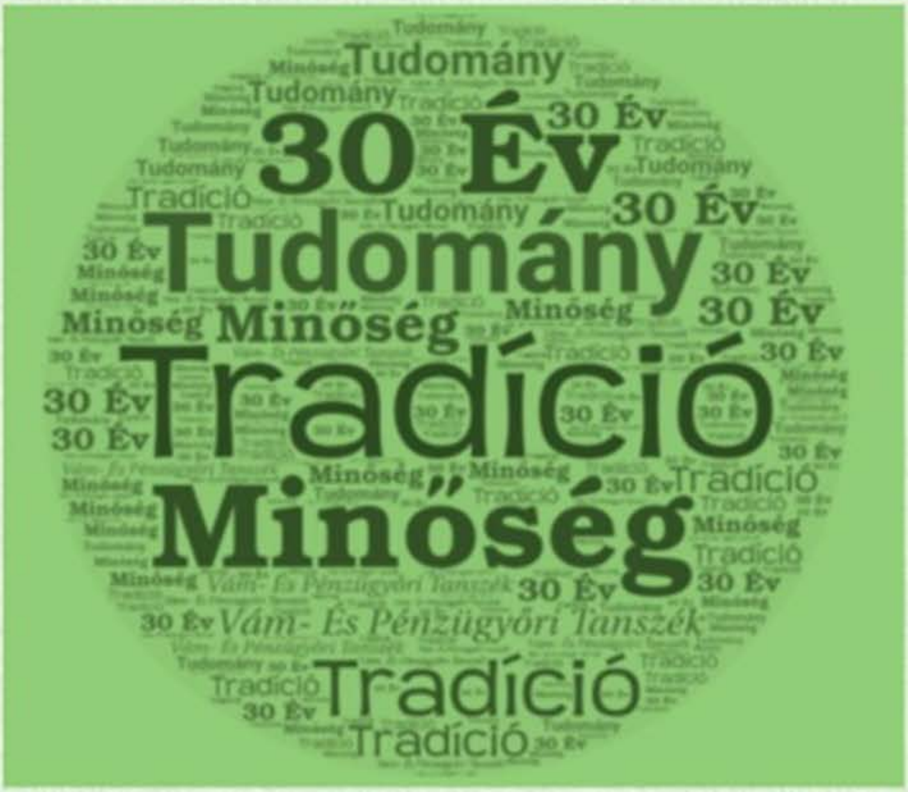

„Tradíció, tudomány, minőség”

Tanulmánykötet

2021

„Tradíció, tudomány, minőség”
30 éves a Vám- és Pénzügyőri Tanszék

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Jurušs, Māris* – Miloseviča, Kristīne* – Šmite-Roķe, Baiba*: Transaction market value range based on arm's length principle for customs and tax purposes

Abstract

The purpose of the article is to examine the similarities and differences between transfer prices and customs values due to the importance of international trade. The transfer price is the price set in the transaction between two related companies if they operate from different countries or customs territories. In this case, the customs burden comes in between and impacts the prices. As price should be an arm's length based on customs and transfer price perspective, some issues could arise as the rules are not identical from customs and transfer pricing perspective.

Keywords: transaction market value, customs valuation, transfer pricing, arm's length principle

Cím magyarul: A szokásos piaci ár elve alapján az ügyleti érték tartományának meghatározása **vám- és adózási célokra**

Absztrakt

A cikk célja, hogy megvizsgálja a külkereskedelem két összefüggő fogalmát, a transzferárat és a vámértékeket. A transzferár az az ár, amelyet két egymással kapcsolatban álló vállalat közötti tranzakcióban állapítanak meg, ha azok különböző országokban vagy vámterületekről tevékenykednek. Ebben az esetben a vámteher közbejön és befolyásolja az árakat. Mivel az árnak a vám és a transzferár szempontjából a szokásos piaci árnak kell lennie, felmerülhetnek bizonyos problémák, mivel a szabályok különböznek a vámérték és a transzferár meghatározása szempontjából.

