trader … [and] automatically update[s] changes in exchange rates, tariff codes and duty rates."[415] Customs can test the taxpayer's system remotely, if need be, to determine whether or not the updates were received and were installed properly.

A Swedish-style VCO is not required. Under the US Streamlined Sales Tax (SST)[416] a similar function is performed by the State through the "taxability matrix" which is required to be made available in downloadable form, and which specifies the rates applied to each product taxed by the State.[417] Sellers who rely on the matrix are relieved of liability for errors in the matrix.[418] Under an SST model it would be more likely that Customs would need to test the taxpayer's system (remotely if need be) to determine that updates are received and properly installed.

A third option (also applied under the SST) would be to facilitate the use of certified service providers (CSP)[419] – third parties who would be responsible for maintaining the software that determines tax compliance. Customs would then need to certify that these parties maintained accurate systems. In this instance one certification would carry through to multiple users, or clients of the CSP.

A fourth approach would be for the Customs Administration to audit the taxpayer's tax research department and make a determination whether or not the taxpayer updates its software system accurately and in a timely manner. Once again, verification could be remotely validated. However, in terms of a "fixed formula," this approach might not be as acceptable.

Certification of the mapping and other system functions. Customs administrations will need to certify the mapping of taxpayer product codes to the customs codes, and

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[415] *See supra* text at note 382.
[416] *See supra* text at note 7.
[417] SSUTA *supra* note 7, at § 328(A).
[418] SSUTA *supra* note 7, at § 328(B).
[419] Uniform Sales and Use Tax Administration Act (USUTA) (as approved on Dec. 22, 200, and as amended on Jan. 22, 2001) § 9(a) (indicating that, "A seller that contracts with a Certified Service Provider is not liable to the state for sales or use tax due on transactions processed by the Certified Service Provider unless the seller misrepresented the type of items it sells or committed fraud. In the absence of probable cause to believe that the seller has committed fraud or made a material misrepresentation, the seller is not subject to audit on the transactions processed by the Certified Service Provider. A seller is subject to audit for transactions not processed by the Certified Service Provider.") The USUTA is the "enabling" legislation that authorizes a State's participation in the SSUTA.

other system functions. The Governing Board of the SST performs a certification of the mapping process in the context of the American retail sales tax.[420] The Governing Board has completed one round of software certifications.[421] In practical terms the certification of the mapping function of customs software would be verification that the installation and set-up of an add-on specialty software program like SAP Global Trade Services has been done correctly, and that the software performs as expected.

Customs standards for mapping certification can be independently developed, or can be borrowed from other certification regimes. The standards for SST certification were derived from third party sources: (1) the AICPA's SAS 94[422] and (2) the US-GAO Federal Information Systems Control Audit Manual.[423] In addition, CSP's and CAS software developers were required to comply with (3) ISO Number 17799[424] of the International Organization for Standardization.[425]

Similar third-party software standards have been developed in VAT. For example, HMRC in partnership with the British Standards Institution (BSI) has recently developed a standard for VAT accounting software.[426] The result is Publicly Available Specification (PAS) 76 - an independent technical specification detailing how accounting software should process VAT.[427] At the present time these VAT standards are not used to certify VAT software.

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[420] SSUTA *supra* note 7, at § 501(a).

[421] On June 12, 2006 the first three software providers were certified as certified service providers (CSP): Avalara, ADPTaxware and Exacor. ADPTaxware was the only company with a product that was deemed to be a certified automated system (CAS). Streamlined Sales Tax Project, CERTIFIED SERVICE PROVIDERS, http://www.streamlinedsalestax.org/certified%20service%20provider.htm

[422] AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, PROFESSIONAL STANDARDS, Vol. 1 AU § 319 *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*, as amending SAS No. 55 Consideration of Internal Control in a Financial Statement Audit.

[423] U.S. GOVERNMENT ACCOUNTING OFFICE, ACCOUNTING AND INFORMATION MANAGEMENT DIVISION, FEDERAL INFORMATION SYSTEMS CONTROL AUDIT MANUAL, (FISCAM) Vol. 1 (GAO-AIMD12.19.6) *available at* http://www.gao.gov/special.pubs/ai12.19.6.pdf (last visited Aug. 2, 2006).

[424] INTERNATIONAL ORGANIZATION FOR STANDARDIZATION, ISO 17799: INFORMATION TECHNOLOGY, SECURITY TECHNIQUES, CODE FOR INFORMATION SECURITY MANAGEMENT (ISO/IEC 17799:2005).

[425] STREAMLINED SALE TAX PROJECT, CERTIFICATION STANDARDS (rev. 5/17-04) (provides a detailed application of SAS 94, FISCAM and ISO 17799 to the SSUTA) *available at* http://www.streamlinedsalestax.org/ (last visited Aug. 2, 2006).

[426] See the announcement at: HMRC, A NEW STANDARD FOR VAT ACCOUNTING SOFTWARE, *available at* http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_ShowContent&propertyType=document&id=HMCE_PROD1_025678#downloadopt

[427] The British Standards Institute indicates that the Specifications aim to:

- form the basis of an accounting systems that facilitates the production and retention of VAT accounting records and declarations
- provide warning of potential VAT errors by applying controls to data input and processing
- offer the ability to self-audit records for VAT purposes by way of reports that apply tests to the retained data to assist in the identification of potential errors, transactions inconsistent with expected or known business activities, and transactions that make up any declared totals

The Australian Tax Office is further along than the HMRC in the development of tax software standards. However, unlike the SST, the Australian Tax Office does not certify the accuracy of the software it only uses its standards to produce a self-test tax matrix.[428] The ATO then posts on its Software Industry Information Centre website (for all those who pass the self-test) the name of the developer and the name of the software program as well as a statement (by the developer) that the software has passed.[429] Tests are available in eleven tax categories including income tax and GST. Currently 342 developers and software products are listed.[430] The OECD expects that a variety of objective standards for certification of tax software programs will be developed for global use.[431]

Certification of the valuation. If a contract references an IT-APA the reported transaction value will always be tentative. An IT-APA indicates (pursuant to Article 13) that there may be a "… delay in the final determination …" of customs value. The importer may nevertheless "…withdraw his goods from customs [but may be required to] … guarantee in the form of a surety, a deposit or some other appropriate instrument, covering the ultimate payment of customs duties for which the goods may be liable."

- offer the ability to make accounting data available to HM Revenue & Customs auditors or other third parties
- offer the ability to provide the information needed to evidence the accuracy and completeness of any VAT-related declaration.

Thus, PAS 76 specifies requirements for accounting software which records, creates and stores transactions relevant to outputs, output tax, inputs and input tax, and which supports the reporting of them for declaration on a Value Added Tax (VAT) return. BRITISH STANDARDS INSTITUTION, PAS 76: ACCOUNTING SOFTWARE – VALUE ADDED TAX IN THE UK – SPECIFICATION, *available at:* http://www.bsi-global.com/en/Standards-and-Publications/Industry-Sectors/ICT/ICT-standards/PAS-76/?recid=2022

[428] AUSTRALIAN TAX OFFICE, SOFTWARE DEVELOPER'S HOME PAGE, (providing test matrix for software developers) *available at*: http://203.98.78.35/home.asp

[429] The following disclaimer is posed on the Software Developer's Home Page by the Australian Tax Office:

> The Software Developers Homepage and Product Register has been developed by the Tax Office to assist businesses and individuals to obtain information about software which may assist them to meet their taxation obligations. The Product Register contains a list of software producers who have provided a declaration to the Tax Office that the software has been tested by the producer against some test scenarios provided by the Tax Office, and producers who have agreed to the Conditions of Use.
>
> Software producers who register and provide the declaration may list their software on the Product Register. This, however, does not constitute an endorsement, sponsorship or approval of such products by the Tax Office.

