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TRANSFER PRICING AND CUSTOMS VALUATION: KEY DIFFERENCES AND MITIGATION OF POTENTIAL RISKS

The paper analyzes tax risks for taxpayers and budget resulting from misalignment of the legal framework for determining transfer pricing and customs valuation of imported goods. The author has determined common and different features of the two methods of the import valuation. Justified various recommendations to address the potential risks arising from the differences in the above mentioned techniques in domestic legislation, as well as guidelines to create favorable conditions for taxpayers.

Key words: transfer pricing, customs valuation, usual price, import of goods.

JEL: H25

According to UNCTAD, 80% of world trade is related to the international trading network of multi-national enterprises. [1] A substantial share of cross-border transactions (from 30 to 60%) is accounted for by multinationals, that is between related parties. This creates undoubted risks for national tax systems, so they need fair taxation mechanisms of international companies.

Based on the same concept, namely arm's length price, transfer pricing (for collection of corporate income tax) and customs valuation (for collection of customs payments such as customs duties, import VAT and excise tax on imports) are needed to define the price of trade transactions for taxation purposes, and are very different methodologically. Because of this, it is very difficult if at all possible, to set a single price (tax base) for direct and indirect taxes within the same transactions.

Different tax base for the same operations for different taxes represent a number of considerable risks both for taxpayers and for budget. Businesses have to face excessive tax burden and issues with justifying contract prices for customs and/or tax authorities. And, for the tax and customs administrations, differences in tax pricing methodologies may lead to tax evasion.

The study conducted by J.Blauin, L.Robinson and J.Seidman showed that high customs duties may cause companies to change their approach to transfer pricing (e.g., choose a different method, use comparable transactions, etc.) in order

to reduce import tax burden. Meanwhile, if the coordination between tax units controlling income tax and those divisions in charge for collection of customs duties is weak, then, as a result of such a "creative" taxpayers' approach to transfer pricing, the state loses much more tax revenues [2]. So both honest taxpayers and tax administrations are interested in finding an approach that could bring together the prices of controlled operations, defined by different methods.

In Ukraine, tax treatment of transfer pricing was introduced with the adoption of the Law of Ukraine "On Amendments to the Tax Code of Ukraine Concerning Transfer Pricing" of 04.07.2013 № 408-18. And the Law of Ukraine of 28.12.2014 № 72-VIII to the Tax Code of Ukraine made various amendments in terms of improving tax control over transfer pricing.

The article's aim is to determine tax risks caused by methodological differences of customs valuation and transfer pricing of controlled transactions.

OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010 [3] is the basic document of transfer pricing regulation in many countries, including Ukraine. Transfer pricing as a technique to define the price of trade transactions for tax purposes is based on the «arm's length principle», whereby related parties carry out transactions with each other with the same prices as unrelated ones.

Customs valuation of goods in WTO member countries is carried out based on another document, namely the Agreement on Implementation of Art. VII of the General Agreement on Tariffs and Trade 1994 [4]. Art. 1 of the Agreement provides that "customs value of imported goods shall be the transaction value, that is, the price actually paid or payable for the goods when sold for export to the importing country ...". In this situation, the fact that the buyer and seller are related to each other shall not in itself be grounds for regarding the transaction value as unacceptable. In this case, the transaction value is accepted if the "circumstances surrounding the sale" showed that relationship between the parties has not affected the price. In practice, the customs authorities usually check – a) whether price was settled between related parties in the same way as it would have been settled for

non related parties; or b) whether the pricing mechanism corresponds to usual pricing practices for the given group of products.

Thus, at first glance, both approaches are similar: in terms of the need to check whether the price in a transaction between related parties corresponds to the price level of the transactions between unrelated companies. However, at the methodological level, transfer pricing and customs valuation of goods have the following differences (Table 1).