Kulcsszavak: ügyleti érték, vámérték, transzferárképzés, szokásos piaci érték elve

***

Methodology

There may be different ways how to calculate the market value interval. For example, using minimum to maximum values, quartiles, and numerical values can be calculated as a base, average arithmetic, weighted average, and total average values. For the best calculation of the market value range of a transaction, appropriate statistics is required. This paper analyses the differences when the arm's length principle is set according to customs value or transfer pricing.

The scientific aim is to find solutions to improve the application of the market value as derived per the arm's length principle for customs and tax compliance.

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Although there are certain similarities between transfer pricing and customs valuation methods, there is only one valuation rule from the customs perspective: transaction value should be considered with transfer pricing methods. The issue of the market value may be approached from both customs and tax points of view. The transaction market value interval should be used where the customs administration sets the interval's lowest, while the tax administration sets the highest value.

The research paper determined the transaction market value range based on the arm's length principle for customs and tax purposes. When companies prepare their transfer pricing policy, they should incorporate additional analysis of the transaction market value range to escape disagreements between the customs and tax administrations on the customs value and the transfer price.

Introduction

This article summarises information about applying the arm's length principle from a customs and tax perspective.

From the tax perspective, the market value is essential in transactions between related companies, where the transaction value is called transfer price (TP). From a customs perspective, the market value is vital in determining customs value (CV). When choosing CV and TP, we need to do it based on the arm's length principle. Arm's length principle from customs and tax perspective has been discussed from the origins, because even though market value should be the same in tax and customs, still it may differ. From a custom's perspective, the market value determined by the arm's length principle can vary from the one specified by tax administration (please refer to Figure 1). To have even a little understanding of how to get the market value, the authors have analysed similar researches and tried to establish the transaction market value based on the arm's length principle, which could be the same from a customs and tax perspective.

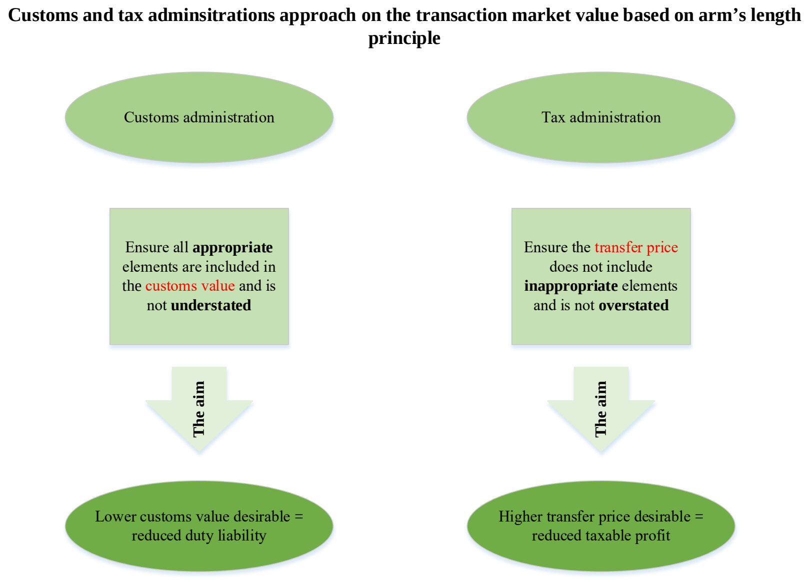

Figure 1. Customs and tax administration approach for the transaction market value based on the arm's length principle (Created by the authors of this research paper based on WCO, 2018).

This research paper aims to find solutions to improve the application of the market value as derived per the arm's length principle for customs and tax compliance.

