Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?

Liu Ping, World Customs Organisation, and Caroline Silberztein, OECD Centre for Tax Policy and Administration

Transfer pricing is more important than ever to multinational enterprises ("MNE"). What is transfer pricing? "Transfer pricing" refers to the determination of the price and other conditions for the transfer of goods, services and assets between affiliated companies situated in different tax jurisdictions. Where goods, intangibles or services are transferred across the borders within an MNE, transfer pricing becomes an important issue for the taxpayers as well as for the national tax and customs authorities which have the responsibility of overseeing these cross-border flows.

Along with increasing globalization, international transactions between related parties (between parent company and their affiliates or between affiliates) are playing an increasingly significant role in world trade and economy. As multinational enterprises are said to account for about 60% of world trade, transfer pricing has become the number one issue in the international tax arena. Globalization is providing opportunities for economic development and growth through intensified cross-border trade, investment and services. At the same time, there is also a growing trend, in both developed and developing economies, of government regulatory bodies stepping up their control over transfer pricing compliance through transfer pricing regulations and audits, with a view to protecting their tax base while avoiding double taxation that would hamper international trade.

While the importance of transfer pricing is increasingly appreciated, the focus has traditionally been on direct taxation and transfer pricing still largely remains a subject for tax specialists. In the past decade, however, it has become obvious that the customs duties and, more recently, the VAT (value added tax) dimensions of transfer pricing can also take quite a toll on a company's profits and on government revenues, and they are now increasingly attracting the attention of governments and businesses. Valuation of Related Party Transactions for Transfer Pricing, Customs and VAT purposes was the subject of two major conferences jointly organised by the World Customs Organisation (WCO) and the Organisation for Economic Cooperation and Development (OECD) in May 2006 and May 2007.

Transfer pricing: what is at stake for governments and businesses?

Transfer pricing influences the level of both direct and indirect taxes that governments collect. The price of cross-border transactions is the starting point for assessing customs duties and for determining profits arising to each party involved and therefore the allocation of tax bases among countries. Transactions between related parties or associated enterprises are not always subject to the same market forces as transactions between independent actors. As a consequence there is a potential for manipulation, through under or over-pricing, of the customs duties basis and allocation of taxable profits.

For tax purposes, transfer pricing determines the amount of income that each party earns and thus, the amount of income tax that is due in both the country of export and the country of import. A higher transfer price may reduce the taxable income in the country of importation and increase the taxable income in the country of export. A lower transfer price has the opposite effect.

For customs purposes, the transfer price has a direct impact on the determination of customs value. The lower the transfer price, the lower the customs value and the applicable customs duties. This also applies to the collection of inland taxes (eg. VAT and excise) when they are calculated on the basis of the customs value of the imported goods.

What are the issues?

The business community has explained on several occasions that the existence of two sets of rules, and, in many countries, of two different administrative bodies to deal with direct taxes and customs duties, can make cross-border trade overly complicated and costly, contrary to the objectives of the international organisations and national governments concerned.

What international rules do national tax and customs authorities use to approach transfer pricing?

Direct tax authorities tend to follow the arm's length principle and OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) which set the international standard for transfer pricing. Customs authorities apply the relevant provisions of the WTO Customs Valuation Agreement (the WTO Agreement). Furthermore, practices in applying certain provisions of these international standards at the national level by customs and tax authorities can vary, to a certain degree, from country to country.

As a basic principle, both sets of rules require that an "arm's length" or "fair" value be set for cross-border transactions between related parties and associated enterprises. That is, the transfer price must not be influenced by the relationship between the parties or it must be set in the same way as if the parties were not related. However, there are significant differences in the application of this broad principle, eg. in relation to such major factors as policy objectives, operational functioning, timing of valuation, valuation methods, documentation requirements and dispute resolution mechanisms.