Table 1

The key differences between customs valuation and transfer pricing in Ukraine

Indicator	Customs valuation of goods	Transfer pricing
Subject of taxation	goods only	Goods, services and property
Periodicity	For each individual transaction	Aggregated basis/annual indicators
Time of implementation	During customs clearance	Implemented with a lag: tax control over compliance of the controlled transactions with the principle of "arm's length" may be exercised a few months after the transaction
Target indicator	Indicates the correspondence of the price of each import transaction to the market level	Indicates the correspondence of the company's profit for a certain period to the market level
Hierarchy	Clear hierarchy	No clear hierarchy. Method of uncontrolled comparable price is generally preferred, and if not possible, the resale price method and the method of "cost plus" are preferable to other methods
Budget risks	Importer is interested in understating customs value to reduce the customs amount	In case with import of the goods, the importer is interested in overstating the price to reduce its corporate income tax liabilities

Source: systematized by the author based on Tax and Customs Codes of Ukraine

To determine fair prices, different approaches and different legal acts prepared in different time are used worldwide, so the development of common principles for the two methods may take many years.

The OECD Guide on Transfer Pricing, that is the base for relevant national legislations of many countries, was adopted in 1995. But, in 2010 an updated version has been issued, which takes into account modern challenges and problems arising between transnational corporations and tax administrations. At the same time, Agreement on Implementation of the Art. VII of GATT was adopted a year earlier than the OECD Guide (in 1994), and has not been reviewed since then. However, since 1994 trade between related parties has intensified, so the procedure for determining the customs value of such transactions requires further clarification in greater details.

Agreement on Implementation of the Art. VII of GATT outlines general approaches to customs valuation of goods and does not always address the current pricing issues in transactions between related parties. According to Paragraph 2 (a) of the Article 1 of the Agreement, if the customs administration has reason to believe that the parties' relationship has influenced the purchase price of the goods, it should examine the "circumstances surrounding the sale." However, the Agreement does not define how exactly the customs administration should investigate these circumstances, and what procedures and documents should be applied and studied in the process. Paragraph 2 (b) of the Article 1 also provides that the transaction value in agreements between related parties shall be accepted as a basis for customs valuation purposes, if the importer demonstrates that such price "closely approximates" to the contract price in the sale between unrelated persons, or to the customs value of identical or similar goods.

But the agreement does not clarify the conditions under which the transaction value should be regarded as "closely approximating" The OECD Guidelines on Transfer Pricing has a concept of price range, when, based on comparable transactions, upper and lower limits of comparable prices, profitability, etc. (depending on the applicable method of transfer pricing) are defined. And, if

the price of a transaction between related parties falls within this range, it is deemed that such price complies with the principle of "arm's length", otherwise - that it does not. Customs valuation lacks a concept of acceptable price range, although it could clarify the issue what value of goods is "close enough" to the test value.

Thus the formation of a harmonized approach to price definition in transfer pricing and customs valuation of goods may require changing international treaties and agreements within the WTO, and this process may be rather time consuming and complicated. Thus, the Agreement on Implementation of Art. VII GATT was adopted during the Uruguay Round negotiations in the WTO, which ended in 1994. The next Doha Round began in November 2001 and its main achievement was the adoption of the "Bali Package" in December 2013. Meanwhile, the "Bali Package" covers only a small part of all the issues that were expected to be settled under the Doha Round.

Some of the methods of transfer pricing are very similar to those used in determining the customs value. Thus, transfer pricing comparable uncontrolled price method, is based on an idea of identification of similar transactions between unrelated parties, and the comparison of these transactions allows to determine the fair market price in controlled transactions. A similar approach is used in the methods of the customs valuation referring to the transaction value of identical or similar goods. In applying the resale minus transfer pricing method and the method of customs valuation based on deducted value, both methods take into account a price for which the imported (or similar/identical) goods are sold in Ukraine to unrelated buyers, as a basis for price calculation. The similarity between the transfer pricing method of "cost plus" and the method of determining the customs value on the basis of computed value is expressed in the fact that, in both cases it is necessary to determine the costs incurred in supplying goods and the usual amount of profit for these costs. However, even between "similar" methods there are a number of differences that may substantially affect the price (Tab. 2).