Australian Tax Office, Software Developer's Home Page Disclaimer, *available at*: http://203.98.78.35/disclaimer.asp

[430] Australian Tax Office, *TAXfacts: Software Industry Information Center for Tax-Related Software Developers*, NAT9874-09.2003.

[431] OECD, ELECTRONIC COMMERCE: FACILITATING COLLECTION OF CONSUMPTION TAXES ON BUSINESS-TO-CONSUMER CROSS-BORDER E-COMMERCE TRANSACTIONS 17-18 (Feb. 11, 2005) (discussing a range of government "approvals" for tax accounting software and indicating that at one extreme is "accreditation" – an approval process functions simply as a mechanism to "formally identify" software that meets certain criteria of acceptability [the Australian approach] – while at the other extreme is "certification" – an approval process that designates software as "an officially authorized mechanism to perform specified functions" [the SST approach]) *available at* http://www.oecd.org (last visited Aug. 2, 2006).

The critical element of an IT-APA is its insistence that pricing adjustments be granular. An IT-APA has a dual focus; a price determination focus and an IT implementation focus. The pricing focus is the traditional concern of an APA, but the IT element of the IT-APA insists on pricing-granularity. It is not sufficient under an IT-APA for an agreement to be reached indicating that aggregate royalty amounts between related parties will be determined by applying a specific formula. An IT-APA will further specify how an aggregate royalty will be allocated, apportioned or associated with goods, services, or other intangible transactions between the parties. An IT-APA will direct invoice-level changes in related party transactions.

Thus, an IT-APA will specify how year-end pricing adjustments (compensating adjustments) will be reflected in the tax and financial accounts and on invoices. An IT-APA will also specify the granular treatment of adjustments made in circumstances where the economic assumptions that underpin the APA are not met. In other words, where the failure to meet economic assumptions extinguishes the traditional APA, aspects of the IT-APA will remain active; directing the granular treatment of pricing adjustments that could be made under other methods if either (a) an audit results, or (b) the taxpayer files under different methods without audit.

IT-APA – A Customs Example

Assume that Parent Company manufactures and sells high technology medical devices and a suite of customized software applications through wholly owned foreign subsidiaries that in turn resells them in the foreign jurisdictions. Assume the medical device is exempt from duty and the customized software is subject to 10% duty. Assume further that an IT-APA is entered into where a key economic assumption is that the resale market for the medical device and the software is between 10,000 and 20,000 units per year. Under this assumption the APA states that (1) a cost-plus method would be applied to the medical device and a gross profit markup of 20% would be appropriate based on comparables selected, and (2) a 90/10 residual profit split (Parent/ Subsidiary) would be applied to the software applications.

Costs are expected to be 1,000 for the medical device. It is invoiced at 1,200 (20% higher than cost estimates). Rough estimates of costs and selling price for the software are used to set the invoice price for the software at 190. This is based on an expected resale price of 200, where aggregate costs of 100 leaves 90 in profit to be allocated to the parent (thus the invoice price of 190) and 10 in profit to remain with the subsidiary.

Compensating adjustment. If 15,000 units (of each product) are sold in the year, the IT-APA will be fully effective. When a compensating adjustment is made at the end of the year to take into account the actual costs and profits it turns out that an additional 150,000 in profit should be allocated to the Parent for sales of the medical device, and an additional 1,350,000 in profit should be allocated to the Parent for sales of the software.

Because the technology focus of an IT-APA is concerned with *granular-pricing adjustments*, the IT-APA will have an allocation formula that will indicate how the compensating adjustment is to be allocated among the specific transactions. If the IT-APA in this case allocates pro-rata for both the medical device and the software, then the revised invoice price for each medical device will be 1,300,[432] and the revised invoice price for the software will be 280.[433]

If the Customs Administration had certified the trader's software system, changes in the invoice price for the medical device and the customized software would immediately generate revised customs declarations. Because the software is subject to a 10% duty an additional payment of 135,000 will be generated and paid (probably both automatically and electronically) with the revised customs return.[434]

Key economic assumption violated. If instead of selling 15,000 units the market demand for the medical device and customized software was extraordinary with 30,000 medical devices sold and 1,000,000 customized software units. Perhaps unexpected demand for the software arose as remote medical locations decided to install software locally that would be associated with a shared medical device held in a central location.

Even though the size of this market is wholly unexpected by the Parent, the invoices drafted for sales to the Subsidiary Company remain at 1,200 for the medical device and 190 for the customized software. The prices are determined (as before) under best estimates based on the cost-plus and residual profit split methods. However, because the key economic assumption of the IT-APA is violated, neither the cost-plus nor the residual profit split methods set out in the IT-APA control pricing.

Assume that demand for the medical device and software are reflected in a premium being paid at retail – the medical device regularly sells for 2,000 (instead of an anticipated 1,500) and the software sells for 300 (instead of an anticipated 200). An audit determines that the resale price (rather than the cost-plus method) best measures the pricing of the medical device. A gross profit margin of 25% applies. In addition the residual profit-split is deemed to still be the best pricing measure for the software, however the allocation percentage is adjusted to 75/25 (Parent/ Subsidiary) instead of 90/10.

Unlike a traditional APA, the IT-APA is not fully extinguished when key economic assumptions are violated. Even though the pricing methodologies of the IT-APA are no longer deemed to control pricing, the technological aspect of the IT-APA

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[432] If the aggregate adjustment to the Parent Company is 150,000, and 15,000 devices are sold, then the adjustment per medical device is 100. Thus, the invoice for the medical devices between the Parent and Subsidiary will need to be revised from 1,200 to 1,300.

[433] If the aggregate adjustment to the Parent Company is 1,350,000 (representing 90% of the additional profits generated by the software) and if 15,000 software units are involved, then the additional adjustment per software unit is 90. (An additional 10 in profit per unit was allocated to the Subsidiary Company.) Thus, the invoice for the software should be increased from 190 to 280 per unit.

[434] Penalties and interest may also apply. If so, a certified automated system would perform this calculation also.

remains active. There remains a concern with translating pricing adjustments into *granular-pricing* changes at the invoice level. Thus, in the above case, a transfer price of 1,500 (instead of 1,200) applies to the medical devices, and a transfer price of 250 (instead of 190) applies to the customized software, if the pro-rata allocation rule remains the governing allocation mechanism under the IT-APA in circumstances where the key economic assumptions of the IT-APA are violated.