Institutionally it is often the case that two administrative bodies value or review the valuation of international transactions between related parties or associated enterprises. A striking point is that customs and revenue authorities within the same country can often have conflicting interests. On a given import transaction, a customs officer's natural inclination would be to verify whether or not the value declared by the importer was under-estimated, as the customs officer would be interested in collecting more duties, while a revenue authority's natural inclination would be to verify whether or not the import value declared was over-estimated, as the revenue officer would be interested in limiting what would be regarded as an excessive tax deductible amount in his/her jurisdiction. Or to put it in another way, where the "arm's length" or "fair" value is not clear, might the customs specialist within a multinational enterprise be tempted to declare an import value on the lowest side of the range, while his/her tax colleague might possibly be interested in higher transfer prices if they can generate greater deductions.

Does this situation make sense from theoretical and practical perspectives? To what extent is it acceptable to have different rules because the agency policy objectives are different? Do different answers to the same question ("what is the arm's length price?") alter the credibility of the assessing authorities? Is there a need for greater convergence of the two sets of rules? If so, what should be the conceptual framework, at national and international levels? These are some of the tough questions that were discussed at the joint WCO-OECD conferences and on which significant further work would be needed.

In addition, these issues can also arise in relation to VAT to a certain extent. First of all, the determination of the acceptable transfer price and subsequent "adjustments" to be made to it under transfer pricing and customs value determination can affect the amount of VAT to be levied and charged on cross-border transactions. Furthermore, a recent EC (European Communities) Council Directive 2006/69/EC opens up the possibility for tax authorities to adjust the valuation of certain goods or service transactions in specific circumstances in case the value declared differs from the "open market value". This has prompted concerns about the additional uncertainties that might be created and complexities that might be added by yet a third set of rules governing the valuation of cross-border related party transactions that business has to comply with. In effect, the Council Directive does not provide any guidance as to the methods to be used to determine the "open market value" and neither the Commission nor the member states concerned have developed guidance on valuation methods so far.

How different are transfer pricing and customs valuation rules?

A discussion of the pros and cons of possibly greater convergence and of more coordinated administrative approaches must start from an examination of the similarities and differences of direct tax and customs rules on the valuation of related party transactions.

Customs, as a border enforcement agency, analyses each product and each import transaction to determine, usually at the time of the importation, what the customs value is for a specific product involved in a specific transaction. This enables the customs authorities to collect the right amount of duty for each product that can be subject to different rates of duties to be calculated on the basis of its value and its tariff classification. The customs value of imported goods means the value of goods for the purpose of levying ad valorem duties of customs on imported goods. However, although there are no specific provisions regarding valuation treatment of services and intangibles, these can be relevant for customs valuation purposes if they are connected with the importation of goods.

In valuing a related party transaction, customs uses the transaction value of the goods that is free from the influence of the relationship between the parties. To determine whether the price would be an acceptable basis for the transaction value, two tests are used: (1) the "circumstances of sale" test to determine whether the relationship influenced the price, and (2) the "test values" test which is used to determine whether the transaction value closely approximates one of three types of "test" values. The "circumstances of sale" test, which is more commonly used, is fairly broad and the provisions strikingly concise.

In case it is established that the transaction value of the imported goods is not acceptable, customs determines the customs value by applying, in a hierarchical order, one of the following alternate valuation methods: transaction value of identical or similar goods, deductive value, computed value and fall-back method.

Enforced by revenue authorities, transfer pricing is grounded in Article 9 of the OECD and UN Model Tax Conventions which establishes the arm's length principle. The arm's length principle is a proxy for open market conditions that ultimately seeks to allocate taxable profits between related parties to achieve a fair allocation of tax revenues amongst tax authorities and avoid double taxation. All cross-border commercial and financial transactions between associated enterprises (goods, services, intangibles, financial transactions) are within the scope of transfer pricing. There are also transfer pricing issues for attributing profits to permanent establishments (ie. between various parts of a single legal entity situated in different tax jurisdictions).

The arm's-length principle requires a comparison of the conditions of a taxpayer's controlled transactions with the conditions of comparable uncontrolled transactions. Two transactions are regarded as comparable where either there are no material differences between them or reasonably accurate adjustments can be made to eliminate the effect of any such differences. The OECD Guidelines provide a set of criteria to be employed to assess comparability between controlled and uncontrolled transactions (characteristics of products/services, functions performed by each party taking account of the assets used and risks assumed, contractual terms, economic circumstances and business strategies). Comparability adjustments are made where comparability can be enhanced.