Methods of transfer pricing and customs valuation: key differences

Methods compared	Key differences
<p>Method of comparable uncontrolled price of transfer pricing and methods for determining customs value under the transaction value of identical/similar goods</p>	<p>In accordance with Articles 59 and 60 of the Customs Code, in case if, for the purposes of applying the method for identical goods, there is more than one transaction value, then, to define customs value, the least such value is to be used.</p> <p>When applying the method of comparable uncontrolled price, it is required to determine the price range based on comparable transactions with identical goods (pp. 39.3.3 of the Tax Code).</p> <p>To define customs value using the method of identical goods, coincidence in country of goods' origin is mandatory (for the method of similar goods, the country of origin may be different), while, for the method of comparable uncontrolled price, that coincidence is not required.</p> <p>For the methods of transfer pricing, it may be required to take into account the companies' market business strategies and the terms of payment, which are not required for the methods of the determining of customs value</p>
<p>Method of the resale price of transfer pricing and method of customs valuation based on deducted value</p>	<p>For the method of resale price, more important is the comparability of functions performed by each party in comparable transactions (pp. 39.3.2.8. of Ukraine's Tax Code) and of sharing risks arising in the process, while, for the method of determining customs value, the comparability of goods (e.g. origin, manufacturer etc.) is a primary characteristics (Art. 62 of Ukraine's Customs Code).</p> <p>"Deducted value" customs valuation method requires the deducting, from the local sale price, the expenses on commission or normal trade allowances and normal expenses incurred in Ukraine on loading, unloading, transportation, insurance and other expenses related to such transactions, while, with the method of resale price, such costs are disregarded.</p> <p>Deductive value customs valuation method provides that a comparable transaction must occur no later</p>

	<p>than up to 90 days after the importation of the goods being valued, (Art. 62 of Ukraine's Customs Code), while the method of resale price requires the use of information for the reporting tax period (year) (pp. 39.3.2.9. CLE).</p>
<p>"Cost plus" method of transfer pricing and method of customs valuation based on computed value</p>	<p>The method of customs valuation based on computed value is very rarely used both in Ukraine and in other countries [5]. Computed value is applicable only if the importer cannot apply the preceding methods. However, the price calculated under the "computed value" can be used by the importer as a test value to prove that the relationship between the seller and the buyer did not influence the price of goods declared in accordance with the primary method of determining the customs value (transaction value).</p> <p>On the other hand, the "cost plus" method is one of the most popular methods of transfer pricing because it is clear and easy to use in most accounting systems</p>

Source: systematized by the author based on Tax and Customs Codes of Ukraine

Despite the fact that the methods of customs valuation are applied in strict sequence, the mechanisms inherent in the methods as to identical and similar goods and on the basis of computed value, can be used to prove the reasonableness of the price declared as transaction value.

Table 2 analyzes the most similar methods, while other methods of customs valuation and transfer pricing have little in common. Thus, applying the method of determining the customs value based on contractual value of imported goods (or the first method) assumes that the price indicated in the customs declaration, already complies with the "arm's length principle" and the relationship of the parties the parties has not affected the price specified in the contract. Meanwhile the TP methods based on transfer pricing of net profit and profit distribution have no analogues among methods of determining the customs value.

Obviously, the methodological differences still do not allow solving the question of different approach to tax control over pricing on the global level, but, if

the legislation takes into account all potential risks caused by these differences, then, for individual taxpayers, solving disputes with customs and tax authorities would be quite realistic.

In world practice, one can highlight two problematic aspects that cause most controversy between customs authorities and taxpayers. First, it is the opportunity for the taxpayers to use transfer pricing documentation...in order to demonstrate whether the relationship of the parties to contract has influenced the price of the goods or not during customs clearance. Secondly, it is a possible adjustment of the goods' customs value after actual importation in the case of price change during transfer pricing, that is, in the case of proportional adjustment of prices in controlled transactions.

An effective way to resolve disputes between the tax administration and taxpayers is concluding advanced pricing agreements (APA). Before concluding advanced pricing agreement, the taxpayer and tax authorities shall negotiate the methods of pricing, sources of information, documentation, etc. So advanced pricing agreement provides the methodology for determining the price for the tax payers for all or some of their transactions with related parties. Advanced pricing agreement may contain significant (for customs valuation) information, which could be used as an evidence that the price paid in accordance with the given documents corresponds to the principle of "arm's length" - hence the relationship between the parties has not affected the contract value of the goods.

