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Customs Valuation and Transfer Pricing

Two Sides of the Same Coin

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Commercial and Tax Law

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Abstract

The purpose of this master's thesis is to examine and analyse how a transfer pricing adjustment is made and how related parties should handle price adjustments from a customs perspective in Sweden. The examination includes describing the valuation methods available for transfer pricing and customs valuation with regards to related parties. In addition, the differences in connection to the valuation are described and analysed.

Goods imported to Sweden must be cleared through customs: the importer presents a customs declaration to the Swedish Customs and pays customs duty. The customs duty is calculated using a customs value and customs valuation is the system that enables the importer to establish correct customs values on imported goods. Transfer pricing is the determination of prices on transactions taken place between companies belonging to the same group and has a direct effect on the income tax payable. There are six customs valuation methods that are hierarchically applied and six transfer pricing methods that are applied somewhat differently. There are similarities between the methods and most of the customs valuation methods have a corresponding transfer pricing method, or vice versa. Even if there are similarities, many factors make reconciliation of the methods difficult. Such factors are the different time for assessing the value and that the customs valuation methods are applied in a strictly hierarchical way with no possibility to choose the most suitable method.

Customs duties and transfer pricing both share the same valuation concept, although interpreted differently, being that the value shall be based on the price that the parties would arrive at under open market conditions. However, relevant values on the same transaction differ significantly due to trying to be in accordance with respective rules. The differences in expectations and the conflicting interests on the outcome of the valuation lead to problems in the tax field. As a conclusion, customs valuation and transfer pricing can undeniably be described as "the two opposing and necessary sides of the same 'coin', whose respective values unavoidably affect the whole balance of a system of closely connected valuation".

In order for related parties to use the transaction value method, which is the superior customs valuation method, the price must not have been influenced due to their relationship. If one of two tests prescribed by law can prove that

the relationship has not influenced the price, the related parties can use the transaction value method to establish the customs value. If the transaction value, for some reason cannot be used, the importer has to address other options on to how to establish the customs value.

The conclusion of this master's thesis is that related parties should include a price review clause in their contract or pricing policy. The company should notify the Swedish Customs about the provisional price and make an incomplete customs declaration. When information enabling the calculation of the customs value is available, the importer should file a complementary declaration. As an alternative, the importer should declare an open claim to the Swedish Customs arguing that the transaction value cannot be applied and, as a consequence thereof, explain in the customs value declaration why the applied customs value is correct.

This thesis provides three recommendations concerning how to deal with the complications of customs valuation and transfer pricing. The first recommendation is that rules and recommendations surrounding transfer pricing and customs valuation should, to the extent possible, be harmonised. The second recommendation is that co-operation between the Swedish Tax Agency and the Swedish Customs must improve, for example through advance pricing arrangements for both transfer pricing and customs purposes, documentation requirements, and joint audits. The third recommendation is that related parties should take the same care and documentation approach for customs purposes as it does for transfer pricing. Importing companies should make a price review clause in their contract before the importation and present an incomplete customs declaration. This way, in case of adjustments, the related party is able to uphold an arm's length standard on the price and has the possibility to use the preferred transaction value for customs purposes, if that is desirable.

Abbreviation list

ACV	Agreement on Implementation of Article VII of the GATT ('Agreement on Customs Valuation')
AEO	Authorised Economic Operator
APA	Advance Pricing Arrangement
ACVA	Advance Customs Valuation Arrangement
CCC	Community Customs Code
CCIP	Implementation of Community Customs Code
CPM	Cost Plus Method
CUP	Comparable Uncontrolled Price
CV method	Customs Valuation method
CVM	Computed Value Method
DVM	Deductive Value Method
EC	European Community
e.g.	<i>exempli gratia</i>
EU	European Union
Etc.	<i>Et cetera</i>
GATT	General Agreement on Tariffs and Trade
Ibid	<i>ibidem</i> ('in the same source')
IBFD	International Bureau of Fiscal Documentation
i.e.	<i>id est</i> ('that is to say')
MCC	Modernised Customs Code
No.	Number
OECD	Organisation for Economic Co-operation and Development
p.	Page
pp.	Pages
para.	Paragraph
paras.	Paragraphs
PSM	Profit Split Method
RPM	Resale Price Method

RÅ	Regeringsrättens Årsbok (the Annual Compilation of Judgements and Orders from the Supreme Administrative Court)
PwC	PricewaterhouseCoopers
SEK	Svenska enkronor (Swedish Currency)
TFH	Swedish Customs' legislation handbook
TNMM	Transactional Net Margin Method
TPD	Transfer Pricing Documentation
TPG	OECD Transfer Pricing Guidelines
TP method	Transfer Pricing method
TVM	Transaction Value Method
TVI method	Method of Transaction Value of Identical goods
TVS method	Method of Transaction Value of Similar goods
VAT	Value Added Tax
Vol.	Volume
WCO	World Customs Organisation
WTO	World Trade Organisation

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Maria Malm

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1 Introduction

1.1 Background

With the economic globalisation, an increasing number of companies, of all sizes, conduct business in multiple countries. Multinational groups have increased during the last years and international transactions (cross-border transactions) between related parties (i.e. companies belonging to the same group) play an important part in world trade and economy. Furthermore, globalisation provides the opportunity for economic development and growth through intensified cross-border trade, investments and services.¹ In 1993, more than one-third of world trade occurred within groups.² Today, about 60 percent of the global cross-border world trade occur within multinational groups.³ The expansion in world trade has however led to more complex taxation issues for both tax authorities and the companies themselves.⁴

According to Statistics Sweden⁵, the value of Swedish exports of goods for the period January to December 2008 amounted to 1,194 billion SEK, and imports to Sweden amounted to 1,087 billion SEK.⁶ With the knowledge that most of world trade occur within international groups, a group's transfer pricing policy has a major influence on states' tax bases.⁷

The price of goods (transfers of physical goods and intangible property) and services provided to a related party is called a transfer price.⁸ The economic globalisation and the increase of cross-border trade have not silently passed national governments. Accordingly, as an effort to take control over the situation of transfer pricing compliance, to avoid double taxation and protect their countries' tax base, many states have issued

¹ Ping, Liu and Caroline Silberstein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, World Commerce Review, Vol.1 Issue 1, 2007, p. 36.

² UNCTAD, *World Investment Report 1995 (Overview)*, "Transnational Corporations and Competitiveness", p. 23, accessed 14 November 2009 from http://www.unctad.org/en/docs/wir1995overview_en.pdf.

³ Swedish Tax Agency, *Internprissättning*, accessed 9 September 2009 from <http://www.skatteverket.se/fordigsomar/foretagare/foretagareallmant/internprissattning.4.3dfca4f410f4fc63c8680005982.html> and Ping, Liu and Caroline Silberstein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 36. See also Hamaekers, Hubert, "Arm's Length – How Long?", in Kirchhof, Paul, Moris Lehner, Arndt Raupach and Michael Rodi (eds.), *International and Comparative Taxation: Essays in Honour of Klaus Vogel* (English version edited by Kees van Raad), 2002, p. 29

⁴ Organisation for Economic Co-operation and Development's (OECD) *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995-2000)* (TPG), "Preface", para. 1. See further TPG, "Preface", paras. 2 to 4.

⁵ In Swedish: 'Statistiska Centralbyrån'.

⁶ Statistics Sweden, accessed 22 October 2009 from http://www.scb.se/Pages/PublishingCalendarViewInfo____259923.aspx?PublObjId=9436.

⁷ Swedish Government bill 2005/06:169 *Effektivare skattekontroll m.m.*

⁸ TPG, "Preface", para. 11.

transfer pricing regulations.⁹ Companies within the same group located in different tax jurisdictions, therefore, need to be aware of applicable transfer pricing regulations and recommendations when transferring goods, services and other property.

Cross-border transactions between related parties are not only important from a transfer pricing perspective but also from a customs perspective.¹⁰ This since cross-border transactions probably involves an importation, which means that a customs duty has to be paid to the customs authority, see section 2.2. The customs duty is based on the customs value.¹¹ When establishing the customs value, as well as establishing a transfer price, there are certain valuation methods available. These two valuation systems provides a way the taxpayer to establish correct customs value and transfer price, and as a result pay the correct customs duty and income tax.¹²

Customs duties and transfer pricing share the same valuation concept, being that the value shall be based on the price that the parties would arrive at under open market conditions.¹³ However, when it comes to establishing a correct customs value and transfer price, relevant value on the same transaction may differ significantly due to trying to be in accordance with respective rules.¹⁴ The existence of two sets of rules for transfer pricing and customs duties, and, as in many countries, including Sweden, two different administrative authorities that deal with direct taxes and customs duties, can make cross-border trade overly complicated and costly.¹⁵

1.2 Purpose

The purpose of this master's thesis is to examine and analyse how a transfer pricing adjustment (including retrospective adjustment) is made and how related parties should handle price adjustments from a customs perspective in Sweden. The examination includes describing the valuation methods available for transfer pricing and customs valuation with regards to related parties. In addition, the differences in connection to the valuation are described and analysed.

Transfer pricing is not only an international issue due to cross-border transactions between related parties, but also a domestic problem because of a conflicting situation between national customs and tax authorities. This thesis attempts to discuss and analyse possible solutions to the inconsistency of a shared concept of value with conflicting interests of the outcome of the valuation.

⁹ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 36.

¹⁰ Fabio, Massimo, *Customs Law of the European Union*, Kluwer Law International, 2009, pp. 4 – 23 to 24.

¹¹ Swedish Customs, *Tullvärde*, accessed 9 September 2009 from <http://www.tullverket.se/sokordao/t/tullvarde.4.4ab1598c11632f3ba9280003301.html>.

¹² Swedish Customs, *Tullvärde* and TPG, para. 1.68.

¹³ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, ERA Forum, 2008, p. 399.

¹⁴ Fabio, Massimo, *Customs Law of the European Union*, pp. 4 – 23 to 24.

¹⁵ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 36.