Research objectives were set as follows:

1. to study principles of determining and applying the market value based on the principle of transactions between unrelated persons in accordance with the needs of customs and taxes stipulated in enactments and international reports;
2. for the purpose of determining the market value, to compare the customs valuation and the transfer pricing methods used by the relevant revenue administrations respectively;
3. to decide the reason for the formation of differences in customs value and transfer prices;
4. to study international practice in market value determination that is extensively used by the customs and tax administrations for customs value and transfer price evaluation;
5. to develop possible solutions to foster the application of the arm's length principle for customs and tax purposes.

Literature review

Unfortunately, empirical customs duty transfer pricing studies are less common than empirical income tax transfer pricing studies. It is likely because of the difficulty of obtaining data on transaction prices or goods flows. (Blouin, 2018) The existence of two sets of rules and two different administrative bodies dealing with income taxes and customs duties makes cross-border trade overly complicated and costly. (Muhsin, 2020)

The relevant question is whether the customs administration can use the TP documentation prepared by the importer and submitted by the importer as a basis for analysing the appropriateness of the prices charged in the sales transaction. On the one hand, the TP documentation submitted by the importer can be a reasonable basis and source of information if it contains relevant and detailed information on the sales transaction. On the other hand, TP documentation may not be suitable or applicable to the analysis of the sales transactions, given that there are some differences between the methods for determining CV and the methods for determining TP. Therefore, TP documentation is required for thy analysis of each sale transaction to measure the CV in import cases. After all, any relevant information and documents concerning the import transaction can be used to analyse the sales transaction so that the TP documentation is considered relevant. (Fabio, 2020b)

Adherence to the rules on transfer pricing and customs valuation for cross-border trade under the traditional customs approach is indeed burdensome. WCO has called on all customs authorities to apply the International Chamber of Commerce (ICC) solutions to facilitate customs relations and speed up international trade. An integrated approach could reduce administrative costs and prevent any risk of sanctions on the world market. (Fabio, 2020)

Although most companies in the European Union and elsewhere have tended to rely on so-called transfer pricing agreements, which are a matter of tax law and customs valuation, this has not been recognised by the European Court of Justice. Following the court's decision, companies must apply a customs valuation system separate from the transfer pricing system in practice. However, transfer pricing studies might be helpful for further discussions on the customs valuation system. (Beretta, 2018)

For legal certainty and uniformity, it would be desirable to communicate the official views of the Customs Expert Group, including some practical guidelines to facilitate the interaction between transfer pricing and customs valuation. (Friedhoff, 2019)

Dong Soo Kim, Duk Won Suh and *Joseph Hong of Yulchon,* in their research paper: "*Transfer pricing and customs should come together*", analyses that TP and CV could be harmonised, to reduce the taxpayers' burden. *Dong Soo Kim, Duk Won Suh* and *Joseph Hong of Yulchon* note that in Canada, TP methodology, which is in line with OECD Guidelines, is used to determine whether the relationship between related parties for customs purposes affects TP. Accordingly, the Canadian customs may accept a price derived from one of the TP methods following the OECD Guidelines if the customs does not have more precise information on the transaction price. (International Tax Review, 2009)

US Internal Revenue Codex or IRC provides that the purchase price imported from related parties may not exceed the customs value. Restricting the transfer price on the income tax side can promote consistency in calculating customs and income taxes. (International Tax Review, 2009)

Erkan Ertuk writes in his research paper "*Intangible assets and customs valuation*" that there are marked similarities between the World Trade Organization's (WTO) and OECD Guidelines' determined methods of CV and TP determination. For example, WTO determined deductive approach, which is described in the Agreement on implementation of Article VII of the general agreement on tariffs and trade 1994. (the Agreement) Article 5 is based on the resale price of the goods, in line with OECD. WTO computed value method (Article 6) is based on a value built up from materials and manufacturing costs, plus profit, similar to the OECD cost-plus method. Customs' focus is on the transaction value method and whether or not the declared price has been influenced when the buyer and seller are related. Customs, therefore, will mainly be examining transfer pricing data in this context and not other WTO methods. (Ertuk, 2018)

