CUSTOMS VALUATION AND TRANSFER PRICING.
IS IT POSSIBLE TO HARMONIZE CUSTOMS AND TAX RULES?

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A mis viejos y a mi hermana ...
(for my parents and my sister ...)

ABSTRACT

There is an overlap between the transfer pricing concepts that apply under tax and under customs regimes. This thesis aims to demonstrate (i) that customs and tax laws often share common principles in respect of related-party transactions; (ii) that transfer pricing as agreed to under one discipline should be recognized under the other; (iii) that the OECD Transfer Pricing Guidelines constitute a body of rules that is appropriate to supplement the related party provisions of the GATT/WTO Valuation Code ("GVC"); and (iv) that such guidelines are generally in accordance with the provisions of the GVC and its general principles and objectives. This thesis also analyzes the tax and customs value of imported goods, and identifies which additions to or deductions from customs value might have to be taken into account in comparing tax and customs results. The thesis concludes with an analysis of the circumstances and conditions under which the introduction of transfer pricing compensatory adjustments to transaction value would be consistent with Article 1 of the GVC.

RÉSUMÉ

Il existe une superposition des normes douanières et des normes d'imposition qui concernent les prix de transfert. La présente thèse tentera de démontrer (i) que les normes douanières et d'imposition possèdent souvent des principes communs quant aux transactions réalisées entre deux personnes liées; (ii) que les prix de transfert déterminés par une discipline devraient être reconnus par une autre discipline; (iii) que les principes directeurs sur les prix de transfert de l'OCDE constituent un ensemble de règles qui peuvent être complémentaires aux normes de l'Accord sur la valeur en douane de l'OMC/GATT applicables aux personnes liées; (iv) que ces principes directeurs sont conformes, de façon générale, aux normes de l'Accord de valeur en douane, à ses principes généraux et à ses objectifs. Nous analyserons aussi les valeurs d'imposition et en douane des marchandises importées et nous identifierons les différentes déductions et additions à la valeur en douane qui devraient être considérées lorsque les résultats douaniers et d'imposition sont comparés. Enfin, nous analyserons dans quelles circonstances et sous quelles conditions la réalisation d'ajustements compensatoires à la valeur transactionnelle pourrait être en accord avec l'article 1 de l'Accord de valeur en douane.

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INTRODUCTION

There is an overlap between the transfer pricing concepts that apply under the customs and tax regimes. As a consequence of this, a lawyer who practices in both tax and customs fields frequently faces a dilema: how to apply two systems of valuation to the same transaction.

Rates of duty are usually established on an *ad valorem* basis. Consequently, it becomes necessary to establish the value of the goods for determining what duty to assess. Valuation constitutes, therefore, one of the main fields of Customs law.

In determining income taxes, it is also necessary to establish the value of imported goods. In effect, the applicable tax rate is applied to taxable income (i.e., the tax base of income taxes) to determine the amount of tax payable. Many of the elements which are necessary to determine taxable income (e.g., sales price, cost of goods sold, adjusted cost base, inventory cost, etc. [hereinafter "tax value" or "value for tax purposes"]) are calculated on the basis of the value of goods (which are involved in income-producing activities). Hence, valuation also constitutes one of main fields of Income Tax law.

Under both tax and customs laws, the transaction value usually governs in determining the value of goods sold or acquired (although sometimes, pursuant to statutory or treaty provisions, certain elements are to be included in or excluded from transaction value in calculating the tax bases of duties or income taxes). In other words, transaction value is the point of departure to calculate tax and customs values of such goods.

However, transactions agreed upon by and between related parties (hereinafter "related-party transactions") present a particular problem: the relationship between the parties may permit them to establish special conditions in their "intra-group" relations that differ from those that would have been established had the parties been acting as independent enterprises. In other words, when associated enterprises deal with each other, their commercial and financial relations may not be directly affected by external market forces. Thus, associated enterprises could manipulate their profits and prices to ensure the most favorable tax and customs treatment for their transactions.[1] Consequently, when transfer pricing does not reflect market forces, the tax and customs liabilities of the associated enterprises and the tax and customs revenues of the host countries could be distorted.

Tax and Customs administrations are each pulling the importer/taxpayer in opposite directions. The larger the gain, as measures in the context of resales after importation, the greater the tax revenue. Thus, tax administrations will generally insist on a low transfer price to ensure the greatest income in their countries. Customs administrations are charged with a similar collection mission. The higher the dutiable value of the imported goods, the greater the duty revenue for Customs.

This means the importer/taxpayer could be squeezed in the middle if neither customs nor tax law recognized transfer pricing as agreed to under the other discipline.[2]

Chapters I, II and III of the present work will be aimed at demonstrating that

(i) customs and tax laws often share common principles in respect of related-party transactions;

[1] Associated enterprises seeking to achieve the most favorable tax and customs treatment, would often set their transfer prices considering, among others, the following factors: income tax rates in the country of exportation and in the country of importation; customs-duty rate in the country of importation; existence of statutory or treaty relief for underlying foreign taxes in the country of importation or exportation (e.g., tax credits, exempt dividends, exempt surplus, etc.); existence of withholding tax on dividends paid to foreign beneficiaries; etc.
[2] See Levey, M., *Taxation of Foreign Controlled Business*, (WL, 2000) at 8.05[1]. Online: WL (Levey, Taxation of Foreign Controlled Business, Tax Treatises).

(ii) transfer pricing as agreed to under one discipline should be recognized under the other;
(iii) the OECD Transfer Pricing Guidelines[3] constitute a body of rules that is appropriate to supplement the related-party provisions of the GATT Valuation Code;[4]
(iv) the provisions of the OECD Guidelines are generally in accordance with the provisions of the GVC, their Notes and their general principles and objectives.

They will also be aimed at determining the particular conditions that must be observed in applying the OECD Guidelines and their methodologies in the customs context.

The objective of Chapter IV will be significantly different. As indicated above, statutory additions to or deductions from transaction value are sometimes required to calculate the tax base of customs duties (i.e., the customs value) or the relevant element of the tax base of income taxes (i.e., the value of the goods for tax purposes).

For instance, certain assists provided by the buyer to the seller free of charge might be regarded as part of the tax value of the imported goods. In contrast, the same assists might not be considered to be part of the customs value of the such goods. In these cases, a comparison between tax and customs values would not provide consistent results unless appropriate adjustments were made to account for differences in the calculation of such values. This comparison may be useful for many purposes. For example, it could avoid double scrutiny of the same transactions by tax and customs authorities. (It should be taken into account that importers/taxpayers usually provide tax and customs administrations with information concerning tax bases.) It could also prevent customs and tax administrations from adopting inconsistent approaches regarding the appropriate determination of arm's length prices.

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[3] Organization for Economic Cooperation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, looseleaf (Paris: OECD, 1995) [hereinafter "OECD Guidelines"].
[4] *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*", 15 April 1994, at 171, online: <http://www.wto.org:80/wto/english/docs_e/legal_e/final_e.htm> (date accessed: 3 August 2000) [hereinafter "GVC"]

Therefore, Chapter IV will be aimed at analyzing the tax base of customs duties and at identifying which additions to or deductions from customs value might have to be taken into account (and eventually adjusted) in comparing tax and customs figures.

Finally, in Chapter V we will address a practical problem that multinational enterprises may face in determining and declaring appropriate arm's length prices to customs, through the application of certain methodologies.

One consequence of the application of a transfer pricing methodology could be a compensating adjustment. For example, when there is a cost-plus pricing and the entry is made when the cost have not been finalized, the transaction value declared to customs would only be estimated or provisional, since some of the elements that are necessary to calculate an appropriate arm's length transaction value will not be known until later.

Whether such provisional or estimated price is arm's length will usually depend on whether or not a compensatory adjustment is finally necessary. Therefore, in such circumstances, an importer would only be able to declare to Customs an appropriate arm's length transaction value, if the customs legislation permitted the introduction of compensatory adjustments to a transaction value that has already been declared.

Consequently, in Chapter V, it will be analyzed in which circumstances and under which conditions the introduction of compensatory adjustments to transaction value would be consistent with GVC Article 1.

CHAPTER I
GENERAL

1. RULES TO BE HARMONIZED.

In the customs valuation field, we will examine the provisions of the GVC (especially, those applicable to related-party transactions).

In the tax field, no multilateral tax convention establishes principles of valuation or methodologies. However, a great number of countries (including, but not limited to, those which are members of the OECD) have drafted their tax conventions based on the OECD Model Tax Convention[5] ("MTC"), where one can identify certain basic rules regarding related-party transactions and, thus, transfer pricing. The arm's length principle has been included in Article 9 of the MTC and gained acceptance as the fundamental principles governing international transfer pricing in all OECD member countries, both in bilateral treaty networks as well as in those countries' tax statutes and implementing regulations[6]. Interestingly, the arm's length principle was included not only in the tax conventions between OECD countries but also in those between OECD countries and non-OECD countries. This created a large treaty network among a great number of countries where related-party transactions are governed by a common principle: the arm's length standard.

One can suggest, therefore, that our object of study in this field seems to be a number of concordant international instruments. However, neither the tax conventions nor the MTC

[5] OECD, Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital*, June 1998 condensed version (Paris: OECD, 199) [hereinafter "MTC"].

[6] See Hammer, et al., *International Transfer Pricing – OECD Guidelines*, (WL, 2000), at 3.01, online: WL (Hammer, Lowell, Burge & Levey, Transfer Pricing Treatises). Note that, in the European Community, the profit allocation principle laid down in the Arbitration Convention (E.C., *Convention 90/463/EEC of 23 July 1990*, [1990] O.J. L 225, 20.8.1990, at 10) is the principle of arm's length dealing and separate accounting. Profits of associated enterprises, and of branches and their head offices, should be determined as if they were dealing wholly independently from each other. The Arbitration Convention, however, does not specify which arm's length method it adheres to (See Terra, B. and Wattel, P., *European Tax Law*, 2nd ed. (London, Kluwer Law International, 1997) at 289).

elaborate on the arm's length standard. They merely embrace the arm's length principle for the tax treatment of transactions among associated enterprises. (Where a treaty-country has made a transfer pricing adjustment to a multinational enterprise, these conventions also provide for corresponding adjustments by the other treaty-country.)

The OECD Committee on Fiscal Affairs has issued a number of reports on transfer pricing. The first major report, published in 1979, was "Transfer Pricing and Multinational Enterprises"[7]. Subsequent OECD reports analyzed specific transfer pricing issues. In 1993 the OECD started revising the 1979 OECD Report. The first five chapters of the revised version were approved by the OECD Council in July 1995 and, consequently, released to the public. This new version was entitled "*Transfer Pricing Guidelines for Multinational Enterprises and Tax administrations*" (OECD Guidelines)[8]. It included the definition of the arm's length principle, the various methodologies for determining prices that would be in accordance with this principle, as well as guidelines regarding documentation and penalties. Competent authority and mutual agreement, simultaneous examinations, burden of proof, advance pricing agreements and arbitration were also covered. The OECD Council adopted three more chapters of the Guidelines in 1996 and 1998.

The OECD is a consultative body, and its decisions and pronouncements are advisory and instructive, not mandatory. It is not a legislative body that can dictate to its members. Nonetheless, the OECD enjoys a high level of prestige among its members and most non-member states. Each of its positions evolves out of multinational dialogues and deliberations and represents a consensus on any particular topic under study.[9] On the other hand, many member and non-member countries have introduced in their tax legislation many of the principles and methodologies recommended in the OECD Guidelines.[10] This broad recognition makes the OECD Guidelines at least comparable to the GVC for the

[7] OECD, Committee on Fiscal Affairs, *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979) [hereinafter "1979 OECD Report"]
[8] See OECD Guidelines *supra* note 3.
[9] See Hammer *supra* note 6 at 1.02[1].
[10] See, e.g., *Ley de Impuesto a las Ganancias, t.o. 1997 y sus modificaciones* (Argentina), Article 15, as amended by *Ley 23.239* (B.O. 31 December 1999) [hereinafter "Argentine Income Tax Law"]

purposes of this analysis. Therefore, in the tax field, we will examine the MTC (which is a representative of the treaty network that supports the arm's length principle) and, especially, the OECD Guidelines.

Since the OECD Guidelines are far more detailed than the provisions of the GVC regarding related-party transactions, our analysis will basically consist in the study of the OECD Guidelines in order to determine whether the latter may complement the GVC's on related party transactions. Fur such purposes, we will also examine advisory opinions, commentaries, explanatory notes, case studies, memorandums and rulings that has been issued by national agencies, courts and international organizations in interpreting the GVC.

2. IS IT NECESSARY OR, AT LEAST, ADVISABLE TO HARMONIZE BOTH TAX AND CUSTOMS TRANSFER PRICING REGIMES?

When facing the question whether harmonization of tax and customs transfer pricing regimes is necessary or advisable, we find a number of problems which arise from (i) the existence of heterogeneous norms and international instruments, and (ii) the fact that tax and customs laws often have different objectives and principles.

The origin and development of the tax transfer pricing regimes compared to those of the customs valuation system have been radically different, what resulted in the different kinds of international and national norms and instruments governing each field. A comparison and subsequent harmonization of these norms and instruments may not be easy, since each of them has different legal authority (or no legal authority at all) and scope of application.

However, although all these particularities may cause some problems in the context of a process of harmonization, they are not a reason to reject the whole idea of harmonization of tax and customs transfer pricing laws. There are many reasons to think that harmonization is not only advisable but also necessary.

A first argument seems to be based on the idea of consistency. If two systems adopt common principles, the results derived from their implementation should be, to greatest extent possible, substantially consistent. (Implementing should not, in principle, change the substance of the rule being implemented.)

As we will see, both customs and tax valuation systems have chosen the arm's length standard as the principle that must govern the relations between related parties. Therefore, a harmonized implementation of such principle seems to be necessary to obtain consistent results. Implementing standards and principles in different and often inconsistent manner is a problem described by the Corporate Customs Counsel of General Motors USA, Mr. Peter Zubrin, as follows:

> A couple of other issues that we encounter in several countries point out the limitations of a global code such as the Valuation Agreement. When this *uniform agreement is implemented in any one country it becomes only a small portion of the whole set of laws and regulations affecting import transactions* within that country.
>
> For example, the Valuation Agreement specifies that retroactive payments may be dutiable under certain circumstances. It is silent, however, on the procedures for reporting such payments to the customs authorities. In the United States, thanks to the Customs Modernization Act, for which GM was a strong proponent, importers will soon have the flexibility to file entry declarations based on estimated values and reconcile those entries within 15 months thereafter by means of a post-importation review process. If additional duty is due for retroactive payments or any other adjustment, we will be required to pay it with interest. In other countries paying additional duty to amend an entry after its original due date automatically exposes the importer to substantial monetary penalties. A mod-act styled provision in the WTO Agreement would facilitate an efficient valuation reporting process by allowing all transactions covering a specific trade flow during a one-year period to be reviewed as a single project.[11]

A second argument appears to be more practical in character. This argument is often presented by members of the international business community and, especially, by multinational enterprises ("MNEs"). Zubrin explains such practical argument as follows:

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[11] WTO, Council for Trade in Goods, *WTO Trade Facilitation Symposium (9/10 March 1998), Report by the Secretariat, Panel 2 – Import and export procedures and requirements, including customs and border crossing problems – D – Compendium of all presentations – "Practical Problems for traders in the area of customs valuation"*, WTO Doc. G/C/W/115 (19 May 1998), online: <http://www.wto.org/wto/ddf/ep/public.html> (date accessed: 3 August 2000) [hereinafter "Practical Problems"]

Continuing with related party transactions, GM and other global traders are required to devote more attention to the special requirements for sustaining related party prices for both customs and tax purposes. The complexities and shortage of expertise has made this difficult and very costly since independent analyses must be done. Like us in the customs and trade profession, the tax professions and organizations such as the OECD are leading an effort towards transparent taxation rules. What amazes me, however, is how little interest the tax and customs authorities in most countries have for developing a harmonized approach for establishing the bona fides of a related party transaction. I might also add, there seems to be relatively little interest in the private sector for this.

*There should be no reason why a **transfer price** established under OECD guidelines that passes the arms-length test under the income tax laws of the exporting and importing country should not be acceptable as a price actually paid or payable for customs purposes. Amending the Valuation Agreement to allow importers the alternative of applying tax rules for this purpose would be a major breakthrough for traders, saving them the additional cost and work of doing two parallel valuation analyses of the same transaction.*[12]

In effect, transfer pricing and customs valuation analysis are often complex, expensive and time consuming. It does not appear to be reasonable (or at least, economically efficient) for an MNE to undertake two parallel valuation analyses of the same transaction.

On the other hand, sometimes an adjustment to transfer prices by the tax authorities may be rejected by the customs authorities and vice versa. Since the arm's length principle is the common standard governing related-party transactions for both tax and customs purposes, it should be necessary to identify whether such rejection arises from actual differences between the tax and customs regimes (which, as we will demonstrate, cannot be found in the rules regarding examination and acceptability of related-party transactions, but in specific rules which define the tax bases of customs duties and income tax) or simply from different opinions of the tax and customs officials.[13]

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[12] See Practical Problems *supra* note 11.

[13] Where customs and tax administrations are parts of the same agency (e.g. Federal Administration of Public Revenue of Argentina), adjustments based on different opinions of tax and customs officials could be blatantly arbitrary.

3. IS HARMONIZATION FEASIBLE?

3.1. CIRCUMSTANCES THAT MAKE THE COMPARISON AND, THUS, THE HARMONIZATION DIFFICULT.

As indicated above, the instruments involved in the present analysis are different in nature and legal status. As well, the fields of the law in question present different objectives. Thus, certain conclusions could work perfectly well in the tax field and be, however, no applicable in the customs field.

Briefly, we can mention the following general objectives of customs law:

(1) Regulate a country's foreign trade;[14]

(2) Revenue objective. (Nowadays, revenue objectives are secondary in most developed countries.)[15]

We can also mention the following general principles of customs valuation law:

(1) not to be an obstacle to international trade;

(2) simplicity;

(3) ease of trade;

(4) uniformity;

(5) avoid arbitrariness and protectionism through valuation. [16]

Bear in mind that customs duties are taxes. Therefore, the general principles of tax law are also applicable to them.

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[14] Alsina, et al., *Codigo Aduanero. Comentarios - Antecedentes - Concordancias*, Vol. 4 (Buenos Aires, Abeledo Perrot) at 154.

[15] *Ibid.* at 634-635 (see, especially, footnote 10)

[16] Most of these principles can be found in the preamble of the GVC. See Sherman, S. and Glanshoff, H., *Customs Valuation. Commentary on the GATT Customs Valuation Code* (New York, Kluwer Law and Taxation Publishers, 1988) at 60.

There are two fundamental objectives of tax law:

1) Revenue objective;
2) Non-fiscal (economic or budgetary) objectives (e.g., tax expenditures, etc.)

One can mention the following general principles of tax law:

(1) equity;
(2) fairness;
(3) neutrality,
(4) ability to pay,
(5) economic efficiency. [17]

Simplicity and ease of trade can also be regarded as principles of tax law.

Therefore, when pursuing harmonization through implementing measures, one should take into account the existence of non-symmetric objectives. Otherwise, the application of the measure might undermine the main objective of customs law, i.e., the regulation of foreign trade. This would be clearly unacceptable since countries would lose an important economic instrument, which is often granted to them by the countries' constitutions.[18]

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[17] See generally Krishna V., *Fundamentals of Canadian Income Tax* (Toronto, Carswell, 1993) at 12-29 (Krishna mentions "equity" as an objective of the tax system). See Jarach, D., *Finanzas Publicas y Derecho Tributario* (Buenos Aires, Ed. Cangallo, 1985) at 299-307 [hereinafter "Finanzas"]. In relation to the principle of "ability to pay" (capacidad contributiva), see Jarach, D., *El Hecho Imponible*, 3rd ed. (Buenos Aires, Abeledo-Perrot, 1982) at 91.
[18] See, e.g., *Constitucion de la Nación Argentina*, Article 75 (1), as amended in 1994.

3.2. CIRCUMSTANCES THAT FACILITATE THE COMPARISON AND, THUS, THE HARMONIZATION.

With respect to the treatment of related-party transactions, both the GVC and the OECD guidelines, have a common objective: determining whether the relationship between buyer and seller in a particular transaction has influenced the price or, in other words, whether the price is arm's length.

The existence of common objectives and principles may be regarded as a basic premise of harmonization processes. We believe that the GVC and the OECD guidelines share such objectives and principles (e.g., the arm's length standard), at least in relation to related-party transactions. This constitutes the grounds on which the present work is based.

A second step in the harmonization process would be the definition of the methodologies for applying the arm's length principle. Where the methodologies defined in one system are different from those defined in the other, harmonization is still possible. However, the prices resulting from the application of one method could sometimes be significantly different from those resulting from the application of another method. Where the systems do not provide flexibility for applying such methods (e.g., existence of a mandatory sequential order of application), the only way to reconcile the results is to identify the elements of the methodologies, which produce the differences.

The GVC is flexible in respect of the methodologies that can be used by the importer to demonstrate that the relationship did not influence the price. However, such flexibility disappears when such circumstance cannot be shown by the importer. Where the price is not acceptable, the GVC defines methodologies to substitute the price agreed upon by the related parties. Such methodologies are not always flexible and, in addition, must be applied in a sequential order. (In other words, the "best method rule" is not applicable once the customs administration has determined that the relationship influenced the price.)

3.3. CONCLUSIONS REGARDING FEASIBILITY OF HARMONIZATION.

The GVC and the OECD Guidelines present many important differences which, in most cases, derive from the inhomogeneous characteristics and nature of the instruments and taxes in question. However, such differences appear not to be so important where the interpreter focuses on the related-party rules of the GVC. The fact that tax and customs rules share a common standard in relation to related-party transactions, facilitates the process of harmonization. Where broad and flexible constructions of tax and customs rules are adopted, an interpreter can achieve an acceptable degree of harmonization. A harmonized approach to the analysis of related-party transactions under the OECD Guidelines and the GVC would consist of:

1. Use of common standards for determining arm's length values and for examining whether the relationship influenced the transaction value. This part of the analysis will be undertaken in Chapters II and III.

2. Identification of the differences between the customs duties' tax base and the relevant elements (e.g. inventory cost of imported property) of the tax base of income taxes. This part of the analysis could involve the examination of possible adjustments and reconciliation of results. This will be explored in Chapter IV.

The single determination of arm's length transaction values for customs and tax purposes constitutes one of the objectives of the present work. Once such transaction values have been so determined, appropriate upward or downward adjustments should be made separately for tax and customs purposes, in order to account for the differences in the regimes. Another possibility would be the determination of the arm's length transaction value of the imported goods for either tax or customs purposes and, once such transaction value has been determined under one of the systems (e.g., customs), subsequent upward or downward adjustments should be made, as required by the other system (e.g. tax), to arrive at the statutory value.

It is important to indicate, however, that once the customs administration has determined that the importer has not been able to demonstrate that the relationship had not influenced the price, the possibilities to obtain consistent results through customs and tax methodologies decrease. In this respect, the role of the customs administrations in the determination of the appropriate arm's length value will determine the extent and degree of harmonization that could be actually achieved.

CHAPTER II

THE ARM'S LENGTH PRINCIPLE

4. DEFINITION – OECD GUIDELINES.

The arm's length principle is defined in the Glossary of the OECD Guidelines as follows:

> The international standard that OECD Member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows: where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

An arm's length price is the price which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions.[19] Levey explains that this has been the Guidelines' guiding principle since the issuance of the 1979 OECD Report.[20]

The Guidelines indicate that, when independent enterprises deal with each other, the conditions of their commercial and financial relations ordinarily are determined by market forces.[21] When transfer prices agreed upon between associated enterprises do not reflect market forces and the arm's length principle, the tax liabilities of such enterprises and tax revenues of the host countries can be distorted. OECD Member countries have adopted the arm's length principle as the standard on which any adjustment to correct such distortions should be based.[22]

[19] See Hammer *supra* note 6 at 3.02[1][a]. See OECD Guidelines *supra* note 3, at 1.3.
[20] Hammer, *ibid.*
[21] See OECD Guidelines *supra* note 3, at 1.2.
[22] *Ibid.* at 1.3.

5. RECOGNITION OF THE ARM'S LENGTH PRINCIPLE IN THE GVC.

5.1. STRUCTURE OF THE GVC. APPLICATION OF THE PROVISIONS OF THE GVC TO RELATED-PARTY TRANSACTIONS.

As a general principle, in determining customs values in cases of related-party transactions, Customs administrations must apply, in first term, the provisions of GVC Article 1.2. Where Customs administrations determine that the importer has not demonstrated that the relationship had not influenced the price, then the provisions of GVC Articles 2, 3, 5, 6 and 7 are applicable (in sequential order) to determine a substitute value.[23]

5.2. GVC ARTICLE 1.2. - RECOGNITION OF THE ARM'S LENGTH PRINCIPLE.

GVC Article 1.2 contains general rules regarding related-party transactions. Such rules should not be used to establish substitute values. Rather, their purpose is to determine whether the transaction value agreed upon between related parties is acceptable for customs valuation purposes.[24]

GVC Article 1.2 sets out a general principle: "the transaction value shall be accepted provided that the relationship did not influence the price". The principle adopted under the GVC is clearly similar to the one adopted by the OECD Guidelines.[25] In effect, the only possible way to determine whether the relationship has influenced the price in any given controlled transaction is to compare such transaction with similar uncontrolled transactions

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[23] World Customs Organization (WCO), Technical Committee on Customs Valuation, *Customs Valuation Compendium* (Brussels, WCO, 1997) [hereinafter "CVC"] at Com14.1/1 – CS10.1/1 (Commentary 14.1 and Case Study 10.1 of the Technical Committee on Customs Valuation)

[24] See GVC Article 1.2 and its Interpretative Note. See also Sherman *supra* note 15 at 191.

[25] Joseph S. Kaplan indicates that "this statutory language is an invitation to transaction-by-transaction analysis as to whether the circumstances of sale rule out the possibility that the relationship between buyer and seller has influenced the price. This is as close as customs valuation law comes to providing an arm's-length test. The lack of clear guidelines as to whether the circumstances of sale justify the conclusion that the related party price is not influenced by the relationship can be overcome by obtaining a binding ruling to this effect from the Headquarters Office of Customs." (Paper delivered at the Transfer Pricing Seminar organized by Insight Information Co., 26-27 April 1999). We believe that the problem of the absence of guidelines in the GVC may be solved if the OECD Guidelines are used to interpret and supplement the related-party provisions of the GVC.

(in comparable circumstances). We can illustrate this idea with the following example (which has been simplified for purposes of illustration. It does not involve economic or valuation analyses):

> The transaction value of the imported goods in a given controlled transaction has been determined through the following formula:
>
> $A + X = D$
>
> $X = B + C$
>
> Where
>
> A = cost of goods sold (COGs).
>
> X = amount for profits and general expenses.
>
> D = Transaction value
>
> B = amount for profits and general expenses (not-influenced by relationship)
>
> C = Other elements present in controlled transactions (which therefore, are not present in open market conditions) (this number may be positive or negative).

In order to accept the transaction value, C must be equal to (or closely approximate) zero.

In this equation, there will always be two variables that we do not know (or if we do know, whose accuracy cannot be proven, in principle): 1) X and 2) D. To solve the equation we need to know at least one of them.

A system of valuation can adopt different methodologies or standards to determine or discover the value of either X or D.