1.3 Methodology

The methods used in this thesis are an adjusted traditional juridical method and, to some extent, a comparative method. The comparative method is used when the different methods are compared and also when discussing the connection of customs valuation and transfer pricing and the differences in valuation. The traditional juridical method¹⁶ uses existing sources of law with the purpose to affirm what rules of law are available (*de lege lata*) or what rules of law necessary to be created by the legislator (*de lege ferenda*).¹⁷ According to this method, laws and other statutes are the prime source of law, followed by preparatory work and case law. The last source of law to address in the order of priority of the juridical method is legal doctrine.¹⁸ However, the method used in this thesis is an adjusted version of the traditional legal method focusing on *de lege lata*. The reason for an adjusted method is a lack of extensive laws and preparatory work on transfer pricing and customs valuation in Sweden. There is, in principle, no modern case law on the area of customs valuation in conjunction with transfer pricing. Most of the materials used in this thesis are therefore regulations and guidelines from the European Community (EC), the World Trade Organisation (WTO) and the Organisation for Economic Co-operation and Development (OECD). However, most of these regulations and guidelines have been incorporated into Swedish law and are considered applicable in Sweden.¹⁹ The reason why reference is made to international sources of law is that Swedish law, in some cases, directly refers to the mentioned statutes.²⁰ Nonetheless, some Swedish laws and preparatory work are used when they provide explicit and specific information concerning Sweden. Legal doctrine is, especially when the problem concerns complicated issues, the source that primarily elaborates solutions and develops the legal progress.²¹ This thesis, therefore, with the objective of more sophisticated discussions on the subjects, uses legal doctrine, such as articles, books and information for example from the Swedish Tax Agency and the Swedish Customs, to a great extent.

Article VII of the General Agreement on Tariffs and Trade (GATT) 1994, and particularly the WTO Agreement on Implementation of Article VII of the GATT 1994 (ACV), are regarded as the most important international sources of customs value legislations and function as a framework when it comes to customs valuation.²² Article VII of

¹⁶ In Swedish: 'rättsdogmatisk metod'.

¹⁷ Lehrberg, Bert, *Praktisk Juridisk Metod*, 4th edition, Iustus Förlag AB, Uppsala 2001, p. 38.

¹⁸ Bernitz, Ulf et al, *Finna rätt – Juristens källmaterial och arbetsmetoder*, 8th edition, Norstedts Juridik AB, Stockholm 2004, pp. 27-28.

¹⁹ See for example *Arm's length value for customs duty purposes (Sweden)*, International Bureau of Fiscal Documentation (IBFD), accessed 3 November 2009 from <http://online2.ibfd.org.bibl.proxy.hj.se/data/tp/tp2/TP-SWE.CS1.doc.p0080.html> and RÅ 1991 ref. 107, the 'Shell-Case'.

²⁰ See for example Article 1.1 of the Swedish Customs Act (2000:1281) which refers to the Community Customs Code (CCC) and implementing provisions (CCIP) for rules concerning customs value (i.e. the regulations have not transferred the text into Swedish law only makes a reference).

²¹ Bernitz, Ulf et al, *Finna rätt – Juristens källmaterial och arbetsmetoder*, p. 28.

²² World Trade Organization (WTO), *Value of declared goods, International level*, accessed 9 September 2009 from http://ec.europa.eu/taxation_customs/customs/customs_duties/declared_goods/international/index_en.htm.

GATT lays down the general principles of valuation for customs purposes, while the ACV lays down the methods of customs valuation.²³ The Interpretative Notes to the ACV are agreed interpretations of GATT Articles and form an integral part of the ACV. The Articles in the ACV are to be read and applied in conjunction with their respective notes.²⁴ Article VII of the GATT has to be integrated into the national customs legislation of each of the WTO members to be applicable. This provision is applicable in Sweden since Sweden has been a member since the start of the WTO in 1995.²⁵²⁶ Article VII of the GATT can only be seen as a frame law concerning valuation for customs purposes. It only states that the value for customs purposes should be based on the actual value, and if the actual price cannot be ascertainable, the value should be based on the nearest ascertainable equivalent for such value.²⁷ The ACV is the complementary regulation to Article VII of the GATT and describes more in detail the customs valuation process.

Since Sweden is also a member of the EU, regulations from the EC are applicable law.²⁸ The EU currently consists of 27 Member States.²⁹ Provisions in the ACV have been transposed into directly applicable EC customs legislation. This transposition is in the form of the European Community Customs Code³⁰ (CCC) and its implementing provisions³¹ (CCIP). These regulations provide for identical customs treatment of goods that enter the EU and have as their purpose to avoid disturbance of the internal market.³² EC legislation, Swedish legislation and various Government authority regulations relevant

²³ Satapathy, C., *Implementation of WTO Agreement on Customs Valuation*, Economic and Political Weekly, Vol. 35, No. 25, 2000, p. 2101 (see note 4), accessed 22 September 2009 from Stable URL: <http://www.jstor.org/stable/4409407>.

²⁴ Article 14 of the WTO Agreement on implementation of Article VII of the General Agreement on Tariffs and Trade (GATT) 1994 (ACV) and WTO, *State Trading Enterprises: Technical Information*, "The rules", accessed 19 October 2009 from http://www.wto.org/english/tratop_e/statra_e/statra_info_e.htm.

²⁵ WTO, *The understanding of the WTO: the Organizations, Members and Observers*, accessed 17 September 2009 from http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm.

²⁶ Article VII of the GATT, *Valuation for Customs Purposes*, para. 1. See also WTO, *Value of declared goods, International level*.

²⁷ Article VII of the GATT, *Valuation for Customs Purposes*, para. 2 (a-b).

²⁸ EU-upplysningen, *EU-regler i Sverige*, accessed 9 September 2009 from <http://www.eu-upplysningen.se/Lagar-och-regler/Sverige-och-EG-ratten/EU-regler-i-Sverige/>. See also Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, IBFD, International Transfer Pricing Journal, September/October 2005, p. 200.

²⁹ Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Great Britain, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain and Sweden.

³⁰ Council Regulation (EEC) No 2913/92 of 12 October 1992 establishing the Community Customs Code (CCC). In Swedish: 'Tullkodex'.

³¹ Commission Regulation (EEC) No 2454/93 of 2 July 1993 laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 establishing the Community Customs Code (CCIP). In Swedish: 'Tillämpningskodex'.

³² Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 200.

to the Swedish Customs are collected in Swedish Customs' legislation handbooks³³ (TFH).³⁴ EC regulations (the CCC and the CCIP) and the Swedish Customs Act (2001:1281) which constitute the basic customs regulation in Sweden, can be found in TFH III:1.³⁵ The Swedish Customs Act refers in Article 1 to the CCC and the CCIP for rules about customs duty. The Swedish Customs Act only includes complementing provisions since the EC regulations constitute directly applicable law in Sweden.³⁶

The provisions regarding customs valuation in the CCC are substantially the same as in the ACV. The ACV is therefore being used as the basic legal source concerning customs valuation in this thesis. Further reference is made to the CCC, CCIP or other legal information when suitable. However, the European Parliament and the Council has issued a Modernised Customs Code³⁷ (MCC). The MCC has not yet been implemented into EU's Member States and this thesis, therefore, regards the CCC as applicable law.

Concerning transfer pricing, it is primarily the OECD that sets the international standard through its Model Tax Convention³⁸ (OECD Model Tax Convention) and Transfer Pricing Guidelines³⁹ (TPG). The OECD encourages its member countries to follow the TPG.⁴⁰ OECD material has gained acceptance in all OECD member countries, both in bilateral treaty networks as well as in the countries' tax statutes and implementing regulations.⁴¹

The TPG are far more detailed than the general provisions in the ACV and its Interpretative Notes regarding transactions between related parties.⁴² The TPG are therefore used as a complementary source when needed during the discussions in this thesis. Even if the provisions in the TPG and the ACV are having an international applicable standard, practices in application can vary at national level by customs and tax authorities

³³ In Swedish: 'Tullverkets författningshandbok'.

³⁴ Swedish Customs, *Legislation*, accessed 23 October 2009 from <http://tullverket.se/en/startpage/legislation.4.16ca6de0120cf835feb80004273.html>.

³⁵ Swedish Customs' legislation handbook, *TFH III:1 - Tullkodex m.m.*.

³⁶ EU-upplysningen, *EU-regler i Sverige*.

³⁷ Regulation (EC) No 450/2008 of the European Parliament and of the Council of 23 April 2008 laying down the Community Customs Code (Modernised Customs Code).

³⁸ OECD Model Tax Convention on Income and on Capital 2005 (OECD Model Tax Convention).

³⁹ OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995-2000) (TPG).

⁴⁰ TPG, "Preface", para 16.

⁴¹ Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, Series on International Taxation, Kluwer Law International, Volume 28, 2002, p. 2. See also Swedish Tax Agency, *Internprissättning*, accessed 9 September 2009 from <http://www.skatteverket.se/fordigsomar/foretagare/foretagareallmant/internprissattning.4.3dfca4f410f4fc63c8680005982.html>.

⁴² Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, p. 14.

and also, to a certain degree, from country to country.⁴³ This thesis is based on these international standards but where there are differences in application in the Swedish statutes, these are presented.

1.4 Terminology

A ‘retrospective adjustment’ is the terminology used for describing a change in a company’s transfer price that is made sometime after the importation of the goods, for example, at the end of the fiscal year. An ‘after-importation amendment’ is used to describe when a change is made on the customs value after the goods has been imported into Sweden.

The importing company (the buyer) is in this thesis seen as both the ‘taxpayer’ and the one being the ‘importer of record’. ‘Taxpayer’ is, however, used when discussing transfer pricing and ‘importer’ is respectively used when discussing customs issues.

Competent authorities for income tax and customs in Sweden are the Swedish Tax Agency and the Swedish Customs.⁴⁴ The word ‘authority’ is, however, used when making general references to such types of government bodies.

1.5 Delimitations and Presumptions

For the purpose of this thesis, it is presumed that goods are imported to Sweden from an unspecified third country outside the European Union’s (EU) customs territory and is released for free circulation in Sweden (and in the EU).⁴⁵ This thesis only focuses on physical goods being imported and that they are liable to customs duty. Other types of assets, such as intangible property, falls outside the scope of this thesis since specific and often complicated rules apply for these types of property. The presumption that the goods are coming from an unspecified country is made in order to not complicate the thesis by describing another country’s potential export rules or other relevant legislations. Customs valuation is at current time a very interesting topic in developing countries,⁴⁶ but a discussion about customs valuation in developing countries falls outside the scope of this thesis and is not considered. Customs duty is only one of the indirect taxes connected to the importation of goods; another important indirect tax is Value Added Tax (VAT). VAT is, however, outside the scope of this thesis and constitutes as delimitation. The OECD has recently released a Proposed Revision of Chapters I-III of the TPG.⁴⁷ The proposed revision is open for public comment until the beginning of January 2010.⁴⁸ Since it only is a proposed revision with an unknown effect, this thesis only

⁴³ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 36.

⁴⁴ In Swedish: ‘Skatteverket’ and ‘Tullverket’.

⁴⁵ Fabio, Massimo, *Customs Law of the European Union*, pp. 4 – 28 to 29.