Michael Landwehr states that to ensure a uniform and legally robust implementation of the Agreement, applying the arm's length principle must be justified. Uncertainty as to how the arm's length principle is applied in the context of CV designation law can be addressed through appropriate input into other international agreements or national TP designation laws adopted based on an international agreement, such as the OECD. (Landwehr, 2019)

In the context of the unrelated party transaction, the European Union (EU) context must also consider the fact that TP is based on OECD Guidelines and national legislation. Still, CV is not based on legislation but trade policy measures based on EU rules and, in some cases, based on the interpretation of the European Court of Justice. Therefore, it must be concluded that the determination of TP may vary in each Member State, but the identification of CV is uniform throughout the EU. Table 1 shows the differences between the customs law of the EU and the essence of the methodology for determining the TP. (Tuominen, 2018)

Table 1: Summary of comparison between different general aspects of TP and EU customs law (Tuominen, 2018)

	TP	EU customs law
Legal basis	OECD model, OECD Guidelines and domestic laws.	EU – level regulations, mainly the UCC, as interpreted by the ECJ. Valuation rules of the UCC are based on the GATT (1994)
Purpose	To allocate profits within multinational enterprises the same way as they would be allocated between independent enterprises.	To harmonise the customs rules throughout the customs territory of the Union and to ensure a level playing field for European trade.
The aim of authorities	Decrease the value of the goods.	Increase the value of the goods.
Tax/ customs duty object	Wide, i.e. the profits of the taxpayer.	Narrow, i.e. the value of the imported goods.
Scope	All cross-border intercompany trade, including goods, services, intangibles and financing.	International trade of goods.

	TP	EU customs law
Tax/customs duty subject	Narrow, i.e. only associated with enterprises.	Wide, i.e. generally everyone who imports goods from outside of the customs territory of the Union.

Based on Joel Cooper, Randall Fox, Jan Loeprick and Komal Mohindra findings, the transfer pricing regimes are often challenging to implement, particularly in countries where commensurate administrative capacity is yet to be developed. Developing such capacity for transfer pricing can be time-consuming and resource-intensive and may be limited by various constraints. A lack of administrative capacity can lead to a disregard for the legislation or may result in "innovative" and poorly targeted enforcement by the tax administration. The former may further erode the tax base due to opportunistic investor behaviour, or simply tax avoidance, or a bias toward risk aversion in countries with more robust administrative capacity. The latter can result in increased uncertainty, undermining investor confidence, and raising transaction costs (for example, double taxation, penalties, or advisor fees). (Cooper et al., 2017)

Methods

Analysing the customs and tax administration's view on the arm's length principle, the authors concluded that each administration has a different interest in the transaction's market value. Respectively, the customs administration has an interest in keeping the market value of the transaction as high as possible. In contrast, the tax administration has an interest in keeping it as low as possible. Therefore, even if the transfer pricing documentation is appropriate, the customs administration could challenge it if it considered that the transfer price set was still too low to be considered as a CV. Therefore, for both parties to be satisfied, it is necessary to determine the range of the transaction's market value, which does not contradict the customs and tax administration. Thus, when talking about the market value of a transaction, we have to talk about the interval of the transaction's market value, where the lower value of the interval would not contradict the customs administration but the upper limit with the tax administration. As TP methods often do not provide a specific market value of the transaction but an interval within which the transaction's market value must be included, the author's task is to ensure that the TP market interval does not conflict with the MV market price.

Although it was concluded at the time of the study that there are similarities between the methods of determining CV and TP, the authors consider that it is wrong to look only from this point of view because, first of all, it should be remembered that the transaction value method is the most relevant and more common when determining CV. Therefore, it would be worthwhile to analyse this method in more detail in connection with TP determination methods.