As before, because the trader's software system has been certified by the Customs Administration, changes in the invoice price for the medical device and the customized software would immediately generate revised customs declarations. The software is subject to a 10% duty, thus an additional payment of 6,000,000 would be generated and paid (probably both automatically and electronically) with the revised customs return.[435]

The IT-APA – IT/VAT

Every jurisdiction considered in this study harmonizes VAT and customs valuation at the borders.[436] Thus, if the automated system that calculate customs tariffs, duties and fees is certified for customs purposes, the system is certified for VAT purposes. Away from the borders the question for the IT-APA is one of scope, based on where a jurisdiction is on the objective/ subjective valuation continuum. There are three permutations.[437]

In some jurisdictions valuation (away from the borders) is entirely subjective. These countries tend to be developing countries. Very few pricing adjustments are made in these jurisdictions for any reason. As a result an IT-APA would have a very limited VAT scope.[438] A second approach is applied in most of the developed countries. In these cases transfer pricing rules are applied to a small subset of all related party transactions. The limitation is that only transactions among related parties where a real loss in VAT revenues is expected are within the scope of the transfer pricing rules. These are cases where either the buyer or the seller is not entitled to full input credits. Thus, the VAT scope of the IT-APA would be similarly limited.[439] A third group of jurisdictions applies transfer pricing rules whenever the parties to a transaction are related. As a result the VAT scope of the IT-APA would be broad, and if the VAT-definition of related party

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[435] Because the original invoice price for the software is 190 the pro-rata revision of the invoices to 250 subjects an additional 60 to the 10% duty. If 1,000,000 software units are sold, an additional 6,000,000 in duty is payable.
[436] For example, see the rule in all 27 cuntries of the the EU (*supra* note 21), Japan (*supra* note 162), New Zealand (GOODS AND SERVICES TAX ACT, 1985 (N.Z.) at §12), Canada (EXCISE TAX ACT, R.S.C., ch. E-15, §212 (Can.)), Iceland (VALUE ADDED TAX ACT, No. 50 at Art. 34 (1998) (Iceland)), South Africa (1991 SA REVENUE 89; REVENUE, VALUE-ADDED TAX ACT No. 89 of 1991 at § 7(3)(b) (South Africa)), Fiji (1991 REPUBLIC OF FIJI 45; VALUE ADDED TAX DECREE No. 45 of 1991 at § 14(2) (Fiji)), Jamaica (THE GENERAL CONSUMPTION TAX ACT, 1991 at §8(1)(a) (Jamaica), Singapore (GOODS AND SERVICES TAX ACT, Cap 117A, at §8(4)(Sing.).
[437] *See supra* text at notes 26 to 29.
[438] Although most of the jurisdictions in this category are developing countries, there are a large number of them. This is the old position of the EU. S*ee supra* text at note 26.
[439] This is the current position of the EU. *See supra* text at note 28.

matched the income tax definition of related party, the IT-APA would match the scope of the income tax.[440]

Example: Transfer Pricing in VAT

It may not be obvious why some of the most developed VAT jurisdictions do not adjust all related party transactions to the arm's length standard (open market value). This limitation places a filter on the pass-through of APA-derived transfer pricing adjustments in IT-APAs. This kind of filter is a normal attribute of automated systems that is easily accommodated at setup through the user interface. This filtering functionality would be certified in an IT-APA. An example is helpful.

Assume Parent Company (PC) manufactures X and has no taxable inputs. PC sells X to its wholly owned Subsidiary Company (SC) for 100, even though the open market value for X is 1000. SC the re-sells X to a Third Party (TP) for 1500. If the VAT rate is 5%, the following occurs:

- PC invoices SC 100 + 5 in VAT.
- PC files a VAT return – tax remitted is 5.
- SC invoices TP 1,500 + 75 in VAT.
- SC files a VAT return – tax remitted is 70 [75 – 5 = 70]
- TOTAL REVENUE = 75

If PC sells to SC at the open market value of 1,000 the total revenue result is the same (although there will be timing or cash-flow differences.) The following occurs:

- PC invoices SC 1000 + 50 in VAT.
- PC files a VAT return – tax remitted is 50.
- SC invoices TP 1,500 + 75 in VAT.
- SC files a VAT return – tax remitted is 25 [75 – 50 = 25]
- TOTAL REVENUE = 75

Because total revenue is the same whether PC charges SC below market (100) or at the correct open market value (1,000), there is no reason (other than cash flow) for the government to compel taxpayers to invoice these related parties correctly.

The result is very different when SC's sales are exempt. In this case total revenue is impacted, because SC will be denied deductions for related input VAT. If SC's sales are exempt the following occurs:

- PC invoices SC 100 + 5 in VAT.
- PC files a VAT return – tax remitted is 5.
- SC invoices TP 1,500 + 0 in VAT.
- SC files a VAT return – tax remitted is 0
- TOTAL REVENUE = 5

If PC sells to SC at the open market value of 1,000 the total revenue result is the very different. The following occurs:

[440] The Australian GST falls in this category. *See supra* text at note 29.

- PC invoices SC 1000 + 50 in VAT.
- PC files a VAT return – tax remitted is 50.
- SC invoices TP 1,500 + 0 in VAT.
- SC files a VAT return – tax remitted is 0.
- TOTAL REVENUE = 50

In this situation there is considerable incentive for taxpayers to under value sales to related parties, and as a result this is where many tax jurisdictions apply transfer pricing rules in VAT.

VAT Certification

Certification of tax compliance software in VAT will follow one of the regimes already in place. Two models are available today. The US retail sales tax has a fully operational model under the Streamlined Sales Tax.[441] The UK is in the final stages of implementing a VAT model under PAS 76 in cooperation with the British Standards Institute. Both regimes are voluntary.[442]

As with customs certification, there are three basic elements in a VAT certification regime: (a) VAT authorities need to be sure that the system is always applying the correct rate; (b) VAT authorities need to be sure that the system is always applying these rates to the correct goods, and (c) VAT authorities need to be sure that the system is always using the correct tax base (the valuation of the goods). Once again, the first and second issues can be met with technology alone; the third requires technology, a law change (relating to penalties that are imposed when a VAT return either understates a liability or overstates an entitlement to repayment of VAT credits[443]), and an APA.

VAT certification – The Correct Rates

There should be very little difference between customs and VAT certification that the correct rates are being used. Four approaches were suggested in the customs section:[444] (1) the Swedish-style VCO approach, (2) the "taxability matrix" approach used under the SSUTA, (3) the certified service provider (CSP) approach under the SSUTA, and (4) the direct certification of research capacity of the taxpayer's tax department.

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[441] SSUTA *supra* note 7.

[442] Seller registration under the SSUTA is voluntary, SSUTA *supra* note 7, at §301. Implementation of PAS 76 is also voluntary, PAS 76, *supra* note 427, at iii.

The SSUTA agreement goes further than PAS 76. Under SSUTA, the mechanism of using third-party vendors as tax collection agents certified by the state literally allows vendors to transfer all sales and use tax collection functions (at no cost to the vendor) to third party software providers (CSP) [SSUTA §203], or through certified automated systems (CAS) [SSUTA §202], or still further through certified proprietary systems (CPS) [SSUTA §207]. Using these systems insulates the vendor from liability from erroneous tax collection, except in the case of misrepresentation or fraud [SSUTA §§306 & 328].

[443] A similar issue was referenced (but not explored) under customs rules in the text at *supra* note 378.

[444] *See supra* text at notes 379 to 383.

Most likely, the same approach to rate certification will be taken under both the customs and the VAT components of the IT-APA. The issues are identical.

VAT certification – The Correct Goods

Similarly with the certification that the correct goods are being associated with the correct rates, the issue is verification that product codes are mapped to the correct tax codes.[445] This functionality is a standard attribute of all ERP packages that incorporate add-on specialty software programs that determine VAT compliance.

Mapping can be tested directly or remotely. The test involves the construction of test scenarios that can be run through the ERP system. The output will be checked against an "answer grid" much like a standardized test.