One possibility can be the, so-called, global formulary apportionment, which would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula.[26] This method has obviously not been adopted by the authors of the GVC. First, the GVC does not provide any formula to determine the value of any element of the price. Second, the GVC does not authorize the use of such a formula. Rather, it appears to prevent such formulae from being used, since it expressly prohibits the use of arbitrary or fictitious values.[27]

By putting the emphasis on the "influence of the relationship", it seems that the GVC has adopted the arm's length standard on the basis of which the unknown elements are discovered through comparison of comparable controlled and uncontrolled transactions. In effect, to determine whether the relationship has influenced the price (element C in our equation), we must determine such fact by examining similar uncontrolled transactions (i.e., transactions in which there is no relationship between the parties).

This approach has also been taken by Revenue Canada for Customs valuation purposes. In effect, Paragraphs 13 and 14 of Memorandum D13-4-5[28], which explains and illustrates the treatment of sales between related persons in determining the value for duty under section 48 of the Customs Act, states:

> 13. In the absence of an acceptable test value, the importer may try to establish the acceptability of prices between related companies, pursuant to subparagraph 48(1)(d)(i) of the *Customs Act*. The information requirements are less well defined than for a test value and there are many ways in which an importer and Customs can reach a conclusion that the price is not influenced.
> 14. Neither the Act nor the G.A.T.T. Customs Valuation Code, to which the Canadian valuation provisions conform, detail the information to be used in establishing that a relationship has not influenced the price in a sale of goods for export. Whatever way an importer chooses to establish the acceptability of the price, his conclusions should be supported by factual evidence. The object of the exercise is to establish that the selling price is not significantly different from that which would have been charged to an unrelated purchaser, given identical circumstances except for that of relationship.

As one can clearly see, Revenue Canada has interpreted GVC Article 1.2 and its Note as laying down the arm's length standard (as defined by the OECD Guidelines) for determining whether related-party transactions are acceptable under the provisions of GVC Article 1.1.

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[26] See Hammer *supra* note 6, at 4.06.
[27] See Preamble and Article 7.2(g) of the GVC.
[28] M.N.R., Memorandum D13-4-5 "Transaction value method for related persons" (30 March 1989) [hereinafter "Memorandum"] online:<http://207.6.23.164/library/librarye.htm> <http://www.ccra-adrc.gc.ca/custom/general> (date accessed: 3 August 2000)

6. THE OECD GUIDELINES CAN BE USED TO DETERMINE WHETHER TRANSACTION PRICE IS ARM'S LENGTH UNDER GVC ARTICLE 1.2.

It is under GVC Article 1.2(a) and its Note, where the OECD Guidelines may be primarily and broadly applied. As we will see, they can provide rules and principles for determining whether the transaction value has been influenced by the relationship and guide the examination of the circumstances surrounding the sale. In other words, the detailed provisions of the Guidelines could complement the more general provisions of GVC Article 1.2(a) and its Note.

The transaction value of sales between related parties forms the basis for determining the customs value of the imported goods (i.e., no substitute value must be determined under the provisions of GVC Articles 2, 3, 5, 6 or 7) only if it is established that the price has not been influenced by the relationship. Under GVC Article 1.2, the responsibility for demonstrating that the relationship has not influenced the prices lies with the importer.[29]

GVC Article 1.2(a) provides that, in determining whether the related-party transaction value has not been influenced by the relationship (i.e., whether such value is acceptable for the purposes of GVC Article 1.1), the circumstances surrounding the sale should be examined. Customs administrations should give the importers an opportunity to supply further detailed information as may be necessary to enable them to examine such circumstances.[30]

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[29] See CVC *supra* note 23 at Com14.1/1 - CS10.1/1 (Commentary 14.1 and Case Study 10.1 of the Technical Committee on Custom Valuation). See also United States Customs Service (USCS), *Customs Valuation Encyclopedia* (USCS, 1998) at chapter XXXIV [hereinafter "CVE"] (see especially Rulings 544686 (31 August 1994), 545813 (11 September 1996), 545638 (13 February 1995) and 546449 (6 January 1998)). But see *ESSO S.A.P.A. v. A.N.A. s/ recurso de apelacion*, (7 October 1993) Tribunal Fiscal de la Nacion, Sala G, File No. 6872-A (Argentina).

[30] Note to Paragraph 2 of GVC Article 1.

The Note to GVC Article 1.2 gives some guidance in relation to the circumstances that Customs administrations should examine and to the information that importers should submit. However, such guidance is very general. Customs administrations and importers cannot be expected to solve complex transfer pricing problems solely on the basis of such general provisions. This might produce inconsistent application of the related-party provisions of the GVC from one country to another, which is clearly contrary to the principle of "uniformity and certainty" in the implementation of GATT Article VII.[31]

Furthermore, the Note to GVC Article 1.2 only provides examples of circumstances or aspects of the transactions which could be examined by Customs administrations. Such examples do not constitute the only circumstances or aspects that Customs administrations might explore. Sherman and Glashoff indicate that "[i]t is extremely important that the Notes be taken only as a starting point and as illustrative."[32] They add that "[t]he Code does not confine itself to the facts regarding the sale – it deals with the broader concept of an inquiry into 'the circumstances surrounding' the sale. This language plainly speaks of the entire context of the transaction and not just of the transaction itself."[33] Interestingly, these authors explain that "if the pricing is done pursuant to a formula which has been accepted by the taxing authorities of either the country of export or the country of importation, evidence to that effect should help to establish that the TV [transaction value] is acceptable."[34] We need to make some comments on such assertion. In some cases, the acceptance by Customs of a transaction value calculated pursuant to a formula which has been accepted by the tax authorities may also lead to non-uniform implementation of the GVC. In effect, where the tax authorities do not use common or consistent standards to evaluate the arm's length character of the transaction, the acceptance of such values for customs purposes might produce an inconsistent implementation of the related-party provisions of the GVC. Therefore, such transaction values should only be accepted for customs purposes if the tax authorities have used common and consistent standards to determine whether the transaction

[31] See Preamble of the GVC.
[32] Sherman *supra* note 15, at 193.
[33] *Ibid.*
[34] *Ibid.*

was arm's length or whether the formula (for determining the price) produced arm's length results. We believe that the OECD Guidelines may provide these common and consistent standards.

The Note to GVC Article 1.2 provides that "the customs administrations should be prepared to examine relevant aspects of the transaction, *including* the way in which the buyer and seller organize their commercial relations and the way in which the price in question was arrived at, in order to determine whether the relationship influenced the price" [emphasis added]. This involves a complete analysis of the transaction in question and uncontrolled transactions in order to determine whether the relationship influenced the price (the examination of those aspects should always have a comparability purpose, since it appears to be the only mechanism authorized by the GVC to determine whether the relationship influenced the price). We can conclude that the language of the Note to GVC Article 1.2 is broad enough to permit a transfer pricing analysis under the more detailed rules of the OECD Guidelines for determining whether the relationship influenced the transaction value. Being a detailed set of rules which has been (totally or partially) adopted by a great number of countries, the OECD Guidelines appear to be an adequate complement to GVC Article 1.2 and its Note for determining the arm's length character of related-party transactions. They could also facilitate an appropriate and uniform implementation of the related-party rules of the GVC, which is one of the clear purposes of its preamble.

Revenue Canada has adopted this approach for customs purposes. In effect, paragraph 15 and 16 of Memorandum D13-4-5 state:

> 15. The Organization for Economic Co-operation and Development (O.E.C.D.) published a report in 1979 entitled "Transfer Pricing and Multinational Enterprises". 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 included in the methods illustrated in paragraph 16 of this Memorandum. ***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*** unless there is information on prices available which is more directly related to the specific importations...
> 16. The following methods are examples of ways of establishing that a price is not influenced by the relationship. They have been listed in the order that they are most likely to be used because of the availability of information. It must be emphasized that this list does not contain all of the

> possible methods of establishing the acceptability of prices between related companies and it is not Customs' intention to be restrictive in this regard...[35] [emphasis added]

This approach of Revenue Canada constitutes a major step towards harmonization of customs and tax transfer pricing laws. Although Revenue Canada refers to the methods of the 1979 OECD Report, we believe that the methods described in the OECD Guidelines should also be accepted, since - as expressed in the Memorandum - "the list does not contain all of the possible methods of establishing the acceptability of prices between related companies and it is not Customs' intention to be restrictive in this regard". A clarification of this issue by Revenue Canada would, nevertheless, be extremely useful.

7. GUIDANCE FOR APPLYING THE ARM'S LENGTH PRINCIPLE. USE OF SUCH GUIDANCE UNDER GVC ARTICLE 1.2.

7.1 COMPARABILITY ANALYSIS.

The OECD Guidelines indicate that the application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. Such comparisons are useful only if the economically relevant characteristics of the situations being compared are sufficiently comparable.[36] To be comparable means that none of the differences between the situations being compared could materially affect the condition being examined in the methodology or that reasonably accurate adjustments can be made to eliminate the effect of any such differences. Among the "conditions being examined" that could be materially affected by the differences, the OECD Guidelines mention (i) the prices or (ii) the profit margins.[37]

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[35] Memorandum *supra* note 28.
[36] See OECD Guidelines *supra* note 3, at 1.15.
[37] *Ibid.*

GVC Article 1.2(a) does not make any reference to comparability analyses. However, the idea of "comparability" is inherent in the provisions of such article. If determining whether the relationship influenced the price implies a comparison of a controlled transaction and an uncontrolled transaction which have been undertaken under the same or similar conditions, then logically the results would not be reliable unless the economically relevant characteristics of the situations being compared were sufficiently comparable.

An analysis of the Note to GVC Article 1.2 indicates that the idea of comparability is clearly present in its provisions. The examples provided by the Note show a clear preference for internal comparables.[38] This same preference is reflected in paragraph 2.20 of the OECD Guidelines:

> When the resale price margin used is that of an independent enterprise in a comparable transaction, the reliability of the resale price method may be affected if there are material differences in the ways the associated enterprises and independent enterprises carry out their business ... These types of characteristics should be analyzed in determining whether an uncontrolled transaction is comparable for purposes of applying the resale price method.

This principle is also applicable in determining whether a transaction is a comparable uncontrolled transaction for the purposes of the cost plus method[39]. If the Note to GVC Article 1.2 and its examples are interpreted in the light of this principles, it appears that the examples that have been selected by the authors of the GVC involved a choice for situations which reflected a high degree of comparability. In other words, the examples chosen by the authors involved a standard of comparability. In applying the arm's length methods, this standard should be regarded as a requisite to be met. Therefore, it could be suggested that the application of any method (either those from which the examples are derived or any other method consistent with the provisions of the Note[40]) should always be supplemented

[38] The preference for internal comparables is reflected by the second example provided by the Note: "where it is shown that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time ... in sales of goods of the same class or kind, this would demonstrate that the price had not been influenced."
[39] See OECD Guidelines *supra* note 3, at 2.34.
[40] Bear in mind that the examples provided by the Note are only illustrative.

by an appropriate comparability analysis (to ensure an adequate degree of comparability between the transactions being examined).

In Ruling 546285[41] (7 June 1996), the US Customs Service undertook an analysis to determine whether the uncontrolled transactions used for the purposes of GVC Article 1.2 were sufficiently comparable. A related buyer received from the seller a higher trade discount than the related U.S. distributors and unrelated U.S. retailers. The U.S. Customs Service examined the following facts: (i) the trade discounts to both the related buyer and unrelated U.S. distributors were based on the volume of their purchases from the foreign seller; (ii) the larger trade discount given to the related buyer was due to the increased warehousing costs incurred by stocking a larger and more extensive line of the foreign seller's products than the unrelated U.S. distributors; and (iii) the related buyer also marketed and advertised the foreign seller's merchandise in the United States. On the basis of these facts, the US Customs Service concluded that it did not appear that the relationship affected the price of the merchandise and that the parties bought and sold from each other as if they were unrelated. It is clear that the US Customs Service evaluated the differences between the transactions (which required some adjustments for comparability purposes – e.g. volume) in determining whether the relationship had influenced the price.

This ruling shows how material differences must be taken into account when making comparisons for customs purposes. This is also suggested in paragraph 1.17 of the OECD Guidelines. This is necessary to establish the degree of actual comparability and to make appropriate adjustments to establish arm's length conditions.[42]

The requirement of "comparability" is also introduced in GVC Article 1.2(b) in applying the test values. The relevant part of GVC Article 1.2(b) reads:

> In applying the foregoing tests, due account shall be taken of demonstrated differences in commercial levels, quantity levels, the elements enumerated in Article 8 and costs incurred by the

[41] See CVE *supra* note 29 at chapter XXXIV.
[42] See OECD Guidelines *supra* note 3, at 1.17.

seller in sales in which the seller and the buyer are not related that are not incurred by the seller in sales in which the seller and the buyer are related.[43]

Although not directly applicable for the purposes of GVC Article 1.2(a), the provision quoted above (in addition to the provisions of GVC Articles 2.1(b) and 3.1(b)) reflects the general structure and principles underlying the GVC.[44] It is important to bear in mind that the factors to be examined under a comparability analysis in the context of GVC Article 1.2(a) are not limited to those mentioned in GVC Article 1.2(b). The application of the arm's length standard - as introduced in the Note to GVC Article 1.2 - requires Customs administrations to undertake a thorough and complete analysis of comparability.

Determining the degree of comparability requires an understanding of how unrelated parties evaluate potential transactions.[45] This may be regarded as part of the circumstances surrounding the sale that shall be examined to determine whether the relationship influenced the price under GVC Article 1.2. M. Levey explains that one enterprise is unlikely to accept a price that an independent enterprise offers for a product if it knows that other potential customers will pay more under similar conditions. He indicates that this point is relevant to the question of comparability, because independent enterprises would generally take into account any economically relevant differences between the options realistically available to them (e.g., differences in the level of risk.)[46]

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[43] The fact that the degree of comparability required under GVC Articles 2 and 3 is lower than that required under Article 1.2 does not mean that a minimum degree of comparability is not required at all. In effect, in applying GVC Articles 2 and 3, the transaction value of identical or similar goods in a sale at the same commercial level and in substantially the same quantity as the goods being values shall be used to determine the customs value. Where no such sale is found, the transaction value of identical goods sols at a different commercial level and/or in different quantities, adjusted to take account of differences attributable to commercial level and/or to quantity shall be used, provided that such adjustments can be made on the basis of demonstrated evidence which clearly establishes the reasonableness and accuracy of the adjustment."

[44] Commentary 10.1 of the Technical Committee on Customs Valuation reads: Although the wording in Article 1.2(b) is somewhat different from that found in Articles 2.1(b) and 3.1(b), it is clear that the principles involved are the same: account has to be taken of differences attributable to commercial level or quantity and it must be possible to make the necessary adjustment on the basis of demonstrated evidence which clearly establishes its reasonableness and accuracy. (CVC *supra* note 23, at Com10.1/1.)

[45] See Hammer *supra* note 6, at 3.03[1][a].

[46] *Ibid.*, at 3.03[1][b].

We can therefore conclude that under GVC Article 1.2(a) as well as under the OECD Guidelines all material differences should be taken into account, since this is necessary to firstly, establish the degree of actual comparability, and thus to make appropriate adjustments to establish arm's length conditions. In order to do so, it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length dealings.[47] The OECD Guidelines refer to the following attributes:

(i) characteristics of the property;

(ii) functions performed by the parties (taking into account assets used and risks assumed);

(iii) contractual terms;

(iv) economic circumstances of the parties;

(v) business strategies pursued by the parties.

7.1.1. CHARACTERISTICS OF THE PROPERTY

Differences in the specific characteristics of the property often account for differences in their value in the open market. Consequently, these features should usually be examined in determining comparability of controlled and uncontrolled transactions.[48] This principle also underlies most of the provisions of the GVC. For instance, the second example provided by the Note to GVC Article 1.2(a) requires a comparison between the profit realized in the related-party transaction and the firm's overall profit realized in sales of goods of the same class or kind. GVC Article 15.3 defines the term "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, and includes identical or similar goods". One can suggest that the term "goods of the same class or kind" has been introduced in the second example to require an adequate level of comparability between the transactions or profit margins being examined in relation to characteristics of the goods involved.

[47] See OECD Guidelines *supra* note 3, at 1.17.
[48] *Ibid.* at 1.19.

The example mentioned in the foregoing paragraph is not the only case in which the GVC introduced comparability requisites concerning characteristics of the property. GVC Articles 1.2(b), 2 and 3 require even higher degrees of product comparability than that required by the example cited above. Under such articles, transactions must involve identical or similar goods. In relation to the concept of identical and similar goods, GVC Article 15 provides:

> (a) 'identical goods' means goods which 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;
> (b) 'similar goods' means 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;
> (c) the terms 'identical goods' and 'similar goods' do not include, as the case may be, goods which incorporate or reflect engineering, development, artwork, design work, and plans and sketches for which no adjustment has been made under paragraph 1(b)(iv) of Article 8 because such elements were undertaken in the country of importation;
> (d) goods shall not be regarded as 'identical goods' or 'similar goods' unless they were produced in the same country as the goods being valued;
> (e) goods produced by a different person shall be taken into account only when there are no identical or similar goods, as the case may be, produced by the same person as the goods being valued.

We can conclude that product comparability is a general requisite in applying the methods laid down in GVC Articles 2, 3, 5 and 6 (certain methods require a higher degree of product comparability than others) and in applying the test values under GVC Article 1.2(b). Product comparability is also evident in the examples of the Note to GVC Article 1.2(a). Consequently, it could be regarded as a general condition in applying the arm's length standard under GVC Article 1.2(a). This is consistent with paragraph 1.19 of the OECD Guidelines.

The OECD Guidelines suggest that, in general, similarity in the characteristics of the property or services transferred have the most significant impact when prices of controlled and uncontrolled transactions are compared (e.g. under the comparable uncontrolled price method – "CUP") and less when profit margins are compared.[49] This is also consistent with

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[49] *Ibid.*

the structure of GVC Articles 2, 3, 5 and 6 and the degree of product comparability required under each of these provisions. In effect, the methods of GVC Articles 2 and 3, which are similar (but not identical) to the CUP method require the use of transaction values of identical or similar goods respectively (i.e., a high degree of product comparability). The methods of GVC Articles 5 and 6, which are based on profit margins, require a lower degree of product comparability. In effect, they use the "profit and general expenses in connection with sales of imported goods of the same class or kind". The GVC recognizes that the impact of product similarity is less significant under Articles 5 and 6, under which profit margins are used.

Among the characteristics to be considered, the OECD Guidelines include the following: the physical features of the property, its quality and reliability, and the availability and volume of supply. The characteristics of the property mentioned in the GVC should also be examined. The fact that the goods being compared are identical, similar, or of the same class or kind, should be properly taken into account vis-à-vis the arm's length method used by importers and tax and customs administrations.[50]

The OECD Guidelines also refer to the characteristics to be considered in case of provisions of services and transfers of intangible property.[51] These recommendations may be useful for customs purposes when provision of services and transfers of intangibles are closely connected to the sale of the imported goods. The Customs administrations should be prepared to examine these other characteristics as a part of the circumstances surrounding the sale.

[50] Commentary 1.1 of the Technical Committee on Customs Valuation provides useful guidance and examples to illustrate the application of the principles for determining whether goods are identical or similar in accordance with GVC Article 15 (See CVC *supra* note 23, at Com1.1/1). We understand that such examples could supplement the rules set forth in the OECD Guidelines.
[51] See OECD Guidelines *supra* note 3, at 1.19.

7.1.2. FUNCTIONAL ANALYSIS.

The OECD Guidelines indicate that, in dealings between two independent enterprises, compensation usually will reflect the functions that each enterprise performs, taking into account assets used and risks assumed.[52] These functions are clearly among those circumstances surrounding the sale that should be examined by the Customs administrations under GVC Article 1.2. If, in the customs valuation context, the issue is whether the relationship influenced the price, and – pricing in uncontrolled transactions usually reflects the functions that each enterprise performs – then the analysis of the distribution of such functions in both controlled and uncontrolled transactions is necessary to determine whether the controlled and uncontrolled transactions are sufficiently comparable and, therefore, whether the relationship influenced the price.

Differences in functions may produce different prices in the open market. If the uncontrolled transaction – selected for comparison purposes – reflected a different distribution of functions than that of the controlled transaction in question, a price derived from a comparison between these transactions would not be likely to be at arm's length. Therefore, it will provide no useful data for demonstrating that the relationship did not influence the price.

We can illustrate this with the following example:

> A, B and C are distributors of product M in country X. Product M is supplied by seller D, who is a resident of country Z. A and D are related parties. A and B undertake marketing and advertising activities and keep in inventory a large number of units of product M. A and C purchase product M from seller D at a price of 10 c.u. per unit, while B purchases the same product from seller D at a price of 13 c.u. per unit. If the Customs administration does not undertake a functional analysis and compares the controlled transaction (A-D) with the transaction between C and D, it will arrive at the erroneous conclusion that the price of the controlled transaction has not been influenced by the relationship. Had the Customs administration undertaken an appropriate functional analysis, it would have determined that the transaction between C and D was not sufficiently comparable. The

[52] *Ibid.* at 1.20.

transaction between B and D represented an appropriate comparable and provided sufficient grounds to determine that the relationship did influence the price.[53]

Functional analysis seeks to identify and compare the significant activities and responsibilities that independent and associates enterprises undertake. The contributions of each party to the transactions must be measured.[54]

The OECD Guidelines provide that:

> The functions that the taxpayers and tax administrations [we should also add "customs administrations"] might need to identify and compare include, e.g., design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing, and management. The principal functions performed by the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which the party is being compared. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transaction that is important.[55]

The extent to which each of these functions is economically significant will depend on each case's facts and circumstances.[56] Assets employed and risks assumed may also be economically significant. Therefore, in identifying and comparing functions performed, it

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[53] Note that, where the commercial level and quantities involved are similar, the test values of GVC Article 1.2(b) could be used at the initiative of importer A. In such a case, the transaction value would have to be accepted since C and D were unrelated parties and there were no differences in commercial level, quantity level, elements enumerated in GVC Article 8 or "costs incurred by the seller in sales in which the seller and the buyer are not related that are not incurred by the seller in sales in which the seller and the buyer are related". In this case, the tax and customs transfer pricing rules would not be consistent, being one of the situations where harmonization appears not to be feasible. However, there are two important considerations: (i) the test values can only be used at the initiative of the importer, constituting a sort of safe harbour; and (ii) an adequate interpretation of the provision that requires that "due account shall be taken of demonstrated differences in ... costs incurred by the seller in sales in which the seller and the buyer are not related that are not incurred by the seller in sales in which the seller and the buyer are related" could provide a good instrument – in most of the cases – to prevent importers from using test values which do not comply with minimum standards of comparability (other than commercial level and quantity). Unfortunately, Commentary 10.1 of the Technical Committee on Customs Valuation did not address the adjustments in relation to this element of Article 1.2(b). Paragraph 4 of the Commentary states that the examples provided therein do not include other adjustments such as for differences in distances and modes of transport. We would be glad to see the Technical Committee addressing this issue in further Commentaries or Advisory Opinions.

[54] See OECD Guidelines *supra* note 3, at 1.20.

[55] *Ibid.* at 1.21.

[56] See Hammer *supra* note 6, at 3.03[2][a].

may be relevant and useful to consider the assets that are employed or to be employed and risks assumed by the respective parties.[57]

The following assets used should be considered: plant and equipment, valuable intangibles, etc. The nature of such assets, such as age, market value and property right protections available, among others, should be properly taken into account.[58]

Even though many of these elements (under certain circumstances) may be excluded from transaction value (e.g., advertising and marketing expenses incurred by the importer in the country of importation) or are not to be added to the price paid or payable for customs purposes[59], there is nothing in GVC Article 1.2(a) preventing such elements from being analyzed in the context of a comparability analysis. Since comparability is one of the most significant features for determining whether a controlled transaction is arm's length (and a specific standard provided for in the Note to GVC Article 1.2), the examination of such elements should be specifically required in the context of a comparability (functional) analysis under GVC Article 1.2.

Note that the examination of the circumstances surrounding the sale, under the Note to GVC Article 1.2, involves the use of the most appropriate methodology – i.e., there is no sequential order of application – and, thus, the examination of a broader scope of uncontrolled transactions. Therefore, a complete functional analysis - whereby all relevant functions, assets and risks are examined – is necessary to choose the adequate arm's length methodology or the appropriate uncontrolled transaction for determining whether the relationship influenced the price.

An analysis of the structure and principles underlying the GVC indicates that any adjustment (e.g. adjustments to account for any material differences in the functions performed by the enterprises being compared) have to be made on the basis of demonstrated

[57] See OECD Guidelines *supra* note 3, at 1.22-1.23.
[58] *Ibid.* at 1.22.
[59] Further discussion of this issue will be found in Chapter IV below.

evidence which clearly establishes their reasonableness and accuracy. (As indicated above, this has been identified by the Technical Committee on Customs Valuation as a general principle underlying the provisions of GVC Articles 1.2(b), 2.1(b) and 3.1(b).[60] This principle can also be found in GVC Article 8.3, the Note to GVC Article 8.1(b)(iv), the Note to GVC Article 8.3 and GVC Article 15.1(c).)

As indicated above, what is important is the economic significance of the functions performed by the enterprises being compared. Therefore, an adjustment should only be made where the differences in functions are economically significant.[61]

In relation to risks assumed, the OECD Guidelines explain that, in the open market, the assumption of increased risk will also be compensated by an increase in the expected rate of return.[62] They also provide that tax administrations should evaluate whether there are significant differences in risks assumed in the controlled and uncontrolled transactions being compared, since this would determine whether such controlled and uncontrolled transactions are sufficiently comparable.[63] Likewise, Customs administrations should always undertake risk analyses where the comparability between controlled and uncontrolled transactions is at stake, since its omission may lead to erroneous conclusions as to whether or not the relationship influenced the price. M. Levey illustrates the issue with the following example:

> DistCo is an unrelated distributor of the optical and camera products that MafCo manufactures. DistCo takes on responsibility for marketing and advertising this line of products by use of its own resources.
> Here, it would be assumed that in the open market, DistCo would be entitled to a commensurately higher anticipated return from the activity than if it were simply acting as agent without financial responsibility for the marketing and advertising expenses. Similarly, a contract manufacturer ... or a contract research provider that takes on no meaningful risk would be entitled to only a limited return.[64]

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[60] See CVC *supra* note 23, at Com10.1/1.

[61] In a different context, the Technical Committee on Customs Valuation indicated that the mere existence of differences in commercial level or quantity would not of itself require that an adjustment be made; an adjustment will be necessary only if a difference in the price or value results from a difference in commercial level or quantity. See CVC *supra* note 23, at Com10.1/1 (Commentary 10.1). One can infer, therefore, that the Technical Committee follows the same principle: "adjustments should be made where the differences are economically significant."

[62] See OECD Guidelines *supra* note 3, at 1.23.

[63] *Ibid.*

[64] Hammer *supra* note 6 at 3.03[2][b].

The Note to GVC Article 1.2 provides that "if the price had been settled in a manner consistent with the normal pricing practices of the industry in question ... this would demonstrate that the price had not been influenced by the relationship." This provision has usually been interpreted as allowing the use of posted prices as a basis of comparison in demonstrating that the relationship did not influence the price.[65] However, this is clearly not the only meaning of this provision. It also means that the price should be settled taking into account *all the elements* that independent enterprises of the industry in question take into account when establishing or negotiating their prices. Since the risk element is usually one of these elements, customs administrations and importers can find authority in the Note to GVC Article 1.2 to undertake risk analysis for customs valuation purposes.[66]

The OECD Guidelines provide some guidance as to which types of risk may be pertinent to examine. Paragraph 1.24 includes the following: (i) market risks, such as input cost and output price fluctuations; (ii) risks of loss associated with the investment in and use of property, plant and equipment; (iii) risk of the success or failure of investment in research and development; (iv) financial risks such as those caused by currency exchange and interest rate variability; and (v) credit risks. Warranty and product liability risks may also be included in this list[67]. Bear in mind that this elements are examined for comparability purposes and not for the purposes of establishing additions to or deductions from the customs value of the imported goods. (These additions and deductions can only be made – under GVC Articles 1 and 8 –, once the price has been found to be arm's length under GVC Article 1.2, which requires a previous examination of the elements indicated above for comparability purposes only.)