The calculation of the market value range of a transaction is also reflected in the OECD Guidelines, which state that in most cases, it is not possible to present only one exact result in the analysis of TP comparative data. The purpose of the TP analysis is to determine whether the terms of a particular transaction are in line with market rules. However, recognising that market conditions change and that the analysis of market conditions is never complete because it is not possible to find all relevant transactions between unrelated companies, *"the application of the arm's length principle only approximates conditions"*. (OECD, 2017) As the analysis of comparable data uses approximation, the OECD Guidelines state that each value from the interquartile range is equally reliable, i.e. *"the application of the most appropriate method or techniques produces a series of numbers, all of which are relatively equally reliable"*. (OECD, 2017)

Based on the above point from the OECD Guidelines and General Statistical Principles, there may be different ways how to calculate the interval. For example, using minimum to maximum values, the calculation of quartiles and numerical values can be taken as base values, average arithmetic values, weighted average values, and total average values. Therefore, to determine how best to calculate the market value range of a transaction, it is necessary to consider which statistics are available at all and which could be viewed as the most appropriate.

All statistics can be divided into two large groups, i.e. individual indicators and summary indicators. In addition, statistics are divided into absolute, relative and average indicators by form of expression. Individual indicators and quantities describe particular objects or individual units - enterprises, firms, households, people, etc. Individual absolute values are the volume of products sold by the company, the turnover of the trading company, household income, etc. Comparing two individual absolute values that characterise the same object or unit gives an individual a relative value. The statistics also calculate individual averages, but only in a time dimension, such as the enterprise's annual average number of employees. Aggregate indicators, quantities instead of individual quantities, describe a group of units that represent part or all of a set of statistics. These indicators are divided into volume and calculation indicators. Volume indicators and values are obtained by adding the meanings of individual units. Calculation indicators are values that are calculated according to different formulas. They are used to analyse socio-economic phenomena and processes - to measure variation, characterise structural change, and assess interrelationships. These indicators are also divided into absolute, relative and average values. (Goša, 2003) According to the authors of the work, the most suitable indicator for calculating the market value range of the transaction from the above is the calculation indicator because it reflects the assessment of the interrelation.

In terms of the form of expression, the average indicator might be the most appropriate. The average value is a numerical characteristic summarising the studied feature of the statistical set under specific site conditions and time. For the averages to accurately reflect the typical levels of the studied phenomena, the set from which the averages are calculated must be large enough and consist of individually varying but qualitatively homogeneous units. The essence of the averages is that they mutually cancel the values of the characteristics of the individual units of the set, which are influenced by random factors and take into account the changes that have taken place as a result of the main factors. This allows the average values to show the typical size of the features and abstract from the individual features in the individual units. The fact that the average is an abstraction does not diminish its scientific significance. (Goša, 2003)

The most important and widely used grade means in practice are:

- arithmetic mean;
- geometric mean;
- root mean square;
- harmonic mean etc.

Depending on the nature of the information to be processed, a distinction is made between unweighted or simple averages calculated from non-aggregated data and weighted averages calculated from aggregated data. Mean values cannot be chosen arbitrarily. Each medium has its economic content and characteristics; therefore, their use must be justified based on the purpose and objectives of the study and the specifics of the processed information. To choose the most appropriate average, it is necessary to know the properties of the average values. The averages always have specific content in the statistics; the calculation process is purposeful and economically interpretable. (Goša, 2003)

If the study population consists of a small number of observation units and individual meanings of known features, the averages are calculated according to the weighted average formula. In this case, the method of arithmetic mean calculation can be used. It is obtained by dividing the sum of the characteristics of the individual units of the set of the studied phenomenon by the number of units of the set. If the study population includes many observation units, then the initial information is usually shown by a distribution row or grouping. If the data are grouped, weighted averages shall be used, calculated from the number of repetitions of each variant or characteristic, i.e. statistical weights. (Goša, 2003)

The authors of this research consider that the most appropriate method of calculation in calculating the market value range of the transaction would be using the formula of unweighted averages and arithmetic average calculation because a large number of observation units will not be used in the calculation. For the author's created transaction market value range, please refer to Figure 2.

