The tax esperanto

The world is growing smaller and companies should put a single-transfer pricing focus on income tax, VAT/GST and customs duties to come out ahead, says Astrid Pieron and Charles-Albert Helleputte from the European Transfer Pricing Centre of Mayer Brown

Globalisation increases interaction and collision between tax systems. Europe, in particular, is still a puzzle despite the continuing efforts to either create harmonisation or promote better coordination when harmonisation appears unrealistic.

There has been a focus up until now, with some success, on horizontal harmonisation or coordination (similar or identical rules applied per category of taxes across several jurisdictions) over vertical harmonisation or coordination (similar or identical rules for all categories of taxes within one jurisdiction).

The business community calls for a combination of both horizontal and vertical harmonisation / coordination. The existence of numerous sets of rules, combined with several tax administrative bodies for direct and indirect taxes, renders international trade overly complicated and costly. It hampers the functioning of a true single European market.

Are those obstacles to international trade justified by the variety of goals pursued by income taxes on one hand and VAT and customs duties on the other hand?

For income taxes, transfer pricing rules aim at measuring related-party transactions against the arm's length standard. The tax authorities review whether there is any shift of income and profits outside of their territory resulting in lower tax revenues. Price is much more centric for transactions-based taxes such as VAT or customs duties.

Those differences lead to divergences in valuation and valuation methods. This has been reinforced by the development of separate concepts (associated enterprises) by the various administrations, often facing conflicting interests within the same jurisdictions.

Convergence of the respective valuation rules has been at the centre of the latest conferences jointly organised by the World Customs Organisation (WCO) and the Organisation for Economic Cooperation and Development (OECD).

Income tax, VAT and customs duties: pursuing different goals?

Each category of tax has some part to play in determining the correct price of related-party transactions when the reported prices might have an impact on the tax base. The degree of concern, including the scope of related-party transactions, is, however, not equal among all taxes.

Income tax transfer pricing rules or how to allocate profits

Income tax transfer pricing rules aim at determining the price and other conditions for the transfer of goods, services and assets between affiliated companies located in different tax jurisdictions.

There is no specific definition for associated companies. Article 9 of the OECD model provides for a common (general) definition and the OECD transfer pricing guidelines do not provide for more details. Whether it means a participation in the management, control or capital of an enterprise is a matter to be decided by reference to domestic company law.

> **Under EU customs valuation rules, a relationship between buyer and seller in and of itself should not lead to a rejection of the transaction value**

The arm's length standard is the measure for reviewing whether the related-party transactions can be accepted by the taxing authorities. In Europe the OECD transfer pricing guidelines are inspiring most of the local tax legislations or tax administrative practices.

Those guidelines provide direction on the application of the arm's length standard and refer to three traditional transaction-based methods, i.e. the comparable uncontrolled price (CUP), the resale price and cost plus, and two profit-based methods, i.e., profit split and transactional net margin.

The review by income tax authorities will generally not take place on a single transaction only but will cover an aggregated set of transactions within a specific tax year. The adjustments might take place years after the facts.

The arm's length standard typically does not focus so much on the price than on the adequate profit margin for functions performed and risks assumed. This can lead to difficulties when different import prices result from the choice of a resale price method.

Customs duties as a tool for setting up a level playing field in international trade

Import duties are applied to the customs value. This value is established on the basis of internationally recognised principles provided in art. VII GATT 1994 as implemented by the GATT Valuation Code (GVC). GVC also covers the concept of related parties; this notion is defined by art. 15 GVC with a clear focus on legal relationship.

In the EU, provisions of the GVC are contained in the community customs code and its implementing provisions.

Customs authorities analyse each product and each import transaction to determine, usually at the time of import, what the customs value is.

In principle, the EU customs value should be based on the transaction value, i.e., the price paid or payable for the product when sold for export. The transaction value may be adjusted, as set out in relevant EU provisions. If this transaction value cannot be used, other valuation methods may be called up (such as transaction value for identical or similar goods or the computed value which starts from the cost of the goods).

Under EU valuation rules, a relationship between buyer and seller in and of itself should not lead to a rejection of the transaction value. However, it is possible for customs authorities to request information to make sure the price is at arm's length. Therefore, the importer should be ready to demonstrate that:

- the price is consistent with normal pricing practices in the sector,
- the price corresponds to prices by the seller to unrelated buyers, or
- the price is adequate to cover all costs and a reasonable profit margin.

If none of these are the case, the transaction value could be rejected.

VAT/GST or how adequately taxing consumption

Value added tax/goods and services tax is a consumption tax; the tax burden is borne ultimately by the final consumer.