[65] See Sherman *supra* note 16, at 192. "The transaction value of imported merchandise sold between related parties may be based upon 'posted prices' which reflect the normal pricing practices of the industry in question" (CVE *supra* note 29, at chapter XXXI (Ruling 542261 – TAA No. 19 – (11 March 1981))

[66] Note, for example, that the Note to GVC Article 6 refers to the usual pricing policies in the branch of industry concerned, when comparing the exporter's profit figures with those of other producers.

[67] See Hammer *supra* note 6, at 3.03[2][b].

Finally, the OECD Guidelines suggest that it may be necessary to consider whether a purported allocation of risk is consistent with the economic substance of the transaction.[68] However, in some cases, this statement might not be applicable since the legislation and jurisprudence of some countries does not authorize their judges to make analyses based only on economic substance.[69]

7.1.3. ECONOMIC CIRCUMSTANCES.

The OECD Guidelines indicate that arm's length prices may vary from market to market even for transactions involving the same property or services. Therefore, to achieve comparability, the markets in which the independent and related enterprises operate must be comparable. To ensure comparability, any differences in the markets should not have a material effect on price unless appropriate adjustments can be made to account for such differences.[70]

Since the analysis of these circumstances constitutes part of the comparability analysis, it should also be part of the analysis undertaken under GVC Article 1.2. Only comparable uncontrolled transactions in comparable economic circumstances can provide valuable information to determine whether the relationship influenced the price.

Note that some of the restrictions contained in GVC Article 7.2 are based on economic circumstances derived from differences between markets.[71] GVC Article 7.2 provides:

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[68] See OECD Guidelines *supra* note 3, at 1.26.
[69] See, e.g., *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622.
[70] See OECD Guidelines *supra* note 3, at 1.30. See also Hammer *supra* note 6, at 3.03[4].
[71] GVC Article 7 is not directly applicable under GVC Article 1.2(a). However, it provides general principles that may be applicable to interpret most of the provisions of the GVC. Article 7 applies where Articles 1, 2, 3, 5 and 6 cannot be applied. It provides for a flexible application of the methods established in those Articles. However, such flexible application is subject to the conditions imposed by Article 7.2. We understand that the conditions imposed by Article 7.2 must necessarily be met in all the methods established by the GVC (including Article 1), since Article 7.1 only provides for a flexible application of them. Consequently, if the "flexible" application of the methods cannot exceed certain limits, the "original" application thereof (i.e., under Articles 1, 2, 3, 5 and 6) cannot exceed such limits either.

> No customs value shall be determined under the provisions of this Article on the basis of: (a) the selling price in the country of importation of goods produced in such country; ... (c) the price of goods on the domestic market of the country of exportation; ... (e) the price of the goods for export to a country other than the country of importation...

These restrictions clearly reflect the purpose of preventing customs administrations and importers from comparing transactions of independent and related enterprises which operate in different (and non-comparable) markets.

For example, the price of a product in transactions between unrelated buyers and sellers on the domestic market of the country of exportation would be probably different to the price of such product when sold for export to the country of importation (or from the price of such product on domestic market of the country of importation).

The OECD Guidelines mention the following economic circumstances that may be relevant to determine market comparability: (i) geographic location; (ii) the size of the markets; (iii) the extent of competition in the markets and the relative competitive positions of the buyers and sellers; (iv) the availability (risk thereof) of substitute goods and services; (v) the levels of supply and demand in the market as a whole and in particular regions, if relevant; (vi) cost of production, including the costs of land, labor, and capital; (vii) transport costs; (viii) the level of the market (e.g. retail or wholesale); and (ix) the date and time of transactions.[72] One can also add to the list, the following: consumer purchasing power; nature and extent of government regulation of the market, etc.[73]

The determination of the geographic market is extremely important, especially in large countries or customs unions like the European Community and Mercosur. The economic circumstances in one country or region within a country may vary from those of another country or region within such country. For example, there may be a significant difference in consumer purchasing power, cost of production and governmental intervention in the markets of the North-east region of Brazil, the state of São Paulo (Brazil), the

[72] See OECD Guidelines *supra* note 3, at 1.30.
[73] See Hammer *supra* note 6, at 3.03[4].

Province of Buenos Aires (Argentina) and the Province of Tierra del Fuego (Argentina). (Note, for example, the special tax and customs provisions laid down in national and Mercosur legislation for Tierra del Fuego and Manaus (Brazil).) The extent of competition, the availability of substitute goods and the levels of supply and demand may be radically different.

When comparing either prices or profit margins, the economic circumstances have to be examined. Where it is necessary and possible, adjustments should be made to account for such differences.

When drafting the GVC, its authors took into account the effect that economic circumstances had on pricing. This is reflected not only in the provisions of GVC Article 7, but also in the Note to GVC Article 6. It provides, in the context of the computed value method, for the examination of economic circumstances when determining whether the producer's figures "for profit and general expenses" are consistent with those usually reflected in sales of goods of the same class or kind – as the goods being valued – which are made by producers in the country of exportation for export to the country of importation.[74] Where the producer can demonstrate that a low profit on sales of the imported goods is due to particular commercial circumstances, the producer's actual profit figures should be used to determine customs value under the computed value method. The Note to GVC Article 6 adds that the "<u>producer's pricing policy must reflect usual pricing policies in the branch of industry concerned</u>". The Note indicates that such a situation might occur, for example, where producers have been forced to lower prices temporarily because of an unforeseeable drop in demand. Bear in mind that the Note to GVC Article 1.2(a) indicates that the controlled price would have not been influenced by the relationship if "<u>the price had been settled in a manner consistent with the normal pricing policies of the industry in question</u>". As one can observe, the wording of the Notes to GVC Articles 1.2 and 6 is similar. We can conclude, therefore, that the example given by the Note to GVC Article 6 provides valid guidance to interpret the Note to GVC Article 1.2. In other words, the provisions of such

[74] See paragraphs 4 and 5 of the Note to GVC Article 6.

example, in the context of the Note to GVC Article 1.2, authorizes the examination of the economic circumstances surrounding the sale in determining comparability under GVC Article 1.2.

7.1.4. BUSINESS STRATEGIES.

Under the OECD Guidelines, the analysis of business strategies of an MNE group constitutes an important element in determining comparability for transfer pricing purposes.[75] The concept of business strategies in this context would be far reaching, including

- Innovation and new product development;
- Degree of diversification;
- Risk aversion;
- Assessment of political changes;
- Input of existing and planned labor laws;
- Other factors bearing upon the daily conduct of business.[76]
- Market penetration schemes.[77]

An important element in evaluating the legitimacy of a taxpayer/importer's claim that is following a specific business strategy is the strategy's timing and likely returns. Some business strategies, such as those involving market penetration or expansion of market share, involve reductions in the taxpayer's current profits in anticipation of increased future profits.[78] Consideration should also be given as to whether the taxpayer can plausibly explain that following such a business strategy will, in fact, produce a return sufficient to justify its costs within a period of time that would be acceptable in an arm's length situation.[79]

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[75] See OECD Guidelines *supra* note 3, at 1.31.
[76] *Ibid.* See also Hammer *supra* note 6, at 3.03[5].
[77] OECD Guidelines *ibid.*, at 1.32.
[78] See Hammer *supra* note 6, at 3.03[5].
[79] *Ibid.*

The analysis of the business strategies of the parties is another element that must be necessarily included in comparability analyses undertaken under GVC Article 1.2. The authors of the GVC paid special attention to this issue, when – in the context of the GVC Article 6 – they established in which cases the producer's profit figures were to be acceptable.[80] In effect, the Note to GVC Article 6 provides:

> 5. It should be noted in this context that the 'amount for profit and general expenses' has to be taken as a whole. It follows that if, in any particular case, the producer's profit figure is low and the producer's general expenses are high, the producer's profit and general expenses taken together may nevertheless be consistent with that usually reflected in sales of goods of the same class or kind. Such a situation might occur, for example, if a product were being launched in the country of importation and the producer accepted a nil or low profit to offset high general expenses associated with the launch. Where the producer can demonstrate a low profit on sales of imported goods because of particular commercial circumstances, the producer's actual profit figures should be taken into account provided that the producer has valid commercial reasons to justify them... Such a situation might occur, for example, ... where [producers] sell goods to complement a range of goods being produced in the country of importation and accept a low profit to maintain competitivity...

The principles laid down in the Note to GVC Article 6 in respect of business strategies are clearly consistent with those of the OECD Guidelines. Paragraph 1.32 of the OECD Guidelines states that "a taxpayer seeking to penetrate a market or to increase its market share might temporarily charge a price for its product that is lower than the price charged for otherwise comparable products in the same market. Furthermore, a taxpayer seeking to enter a new market or expand (or defend) its market share might temporarily incur higher costs (e.g. due to start-up costs or increased marketing efforts) and hence achieve lower profit levels than other taxpayers operating in the same market".

Levey explains that some business strategies raise a threshold issue of which party bears the strategy's economic risk. It is important to determine whether a manufacturer incurs lower margins or loss by charging a lower price to its distributor, or the distributor does this by its selling at a lower price than comparable products or incurring extraordinary

[80] Bear in mind that the examples given by the Note to Article 6 are generally applicable in the context of the Note to Article 1.2, as indicated in the last paragraph of sub-chapter 7.1.3. above.

marketing and promotion expenses. In the former situation the economic risk is on the manufacturer; in the latter, on the distributor.[81]

In the context of a comparability analysis, Customs and tax administrations and importers should be prepared to examine all these circumstances as circumstances surrounding the sale. If success of a strategy was unreasonable at the time of the adoption, or if such a business strategy is unsuccessful but nonetheless is continued beyond a period of time that an independent enterprise would accept, the taxpayer/importer's strategy may be disregarded.[82] In this kind of cases, final determination of the Customs value might have to be delayed. We will explore these issue in Chapter V below.

Another issue that arises in a market penetration context (and that – consequently – should be taken into account for customs valuation purposes) concerns which associated enterprise is the appropriate party to take the economic risk of the market penetration strategy. This should be the party that will also earn the economic return if the strategy is successful.[83] In essence, what occurs in a market penetration situation is the development of marketing intangibles relating to the product and the market in question.[84] When related-party transactions are being scrutinized for customs valuation purposes, this fact cannot be disregarded. The fact that marketing activities undertaken by the importer in the country of importation that benefit the exporter are not included in transaction value[85], does not mean that such activities must also be disregarded when examining whether the relationship influenced the price or when establishing comparability between controlled and uncontrolled transactions. Any adjustment to the price (including or excluding elements) is to be made after it has been determined that the related-party transaction value is acceptable under GVC Article 1.2. For the purposes of determining such fact, market penetration strategies should be taken into account in establishing comparability.

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[81] See Hammer *supra* note 6 at 3.03[5][a].
[82] See OECD Guidelines *supra* note 3, at 1.35. See also Hammer *supra* note 6, at 3.03.[5][a].
[83] Hammer *ibid.*, at 3.03[5][a][ii].
[84] *Ibid.*
[85] See Note to GVC Article 1.1(b).

7.2. EVALUATION OF SEPARATE AND COMBINED TRANSACTIONS.

This topic presents a difficult issue when harmonization of tax and customs transfer pricing rules is being sought. While no adverse consequence may result in the tax context if certain transactions are evaluated together, such an evaluation may, nevertheless, produce adverse consequences in the customs context (and vice versa).

The OECD Guidelines indicate that, "[i]deally, to arrive at the most precise approximation of fair market value, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis."[86] The OECD Guidelines provide some examples of these situations:

- Long-term contracts for the supply of commodities or services,
- Rights to use intangible property, and
- Pricing a range of closely linked products (e.g., in a product line).

Under the GVC, the valuation analysis is clearly focused on single import transactions. The provisions of GVC Article 1.2(a) are designed to determine whether the transaction value of a transaction is acceptable for customs purposes. However, nothing in the GVC prevents a customs administration from examining a number of separate related-party transactions on a combined basis in order to determine whether the relationship influenced the price. Each of these transactions may be regarded as a "circumstance surrounding the sale" vis-à-vis the other transactions.

Nevertheless, the combined analysis of separately contracted transactions should only be made for comparability purposes (e.g., in order to undertake a more accurate functional analysis or to better understand the economic circumstances or the business strategies of the enterprises). The combined analysis cannot, however, be used to determine

[86] See OECD Guidelines *supra* note 3, at 1.42.

whether a number of transactions – as a whole – are arm's length (regardless of whether or not the price of each individual transaction is arm's length), since this may not be consistent with GVC Article 1 or with the general objectives and principles of Customs law. Such inconsistency is illustrated in the following example:

When sold for export, two different goods (classified in different tariff headings and subject to different duty rates) are invoiced at individual prices which are individually non-arm's-length:

Invoice No. 001 for product A	100 c.u.
Invoice No. 002 for product B	400 c.u.

The arm's length values of the products are the following:

arm's length value of product A	200 c.u.
arm's length value of product B	300 c.u.

Consequently, tax and customs administrations determine that the total price invoiced for the goods (when considered together – i.e., 500 c.u.) is actually arm's length.
From a tax standpoint, assuming that the goods are imported for resale in the country of importation, there would probably be no adverse tax consequence derived from a combined analysis of the transactions.[87] In effect, if product A is sold at a price of 300 c.u. and product B is sold at a price of 500 c.u., the gross profit realized by the importer would be equal to 300 c.u.[88] The gross profit would have been the same had the importer declared the individual arm's length value of each product.

From a customs standpoint, the result might be dramatically different. Assuming that product A is subject to a customs-duty rate of 30 % and product B is subject to a customs-duty rate of 1 %, the results would be the following:

customs duties on transaction values	34 c.u.
customs duties on arm's length values	63 c.u.

While some separately contracted transactions between associated enterprises may need to be evaluated together in order to determine whether the conditions are arm's length, other transactions contracted between such enterprises as a package may need to be evaluated separately. In some cases, it may not be feasible to evaluate the package as a whole so that the elements of the package must be segregated. If such is the case, after determining separate transfer pricing for the separate elements, tax administrations should consider whether in total the transfer pricing for the entire package is arm's length.[89]

[87] However, if the imported goods are capital assets of the importer, differences in the rate of depreciation of the assets may, nevertheless, produce adverse tax consequences.
[88] For the purposes of the example: Gross Profit = Resale Price – COGS. Other factors or elements are not included for simplicity purposes.
[89] See OECD Guidelines *supra* note 3, at 1.43.

The Technical Committee on Customs Valuation, in Commentary 8.1[90] defines "package deal" as an agreement to pay a lump sum for a correlated group of goods, or a group of goods sold together, the price of the goods sold constituting the only consideration. Note that the OECD refers mainly to those situations where an MNE establishes a single price for a number of benefits such as licenses for patents, know-how and trademarks, the provisions of technical and administrative services and the lease of production facilities. The OECD remarks that such comprehensive packages would be unlikely to include sales of goods (although the price charged for sales of goods may cover some accompanying services.[91] As one can see, the OECD Guidelines do not appear to focus on sales of goods.

Although paragraph 5 and 6 of Commentary 8.1 do not refer to package deals including services or intangibles, the principles underlying such paragraphs suggest that, where such elements are involved in a package deal that includes the sale of goods, the transaction value would not to be acceptable under GVC Article 1.[92] Therefore, the application of GVC Articles 2, 3, 5, 6 and 7 may difficult achievement of harmonized results under tax and customs transfer pricing rules.

Where different goods are sold and invoiced at a single overall price, the fact of such single overall price for different goods does not constitute an impediment to establishing transaction value provided that the other conditions of GVC Article 1 are met.[93] Commentary 8.1 indicates that, in those instances where the goods are classifiable under separate tariff headings at different rates of duty, the overall price – which has been

[90] See CVC *supra* note 23, at Com8.1/1. Note that Commentary 8.1 does not refers specifically to related-party transactions but, generally, to any kind of package deal.
[91] See OECD Guidelines *supra* note 3, at 1.43.
[92] Paragraphs 5 and 6 read: "(B) Goods of different quality sold and invoiced at a single overall price are only partially declared for home use in the country of importation.- 5. In this situation, the nature of the problem is different and can be illustrated by the following example: A consignment comprising goods of three different qualities (top quality A, average quality B and low quality C) is purchased at an overall unit price of 100 currency units per kilo. In the country of importation, the buyer declares quality A for home use at 100 currency units per kilo but assigns the other qualities to some other procedure.- 6. Since the overall price actually paid or payable has been agreed for a set of goods of various qualities there is no selling price for the goods declared for home use and Article 1 of the Agreement is therefore not applicable in this instance."
[93] See CVC *supra* note 23, at Com8.1/1 (paragraph 3 of Commentary 8.1)

negotiated as part of a package deal – should not be rejected when applying GVC Article 1, solely for the purposes of tariff classification.

The Technical Committee on Customs Valuation recognizes that the proper apportionment of the overall price among the goods which are classifiable in different headings constitutes a practical problem. It suggests that "[s]everal methods are possible including, for example, the use of prices or values of identical or similar goods in previous importations, if such methods can provide a valid indication of the price of the various goods covered by the package deal."[94] Note that these recommendations are similar to those provided by paragraph 1.44 of the OECD Guidelines. The relevant part of such paragraph provides:

> Even in uncontrolled transactions, package deals may combine elements that are subject to different tax treatment under domestic law or an income tax convention ... In such circumstances, it may be still appropriate to determine transfer pricing on a package basis, and the tax administration could then determine whether for other tax reasons it is necessary to allocate the price to the elements of the package. In making this determination, tax administrations should examine the package deal between associated enterprises in the same way that they would analyse similar deals between independent enterprises. Taxpayers should be prepared to show that the package deal reflects appropriate transfer pricing.

7.3. USE OF AN ARM'S LENGTH RANGE.

The OECD Guidelines explain that it will sometimes be possible to apply the arm's length principle to arrive at a specific price or profit margin that is most reliable to establish whether the conditions of the transaction are arm's length. However, they indicate that the application of the most appropriate method or methods often produces a range of figures all of which are equally reliable.[95] The arm's length principle only produces an approximation of conditions that would have been established between independent enterprises. This fact may cause the differences in the figures that comprise the range. The Guidelines indicate that the different points in a range may simply represent the fact that independent enterprises

[94] CVC *supra* note 23, at Com8.1/1 (paragraph 4 of Commentary 8.1)
[95] See OECD Guidelines *supra* note 3, at 1.45.

engaged in comparable transactions under comparable circumstances may not establish exactly the same price.[96]

Nothing in GVC Article 1.2 or its Note prevents the importer or customs administrations from using an arm's length range in order to produce an approximation of conditions that would have been established between independent enterprises and, therefore, to produce a range of figures that – being all of equal reliability – would be acceptable for the purposes of GVC Article 1. An analysis of the provisions of the Note to GVC Article 1.2 suggests that the use of an arm's length range may be appropriate under certain circumstances. In effect, where the examination of the normal pricing practices of the industry, or of the way the seller settles prices for sales to unrelated buyers, produces a range of figures of equal reliability, the use of an arm's length range appears to be in accordance with the text of the Note.[97] In relation to this issue, the principles underlying the provisions of the GVC seem to be similar to those stated in the OECD Guidelines.

Commentary 15.1 of the Technical Committee on Customs Valuation[98] – regarding the application of the deductive value method – provides guidance to interpret the meaning of the expression "additions usually made for profit and general expenses in connection with sales in such country of imported goods of the same class or kind" in the context of GVC Article 5. This guidance may also be helpful in interpreting the second example of the Note to GVC Article 1.2, since the wording of such example has several points in common with the expression quoted above.[99]

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[96] *Ibid.*

[97] It should be taken into account that the harmonization of customs and tax rules becomes easier where the OECD Guidelines are integrated in the GVC through an appropriate construction of the provisions of the latter. Needless to say that such construction must respect not only the provisions of the GVC and their Notes, but also the general principles and objectives underlying them. If neither GVC Article 1.2 nor the GVC's general principles preclude the application of the OECD Guidelines in examining related-party transactions, such Guidelines should be used to interpret and implement the provisions of Article 1.2.

[98] See CVC *supra* note 23, at Com15.1/1.

[99] In effect, the second example provided by the Note reads: "where it is shown that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized ... in sales of goods of the same class or kind, this would demonstrate that the price had not been influenced." Both the

Paragraph 11 of Commentary 15.1 indicates that "the usual amount for commission or profit and general expenses could constitute a range of amounts which probably would vary according to the class or kind of the goods being valued. In order for a range to be acceptable, it should be neither too wide nor too deficient in population. The range should be obvious and easily discernible in order for it to be the 'usual' amount."[100] As one can see, the Technical Committee on Customs Valuation understood that ranges could be used for the purposes of determining the appropriate "usual amount for profit and general expenses" under GVC Article 5. On the basis of such understanding, one can suggest that arm's length ranges could also be used for the purposes of examining profit margins under the Note to GVC Article 1.2. (i.e. for producing an approximation of conditions that would have been established between independent parties and, thus, for determining whether the relationship influenced the price).

Moreover, GVC Article 1.2(a), unlike Articles 2, 3, 5, 6 and 7, does not establish a strict sequential order of application of arm's length methods. In determining whether the relationship influenced the transaction value, the methods can be applied in any order[101] or even simultaneously. (GVC Article 1.2(a) only provides examples to illustrate situations where the relationship did not influence the price, but it does not set out the methods to be used or the order in which those methods must be applied. Note also that GVC Article 1.2(b) does not provide for a sequential order of application of its test values.) In this respect, the OECD Guidelines indicate that "a range of figures may also result when more than one method is applied to evaluate a controlled transaction." The use of arm's length ranges under GVC Article 1.2(a) is, therefore, consistent with the absence of strict sequential order of application and with the possible application of more than one method under such article.

The OECD Guidelines provide further guidance in relation to the use of arm's length ranges:

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example and the expression quoted above, require the examination of profit margins realized in sales of goods of the same class or kind.

[100] See CVC *supra* note 23, at Com.15.1/2.

[101] Note that, although there is no sequential order of application, under certain circumstances some methods are preferred over others. Further discussion of this issue will be found in section 11.1 below.

> Where the application of one or more methods produces a range of figures, a substantial deviation among the points in that range may indicate that the data used in establishing some of the points may not be as reliable as the data used to establish the other points in the range or that the deviation may result from features of the comparable data that require adjustments. In such cases, further analysis of those points may be necessary to evaluate their suitability for inclusion in any arm's length range.

These guidelines may be complemented by those provided by the Technical Committee on Customs Valuation in paragraph 11 of Commentary 15.1 (quoted above). Where the importer submits information based on more than one method, customs administrations should be prepared to use arm's length ranges in order to arrive at more accurate results.[102]

7.4. USE OF MULTIPLE YEAR DATA.

The main purpose of customs valuation is to determine the customs value of the goods when they enter the customs territory, avoiding arbitrary or fictitious values. The customs value of the goods constitutes the tax base of the customs duties. Unlike income tax, customs duties are not intended to tax the income of the taxpayer. Customs duties are indirect taxes.[103] The importation of goods evidences the existence of ability to pay (either that of the importer, or that of the final consumer who finally bears the tax burden), and the customs value of the good is the basis that has been chosen (usually by the legislative branch of the state) to measure such ability.

One can suggest that, what is important for customs valuation purposes is the customs value of the good at a certain and specific point in time (e.g., the importation, the sale for export to the country of importation, etc.).

[102] Note that GVC Article 7.2 only prevents the Customs administrations from using a system which provides the acceptance for customs purposes of the higher of two values. The use of arm's length ranges does not fall within the provisions of Article 7.2, since it is not a method for determining substitute values. The transaction values declared by the importer are accepted under Article 1, if they are within the arm's length range.

[103] See Levey *supra* note 2, at 8.05[1]. See also Finanzas *supra* note 16, at 757-804 (Jarach includes customs duties among the taxes on consumption).

For income tax purposes, the point of departure is quite different. The tax base is the income of the taxpayer (as defined under each legislation). For tax calculation purposes, the business lifetime must be divided in arbitrary segments (what gives rise to most problems of accurate income calculation). A taxpayer's lifetime is segmented into annual periods and the income realized during such period constitutes the tax base. However, the ascertainment of business profits at fixed intervals of 12 months is so arbitrary a process, considering the continuous nature of business operation, that methods of carry-forward (and, sometimes, carry-back) of loss are considered to be "an obvious concession to common sense"[104] and, thus, usually included in most of the income tax laws. The period over which benefits are received from any given expenditure may be long, and a liberal carry-forward of losses is essential to overcome this limitation of the annual period of measurement.[105]

As one can see, income measurement tends to be based on yearly data or, even, on multiple-year data.

This seems to be a major difference between the customs and tax systems. However, this difference is only apparent. Even though income tax is calculated through a period of time (unlike customs duties that are calculated at a specific point in time), and that such calculation is made on income rather than on the value of the goods, this latter element must always be determined for income calculation purposes. (In effect, the determination of sales price and cost of goods sold is necessary to determine profits or losses). The analysis of the present work aims at this specific element (value of the goods) and not to the whole process of income calculation.

One must distinguish two different sources of multiple-year data:

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[104] Ellis, J., "Aggregation of Income and Losses from Various Sources" in *Canadian Taxation* (Toronto; Richard de Boo, 1981) at 446.
[105] Canada, *Report of the Royal Commission on Taxation* (Carter Report), Vol. 4 (Ottawa: Queen's Printer, 1966) at 252-55.

(i) Multiple year data related to income calculation: among others, we can mention carry-forward and carry-back data which will affect the calculation of income of a specific period. It is irrelevant for customs valuation and transfer pricing purposes.

(ii) Multiple year data used for comparability purposes: this kind of data (e.g., results of business activities, etc.) is used as a guide for applying the arm's length principle. The OECD Guidelines provide that "[t]o obtain a complete understanding of the facts and circumstances surrounding the controlled transaction, it might generally be useful to examine data from both the year under examination and prior years."[106] There is nothing in the GVC preventing an importer or a customs administration from using such kind of information in determining whether the relationship influenced the price. GVC Article 1.2 and its Note refer broadly to the examination of "the circumstances surrounding the sales" and the "relevant aspects of the transaction". Nothing seems to prevent the taxpayer from submitting, and the customs administration from examining, multiple-year data for comparability purposes.

There are other problems caused by differences in timing between tax and customs law, which derive mainly from limitations in the procedure of valuation and liquidation of customs duties. We will analyze these problems in Chapter V below.

[106] See OECD Guidelines *supra* note 3, at 1.49.

CHAPTER III

DETERMINING WHETHER THE RELATIONSHIP INFLUENCED THE PRICE.

ARM'S LENGTH PRICES.