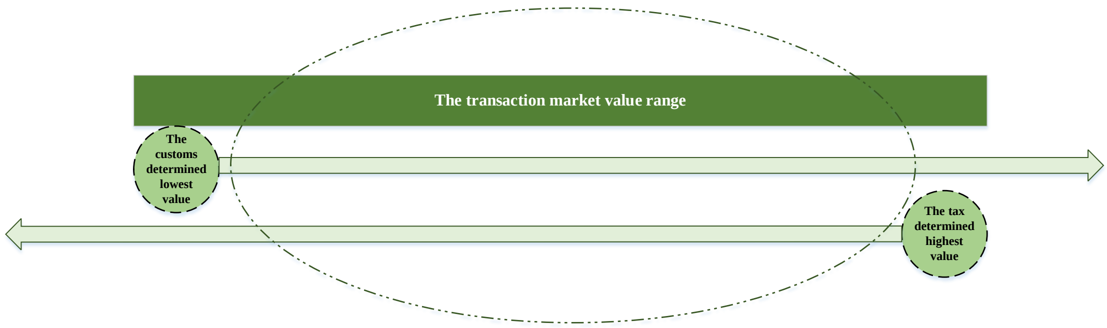

Figure 2. The transaction market value range
(Created by the authors of this research paper).

Results

To calculate the transaction market value range, the same product at the exact transaction time CV and TP must be determined (i.e. in the case of imports of goods effected during a given period). (see Figure 2) This may occur in two different situations.

Ideally, the market value of the transaction in both cases (i.e. determining the CV by the transaction value method and TP is recognised as the transaction market value by one of the TP valuation methods) would coincide, indicating that TP can and should be based on the CV in order not to create additional administrative burdens. In particular, CV is determined before TP and as CV is determined at the time of import. Still, TP is recognised as the transaction's market value after justification according to the arm's length principle, which is normally at the end of the financial year in which these transactions occur (unless an appropriate TP policy is developed that focuses on future transactions).

In the second situation, the transaction's market value differs slightly, leading to the formation of the transaction market value range (see Figure 2). The main problem is that TP and CV go to their respective sides, and it is impossible to create an interval. In such a case, to determine the interval, the lowest allowable value of CV and the maximum allowable value of TP would have to be calculated. Thus an interval of the transaction market value would be created. (see Figure 3).

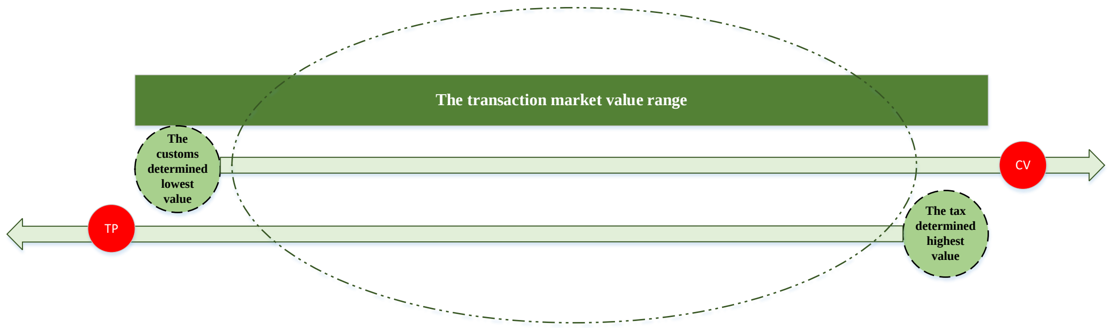

Figure 3. Location of CV and TP in the transaction market value range (Drafted by the authors).

Applying the appropriate methods for determining CV and TP, developed by the authors of this research paper, came to the following TP intervals (see Figure 4) and at the same time to one specific CV.