In terms of hierarchical order for applying transfer pricing methods, traditional methods (comparable uncontrolled price, resale price method, cost plus method) are preferred over transactional profit methods (transactional net margin method, profit split) in the current OECD TP Guidelines. All OECD-approved methods have a strong transactional focus and there are rules for aggregation of a taxpayer's transactions where they are interrelated or form a continuum. The choice of the method depends on the circumstances of the case. One generally arrives at an arm's length range rather than a single point.

Generally speaking, transfer pricing valuation by taxpayers takes place either at the point in time when the transaction is entered into (the so-called "arm's length price-setting approach"), or upon filing of the tax return (the so-called "arm's length outcome" approach). In countries which follow the "arm's length outcome" approach, end-of-period adjustments to the value initially reported can be common when there are differences between the initial pricing and the outcome of the analysis performed at the time of the filing of the tax return. Typically, information is available to revenue authorities at the year-end upon filing of the tax return and/or later upon retrospective audits (eg. 3-4 years after the transaction).

Another important aspect about transfer pricing is documentation. Transfer pricing documentation typically covers, quite extensively, the economic context (industry and taxpayer's), a description of the controlled transaction (terms and conditions), an explanation of the choice and application of the transfer pricing method, the comparability analysis (including data on uncontrolled transactions that are used as comparables). Tax authorities have access to information through domestic provisions (general tax audit provisions, specific transfer pricing documentation requirements) and bilateral treaties (exchanges of information). In contrast, the WTO Agreement does not detail the information to be used for the determination of the acceptability of the transfer price for customs purposes. The documentation requirements for customs purpose depend on the declaration and documentation requirements of the importing country.

The above general introduction reveals that while common purposes and similar concepts obviously exist in international transfer pricing and customs valuation rules, there are also significant divergences. At the national level, the situation varies in relation to the degree of convergence of the rules and of coordination of the tax and customs administrative efforts. As things stand now, tax and customs authorities are not obliged to accept a value that is calculated in accordance with each other's legislative requirements. Customs administrations need to develop specific strategies, procedures and expertise to address transfer pricing. MNEs need to comply with obligations under both tax and customs legislation and regulations as well as other regulatory requirements (eg. foreign exchange control) where applicable.

Convergence or not: the tale of two schools of thought

Due to the growing importance of transfer pricing to international trade transactions and in order to address the tough questions presented by transfer pricing, the WCO and the OECD have joined hands to hold two joint international conferences on Transfer Pricing and Customs Valuation of Related Party Transactions, in May 2006 and May 2007 respectively, initiating a promising dialogue. The common objective of the two organisations was to provide a platform for public and private sector representatives to collectively explore, and attempt to advance, the issues identified and to encourage global coordinated efforts among business and governments, tax experts and customs specialists.

At the first conference, two schools of thought seemed to have emerged on the desirability and feasibility of having converging standards for transfer pricing and customs valuation systems: those who viewed convergence of rules as highly desirable and largely feasible; and those who were more cautious. While these two views still exist, there was at the second conference held in May 2007 greater recognition in general of the benefits that could be derived from improved consistency and increased certainty in the two systems.

Those who are in favour of convergence point out that a credibility question does arise if two arms of the same ministry can come up with different answers to virtually the same question ("what is the arm's length/fair value for a transaction?"). They hold that this situation results in greater compliance costs for businesses which must follow and document two sets of rules, and greater enforcement costs for governments which must develop and maintain two types of expertise (ie. have customs specialists and transfer pricing experts examine the same transactions at different points in time and in light of two different standards).

Those who are more cautious about convergence point out that the two systems are grounded in different theoretical principles (direct versus indirect tax systems). Hence they argue that convergence could be more costly than the status quo. They also express concerns about the state of capacity building of revenue authorities in developing economies in the areas of transfer pricing and customs valuation. In fact, developing economies are often much more dependent on customs than on direct tax revenues, and many of them are still experiencing difficulties in the application of the basic provisions of the WTO Agreement.