8. THE OECD ARM'S LENGTH METHODS AND THE METHODS LAID DOWN IN GVC ARTICLES 2, 3, 5 AND 6.

The transfer pricing methods in the OECD Guidelines establish whether the conditions imposed in commercial and financial relations between associated enterprises are consistent with the arm's length principle. It must be noted that no one method is suitable in every possible situation.[107] Although in some cases the choice of a method may sometimes not be straightforward and more than one method may have to be initially considered, it should ultimately be possible to select one method that is apt to provide the best estimation of an arm's length price. However, there are many types of difficult situations where no one approach is conclusive. In these situations, a flexible approach allows various methods to be used in conjunction. Here, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all parties, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration.[108]

The methods set forth in GVC Articles 2, 3, 5 and 6 of the GVC 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 price), 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 the Customs authorities to determine substitute values. Even

[107] See Hammer *supra* note 6, at 3.03[14].
[108] See OECD Guidelines *supra* note 3, at 1.69.

though they require a certain degree of comparability between the transaction being valued and the transactions the prices (or profit margins) of which will be used to assess the substitute value, such requirement is far less important than that of the OECD Guidelines. In respect of the TVI[109] and TVS[110] methods, Sherman said that

> [t]here is a flow in the logic of TVI and TVS which should be pointed out at once. The other transaction may not be truly comparable for any of several reasons which are not taken into account by the Code. The most important is that the other transaction may not have been entered into at the same time. Assume, for example, that prices have been steadily rising and that one importer purchases pursuant to a 5-year fixed-price supply contract, while the other importer buys on a spot basis and pays today's far higher spot price. Either one of these importers may find his goods being valued for customs purposes on the basis of the other's very different price if, for any reason, his own TV [transaction value] is rejected or does not exist. The low price importer can end up with a high customs value, or vice versa... There is also some danger that an importer who has, for example, carefully excluded advertising costs or warranty costs or constructing and erection costs from his pricing will find his goods being valued on the basis of a price set by others who were not as careful[111]

The importer will not use them to set its prices, nor are the Customs authorities permitted to use them to evaluate whether the relationship influenced the price. Even though this is not expressly established by the GVC, the wording of the Note to GVC Article 1.2(a) allows such an interpretation. In effect, no reference to the valuation methods of Articles 2, 3, 5 and 6 is made in such Note. Furthermore, none of the examples provided by the Note is strictly equivalent to any of those methods (although some of the examples might imply an application thereof). Finally, the methods laid down in GVC Articles 2, 3, 5 and 6 are to be used for the purpose of determining substitute values[112] if (and only if) the transaction value under GVC Article 1 is rejected or cannot be applied[113]. When examining whether the relationship influenced the price under GVC Article 1.2, the transaction value has not yet

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[109] "Transaction value of identical goods" under GVC Article 2.
[110] "Transaction value of similar goods" under GVC Article 3.
[111] Sherman *supra* note 16, at 200. This author noted that, in his view, the Code should be interpreted to exclude such applications, but that it may not be interpreted in this way.
[112] See, generally, Musso de Zunino, C., *Valoración aduanera en las importaciones. Problemas que se suscitan en relación a la aplicación del actual régimen de valor* (Derecho Tributario, 9, 227). See also *ESSO S.A.P.A. v. A.N.A. s/ recurso de apelacion*, (7 October 1993) Tribunal Fiscal de la Nacion, Sala G, File No. 6872-A (Argentina)
[113] See General Introductory Commentary to the GVC. See also Sherman *supra* note 16, at 200.

been rejected. Rather, this process of examination is the one that will determine whether the related-party transaction value is acceptable or has to be rejected[114].

9. TEST VALUES.

It should be noted that the application of test values under GVC Article 1.2(b) is also not equivalent to the application of the methods of GVC Articles 2, 3, 5 and 6.

GVC Article 1.2(b)(i) generally requires a higher degree of comparability between the transaction being examined and the test transaction than that required by GVC Articles 2 and 3. In effect, even though GVC Articles 2 and 3 require certain comparability criteria to be met (e.g., goods identical or similar, same country of importation, same commercial level and same quantity - or, otherwise, appropriate adjustments -), they do not provide, unlike GVC Article 1.2(b), that "the elements enumerated in Article 8 and costs incurred by the seller in sales in which the seller and the buyer are not related that are not incurred by the seller in sales in which the seller and the buyer are related" must be taken into account in applying the test values. This clause prevents the importer from using test values that do not comply with minimum standards of comparability. In other words, it authorizes Customs administrations to require to the importer the use of actually comparable test values. It should also be noted that the test value of GVC Article 1.2(b)(i) involves transaction values that are not controlled (i.e., transaction values in sales to unrelated buyers). This is not required under GVC Articles 2 and 3.

The test values laid down in GVC Articles 1.2(b)(ii) and (iii) require previous determinations of value of identical or similar goods under GVC Articles 5 or 6, which must have been accepted by the customs administration. Therefore, these test values do not consist of a determination of value through the methods of GVC Articles 5 and 6, or of a

[114] See Note to Paragraph 2 of Article 1. See Sherman *supra* note 16, at 189 (..."relationship is not even presumptively a ground for departing from TV [transaction value]. It is only a reason for further inquiry or scrutiny. Departure from TV is not permitted unless justified on the basis of the results of the inquiry).

comparison of the transaction value with a theoretical value arrived at through the application of those methods. Rather, they provide for the use - as a basis of comparison - of an actual customs value already accepted by the customs administration.[115]

10. CONSIDERATIONS REGARDING THE OECD ARM'S LENGTH METHODS.

In the following sub-chapters we will analyze the application of the OECD arm's length methods for the purpose of determining whether the relationship influenced the price under GVC Article 1.2(a). Being the methods set forth in GVC Articles 2, 3, 5 and 6 not directly applicable under GVC Article 1.2, there is no point in comparing them with the OECD arm's length methods. Where appropriate, we will make reference to the provisions of such articles and Article 7 since they contain general principles that are present in all the provisions of the GVC. Where appropriate, we will also make reference to the relationship between GVC Article 1.2(a) and GVC Article 1.2(b).

Finally, it should be noted that the OECD Guidelines should be used not only by importers (to ensure the arm's length character of their related-party transactions) but also by Customs administrations for the purposes of protecting the tax base and performing their functions of control on foreign trade. If the Note to GVC Article 1.2 were interpreted too broadly, wide acceptance of transaction values in controlled transactions might erode the tax base of customs duties and be harmful to the country of importation (not only in connection with its revenue but also in relation to its right to control foreign trade in its jurisdiction). This appears to be contrary to the general objectives of the GVC, especially after the adoption of the "Decision regarding cases where customs administrations have reasons to doubt the truth or accuracy of the declared value" by the Committee on Customs

[115] See paragraph 4 of the Note to GVC Article 1.2. See also Sherman *supra* note 16, at 194. See CVC *supra* note 23 at AO7.1/1 (Advisory Opinion 7.1). See also CVE *supra* note 29 at chapter XXXIV (Ruling 543568 (30 May 1986))

Valuation.[116] The OECD arm's length methods provide the Customs administrations with adequate instruments to protect the tax base of customs duties.

11. TRADITIONAL METHODS.

11.1. COMPARABLE UNCONTROLLED PRICE METHOD ("CUP").

Under the OECD Guidelines, the CUP method compares the price charged for property or services transferred in a controlled transaction with the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. Any difference between the two prices may indicate that some or all of the commercial and financial relations between the associated enterprises are not arm's length[117] and, therefore, that the relationship did influence the price for the purposes of GVC Article 1.2.

The Note to GVC Article 1.2. provides an example of application of this method:

> As an example of this, if the price had been settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related to the seller, this would demonstrate that the price had not been influenced by the relationship.

The use of the CUP method as a way of establishing that the transaction value has not been influenced by the relationship was accepted by Revenue Canada in paragraphs 15 and 16 of Memorandum D13-4-5.[118] The CUP method is reflected by the examples of subparagraphs (a) and (c) of paragraph 16 of the Memorandum, which state:

> (a) The vendor has sales to unrelated customers in Canada who purchase under basically the same conditions as does the related purchaser. The importer has evidence which shows that the vendor's

[116] WTO Doc. G/Val/1 (27 April 1995). This decision appears to address cases where the requisites mentioned in Article 1.1(i), (ii), (iii) and (iv) are met. However, it also provides a general rule applicable to all the cases where the Customs administrations have to examine transaction value (what also includes related-party transactions).

[117] See OECD Guidelines *supra* note 3, at 2.6.

[118] See Memorandum *supra* note 28. Revenue Canada expressed 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 [the 1979 OECD Report] unless there is information on prices available which is more directly related to the specific importations."

> prices to unrelated customers in Canada are the same as those paid by the importer, that the unrelated purchasers are at the same trade level and buy in approximately the same quantities, terms and conditions as does the importer...
>
> (c) The vendor has sales to unrelated customers in Canada who purchase under conditions that are different from those pertaining to the related purchaser, and differences in price can be justified by these differences in conditions. For example, the related purchaser is at the distributor level of trade and the unrelated Canadian customers are at the wholesale level and buy in smaller quantities than the related purchaser. In this example, the importer could provide evidence to show that, although the vendor's price to the wholesalers is higher, the difference is accounted for by economies realized by the vendor in dispatch costs, larger production runs, selling costs, overhead costs, bad debt expenses, etc. It would be necessary for the importer to obtain this evidence from the vendor.[119]

The example of the Note to GVC Article 1.2, quoted above, seems to recommend the application of the CUP method using internal comparables (i.e., a comparison between the prices charged by the related seller to the related buyer and the price charged by the same seller to independent buyers). The OECD Guidelines provide a similar example in paragraph 2.13.

As indicated above, it is important to bear in mind that the examples of the Note to GVC Article 1.2 are only illustrative. Therefore, they should only be taken as a starting point[120]. Nothing in the GVC prevents the importers or customs administrations from considering external comparables (i.e., prices charged by other sellers to independent buyers) for determining whether the relationship influenced the price.

In applying the CUP method, the OECD Guidelines suggest that an uncontrolled transaction is comparable to a controlled transaction 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 in the open market; or (2) reasonably accurate adjustments can be made to eliminate the material effects of such differences. As indicated in Chapter II above, the criteria of comparability are extremely important to determine whether the relationship influenced the price, and thus wholly applicable under GVC Article 1.2(a).

[119] Memorandum *supra* note 28.
[120] See Sherman *supra* note 16, at 193.

The OECD Guidelines provide that, where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable way to apply the arm's length principle. Consequently, they recommend that, in such cases, the CUP method is preferable over all other methods. The Note to GVC Article 1.2 does not set out any particular order of application of the methods nor does it reveal preference for any of them[121]. However, we understand that the preference for the CUP method, where it is possible to locate comparable uncontrolled transactions, could be found in the structure of the GVC and in the general principles underlying its provisions. In effect, the methods of GVC Articles 2 and 3, although not equivalent, are similar to the CUP method. In effect, they are based on the transaction price of comparable transactions (identical or similar goods, same commercial level and quantity, etc.). The sequential order of application of the methods establishes the preference for such methods over the others, where such comparable transaction values are available and where - existing differences of commercial levels or quantities - an appropriate adjustment on the basis of demonstrated evidence can be made[122]. Even though such sequential order is not applicable to GVC Article 1.2 (as indicated in section 7.3 above), such order reflects a general principle or understanding vis-à-vis the degree of reliability of each of the methods. This indicates a preference that should be observed in interpreting and applying GVC Article 1.2.

In effect, the hierarchical order of application of the methods has been identified by the Technical Committee on Customs Valuation as a principle or general provision of the Agreement. To the question as to whether it is necessary to follow the hierarchical order with respect to the methods of valuation in GVC Articles 1 to 6, when applying GVC Article 7, the Technical Committee replied:

> There is no provision in the Agreement that specifically provides that the hierarchical order of Articles 1 to 6 should be followed when Article 7 is applied. However, Article 7 require the use of reasonable means consistent with the principles and general provisions of the Agreement and this indicates that where reasonably possible, the hierarchical order should be followed. Thus, where

[121] Note that it does not even mention which are those methods. It only provides examples where one can discern the application thereof.

[122] General Interpretative Note of the GVC.

several acceptable methods can be used to determine Customs value under Article 7, the hierarchy should be maintained.[123]

The specific comparability criteria for applying the CUP method provided by paragraph 2.9 of the OECD Guidelines should also be taken into account in the context of GVC Article 1.2. Paragraph 2.9 states:

> In considering whether controlled and uncontrolled transactions are comparable, regard should be had to the effect on price of broader business functions other than just product comparability (i.e. factors relevant to determining comparability under Chapter I). Where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those transactions, it may be difficult to determine reasonably accurate adjustments to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method. Practical considerations dictate a more flexible approach to enable the CUP method to be used and supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy...

It is interesting to analyze, from a customs perspective, the example provided in paragraph 2.11 of the OECD Guidelines. The first part of the example reads as follows:

> The CUP method is a particularly reliable method where an independent enterprise sells the same product as is sold between two associated enterprises. For example, an independent enterprise sells unbranded Colombian coffee beans of a similar type, quality, and quantity as those sold between two associated enterprises, assuming that the controlled and uncontrolled transactions occur at about the same time, at the same stage in the production/distribution chain, and under similar conditions...

In this part of the example, the OECD Guidelines follow criteria that are clearly consistent with those underlying the GVC. (Even though such comparability criteria are not expressly included in GVC Article 1.2(a), they are present in other provisions of the code, such as GVC Articles 1.2(b), 2 and 3). In effect, the transactions being compared in the example involve similar goods, sold in similar quantities and at the same commercial level. The example continues as follows:

> ... If the only available uncontrolled transaction involved unbranded Brazilian coffee beans, it would be appropriate to inquire whether the difference in the coffee beans has a material effect on the price. For example, it could be asked whether the source of coffee beans commands a premium or requires a discount generally in the open market. Such information may be obtainable from commodity markets or may be deduced from dealer prices. If this difference does have a material effect on price, some adjustments would be appropriate. If a reasonably accurate adjustment

[123] Note that, as indicated above, the principle of hierarchical order, in the context of GVC Article 1.2, would only indicate a preference for the methods of Articles 2 and 3 over the other methods. It does not prevent the importer or customs administrations from combining methods or altering the order where the application of the CUP method does not produce reliable outcome (e.g., problems of comparability, existence of unique intangibles, etc).

> cannot be made, the reliability of the CUP Method would be reduced, and it might be necessary to combine the CUP method with other less direct methods, or to use such methods instead.

The use of an uncontrolled transaction involving goods of different origin would not be, in principle, contrary to the principles reflected by GVC Article 7 or to the criteria provided by the Note to GVC Article 1.2. However, goods cannot be regarded as "identical goods" or "similar goods" unless they were produced in the same country as the goods being valued. Thus, it could be argued that, not being useful for the purposes of GVC Articles 1.2(b), 2 or 3, transactions involving such goods should not be used for the purposes of the CUP method under GVC Article 1.2(a).

We do not believe that GVC Article 1.2(a) prevents the importer or the Customs administrations from comparing transactions involving goods of different origin. Sherman explains that "[i]n principle, and in practice as well, there should be no limit set to the exercise of persuasive intelligence to support the acceptability of a transfer price."[124] The Note to GVC Article 1.2 makes no reference to "identical goods" or "similar goods". It only makes reference to goods of the same class or kind in one of its examples of situations where the relationship did not influence the price. GVC Articles 2 and 3 describe a method of valuation that is similar but not equivalent to the CUP method. A major difference is the fact that GVC Articles 2 and 3 are not designed to evaluate whether a related-party transaction value is arm's length, but only to determine substitute values once the transaction value has been rejected. Therefore, in interpreting or applying the provisions of GVC Article 1.2(a), the provisions of GVC Articles 2 and 3 should not be regarded as strict rules to be complied with, but only as guidance which reflects certain understandings and principles under the GVC. Taking into account such guidance, we can conclude that the comparison of transactions involving goods of different origin - although not precluded - should be minimized as much as possible for the purposes of the CUP Method under GVC Article 1.2(a). In other words, transactions involving goods produced in different countries should only exceptionally be regarded as comparables.

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[124] See Sherman *supra* note 16, at 193.

It is also interesting to address the solution suggested by the OECD Guidelines to situations where there is a difference between the controlled and the uncontrolled price, which indicates that the conditions of the commercial and financial relations of the related parties are not at arm's length. The OECD Guidelines indicate that, in such a case, the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction. This solution would not be consistent, in principle, with the GVC. Under the GVC, such a difference between prices would indicate that

(i) the relationship did influence the price;
(ii) the transaction value is not acceptable; and
(iii) the value cannot be determined under the provisions of GVC Article 1.

In this case, neither the importer nor the Customs administrations can substitute the price in the uncontrolled transaction for the price in the controlled transaction. In effect, GVC Article 1.2 does not authorize such a substitution. Where the transaction value is rejected, the customs value must be determined through the sequential application of the methods laid down in GVC Articles 2, 3, 5, 6 and 7.[125]

This could produce certain inconsistencies between the results derived from the application of tax and customs rules. For example, if during the examination of the circumstances surrounding the sale, the Customs and tax administrations based their analyses on the cost-plus method, and such method demonstrated that the price had been influenced by the relationship (i.e., the price was not arm's length), then the tax administration (on the basis of the OECD Guidelines) would try to substitute the cost-plus price arrived at, for the transaction value. At the same time, the Customs administration would be obliged to go sequentially through the methods of GVC Articles 2 through 6. As

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[125] Note that this is expressly established for the purposes of GVC Article 1.2(b). GVC Article 1.2(c) provides: "Substitute values may not be established under the provisions of paragraph 2(b)." The General Note to the GVC states: "Where the customs value cannot be determined under the provisions of Article 1, it is to be determined by proceeding sequentially through the succeeding Articles to the first such Article under which the customs value can be determined." The Technical Committee on Customs Valuation provides an example in Case Study 10.1 which shows the functioning of this principle (see CVC *supra* note 23, at CS10.1/3 (paragraph 15)

indicated above[126], the degree of comparability required under the methods of GVC Articles 2 and 3 is lower than that required under the OECD Guidelines. Thus, the Customs administration may find a transaction involving similar goods, at a similar commercial level and in the same quantities, but with an allocation of functions that is substantially different from that of the transaction in question. While the customs administration will determine the customs value on the basis of such transaction, the tax administration will simply substitute the cost-plus value for the transaction value. In effect, the tax administration would not be forced to duplicate the transfer pricing analysis or to accept the value of a transaction which does not comply with the OECD Guidelines' standards of comparability.[127]

The most consistent results can be achieved where the importer undertakes a thorough transfer pricing analysis. In effect, the application of the OECD Guidelines is possible under GVC Article 1.2(a), i.e., in examining the circumstances surrounding the sale and in determining whether the relationship influenced the price. However, the application of the OECD Guidelines is difficult (or even impossible) once the transaction value has been rejected, since the customs administrations are forced to apply sequentially the methods of GVC Articles 2 through 6.[128]

11.1.1. EXAMPLES OF APPLICATION OF THE CUP METHOD UNDER GVC ARTICLE 1.2(A).

The US Customs Service has often applied this method in the context of GVC Article 1.2(a). We can mention Rulings 543984 (22 February 1988), 544809 (1 June 1994), 546285 (7 June 1996), among others.[129]

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[126] See sub-chapter 8 above.
[127] Bear in mind that, under GVC Articles 2 and 3, the transaction used for the purposes of determining the customs value may be another controlled transaction.
[128] Nonetheless, an appropriate interpretation of such Articles could help reduce such inconsistencies. (However, an inquiry into this issue would exceed the purposes of this work.)
[129] See CVE *supra* note 29, at 35.

11.1.2. TEST VALUES UNDER GVC ARTICLE 1.2(b)(i).

The application of this test value at the initiative of the importer could also produce results that would not be consistent with those derived from the application of the OECD Guidelines. However, inconsistencies could be eliminated (or, at least, reduced), through an adequate interpretation of the provisions of GVC Article 1.2(b).

In effect, the comparability factors to be examined under GVC Article 1.2(b) include not only similar commercial level and quantities but also "the elements enumerated in Article 8" and "costs incurred by the seller in sales in which the seller and the buyer are not related that are not incurred by the seller in sales in which the seller and the buyer are related". This would authorize the Customs administration to require the importer to apply actually comparable test values.

11.2. RESALE PRICE METHOD.

The OECD Guidelines provide that "the resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The price (the resale price) is then reduced by an appropriate gross margin (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after adjustment for other costs associated with the purchase of the product (e.g. customs duties), is an arm's length price for the original transfer of property between the associated enterprises".[130] The OECD Guidelines suggest that this method is most useful where it is applied to marketing operations.

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[130] See OECD Guidelines *supra* note 3, at 2.14.

None of the examples of the Note to GVC Article 1.2 seems to be derived from the application of this method. In Ruling 545800 (28 June 1996), the US Customs Service analyzed certain information submitted by a related importer to demonstrate that the relationship did not influence the price. Among others, the importer provided information concerning costs and profits involved with its reselling the imported merchandise in the United States. The US Customs Service indicated that

> [e]ven if the general expenses and profit realized by Tundra [the importer] are within the range of what constitutes the usual general expenses and profits of the relevant industry, this would not show that the price between Standard [the exporter] and Tundra was settled in a manner consistent with normal pricing practice in the industry ... In addition, the evidence submitted by counsel is not sufficient to show that the price of the imported merchandise was sufficient to recover all cost plus a profit equivalent to the firm's overall profit realized over a representative period [of] time. Counsel has provided information regarding costs that Tundra incurs in selling the merchandise to its customers. However, this cost information does not indicate whether the price charged by Standard is sufficient to cover all its costs and earn a profit equal to its overall profit over a representative period of time. In other words, the relevant consideration would be Standard's [the exporter's] costs in producing the imported sweaters not Tundra's [the importer's] costs in reselling the sweaters in the United States. Since no evidence has been submitted on how much it costs for Standard to produce the imported sweaters, we cannot ascertain whether it has been able to recover all its costs plus earn a profit equal [to] its overall profit over a representative period of time through its pricing practices with Tundra."

It is clear that the US Customs Service interpreted the second example of the Note to GVC Article 1.2 as only allowing the use of the cost plus (or computed value) method. Note that the US Customs Service rejected the information submitted by the importer on the grounds that such information relates to a resale price method, and not to the methods from which the examples of the Note to GVC Article 1.2 are derived. In other words, the US Customs Service interpreted the Note as preventing the importer from using a resale price method in demonstrating that the relationship had not influenced the price.

This interpretation ignores the fact that the examples of the Note are only illustrative. The importers are forced to base their analyses on the narrow situations described in such examples. This is inconsistent not only with the text, but also with the principles and objectives of GVC Article 1.2. On the one hand, the Note to GVC Article 1.2 does not establish "methodologies", which would be the logical instrument for determining whether the transaction value is at arm's length.[131] It only provides simple examples designed to give some guidance as to which methodologies can be used in determining whether the relationship influenced the price. Being illustrative in character (as most examples are), they do not authorize Customs administrations to limit the methodologies that the importer can avail himself of to those strictly used in the examples. The Customs administrations may reject a methodology that is contrary to the purposes of the examples or inconsistent with the general principles and objectives of the GVC. For example, the Customs administrations could reject a methodology which is based on arbitrary formulae of allocation of profits or fictitious values.

On the other hand, the second example of the Note might also be regarded as an application of the resale price method if flexibly interpreted.[132]

As indicated above, since the examples are only illustrative, the methods of the OECD Guidelines should be accepted in the context of GVC Article 1.2, as long as they are useful and reliable in determining whether the relationship influenced the price. On these grounds, importers and customs administrations would be authorized - where appropriate - to use this method in examining the circumstances surrounding the sale.

This is also the understanding of Revenue Canada, in Memorandum D13-4-5. As indicated above, the Canadian customs service will accept for valuation purposes, a price paid or payable which is derived from one of the methods set out in the 1979 OECD report unless there is information available which is more directly related to the specific

[131] Note that the other provisions of the GVC, which are designed to determine customs values, laid down methodologies and not simple examples.
[132] In effect, the example says: "Where it is shown that the price [it does not state whether it refers to sales or purchase price] is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time ... in sales of goods of the same class or kind". The reference to the firm's overall profit in <u>sales</u> of goods of the same class appears to be connected with the price mentioned at the beginning of the sentence, what gives the idea that the price, that ensures a gross margin comparable to the firm's overall margin, is the sales price and not the purchase price. However, since not only a controlled sales price but also a controlled purchase price can affect the gross profit margin, a flexible interpretation may suggest that the example also refers to the resale price method.

importations.[133] The Memorandum also indicates that the methods of the 1979 OECD Report are included in the methods illustrated in paragraph 16 of such Memorandum.[134] The Memorandum explains that these methods are "examples of ways of establishing that a price is not influenced by the relationship."[135] The resale price method is illustrated in subparagraph (g) of paragraph 16, as follows:

> (g) The Canadian purchaser's gross margin percentage on sales in Canada of goods purchased from unrelated suppliers is not markedly different from the gross margin percentage realized on sales of comparable goods purchased from the 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 realised on products advertised by the foreign vendor to the margins realised on products where the purchaser is responsible for the cost of advertising. In addition, the purchaser's gross profit margin would have to be comparable to the industry margin.

11.2.1. INTERNAL AND EXTERNAL COMPARABLES.

The OECD Guidelines provide that the resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions.[136] The examples of the Note to GVC Article 1.2 appear to refer, generally, to this kind of comparables (i.e., internal comparables).

The Guidelines add that "[a]lso, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions [*i.e., external comparables*] may serve as a guide."[137] As indicated above, the examples of the Note are illustrative and should not be interpreted as precluding the examination of comparable transactions different from those described thereby. The question that arises is whether the use of external comparables is

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[133] See Memorandum *supra* note 28 (paragraph 15).
[134] *Ibid.* Note that paragraph 16 of the Memorandum indicates that the list of methods included thereunder does not contain all of the possible methods of establishing acceptability of prices between related companies and that it is not Custom's intention to be restrictive in this regard.
[135] Memorandum *supra* note 28 (paragraph 16).
[136] See OECD Guidelines *supra* note 3, at 2.15.
[137] OECD Guidelines *supra* note 3, at 2.15.

consistent with GVC Article 1.2 or with the general principles of the GVC. For this purpose, one can find some guidance in Paragraph 6 of the Note to GVC Article 5 which sets out rules for applying the deductive value method – which is similar to the resale price method. The relevant part of Paragraph 6 provides:

> The figure for the purposes of this deduction should be determined on the basis of information supplied by or on behalf of the importer unless the importer's figures are inconsistent with those obtained in sales in the country of importation of imported goods of the same class or kind. Where the importer's figures are inconsistent with such figures, the amount for profit and general expenses may be based upon relevant information other than that supplied by or on behalf of the importer.

In this respect, the Technical Committee on Customs Valuation said:

> As a practical matter, it would not appear useful that the data necessary for ascertaining the usual amounts for commissions or profit and general expenses be obtained and maintained on an ongoing basis. In many instances, practical application will require Customs to consider situations involving multi-product companies, small industries with a limited number of importers, industries with a large number of related party transactions, etc. on a case by case basis. In this context, Customs could have recourse to its own records. The data could also be obtained from trade organizations, *other importers*, accounting firms, government agencies ... or any other reliable source.[138] [emphasis added]

As one can see, the Technical Committee understands that external comparables could be used – in certain circumstances – in the context of GVC Article 5. Sherman confirms this understanding as follows:

> Still another application [of the deductive value method] will come in a related party situation (e.g. an export sale to a subsidiary) in which the transfer price is rejected as a basis for TV [transaction value]. Here, since the price at which the subsidiary purchases is thought to be distorted, the difference between the price and the resale price is presumably also distorted. In such a situation, the usual mark up must be found in the experience of other companies...[139]

In the context of GVC Article 1.2(a), the transaction value has not yet been rejected. However, the purpose of paragraph 6 of the Note to GVC Article 5 and that of the resale price method - when applied for the purposes of GVC Article 1.2 - are similar:

- Paragraph 6 seeks to determine an appropriate mark up, since the price at which a related party purchases is thought to be distorted and thus, the difference between such price and the resale price (mark up) is presumably also distorted;

[138] See CVC *supra* note 23, at Com 15.1/2 (Commentary 15.1)
[139] Sherman *supra* note 16, at 215

- The resale price method – when applied for the purposes of GVC Article 1.2 – seeks to determine whether the price at which a related party purchases has actually been distorted. For such purposes, the resale price method seeks to determine whether the mark up (i.e., the difference between the purchase price and the resale price) has been the appropriate one.