⁴⁶ See for example article: Satapathy, C., *Implementation of WTO Agreement on Customs Valuation*.

⁴⁷ OECD Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines.

⁴⁸ *OECD releases new transfer pricing guidelines*, International Tax Review, accessed 4 November 2009 from <http://www.internationaltaxreview.com/Default.asp?Page=10&PUBID=35&ISS=25495&SID=722819&TYPE=2>.

uses the existing applicable TPG. The final presumption is that the parties at hand are related, since that is a necessity in order for a discussion about related parties' choice of customs valuation method to take place.⁴⁹ The thesis does not take into account different national legislations of what constitutes related parties. The prerequisite for being a related party as stated in the ACV is briefly mentioned in section 5.2.

1.6 Disposition

The first chapter after the introductory chapter, chapter 2, contains information about the two main areas of this thesis; customs value and transfer pricing. The chapter describes and defines information used throughout the thesis. The purpose of this chapter is to introduce the reader to the subject and give necessary background information for further understanding. The following chapter, chapter 3, discusses more in detail the connection of customs valuation and transfer pricing. The chapter focuses on presenting the underlying problems and provides the basis for the analysis of this thesis. Even if the valuation methods are not the main focus in this thesis, it is necessary that the reader has basic knowledge about them in order to understand further discussions about the variances in valuation. Chapter 4, therefore, describes all established valuation methods for both customs and transfer pricing. The chapter also contains a brief comparison of the valuation methods. The focus in this thesis is related parties' use of valuation methods. Hence, the following chapter briefly discusses the definition of related parties. Chapter 5 also contains a discussion about the possibility to use the transaction value method as the customs valuation method and what tests are necessary to be able to show that the relationship has not influenced the price. Chapter 6 is the final chapter before the analysis and contains the discussion about adjustments, which is the main focus in this thesis. The chapter describes the problems with adjustments and what characterisations and categories there are. Chapter 6 also contains strategies for solving potential problems with adjustments. The analysis is situated in chapter 7 and analyses and discusses the problems presented in previously chapters. The final chapter in this thesis, chapter 8, contains the conclusion, which focuses on answering the purpose of this thesis. Chapter 8t also contains recommendations for solving the problem concerning the conflict between customs valuation and transfer pricing. Recommendations are also provided on how related parties optimally should handle adjustments and amendments.

⁴⁹ See Fabio, Massimo, *Customs Law of the European Union*, p. 4 – 24.

2 Customs Value and Transfer Pricing

2.1 Introduction

This chapter contains definitions and background information concerning customs value and transfer pricing. The objective of the chapter is to provide a better understanding of discussions and elaborations in following chapters. The chapter defines customs value and transfer price including the arm's length principle. It further describes the availability of advance rulings, documentation requirements and the concept of Authorised Economic Operator (AEO).

2.2 Importation and Customs Value

When goods (or services) enter Sweden from a place outside the EU territory, an importation has taken place. To be able to use or sell the goods in Sweden, the goods have to be cleared through customs, which means to present a customs declaration to the Swedish Customs. In addition, charges for duty (customs duty), VAT and other taxes have to be paid.⁵⁰ Since Sweden is a member of the EU, which is a single customs union with one common customs border, there are no customs barriers between Sweden and other EU Member States. Consequently, only goods coming from a state outside the EU customs territory need to be cleared through customs. Regions or states not included in this territory are called third countries.⁵¹

In addition to the customs declaration, if a customs value has to be determined the importer also has to present a customs value declaration. A customs value declaration form⁵² must be filled in if the importer is liable to pay customs duty and the importation exceeds 97,400 SEK.⁵³ The objective of this requirement is that the importer has to show all costs, or other circumstances, that may have affected the price of the imported goods.⁵⁴

In principle, all information necessary for the calculation of customs duties must be available at the time of importation. The Swedish Customs, however, accepts incomplete customs declarations⁵⁵ if not all required information or documents are available for establishing the correct customs value of the goods to be imported.⁵⁶ It is not required to have a permit for submitting an incomplete declaration since the customs of-

⁵⁰ Swedish Customs' fact sheet, *Importing goods*, p. 6, accessed 9 September 2009, from <http://tullverket.se/download/18.3cc1940611667e5db7f80005546/importing+goods.pdf>.

⁵¹ Ibid, p. 1.

⁵² In Swedish: 'Tullvärdedeklaration', Customs Value Declaration Form Tv 745.1.

⁵³ Swedish Customs, TV 790.14, *Tullvärdehandledning*, pp. 25 to 26, accessed 9 September 2009 from <http://tullverket.se/download/18.7ebd8a201190f9e732f80001614/tullv%C3%A4rdehandledningen+tv790.14.pdf>.

⁵⁴ Swedish Customs' fact sheet, *Importing goods*, p. 6.

⁵⁵ See Articles 253.1 and 253 to 259 of the CCIP concerning incomplete declarations.

⁵⁶ Swedish Customs' fact sheet, *Importing goods*, p. 7 and Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, pp. 208 to 209.

office makes a decision from one case to another. As soon as the necessary information or documents are available, the importer should present a complementary declaration.⁵⁷

In order to establish the customs duty to be paid on the imported goods, which is calculated using the customs value as the basis, a customs valuation is necessary. The definition of customs valuation is a customs procedure applied to determine the customs value of imported goods.⁵⁸ The customs value is multiplied by an *ad valorem*⁵⁹ rate of duty (e.g. 5 percent) in order to arrive at the amount of payable duty.⁶⁰ The process of customs valuation can be very problematic and according to the WTO, “just as serious as the actual duty rate charged”.⁶¹ Fabio agrees and states that “[t]he correct determination of the customs value is certainly one of the most delicate issues to deal with when crossing a border”.⁶² The ACV therefore aims at a fair, uniform and neutral system for the valuation of goods for customs purposes.⁶³

2.3 Transfer Pricing

When goods are sold between related parties situated in different tax jurisdictions, there is a risk that they stipulate incorrect transfer prices on transactions made between them. A transfer pricing analysis is then necessary in order to control that the arm’s length principle is attained in the transfer pricing policy. Furthermore, to control that companies do not intend to transfer profits to foreign countries, especially with low-taxation systems.⁶⁴

To solve the problem with deviating transfer pricing, the OECD has issued recommendations on how transfer prices should be set.⁶⁵ If associated companies do businesses with each other, the determination of prices should be as if they were independent parties.⁶⁶ This recommendation constitutes the arm’s length principle. This principle seeks to achieve a fair allocation of tax revenues amongst tax authorities and to avoid double taxation.⁶⁷ Arm’s length transfer prices are achieved through applying the most suitable

⁵⁷ Swedish Customs’ fact sheet, *Importing goods*, p. 7.

⁵⁸ WTO, *Customs Valuation: Technical Information*, “Technical Information on Customs Valuation”, accessed 9 September 2009 from http://www.wto.org/english/tratop_e/cusval_e/cusval_info_e.htm.

⁵⁹ Latin for “according to value”.

⁶⁰ WTO, *Customs Valuation: Technical Information*, “Technical Information on Customs Valuation”.

⁶¹ WTO, *Customs Valuation*, accessed 8 September 2009 from http://www.wto.org/english/tratop_e/cusval_e/cusval_e.htm.

⁶² Fabio, Massimo, *Customs Law of the European Union*, Kluwer Law International, 2009, p. 4 - 23.

⁶³ WTO, *Customs Valuation*.

⁶⁴ Fabio, Massimo, *Customs Law of the European Union*, pp. 4 – 23 to 24. See also Swedish Government bill 2005/06:169 *Effektivare skattekontroll m.m.*, p. 88.

⁶⁵ TPG, “Preface”, paras. 8 to 9. See also Swedish Government bill 2005/06:169 *Effektivare skattekontroll m.m.* pp. 88 to 89.

⁶⁶ Article 9 of the OECD Model Tax Convention, and the principle is expressed through the Swedish ‘rule of rectification’ in Chapter 14, Section 19 of the Swedish Income Tax Act (1999:1229).

⁶⁷ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 37.

transfer pricing method that provides the best estimation of the price.⁶⁸ In Sweden, about 22,000 companies are affected by the rules of transfer pricing.⁶⁹

2.4 Advance Pricing Arrangement and Advance Customs Valuation Arrangement

2.4.1 Advance Pricing Arrangement

An advance pricing arrangement (APA) is an arrangement that determines, before the controlled transactions take place, an appropriate set of criteria (e.g. method, comparables and the appropriate adjustments, critical assumptions as to future events) for the determination of the transfer pricing for the controlled transactions over a fixed period of time. An APA may be unilateral; involving one tax administration and a taxpayer, or multilateral; involving the agreement of two or more tax administrations.⁷⁰ An APA is formally initiated by a taxpayer and requires negotiations between the taxpayer, one or more related parties and one or more tax authorities. The purpose of an APA is to supplement the traditional administrative, judicial and treaty mechanism for resolving transfer pricing issues.⁷¹

The Swedish government has recently published a government bill⁷² proposing the introduction of a law that makes it possible to apply for an APA in Sweden. If the Swedish Parliament approves the bill, the new law will be effective as of January 2010.⁷³

2.4.2 Advance Customs Valuation Arrangement

An advance customs valuation arrangement (ACVA) is a unilateral arrangement entered into by the importer and the customs authority. The purpose of the ACVA is to allow the taxpayer to proactively seek advance approval of the import prices determined between related parties. ACVAs provide a way for the taxpayer to avoid, or at least minimise often unpleasant debatable audits by customs authorities. The ACVA would, therefore, safeguard import prices from post-importation audits, similar to the protection provided under an APA for transfer pricing purposes.⁷⁴

ACVAs are not implemented in Sweden and cannot be found in the provisions of the ACV or the CCC.⁷⁵

⁶⁸ TPG, para. 1.69.

⁶⁹ Swedish Tax Agency, *Internprissättning*, accessed 9 September 2009 from <http://www.skatteverket.se/fordigsomar/foretagare/foretagareallmant/internprissattning.4.3dfca4f410f4fc63c8680005982.html>.

⁷⁰ TPG, "Glossary".

⁷¹ TPG, para. 4.124.

⁷² Swedish government bill 2009/10:17 *Prissättningsbesked vid internationella transaktioner*.

⁷³ *Ibid*, p. 2.

⁷⁴ Lee, Jong Yul, Wang Gi Ahn and Chris Sung, *Customs APA: Introduction of Advance Customs Valuation Arrangements*, IBFD, *International Transfer Pricing Journal*, May/June 2008, p. 159.

⁷⁵ An ACVA has, however, been introduced in Korea after several years of an increasing intensity of customs audits and inspections.