Advanced pricing agreement may be also used to justify, for customs purposes, the contract price and the circumstances surrounding the sale of goods. Customs administrations of some countries agree to accept advanced pricing agreement as documentary evidence to support the declared customs value. For example, the Canada Border Services Agency agrees to take into consideration the prices established under the advanced pricing agreement terms as the price paid or payable with adjustments in accordance with customs legislation. [6].

An alternative use of transfer pricing documentation for approval of the customs and transfer pricing has been proposed by the Customs and Border

Protection (Australia). After the conclusion of advanced pricing agreement (with tax authorities), the tax payer may request the Customs and Border Protection to obtain a ruling on the customs value (valuation advice), which is to justify the method of customs valuation and documentation acceptable to its confirmation, and, where necessary, also the way in which value adjustments are to be conducted [7]. So advanced pricing agreements (for income tax purposes) is a prerequisite for similar price coordination for customs purposes.

In South Korea, issues in determining the customs value for imports from a related party are settled through agreement on the coordination of prices during customs valuation (Korean Advanced Customs Arrangement). A prerequisite for the emergence of such a tool to resolve disputes between customs authorities and taxpayers was the intensification of the customs audits in Korea, which led to increased additional amounts of customs duties and penalties. As a result, the Korean businesses appealed to the customs authorities with a compromise proposal to seek for tools to resolve the conflict. [8] Agreement on the coordination of prices in the customs assessment procedure includes the procedure of determining the customs value of imported goods in import transactions between related parties and ensures that the company, which does not violate the treaty, will not be subject to audit by customs authorities. This agreement is a complete analog to that on harmonization of prices in controlled transactions concluded with the tax authorities for income taxation.

While taking account of the advanced pricing agreements by customs authorities could be a good option for defining single or approximate price for customs and tax purposes, which is not always possible. The procedure of concluding an agreement of price coordination is long and complex in practice. Such agreements are not concluded by all companies, which are subject to the regulation of transfer pricing. As shown by the experience of United Kingdom, annually the tax authorities are able to process only a few dozen applications for such agreements (Table. 3).

Application of advanced pricing agreements in the UK

Indicator	2009/2010	2010/2011	2011/2012	2012/2013
Applications submitted, annual	32	49	32	45
Agreements concluded, annual	20	35	32	47
Average duration of coordination procedure (months)	20,3	22,7	16,9	26

Source: Her Majesty's Revenue and Customs. – available at: <http://webarchive.nationalarchives.gov.uk/20140206152654/http://www.hmrc.gov.uk/international/transfer-pricing-stats.pdf>

In countries where transfer pricing legislation was introduced recently, the conclusion of advanced pricing agreement for taxpayers may be even more difficult. Thus, in Russia, where effective regulation of transfer pricing only began in 2012, such agreements were concluded only in isolated cases. In 2012 only one agreement was signed (with OJSC "NK Rosneft"), and in 2013 - 3 more agreements (with "Gazprom Neft», Aeroflot" and "Lukoil" [9]. We can assume that, in Ukraine, in the first years after the start of transfer pricing adjustment, the cases of conclusions of advanced pricing agreement will be isolated.

World Customs Organization (WCO) considers that the transfer pricing documentation can be an important source of information when it contains information about the circumstances surrounding the sale of goods [10] In our opinion, in Ukraine, according to the recommendations of the WCO and international practices, it is advisable for the customs authorities to treat transfer pricing documentation as proof of the circumstances surrounding the sale of goods, in cases where it is necessary and adequately perceived. However, the great variety of transfer pricing documentation prevents a clear legal definition of what documents may be acceptable for customs clearance. Therefore, the possibility of taking into account transfer documents largely depends on the professional abilities of customs officers and their readiness for a dialogue with business.

Another possible instrument that would regulate the issue of customs valuation and transfer pricing may be pricing agreement between taxpayer and customs administration (advanced customs valuation rulings). WTO Agreement on Trade Facilitation, approved during the Bali round negotiations at the end of 2013 (Art. 3), provides that the customs administration may issue preliminary binding decisions on the method and criteria for determining the customs value for a particular set of circumstances [11]. The introduction of such a tool in domestic practice would contribute to building constructive dialogue between taxpayers and fiscal authorities, reduce the number of disputes over the customs valuation, and thus would reduce the risk to budget revenues [12, p. 88].