Where the purposes of two provisions (i.e., determining (i) the appropriate mark up or (ii) whether the mark up has been the appropriate one) are similar, arguably the guidance provided by one of such provisions could be used in interpreting and applying the other. Therefore, since paragraph 6 of the Note to GVC Article 5 authorizes the use of external comparables to determine the appropriate mark up, one can conclude that external comparables appear also to be acceptable, in determining whether the mark up in a related party transaction has been the appropriate one for the purposes of GVC Article 1.2(a).

Needless to say that, in the context of GVC Article 1.2(a), external comparables should comply with appropriate comparability standards.

The OECD Guidelines also state that, where the reseller is carrying on a brokerage business, the resale price margin may be related to a brokerage fee, which is usually calculated as a percentage of the sales price of the product sold. The determination of the resale price margin in such a case should take into account whether the broker is acting as an agent or a principal.[140] Note that this is consistent with the general structure of GVC Article 5, which properly distinguishes between deductions usually made for commission and those usually made for profit and general expenses.[141] This is reflected by the following paragraph of Commentary 15.1 of the Technical Committee on Customs Valuation – which also provides additional guidance:

> Article 5 merely stipulates that the deduction will be for either commission or profit and general expenses but it does not establish the criteria for determining which of these is to be deducted. In dealing with this issue and having regard to the General Introductory Commentary of the Agreement which recognizes that Customs value should be based on simple and equitable criteria consistent with commercial practices, a deduction for commission would normally occur where

[140] See OECD Guidelines *supra* note 3, at 2.15.
[141] See GVC Article 5.1(a)(i).

the sale in the country of importation of the goods being valued was or is to be made on an agency/commission basis. The deduction for profit and general expenses would normally be resorted to in transactions which do not involve commissions.[142]

11.2.2. APPLICATION OF THE METHOD.

11.2.2.1. PRODUCT COMPARABILITY.

Under the principles of the OECD Guidelines, an uncontrolled transaction can be regarded as comparable to a controlled transaction for purposes of the resale price method if one of the following conditions is met

1. None of the differences between the transactions being compared or between the enterprises undertaking those transactions could materially affect the resale price margin in the open market; or
2. Reasonably accurate adjustments can be made to eliminate the material effects of such differences.

The Guidelines also explain that, in making comparisons for purposes of the resale price method, fewer adjustments are normally needed than under the CUP method, due to the fact that minor product differences are less likely to have as material effect on profit margins as they do on price.[143] This is clearly implied in GVC Article 5, when it is read together with GVC Articles 2 and 3. In effect the latter two Articles – the methods of which are based on a direct comparison of prices – require a high degree of product comparability (i.e., identical or similar products, respectively). In determining profit margins, the degree of product comparability required under GVC Article 5 is significantly lower than that required under GVC Articles 2 and 3. GVC Article 5 refers to "commissions usually paid ... or additions usually made for profit and general expenses in connection with sales ... of *imported goods of the same class or kind*"[emphasis added]. GVC Article 15 defines "*goods*

[142] See CVC *supra* note 23, at Com15.1/2 (Commentary 15.1)
[143] See OECD Guidelines *supra* note 3, at 2.16.

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...".

Sherman explains that the GVC seems to make some assumptions, especially as regards profit and general expenses:

- That importers of goods of the same class or kind in any one country of importation will have one markup or a narrow range of markups for goods which might by regarded as being of the same class or kind;
- That the same markup or close range of markups can be obtained on goods within a class or kind irrespective of the country from which imported.[144]

Sherman suggests that none of the above assumptions is necessarily true. He considers that, sometimes, market conditions are volatile and trade must react to market changes from day to day.[145] In this respect, it is interesting to consider paragraphs 2.17 and 2.18 of the OECD Guidelines. The relevant part of paragraph 2.17 provides that

> [i]n a market economy, the compensation for performing similar functions would tend to be equalized across different activities. In contrast, prices for different products would tend to equalize only to the extent that those products were substitutes for one another. Because gross profit margins represent gross compensation, after the cost of sales for specific functions performed ..., product differences are less significant. For example, the facts may indicate that a distribution company performs the same functions (taking into account assets used and risks assumed) selling toasters as it would selling blenders, and hence in a market economy there should be a similar level of compensation for the two activities.

However, the last sentence of paragraph 2.17 and paragraph 2.18 address the issue pointed out by Sherman:

> However, consumers would not consider toasters and blenders to be particularly close substitutes, and hence there would be no reason to expect their prices to be the same.
>
> Although broader product differences can be allowed in the resale price method, the property transferred in the controlled transaction must still be compared to that being transferred in the uncontrolled transaction. Broader differences are more likely to be reflected in differences in functions performed between the parties to the controlled and uncontrolled transactions. While

[144] See Sherman *supra* note 16, at 219.
[145] *Ibid.* at 220.

less product comparability may be required in using the resale price method, it remains the case that closer comparability of products will produce a better result ...[146]

The principles derived from the provisions of GVC Articles 2 to 7 should be used to inform the application of GVC Article 1.2(a) while respecting certain comparability standards. The paragraphs of the OECD Guidelines quoted above provide guidance for determining such standards.

II.2.2.2. FUNCTIONS.

Where all the characteristics – other than the product itself – of two transactions are comparable, the resale price method might produce a more reliable measure of arm's length conditions than the CUP method.[147]

The resale price method depends on comparability of functions performed (taking into account assets used and risks assumed) since the amount of the resale price margin will be often influenced by the level of activities performed by the reseller.[148] The resale price margin could, in light of functions performed, be a small one, if the reseller in the controlled transaction does not carry on a substantial commercial activity but only transfers the goods to a third party. In contrast, where the seller bears special risks or contributes substantially to the creation or maintenance of intangible property associated with the product, it should be expected that the resale price margin will be higher.[149]

[146] The last sentence of paragraph 2.18 gives the following example: "Where there is a high-value or relatively unique intangible involved in the transaction, product similarity may assume greater importance and particular attention should be paid to it to ensure that the comparison is valid."
[147] See OECD Guidelines *supra* note 3, at 2.19.
[148] In this respect, it is interesting the analysis of functions and risks made by Sherman regarding distributors and agents in the context of GVC Article 5. See Sherman *supra* note 16, at 215.
[149] See OECD Guidelines *supra* note 3, at 2.24. Paragraph 2.24 of the Guidelines also explain that the "level of activities can range widely from the case where the reseller performs only minimal services as a forwarding agent to the case where the reseller takes on the full risk of ownership together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stocks, and other connected services."

Using an unadjusted resale price margin derived from uncontrolled transactions may be inappropriate in certain circumstances. This might occur, for example, if the reseller employs valuable and possible unique assets, such as intangible property. The Guidelines indicate that, in such a case, the resale price margin in the uncontrolled transaction may underestimate the profit to which the reseller in the controlled transaction is entitled, *unless the comparable uncontrolled transaction involves the same reseller* or a reseller with similarly valuable marketing intangibles.[150] This appears to be consistent with the examples of the Note to GVC Article 1.2 which show a preference for internal comparables.

11.2.3. SUPERDEDUCTIVE VALUE METHOD.

The OECD Guidelines indicate that an appropriate resale price is easiest to determine where the reseller does not add substantially to the value of the product. In contrast, it may be more difficult to use the resale price method to arrive at an arm's length result where, before resale, the imported products are further processed or incorporated into a more complicated product so that their identity is lost or transformed.[151] This is expressly recognized under the GVC in the context of GVC Article 5. The Guidelines, read together with GVC Article 5.2, provide grounds to support the adoption of this principle in the context of GVC Article 1.2(a).

GVC Article 5.2 provides that

> [i]f neither the imported goods nor identical nor similar imported goods are sold in the country of importation in the condition as imported, then, if the importer so requests, the customs value shall be based on the unit price at which the imported goods, after processing, are sold in the greatest aggregate quantity to persons in the country of importation who are not related to the persons from whom they buy such goods, due allowance being made for the value added by such processing and the deductions provided for in paragraph 1(a).

This provision is usually referred to as the "superdeductive value method". The following should be noted:

[150] *Ibid.* at 2.25.
[151] *Ibid.* at 2.22.

1. It applies only where neither the goods being valued nor identical nor similar goods are sold in the condition as imported (i.e., it operates as a last resort method);
2. It applies only if the importer elects to have it applied;
3. It is only based on the resale price after further processing of the imported goods being valued, and not on the resale price of other goods similarly processed.[152]
4. The Note to GVC Article 5.2 recognizes that the superdeductive value method would normally not be applicable when, as a result of the further processing, the imported goods lose their identity.

As one can see, when regulating the superdeductive value method, the OECD Guidelines and the GVC are governed by similar principles.

11.2.4. CONSIDERATIONS REGARDING INTANGIBLE PROPERTY.

The examination of the resale price margin requires particular care where the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (e.g., trademarks or tradenames) which is owned by a related party. In such cases, the contribution of the goods originally transferred to the value of the final product cannot be easily evaluated.[153]

As indicated above, even though customs administrations usually focus on transfers of tangible property, the examination of transfers, licenses, ownership and/or development and maintenance of intangible property plays a fundamental role where profit margins have to be compared. Therefore, in determining whether the relationship influenced the price, customs administrations should be prepared to examine such circumstances as part of the circumstances surrounding the sale.

[152] See Sherman *supra* note 16 at 224.
[153] See OECD Guidelines *supra* note 3, at 2.22.

11.2.5. TIME ELAPSED BETWEEN PURCHASE AND RESALE.

The OECD Guidelines provide that

> [a] resale price margin is more accurate where it is realized within a short time of the reseller's purchase of the goods. The more time that elapses between the original purchase and resale the more likely it is that other facts -- changes in the market, in rates of exchange, in costs, etc. -- will need to be taken into account in any comparison.[154]

In the context of the deductive value method, GVC Article 5.1(b) addresses this problem, providing that:

> [i]f neither the imported goods nor identical nor similar imported goods are sold at or about the time of importation of the goods being valued, the customs value shall be, subject otherwise to the provisions of paragraph 1(a), be based on the unit price at which the imported goods or identical or similar goods are sold in the condition as imported at the earliest date after the importation of the goods being valued but before the expiration of 90 days after such importation.

Although this provision is to be applied in determining substitute values under GVC Article 5, it provides a general rule for applying the deductive value method which, as indicated above, is similar to the resale price method. Therefore, it could reasonably be followed for applying the resale price method in the context of GVC Article 1.2(a).[155]

11.3. COST PLUS METHOD.

The cost plus method begins with the costs incurred by the supplier of property in a related-party transaction for property transferred provided to a related purchaser. An appropriate cost plus mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions.[156] This definition is similar (although not identical) to the definition of the computed value method under GVC Article 6. Interestingly, the Note to GVC Article 6 indicates that the use of this method will

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[154] *Ibid.* at 2.23.

[155] Note, however, that the 90-day period should not be interpreted strictly in the context of Article 1.2(a). Bear in mind that a flexible administration of this requirement is not precluded under Article 7 for the purposes of the fall-back method.

[156] See OECD Guidelines *supra* note 3, at 2.32.

generally be limited to those cases where the buyer and seller are related. It seems for this reason that the Note includes detailed guidance for determining the "amount for profit and general expenses" to be added.

Although not directly applicable in the context of GVC Article 1.2(a), the provisions of GVC Article 6 and its Note provide guidance for interpreting and applying the cost plus method in such a context. Therefore, reference to the provisions of GVC Article 6 and its Note will be made throughout this subchapter.

The OECD Guidelines explain that the cost plus method probably is most useful where semi-finished goods are sold between related parties, where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements.[157]

What is arrived at after adding the cost plus mark up to the costs may be regarded as an arm's length price of the original controlled transaction.[158] The comparison of this price with the transaction value originally agreed upon between the related parties would determine whether the relationship influenced the price. This understanding can be derived from the Note to GVC Article 1.2(a), which states:

> As a further example, where it is shown that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time ... in sales of goods of the same class or kind, this would demonstrate that the price had not been influenced.

One could suggest that this example is an application of the cost plus method. In effect, the example of the Note can be represented by the following formula:

$$C = A + B$$

Where

A = all the costs

B = profit (representative of the firm's overall profit realized in sales of goods of the same class or kind)

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[157] *Ibid.*
[158] *Ibid*

C = amount to be compared to the transaction value.

Then, if C were equal to (or less than) the transaction value agreed upon between the related parties, the latter would not be regarded as being influenced by the relationship.

In Ruling 546211, the acceptability of a related-party transaction value was at stake. The importer submitted information establishing that the transfer price had been calculated according to a formula of standard cost plus [x] percent. The information detailed the allocation of costs between domestic sales and sales to the related importer in accordance with the formula agreed to by the related parties. The US Customs Service understood that such information established that the related exporter had intended to settle prices with the related importer in the same fashion that it settled prices to unrelated buyers since the same costs were reflected in both prices and the same return was anticipated. Thus, the US Custom Service decided that, based on the information provided, the transfer price was sufficient to recover all costs plus a profit that exceeded the exporter's overall profit based on the exporter's financial statements. Therefore, the transaction value was accepted as a basis of appraisement of the imported goods.[159]

As one can see, the US Customs Service accepted an analysis under the cost plus method to demonstrate that the relationship had not influenced the related-party transaction value. Indeed, it framed such analysis not only in the second example provided by the Note to GVC Article 1.2, but also in the first example provided by such Note (i.e., that the exporter intended to settle prices with the related importer in the same fashion that it settled prices to unrelated buyers).

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[159] See United States Customs Service, Ruling No. 546211 (10 June 1996), online: <http://www.customs.ustreas.gov/impoexpo/impoexpo.htm> (date accessed: 3 August 2000). In such Ruling, the US Customs Service said that "Company Y's related party sales were ... the most profitable part of its operation. Thus, based on the information provided, the transfer price was sufficient to recover all costs plus a profit that exceeded Company Y's overall profit based on the company's 1993 financial statements. It is therefore our position that transaction value is an acceptable basis of appraisement."

On these grounds, it could be concluded that the cost plus method is applicable in the context of GVC Article 1.2(a). The OECD Guidelines, read together with the provisions of GVC Article 6 and its Note, could provide useful guidance for applying such method in such a context.

11.3.1. INTERNAL AND EXTERNAL COMPARABLES.

The example of the Note to GVC Article 1.2, quoted above, clearly refers to the use of internal comparables. In this respect, the Guidelines provide that "[t]he cost plus mark up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark up that the same supplier earns in comparable uncontrolled transactions."[160]

Nevertheless, the Guidelines also state that "[i]n addition, the cost plus mark up that would have been earned in comparable transactions by an independent enterprise may serve as a guide".[161]

This statement would not be inconsistent with the Note to GVC Article 1.2. As indicated above, the examples of the Notes are illustrative and do not preclude the use of methods which are consistent with the general principles of the GVC (as reflected by the Note to GVC Article 1.2 read together with the other provisions of the GVC). Firstly, the use of external comparables is not arbitrary or fictitious, being, therefore, consistent with the preamble of the GVC. Secondly, the examination of external comparables would be generally consistent with the process of examining the "normal pricing practices of the industry"[162]. Thirdly, the Note to GVC Article 6 allows the use of external comparables. In effect, where the producer's own figures for profit and general expenses are not consistent with those usually reflected in sales of goods of the same class or kind as the goods being

[160] See OECD Guidelines *supra* note 3, at 2.33.
[161] *Ibid.*
[162] Even though the reference to "normal pricing practices of the industry" is made in another example, consistency with such practices would demonstrate consistency with the principles underlying the Note.

valued which are made by producers in the country of exportation for export to the country of importation, the amount for profit and general expenses may be based upon relevant information other than that supplied by or on behalf of the producer of the goods.[163]

11.3.2. APPLICATION OF THE METHOD.

11.3.2.1. PRODUCT COMPARABILITY.

The comparability standards described in sub-chapter 7 above should be observed in applying the cost plus method. This is specially true when such method is used in the context of GVC Article 1.2(a). The OECD Guidelines explain that, for the purposes of the cost plus method, an uncontrolled transaction is comparable to a controlled transaction if one of two conditions is met:

1. None of the differences between the transactions being compared or between the enterprises undertaking those transactions materially affect the cost plus mark up in the open market; or
2. Reasonably accurate adjustments can be made to eliminate the material effects of such differences.[164]

The OECD Guidelines also indicate that "fewer adjustments may be necessary to account for product differences under the cost plus method than the CUP method and it may be appropriate to give more weight to other factors of comparability described in Chapter I, some of which may have a more significant effect on the cost plus mark up than they do on price...".[165] In this respect, see the analysis made in subsection 11.2.2.1 above, which is also applicable in the context of the cost plus method.

[163] See paragraph 5 of the Note to GVC Article 6.
[164] See OECD Guidelines *supra* note 3, at 2.34.
[165] *Ibid.*

11.3.2.2. ECONOMIC CIRCUMSTANCES AND RELATIVE EFFICIENCY.

The OECD Guidelines state that the cost plus method presents some difficulties in the determination of costs. The Guidelines indicate that "[a]lthough it is true that an enterprise must cover its costs over a period of time to remain in business, those costs may not be determinant of the appropriate profit in a specific case for any one year. While in many cases companies are driven by competition to scale down prices by reference to the cost of creating the relevant goods or providing the relevant service, there are other circumstances where there is no discernible link between the level of costs incurred and a market price (e.g., where a valuable discovery has been made and the owner has incurred only small research costs in making it)."[166]

All these circumstances should also be taken into account in applying the cost plus method in the context of GVC Article 1.2(a). Grounds to support this argument can be found in paragraph 5 of the Note to GVC Article 6, which also provides further guidance in this respect. The relevant part of such paragraph indicates that:

> ... '[t]he amount for profit and general expenses' has to be taken as a whole. It follows that if, in any particular case, the producer's profit figure is low and the producer's general expenses are high, the producer's profit and general expenses taken together may nevertheless be consistent with that usually reflected in sales of goods of the same class or kind. Such a situation might occur, for example, if a product were being launched in the country of importation and the producer accepted a nil or low profit to offset high general expenses associated with the launch. Where the producer can demonstrate a low profit on sales of the imported goods because of particular commercial circumstances, the producer's actual profit figures should be taken into account provided that the producer's pricing policy reflects usual pricing policies in the branch of industry concerned. Such a situation might occur, for example, where producers have been forced to lower prices temporarily because of an unforeseeable drop in demand, or where they sell goods to complement a range of goods being produced in the country of importation and accept a low profit to maintain competitivity.

Sherman explains that this attitude under the GVC is in sharp contrast to the prevailing views under the old US valuation system. Under the former, a price yielding little or no profit would in practice generally be rejected because it was "lacking an element of value". Under the GVC, it is sufficient for the manufacturer to show good commercial reasons for his making little or no profit. Such reasons need not apply to all competing

[166] OECD Guidelines *supra* note 3, at 2.36.

producers, so long as they reflect usual policies for the branch of industry.[167] This author also indicates that "[a]ll of this is one of the clearest indications of the powerful conviction underlying the Code, that valuation should be based on commercial reality – even to the extent of recognizing that commercial reality sometimes includes selling at little or no profit."[168]

In this context, another interesting issue is that of the relative efficiency of the enterprises being compared. Levey explains that an unrelated party probably would not accept paying a higher price resulting from the other party's inefficiency. Likewise, if the other party is more efficient than can be expected under normal circumstances, it should benefit from that advantage.[169] The OECD Guidelines indicate that, in these circumstances, unless it is possible to adjust for the effect of differences in profit margins, the application of the cost plus method would not be wholly reliable.[170] This should also be taken into account in the context of GVC Article 1.2(a). It should be examined as part of the producer's valid commercial reasons to justify the producer's actual profit figures[171] and as part of the circumstances surrounding the sale under GVC Article 1.2(a).

11.3.2.3. FUNCTIONS PERFORMED.

In applying the cost plus method, it is particularly important to consider differences in the level and types of expenses associated with functions performed and risks assumed by the parties to the transactions being compared. Differences in these expenses may indicate the following:

- An adjustment to the cost plus mark up may be required if the expenses reflect a functional difference which has not been taken into account in applying the method;

[167] See Sherman *supra* note 16, at 232.
[168] Sherman *supra* note 16, at 232.
[169] See Hammer *supra* note 6, at 4.04[2][g].
[170] See OECD Guidelines *supra* note 3, at 2.35.
[171] See paragraph 5 of the Note to GVC Article 6.

- If the expenses reflect additional functions that are distinct from the activities tested by the method, separate compensation for those functions may need to be determined.
- No adjustment to the gross margin may be appropriate if differences in the expenses of the parties being compared merely reflect efficiencies or inefficiencies of the enterprises (as would often be the case for supervisory, general, and administrative expenses).[172]

The Guidelines also indicate that, in any of the above circumstances, it may be appropriate to supplement the cost plus method by considering the results obtained from applying other methods.[173] As indicated in section 7.3 above, this combined application of methods is possible under GVC Article 1.2.

11.3.2.4. ACCOUNTING CONSISTENCY.

The General Note to the GVC states that

> [f]or the purposes of this Agreement, the Customs administrations of each Member shall utilize information prepared in a manner consistent with generally accepted accounting principles in the country which is appropriate for the Article in question. For example, the determination of usual profit and general expenses under the provisions of Article 5 would be carried out utilizing information prepared in a manner consistent with generally accepted accounting principles of the country of importation. On the other hand, the determination of usual profit and general expenses under the provisions of Article 6 would be carried out utilizing information prepared in a manner consistent with generally accepted accounting principles of the country of production. As a further example, the determination of an element provided for in paragraph 1(b)(ii) or Article 8 undertaken in the country of importation would be carried out utilizing information in a manner consistent with the generally accepted accounting principles of that country.

Accounting consistency is a relevant concern under the OECD Guidelines. Where the accounting practices are different in the controlled transaction and the uncontrolled transaction, the Guidelines indicate that appropriate adjustments should be made to the data used, to ensure that the same kind of costs are used in each case to ensure consistency.[174] As indicated by the General Note, generally accepted accounting principles of different countries could be involved in determining customs values under the GVC. Thus – since

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[172] See OECD Guidelines *supra* note 3, at 2.38.
[173] *Ibid.*
[174] *Ibid.* at 2.39.

accounting inconsistencies might occur – importers and customs administrations should pay special attention to ensure accounting consistency and be prepared to make appropriate adjustments to the data used in determining whether the relationship influenced the price.[175]

12. OTHER METHODS.

The OECD Guidelines provide other approaches that might be used to approximate arm's length conditions. This alternative approaches should only be used where the traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all.[176] The Guidelines expressly indicate the preference for the traditional transaction methods over the transactional profit methods as a means of establishing whether a transfer price is arm's length.[177]

In this sub-chapter we will briefly explore these methods and address the questions as to (a) whether they are applicable under GVC Article 1.2(a) – especially whether they are consistent with the principles of the GVC – and (b) whether they should be applied, in this context, in the way suggested by the Guidelines (i.e., mainly in combination with transactional methods).

[175] The Guidelines also provide that the gross profit mark ups must be measured consistently between the associated enterprise and the independent enterprise. See OECD Guidelines *supra* note 3, at 2.39. In this respect, it is interesting to note that, under the Guidelines, the cost plus method will use margins computed after direct and indirect cost of production (a net margin method will use margins computed after operating expenses as well – see OECD Guidelines *supra* note 3, at 2.41). The Note to GVC Article 6, in a manner consistent with the Guidelines, provide that "general expenses" include "the direct and indirect costs of producing and selling the goods for export which are not included under paragraph 1(a) of Article 6" (the cost included under paragraph 1(a) is the cost or value of materials and fabrication or other processing employed in producing the imported goods).

[176] See OECD Guidelines *supra* note 3, at 3.1.

[177] *Ibid.* at 3.49.

12.1. DEFINITION.

A transactional profit method, as defined by the OECD Guidelines, examines the profits that arise from particular controlled transactions.[178] In this respect, these methods – being transactional in character – follow the general structure of the methods of the GVC, which are also transactional in character.

For the purposes of the OECD Guidelines, the transactional profit methods are the profit split method and the transactional margin method.

The OECD Guidelines indicate that it is unusual to find enterprises entering into transactions in which profit is a condition "made or imposed" in the transactions. In fact, enterprises rarely if ever use a transactional profit method to establish their prices.[179] It is interesting to analyze this issue in the context of GVC Article 1.2 and its Note.

If enterprises "rarely if ever use a transactional profit method to establish their prices", the use of such a method to determine whether the relationship influenced the price appears – in principle – not to be in accordance with the first example provided by the Note. In effect, such example indicates that, "if the price had been settled in a manner consistent with the normal pricing practices of the industry in question or with the way the seller settles prices for sales to buyers who are not related to the seller, this would demonstrate that the price had not been influenced by the relationship." However, we understand that, although this example could justify a preferred application of the traditional transaction methods over the transactional profit methods, it would not preclude the use of the latter, since, as indicated above, the examples are only illustrative. Note that the second example of the Note focuses on the profits realized by the related enterprise. Room for the application of the transactional profit methods could be found where such example is interpreted flexibly. In this respect, the OECD Guidelines state:

[178] *Ibid.* at 3.2.
[179] *Ibid.*

> Nonetheless, profit arising from a controlled transaction can be a relevant indicator of whether the transaction was affected by conditions that differ from those that would have been made by independent enterprises in otherwise comparable circumstances[180]

The paragraph quoted above shows that the provisions of the OECD Guidelines regarding transactional profit methods respect the general purpose of GVC Article 1.2(a) and its Note, i.e., determining whether the relationship influenced the transaction value. The Guidelines add:

> Thus, in those exceptional cases in which the complexities of real life business put practical difficulties in the way of the application of the traditional transaction methods and provided all the safeguards set out in this chapter are observed, application of the transactional profit methods ... may provide an approximation of transfer pricing in a manner consistent with the arm's length principle.[181]

In the customs context, these methods should be applied in a manner consistent with the general principles of the GVC. In this regard, useful guidance could be found in the provisions of GVC Article 7. What is not permitted under GVC Article 7 should not be permitted, in principle, under the provisions of GVC Article 1.2(a).[182]

One can conclude that, under the GVC, as well as under the Guidelines, the transactional profit methods should only be applied in cases where traditional transaction methods cannot be reliably applied alone or cannot be applied at all. These would be considered cases of last resort.[183] Note that this approach is consistent with Advisory Opinion 12.1 of the Technical Committee on Customs Valuation. In this case, the question was whether, in the application of GVC Article 7, methods other than those set out in GVC Articles 1 to 6 can be used. The Technical Committee expressed the following view:

> Paragraph 2 of the Interpretative Note to Article 7 provides that the methods to be employed under Article 7 should be those laid down in Articles 1 to 6 inclusive but applied with a reasonable flexibility.
> However, if a Customs value cannot be determined by using these methods even in a flexible manner, as a final resort the Customs value may be determined using other reasonable methods provided such methods are not precluded by Article 7.2.
> In determining the customs value under Article 7, the method used must be consistent with the principles and general provisions of the Agreement and of Article VII of the GATT 1994.[184]

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[180] *Ibid.*
[181] *Ibid.*
[182] See subsection 7.1.3 above.
[183] See OECD Guidelines *supra* note 3, at 3.50.
[184] See CVC *supra* note 23, at AO12.1/1.

Even though this opinion was expressed in a different legal context (application of the fall back methods under GVC Article 7) the principles derived therefrom can supplement the provisions of GVC Article 1.2 and its Note.