VAT certification – The Correct Valuation

The third concern is the VAT tax base. Automated systems are designed to pull the tax base figures from the invoice files in the ERP financial package. In most cases identifying the price recorded on the printed invoice is all that is needed. Problems arise when this value needs to change.

With the granular pricing adjustments made by an IT-APA the invoice price can change in two ways. An IT-APA will potentially re-determine the *customs value* (and consequently the related VAT valuation) after importation.[446] In addition, *income tax adjustments* not associated with customs may change prices (sales of services not related to the sales of goods, for example), and require corresponding adjustments to invoices and VAT determinations. A certified system will filter these income tax adjustments so that only those among related parties (as understood in the domestic VAT law) will be carried forward. However, in those instances where pricing changes do impact VAT determinations, returns will most likely have been filed, and invoices will have been issued. A certified system will automatically generate corrected invoices, produce amended returns, and make additional payments or request refunds as appropriate.

Under current rules penalties apply under customs (non-disclosure related to valuation)[447] and VAT (understatement of liability or overstatement of entitlement to repayment of credits).[448] These penalties can be significant, and would need to be reduced or eliminated in instances where the operation of a certified system under am IT-APA required payments of additional tax, amended returns or invoices. In both instances the reason for eliminating the penalties is that precise customs and VAT amounts were undeterminable at the time calculations were made, and that reasonable

[445] *See supra* text at note 384.
[446] *See supra* text at notes 385 to 412.
[447] SHERMAN & GLASHOFF *supra* note 59, at 74.
[448] For example under the UK VAT penalties for understatement of liability, or overstating an entitlement to repayment of VAT credits (and the amount of the VAT which would have been lost is £1 million or 30% of the gross amount of VAT) is 15% of the VAT which would have been lost. Value Added Tax Act, 1994, §§ 63, 71(2) & Sch. 13, para. 15 (UK); VAT Notice 700/42/02 (UK)..

assurances were presented (through the IT-APA) for adjustments when more complete information became available.

The IT-APA – IT/Income Tax

On the transaction tax side (customs and VAT) the focus of this study has been on certification of transaction tax software systems. On the income tax side it is not software that is certified, it is the appropriateness of a pricing methodology that is certified. The most important aspect of this certification in the IT-APA context is its granularity.

In other words, it is not sufficient under an IT-APA for the agreement to specify the method that will produce an agreed arm's length price (given a specific set of economic and market assumptions). The IT-APA must go further. It must accommodate the needs of the *certified transaction tax system* that is integrated into the taxpayer's ERP system and allow these programs to recalculate values for customs and VAT purposes, even if the time of that recalculation is at a distance from the moment when the transaction occurred. An IT-APA must specify the elements and identify the specific links that will break an aggregate pricing adjustment down into product and invoice-specific elements.

The IT-APA is primarily concerned with vertical harmonization of transfer prices among income tax, customs and VAT. It is unilateral. An IT-APA may be associated with bilateral or multilateral pricing agreements, but these agreements are not a necessary part of the IT-APA. Its focus is not the avoidance of double taxation between jurisdictions (horizontal harmonization) but rather to avoid inconsistent valuations among multiple tax types within a single jurisdiction (vertical harmonization).[449]

APAs and ACRs

Under today's global matrix of income tax, customs and VAT rules, the IT-APA cannot be the *whole answer* to the vertical harmonization question, nor can they be the *final answer*.

IT-APAs cannot be the *whole answer* for the simple fact that not all jurisdictions that have transfer pricing rules in the income tax, and of those that do, not all of them have an established APA program. Fortunately, there is a fall-back advance ruling system in customs. Advance Customs Rulings (ACRs) are available in many, but again not all, customs jurisdictions. Thus, the concept of an IT-ACR will also be proposed.

IT-APAs cannot be the *final answer* because they are partial remedies to a systemic problem. Only those with resources can afford to apply, the tax results for those who are successful in acquiring an APA are different from the tax results the rest of the

[449] This "inconsistency" may result in over or under taxation. It is similar to, but probably not exactly equivalent to the familiar dichotomy of "double taxation/ non-taxation" that is a familiar expression in the horizontal harmonization literature.

population receives, and the rules and methods applied are confidential. APA's are criticized as "private tax law." An IT-APA can be justified as an *incubator of ideas and solutions* applied to the vertical harmonization problem. This issue (the final answer) will be taken up last section of this study.

Advanced Pricing Agreements. APAs are dedicated vehicles for resolving transfer pricing issues in income tax regimes in advance of filing an income tax return. APAs are a recent procedural development that is increasingly becoming an important part of domestic income tax rules. Adoption has been rapid and global in scope (at least among those jurisdictions with an active enforcement presence in income tax transfer pricing).

Beginning in Japan in 1987 where it was known as the pre-confirmation system,[450] the APA system spread widely after the US introduced its program in 1991.[451] Guidelines for APAs appeared in Canada (1993), the Pacific Association of Tax Administrators (1994),[452] OECD Guideline (1995), Australia (1995), Mexico(1995), New Zealand (1995), Korea (1996), People's Republic of China (1998), UK (1999), France (1999) Netherlands (2001) Germany (draft guidance in 2000, finalized in 2006), Italy (2004), Poland (2006), Hungary (2007), and on June 5, 2007 guidelines on APAs were endorsed and recommended for all 27 EU Member States by the EU Council of Ministers of Economy and Finance (ECOFIN).[453]

Advanced Customs Rulings. ACRs have been around for much longer than APAs. In fact, it was an advanced customs ruling which was at the heart of the *Brittingham*[454] case. The ruling in *Brittingham* was issued in 1958 a full thirty-three years before the US put an APA program in place.

ACRs are national trade facilitation measures. They are not internationally harmonized (or required) under GATT.[455] As a result not every jurisdiction allows them,

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[450] Ken Okawara, Mark T. Campbell & Karl Gruendel, *Status Report on Advanced Pricing Arrangements: National Tax Agency's APA Program Report and Current State of APA Program,* 11 INT. TRANSFER PRICING J. 138 (May/Jun 2004) (summarizing and assessing the first report of the Japanese National Tax Agency on the Japanese APA program).
[451] *Rev.Proc.*91-22, 1991-1 C.B. 526.
[452] PATA is an association formed by the tax administrations of Australia, Canada, Japan and the United States. *See* Steve S. Saeger, Rahul Tomar & Deloris R. Wright, *Comment on PATA Guidance for Bilateral APAs,* 12 INT. TRANSFER PRICING J. 3 (Jan./Feb. 2005).
[453] Qin Xu, *New Advance Pricing Agreement Procedure*, 12 INT. TRANSFER PRICING J. 69 (Mar./ Apr. 2005); Zaid S. Sethi, *Advance Pricing Agreements: The Way Forward?* 14 INT. TRANSFER PRICING J. 185 (May/Jun. 2007); Sylwia Rzymkowska, *Initial Experience with APA Practice and Update on Recent Changes to APA Procedures,* 14 INT. TRANSFER PRICING J. 116 (Mar./Apr. 2007); 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 Guidelines for Advance Pricing Agreements within the EU, COM(2007) 71 final.
[454] Brittingham *supra* note 75, at 390 ("… the material facts [were] asserted in 1958 in [an] application to the Bureau of Customs for a ruling on the dutiable value of tile manufactured in Mexico …").
[455] Standard 9.9 of the Revised Kyoto Convention provides guidance to countries that want to establish binding rulings/ advance rulings programs. The WCO summary is *available at*: http://www.wcoomd.org/ie/WTO/Binding%20Rulings%20-%20TP.pdf. *See also* WORLD CUSTOMS

and those that do allow them have inconsistent rules. There are WTO proposals to make ACRs an obligation for all members in the context of the current trade facilitation negotiations, but they remain proposals.[456] The level of attention ACRs have received lately has contributed to law changes in several jurisdictions.[457] But in other jurisdictions there is little sign of progress.[458] There are offers of technical assistance and capacity building from developed countries to make ACRs workable in developing countries.[459]

ORGANIZATION, KYOTO CONVENTION: GENERAL ANNEX GUIDELINES, Ch. 9: *Information, Decisions and Rulings Supplied by Customs* 10-12, at ¶3.7 to 3.12 (July 2000) (considering Standards 9.9 on binding rulings, sampling of goods, notification of binding rulings, time-limits for validity of rulings, use of binding rulings, annulment of binding rulings).