Another important question that requires settlement is taxpayer's changing his obligations regarding the customs duties in the case of proportional adjustment. Item 39.5.5 of the Tax Code provides that, when, as a result of an audit of the correspondence of the conditions of controlled transactions to the principle of "arm's length", a supervisory body found a deviation from this principle, and made additional charges or adjustments to the negative value of the object of taxation or other tax indicators. In the case where the taxpayer made a self adjusting, the other party controlled operation, i.e. the related person has the right to adjust his tax obligations based on the conditions that correspond to the principle of "arm's length".

Customs Code and Tax Code of Ukraine do not contain any clear rules that would define obligations of the taxpayer to notify the customs authorities and to make changes in his customs declaration in case of the use of proportional adjustment. Taxpayers may carry out proportional adjustments of their tax obligations both towards increase and towards decrease in the prices of controlled transactions. In terms of domestic legislation, these two cases will have different effects for the taxpayer.

Let us consider the case where taxpayer intends to increase the price in controlled transactions. According to Item 3.3 of the Instruction on Monitoring the Export and Import Transaction approved by the NBU on 24.03.1999 No 136, the

bank removes control from the resident's transaction in case of the good's import with bringing it to Ukraine after receiving information about the transaction in the registry of customs declarations.

As the mentioned Instruction does not imply that the transfer of money can be based on the reports of the possibility of proportional adjustment, in order to transfer funds, in case of proportional adjustment of goods import transactions, the importer will need to submit adjusted customs declaration to confirm the legality of the payment. Thus, importer, in case of proportional adjustment and the need to transfer funds to non-resident will be required to apply to the customs authority to adjust the customs declaration.

In this situation it is important to determine whether the taxpayer to pay fines in case of upwards adjustment of the prices in controlled transactions. Art. 50 of the Tax Code provides that a taxpayer who individually reveals the fact of understatement of tax liability of past tax periods, shall submit a clarifying calculation and pay the amount of underpayment and penalty of 3% of the corresponding amount before the submission of the clarifying calculation. In case of upwards adjustment of the customs value, importer may be required to pay not only the appropriate customs duties, but also a fine. At the same time, the right to proportional adjustment is directly provided for in the Tax Code does not provide for payment of any penalty (item 39.5.5). Thus, the need to pay a fine in case of proportion adjustment is controversial.

Refund of excessively paid customs duties is another problematic situation that can occur as a result of a downward adjustment of customs value during proportional adjustment. In international practice, no single approach exists as to whether the customs authorities must refund the relevant amounts of import tax in case of price reduction during proportional adjustment. In this situation, in Austria, France, India, Italy and Switzerland, customs authorities do not reimburse any funds to the taxpayer. In some countries, namely China, Japan, Russia and UK such a refunding is not prohibited, but in practice almost never happens. [13]

In the Czech Republic, Germany and Korea, refund resulting from proportional refund adjustment is allowed if the possibility of adjusting the customs value was known during customs clearance. [13] For example, if a company concludes, with tax authorities, an advanced pricing agreements and this agreement contains a clause on the conditions of proportional annual adjustment, this clause can serve, at the customs point, evidence that the value indicated in the invoice is not final at the time of the goods' import. Therefore, the company has reasonable grounds for retrospective adjustment of customs value [14].

Gradually, more and more countries recognize the taxpayer's right for refund of customs duties during proportional adjustment. In the US, since 2012, an approach has been introduced whereby the policy on transfer pricing between related parties during import, is considered as an objective formula. Therefore, in case of proportional adjustment, a company can demand refund of overpaid taxes. [15] Since 2015, in Canada, the barriers to the refunding of customs payments in the case of proportional adjustment were removed as well [16]. Thus the approach entitling the importer with the right for refunding of indirect taxes in case of downward proportional price adjustment is becoming increasingly common.

Ukrainian legislation provides for the refund of overpaid tax if the customs declaration is modified annulled (Art. 301 of the Customs Code). However, the key question is whether customs authorities consider proportional adjustment as sufficient grounds for the amendment of the customs declaration and refunding. The answer to this question is ambiguous and requires legal regulation. In particular, it is appropriate to include, in Art. 301 of the Customs Code, a provision stating that a sufficient reason for the refund of customs duties is application of proportional adjustment in accordance with Clause. 39.5.5 of the Tax Code.