2.5 Documentation Requirement

Sweden has a documentation requirement for transfer pricing purposes since 2007.⁷⁶ The transfer pricing documentation (TPD) shall include, for example, information about the company and its transactions with related parties and a description of chosen transfer pricing method.⁷⁷ The provision is only a frame law and more information can be found in regulations from the Swedish Tax Agency.⁷⁸ Recommendations for international standards concerning TPD requirements can be found in Chapter V of the TPG. For customs purposes, documentation is not a requirement in Sweden.

2.6 Authorised Economic Operator

AEO is a joint EU certificate programme designed to increase the world security as well as to harmonise the customs related operations within the EU and make them more efficient. Every company can apply to have an AEO status, if necessary due to cross-border trade and the AEO status is valid in every EU Member State. The AEO status serves as a mark of good quality and security for companies and their related parties. It also provides access to certain simplifications, which in turn makes goods flow faster and more secure.⁷⁹

⁷⁶ Chapter 19, Section 2a and b of the Swedish Tax Return and Statements of Income Act (2001:1227).

⁷⁷ Chapter 19, Section 2 (a) of the Swedish Tax Return and Statements of Income Act.

⁷⁸ Swedish Tax Agency's regulations on documentation of transfer pricing between associated enterprises, SKVFS 2007:01 (English Version see SKVFS 2007:01B).

⁷⁹ Swedish Customs, *Authorised Economic Operator, AEO*, accessed 6 November 2009 from <http://tullverket.se/en/startpage/keywordsaz/az/authorisedeconomicoperatoraeo.4.2337793011afcaba766800010.html>.

3 Connection between Customs Valuation and Transfer Pricing

3.1 Introduction

The connection between customs and transfer pricing has existed at least since 1973.⁸⁰ The relationship between seller and buyer and the situation of crossing of a border was in the past managed separately. This means that transfer pricing was, and still is, regarded as a matter of direct taxation. Customs, on the other hand, being a harmonised indirect tax, has been regarded as a matter of logistics. Today, the two situations are more linked together due to the increased expansion of multinational groups and cross-border transactions.⁸¹ Fabio describes the connection of transfer pricing and customs value as being “the two opposing and necessary sides of the same ‘coin’, whose respective values unavoidably affect the whole balance of a system of closely connected valuation”.⁸²

The connection between customs valuation and transfer pricing constitutes the basis for this thesis and that is discussed in this chapter. The concept of an arm’s length principle for the purpose of both transfer pricing and customs valuation are discussed as well as whether the different taxes share this principle or not. This chapter also discuss the issue of conflicting interests in the outcome of the valuation and what reasons can be found behind this conflict.

3.2 Sharing the Arm’s Length Principle

The wording in Article 1.2 (a) of the ACV⁸³ stating “that the relationship [of the related parties] did not influence the price” is clearly similar to the OECD concept of the arm’s length standard.⁸⁴ The arm’s length principle has briefly been described in section 2.3. The fact that “the circumstances surrounding the sale shall be examined”⁸⁵ in order to find out if the relationship between the related parties has influenced the customs value, is as close as customs valuation regulations come to providing an arm’s length test.⁸⁶ It is therefore clear that both sets of rules share the requirement of using an arm’s length standard when establishing the price for cross-border transactions between related parties.⁸⁷

⁸⁰ Van Herksen, Monique, *Transfer Pricing and Customs Valuation – Two worlds to tax as one*, p. 1, accessed 14 November 2009 from http://www.ibfd.org/portal/pdf/TPCV_sample.pdf.

⁸¹ Fabio, Massimo, *Customs Law of the European Union*, p. 4 - 25.

⁸² *Ibid*, p. 4 - 25.

⁸³ Correspondent in Article 29.2 (a) of the CCC.

⁸⁴ See Article 9.1 of the OECD Model Tax Convention and further discussed in Chapter 1 of the TPG. The issue of related parties is discussed in chapter 5 of this thesis.

⁸⁵ Article 1.2 (a) of the ACV.

⁸⁶ Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, p. 12 (see the page’s footnote no. 29).

⁸⁷ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 36 and Fabio, Massimo, *Customs Law of the European Union*, p. 4 - 27.

The arm's length principle is generally applied by many customs authorities as a principle of comparison between a good's value imported by related parties and by independent parties.⁸⁸ The objective of both valuation systems is that the price should not be affected by the fact that the transaction is entered into by related parties, or even better; that this fact is disregarded.⁸⁹

To be able to determine the fulfilling of an arm's length price on transactions between related parties, according to the TPG, a comparison has to be made of comparable controlled and uncontrolled transactions. This comparison can also be described as making a comparability analysis and the economically relevant characteristics of the situation being compared have to be sufficiently comparable.⁹⁰ Even if the TPG explicitly discuss comparability, the ACV⁹¹ does not make any reference to a comparability analysis. The Interpretative Note to Article 1.2 states that “[w]here it can be shown that the buyer and seller, although related [...], buy from and sell to each other as if they were not related, this would demonstrate that the price had not been influenced by the relationship.”⁹² This statement indicates that there is a clear similarity between the comparability analysis for transfer pricing purposes and demonstration of correct prices for customs valuation purposes. The idea of comparability is, according to Jovanovich, clearly present in the provisions of the ACV, simply not explicitly stated.⁹³

3.3 Different Outcome of the Valuation

3.3.1 Introduction

Customs valuation and transfer pricing, initially, share the same concept of value.⁹⁴ The tax and customs authorities have the objective to ensure that related parties are trading on an arm's length basis. Nonetheless, the competent authorities have different points of view regarding the valuation of the goods. Companies can find themselves being pulled in opposite directions due to the conflicting interests of the two authorities. The transfer price for company tax purposes and declared value for customs purposes are not necessarily the same.⁹⁵ Both customs valuation and transfer pricing are both referred to as taxes. They are, nonetheless, based in completely distinct disciplines and this distinction constitutes the most determinative difference of the two systems; customs valuation be-

⁸⁸ TPG, para. 1.65.

⁸⁹ Fabio, Massimo, *Customs Law of the European Union*, p. 4 - 27.

⁹⁰ TPG, para. 1.15. See also Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, pp. 12 and 18 and Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 37.

⁹¹ Article 1.2 of the ACV.

⁹² Interpretative Note to Article 1.2, para. 3.

⁹³ Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, p. 19.

⁹⁴ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 399.

⁹⁵ *Attaining Customs Valuation compliance after implementation of your new Transfer Pricing Documentation*, PwC, Worldtrade Management Service, “Key Issues”, p. 1, accessed 14 October 2009 from http://pwccustoms.com/webmedia/doc/633862784661964638_customs_valuation_compliance.pdf.

longs to the area of indirect taxation while transfer pricing belongs to the area of direct taxation.⁹⁶ The main reason to why the situation of a conflicting valuation exists is that the taxpayer/importer and the tax and customs authorities have different points of view. Another reason is different expectations on the value from a revenue and customs perspective.⁹⁷ The competent authorities also have different focuses.⁹⁸

There are, as stated by Ping and Silberztein, some significant differences in the application of the arm's length standard. They describe them as being "policy objectives, operational functioning, timing of valuation, valuation methods, documentation requirements and dispute resolution mechanisms".⁹⁹ Some of these differences are discussed throughout the thesis: documentation requirements in section 2.5, the difference in valuation (policy objectives) and timing of valuation are described hereafter in section 3.3.2 and valuation methods are discussed in section 4.4.

3.3.2 Reasons for Differences in Valuation

3.3.2.1 Different Focus

Competent authorities for revenue and customs have a different focus. The tax authority usually regards the whole taxable income and profitability of an operating entity over a period of time and focuses on the accuracy of a transfer price as reflected on an annual tax return.¹⁰⁰ The reason is because transfer pricing, mostly, uses an annualised pricing determination.¹⁰¹ Conversely, the customs authority focuses on applying duties against the value of the goods at the time of entry into the customs territory.¹⁰² Customs is a transaction-based indirect tax and the determination of the customs value is, therefore, transaction-specified.¹⁰³

This difference in focus leads to especially two important complications; tax point variance and problems concerning audit adjustments. The tax point variance, or the time for assessing the value, is for customs on a time-specific tax point (for example, the moment of importation or the delivery date). Transfer pricing, on the other hand, has a time-deferred tax point (for example, the date of sale or purchase or the annual return).¹⁰⁴ An example of this: on January 1, a Foreign Parent Company sells goods to its

⁹⁶ Van Herksen, Monique, *Transfer Pricing and Customs Valuation – Two worlds to tax as one*, p. 3.

⁹⁷ Fabio, Massimo, *Customs Law of the European Union*, p. 4 - 25.

⁹⁸ *International transfer pricing 2009*, PwC, p. 168.

⁹⁹ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 36.

¹⁰⁰ *International transfer pricing 2009*, PwC, p. 168.

¹⁰¹ Ainsworth, Richard Thompson, *IT-APA:s Harmonizing Inconsistent Transfer Pricing Rules in Income Tax – Customs – VAT*, Working Paper Series, Law and Economics, Working Paper No. 07-23, 2007, p. 14. Can be downloaded from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1013518.

¹⁰² *International transfer pricing 2009*, PwC, p. 168.

¹⁰³ Ainsworth, Richard Thompson, *IT-APA:s Harmonizing Inconsistent Transfer Pricing Rules in Income Tax – Customs – VAT*, p. 14.

¹⁰⁴ *Ibid*, p. 14.

Subsidiary for 10. This purchase is then aggregated with other inventory purchases for a total value of 100,000. On March 15 the following year the total value is reported as costs of goods sold on the annual income return. If the customs value on January 1 is 10, the company should be able to confirm that when the purchase of specific goods are aggregated into other costs for income tax purposes the following March 15, the base amount included on that return is also 10.

Price adjustments (retrospective adjustments) can, for direct taxes, be made many years after the date of a specific transaction. The problem is how to be able to carry these adjustments back into prior customs filings (i.e. how to make necessary after-importation amendments on the customs value).

Example: it has been three years since the tax return in the previous example was filed. The aggregated price for the purchase of the goods is adjusted on tax audit from 100,000 to 150,000. The adjustment on 50,000 is to be carried back to specific transactions involved and also make after-importation amendments on the customs returns filed. The problem is, however, to break down the adjustment on transactions and not just report the total sum of adjustments.¹⁰⁵

In Sweden, a tax audit can take place up to five years after the assessment year, but the assessment of customs duties can only be made up to three years after the submission and acceptance on a customs declaration.¹⁰⁶ The problems with adjustments are further discussed in chapter 6.