12.2. PROFIT SPLIT METHOD.

The OECD Guidelines provide that "[w]here transactions are very interrelated it might be that they cannot be evaluated on a separate basis. Under similar circumstances, independent enterprises might decide to set up a form of partnership and agree to a form of profit split. Accordingly, the profit split method seeks to *eliminate the effect on profits of special conditions made or imposed in a controlled transaction* ... by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions."[185] [emphasis added]

Thus, this method would be useful not only in the context of GVC Articles 1.1(d) and 1.2(a) (i.e., in determining whether the relationship influenced the price) but also in that of GVC Article 1.1(b), (i.e., in determining the value of *certain conditions or considerations – to which the sale or price is subject* – for which a value cannot, otherwise, be determined). The result of this would be that the rejection of the transaction value, under GVC Article 1.1(b), might be substantially reduced. This would be in accordance with one of the general purposes of the GVC, which is expressed in its Preamble as follows:

> ... the basis for valuation of goods for customs purposes should, to the greatest extent possible, be the transaction value of the goods being valued.

Sherman explains that this portion of the Preamble of the GVC makes clear the strong preference of the GVC's authors for the use of transaction value basis of valuation wherever appropriate.[186]

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[185] See OECD Guidelines *supra* note 3, at 3.5.
[186] See Sherman *supra* note 16, at 62.

In this respect, it is interesting to examine Advisory Opinion 16.1 of the Technical Committee on Customs Valuation. The relevant part of such opinion states:

> According to clause (b) of Article 1.1 the Customs value of the imported goods cannot be established on the basis of the transaction value if the sale or price is subject to some condition or consideration for which a value cannot be determined with respect to the goods being valued.
> The provision of clause (b) of Article 1.1 should be interpreted to mean that if the value of a condition or consideration can be determined with respect to the goods being valued, the Customs value of the imported goods should, subject to the other provisions and conditions of Article 1, be the transaction value as determined under that Article. Interpretative Notes to Article 1 and Annex III make it very clear that the price actually paid or payable is the total payment made by the buyer to or for the benefit of the seller, that the payment may be made directly or indirectly and that the price includes all payments actually made or to be made by the buyer to the seller, or by the buyer to a third party. Thus the value of the condition, when it is known and relates to the imported goods, is a part of the price actually paid or payable.
> It should rest with individual administrations as to what they consider would be sufficient information to specifically determine the value of a condition or consideration.[187]

The last paragraph of this opinion is especially important. A narrow approach as to what is considered to be sufficient information could bar every transfer pricing analysis under the profit split method. This might produce major inconsistencies between customs and tax valuation results, since in the absence of an acceptable transaction value under GVC Article 1.1(b), the methods of GVC Articles 2, 3, 5, 6 and 7 would be applicable, i.e., no transfer pricing analysis would need to be undertaken under GVC Article 1.2. In contrast, a flexible approach would eliminate most of these inconsistencies, since the price would be less likely to be rejected on the basis of GVC Article 1.1(b). This approach would, therefore, enable customs administrations to undertake transfer pricing analyses – under GVC Article 1.2 – in cases where such analysis would otherwise be impossible.[188]

12.2.1. FUNCTIONING OF THE METHOD.

The profit split method first identifies the profit to be split for the related enterprises from the controlled transactions in which the related enterprises are engaged. This method

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[187] CVC *supra* note 23, at AO16.1

[188] In relation to the examples given by the Note to GVC Article 1.1(b), Sherman explains that "loosely read or interpreted, they erroneously could be taken to imply that there can be no TV [transaction value] in any barter transaction" (Sherman *supra* note 16, at 181).

then splits those profits between the related enterprises on an economically valid basis that approximates the division of profits that would have been reflected in an agreement made at arm's length. The combined profit may be the total profit from the transactions or a residual profit intended to represent the profit that cannot readily be assigned to one of the related enterprises, such as the profit derived from high-value intangibles. The contributions of each related enterprise are identified through functional analysis.[189]

The OECD Guidelines indicate that the external market criteria may include – among others – profit split percentages or returns observed among independent enterprises with comparable functions.[190]

Finally, the Guidelines discuss two approaches for estimating division of profits (based on either projected or actual profits that independent enterprises would have expected). These approaches (the analysis of which exceeds the purposes of this work) are the contribution analysis and the residual analysis.[191] Under a contribution analysis, the combined profit (i.e., the total profits from the controlled transactions) would be divided between the related enterprises based upon the relative value of the functions performed by each of the related enterprises, supplemented as much as possible by external market data that indicate how independent enterprises would have divided profits in similar circumstances.[192] A residual analysis divides the combined profit from the controlled transaction in two stages. In the first stage, each related enterprise is allocated sufficient profit to provide it with basic return appropriate for the type of transactions in which it is engaged. This basic return (which would generally not account for the return that would be generated by unique and valuable assets possessed by the related enterprises) could be determined by reference to the market returns achieved for similar types of transactions by independent enterprises.

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189 See OECD Guidelines *supra* note 3, at 3.5.
190 *Ibid.*
191 *Ibid.* at 3.15.
192 *Ibid.* at 3.16.

In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the related parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises. The OECD Guidelines add that indicators of the parties' contributions of intangible property and relative bargaining positions could be particularly useful in this context.

Bear in mind that, in the customs context, these methods – as well as the traditional transaction methods – are only to be used for the purposes of examining whether the relationship influenced the price (i.e., not to determine substitute values).

12.3. TRANSACTIONAL NET MARGIN METHOD.

The OECD Guidelines define this method in the following words:

> The transactional net margin method examines the net profit margin relative to an appropriate base (e.g., costs, sales, assets) that a taxpayer realizes from a controlled transaction (or transactions that are appropriate to aggregate under the principles of Chapter I). Thus, a transactional net margin method operates in a manner similar to the cost plus and resale price methods. This similarity means that in order to be applied reliably, the transactional net margin method must be applied in a manner consistent with the manner in which the resale price or cost plus method is applied. This means that the net margin of the taxpayer from the controlled transaction ... should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions.[193]

Provided that all the safeguards indicated in subchapter 12.1 above are observed, the transactional net margin method appears to be consistent with the second example provided by the Note to GVC Article 1.2. In effect, such example compares the profit of the controlled transaction ("price" less "all costs") and a profit which is representative of the firm's overall profit (it does not indicate whether such profit should be gross or net) realized in sales of goods of the same class or kind.

[193] OECD Guidelines *supra* note 3, at 3.26.

The OECD Guidelines also indicate that, where it is not possible to establish the net margin of the taxpayer from the controlled transaction by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions, the net margin that would have been earned in comparable transactions by an independent enterprise may serve a guide. In this case, a functional analysis of the related enterprise and the independent enterprise is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results.[194]

One practical strength of this method is that it is not necessary to determine the functions performed and responsibilities assumed by more than one of the related enterprises. The Guidelines indicate that this can be practically advantageous when one of the parties to the transaction is complex and has many interrelated activities or when it is difficult to obtain reliable information about one of the parties. This is specially important in the customs context, where it is generally recognized that the customs value should be (i) based on simple and equitable criteria[195] and (ii) determined on the basis of information readily available in the country of importation.[196]

12.3.1. MULTIPLE YEAR DATA AND ARM'S LENGTH RANGE.

The Guidelines indicate that multiple year data should be considered in the transactional net margin method for both the related enterprise under examination and independent enterprises to the extent that their net margins are being compared, to take into account the effects on profits of product life cycles and short term economic conditions. Such data could also show whether similar business patterns over a similar length of time affected the profits of comparable independent enterprises in the same way as the related

[194] See OECD Guidelines *supra* note 3, at 3.26.
[195] See Preamble of the GVC.
[196] See Note to GVC Article 6. Note that the first sentence of such note provides a "general rule" applicable under the whole agreement.

enterprise under examination.[197] In connection with this issue, further discussion can be found in section 7.4 above.

The Guidelines also explain that it is important to take into account a range of results when using the transactional net margin method. The use of the range in this context could help reduce the effects of differences in the business characteristics of related enterprises and any independent enterprises engaged in comparable uncontrolled transactions, since the range would permit results that would occur under a variety of commercial and financial conditions.[198] In relation to this issue, further discussion can be found in section 7.3 above.

[197] See OECD Guidelines *supra* note 3, at 3.44.
[198] *Ibid.* at 3.45.

CHAPTER IV

TAX BASES.

CUSTOMS VALUE AND TAX VALUE OF IMPORTED GOODS.

ADJUSTMENTS

13. INTRODUCTION.

In the previous chapters, we proposed that the OECD Guidelines could be used, in the customs context, for the purposes of GVC Article 1.2(a). In other words, we suggested that the OECD Guidelines constitute a detailed body of rules that could not only supplement successfully the general provisions of GVC Article 1.2(a), but also help harmonize the customs and tax transfer pricing systems.

Ideally, our proposal intends to achieve a degree of harmonization such that transfer pricing for tax and customs purposes would be based on a single determination or examination of arm's length conditions. This single determination should be made using criteria that are acceptable under both tax and customs rules. In Chapters II and III, our objective was to demonstrate that such criteria can be found in the OECD Guidelines.

However, we are aware that most of the countries are far from achieving such degree of harmonization. Therefore, in most of the cases, the value of the imported goods will be first established or determined for the purposes of one of the systems (e.g., for customs purposes), and then for the purposes of the other (e.g., for tax purposes). Our goal would be, in such circumstances, that the transfer price established or determined under the rules of one system be acceptable under the rules of the other. This would be enough to avoid an unnecessary double determination (or examination) of transfer prices. However, this would only be possible where the criteria used to establish or determine the transfer prices are acceptable under both tax and customs rules. Hence, our objective in Chapters II and III (i.e., to demonstrate that such commonly accepted criteria could be found in the OECD Guidelines) was also valid in this more realistic context.

The fact that the OECD Guidelines should be accepted to establish or determine transfer prices under both tax and customs rules, does not mean that the transfer price established or determined under the rules of one system will constitute the tax base of duties or taxes under the rules of the other system. Rather, it only means that an arm's length transaction value established under the rules of one system can constitute a valid transaction value under the rules of the other system. This transaction value will only be one element among the many elements that make up the tax base of duties and taxes under each of the systems. In effect, the transaction value constitutes one of the elements of the customs value, which is the tax base of customs duties in those countries that adopted the GVC. Customs value includes some elements which may or may not be included in the transaction value. Where such elements have not been included in the transaction value, GVC Article 8 provides for its inclusion into customs value (i.e., in the tax base of customs duties). In the same way, customs value does not include some elements that may or may not be included in the transaction value. Where such elements have been included in transaction value, the GVC provides – subject to certain conditions – for their deduction from customs value. Likewise, transaction value constitutes one element of the tax base of income taxes (e.g., sales price), or even one specific part of a broader element of such tax base (e.g., cost of goods sold, inventory cost, etc.).

As indicated above, ideally, the importer/taxpayer should determine arm's length transaction values for both tax and customs purposes, and then calculate the tax bases of income tax and customs duties. Likewise, customs and tax authorities could examine whether transfer prices are arm's length, irrespective of whether such transfer prices have been declared for tax or customs purposes. However, importers and taxpayers usually determine and declare tax bases. The process of determination is sometimes undertaken first under the rules of one system and, afterwards, under the rules of the other. In other words, sometimes there is not merely one single determination of an arm's length transfer price (which is later included into the tax bases of income tax and customs duties), but rather two separate determinations (i.e., one for tax purposes and another for customs purposes) in which the determination of the arm's length transaction value and that of the tax base are not clearly distinguished.

If the importer/taxpayer wished to use the results of one of these determinations to establish the arm's length transaction value for the purposes of the other (thus, avoiding an unnecessary double determination of arm's length prices), the results would not be accurate unless the differences between the tax bases were properly identified and appropriate adjustments were made to account for such differences.

Likewise, if the customs administration determined that the customs values declared by the taxpayer/importer were acceptable under GVC Article 1.2(a), this information would not be useful for the tax administrations (e.g., to avoid double scrutiny of the taxpayer) unless the differences between the tax bases were properly identified.

If the taxpayer declared arm's length transaction values for tax and customs purposes, then the customs value and the appropriate element of the tax base of income taxes (e.g., COGs) should be equivalent, once the differences between such tax bases have been identified and appropriate adjustments to account for such differences have been made. This argument could constitute a shield in the hands of a taxpayer to prevent customs and tax administrations from taking inconsistent positions in determining the appropriate arm's length transaction value. In effect, if a tax administration had already decided that a transaction value declared by the importer/taxpayer was arm's length, and the importer had demonstrated that the customs value – once the appropriate adjustments to account for differences in the tax bases of customs duties and income tax have been made – is equivalent to such transaction value, then the customs administration would not be entitled to reject such value on the basis of GVC Article 1.2(a), unless it demonstrated that the decision of the tax administration was incorrect.

Therefore, it could be necessary to clearly identify the differences between the tax bases of customs duties and income taxes, to avoid unnecessary double determinations or examinations of arm's length transfer prices.

The different elements of the taxable base of income taxes (e.g., cost of goods sold, inventory cost of property, etc.) are defined in the income tax statutes of the different countries. The analysis of multiple income tax statutes would exceed the purposes of this work. In contrast, the elements of the tax base of customs duties are defined in the GVC, which is applicable in most of the WTO Members. Therefore, in this Chapter, we will analyze the rules of computation of customs value (i.e., the tax base of customs duties) under the GVC, in order to identify the most relevant additions to and deductions from the customs value of imported goods.[199] This will help undertake any subsequent comparison between the GVC and any particular income tax statute. We will also indicate which of these additions or deductions may generally have a different treatment for income tax purposes and, thus, when adjustments to account for such differences in treatment might be required.

Note that, throughout this Chapter, we will refer to adjustments in computing either the tax base of customs duties or the elements of the tax base of income tax, depending on the kind of adjustment and depending on whether the original determination (to be adjusted) was made under tax or customs rules.

14. IRC SECTION 1059A.

Section 1059A of the Internal Revenue Code ("IRC") of the United States[200] could be viewed as an effort to harmonize tax and customs transfer pricing regimes. However, such an understanding might not be completely correct. Section 1059A provides that:

> 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

[199] Note that this additions to and deduction from the transaction value have, in principle, no relationship with the process of determining whether the relationship influenced the price. The additions to and deductions from the price paid or payable (i.e., the transaction value) must be made under GVC Articles 1 and 8 irrespective of whether or not the transaction is controlled.
[200] *Internal Revenue Code*, 26 U.S.C. §1059A.

> (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 [chapter 26 of the United States Code, which is the Internal Revenue Code in general], be greater than the amount of such cost taken into account in computing such customs value.

The specific concern that the US Congress addressed in introducing Section 1059A was the possibility that the "Brittingham case"[201] provided an incentive to U.S. companies to declare one value for U.S. Customs purposes and a different, presumably higher, value (as a COGS figure) for U.S. tax purposes.[202] In such case, the price a U.S. importer paid to a related Mexican seller was higher than the customs valuation (declared by the importer), and this price was used as the COGS figure for U.S. tax purposes. The Internal Revenue Service ("IRS") based its deficiency determination on the customs valuation. This resulted in a lower cost of goods sold and higher profit margins. The Tax Court found that, being the customs values based on inappropriate criteria for Section 482[203] purposes, such customs value was not indicative of an arm's length price. Thus, the Tax Court upheld the position of the importer.[204] In the GAO Report 94-61[205], it was explained that "the legislative history indicates that Congress understood that Brittingham supported the proposition that some importers could claim a transfer price for income tax purposes that was higher than would be consistent with the transfer price claimed for customs purposes."

Section 1059A came to require certain consistency between customs and tax rules. In this respect, Section 1059 constitutes an actual application of some of the ideas and principles described in Chapters I, II and III above and, consequently, a valuable legislative precedent to support them.

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[201] Brittingham v. Commissioner, 66 TC 373 (1976), aff'd [1979], 598 F2d 1375 (5th Cir. 1979).
[202] See Lowell, Burge & Briger, *US International Transfer Pricing*, (WL, 2000) at 18.03[3][b]. On line: WL (Lowell, Burge & Brieger, US International Transfer Pricing) (date accessed: 28 May 2000) [hereinafter "USITP"]
[203] *Internal Revenue Code*, 26 U.S.C. § 482.
[204] *Ibid.*, at 18.03[2].
[205] U.S., General Accounting Office, *International Taxation: IRS' Administration of Tax-Customs Valuation Rules in Tax Code Section 1059A.*(4 February 1994). GAO/GGD-94-61. [hereinafter, "GAO"] On line: <http://www.unclefed.com/GAOReports/gao94-61.html> (date accessed: 15 July 2000)

However, the application of these ideas and principles under Section 1059A has not been complete. In effect, Section 1059A only prevents the use of higher values for tax than for customs declaration purposes.[206] The legislative history indicates that the U.S. Congress did not express the view that valuation of property for customs purposes should always determine valuation of property for tax purposes.[207] Thus, the legislative history does not indicate whether Section 1059A may be used by the taxpayer to prevent tax and customs authorities from taking inconsistent positions in determining whether a controlled transaction is arm's length.[208]

Under the principles indicated in subchapter 13, a determination of the arm's length character of a transaction value which followed appropriate standards of comparability and methodologies (e.g., those of the OECD Guidelines) should be acceptable for both customs and tax purposes. Ideally, where a transaction value has been successfully defended by the importer in a customs procedure and such transaction value (subject to the adjustments indicated in subchapter 13 above to account for differences in the tax bases of income tax and customs duties) has been declared to the tax administration for income tax purposes, internal legislation of the country should prevent the tax administration from re-examining such transaction value. This would also be true in the case of transaction values successfully defended by the importer/taxpayer in tax procedures, vis-à-vis re-examinations undertaken subsequently by the customs administration.

Nevertheless, the examination of Section 1059A and its regulation is specially useful for the purposes of this Chapter, since they address the adjustments to be made to customs value to account for differences in the tax bases of customs duties and income tax.[209] Taking

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206 See USITP *supra* note 202, at 18.03[c].
207 See GAO *supra* note 205.
208 See USITP *supra* note 202, at 18.03[3][b].
209 The U.S. Congress indicated that tax and customs valuation principles differ in several areas and appropriate adjustments would need to be made in order to accommodate the distinctions in the respective regimes. It also said that the IRS would provide rules for coordinating customs and tax valuation principles, including provisions for proper adjustments for amounts such as freight charges, where customs pricing rules may differ from appropriate tax valuation rules (see U.S., Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. 1062 (1987). See also USITP *supra* note

into account the observations made above, we will make reference to them throughout this Chapter, since they could constitute a guide to analyze the tax base of customs duties and the adjustments that might be necessary to account for differences between such tax base and that of income taxes.

15. TAX BASE OF CUSTOMS DUTIES.

In the countries that adopted the GVC, the tax base of customs duties (and, sometimes, of other taxes applied on importation of goods) is the customs value of the imported goods. Under GVC Article 1[210], this term is defined as "the transaction value ... adjusted in accordance with the provisions of Article 8". The Note to GVC Article 1 supplements this definition, excluding – under certain specific conditions – certain elements from transaction value.

Therefore, the tax base of customs duties (hereinafter "customs value") is equal to

$$A + B - C$$

Where

A = transaction value (hereinafter, also referred to as "price actually paid or payable").

B = elements listed in GVC Article 8

C = elements listed in the Note to GVC Article 1.

202, at 18.03[3][e]). In the context of related party transactions (i.e., in determining whether the relationship influenced the price) one can argue that tax and customs valuation principles do not really differ (as indicated in Chapters II and III above). The differences can be found in the rules for computing the taxable bases of customs duties and income taxes. This conceptual difference is extremely important to avoid unnecessary inconsistencies when tax and customs valuation systems are applied.

[210] For the purposes of this chapter, we assume that the relationship did not influence the price and, therefore, that the price is acceptable under Article 1. Therefore, we will not analyze the definitions of customs value under Articles 2 through 7.

15.1. TRANSACTION VALUE.

Not every transaction value is acceptable for customs purposes. Transaction value is the price actually paid or payable for the goods when sold for export to the country of importation.[211] The price actually paid or payable is the total payment made or to be made by the buyer to or for the benefit of the seller for the imported goods.[212]

The payment need not necessarily take the form of a transfer of money. It may be made directly or indirectly.[213]

15.1.1. EXISTENCE OF A SALE.

The existence of a sale is a basic requisite under GVC Article 1. Where there is no sale, the value cannot be determined under Article 1 and, therefore, it should be determined under Articles 2 through 7. A clear understanding of this issue is extremely important for the purposes of this work since, where there is no sale for export to the country of importation, the results obtained through the sequential application of the methods of Articles 2 through 7 may not be consistent with those derived from the application of the OECD Guidelines.[214] Therefore, harmonization of the regimes applicable to these situations would require an amendment to either the customs or the tax rules.

The GVC contains no definition of sale. The Technical Committee on Customs Valuation, in Advisory Opinion 1.1 suggested that, in conformity with the basic intention of the GVC – i.e., that the transaction value of imported goods should be used to the greatest extent possible for customs valuation purposes – uniformity of interpretation and application can be achieved by taking the term "sale" in the widest sense, to be determined only under

[211] See GVC Article 1.1.
[212] See Note to GVC Article 1.1.
[213] *Ibid.*
[214] See sections 3.2 and 11.1 above.

the provisions of Articles 1 and 8 read together.[215] The Technical Committee considered useful to prepare a list of cases which would not be deemed to constitute sales meeting the requirements and conditions of the GVC. Even though the list is not intended to be exhaustive, it provides useful guidance on this issue. Thus, free consignments, goods imported on consignment, goods imported by branches (in cases where a branch cannot be regarded as a separate legal entity under the legislation concerned), goods imported under a hire or leasing contract (even if the contract includes an option to purchase the goods), goods supplied on loan (which remain property of the sender) or goods imported for destruction in the country of importation (with the sender paying the importer for his services) cannot be regarded as sales under the GVC.[216]

15.1.2. CASH OR KIND – DIRECT OR INDIRECT PAYMENT.

The Note to GVC Article 1 state that the payment need not necessarily take the form of a transfer of money and may be made directly or indirectly. Sherman explains that the only requirement is that the goods or services must have an agreed price.[217] This author also explains that there is one important exception, and that is where the buyer provides goods or services for use in connection with the production or sale for export of the imported goods – without charging the full cost or value to the manufacturer – such items are to be added to the price only if they are listed in GVC Article 8.1(b). Otherwise, they should be regarded as non-dutiable contributions, rather than as payments for the goods forming part of the price and, thus, of the customs value.[218] This assertion implies that those goods or services - that are provided by the buyer without charging the full cost or value to the manufacturer but that do not qualify as assists under 8.1(b) - cannot be regarded as indirect payments. Some observations should be made in relation to this issue. The Technical Committee on Customs Valuation, in Advisory Opinion 16.1, has said that

[215] See CVC *supra* note 23, at AO1.1/1
[216] *Ibid.*
[217] See Sherman *supra* note 16, at 73.
[218] *Ibid.*

Interpretative Notes to Article 1 and Annex III make it very clear that the price actually paid or payable is the total payment made by the buyer to or for the benefit of the seller, that the payment may be made directly or indirectly and that the price includes all payments actually made or to be made by the buyer to the seller, or by the buyer to a third party. Thus the value of the condition, when it is known and relates to the imported goods, is a part of the price actually paid or payable.[219]

Article 148 of the Implementing Regulations for the European Customs Code[220] appears to follow such opinion. The relevant part of Article 148 reads:

> Where, in applying Article 29(1)(b) of the Code, it is established that the sale or price of imported goods is subject to a condition or consideration the value of which can be determined with respect to the goods being valued, such value shall be regarded as an indirect payment by the buyer to the seller and part of the price actually paid or payable provided that the condition or consideration does not relate to either:
> (a) an activity to which Article 29(3)(b) of the Code applies; or
> (b) a factor in respect of which an addition is to be made to the price actually paid or payable under the provisions of Article 32 of the Code.

GVC Article 8.4 provides that "[n]o additions shall be made to the price actually paid or payable in determining the customs value except as provided in this Article". However, the value of a condition or consideration – the value of which can be determined with respect to the goods being valued – constitutes an indirect payment and, therefore, part of the price paid or payable. Under this understanding, the value of the condition or consideration is not an "addition" to the price (in the meaning of GVC Article 8) but is the price itself (or a part of it). If such value is part of the price and not an addition to such price, then it is not within the scope of GVC Article 8.4 but, rather, under the scope of GVC Article 1.1 and its Note. Therefore, it would be part of the customs value.

However, this understanding seems to be inconsistent with other provisions of the GVC and with the interpretation made by the Technical Committee in Case Study 1.1. The Note to GVC Article 1.1(b) reads:

> ... the fact that the buyer furnishes the seller with engineering and plans undertaken in the country of importation shall not result in rejection of the transaction value for the purposes of Article 1.

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[219] See CVC *supra* note 23, at AO16.1/1.

[220] E.C., *Commission Regulation No. 2454/93 of 2 July 1993 laying down provisions for the implementation of Council Regulation (ECC) No. 2913/92 establishing the Community Customs Code,* [1993] O.J. L. 253 11.10.1993 at 1. [hereinafter "IRECC"]. See, generally, Lasok, D., *The Trade and Customs Law of the European Union,* 3rd ed. (London, Kluwer Law International, 1998) at 279-83. See, generally, Inama, S. and Vermulst, E., *Customs and Trade Laws of the European Community* (London, Kluwer Law International, 1999) at 167.

> Likewise, if the buyer undertakes on the buyer's own account, even though by agreement with the seller, activities relating to the marketing of the imported goods, the value of these activities is not part of the customs value nor shall such activities result in rejection of the transaction value.

In paragraph 8 of Case Study 1.1, the Technical Committee did not add to the selling price certain services (graphs and drawings) provided within the country of importation to the seller. Nor did the Technical Committee add the cost of engineering services furnished by the buyer within the country of importation to the selling price. Moreover, the Technical Committee did not regard these services as indirect payments.

Therefore, the assertion made by Sherman appears to be correct, at least, with respect to the treatment of assists expressly excluded under GVC Article 8.2(iv)[221]. However, it is not clear whether this principle also applies to other services supplied by the buyer free of charge which, although not included in the list of GVC Article 8.1, constitute a consideration the value of which is known and relates to the goods being valued. In effect, where it can be demonstrated that the value of the consideration relates to the goods being valued (i.e. the consideration is a payment for the goods and not for other concept, such as financial services[222]) and such value is known, the value of such consideration might be regarded as an indirect payment and, thus, as part of the price paid or payable if Advisory Opinion 16.1 were followed. (Note that this understanding could also be inconsistent with paragraph 2 of the Note to GVC Article 1.1, which provides that "[a]ctivities undertaken by the buyer on the buyer's own account, other than those for which an adjustment is provided in Article 8, are not considered to be an indirect payment to the seller. The cost of such activities shall not, therefore, be added to the price actually paid or payable in determining the customs value.") The Technical Committee on Customs Valuation should clarify this issue and, especially, the meaning of paragraph 2 of the Note to Article 1.1 in this context.[223]

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[221] Paragraph (iv) of Article 8.1 reads: "engineering, development, artwork, design, work, and plans and sketches *undertaken elsewhere than in the country of importation* and necessary of the production of the imported goods." [emphasis added]

[222] In relation to this, see paragraph 13 of Case Study 2.2. (see CVC *supra* note 23, at CS2.2/2).

[223] Note that the Technical Committee on Customs Valuation did not address this specific issue in Commentary 9.1. See CVC *supra* note 23, at Com9.1/1.

15.1.3. ACTIVITIES BENEFITING BOTH BUYER AND SELLER.

As indicated above, paragraph 2 of the Note to GVC Article 1.1 provides that activities undertaken by the buyer on the buyer's account, other than those for which an adjustment is provided in GVC Article 8, are not considered to be an indirect payment to the seller, even though they might be regarded as of benefit of the seller. The cost of such activities should not, therefore, be added to the price actually paid or payable in determining the customs value.