The taxable amount in VAT/GST is primarily transaction-based as VAT is levied on everything which 'constitutes consideration obtained or to be obtained by the supplier in return of a supply'. In the EU VAT system, the taxable base is, in principle, a subjective value, i.e., the value actually received, and not a value estimated according to objective criteria or methods. Interestingly, in the *Hotel Scandic* case, the European Court of Justice held that whether the price paid for an economic transaction is higher or lower than the cost price is irrelevant to the question of whether a transaction is to be regarded as a 'transaction effected for consideration'.

Compared with customs duties and income tax, VAT/GST is a newcomer to transfer pricing questions. The reason for this is embedded in the mechanisms of consumption taxes themselves. As long as parties to a transaction are fully taxable VAT taxpayers, the transfer price among related parties should not be a concern for VAT authorities. Indeed, ultimately VAT-types of taxes are borne by the final consumer. However, from an enforcement perspective, a non arm's length price between related parties before final consumption will typically require more attention in the VAT collection chain, as illustrated in the chart.

The EU VAT system recently introduced some transfer pricing mechanisms aimed at re-evaluating the taxable basis of related-party transactions up to the open market value. However, the scope of these rules only triggers a small subset of all related-party transactions, i.e., where tax evasion or avoidance are at stake and when one of the party to the transaction is an exempt or partially exempt taxpayer (i.e., absence of full input VAT recovery).

In such circumstances, member states may take measure to ensure that the taxable amount is the open market value, as defined in art. 72 of the EC VAT directive:

> "the full amount that, in order to obtain the goods or services in question at that time, a customer at the same marketing stage at which the supply of goods or services takes place, would have to pay, under conditions of fair competition, to a supplier at arm's length within the territory of the Member State in which the supply is subject to tax".

In absence of a comparable supply of goods, open market value represents:

> "an amount that is not less than the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, determined at the time of supply".

	Price (excl. VAT)	VAT @ 15%	VAT paid to the State
Sale A to B	100	15	15
Sale B to D (related party - arm's-length price)	220	33	18
Sale to final consumer	260	39	6
		TOTAL	**39**

Situation 1

	Price (excl. VAT)	VAT @ 15%	VAT paid to the State
Sale A to B	100	15	15
Sale B to D (related party - non arm's-length price)	110	16.5	1.5
Sale to final consumer	260	39	**22.5**
		TOTAL	**39**

Situation 2

Non arm's length prices (situation 2) do not impact the VAT amount collected throughout the chain (compared to Situation 1) but only the VAT amount collected at once in the last transaction.

Interestingly, this last valuation method has some historical background in self-supplies (i.e., when a taxpayer is using some of its business assets for private use) and in intra-community transfer of goods (i.e., deemed supply of goods for intra-community transfer of goods realised by a single taxpayer) even before any reference was made to open market value in the VAT area.

Can taxes speak esperanto?

While international organisations tend to focus on whether a common language can be developed so as to achieve horizontal harmonisation, countries or integrated markets are often trying to seek a certain extent of vertical convergence between, income tax, VAT and customs duties in their domestic transfer pricing rules.

Vertical integration: existing rope bridges between income tax, customs and/or VAT/GST transfer pricing sets of rules

The most common example of vertical integration lies in the fact that almost all countries with a VAT/GST apply customs valuation rules for determining the taxable amount of imported goods. As an example, according to art. 85 of the EC VAT directive, the taxable amount shall be the value for customs purposes determined in accordance with the provisions of the EU's customs code and its implementing provisions. However, some corrections apply.

Nevertheless, it is difficult for domestic systems to harmonise income tax and customs rules, especially with regard to aspects such as first sale for export concept. In the EU, customs valuation rules still provide that the transaction value used for assessing import duties and VAT is not necessarily the transaction that leads to the introduction of the goods into the Community's customs territory but a previous transaction. It is however under scrutiny.

Canada is probably one of the few exceptions in its effort to directly harmonise income tax and customs valuation methods. Canada provides, in some circumstances and for some taxpayers, a mechanism for harmonising the valuation methods of all three taxes at the border. Indeed, the Canadian revenue authority accepts an OECD-based valuation of goods (an income tax measure of value) as the transaction value (a customs measure of value). This is also used for GST computation.

However, related-party transactions go far beyond imports. In other related-party transactions, vertical integration is often only binary. It could take place, for example, at the level of available valuation methods. As an example, the Japanese consumption tax and Spanish VAT directly borrow their transfer pricing methods from corporate income tax. A similar approach exists in Russia: a general part of the tax code describes the methods with income tax and VAT provisions just referring to these harmonised definitions.

Working all together, the feasibility of cross-taxes APAs

As convergence will likely not be achievable in the short or medium terms, the possible development of joint advanced customs and transfer pricing agreements is promising for business certainty.