3.3.2.2 Different Expectations on the Value – Customs and Tax Authorities

Another important reason behind the different points of view on valuation is the different expectations on the valuation of tax and customs authorities. Jovanovich describes this as the authorities “pulling the importer/taxpayer in opposite directions”.¹⁰⁷ The tax authority, naturally, seeks a result that will maximise the amount of tax to ensure the greatest possible income in its country. Therefore, the tax authority generally wants a low value on the transaction for income tax purposes.¹⁰⁸ Fabio describes this as the tax authority wanting the costs borne by the importer to be reasonably low, and should not have a negative influence on the taxable income for direct taxation purposes. This is especially important when the selling related party is situated in a country with a low tax rate; the tax authority then wants to prevent profits from being transferred from the country of importation to a country with lower tax rate.¹⁰⁹ The customs authority also

¹⁰⁵ Ainsworth, Richard Thompson, *IT-APA:s Harmonizing Inconsistent Transfer Pricing Rules in Income Tax – Customs – VAT*, p. 14.

¹⁰⁶ Article 4, Section 13 of the Swedish Tax Assessment Act (1990:324) and Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 406. See Chapter 6, Section 26 of the Swedish Customs Act about customs audits.

¹⁰⁷ Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, “Introduction”, p. xvi.

¹⁰⁸ *Ibid*, p. xvi. See also Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 400.

¹⁰⁹ Fabio, Massimo, *Customs Law of the European Union*, p. 4 - 25.

has a similar collection mission, but reversibly, it wants the customs value to be reasonably high. A high value will maximise the collectable customs duty.¹¹⁰

Ping and Silberztein describe the conflicting interest of the authorities differently; explaining it as different natural inclinations of the customs and tax authorities. A customs representative would naturally want to verify whether or not the declared value was under-estimated, as the customs would be interested in collecting more duties. The tax representative, on the other hand, would try to verify if the transaction value was over-estimated, as the tax authority would be interested in limiting what would be regarded as an excessive deductible amount of tax.¹¹¹

3.3.2.3 Conflicting Interests – Taxpayer/Importer Point of View

Another reason is that there are conflicting interests in relation to customs and income tax from a taxpayer/importer point of view. The importer generally wants to have a low customs value resulting in lower amount of customs duties. However, when it comes to tax purposes, the taxpayer generally, wants to have a high transfer price for the same goods in order to increase deductible costs in the country of importation since it would result in less taxable income and, consequently, a lower amount of tax.¹¹²

As described by Ping and Silberztein, a customs specialist of a multinational enterprise would want to declare an imported value on the lowest side of the range, while the tax expert would probably want to have a higher transfer price in order to generate greater deductions and therefore less taxable income.¹¹³ This has the result of a conflict of interests.

3.3.3 Examples

Maisto describes two illustrative examples of the differences between the valuation methods for customs and direct tax.¹¹⁴ In the first example, Company (C) manufactures products in an unspecific country X and then sells it to its Subsidiary (S) in another country Y. The sales price per item charged by C to S is 600. In connection with the distribution, S undertakes marketing functions, which go beyond activities that an independent distributor would undertake under similar circumstances. C also sells identical products in the same quantities to third parties in country Y. The third-party distributors (DD) are engaged at the same commercial level as S, but they are not engaged in the extra marketing activities, which may be estimated in the range of 200. The price paid by the DD is 800 for each item.

¹¹⁰ Fabio, Massimo, *Customs Law of the European Union*, p. 4 - 25 and Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, “Introduction”, p. xvi.

¹¹¹ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 36.

¹¹² TPG, para. 1.67 and Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 400.

¹¹³ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 36.

¹¹⁴ Maisto, Guglielmo, *Cross-Border Valuation for Income Tax, Customs Duties and VAT*, IBFD Bulletin, March 2001, p. 112.

Chart 3-1 Differences in Valuation - Example 1

	Direct Taxes	Customs Duties
Comparable (price paid by DD)	800	800
Adjustment required to permit comparability (extra marketing functions)	200	0
Arm's length price	600	800

The situation in the second example is that a Company (C) in country X sells product manufactured in country X to its Subsidiary (S) located in country Y, an EU Member State. The sales price charged by C to S is 500 per item. A third party (MFC) located in country Y manufactures and sells identical goods in country Y for 630 per item.

C also sells identical products in the same quantities to third-party distributors (DD) located in country Z, another EU Member State. The price charged by C to DD is 550 per item. Third parties in country Y do not manufacture any products, while identical products are sold in country Z by third parties for 600 per item.

Chart 3-2 Differences in Valuation - Example 2

	Direct Taxes	Customs Duties
Comparable (price charged by C to DD in country Z)	Not applicable	550
Comparable (price charged by MFC in country Y)	630	Not applicable
Arm's length price	630	550

The markets in countries Y and Z are for direct tax purposes not comparable and, therefore, the sales by S to third parties in country Z do not constitute a basis for determining the transfer price.

The sales made by MFC in country Y constitute a comparable for direct tax purposes, but cannot be used as a comparable for customs purposes because, according to Article 7.2 (a) of the ACV¹¹⁵, the determination of a customs value may not be made on the basis of "the selling price in the country of importation of goods produced in such country".¹¹⁶

¹¹⁵ Correspondent in Article 1.2 (a) of the CCC.

¹¹⁶ Maisto, Guglielmo, *Cross-Border Valuation for Income Tax, Customs Duties and VAT*, p. 112.

3.4 Concluding Comments

The connection between customs valuation and transfer pricing has been made obvious through discussions in this chapter. The differences in expectations and the conflicting interests on the outcome of the valuation, nevertheless, lead to problems in the tax field. The situation at national level depends on the degree of divergence of the rules and of co-ordination of tax and customs authorities. These authorities are not obliged to accept a value that is calculated in accordance with each other's legislative requirements.¹¹⁷ The TPG suggest that the problem with conflicting interests can be resolved by a greater co-operation between tax and customs authorities.¹¹⁸ This and other possibilities to solve the conflicts are addressed further on in the thesis.

¹¹⁷ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 37.

¹¹⁸ TPG, para. 1.67.

4 Valuation and Pricing Methods

4.1 Introduction

This chapter introduces the available valuation methods for the purpose of customs and transfer pricing. The customs valuation methods (CV methods) are first described followed by the transfer pricing methods (TP methods). The final section in this chapter briefly compares the two systems. The comparison is made in order to support the analysis in this thesis concerning the lack of reconciliation and to understand how adjustments can affect the price.

4.2 Customs Valuation Methods

4.2.1 Introduction

This section describes the six different established CV methods. The methods are applied in a strictly hierarchical way.¹¹⁹ The methods for establishing a correct customs value are:

1. Transaction Value method (TVM);
2. Method of transaction value of identical goods (TVI);
3. Method of transaction value of similar goods (TVS);
4. Deductive value method (DVM);
5. Computed value method (CVM); and
6. Residual method.

4.2.2 Method of Transaction Value

Article 1 of the ACV¹²⁰ stipulates that customs valuation shall, except under specific circumstances, be based on the actual price of the goods to be valued. The actual price is usually the one shown on the invoice. This price, plus mandatory additions and deductions listed in Article 8 of the ACV, constitutes the transaction value. The transaction value method (TVM) is the first method to apply when establishing a correct customs value and the most important method of valuation referred to in the ACV.¹²¹ This valuation method is approximately used on 95 percent (2005) of all imports into the EU.¹²²

The transaction value can only be used as the customs value if the conditions in Article 1 of the ACV are fulfilled and the required adjustments in Article 8 of the ACV¹²³ have been made correctly. Articles 1 and 8 of the ACV must, therefore, be read together.¹²⁴

¹¹⁹ “General Introduction Commentary” paras. 1 to 4 of the ACV and Interpretative Notes, “General notes, Sequential Application of Valuation of Methods”. See also Article 30.1 of the CCC.

¹²⁰ Correspondent in Article 29 of the CCC.

¹²¹ “General Introduction Commentary” para. 1 of the ACV.

¹²² Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 204.

¹²³ Correspondent in Article 32 of the CCC.

¹²⁴ “General Introduction Commentary” para. 1 of the ACV.

According to Article 8 of the ACV, adjustments can result in (i) adding costs to the transaction value; to the extent such costs have not been included, and (ii) excluding costs from the value. Examples of elements to be included in the transaction value are: commissions and brokerage, the cost of packing and royalties and licence fees related to the goods being valued.¹²⁵ According to the Interpretative Note to Article 1, costs to be excluded are, if specified separately: (a) charges for construction, erection, assembly and maintenance or technical assistance, undertaken after the importation on imported goods such as industrial plant, machinery or equipment, (b) the cost of transport after importation, and (c) duties and other taxes to be paid due to the importation.¹²⁶ The Swedish Customs also excludes costs such as buying commissions and cost for the right to reproduce the imported goods in the EU.¹²⁷

The conditions to be fulfilled in Article 1 of the ACV in order to use the transaction value are that:

- There must be evidence of a sale for export to the country of importation (i.e. commercial invoices, contracts, purchase orders, etc.);¹²⁸
- There are no restrictions to the disposition of the goods by the buyer;¹²⁹
- The price is not subject to conditions or considerations;¹³⁰
- No part of the proceeds of any subsequently resale, disposal or use of the goods by the buyer will accrue to the foreign seller;¹³¹ and
- The buyer and seller are not related, as stated in Article 15.4.¹³²

<p>$A + B - C = \text{Customs Value}$</p> <p>A = Transaction value (price actually paid or payable)</p> <p>B = Elements listed in Article 8 of the ACV</p> <p>C = Elements listed in the Implementing Note to Article 1 of the ACV</p>

Figure 4-1 Customs Value using the Transaction Value Method

¹²⁵ Article 8.1 of the ACV.

¹²⁶ Interpretative Note to Article 1, “Price Actually Paid or Payable”, para. 3.

¹²⁷ Swedish Customs, TV 790.65, *Vad ingår i tullvärdet?*, p. 6. Accessed 9 September 2009 from <http://tullverket.se/download/18.4ab1598c11632f3ba9280005563/tullv%C3%A4rdet%2C+vad+ing%C3%A5r+i+tv790.65.pdf>.

¹²⁸ Article 1.1 of the ACV and WTO, *Customs Valuation: Technical Information*, “Technical Information on Customs Valuation”.

¹²⁹ Article 1.1 (a) of the ACV.

¹³⁰ Article 1.1 (b) of the ACV.

¹³¹ Article 1.1 (c) of the ACV.

¹³² Article 1.1 (d) of the ACV.