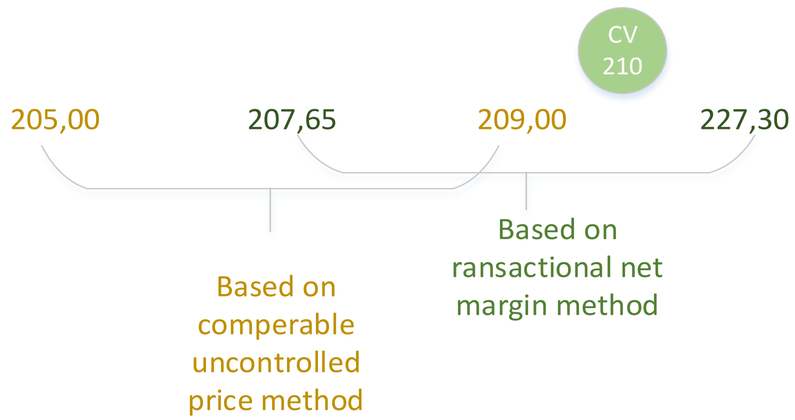

Figure 4. Potential market-level ranges from TP's point of view (Created by the authors of this research paper).

As only a single market value of the transactions was determined for CV, no further calculations were required in this case, and this value is shown in Figure 5 as the lowest value determined by customs. In contrast, two potential intervals were determined by TP determination methods (i.e. from EUR 205 to EUR 209 and from EUR 207.65 to EUR 227.30), which is in accordance with the arm's length principle according to the chosen methods of determining TP (i.e. according to the comparable uncontrolled method and transaction net margin method). In this case, the previously mentioned calculation was used, and the highest value from the tax perspective was determined as an average value from both intervals' highest value (i.e. (209 + 227.30)/2=218.15).

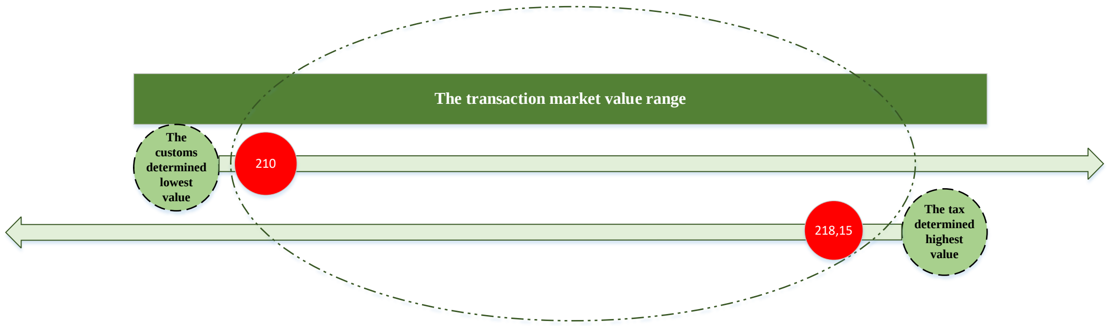

Figure 5. The transaction market value range for the example given in the research paper (Created by the authors of this research paper).

Discussions

Business development highly depends on considerable financial resources, which may be challenging in developing countries, according to Kristina Kindsfaterienė and Kazys Lukaševičius' research paper "The Impact of the Tax System on Business Environment". The most effective methods are employed to create an investment-friendly environment. Tax burden or, more generally, tax policy plays a crucial role in determining the attractiveness of a business environment. (Kindsfaterienė, 2008) The TP is one of the critical variables that can result in tax burden to companies, especially when there are uncertainties in conjunction with international trade and customs. The manipulation of transfer prices changes the relative tax burdens multinational firms face in their different countries of operation and may even reduce a firm's worldwide tax payments. (Swenson, 2001) Transfer pricing is of increasing importance to corporations in a globalised economy; their operations extend to countries with diverse taxation regimes and regulatory capacities. (Sikka, 2010) TP for multinational enterprises can also be more like a corporate strategy. (Cravens, 1997) Krystyna Zoladkiewicz and Renata Orłowska, in their research paper, examines the negative impact of the paralysis observed in the WTO functioning on international business. There are loopholes in the WTO rules and principles which became severe threats to the multilateral trading system. (Zoladkiewicz, 2020)