An advanced pricing agreement (APA) is an arrangement *"before the fact"* that determines an appropriate set of criteria such as method and comparables for the determination of the transfer pricing of controlled transactions over a fixed period of time.

Getting such combined APA is not an easy task. Indeed, the ability to enter into APAs and the APA's scope varies from jurisdiction to jurisdiction despite recent EU guidelines. Such a combined approach has been largely supported at the joint WCO and OECD conferences and has been seen as a valuable tool to reduce time and efforts spent in audits by both the taxpayer/importer and the tax administrations. Few illustrations are available yet.

The absolute requirement for an integrated approach

When tax directors are complying with income tax transfer pricing and have documented it properly, they tend to believe they will also meet customs and VAT requirements. This is often not the case. Business decisions can have contrasting effects on income tax, VAT/GST, customs and excise duties. This is why all angles should be examined.

Inside combined APAs

There are few examples of combined APAs: Belgium and the US are among the happy few. In Belgium, transfer pricing clearance on specific transactions can be requested upfront from a ruling commission. The Commission has concluded in one specific case that a transfer pricing method was appropriate for fixing the arm's length price for income taxes and the transaction value for customs (ruling nr. 700.473, January 22 2008).

In the US, a customs ruling (private ruling HQ 546979, April 2000) was based on a bilateral APA, recognised as valuable information in applying the COS test. It enabled the importer to use APA-approved prices as the basis for customs value. The interesting point is the customs authorities' involvement in APA negotiations, allowing them to review, for example, the selection of comparables, the selection of years for comparison and use of the interquartile range. Finding such a common approach that satisfies a minimum standard for each authority (tax and customs) can be a way forward and is being investigated by some other countries.

How can the choice of an income tax transfer pricing method impact customs and VAT?

Customs valuation rules have a direct impact on taxes notably in the EU at the level of the assessment of the taxable basis for import as mentioned above.

Indirect interactions or tensions can also occur when income tax transfer pricing rules meet customs valuation rules.

The business case

A non-EU manufacturer sells finished products to an EU affiliate (importer), based on resale price. The driver of the prices is the in-market resale price to unrelated customers. These resale prices vary by jurisdiction, leading to different import prices.
Is this raising customs issues?

The tax questions

Fortunately, a deductive valuation method (the customs equivalent of resale price) is available under the community customs code. It can be used, instead of the transaction value where sales price is cast into doubt.

However, the customs method has some specifics compared to resale price as there is an expressed preference in customs for comparables derived from the country of importation. Moreover, the deductive valuation method requires that comparable transactions occur within a 90-day period after the related-party transaction and there is a customs preference to measure value against the normal pricing practices of an industry or industry sector. The application of the deductive method raises some concerns in the case in hand as it usually takes as reference the transaction with the highest number of sales, based on the greatest aggregate quantity. This does not reconcile with the income tax approach and deserves particular attention.

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Another interesting interaction occurs between customs valuation rules and VAT/GST in the area of royalties. Indeed, it illustrates how existing requirements in valuation mechanisms could achieve unlikely results like double-taxation. This is the case in the EU because of the combined effect of customs valuation requiring the inclusion of some royalties and license fees related to goods imported and the levying of VAT on the royalty income in the country of destination. Stakeholders are highlighting the issue that is also under review at WCO and EU level (but likely in a way to broaden situations where royalties should be included in the customs value and subject to customs duties).

How can customs classification endanger uniform VAT and excise level playing fields?

In the EU, customs and VAT also meet at the corner of reduced VAT rates. Article 98, para. 3 of the EC VAT directive authorises member states to use the combined nomenclature (CN) to establish the products falling (or not) within a defined VAT category.

The business case

An operator intends to market foodstuffs across different domestic markets in the EU and applies for binding tariff information (BTI) in one targeted country.

The tax questions

Customs duties are not at stake here but rather the impact that a given customs classification can have on VAT and excise duties. Whether or not products are eligible for reduced rates may differ, depending on the criteria adopted, such as their tariff classification.

As an illustration, Belgium provides for a broad category of foodstuffs eligible for the reduced VAT rate but generally does not use the CN, or only as an indication. Each member state may act differently, leading to distortion between markets or, even worse, between relatively similar products within one market. Moreover, a given customs heading may impact national excise duties, as some EU countries are connecting the scale (or exemption) of national excise duties to a defined CN heading. The combination of both elements can have a decisive impact on price and affect the competiveness of the operator.

Convergence, a reality?

Esperanto is a limited success so far, and achieving full convergence in taxes is probably nothing more than a pipedream. Further developments in joint APA programmes should ease dialogue between tax authorities and hopefully provide for a common determination of valuation for related-party transactions. Dialogue can be pursued towards joint audits or even common dispute resolution mechanisms as suggested during the second joint WCO/OECD conference.

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