Besides, many disputes between tax authorities and taxpayers may be due to the binding of VAT tax credit to transfer pricing. Thus, according to Clauses 198.3 of the Tax Code, tax credit of the reporting period is determined with regard to contractual (contract) value of goods / services (which, in case of controlled

transactions is not higher than normal level of prices determined in accordance with Art. 39 of the Code).

First, the national legislation does not define which operations are controlled for the purposes of VAT collection. Clause 39.1.2 of the Law of Ukraine "On Amendments to the Tax Code of Ukraine concerning transfer pricing" of 04.07.2013 № 408-18 establishes that "pricing during controlled transactions is carried out (in accordance with the methods formulated in Clause 39.3 of this article) to verify the correctness and completeness of the calculation and payment of corporate income tax and value added tax." However, the Law of Ukraine "On Amendments to the Tax Code of Ukraine in the context of the improvement of tax control over transfer pricing" of 28.12.2014 № 72-VIII changes the provisions of Article 39 and stipulates that the control over transfer pricing only applies to income tax.

Secondly, para. 198.3 of the Tax Code creates the risk that an entity will not be able to include the full amount of VAT paid when importing goods in the amount of tax credit. Thus, if, during customs clearance, the customs office disagrees with the declared customs value and makes upward adjustments, the company will have to pay more taxes, including VAT. However, when determining the price of a controlled transaction, tax authorities may determine the price level below the one that was installed by the customs authority. As a result, the company will determine the tax credit, given the price less than the under which they made payment of VAT during customs clearance. Therefore, the company will have to reduce the amount of claimed tax credit and pay the penalty [12, c. 91].

Linking indirect taxes to prices in controlled transactions is not typical for most countries. Obviously, current version of Clause 198.3 is aimed at fighting evasion of indirect taxes. However, such linking has a negative impact on the activities of bona fide taxpayers and investment environment, and therefore the rules governing transfer pricing should not create limitations to determining the base of import VAT and the corresponding tax credit.

Conclusions

The analysis allows concluding that the national legislation still has many uncertainties as to how customs authorities should work under the implementation of improved regulation of transfer pricing. An undoubtful step towards taxpayers would be enabling customs authorities to accept documents on transfer pricing as a confirmation of the circumstances of the sale of goods between related parties, which would be consistent with international practices and recommendations of the World Customs Organization.

For effective operation of customs authorities, after the adoption of the new legislation on transfer pricing in Ukraine, it is necessary prepare an official document, that would clarify the customs' attitude as to assessment and refunds of indirect taxes in case of proportional adjustment and envisage providing the customs with necessary documents and procedures for enforcement.

To resolve the conflicting rules in the Tax Code, it is necessary to stipulate that, in case of proportional adjustment in accordance with par. 39.5.5, the fines under Art. 50 from the taxpayer will not be charged. In international practice, in such cases, fines are rarely imposed. It should be noted that the right to proportional adjustment is provided by the Tax Code (and such adjustment needs a prior agreement with the tax authorities) so the adoption of such rules would guarantee the taxpayers a legal right to use proportionate adjustment.

The attitude of customs authorities around the world as to the return of customs payments in case of price reduction with a proportional adjustment is ambiguous. More and more countries conclude that, in such cases, overpaid taxes need to be refunded, especially if the possibility of correction was known at the time of customs clearance. Taxes with proportional adjustment are usually refunded in those countries that are trying to promote conscientious business so Ukrainian fiscal authorities too should adopt this practice.

So far, harmonization of the methods of customs valuation and transfer pricing has not been reached at the global level. Obviously, international documents regulating

pricing for tax purposes need to be changed and adapted to modern challenges. The procedure of adoption of such documents is long and complex, while taxpayers and fiscal authorities require immediate settlement in many situations. Therefore it is necessary, both at the legislative level and at the level of fiscal authorities, to make it possible to create proper conditions for the harmonization of the two methodologies and solution of problematic issues for a particular taxpayer.