4.2.3 Method of Transaction Value of Identical Goods

If the conditions in Article 1 of the ACV cannot be fulfilled or if there is no transaction value, the customs value has to be determined using an alternative method. Since the application of CV methods is hierarchical, the second method to use when establishing a customs value is the transaction value of identical goods (TVI) under the provisions in Article 2 of the ACV.¹³³

Article 2 of the ACV¹³⁴ states that the customs value shall be the transaction value calculated on identical goods. To be able to use the method of TVI, the goods have to be (i) sold for export in the same country of importation and (ii) exported at or about the same time as the goods being valued.¹³⁵

When applying the TVI method, the optimal solution is to use a sale of identical goods at the same commercial level and in substantially the same quantities as the goods being valued. Where no such sale can be found, it is possible to use a transaction value of a sale of identical goods under one of the following three conditions:

1. A sale at the same commercial level but in different quantities;
2. A sale at different commercial level but in substantially the same quantities; or
3. A sale of different commercial level and in different quantities.

If a sale can be found under any of the above stated conditions, adjustments will be made as the case may be, for:

1. Quantity factors only;
2. Commercial level factors only; or
3. Both commercial level and quantity factors.¹³⁶

An adjustment, whether it leads to an increase or decrease in the value, must however be made only on the basis of demonstrated evidence that clearly establishes the reasonableness and accuracy of the adjustment.¹³⁷ An example of acceptable evidence in the Interpretation Note to Article 2 is an existing valid price list containing prices referring to different commercial levels or different quantities.¹³⁸

There are certain requirements that need to be fulfilled in order to use the TVI. The goods according to Article 15.2 of the ACV have to be:

- The same in all respects including physical characteristics, quality and reputation;¹³⁹ and

¹³³ “General Introduction Commentary” paras. 1 to 2 of the ACV. See Article 30.1 of the CCC.

¹³⁴ Correspondent in Article 30.2 (a) of the CCC.

¹³⁵ Article 2.1 (a) of the ACV.

¹³⁶ Article 2.1 (b) of the ACV and Interpretative Note to Article 2.

¹³⁷ Article 2.1 (b) of the ACV.

¹³⁸ Interpretative Note to Article 2, para. 5.

¹³⁹ Article 15.2 (a) of the ACV.

- Produced in the same country and produced by the producer as the goods being valued.¹⁴⁰

There are, however, some acknowledged exceptions, in particular where (i) there are no identical goods produced by the same person in the country of production of the goods being valued, goods produced by a different person in the same country may be taken into account, and (ii) minor differences in appearance would not disqualify goods which otherwise conform to the definitions from being regarded as identical.¹⁴¹

4.2.4 Method of Transaction Value of Similar Goods

If the customs value cannot be determined under Articles 1 or 2 of the ACV, meaning that there is no transaction value for the goods and no identical goods can be found, the third CV method shall be used.¹⁴² Article 3 of the ACV¹⁴³ states that the customs value subsequently is calculated using the method of transaction value of similar goods (TVS). Just as with identical goods, in order to be able to use the TVS method, the goods have to be (i) sold for export in the same country of importation and (ii) exported at or about the same time as the goods being valued.¹⁴⁴

The TVS has the same application requirements as the TVI; applying similar goods in a sale at the same commercial level and in substantially the same quantity using proper adjustments.¹⁴⁵ Similar goods are goods which:

- Closely resembles the goods being valued in terms of component materials and characteristics;
- Are capable of performing the same functions and are commercially interchangeable with the goods being valued;¹⁴⁶ and
- Are produced in the same country as and by the producer of the goods being valued.¹⁴⁷

4.2.5 Deductive Value Method

According to Article 4 of the ACV, if the customs value cannot be determined under the first three articles, the customs value shall be determined under the provisions of Article 5 or 6 of the ACV (reversible articles depending on the situation at hand and if re-

¹⁴⁰ Article 15.2 (d-e) of the ACV.

¹⁴¹ Article 15.2 (a and e) of the ACV.

¹⁴² Article 3.1 (a) of the ACV.

¹⁴³ Correspondent in Article 30.2 (b) of the CCC.

¹⁴⁴ Article 3.1 (a) of the ACV.

¹⁴⁵ Article 3.1 (b) of the ACV with comparison to Article 2.1 (b) of the ACV.

¹⁴⁶ Article 15.2 (b) of the ACV.

¹⁴⁷ Article 15.2 (d-e) of the ACV.

quested by the importer). Article 5 of the ACV¹⁴⁸ contains the deductive value method (DVM) and Article 6 of the ACV¹⁴⁹ the computed value method (CVM).

The DVM in Article 5 of the ACV states that the customs value is determined on the basis of the unit price at which the imported/identical/similar goods are sold to an unrelated buyer in the greatest aggregated quantity in the country of importation.¹⁵⁰ The prerequisites to use this method are that:

- The buyer and the seller in the importing country cannot be related; and
- The sale must take place at or about the time of importation of the goods being valued. If no sale took place at or about the time of importation, it is permitted to use sales up to 90 days after importation of the goods being valued.¹⁵¹

The greatest aggregated quantity is the basis for establishing the customs value. The greatest aggregated quantity is the price at which the greatest number of units is sold in sales to unrelated persons at the first commercial level after importation at which such sales take place. To determine this, all sales at a given price are taken together and the sum of all the units of goods sold at that price is compared to the sum of all the units of goods sold at any other price. The greatest number of units sold at one price represents the greatest aggregated quantity.¹⁵²

The starting point when calculating the deductive value is, as already stated, the sale price in the country of importation. It is therefore necessary to apply various deductions in order to determine the appropriate customs value. Relevant deductions to be made as stated in Article 5 of the ACV are:

- Commissions usually paid or agreed to be paid, or the sum of profits and general expenses added in connection with sales in such country of imported goods of the same class and kind;
- The usual transport costs and corresponding insurance when these costs are usually incurred within the country of importation;
- Cost and charges in Article 8.2 of the ACV, when applicable; and
- Customs duties and other national taxes payable in the country of importation by reason of the importation or sale of the goods.¹⁵³

4.2.6 Computed Value Method

Article 6 of the ACV contains the CVM, which states that the customs value shall consist of the sum of certain costs. The CVM determines the customs value on the basis of

¹⁴⁸ Correspondent in article 30.2 (c) of the CCC.

¹⁴⁹ Correspondent in Article 30.2 (d) of the CCC.

¹⁵⁰ Article 5.1 (a) of the ACV.

¹⁵¹ Article 5.1 (a-b) of the ACV.

¹⁵² Interpretative Note to Article 5, para. 1.

¹⁵³ Article 5.1 (a.i-iv) of the ACV. See also WTO, *Customs Valuation: Technical Information*, “Method 4 - Deductive value”.

the production cost of the goods being valued, plus an amount for profit and general expenses usually reflected in sales from the country of exportation to the country of importation of goods of the same class or kind and other expenses necessary to add.¹⁵⁴ According to the WTO the CVM is the most difficult and rarely used method.¹⁵⁵

4.2.7 Residual Method

If none of the first five CV methods can be used to determine the customs value, it is possible to use a residual method. This method is found in Article 7 of the ACV¹⁵⁶. It states that the customs value can be determined using reasonable means consistent with the principles and general provisions of the ACV, Article VII of GATT 1994 and on the basis of data available in the country of origin.¹⁵⁷

4.3 Transfer Pricing Methods

4.3.1 Introduction

This section describes the six TP methods that can be used to set and evaluate transfer prices consistency with the arm's length principle. There are three traditional transaction methods, two transactional profit methods, and one "other" method.¹⁵⁸ The traditional methods should be regarded before the profit methods but each method is not suitable for every possible situation and the taxpayer can choose the most suitable method that provides the best estimation of an arm's length price.¹⁵⁹ Even if the traditional transaction methods theoretically are preferable, practical difficulties can be in the way of the application of these methods. If there is no available data, or insufficient quality on available data, it is hard to rely on the traditional transaction methods.¹⁶⁰

The transfer pricing methods described are:

1. Comparable uncontrolled price (CUP) method;
2. Resale price method (RPM);
3. Cost plus method (CPM);
4. Profit split method (PSM);
5. Transactional Net margin method (TNMM); and
6. Other method.

¹⁵⁴ Article 6.1 (a-b) of the ACV.

¹⁵⁵ WTO, *Customs Valuation: Technical Information*, "Method 5 - Computed value". Examples of production costs, profit and general expenses and other expenses can be found in Interpretative Note to Article 6 of the ACV.

¹⁵⁶ Correspondent in Article 31 of the CCC.

¹⁵⁷ Article 7.1 of the ACV.

¹⁵⁸ TPG, Chapters II and III.

¹⁵⁹ TPG, paras. 1.68 to 1.69.

¹⁶⁰ TPG, para. 2.49.

4.3.2 Traditional Transaction Methods

4.3.2.1 Comparable Uncontrolled Price Method

The most direct and preferred way to establish whether the conditions made or imposed between associated companies are at arm's length is to compare the prices charged in controlled transactions undertaken between those companies with prices charged in comparable transactions undertaken between independent parties.¹⁶¹ If there is a difference between the two prices, it may indicate that the conditions are not at arm's length. The price should be set as equal to the price charged between independent parties. This method to establish a transfer price is the first of the traditional transaction methods and is called the comparable uncontrolled price (CUP) method.¹⁶² An uncontrolled transaction is comparable to a controlled transaction in the CUP method 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.¹⁶³

There are not always comparable transactions available to make an accurate comparison using the CUP method. It may therefore be necessary to make a comparison using other less direct indicia from controlled and uncontrolled transactions to establish whether the conditions between related parties are arm's length.¹⁶⁴

4.3.2.2 Resale Price Method

The second of the traditional transaction methods is the resale price method (RPM). The RPM calculates the transfer price beginning with a price at which a product that has been purchased from an associated company is resold to an independent company. This resale price is then reduced by a 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 subtracting the gross margin can be regarded as an arm's length price for the original transfer of property between the associated companies. The RPM is, according to the TPG, most useful where it is applied to marketing operations.¹⁶⁵

4.3.2.3 Cost Plus Method

The third, and final, traditional transaction method is the cost plus method (CPM). The calculation using this method begins with the cost incurred by the supplier of property in a controlled transaction for property transferred to a related purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of

¹⁶¹ TPG, paras. 2.6 to 2.7.

¹⁶² TPG, para. 2.6.

¹⁶³ TPG, para. 2.7.

¹⁶⁴ TPG, para. 2.5.