[456] Australia, Canada and the US proposed an ACR as part of the GATT Article X obligations. The proposals were made to the Negotiation Group on Trade Facilitation, and are reproduced at: WTO NEGOTIATIONS ON TRADE FACILITATION COMPILATION OF MEMBERS' TEXTUAL PROPOSALS 13 TN/TF/W/43/Rev.12 (Jul. 25, 2007). The proposal is:

> A Member shall issue an advance ruling in a time bound manner to an applicant submitting a written request which contains all necessary information.
>
> An advance ruling applies in respect of the applicant for a reasonable period of time after its issuance, unless:
>
> > i) the facts or circumstances supporting the original ruling have changed, and
> > ii) the Member notifies the applicant in writing of any revocation or modification of the ruling.
>
> A Member shall publish, at a minimum, (i) the time period by which it will issue an advance ruling, (ii) the length of time for which the advance ruling is valid, and (iii) what information is necessary from the applicant to issue an advance ruling[456].
>
> A Member shall provide, upon the request of the applicant, for a review by the issuing authority of the advance ruling or the decision to revoke or modify the advance ruling[456].
>
> A Member shall endeavor to make available information on advance rulings which are considered to set a wider precedent applicable to other traders, taking into account the need to protect commercially confidential information.

Note 1: An "advance ruling" is defined as: "a determination of a Member, provided in writing to an applicant, of the tariff classification [other subject matter such as customs valuation, duty drawback] of a good for customs purposes, prior to the commencement of trade in the good concerned."
Note 2: An applicant for an advance ruling is defined as: "an importer, exporter or producer, or a representative of an importer, exporter or producer."
Available at http://www.wto.org/english/tratop_e/tradfa_e/tradfa_negoti_docs_e.htm (the document TN/TF/W/43/Rev.12 can be found in the Working documents of the Negotiating Group on Trade Facilitation (Document code TN/TF/W/*) 2007.

[457] For example, effective January 1, 2007 Papua New Guinea has instituted a "Binding Rulings/ Advance Rulings" procedure that is " … part of the modernization process being undertaken by the PNG Customs Service to enable it to accede to the World Customs Organization's Revised Kyoto Convention on Simplification and Harmonization of Customs Procedures. … [where] the most common decision issued by Customs at the present is tariff classification, origin and valuation." Papua New Guinea Customs, *Information Sheet: Binding Rulings/ Advance Rulings* (Nov. 2006) *available at*: http://www.customs.gov.pg/PDF_files/Information/Binding%20Rulings.pdf.

[458] Dushni Weerakoon, Jayanthi Thennakoon & Bilesha Weerartne, *Multilateral Agreement on Trade Facilitation Important but Complex Agenda for South Asia* in SOUTH ASIAN POSITIONS IN THE WTO DOHA ROUND – IN SEARCH OF A TRUE DEVELOPMENT AGENDA 283 (2005) (indicating, "… in tha case of Bangladesh, Pakistan and Nepal there is still no progress reported with regard to advance rulings. None of

Although an IT-ACR can be imagined, it is not as complete an answer to the vertical harmonization question as is an IT-APA. It is difficult for customs (alone) to accommodate (in advance) changes that occur in prices over time. For example, customs has difficulty establishing a value for goods in advance (or is resistant to being bound by a determination of value in advance) when legitimate price changes can occur: (a) at the time of importation, because of normal market conditions, (b) a short time after importation, through year end (foreign) compensating adjustments, and (c) a long time after importation, through audit adjustment initiated by revenue actions taken against an overseas related party.

These final two categories are particularly an issue for developing countries. If a country does not have an active income tax transfer pricing regime, domestic subsidiaries can be notified of potential customs-impacting price changes that are being imposed on a related party by a foreign tax authority. An ACR that binds customs to a specific *numerical* price would be far more problematical than an ACR that bound customs to determine the price by a *formula* embedded in the importer's IT system. If this formula is associated with rules that adjust customs returns (based on adjustments to financial statements or income tax returns) then a workable solution may be available, provided those adjustments are sufficiently granular to allow the IT system to re-determine liabilities.

The OECD has identified the "timing" element in price changes as a particular problem for ACRs when they are used in the valuation context. The OECD indicates:

> … the Customs Office of the importing country is in a position to provide a binding ruling in advance, as this might be a necessary element to conclude a sales contract. Such a ruling would also be important to determine the value of the imported merchandise, which will be used to calculate the amount of Customs duties (and sometimes other taxes) to be paid. However, quite a few developing countries have a hard time to introduce the valuation method prescribed by the WTO because it requires

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the countries has established a single window enquiry point for traders. In addition, there is no consultative mechanism at the moment is many countries.").

[459] Gainmore Zanamwe, Trade Facilitation and the WTO: A Critical Analysis of Proposals on Trade Facilitation and their Implications for African Countries 25- 26 Tralac Working Paper, No. 5/2005 (Sept. 2005) (emphasis supplied) available at: http://www.tralac.org/pdf/20050927_WP5%20Zanamwe.pdf

> The EC, the US, Canada, New Zealand and China expressed their commitment to provide technical assistance and capacity building. The EC indicated that it will provide bilateral technical assistance to developing countries to establish requisite information platforms in electronic format. It offered to provide technical assistance needed to establish enquiry points advance ruling systems, administrative appeals and for the publication of rules and procedures.
>
> … On advance rulings, the US pointed out that costs may be met by having a fee structure for obtaining a ruling or by establishing a regional ruling authority. The US proposes a situational approach which looks at the unique situation of each Member and proposes the use of diagnostic tools to assess specific needs which then lead to appropriate and workable transition periods and targeted assistance in individual situations.

> Customs to verify the transaction value for the good concerned. If the actual invoiced price appears to deviate from that benchmark, the prices of identical or similar transactions have to be used as reference. This is why advance rulings on valuation are usually considered to be part of advanced reform steps (mentioned in Level 2).
>
> … *Level 2: more efficient border clearance.*
>
> … *Rule on the value of a trade in advance*. This service to traders will help them to make a decision on a contract knowing the border transaction costs. It completes the rulings on tariff classification and origin, envisaged in previous paragraphs, but is considerably more complex as it relies on the specific circumstances of a transaction and on the possibility to compare with the cost of similar transactions. … Many experts question whether it is appropriate to provide this service as some cost elements cannot be determined in advance and propose to limit the advance ruling to explaining to the trader the method of verification that will be employed.[460]

Joint APA-ACRs

Commentary suggests that one way to vertically harmonize transfer pricing rules (at least with respect to income tax and customs) is to enter into joint APA-ACR agreements.[461] 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),[462] a suggestion that French authorities may be considering joint agreements,[463] and a number of jurisdictions where multi-tax advance rulings on transfer pricing are "possible," but none have been reported.[464]

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[460] OECD, OECD/DAC PROJECT OF TRADE FACILITATION: MAKING TECHNICAL ASSISTANCE AND CAPACITY BUILDING FOR TRADE FACILITATION EFFECTIVE AND OPERATIONAL 12, at ¶31 & 12, at ¶ 37 DCD/DAC (2006) 49 (Nov. 8, 2006) (underscored emphasis added, italicized emphasis in original *available at*: http://www.olis.oecd.org/olis/2006doc.nsf/7b20c1f93939d029c125685d005300b1/75f8b6c917121d77c1257220002f0b3a/$FILE/JT03217370.PDF.