The most important of such activities are advertising and warranty and other marketing and promotion efforts, which benefit both the exporter and the importer by increasing sales and by making the trademark – if there is one – more valuable.[224]

The Note also states that "if the buyer undertakes on his own account, even though by agreement with the seller, activities relating to the marketing of the imported goods, the value of these activities is not part of the customs value nor shall such activities result in rejection of the transaction value."

If the exporter pays the importer for advertising activities and recovers the expense through his pricing, the cost is included in his price and there is no provision in the GVC for excluding it from transaction value (A in our formula of customs value). The result is, therefore, more favorable from a customs perspective if the amount for advertising is deducted from the purchase price at the outset and the buyer is obliged to spend at least a corresponding amount on advertising.[225]

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[224] See Sherman *supra* note 16, at 75.
[225] *Ibid.* at 76.

15.1.4. DISCOUNTS.

A discount freely agreed upon after the date of valuation in principle does not affect the customs value retroactively.[226]

This kind of discounts generally affects the tax base of income taxes (e.g., they could affect the COGS or the inventory cost of imported property) and must usually be declared. Thus, the existence of this type of discounts should be taken into account when the customs value of imported goods and the elements of the tax base of income taxes are being compared. In other words, where this type of discounts have been effected, the customs value would not be equivalent to the transfer price for tax purposes, unless appropriate adjustments were made to account for such discounts.[227]

A special case is presented where the seller allows a cash discount for prompt payment. In such cases, there are in effect two (or more) agreed prices, depending on when the payment is made.[228] If payment has been made before the goods have arrived or are entered through customs, the actual amount paid must govern.[229] If payment has not been made before the goods have arrived or entered through customs, the solution of the GVC is not clear. The Technical Committee on Customs Valuation, in Advisory Opinion 5.3, has expressed the following view:

> When a cash discount is available but payment has not yet been made at the time of valuation, the amount the importer is to pay for the goods should be taken as the basis for transaction value under Article 1. Procedures for determining what is to be paid may vary: for example a statement on the invoice might be accepted as sufficient evidence or a declaration by the importer as to the

[226] *Ibid.* at 78. In the United States, this principle is also stated in 19 U.S.C. 1401a(b)(4)(B), which provides: "Any rebate of , or decrease in, the price actually paid or payable that is made or otherwise effected between the buyer and seller <u>after</u> the date of importation of the merchandise into the United States shall be disregarded in determining the transaction value under paragraph (1)."

[227] Bear in mind that, for the purposes of this work, we do not refer to "adjustments" as the procedure of adding elements to or deducting elements from the customs value to arrive at the value of the imported property for income tax purposes (or at a specific limit to inventory cost of imported property). Rather, the term "adjustments", in this work, is used in the context of a comparison between tax and customs results. This comparison is made for the purposes mentioned in subchapter 13 above.

[228] See Sherman *supra* note 16, at 79.

[229] *Ibid.* See CVC *supra* note 23, at AO5.1/1 (Advisory Opinion 5.1 of the Technical Committee on Customs Valuation)

amount he is to pay could be the basis for action, subject to verification and to possible application of Article 13 and 17 of the Agreement.[230]

GVC Article 13 has been interpreted by the Technical Committee to permit a delay in the final determination of the customs value.[231] Therefore, where the legislation of the country adopts any of the procedures proposed above by the Technical Committee (or any other procedure to permit verification and acceptance of the discounted price), such discounts would be taken into account in determining the transaction value.[232]

15.1.5. INTEREST CHARGES.

This issue was originally addressed by the Committee on Customs Valuation on 26 April 1984, through the adoption of Decision 3.1 "Treatment of Interest Charges in the Customs Value of Imported Goods"[233] This decision was also adopted by the World Trade Organization's Committee on Customs Valuation at its meeting of 12 May 1995.[234]

The decision expresses that charges for interest under a financing arrangement entered into by the buyer and relating to the purchase of imported goods shall not be regarded as part of the customs value provided that the following conditions are met:

(1) the charges are distinguished from the price actually paid or payable for the goods;
(2) the financing arrangement was made in writing;
(3) where required, the buyer can demonstrate that (a) the goods are actually sold at a price declared as the price actually paid or payable, and (b) the claimed rate of interest does

[230] See CVC *supra* note 23, at AO5.3/1.
[231] See CVC *supra* note 23 at Com4.1/1 (Commentary 4.1)
[232] Note that the United States Customs Service has taken a different position. In Ruling 546037 (31 January 1996), the USCS said that: "A discounted price must be agreed to and *effected prior to importation* in order for the discounted price to constitute the price actually paid or payable." [emphasis added] (CVE *supra* note 29, at chapter XIII).
[233] GATT Doc. Val/M/9.
[234] WTO Doc. Val/6/Rev.1. (WTO Doc. G/Val/5, 13 October 1995)

not exceed the level for such transactions prevailing in the country where, and at the time when the finance was provided.

Despite its clear basic principle, the Decision introduced some vague terms and conditions which may be difficult to comply with in commercial practice.[235] Where such conditions are not met, the interest charges will be part of the price paid or payable (A in our formula of customs value). This inclusion should be taken into account when the customs value of imported goods and the elements of the tax base of income taxes are being compared. In effect, where – pursuant to Decision 3.1 – interest charges are to be included into transaction value in computing the customs value of the imported goods, the customs value might not be equivalent to the value of the imported goods for income tax purposes, unless appropriate adjustments were made to account for such charges. (Note that under the income tax legislation of some countries, interest payments made to non-resident persons are subject to income tax withholdings.[236] Thus, if the customs value included the interest charges, such charges might have to be identified and segregated from the price paid or payable for income tax purposes.)

15.2. GVC ARTICLE 8 – ADDITIONS TO THE PRICE PAID OR PAYABLE.

15.2.1. COMMISSIONS AND BROKERAGE– BUYING COMMISSIONS.

GVC Article 8.1 requires the addition of "commissions and brokerage" – except buying commissions – to customs value, provided they have not been included in the price paid or payable.

For the purposes of this work, it is interesting to analyze the concept and treatment of "buying commissions" under the GVC, since their exclusion from customs value might need to be accounted for in comparing tax and customs valuation results.

[235] See Sherman *supra* note 16, at 95.
[236] See, e.g., *Ley de Impuesto a las Ganancias, t.o. 1997 y sus modificaciones,* (Argentina), Article 93.

The term "buying commissions" is defined as "fees paid by an importer to the importer's agent for the service of representing the importer abroad in the purchase of the goods being valued."[237] Sherman explains that these provisions deal with the compensation of middlemen.[238] Commentary 17.1 of the Technical Committee on Customs Valuation provides further guidance in relation to "buying commissions". Such commentary addressed the question of what evidence would be necessary to establish whether fees paid by the buyer to an intermediary are buying commissions. The Technical Committee mentioned, among other elements, the existence of an agency contract between the agent and the buyer, which should accurately reflect the terms of the agreement between them. The Technical Committee also mentioned other documentary evidence, such as purchase orders, letters of credit, correspondence, etc.. It also recommended the examination of a number of factors related to the nature of the activities of the so-called agent. One of these factors may be whether the buying agent assumes any risk or performs additional services other than those normally carried out by buying agents. The extent of these additional services could affect the customs treatment of the buying commissions.[239]

Buying commissions generally affect the tax base of income taxes (e.g., they could affect the COGS or the inventory cost of imported property – increasing such cost –). Thus, the existence of this type of commissions should be taken into account when the customs value of imported goods and the elements of the tax base of income taxes are being compared. Where buying commissions (as defined under the GVC) have been paid, the customs value might not be equivalent to the value of the imported goods for income tax purposes (e.g., the value of the goods in computing COGS), unless appropriate adjustments were made to account for such buying commissions.

[237] Note to GVC Article 1(a)(i).
[238] See Sherman *supra* note 16, at 109.
[239] See CVC *supra* note 23, at Com17.1/1.

15.2.2. CONTAINERS AND PACKING.

In determining the customs value, the cost of containers which are treated as being one for customs purposes with the imported goods and the cost of packing whether for labor or materials, must be added to the customs value (B in our formula of customs value). However, such inclusion must be made only if:

(i) the costs are incurred by the buyer; and
(ii) they are not included in the price paid or payable.[240]

Sherman explains that these provisions are not intended to include the cost of large commercial containers used for long-distance transport and then reused for other shipments, nor the cost of reusable containers. These "containers" constitute modes of transport which usually – due to classification rules – will not be treated as being one with the goods. The provisions are intended to cover only items which are generally classified under the tariff item of the goods packed in them. The provision refers to cost (no the value) of the containers, which means the actual charge incurred by the buyer.[241]

15.2.3. ASSISTS.

Pursuant to GVC Article 8.1(b), another addition to the customs value is the value, apportioned as appropriate, of the following goods and services where supplied directly or indirectly by the buyer free of charge or at a reduced cost for use in connection with the production and sale for export of the imported goods, to the extent that such value has not been included in the price paid or payable:
(1) materials, components, parts and similar items incorporated in the imported goods;
(2) tools, dies, moulds and similar items used in the production of the imported goods;
(3) materials consumed in the production of the imported goods;

[240] See GVC Article 8.1(a)(ii) and (iii).
[241] See Sherman *supra* note 16, at 111.

(4) engineering, development, artwork, design work, and plan and sketches undertaken elsewhere than in the country of importation and necessary for the production of the imported goods.

These goods and services are usually referred to as "assists". Sherman explains that a number of conditions must be met before the assist addition provided for in GVC Article 8.1(b) is required.

These conditions are particularly important, in the context of this work, since the addition to or deduction from customs value of assists might be a factor of adjustment where tax and customs valuation results are to be compared. In effect, where the tax statutes require certain assists to be included in the value of the imported property for income tax purposes (e.g., in the inventory cost of such property) and such assists are not added to the customs value of the imported goods pursuant to GVC Article 8, a comparison between the tax and customs values of the goods would not be possible, since these tax bases would not be homogeneous. To achieve homogeneity, adjustments to account for the differences between the tax bases (in this case, the addition to or deduction from customs value or tax value of assists) should be made. The conditions that must be met before the assist addition to customs value is required, are the following:

(1) the goods or services must be supplied free of charge or at reduced cost[242];
(2) the assist must be used in connection with the production or sale for export of the imported goods. Thus, services not related to production are not dutiable. Services in the nature of marketing or sales-related activities are not included in customs value[243];
(3) the value of the assist must not be included in the price;

[242] The USCS said that "[p]ayments made to the seller for expenses incurred for research and development are part of the price actually paid or payable rather than added on as an assist." (CVE *supra* note 29, at chapter XX, Ruling 543324, 8 August 1984). It also said that "[p]ayments made by the buyer to the seller for tooling are indirect payments and part of the price actually paid or payable for the imported merchandise." (CVE *supra* note 29, at chapter XX, Ruling 543951, 23 September 1987)
[243] See Neville, M., "Customs planning may avoid conflict with IRS transfer pricing rules" (1993) 4 J.Int'l Tax'n 70, online: LEXIS (date accessed: 5 July 2000)

(4) the value of the assist must be "apportioned as appropriate" to determine the amount properly attributable to the particular goods being valued. (Differences in the methods of apportionment eventually used for tax and customs purposes might also result in differences in tax bases. Therefore, such differences should also be identified.)

(5) the assist must be of a category listed in GVC Article 8. Article 8.4 provides that no additions to price shall be made unless provided for in Article 8.[244] Sherman explains that certain categories of assistance sellers receive from buyers were deliberately not included in the list and are not part of the customs value.[245] The furnishing of financial assistance by the buyers to the seller has been held in the United States not to be a dutiable assist.[246] Neville provides a list of items of value furnished by a buyer to a seller that the U.S. Customs Service has not characterized as dutiable assists:

- management services (Ruling 543820 – 12 December 1986);
- salaries of production foremen and production engineers if incidental to work undertaken in the United States (Ruling 542141 – 4 February 1981);
- salaries of plant manager, plant engineer, production foremen and quality control personnel (Ruling 542696 – 22 February 1982);
- costs associated with purchasing, receiving, inspection, warehouse, production control, design, engineering, accounting, and sales functions (Ruling 542412 – 27 March 1981);
- machinery and equipment not used in actual production (Ruling 542302 – 27 February 1981); and
- management, accounting and legal services (Ruling 542122 – 4 September 1980).[247]

[244] For a discussion regarding whether or not some assists that are not included in the list of Article 8, might be regarded as being an indirect payment, see section 15.1.2 above.
[245] See Sherman *supra* note 16, at 113.
[246] *Ibid.* See also USCS, *Customs Valuation Rulings under the Trade Agreement Act of 1979* (December 1984), Trade Agreement Act Decision 17. A similar understanding can be found in paragraph 13 of Case Study 2.1 of the Technical Committee on Customs Valuation (see CVC *supra* note 23, at CS2.1/2).
[247] See Neville *supra* note 243.

In this respect, it is interesting to refer to some adjustments allowed by the Internal Revenue Service ("IRS") under Section 1059A. The U.S. Customs Service generally defined "assists" as various general purpose equipment expenses and direct manufacturing expenses.[248] In response to IRS's questions about what is included in customs value, customs advised IRS that general, administrative and overhead expenses were not assists. Customs advised IRS that the following related-party expenses were not assists: office equipment rental fees; business expenses; telephone bills; postage expenses; removal of trash; legal fees; classified advertising; executive development; travel and entertainment expenses; professional dues and subscriptions; charitable contributions and expenses attributable to conversion currencies.[249] The IRS recognized that – under tax law – these expenses were the kind of items that were properly includible in cost basis for federal tax purposes.[250] Therefore, in a technical advice memorandum, the IRS concluded that it could not apply Section 1059A to prevent the U.S. taxpayer from including the expenses paid on behalf of its foreign related party in its cost basis because the expenses were not subject to customs duty. In other words, in determining the limitation on claimed basis or inventory cost of property under Section 1059A, the taxpayer may increase the customs value of imported property by amounts corresponding to the referred expenses.[251] These amounts would fall within the fourth type of adjustment cited in the Regulations for Section 1059A[252] (i.e., "[a]ny other amounts which are not taken into account in determining the customs value, which are not properly includible in customs value, and which are appropriately included in the cost basis or inventory cost for income tax purposes").[253]

One can observe that the IRS required homogeneous tax bases (or elements of such tax bases) for comparing tax and customs values of imported property under the provisions of Section 1059A. Thus, the adjustments we examined in the foregoing paragraph constitute

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[248] See GAO Report *supra* note 205.
[249] *Ibid.*
[250] *Ibid.*
[251] *Ibid.*
[252] 26 CFR § 1.1059A-1 (revised as of 1 April 2000). [hereinafter "Regulations for Section 1059A"]
[253] See Neville *supra* note 243. See also USITP *supra* note 202, at 18.03[4][b].

an example of those analyzed throughout this Chapter.[254] It should be noted that, under the income tax statutes of some countries, adjustments for these items might not be necessary. It will depend on how taxable income is computed under such statutes.

15.2.4. ROYALTIES AND LICENCE FEES.

Pursuant to GVC Article 8.1(c), royalties and licence fees related to the goods being valued that the buyer must pay, either directly or indirectly, as a condition of sale of the goods being valued, must be added to the customs value, to the extent that such royalties and fees are not included in the price actually paid or payable (A in our formula of customs value).

There is no definition of the terms "royalties" and "licence fees" in the GVC. Sherman explains that

> ... there is no part of the Code where so much is left to interpretation and implementation, and so little can be derived from a literal reading of the words used. Some critics have thought the authors of the Code did not explore this subject sufficiently, and it is true that the subject was only reached rather late in Geneva negotiations and revealed considerable differences between governments (often as to what problems required attention, rather than how they should be resolved).[255]

Article 157 of the IRECC provide some guidance:

> 1. For the purposes of Article 32(1)(c) [*similar to GVC Article 8.1(c)*] of the Code, royalties and licence fees shall be taken to mean in particular payment for the use of rights relating:

[254] In Private Ruling 9543048 (1 August 1995) the Internal Revenue Service said: "Application of Section 1059A, as impacted by Nissho Iwai, may be summarized as follows: 1. If a taxpayer reports different values to Customs and IRS, a reduction to the tax value reported to the IRS may be made under section 1059A if the value reported to Customs is lower than the value reported for income tax purposes. The potential adjustment to the tax value is the entire amount of the difference between the two values. However, the adjustment if reduced to the extent the taxpayer establishes that the differences between the amount reported to the IRS and Customs are attributable to such items as freight, insurance, and American content which are not includible in dutiable value; and to differences in the valuation methods that can be objectively identified by the taxpayer. Also, the value taken into account for income tax purposes (that is compared to the value reported to Customs) must conform to the rules for determining cost basis or inventory cost under section 263A and section 1.471-11 of the Regulations. 2. If a taxpayer reports the exact same value to both Customs and the IRS, or a greater value to Customs than to the IRS, no adjustment may be made under section 1059A. However, if the IRS determines that the value reported to the IRS is not arm's length, an adjustment may be made under section 482." (US, Internal Revenue Service, *Private Ruling 9543048*, 1 August 1995)

[255] See Sherman *supra* note 16, at 123.

- to the manufacture of imported goods (in particular, patents, designs, models and manufacturing know-how), or
- to the sale for exportation of imported goods (in particular, trade marks, registered designs), or
- to the use or resale of imported goods (in particular, copyright, manufacturing processes inseparably embodied in the imported goods).[256]

Paragraph 2 of Article 157 sets out the conditions that must be met in order for a royalty or licence fee to be added to Customs value:

1. The payment of the royalty or licence fee must be related to the goods being valued[257], and
2. Such payment must constitute a condition of sale of the imported goods.[258]

There is a close economic relationship between these conditions.[259] In the European Community, it may be assumed, in the absence of evidence to the contrary, that the payment of a royalty or licence fee is related to the imported goods, where the method of calculation of the amount of such royalty or licence fee derives from the price of the imported goods.[260] It should be noted that the addition to the customs value cannot be avoided merely by connecting the calculation of the royalty or licence fee to the later proceeds from the resale of the imported goods or of the goods produced from them or to any other basis.[261] In this respect, the second paragraph of Article 161 of the IRECC provides that, where the amount of a royalty or licence fee is calculated regardless of the price of the imported goods, the payment of that royalty or licence fee may nevertheless be related to the goods to be valued.

Charges for the "right to reproduce" the imported goods in the country of importation are not added to the customs value of the imported goods.[262] Commentary 19.1 of the

[256] IRECC *supra* note 220.
[257] In relation to this condition, the Technical Committee on Customs Valuation has provided guidance in Advisory Opinions 4.1, 4.4, 4.7, 4.8, 4.10, 4.11 and 4.12. See CVC *supra* note 23, at AO4.1/1-AO4.12/1
[258] In relation to this condition, the Technical Committee on Customs Valuation has provided guidance in Advisory Opinions 4.2, 4.3, 4.5, 4.6, 4.7, 4.9, 4.10, 4.11 and 4.13. See CVC *supra* note 23, at AO4.2/1-AO4.13/1.
[259] See Sherman *supra* note 16, at 123.
[260] See IRECC, Article 161, *supra* note 220.
[261] See Sherman *supra* note 16, at 126.
[262] See Note to GVC Article 8.1(c).

Technical Committee on Customs Valuation[263] provides some guidance on the types of activities intended to be covered by the phrase "right to reproduce". The Technical Committee suggests that such phrase would seen to refer not only to the physical reproduction of the imported goods but also to the right to reproduce an invention, creation, thought or idea incorporated in the imported goods. In the opinion of the Technical Committee, it would also refer to originals and copies of scientific works, originals of literary works, models, prototypes and animal or plant species. The Technical Committee suggests an analysis of the following factors: (a) whether an idea or original work is incorporated in the imported goods; (b) whether the reproduction of the idea or work is the subject of a reserved right; (c) whether the right of reproduction has been assigned to the buyer in the contract of sale or through a separate agreement; (d) whether the holder of the reserved right has required a remuneration for the assignment of the right of reproduction.

In relation to the right to use a trade mark, Article 159 of the IRECC provides that a royalty or licence fee is only to be added to the customs value if three conditions are met:

1. the royalty or licence fee refers to goods which are resold in the same state or which are subject only to minor processing after importation'
2. the goods are marketed under the trade mark, affixed before or after importation, for which the royalty or licence fee is paid, and
3. the buyer is not free to obtain such goods from other suppliers unrelated to the seller.

GVC Article 8.1(c) provides for the addition of the royalty or licence fee whether it is paid directly or indirectly. In this respect, Article 160 of the IRECC states that, when the buyer pays royalties or licence fees to a third party, the conditions provided in Article 157 (see above) are not considered as met unless the seller or a person related to him requires the buyer to make that payment. This is consistent with the position of the U.S. Customs Service in Rulings 544781 (4 March 1994), 543070 (18 July 1983) and 545361 (20 July 1995).[264]

[263] See CVC *supra* note 23, at Com19.1/1.
[264] See Levey *supra* note 2, at 8.05[5][c][iv].

We have determined which royalties should be included in customs value. Now we will explore the most relevant issues arising from the existence of royalty payments when tax and customs values of imported goods are being compared.

A first issue to be considered when comparing tax and customs values of imported goods (or the rules for determining such values) relates to the definition of the term "royalty" under tax and customs laws. Even when "royalties" were added to or deducted from customs and tax values in the same manner, the customs value and the value of the imported goods for income tax purposes, might not be equivalent if there were differences in the definition of the term "royalties" under tax and customs laws. Therefore, in order to compare tax and customs valuation results, the definitions of the term "royalties" – if any – under tax and customs laws should be examined. Differences between those definitions should be identified and accounted for through appropriate adjustments. In many cases, it may also be necessary to examine the definition of a such term adopted under international tax treaties. For example, Article 12 of the MTC includes the following definition:

> 2. The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience[265]

In this respect, the OECD Guidelines indicate that

> The conditions for transferring intangible property may be those of an outright sale of the intangible or, more commonly, a royalty under a licensing arrangement for rights in respect of the intangible property. A royalty would ordinarily be a recurrent payment based on the user's output, sales, or in some rare circumstances, profits...[266]

Since there is no definition of the term "royalties" under the GVC, the MTC and the OECD Guidelines may also provide guidance on the interpretation of such term under GVC Articles 1 and 8. This may help avoid inconsistencies between the tax bases (or elements thereof) of customs duties and income taxes.

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[265] MTC *supra* note 5, at 33.
[266] See OECD Guidelines *supra* note 3, at 6.16.

A second issue to be considered is whether the rules of valuation of goods laid down in the income tax statutes (e.g., for purposes of inventory cost of imported property) require such royalties (or some types of royalties) to be added to, or excluded from, the value of the goods. (Note that the rules of valuation of goods in some tax statutes may also provide for the exclusion of royalties that have already been included in the price paid or payable for the imported goods.) Identification of any difference between tax and customs rules is necessary to make appropriate adjustments to, and appropriate comparisons between, tax and customs values of imported goods.

A third issue, closely connected with the former, is whether the payment of such royalties is subject to income tax withholding under national tax statutes and/or treaty provisions. Payments made in consideration for the sale of goods for export to the country of importation are generally not subject to income tax withholding. Where such payments include charges for intellectual property, such part of the payment might be subject to income tax withholding. In this respect, the OECD Guidelines provide that

> [t]he compensation for the use of intangible property may be included in the price charged for the sale of goods when, for example, one enterprise sells unfinished products to another and, at the same time, makes available its experience for further processing of these products ... The transfer price may be a package price, i.e., for the goods and for the intangible property, in which case, depending on the facts and circumstances, an additional payment for royalties may not need to be paid by the purchaser for being supplied with technical expertise. This type of package pricing may need to be disaggregated to calculate a separate arm's length royalty in countries that impose royalty withholding taxes.[267]

One can identify, therefore, the following situations:

(1) Tax and customs valuation rules set out equivalent rules of determination of tax bases – or elements thereof – in particular, in relation to the treatment of royalty payments. In this case, no adjustment would usually be required for the purposes of comparison between customs and tax results;

[267] *Ibid.* at 6.17.

(2) (a) Tax rules require deductions from transaction value (e.g., in respect of royalties which were already included in the price paid or payable) that are not allowed under customs rules.

(b) Tax rules do not allow additions to transaction value (e.g., in respect of royalties related to the imported goods, that the buyer must pay to the seller as a condition of the sale of such goods) that are required under customs rules.

(c) Tax rules allow additions to transaction value that are not required to be made under customs rules.

(d) Tax rules do not allow deductions from transaction value that are allowed under customs rules.

In the situations mentioned in (2) above, a comparison between tax and customs values of the imported goods will usually require adjustments to account for the differences in the treatment of royalties under tax and customs rules. The situations described in (2) above may appear combined, depending on the different income tax statutes. These could add complexity to any process of comparison.

15.2.5. PROCEEDS OF RESALE, DISPOSAL OR USE OF THE IMPORTED GOODS.

GVC Article 8.1(d) provides for the addition to the customs value of the value of any part of the proceeds of any subsequent resale, disposal or use of the imported goods that accrues directly or indirectly to the reseller.

Sherman explains that "more often than not, a royalty or licence fee is expressed as a percentage of resale price".[268] This author understands that "it would make no sense to go through the refined analysis called for by GVC Article 8.1(c) and conclude that the payment is not dutiable as a royalty only to find that the payment is dutiable under the companion provision of GVC Article 8.1(d) as proceeds of subsequent resale. He believes that the line

[268] See Sherman *supra* note 16, at 144.

of distinction which makes possible to reconcile GVC Articles 8.1(c) and (d) is that GVC Article 8.1(c) relates to payments for intangibles and GVC Article 8.1(d) relates to payments for the tangible imported goods. Therefore, he concludes that if a royalty for rights, information or services is not dutiable under GVC Article 8.1(c) it cannot be dutiable under GVC Article 8.1(d), even if it is measured or expressed as a portion of resale price.[269]

With the Hasbro Ruling[270], the U.S. Customs Service – that had originally had the same understanding[271] – took the view that even if a royalty were not dutiable because it was not a condition of the import transaction, it nonetheless might be dutiable as proceeds of a subsequent resale if accruing to the benefit of the seller.[272]

Since the language of the GVC is ambiguous (especially if the Note to GVC Article 1 and GVC Articles 8.1(c) and (d) are read together) a clarification of this issue by the Technical Committee on Customs Valuation through an advisory opinion or commentary would be desirable not only for Customs administrations and practitioners, but also to promote uniform interpretation of the GVC.[273]

The analyses made in sub-section 15.2.5 above, in relation to adjustments and comparison between tax and customs values of imported goods, are also applicable for the purposes of this section. However, the customs treatment of certain royalties and licence fees (e.g., those which are calculated as part of the proceeds of subsequent resale of the imported goods) depends on the interpretation by the Customs administrations and Courts of

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[269] Sherman bases this understanding on a detailed analysis of the language of GVC Articles 8.1(c) and (d), the Brussels Definition of Value and the Notes to GVC Article 1. (See Sherman *supra* note 16, at 155)
[270] USCS, Ruling 544436 (4 February 1991), Customs Bulletin Vol. 25, No. 18 (June 1991)
[271] In Ruling 542900 (9 December 1982), the USCS had held that the existence of two separate categories, one specifically relating to royalty and licence fees and the other to the proceeds of subsequent resale, use or disposal of the imported goods, clearly indicated that the two categories were not intended to cover the same set of circumstances. Thus, when the royalty or licence fee was find not to be part of customs value as a royalty, no authority existed for including the fee in customs value as proceeds of subsequent resale (see CVE *supra* note 29 at chapter XXXVIII). See also Levey *supra* note 2, at 8.05[5][c][iv]. See also Neville *supra* note 243.
[272] See Levey *supra* note 2, at 8.05[5][c][iv]. See Neville *supra* note 243.
[273] See Article 18.2 and Annex IIA of the GVC.

each country of GVC Article 8.1(d). Thus, whether or not certain adjustments in relation to such royalties are needed depends upon such interpretations.