¹⁶⁵ TPG, para. 2.14.

functions performed and current market conditions. The price reached after adding the cost plus mark-up can be regarded as an arm's length price of the original controlled transaction. The CPM is, according to the TPG, most useful in cases where semi-finished goods are sold between related parties or where related parties have concluded joint facility agreements or long-term buy-and-supply arrangements.¹⁶⁶

4.3.3 Transactional Profit Methods

4.3.3.1 Profit Split Method

The first of the two transactional profit methods is the profit split method (PSM). This method can be used when transactions are very interrelated and when independent parties have set up some form of partnership and have agreed to a form of profit split. The PSM 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 companies would have expected to realise from engaging in the transaction or transactions. The method first identifies the profit to be split for the associated companies from the controlled transactions in which the associated companies are engaged. It then splits those profits between the related parties on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement at arm's length.¹⁶⁷

4.3.3.2 Transactional Net Margin Method

The second transactional profit method is the transactional net margin method (TNMM). It examines the net profit margin relative to an appropriate base that a taxpayer realizes from a controlled transaction. The TNMM operates in a manner similar to the CPM and the RPM. The net margin of the taxpayer from a controlled transaction should ideally be established by reference to the net margin that the same taxpayer earns in comparable uncontrolled transactions. If this is not possible the net margin that would have been earned in comparable transactions by an independent enterprise may serve as a guide.¹⁶⁸

4.3.4 Other Method

A taxpayer may in some special cases use a method not described in the TPG and also, for difficult cases, use various methods in conjunction. The most important thing to keep in mind is that the transfer price must satisfy the arm's length principle and that the company should have a TPD showing how its transfer prices were established.¹⁶⁹

4.4 Comparison of Methods

It is not sufficient to restrict the determination of value to transfer pricing issues when there is a cross-border transaction. It is also necessary to determine the value for customs purposes and how the value for income taxation purposes affects the customs value. Even if there is a correlation between the valuations, there is no support of recon-

¹⁶⁶ TPG, para. 2.32.

¹⁶⁷ TPG, para. 3.5.

¹⁶⁸ TPG, para. 3.26.

¹⁶⁹ TPG, paras. 1.68 to 1.69.

ciliation in provisions in the CCC or national law.¹⁷⁰ Furthermore, the TPG merely state that similarities and differences of the valuation methods exist and do not discuss them further.¹⁷¹

After evaluating the previous sections in this chapter, it is clear that there are similarities between the methods. The first, quite obvious, similarity is that there are six methods of both valuation systems. Based on the way the methods are composed and what type of comparables they use, chart 4.2 shows which CV method is comparable to which TP method.

<u>CV methods</u>		<u>TP methods</u>
TVM		
TVI method	↔	CUP method
TVS method	↔	CUP method
DVM	↔	RPM
CVM	↔	CPM
		PSM
		TNMM
Residual Method	(↔)	Other Method

Figure 4-2 Method Comparison

The TVM does not have a corresponding TP method. The reason is that the transaction value is based on the invoice price plus mandatory additions and deductions and that correspondent rule does not exist in the transfer pricing system. The TVI and the TVS both correspond to the CUP since they all use the value of comparables when setting the price. The DVM and CVM are based on the same valuation principles as the RPM respectively the CPM, for example since both extract and, conversely, add elements in order for the valuation to result in an arm's length price. Neither the TNMM nor the PSM have a corresponding CV method.¹⁷² One reason is because customs valuation is based on a transaction and product specific comparison at a gross margin, instead of at net margin level.¹⁷³

Fabio states that a solution where the values are based on customs law and receive acceptance by the customs offices, while supporting the corresponding price with a pric-

¹⁷⁰ Fabio, Massimo, *Customs Law of the European Union*, p. 4 – 30.

¹⁷¹ Maisto, Guglielmo, *Cross-Border Valuation for Income Tax, Customs Duties and VAT*, p. 108. For a more detailed discussion about the comparison, see *ibid.* pp. 109 to 111.

¹⁷² Fabio, Massimo, *Customs Law of the European Union*, p. 4 – 31 and Maisto, Guglielmo, *Cross-Border Valuation for Income Tax, Customs Duties and VAT*, p. 108.

¹⁷³ *Attaining Customs Valuation compliance after implementation of your new Transfer Pricing Documentation*, PwC, “Key Issues”, p. 1.

ing policy can have a high certainty to be accepted.¹⁷⁴ According to Ainsworth, both income tax and customs regimes share common objectives, but similarities in the methods need to be seen as superficial (not profound) and in need of adjustment from both sides. He also states that the TPG and the ACV differ significantly at a practical level.¹⁷⁵

Many of the reasons behind the differences in valuation from a tax and customs perspective are described in section 3.3.2. Reasons behind differences in the methods are that the definition of comparables for customs valuation is quite different to the ones applied for transfer pricing purposes, and sales below costs are generally unacceptable for customs valuation purposes.¹⁷⁶

Fabio states that a reconciliation of the methods seems hard at first due to the use of different provisions of rules. As already stated, customs rules are completely harmonised and structured by provisions in the CCC and CCIP, which are binding for traders and customs authorities within the EC. The TPG only briefly mention customs valuation¹⁷⁷ and the EC Code of Conduct is only a non-binding resolution. Subsequently, there is a lack of balance from the point of view of law.¹⁷⁸

4.5 Concluding Comments

It is evident that there are similarities between the methods for both income tax and customs purposes. Most of the CV methods have a corresponding TP method, or vice versa. Even if there are similarities between the methods, many factors make reconciliation difficult. One such factor is differences in the time for assessing the value; date of sale or purchase for assessing the transfer price and the date of importation for customs value.¹⁷⁹ Another factor is that CV methods are applied in a strictly hierarchical way and it is not possible to choose the most suitable method. Fabio's solution is that even if a CV method cannot be chosen, once the correct value is set, it can be matched with the corresponding TP method. And conversely, if the value for transfer price has been set it can be matched for the purpose of customs valuation, if there is a corresponding acceptable method. A theoretical example: goods entering Sweden cannot be valued using the first CV methods according to the sequence hierarchy and the method applicable for customs purposes is the computed value. If Swedish Customs accept this customs value, the group can use the corresponding CPM when establishing the transfer price.¹⁸⁰

¹⁷⁴ Fabio, Massimo, *Customs Law of the European Union*, pp. 4 – 30 to 32.

¹⁷⁵ Ainsworth, Richard Thompson, *IT-APA:s Harmonizing Inconsistent Transfer Pricing Rules in Income Tax – Customs – VAT*, pp. 7 to 8.

¹⁷⁶ *Attaining Customs Valuation compliance after implementation of your new Transfer Pricing Documentation*, PwC, “Key Issues”, p. 1.

¹⁷⁷ TPG, paras. 1.65 to 1.67.

¹⁷⁸ Fabio, Massimo, *Customs Law of the European Union*, p. 4 – 30.

¹⁷⁹ Maisto, Guglielmo, *Cross-Border Valuation for Income Tax, Customs Duties and VAT*, p. 107.

¹⁸⁰ Fabio, Massimo, *Customs Law of the European Union*, pp. 4 – 30 to 31.

5 Related Parties' Application of Valuation Methods

5.1 Introduction

In order to apply the appropriate CV method, it is important to first establish if the seller and buyer are related. A customs value needs to be determined between unrelated buyers and due to the fact that the ACV contains a special provision concerning related parties, see section 4.2.2.¹⁸¹ This thesis presumes that the buyer and seller are related. It is therefore necessary to examine whether the existence of the relationship has influenced the price or not, in order for the importer to be able to use the transaction value as the customs value.¹⁸² The chapter examines how related parties can show that their relationship has not influenced the price and that they are therefore able to use the TVM when establishing their customs value.

5.2 Definition of Related Parties

The buyer and seller are related according to Article 15.4 of the ACV, if they (i) directly or indirectly control the other party, (ii) both are directly or indirectly controlled by a third person, or (iii) together directly or indirectly control a third person. This definition is similar to the definition of associated enterprises in Article 9 of the OECD Model Tax Convention. The definition of related parties for customs purposes is, however, more expansive than the generally applied definition for company income tax purposes.¹⁸³

5.3 Application of Transaction Value Method

The TVM shall be used prior to the other CV methods. Other CV methods can only be applied if the transaction value cannot be used. One of the requirements to use the transaction value is according to Article 1.1 (d) of the ACV that the parties are not related. However, Article 1.2 (a) of the ACV¹⁸⁴ states that if the buyer and seller are related, as defined in Article 15 of the ACV, this shall not in itself constitute a basis for the transaction value to be unacceptable. In the case of a related party transaction, the circumstances surrounding the sale shall be examined and the transaction value shall be accepted as the customs value if the relationship did not influence the price.¹⁸⁵

It is important to note that it is only necessary to make an examination of the circumstances if there are doubts about the acceptability of the price and not only because the sale occurs between related parties. If there is no doubt about the acceptability of the price, the customs authority shall accept the transaction value without requesting further information. Reasons for the customs authority not to doubt the price could be that the customs authority already previously has examined the relationship at hand, or may al-

¹⁸¹ Article 1.2 of the ACV.

¹⁸² Article 1.2 (a-b) of the ACV. See also Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 402.

¹⁸³ Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 206. See also Article 143.1 (d) of the CCIP.

¹⁸⁴ Corresponding Article 29.2 (a) of the CCC.

¹⁸⁵ Article 1.2 (a) of the ACV.

ready has detailed information concerning the buyer and seller and is satisfied from such examination or information.¹⁸⁶

If the customs authority cannot accept the transaction value, it shall communicate its grounds to the importer and the importer shall be given a reasonably opportunity to respond.¹⁸⁷ The provided information shall be as detailed as necessary for the customs authority to examine the circumstances surrounding the sale. Important issues to examine are relevant aspects of the transaction, including the way in which the buyer and seller organise their commercial relations and the way in which the price in question was arrived at.¹⁸⁸ It is the customs authority that bears the primary burden of proof with regard to the issue of whether or not the transaction price has been influenced by the relationship between the parties.¹⁸⁹

5.4 Relationship Tests

5.4.1 Two Tests

There are two tests available in the ACV to ascertain whether or not the relationship of related parties has influenced the price. The two tests are usually called the ‘circumstances of sale’ test and the ‘test values’ test.¹⁹⁰ The ‘circumstances of sale’ test compares to the examination of the circumstances of the sale as stated in Article 1.2 (a) of the ACV. The ‘test values’ tests are found in Article 1.2 (b) of the ACV.