[461] JOVANOVICH, *supra* note 17, at 18.

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

[463] 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 2 (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.

[464] 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

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 the IT-APA 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).

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, that they would be creating 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;

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with 20 large Netherlands multinational taxpayers that has a scope broad enough to include transfer pricing issues in income tax, customs and 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.

- how the comparable companies were selected;
- 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.[465]

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.[466] The ACR states:

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

[466] US CUSTOMS & BORDER PROTECTION 16 (2007), *supra* note 95 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

> [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)[467]

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.[468] 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.[469]

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,

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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 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.

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

[468] §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* note15, at Art. 2(a).

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

> … 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.[470]

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.

CONCLUSION (PART 1): The IT Part of IT-APAs

It is reasonably clear that the real barriers to vertical harmonization of transfer pricing rules in income tax, customs and VAT have to do with timing and granularity. Income tax valuations are completed much later in time than customs and VAT regimes are comfortable with. Transaction taxes are designed around either having a *number* or a *fixed formula* that will objectively determine the number that is the tax base. An IT-APA (or an IT-ACR) harmonizes transfer pricing results by using a fixed formula. The formula is embedded in the taxpayer's VAT and customs software, and linked through the ERP to the financial statements and the income tax return. Certification of this digital valuation formula solves the timing issue in vertical harmonization.

The difficulty with integrating income tax transfer pricing adjustments into certified transaction tax systems revolves around granularity. If income tax adjustments are aggregate adjustments to profit or to overall royalties due, then invoices cannot be corrected, VAT amounts cannot be adjusted, and customs duties supplemented. The IT-APA therefore requires that an agreement be reached on allocating income tax adjustments in sufficient detail so that invoices can be revised.

Jurisdictions that do not have APA programs may come close to this solution through an IT-ACR. The IT-ACR would need to certify a company's transaction tax software in the same manner as an IT-APA does, but in place of demanding that reporting under the income tax be granular, the IT-ACR would further agree to a set of schedules and formulas that would allocate the domestic results of income tax adjustments made in foreign jurisdiction to transactions involving domestic entities.

CONCLUSION (PART 2): The APA Part of IT-APAs

APAs are not a universally admired procedural innovation,[471] but they appear to be here to stay and are growing in use. The jurisdictions that have APA programs have

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

[471] Diane M. Ring, *On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation,* 21 MICH. J. INT'L L. 143, 148 (2000). In her study linking procedural innovation (in this case the US APA program) to broader theories of administrative law and regulatory reform, Professor Ring presents the positives and negatives of APAs as follows:

> On the positive side, a successful APA program might reduce government administration and enforcement costs, providing a generalized benefit. Also to the extent the Service gains more detailed knowledge about transfer pricing practice and can translate that learning into improved rules, then all taxpayers with transfer pricing questions may

witnessed significant growth in applications,[472] just as the numbers of jurisdictions where APA programs are established are growing.[473] Three types of APAs are common: unilateral, bilateral, and multilateral.[474] Most jurisdictions that have APA programs allow for all three.[475]

An IT-APA is unilateral. Its focus is solely on resolving a domestic issue among multiple (domestic) tax regimes. It is not concerned with an international issue among multiple tax jurisdictions.

The OECD does not recommend unilateral APAs. This is due in large part to the OECD's focus on preventing (horizontal) double taxation between countries, not on preventing (vertical) double taxation within a single country.[476] However, taking the

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> benefit. On the negative side, the program's use of private individualized agreements raises a number of risks that might not be acceptable in an administrative regime, including the specter of uneven application of substantive law.

Hubert Hamaekers, *Arm's Length – How Long?* 8 INT. TRANSFER PRICING J. 30, 31 (Mar/Apr 2001) (indicating that APAs are very labor intensive, expensive and difficult to bring to agreement unilaterally and even more difficult bilaterally); Akinori Tomohara, *Inefficiencies of Bilateral Advanced Pricing Agreements (BAPA) in Taxing Multinational Companies*, 57 NAT TAX J. 863, 864 (2004) (demonstrating that even if the BAPA prohibits income shifting by a multinational company through transfer pricing, the BAPA nevertheless creates efficiency losses by distorting production decisions); Steven Allen, Rahul Tomar & Deloris R. Wright, *supra* note 452, at 257. In their comments and summary of the 2006 Annual Report on the APA program they indicate,

> While the number of APAs [in the US] has grown over the years, the program has not been successful (when measure by the number of APAs) as was initially anticipated, and has failed to become a mainstream option for US taxpayers. There are a number of reasons for this failure. For example, US companies are reluctant to make the IRS their "business partner" with respect to such am important aspect of their international operations. In addition the time required to complete an APA is significant and costly … it seems that the benefits (certainty) are outweighed by the costs in most instances.

[472] In the US, by the end of 2006 a total of 692 APAs had been executed. Steven Allen, Rahul Tomar & Deloris R. Wright, *supra* note 452, at 257. In Japan137 new bilateral APA cases were received from 2000 to 2002, compared to 121 cases in the 13 year period from 1987 to 1999. Ken Okawara, Mark T. Campbell & Karl Gruendel, *supra* note 450, at 138. In China more than 130 enterprises have signed APA with the STA. Qin Xu, *supra* note 453, at 70.

[473] *See supra* text at notes 450 to 453.

[474] Steven S. Saeger, Rahul Tomar & Deloris R. Wright, *supra* note 452, at 5 – 6 (assessing the relative numbers of unilateral and bilateral APAs among Australia, Canada, Japan and the US and indicating the while the US executes nearly equal numbers of unilateral and bilateral APA, the Japanese execute far more multilateral APAs than unilateral APAs, which is similar to the Canadian results, although in Australia the ratios are reversed with the number of unilateral APA's heavily outweighing bilateral APAs).

[475] However, until recently, the only kind of APA allowed in Germany was unilateral. Stephan Schnorberger & Petra Wingendorf, *Germany: Planning Certainty through Advance Pricing Agreements*, 12 INT. TRANSFER PRICING J. 77, 78 & n.5 (Mar/Apr 2005) (indicating that the Bavarian Ministry of Finance issued a decree allowing APAs in 1995, followed by the Federal Ministry of Finance in 2003). However, the rule in France is just the opposite. Only bilateral APAs are permitted under French legislation. Luciano Patelli & Francesco Porpora, *Italy: Advance Pricing Agreements to be Implemented: Commentary and Comparative Study,* 12 INT. TRANSFER PRICING J. 37, 41 (Jan/Feb 2005).