A number of specific issues were discussed at the May 2007 conference. First of all, there was the question of the consequences of a transfer pricing adjustment to a value previously accepted by customs and vice versa. Acceptability by customs authorities of post import/end-of-period adjustments and of transfer pricing analyses that rely on aggregated transactions (in particular when a transactional net margin method or comparable profit method is used for transfer pricing purposes) was often at the centre of the debate.

The usefulness of transfer pricing documentation for customs purposes is also an important area to explore. Transfer pricing compliance requirements, including the need for taxpayers to prepare specific documentation packages, have been put in place in an increasing number of countries. MNEs often put a lot of compliance efforts into developing such transfer pricing documentation packages and could find it advantageous if they served a dual purpose. Customs authorities could also be interested in being provided with the extensive information that is generally found in these documentation packages, if it addressed their valuation requirements.

Furthermore, the possible development of joint advanced customs and transfer pricing agreements was perceived as promising, despite limited and contrasting experiences in countries so far. In the transfer pricing field, an Advanced Pricing Arrangement ("APA") is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (eg. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more associated enterprises, and one or more tax administrations. APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues. A presentation of recent experiences in the United States and in Australia, where rulings could be concluded involving both the revenue and the customs authorities, was very favourably received by the audience, as those experiences open up the prospects for an effective, coordinated dispute prevention mechanism.

In addition, the conference discussed the possible development of joint customs and transfer pricing audits, the objectives of which would be to reduce the time and efforts spent in audits by the taxpayer and the authorities and to arrive to the extent possible at a common determination of the valuation of related party transactions that would be acceptable for both customs and tax authorities. More generally, the conference participants discussed the pros and cons of greater cooperation between customs and revenue authorities at both domestic and international levels. In these areas, recent regional developments show encouraging trends towards convergence of administrative approaches, including joint actions and information sharing between tax and customs authorities.

The way forward

At the two conferences, the WCO and the OECD noted that they wish to encourage dialogue between customs, tax authorities and business, possibly by establishing a mechanism for liaison. In particular, it seems desirable to continue sharing best practices between countries' revenue and customs administrations. A "whole of government" approach is desirable between customs and tax authorities. In this connection, both customs and tax authorities could benefit from better understanding each other's rules, objectives and constraints.

Many interesting proposals were presented by the participants at the second conference, including the possible setting up of a central arbitration body and the greater use of technology-based audit mechanisms. The WCO Technical Committee on Customs Valuation could play a role in examining specific proposals from its membership.

At the global level, the WCO and the OECD should continue their existing cooperation, such as sharing of knowledge and developing training material, including an e-learning module.

There was a suggestion to create small focus groups of customs and tax experts involving also the WTO and business representatives, in order to study further the issues identified, with an initial focus on practical and concrete case studies, based on commercial reality. Specifically, further work could be done in the following areas:

Valuation:

These issues would benefit from an examination of the interaction between the valuation methods used by customs and revenue authorities, the hierarchy of methods used, what role if any functional analysis could play for customs, and whether a common definition of intangibles could be arrived at.

Provision of greater certainty for business:

The prospect of making more use of joint rulings or APAs attracted a lot of interest among the participants. Another related topic that could be explored is whether more effective dispute resolution mechanisms can be developed, possibly covering both direct taxes and customs duties.

How can we improve compliance?

One practical area for possible study is whether greater consistency could be achieved in the transfer pricing and customs documentation requirements, eg. the extent to which transfer pricing documentation packages prepared by taxpayers could be a useful basis for customs authorities' reviews. A related question is whether better flows of information can be achieved between tax authorities and customs authorities, including an examination of the pros and cons of joint audits that could go with joint dispute resolution mechanisms.

Improving administrative capacity of tax and customs departments:

Governments should continue building their administrative capacity in better addressing transfer pricing and customs valuation. The WCO and OECD discussed whether joint training programmes could be developed. It would be worth reviewing the experience of countries that have merged or de-merged their customs, VAT and direct tax departments.

The two organisations intend to explore further with their members and other stakeholders, including the business community, how best to pursue these recommendations. ■

This article expresses the views of its authors and not necessarily the views of the WCO, of the OECD or of their members