The authors of this research paper consider that the most significant problems faced in CV and TP are the TP adjustments. TP adjustments pose a significant issue between the tax and customs side because if in one case it is normal and necessary to make these adjustments, then in the other case, it is already prohibited. Maria Malm also makes a similar conclusion in her master's thesis "Customs Valuation and Transfer Pricing – Two Sides of the Same Coin". (Malm, 2009) There are even more than one TP adjustment possible to perform. Duarte Nuno Tenreiro Freitas dos Reis describes these types of adjustments in his research paper. As he mentions, the first and most common adjustment is called a primary adjustment. These adjustments represent changes to taxable profit that a tax administration in a first jurisdiction makes to a company's taxable profits due to applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction. (Reis, 2012) As Fyfe points out in his research paper, these adjustments can lead to double taxation with income tax. (Fyfe, 2016)

It is most commonly considered that the dividends do not justify an adjustment of customs value because they are no part of the payments for the sale of the merchandise, notes Juan Pablo Rizzi in his research paper. Rizzi understands that if the costs for dividends are related to the imported merchandise, they become part of the CV. Therefore, it is possible to adjust customs value. (Rizzi, 2019) *Krzysztof Lasinski-Sulecki* mentions that the Court of Justice of the EU has issued two judgments in customs valuation matters. These confirmed the possibility of adding specific amounts to transaction value that were not explicitly mentioned in Article 32 of the

Community Customs Code. The Court of Justice seems to have relied on the concept of abuse, although it did not make explicit references to this concept. (Lasinski-Sulecki, 2015) The authors of this research paper consider that both research papers show that there are possibilities that differences between TP and CV caused by TP adjustments could be eliminated.

Consequently, one solution in this aspect could be to amend the relevant legislation on the determination of CV so that these adjustments can also be recognised by the customs administration; however, as such amendments may be challenging to make because the Union Customs Code was established by a Regulation of the European Parliament and the Council. The Council usually takes decisions by a qualified majority, except in sensitive areas such as foreign and tax policy, where unanimity is required, or all countries must vote equally. (Union) Bearing in mind that the WTO has drawn up an Agreement that stipulates the liberalisation of multilateral trade and reducing tariff barriers. WTO has 164 Member States (WTO) and decisions about some changes WTO accepts according to the Agreement after the principle of unanimity, which means that everyone must agree to these decisions. Thus, if the difference is to be made about the CV, unanimity among decision-makers would be required, which could be difficult, as each country always thinks first of its interests and only then of the common wellbeing. As *Catherine Truel* and *Emmanuel Maganaris* emphasised in their study, when Community Customs Code reached its limits, the Union Customs Code were introduced as its replacement. (Maganaris, 2015) As there have been already changes, this shows that it is possible to make changes again.

Conclusions

The authors of this research concluded that even though there are similarities between transfer pricing methods and customs valuation methods, only one valuation method from the customs' perspective – transaction value methods, should be analysed concerning transfer pricing methods. Regarding market value, which is appropriate for both customs and tax, the transaction market value interval should be used where the customs administration sets the interval's lowest value. Still, the tax administration sets the highest value. Considering the interests of both customs and tax administrations, when companies are preparing their transfer pricing policy, they should include additional analysis of the transaction market value range in their policies to escape any disagreements between the customs and tax administrations on the customs value and the transfer price.

The authors of this research, in her opinion, found a solution on how to improve the application of market value for customs and tax purposes by developing a transaction market value range and the mechanism on how to calculate it.

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