[476] OECD, GUIDELINES, *supra* note 14 at ¶¶4.148 & 4.149, with ¶ 4.148 specifying that:

> [u]nilateral APAs may present significant problems for tax administrations and taxpayers alike. From the point of view of other tax administrations, problems arise because they may disagree with the APA's conclusions. From the point of view of the associated

OECD's concerns into consideration, it is expected (as it was with HQ 546979) that most enterprises entering into an IT-APA will also engage in companion bilateral APAs that will deal solely with the international income tax treatment of the same transactions.

The IT-APA as an incubator of ideas and solutions. There has long been a second – less well publicized – side to the APA. The short view of an APA is that it provides immediate certainty to taxpayers over the treatment of specific transactions. But there is a longer view, a view broadly recognized, but not often articulated. Michelle Markham, a South African scholar researching US, Australian and European transfer pricing rules on intangibles observes, and cites Robert E. Ackerman, former head of the US APA program as follows:

> The current APA process is enabling taxpayers and tax authorities to forge *co-operative, proactive solutions to difficult, complex transfer pricing transactions* such as those involving intangible assets. It is anticipated that ongoing experience and a co-operative attitude that flows over into relations between competent authorities will result in the time factor involving completing an APA application being reduced, with concomitant reductions in resources required and costs involved for all participants in the process.
>
> Perhaps the ultimate accolade for APAs comes for a renowned US tax professional:
>
> > To date, the APA program has proven to be a *problem-solving technique* far superior to the traditional dispute resolution mechanisms employed by the tax authorities of the world. (emphasis added)[477]

It is this theme, that APAs provide *co-operative, proactive solutions to difficult, complex transfer pricing transactions*, and that they bring *superior problem-solving techniques* to the table where transfer pricing issues are being discussed, that is the real long term reason for adopting the IT-APA procedure. From this perspective, the IT-APA is the beginning, not the end of the quest for vertical harmonization of transfer pricing norms. An example is helpful.

Example – Global Dealing.[478] The current discussion around the proper treatment of global dealing operations is the classic example of where an APA program has

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> enterprises involved, one problem is the possible effect on the behavior of the associated enterprises. Unlike bilateral or multilateral APAs, the use of a unilateral APAs may not lead to an increased level of certainty for the taxpayer involved and a reduction in economic or juridical double taxation for the MNE group. If the taxpayer accepts an arrangement that over-allocates income to the country making the APA in order to avoid lengthy and expensive transfer pricing enquiries or excessive penalties, the administrative burden shifts from the country providing the APA to the other tax jurisdictions. Taxpayers should not feel compelled to enter into APAs for these reasons.

[477] MICHELLE MARKHAN, THE TRANSFER PRICING OF INTANGIBLES 303-04 (2005) citing Robert E. Ackerman, *Resolution of Transfer Pricing Disputes for Large and Small Businesses Using APAs,* ERNST AND YOUNG INTERNATIONAL TAX SERVICES: TRANSFER PRICING 2, at 9 (2000).

[478] 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

transformed potentially adversarial discussions into co-operative dialogues where taxpayers and tax administrations consider new ideas, proactive solutions, and experimental approaches to very difficult problems.

But the APA global dealing negotiations have done much more. The remarkable end result of these negotiations is a global tax policy change. Both the US and the OECD are now moving toward a formulary apportionment methodology in this area.

The global dealing issue reached the public eye in 1990 when the IRS indicated that guidance was requested on how the income from global dealing operations should be divided among the countries the dealers operated in.[479] When the APA program began the following year a number of taxpayers petitioned for APAs because official guidance remained limited and the risk of (and penalties associated with) audit was high.[480]

In the initial wave of global trading APAs a formulary apportionment methodology was applied.[481] 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

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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.

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

[480] Diane M. Ring, *supra* note 471, at 722 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.

[481] 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 over (and could issue APAs to) branch structures under the mutual agreement provisions of the tax treaties, just as they could when the organization was structured through subsidiaries, APA activity accelerated.[482] 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.[483]

As these APAs moved forward the OECD began work on a Discussion Draft dealing with global trading that was released in 1998.[484] 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 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.[485]

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[482] 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.

[483] *Id.*

[484] 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).

[485] 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 scope of influence that the APA program exerted on policy positions on global trading, 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 OECD[486] and the US.[487]

Walter Hellerstein's paper presented at the Income Allocation in the 21st Century: The End of Transfer Pricing? Conference in honor of the retirement of Hubert Hamaekers as Chief Executive Office of the IBFD points clearly to this US and OECD policy reversal on formulary apportionment. Commenting on the later version of the OECD report[488] he indicates:

> While the draft report stoutly maintains that this approach is simply a method of "transfer pricing" [para. 159] that reflects the "arm's length principle," [para. 160] one may suggest that formulary apportionment by any other name would smell as sweet.
>
> My point here is not to play "gotcha" with the OECD and the US Treasury. Rather, it is simply to point out that, at least in one situation where the case for *formulary apportionment is at its strongest* (i.e. the carrying-on of an integrated operation by a single entity in different states with essential but indeterminate contributions to income made by labor , capital and markets in different locations), there is a *powerful case* for the application of formulary apportionment as a means of allocating income among states with a plausible claim to it, which even some of the most stalwart opponents of formulary apportionment appear to recognize. (emphasis added).[489]

What Professor Hellerstein fails to mention is that even though the argument in favor of formulary apportionment had been made time and time again by leading academics and tax professionals,[490] it was the APA program that found the point where

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[486] OECD, GUIDELINES *supra* note 14, 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 fund at ¶¶ 3.1 & 3.58 – 3.74.

[487] 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).

[488] OECD, DISCUSSION DRAFT (2003) *supra* note 484.

[489] Walter Hellerstein, *The Case for Formulary Apportionment*, 12 INT'L TRANSFER PRICING J. 103, 106 (May/Jun. 2005).

[490] A large number of scholars, tax practitioners, and former heads of the US APA program have approached this topic theoretically. They generally encourage the limited use of formulary apportionment in cross-border international income taxation. The classic articles are: Walter Hellerstein, *Federal Income*

formulary apportionment was at its strongest, and it was the APA program that made the *powerful case* that changed OECD and US policy.

Changing tax policy with the IT-APA. It is the long term goal of the IT-APA to do exactly the same thing. If it is adopted as a way to vertically harmonize transfer pricing norms within a number of jurisdictions, the IT-APAs will make the *powerful case* that vertical harmonization can be achieved. The essential elements will be (1) a *harmonization or linking of basic definition*s ("related party" or the workings of a transfer pricing method), (2) the *certification of transaction tax software* and (3) the insistence that income tax adjustment (audit-base or compensating) be *granular*.

Because the IT-APA is unilateral, it is expected that there will be as many types of IT-APAs as there are taxing jurisdictions. But it is also expected that some approaches will be clearly better than others, will be copied, and begin to establish an international standard. At the sub-national level, this is one of the ways that tax policy is determined in the US, and it seems to be one of the most effective ways of doing so internationally. As Supreme Court Justice Louis Brandeis stated,

> It is one of the happy incidents of the federal system that a *single courageous State* may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country.[491]

In the current effort to harmonize the transfer pricing regimes in income tax, customs and VAT, the WCO and OECD are looking for exactly the same thing – *a single courageous State* that is willing to *try a novel social and economic experiment.* That experiment is the IT-APA.

Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment, 59 TAX NOTES 1131 (Aug. 23, 1993); Louis M. Kauder, *Inter-company Pricing and Section 482: A Proposal to Shift from Uncontrolled Comparables to Formulary Apportionment,*58 TAX NOTES 485 (Jan. 25, 1993); Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solutions to the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?* 56 TAX NOTES 339 (July 20, 1992); Robert Culbertson, *Is There a Formula in your Future? Formulary Apportionment, the Arm's Length Principle, and the Future of Profit Splits,* 5 Transfer Pricing 557 (Jan. 15, 1997). The most recent in this line of articles is: Reuven S. Avi-Yonah & Kimberly A. Clausing, *A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project* U of Michigan Law & Economics, Olin Working Paper No. 07-009, U of Michigan Public Law Working Paper No. 85 (June 25, 2007) *available at* http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=208790. Another line of articles follow the global trading breakthrough with formulary apportionment, and seek applications to other industries. *See,* Jerome B. Libin, *Formulary Apportionment for 'Global Trading' in the Manufacturing Industry: Can It Be Made to Work?* 11 TAX NOTES 1375 (Nov. 20, 1995) (analysis of whether the principle applied in the global trading APAs can be similarly applied to manufacturing industries and in other contexts).

[491] New State Ice Company v. Liebman, 285 US 262, 311 (1932) (Brandeis, J., dissenting)

IT-APAs:
HARMONIZING INCONSISTENT TRANSFER PRICING RULES IN INCOME TAX – CUSTOMS – VAT[1]

Richard Thompson Ainsworth

Section	Page
INTRODUCTION	1
A Trade Barrier and the Reason for WCO/ OECD Cooperation	4
Organization of the Text	6
PART ONE: THE VERTICLE CONTEXT	7
Superficial similarities, non-existent rules, and the impact of time	7
Problem One: Superficial similarities	7
Problem Two: Inconsistent, incomplete or non-existent rules	8
Problem Three: The impact of time	14
Tax point	14
Audit adjustments	14
The impact of inconsistent transfer pricing regimes on tax automation	15
PART TWO: VERTICAL HARMONIZATION – A POLICY PASSED OVER	18
Relationship – The First Question	19
The horizontal aspect	20
Types of relationship rules	20
Economic relationship	21
Legal relationship	21
Deemed relationships	25
No relationship rules other than customs	26
Relatedness ignored in transfer pricing application	27
Examples: Vertical Harmonization Passed Over – Relationship	28
Brittingham v. Commissioner	29
Factual context	29
Dallas Ceramic	29
Ceramica Regiomontana	29
Decisions	30
Analysis	31
Vertical harmonization (customs and income tax) in the US – related parties	33

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			Directive 2006/69/EC – the Rationalization Directive				35
				Background			35
				Connected persons			36
					National definitions – connected persons		37
	Methods – The Second Question						44
		Tax policy differences – exact justice v. rough justice					45
		Valuation methods – traditional v. profit methods					46
		Self-help harmonization					47
		Five basic methodologies					47
			Three Traditional Methods				48
				Comparable uncontrolled price (CUP) &Transaction value of Identical/ Transaction value of similar goods (TVI/ TVS) methods			48
					Income tax (CUP)		49
					Customs (TVI/ TVS)		49
						Vertical Harmonization – Income Tax CUP & Customs TVI/ TVS	50
					VAT		51
						Fully harmonized CUP – Japan, Spain, Russia, Azerbaijan, Turkmenistan, and Georgia, with further consideration of Uzbekistan, Chile and Ecuador	51
						Parallel harmonized CUP or TVI/ TVS – Australia & New Zealand	55
						Roughly harmonized – Botswana & Lesotho	56
						No CUP or TVI/ TVS methods – Croatia & Albania	59
				Resale price method (RSP) & Deductive value method (DVM)			60
					Income tax (RSP)		60
					Customs (DVM)		60
						Vertical Harmonization – Income Tax RSP & Customs DVM	61
					VAT		62
						Full harmonization – Japan, Spain, Russia, Azerbaijan & Turkmenistan	63
						Parallel harmonization	63

						regimes – RSP & DVM omitted – Australian & New Zealand	
						No RSP or DVM methods	64
				Cost-plus method (C+) & Computed value method (CVM)			64
					Income tax (C+)		64
					Customs (CVM)		65
						Vertical Harmonization – Income tax C+ & Customs CVM	65
					VAT		66
						Fully harmonized with C+ – Japan, Spain, Russia, Turkmenistan, & Azerbaijan	66
						Parallel harmonization – Australia, New Zealand & Iceland	67
						Harmonization through the Commissioner's (unspecified) judgment – South Africa, Botswana, Lesotho & Uganda	70
			Two Profit-based Methods				70
				Profit split methods (PS) & Comparable profits (CPM)/ transactional net margin method (TNMM)			70
					Income tax – US		70
					Income tax – OECD		71
					Customs – no applicable methods		72
					VAT		73
						Fully harmonized profit-splits and transactional net margin methods – Spain & Japan	74
						Professional appraisal – Australia & Azerbaijan	74
		Examples: Vertical Harmonization Passed Over – Can Methods be Harmonized through Case Law?					75
			First Pattern – Income tax-customs litigation – Procureur de la République v. René Chatin & Ross Glove Co. v Commissioner				76
				Procureur de la République v. René Chatin			76
				Ross Glove Co. v Commissioner			77
			Second Pattern – Income tax-VAT litigation – Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc & Between: Southpark Estates Inc.,				79

			S.A.M. (Colorado) Inc., Villa Beliveau Inc., Virden Kin Place Inc, and Her Majesty the Queen [Indexed as: Southpark Estates Inc. v. Canada]			
				Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc		80
				Southpark Estates Inc. v. Canada		81
	Conclusion Part II: Efficiency and the Pressure to Vertically Harmonize Transfer Pricing Norms					82
		What have we leaned so far (the relationship aspect)?				82
		What have we learned so far (the methodology aspect)?				86
		Where are we going?				89
PART THREE: VERTICLE HARMONIZATION & CERTIFICATION – IT-APAs						89
	The IT-APA – IT/Customs					90
		The Single Window Trade Portal Movement				91
		Customs Certification				93
			Customs certification – The Correct Rates			93
			Customs certification – The Correct Goods			94
			Customs certification – The Correct Valuation			94
				Commentators		96
				Technical Committee on Customs Valuation		97
				US Customs and Border Protection		97
		Customs certification and the IT-APA				98
			Certification of the rates			99
			Certification of the mapping and other system functions			99
			Certification of the valuation			101
		IT-APA – A Customs Example				102
			Compensating adjustment			102
			Key economic assumption violated			103
	The IT-APA – IT/VAT					104
		Example: Transfer Pricing in VAT				105
		VAT Certification				106
			VAT certification – The Correct Rates			106
			VAT certification – The Correct Goods			106
			VAT certification – The Correct Valuation			107
	The IT-APA – IT/Income Tax					107
		APAs and ACRs				108
			Advanced Pricing Agreements			109
			Advanced Customs Rulings			109
			Joint APA-ACRs			112
				Private Ruling HQ 546979		113
					Facts – HQ 546979	113
					Importer's Argument & Custom's Rejection – HQ 546979	114

					Custom's Solution: Resolving the Granularity & Timing Issues – HQ 546979					115
CONCLUSION (PART 1): The IT Part of IT-APAs										116
CONCLUSION (PART 2): The APA Part of IT-APAs										116
	The IT-APA as an incubator of ideas and solutions									118
		Example – Global Dealing								118
		Changing tax policy with the IT-APA								120