15.2.6. TRANSPORTATION AND RELATED CHARGES.

GVC Article 8 provides that "each Member shall provide for the inclusion in or exclusion from the customs value, in whole or in part, of the following: (a) the cost of transport of the imported goods to the port or place of importation; (b) loading, unloading and handling charges associated with the transport of the imported goods to the port or place of importation; and (c) the cost of insurance." Sherman explains that, the fact that most countries are on a CIF basis of customs valuation[274] whereas the United States[275] and some others are on an FOB basis of customs valuation is reflected by this provision. The negotiators of the GVC decided not to undo this difference.[276]

Adjustments for the purposes of comparing tax and customs values under customs and income tax laws, would generally be necessary where a country has adopted an FOB basis of valuation for customs purposes, and the cost of transport and insurance are included in the value of the goods for income tax purposes (e.g., in the inventory cost of the imported goods).

An example of this type of adjustment can be found in the regulations for Section 1059A. They provide that taxpayers, in determining the limitation on claimed basis or inventory cost of property, may increase the customs value of imported property by certain amounts. Freight charges and insurance are two of the four types of adjustment cited in the regulations.[277]

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[274] See, e.g., E.C, *Council Regulation 2913/92 of 12 October 1992 establishing the Community Customs Code,* [1992] O.J. L. 302/1, Article 32(e)
[275] See 19 USC § 1401a(b)(4)(A).
[276] See Sherman *supra* note 16, at 159.
[277] See Regulations for Section 1059A *supra* note 252. Such regulations read: "Adjustments to customs value. To the extent not otherwise included in customs value, a taxpayer, for purposes of determining the limitation on claimed basis or inventory cost of property under this section, may increase the customs value of imported

15.3. DEDUCTIONS FROM PRICE PAID OR PAYABLE.

The Note to GVC Article 1 provides for three deductions from customs value (C in our formula of customs value):

(a) charges for construction, erection, assembly, maintenance or technical assistance, undertaken after importation on imported goods such as industrial plan, machinery, or equipment;
(b) the cost of transport after importation; and
(c) duties and taxes of the country of importation.

However, in order for such elements to be deducted, they must be distinguished from the price actually paid or payable.[278]

All these elements represent costs and values added after the goods have been imported, reflecting the principle that customs value should not include values attaching after importation.[279]

When comparing tax and customs valuation results, and adjustment for these elements may be required. In effect, where national tax statutes include such elements in the cost of imported property (e.g., in its inventory cost or in its adjusted cost base), an adjustment to the tax or customs figures would be necessary to make such figures homogeneous, and to permit an appropriate comparison.

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property by the amounts incurred by it and properly included in inventory cost for-- (i) Freight charges, (ii) Insurance charges ...". See also GAO *supra* note 205. Bear in mind that, pursuant to Section 1059A, the claimed basis or inventory cost for income tax purposes cannot exceed the customs value plus four classes of additions (adjustments).

[278] See Note to GVC Article 1.

[279] See Sherman *supra* note 16, at 171.

The Regulations for Section 1059A offer an example of these adjustments. In determining the limitation on claimed basis or inventory cost of property, charges for construction, erection, assembly, maintenance or technical assistance provided with respect to the property after its importation into the United States, constitute the third type of adjustment permitted under such regulations.[280]

[280] See Regulations for Section 1059A *supra* note 252. Such regulations read: "Adjustments to customs value. To the extent not otherwise included in customs value, a taxpayer, for purposes of determining the limitation on claimed basis or inventory cost of property under this section, may increase the customs value of imported property by the amounts incurred by it and properly included in inventory cost for-- [...] (iii) The construction, erection, assembly, or technical assistance provided with respect to, the property after its importation into the United States ...". See also GAO *supra* note 205.

CHAPTER V

PRICE REVIEW CLAUSES AND FORMULA PRICING.

16. INTRODUCTION.

In Chapter IV we explored the rules governing the tax base of customs duties, and examined the cases where a comparison between tax and customs values of imported property could not be made without appropriate adjustments to account for differences in computation of such values.

In this chapter, we will examine some adjustments an importer may be required to make to the price originally declared to customs. This adjustments could be the consequence of a transfer pricing study for tax purposes. We will refer to this type of adjustments as "compensating adjustments".[281]

From a customs standpoint, a compensating adjustment would involve a value declared to customs on a provisional basis – which is linked to variables which come into play some time after the goods have been imported – and a definitive value to be declared to customs subsequently, when such variables are finally known.

The compensating adjustment would be based on such variables. If the price is adjusted upwards, both the dutiable value and the amount of customs duties will be increased. If the price is adjusted downwards, the effect would be the opposite: both the dutiable value and the amount of customs duties will be decreased. In this latter situation, the importer may be entitled to a refund.[282]

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[281] See Levey *supra* note 2, at 8.05[10][f].
[282] *Ibid.*

Compensating adjustments may arise not only from adjustments made by the tax authorities under national tax regulations, but also when there is a cost-plus pricing and the customs entry is made when the costs have not been finalized.[283]

In this chapter we will, therefore, analyze whether transaction values subject to compensatory adjustments may be acceptable under GVC Article 1 and, if so, under which conditions such adjustments should be made.

17. PRICE REVIEW CLAUSES – FORMULA PRICING.

Where a contract does not establish price review clauses or pricing formulae and the price is declared to customs at entry in a definitive manner, any subsequent modification to the price paid or payable would have the following customs consequences:

(a) where the modification of the price (e.g., a rebate not required under the contract) is made by the exporter, for whatever reason, but based on a new decision after the merchandise has been imported, the customs value would not be affected;[284]

The U.S. Customs Service has indicated that "retroactive price adjustments between related parties agreed to after importation of merchandise does not affect the transaction value of the goods, provided that it is determined that the parties' relationship does not influence the price."[285] (This condition would lead to the next customs consequence.)

(b) where the modification of the price is agreed to after importation due to *transfer pricing* (retroactive) adjustments, the originally declared transaction value could be regarded as being influenced by the relationship and, thus, rejected as basis of appraisement under GVC

[283] *Ibid.*
[284] See Sherman *supra* note 16, at 83. See also CVE *supra* note 29, at chapter XXXIII, Rulings 542797 (19 May 1982), 543246 (30 April 1984), 543457 (9 April 1985) and 543537 (14 February 1986).
[285] CVE *ibid.*, Ruling 542797 (19 May 1982).

Article 1. In effect, if the price has been definitively declared to customs based on a definitive price agreed upon by the related parties, any subsequent adjustment to comply with the arm's length standard would simply indicate that the originally declared price did not comply with such standard and, thus, that it has been influenced by the relationship.

However, where the contract establishes a pricing formula or price review clauses, the situation is radically different. Where there are pricing formulae, or price review clauses, *in effect at the time of importation* (although the actual price under the formula cannot be determined until later) the price actually payable for the imported goods can be established on the basis of the data specified in the contract. An example of this would be a cost-plus contract, if the cost figures are not yet available at the time of importation. Therefore, in this cases, there is a transaction value and the pricing formula or price review clause cannot be regarded as constituting a condition or consideration for which a value cannot be determined.[286]

The Technical Committee on Customs Valuation has said that, in contracts containing a price review clause, the transaction value of the imported goods must be based on the total final price paid or payable in accordance with the contractual stipulations. It concluded that "given that the Agreement recommends that, as far as possible, the transaction value of the goods being valued should serve as a basis for valuation, and given that 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 payable at the time of importation, price review clauses should not of themselves, preclude valuation under Article 1 of the Agreement."[287]

This last point is central in understanding the problems arising from compensating adjustments. Pricing formulae and price review clauses should be used to permit valuation under GVC Article 1, especially in case of related-party transactions. As noted by the

[286] See CVC *supra* note 23, at Com4.1/1 (Commentary 4.1 of the Technical Committee on Customs Valuation)
[287] CVC *supra* note 23, at Com.4.1/1.

Technical Committee, Articles 1 and 13 read together provide for the possibility of delaying the final determination of customs value. Transfer pricing compensatory adjustments are often necessary to ensure the arm's length character of the transaction value agreed upon between related parties. The use of pricing formulae or price review clauses makes possible the introduction of such compensatory adjustments to transaction value without affecting the acceptability of such value under GVC Article 1. This enables importers to declare appropriate arm's length prices and, consequently, to have their goods appraised under GVC Article 1. They also give the importer the opportunity to demonstrate that the relationship did not influence the price. In effect, where the transfer pricing method used by the taxpayer/importer to determine its prices requires the use of data that is not available at the time of the import (e.g., cost plus method), the importer will only be able to declare an arm's length price when such data becomes available. Obviously, it will not be able to demonstrate that the relationship did not influence the price if the Customs administration does not delay final determination of customs value until such data becomes available.

One must bear in mind that the basis for valuation of goods for customs purposes should, to the greatest extent possible, be the transaction value of the goods being valued.[288] National legislation should provide for the possibility of declaring related-party transaction values, subject to eventual transfer pricing compensatory adjustments to be introduced through pricing formulae or price review clauses. Such pricing formulae or clause review clauses should be properly declared to customs at entry. This would logically imply the possibility of delaying the final determination of customs value. The purpose of this should always be to permit customs value to be determined under GVC Article 1 (i.e., to allow the importer to declare an appropriate arm's length price).[289]

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[288] See Preamble of the GVC.

[289] François Vincent suggested that "in the course of an APA, where the Canadian importer is using estimated purchase price during the year, for instance where a profit-split method based on year-end results is the TPM [*transfer pricing method*], for customs purposes the price paid or payable should be that as finally determined and taking into consideration any compensating adjustment ... [W]hether in an APA context or otherwise, Canadian importers should be able to establish pricing mechanisms by which the final determination of the price paid or payable rests on some calculation to be done subsequently to the importation itself. This does not mean that this is a way by which rebates can indirectly be given effect for customs valuation purposes. However, it is definitively an avenue worth exploring for transfer pricing purposes and the legislation in play,

At this point, it is worth making some comments on the "Notice to test the use of reconciliation for adjustments made to the price of imported merchandise by related party companies under 26 U.S.C. 482"[290]

The Notice announced "a Customs plan to conduct a test for those related party importers which have reason to believe upward adjustments may be made to the price of imported merchandise for tax purposes pursuant to 26 U.S.C. 482".[291] The text was intended to facilitate the IRS/Customs decision as to whether reconciliation procedures provided a viable and appropriate circumstance for a taxpayer/importer to make a post entry upward adjustment to the price of imported merchandise.

The Notice explains that reconciliation would allow an importer to provide Customs with information not available at the time of entry summary filing and which is necessary to ascertain the final appraisement of imported merchandise. The reconciliation would have to be filed no later than 15 months from the date of the first entry summary filed under that reconciliation. A reconciliation would permit the liquidation of an entry despite the fact that undetermined information would be transmitted to Customs at a later time through reconciliation process.[292]

Interestingly, the Notice indicated that the valuation of the merchandise subject to reconciliation is not to be made under transaction value (i.e., GVC Article 1). The Notice established the following requisite:

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the Customs Act and the ITA [Income Tax Act] may be reconcilable – contrary to past beliefs and positions. (Vincent, F., *Transfer Pricing in Canada*, notes furnished by Vincent to the author of the present work).

[290] United States Customs Service, Department of Treasury, Vol. 60 Federal Register No. 128 (5 July 1995) 35105. [hereinafter "Notice"]

[291] Suzanne Offerman indicates that this "Reconciliation Prototype was never implemented because there were no applicants." (Offerman Suzanne, "The Effect of Customs Reconciliation on Taxable Income" [1999] 25 Brooklyn J. Int'l L. 693). The "Announcement of National Customs Automation Program Test of Account-Based Declaration Prototype" (U.S. Customs Service, Department of the Treasury, Vol. 62 Federal Register No. 59, 27 March 1997) indicated that "[i]n 1995 a notice was published in the Federal Register concerning a reconciliation prototype for related party importers making upward adjustments to the price of imported merchandise, pursuant to 26 U.S.C. 482. This prototype did not become operational."

[292] See Notice *supra* note 290.

> 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 [*equivalent to the method laid down in GVC Article 7*], if, in fact, an upward section 482 adjustment is made for tax purposes.[293]

One can clearly observe that the reconciliation test announced in the Notice is not one of the mechanisms that was suggested in this chapter for introducing compensating adjustments in transaction value. The purpose of pricing formulae and price review clauses – in addition to that of the mechanisms to delay final determination of the customs value under GVC Articles 1 and 13 – is to make possible a final appraisal of the imported goods under

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[293] This requisite was confirmed in "Notice to Test the Use of Reconciliation for Adjustments Made to the Price of Imported Merchandise by Related Party Companies under 26 U.S.C. 482" – Final Notice –. (United States Customs Service, Department of the Treasury, Vol. 60, Federal Register No. 171, 5 September 1995). The U.S. Customs Service expressed the following view: "Customs considers the fact that the related party importer has reason to believe that an upward adjustment may be made to the price of the imported merchandise as evidence that the relationship may have affected the price actually paid or payable for the merchandise. Therefore, transaction value will not be considered to be the proper basis of appraisement. The importer continues to have the right to have the hierarchy of appraisement applied to its transactions. However, if the importer claims another basis of appraisement, such as deductive value, then the importer will not be able to participate in the proposed test. This is due to the fact that the test is designed to determine how Customs can use the prices that the importer paid to the seller and the upward adjustments to those prices by using reconciliation. If a basis of appraisement is used that does not use these adjusted prices then the information is meaningless, for purposes of this test. Appraisement under section 402(f) of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 allows Customs to utilize the importer's information on the price it paid, and to reasonably appraise the merchandise using that information." However, Suzanne Offerman explains that "the legislative history of the Reconciliation program in the Mod Act indicates that reconciliation was a procedure implemented to help Customs and importers enter merchandise 'in a more business-like way, reducing paperwork and many of the administrative costs'. Nothing in its legislative history suggests that a reconciliation should change the manner in which transaction value is calculated. In fact, to the contrary, the legislative history of the Reconciliation program indicates that Congress wished to keep all Customs entry procedures the same, buy simply add the option to reconcile certain unknown value issues when they become available. Congress wrote 'a reconciliation will permit importers to submit information not available at the time of entry that is necessary ... to determine the correct amount of duty on a shipment" and yet, the method remains the same for: (i) determining transaction value for the underlying merchandise; (ii) liquidating merchandise at the time of the entry; and (iii) protesting Customs determinations. Given that valuation methods remain unchanged by the reconciliation program, entries flagged for reconciliation can be tested for an arm's length transaction price as any related party transaction is examined. A related party transaction is at arm's length when the price is uninfluenced by the relationship between the parties ... Moreover, an importer may file a reconciliation for entries imported form an unrelated party or a related party. The assumption that the relationship between the parties affected the price any time an importer flags for a reconciliation an entry imported from a related party prevents a related party from ever using reconciliation ... To discriminate against related parties is both unfair and unsupported in the legislative history of the Customs Valuation Statute and Reconciliation Program of the Mod Act, as a reconciliation is the sole manner by which an importer may liquidate entries and yet still hold open an unknown value. It follows that provided the circumstances of the sale show that the appraised value of the merchandise was not influenced by the relationship between the parties, there is no reason to treat entries that are flagged for reconciliation differently from an entry that is not." (Offerman *supra* note 291)

transaction value (as recommended in the Preamble of the GVC), and not to apply a new method of valuation under GVC Article 7.

The delay in the determination of the customs value should be directed towards the final declaration of an appropriate arm's length price under GVC Article 1.

Where adjustments to transaction value are made through pricing formulae or price review clauses, that have been properly declared at the time of the entry, there would be no reason to reject transaction value. In effect, the price declared after the adjustment would be

(i) an arm's length transaction value;
(ii) the price actually paid or payable for the imported goods; and
(iii) the transaction value definitively declared to customs.

For this reason, we understand that the mechanisms to delay final determination of the customs value in cases of related-party transactions, should be based on the acceptance of transaction values subject to pricing formulae or price review clauses properly declared to customs at the time of the entry. In other words, where the importer believes that compensatory adjustments may be made to the price of the imported goods, it must agree upon and declare the price subject to appropriate pricing formulae or price review clauses. Customs legislation should provide for appropriate procedures to enable importers to file provisional declarations of value and, subsequently – once compensatory adjustments have been made pursuant to pricing formulae or price review clauses –, to file definitive declarations of value on which final appraisal should be based.

CONCLUSIONS.

The existence of two different valuation regimes applied to the same transactions gave rise to the issue analyzed in the first chapter of this work: whether it is necessary and feasible to harmonize tax and customs transfer pricing regimes.

First, we decided which regimes were going to be analyzed, since in the tax field the existence of multiple pieces of tax legislation could make comparison extremely complex.

In the customs field, the GVC is the valuation system adopted by almost all the WTO Members. Therefore, it seemed to be the appropriate example of customs valuation legislation. In the tax field, the MTC and the OECD Guidelines have been adopted (either partially or totally) by a great number of states (OECD members and non-OECD members). Although the OECD is not a legislative body that can dictate to its members, it enjoys a high level of prestige among its members, and most non-member states also hold it in high repute. Therefore, the MTC and the OECD Guidelines are an appropriate example of transfer pricing tax legislation. In addition, the OECD Guidelines are also a detailed set of rules that could be used to supplement the more general related-party provisions of the GVC.

Two arguments indicated that harmonization is, in fact, necessary or advisable. The first argument suggested that, where common principles and standards were adopted under both customs and transfer pricing regimes, the results obtained under such regimes should not be substantially different. The second argument, more practical in character, indicated that it did not appear to be reasonable (or at least, economically efficient) for an MNE to undertake two parallel valuation analyses for the same transaction.

In subchapter 3 we analyzed the question of whether harmonization was feasible. It was indicated that the GVC and the OECD Guidelines present many important differences which, in most cases, derive from the inhomogeneous nature of the instruments and taxes in question. However, it was also indicated that such differences were not so important where the interpreter focused on the related party transactions of the GVC. We concluded that the fact that tax and customs rules shared common standards in relation to the treatment of related-party transaction, could make possible the process of harmonization.

In Chapter II we explored the standards for determining arm's length values and for examining whether the relationship influenced the transaction value. Firstly, the definition of the arm's length principle was examined and it was concluded that such a principle is also reflected by GVC Article 1.2.

Secondly, we analyzed GVC Article 1.2(a), its Note and the other provisions of the GVC in order to determine whether the OECD Guidelines could be used to complement the related-party provisions of the GVC. We observed that importers and customs administrations could not be expected to solve complex transfer pricing problems solely on the basis of the general provisions of GVC Article 1.2 and its Note. This might produce inconsistent application of the related-party provisions of the GVC from one country to another, which is contrary to the principle of "uniformity and certainty" in the implementation of GATT Article VII. We concluded that the OECD Guidelines – being a detailed body of rules established for the purpose of applying the arm's length standard – could be applied broadly in the context of GVC Article 1.2. We also concluded that the use of the OECD Guidelines to supplement the provisions of Article 1.2 and its Note would help to harmonize not only tax and customs rules, but also implementation of the GVC's related-party provisions among the WTO Member countries.

Thirdly, we explored the guidance provided by the OECD Guidelines concerning the application of the arm's length principle. We analyzed the application of the comparability analysis in the context of GVC Article 1.2, paying special attention to the provisions of the GVC relating to product comparability, to the functions performed by the parties to a transaction, and to the economic circumstances and business strategies of such parties. Finally, we evaluated the possibility of undertaking combined examination of separate transactions under the GVC, of the use of arm's length ranges and of the use of multiple year data. In each case we determined that the OECD Guidelines are generally applicable, but that in certain circumstances (e.g., the combined examination of separate transactions), special care has to be taken since their application might not be consistent with GVC Article 1, or with the general objectives and principles of customs law. We also observed that these rules must only be applied for comparability purposes.

In Chapter III we examined the OECD arm's length methods in connection with GVC Article 1.2 and its Note. Firstly, we distinguished such methods from those laid down in GVC Articles 2, 3, 5 and 6. However, we said that the principles underlying such articles could be useful to interpret the GVC's related-party provisions and that, therefore, they could provide guidance as to how the OECD arm's length methods should be applied in the context of Article 1.2.

Secondly, we explored the CUP method and the comparability criteria to be observed in applying such method. We indicated that the Guidelines follow criteria that are consistent with those underlying the GVC. In this context, we examined the solutions the OECD Guidelines provide for situations where there is a difference between the controlled and the uncontrolled price indicating that the conditions of the commercial and financial relations of the related parties are not arm's length. We observed that the solutions suggested by the Guidelines are not consistent with those of the GVC, since no substitute value could be determined under Article 1.2. It was concluded that this fact might produce inconsistencies between the results derived from the application of tax and customs rules. It was also concluded that the most consistent results could be achieved where the importer undertook a thorough transfer pricing analysis, prior to declaration of any transaction value to customs or tax authorities. In effect, the application of the OECD Guidelines is only possible where the importer can demonstrate that the relationship did not influence the price under Article 1.2(a). Where the importer is unable to demonstrate such circumstances, the transaction value is rejected and the methods of GVC Articles 2, 3, 5, 6 and 7 become applicable. The results obtained by the customs administrations under these methods might not be consistent with those arrived at by the tax administrations on the basis of the OECD Guidelines.

Thirdly, we examined the resale price method in connection with GVC Article 1.2(a). We determined that this method is applicable under that article, and that, even though the GVC showed a preference for internal comparables, external comparables could also serve as a guide. (over external comparables, the latter could also serve as a guide.) Next, we analyzed the provisions regarding the application of the method. It was concluded that under the GVC, as well as under the OECD Guidelines, less product comparability might be required in using the resale price method. However, closer comparability of products would produce better results. It was also concluded that the resale price method depends on comparability of functions performed, since the amount of the resale price margin is often influenced by the level of activities performed by the reseller. It was also determined that the provisions of the OECD Guidelines and of the GVC are consistent with regards both to the superdeductive method, and to the time elapsed between purchase and resale. Finally, we observed that, under the resale price method, customs administrations have to be prepared to examine the existence of transfers, licenses, ownership and/or development and maintenance of intangible property where profit margins have to be compared. This could constitute part of the circumstances surrounding the sale of tangible property.

Fourthly, we analyzed the application of the cost plus method in the context of GVC Article 1.2. We indicated that one of the examples of Article 1.2 could be regarded as derived from the application of such a method. It was concluded that the cost plus method is applicable in the context of GVC Article 1.2, and observed that the OECD Guidelines, read together with the provisions of Article 6 and its Note, could provide useful guidance for applying such method in such context. Next, it was indicated that, even though the GVC shows a preference for internal comparables, external comparables could also serve as a guide in applying the cost plus method. This statement was supported by, among others, the Note to GVC Article 6. We also analyzed the provisions of the GVC and OECD Guidelines regarding the effect of economic circumstances and relative efficiency of the enterprises being compared on cost plus analyses. It was again found that such provisions are consistent. Finally, we determined that, in applying the cost plus method under both the OECD Guidelines and the GVC, due account has to be taken of functions performed by the enterprises being compared, and of accounting consistency of the data used for the purposes of comparison.

Finally, we analyzed the transactional profit methods of the OECD Guidelines and their possible application in the context of GVC Article 1.2.

We concluded that both the profit split method and the transactional net margin method, could only be used in determining whether the relationship influenced the price in cases where traditional transaction methods could not be reliably applied alone, or could not be applied at all. These would be considered methods of last resort. We observed that those methods have to be applied in a manner consistent with the general principles of the GVC.

The purposes of Chapter IV were different from those of Chapters I, II and III. Under Chapter IV, we assumed that the OECD Guidelines were applicable in the context of GVC Article 1.2. Our point of departure was to distinguish transaction value from the tax base of customs duties, or from any of the different elements of the tax base of income taxes. Although the determination of an arm's length transaction value should be equivalent under tax and customs rules, the computation of the customs value and of the tax value of imported goods might be significantly different. Importers/taxpayers usually determine and declare tax bases. Likewise, tax and customs administrations have information about such tax bases and, consequently, base their examinations on such information. If, for example, a customs administration determined that the customs values declared by the importer/taxpayer were acceptable under GVC Article 1.2(a), then this information could be useful for the tax administration to avoid double scrutiny of the same transactions. However, the tax administration could not use the information collected by the customs administration (usually, information about the tax base of customs duties) if the differences in computation of tax and customs values are not duly identified and accounted for. If the taxpayer has declared arm's length transaction values for tax and customs purposes, the customs value and the tax value (e.g. adjusted cost base, inventory cost or COGS) should be equivalent, once the differences between such values have been identified, and appropriate adjustments to account for such differences have been made. A taxpayer could present this argument to prevent customs and tax administrations from taking inconsistent positions in determining the appropriate arm's length transaction value. The purposes of Chapter IV were (i) to analyze the tax base of customs duties (as defined by the GVC), (ii) to identify additions to or deductions from such a tax base that are required or allowed under the GVC, and that are not usually required or allowed under income tax statutes, and (iii) to indicate in which situations adjustments have to be made to account for differences in tax bases of customs duties and income taxes.

We analyzed, among other things, the provisions of the GVC, advisory opinions and decisions concerning discounts and interest charges. We identified the cases in which discounts do not affect transaction value for purposes of GVC Article 1, and indicated that, where such discounts affect the value of the imported goods for income tax purposes, an appropriate adjustment is required in order to compare tax and customs values. We also identified the cases in which interest charges are to be included in transaction value for the purposes of GVC Article 1, and the possible adjustments that could be required – in comparing tax and customs results – to account for such inclusion.

Subsequently, we examined the additions to customs value required under GVC Article 8. We observed that certain elements, such as buying commissions and certain types of assists and royalties which are not required to be added to customs value under Article 8, might be required to be added to the tax value of imported goods under some income tax statutes. In these cases, an adjustment to account for these elements might be necessary in comparing tax and customs values. It was also observed that adjustments to account for the exclusion of transport and insurance costs from customs value, are often necessary in cases of countries that adopted a FOB basis of valuation for customs purposes pursuant to GVC Article 8.

Finally, we examined the deductions from transaction value allowed under the Note to GVC Article 1. It was indicated that, when comparing tax and customs values, an adjustment for such elements may also be required to make customs and tax figures homogeneous.

Under Chapter V, we examined some adjustments an importer might be required to make to the price that is originally declared to customs, as a consequence of transfer pricing studies or determinations (usually for tax purposes). Compensating adjustments may be necessary when there is a cost-plus pricing and the customs entry is made when the costs have not been finalized. The importer would not be able to declare an arm's length price unless customs administrations permit him to introduce compensating adjustments to transaction value.

It was concluded that the use of pricing formulae or price review clauses is an appropriate way to introduce compensating adjustments to transaction value. Such pricing formulae or price review clauses have to be agreed upon prior to the entry of the goods through customs, and properly declared to customs at the time of such entry. Where adjustments to the transaction value are made under such conditions, the adjusted transaction value should be accepted as basis of appraisal under GVC Article 1, since such transaction value would be: (i) an arm's length value; (ii) the price actually paid or payable for the imported goods; and (iii) the transaction value definitively declared to customs. It was also concluded that customs legislation should provide for appropriate procedures to enable importers to submit provisional declarations of value, and subsequently to submit definitive declarations of adjusted values on which final appraisal should be based. In other words, customs administrations should delay the final determination of transaction value, in order to appraise the imported goods on the basis of the total final price paid or payable in accordance with the contractual stipulations.

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