5.4.2 The ‘Circumstances of Sale’ Test

The ‘circumstances of sale’ test in Article 1.2 (a) of the ACV analyses relevant aspects of the transaction such as:

- The way in which the buyer and the seller organise 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.¹⁹¹

The Interpretative Note to Article 1 supplies examples of when the transaction value should be accepted under the ‘circumstances of sale’ test:

1. If the price was settled in a manner consistent with the normal pricing practices of the industry in question,¹⁹² (i.e. the industry that produces goods of the same

¹⁸⁶ Interpretative Note to Article 1.2, “Paragraph 2”, para. 2.

¹⁸⁷ Article 1.2 (a) of the ACV.

¹⁸⁸ Interpretative Note to Article 1.2, “Paragraph 2”, para. 3.

¹⁸⁹ Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let’s Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 206.

¹⁹⁰ See Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 402 and Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 37.

¹⁹¹ Interpretative Note to Article 1, “Paragraph 2”, para. 3. See also Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 403.

¹⁹² Interpretative Note to Article 1, “Paragraph 2”, para. 3.

class or kind. Marsilla states that this test does not focus on the function performed by the parties, as transfer pricing rules do)¹⁹³;

2. If the price was settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related,¹⁹⁴ (this test is, according to Marsilla equivalent to the CUP method)¹⁹⁵; or
3. If the price is adequate to ensure recovery of all costs plus a profit that is equivalent to the firm's overall profit realized over a representative period of time (e.g. on an annual basis) in sales of merchandise of the same class or kind.¹⁹⁶ (Marsilla states that this test is equivalent to the CPM, but focuses on merchandise of the same class or kind instead of the functions performed by the parties)¹⁹⁷.

5.4.3 The 'Test Values' Test

Article 1.2 (b) of the ACV provides the opportunity for the importer to prove that the transaction value closely approximates to a test value. There are in total three different test values:

- The first is the transaction value in sales to unrelated buyers of identical or similar goods for export to the same country of importation occurring at or about the same time;¹⁹⁸
- The second is the customs value of identical or similar goods as determined via the deductive valuation method;¹⁹⁹ and
- The third test value is the customs value of identical or similar goods as determined via the computed valuation method.²⁰⁰

When applying the test values, account shall be taken regarding the differences in commercial levels, quantity levels and requirements in Article 8 of the ACV as well as costs incurred that would not occur in sales between related parties.²⁰¹ The tests are to be used at the initiative of the importer and only for comparison purposes, meaning that the compared value cannot be used as a substitute value.²⁰²

The second and third test values require previous determinations of value of identical or similar goods, which must have been accepted by the customs authority and are therefore acceptable under Article 1 of the ACV. The tests provide a basis for comparison of

¹⁹³ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 403.

¹⁹⁴ Interpretative Note to Article 1, "Paragraph 2", para. 3.

¹⁹⁵ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 403.

¹⁹⁶ Interpretative Note to Article 1, "Paragraph 2", para. 3.

¹⁹⁷ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 403.

¹⁹⁸ Article 1.2 (b. i) of the ACV.

¹⁹⁹ Article 1.2 (b. ii) of the ACV.

²⁰⁰ Article 1.2 (b. iii) of the ACV.

²⁰¹ Article 1.2 (b) of the ACV.

²⁰² Article 1.2 (c) of the ACV.

an actual customs value already accepted by the customs.²⁰³ Consequently, if there is no parallel import into the same customs territory by buyers not related to the seller, the test values cannot be used. However, since Sweden is an EU Member State; imports accepted by a customs authority in another Member State can be used as the test value.²⁰⁴

Certain factors need to be taken into consideration in order to determine if the transaction value ‘closely approximates’ to the test value. Such factors include the nature of the imported goods, the nature of the industry itself, the season in which the goods are imported and whether or not the difference in values is commercially significant.²⁰⁵

5.5 Concluding Comments

The starting point for calculating customs duties is the transaction value, i.e. the price of the cross-border transaction. This price is also used for determining profits to each company involved and subsequently also the allocation of tax base among countries. Transactions between related parties are not always subject to the same market forces as transactions between unrelated parties. This fact, together with other factors, makes it possible for groups with cross-border transactions to conduct tax planning. This can be made through under or overpricing the customs duties bases and the group can plan how to allocate taxable profits.²⁰⁶

In order for related parties to use the TVM, which is the superior CV method, the price must not have been influenced due to their relationship. If the customs authority has grounds to suspect that the relationship indeed has influenced the price, the parties must show the opposite. There are two tests prescribed by law that can show if the relationship has influenced the price or not. Where a test is met under the ‘test value’ test, it is unnecessary to make the ‘circumstances of sale’ test.²⁰⁷ If either one of the tests can prove that the relationship has not influenced the price, the related parties can use the TVM to establish the customs value. But if the relationship, in some way, has influenced the price, the parties need to use another CV method.

²⁰³ Interpretative Note to Article 1, “Paragraph 2”, para. 4. See also Martin Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, p. 45.

²⁰⁴ *International transfer pricing 2009*, PwC, p. 171.

²⁰⁵ Interpretative Note to Article 1, “Paragraph 2(b)”.

²⁰⁶ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 36.

²⁰⁷ Interpretative Note to Article 1, “Paragraph 2”, para. 4.

6 Adjustments

6.1 Introduction

The customs and tax authorities use different approaches when reviewing a value declared by the importer and the transfer price. For customs purposes, another CV method must be used, possibly resulting in a different customs value. For income tax purposes, the transfer price can be accepted after making certain adjustments. This conflict can lead to the least favourable outcome for the importer; being charged with a high customs value and a low transfer price.²⁰⁸ Tax authorities have, due to the increased concern about tax base erosion, increased its inspections on transfer pricing issues. Transfer pricing audits are more and more common (also in Sweden due to a specially organised transfer pricing project by the Swedish Tax Agency)²⁰⁹, and are therefore a major issue for taxpayers. Transfer pricing adjustments do not only lead to double taxation from a company income tax perspective, but also affect customs duties paid with the respect to the goods imported being amended.²¹⁰

This chapter contains information about adjustments that can be made to a declared price and different adjustment problems are discussed. The different categories of adjustments and the three types of adjustment are described. The most important part of this chapter, with regard to the purpose of this thesis, is the discussion of what effect transfer pricing adjustments have on the customs value and how this situation best can be solved.

6.2 Characterisation of Adjustments

The first example of a characterisation of adjustment is a change in a price triggered when a subsidiary has charged a price below market value to a parent company. This may be characterised as a deemed dividend distribution, possibly causing dividend withholding issues. Another example of the characterisation is when a parent company has overpaid a subsidiary and it can be categorised as a deemed capital contribution, possibly triggering capital duty issues. The third and final example is when an adjustment is reported as a credit or debit note related to the actual transaction, or as a fee rebate or surplus charge.

6.3 Categories of Adjustments

6.3.1 Primary Adjustment

Primary adjustments are those imposed by the tax authority in one of the relevant jurisdictions to ensure that the arm's length principle is applied and that the appropriate

²⁰⁸ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 406.

²⁰⁹ Swedish Tax Agency, *Internprissättning*, accessed 18 November 2009 from <http://www.skatteverket.se/omskatteverket/beskattningsverksamheten/interprissattning.4.ed340c11d3fb2d88680003587.html?posid=4&sv.search.query.allwords=internpriss%C3%A4tning>.

²¹⁰ Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 201.

amount of tax is reported on transactions in the taxpayer's country.²¹¹ The legal basis for primary adjustments is in Article 9 of the OECD Model Tax Convention.²¹² A primary adjustment is often made as a result of a tax audit and the Swedish Tax Agency can make a tax audit up to five years after the assessment year.²¹³

6.3.2 Corresponding Adjustment

Corresponding adjustments are made to ensure that no double taxation arises in the country of the related party of the taxpayer as a result of the primary adjustment. The corresponding adjustment has, with other words, the objective to make sure that the allocation of profits by the two tax jurisdictions is consistent.²¹⁴ A corresponding adjustment is, by nature, one that is made after the taxable year has terminated and is usually made based on treaty provisions and uses the competent authority process to avoid double taxation.²¹⁵

6.3.3 Compensating Adjustment

The third category of adjustments is called compensating adjustment, which is the collective name when a taxpayer adjusts transfer prices without the involvement of the tax authority.²¹⁶ Compensating adjustments can be seen as a form of self-help to ensure that prices and income are reported consistently with the arm's length standard.²¹⁷ A compensating amendment for customs purposes is the change an importer may be required to make to the price originally declared to the customs authority. This amendment could be the consequence of a transfer pricing study for tax purposes, and also when there is a cost plus pricing and the customs entry is made when the costs have not yet been finalised. A compensating adjustment would involve value declared to customs on a provisional basis and a defined value to subsequently declare to customs, when such variables are finally known.²¹⁸

6.4 Price Adjustments' Effect on Customs Value

Neither the ACV nor the EU customs provisions (CCC and CCIP) contain any specific provisions regarding how to deal with amendments to transaction values. Even though there are no explanatory provisions regarding after-importation amendments, it does not

²¹¹ TPG, "Glossary". See also Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 199.

²¹² Article 9.1 of the OECD Model Tax Convention.

²¹³ Article 4, Section 13 of the Swedish Tax Assessment Act.

²¹⁴ TPG, "Glossary". See also Article 23 A and B of the OECD Model Tax Convention.

²¹⁵ Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 199.

²¹⁶ TPG, "Glossary".

²¹⁷ Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 199.

²¹⁸ Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, p. 113.

necessarily mean that they do not influence the customs value of the goods.²¹⁹ Since there is a lack of regulations and recommendations on the effect a transfer price adjustment has on customs value, it is the rules and practice in each country that is of importance. It is national provisions that determine how a customs authority should respond if adjustments are made on an already paid price for tax purposes.²²⁰

For transfer pricing purposes, all the categories of adjustments may be imposed or necessary to make in order for the price to reflect an arm's length price and adjustments may be unavoidable. Even if adjustments can be categorised differently, there are generally two routes to make adjustments:

1. In the capital realm of the related parties (by an additional dividend payment or capital contribution); or
2. By retroactively increasing or decreasing the prices of the transaction.

The second route, being an actual compensating price adjustment, is made between the parties. These adjustments are in practice made, for example, if the taxpayer discovers that the average internal price does not reflect any transfer pricing principles.²²¹

Any significant changes to a company's transfer pricing policy may affect the validity of the transaction price for customs purposes. Examples of significant changes are a shift in the allocation of profit or a shift of responsibility for certain functions from one company to the other, or a change in the transaction structure.²²²

6.5 Options for Non-Acceptable Values

As already established in section 5.5, there is a possibility that none of the relationship tests can be used to enable the transfer price to be validated for customs valuation purposes. Besides from the previously stated option, to submit valuation for customs purposes on the basis of one of the subsequent customs valuation methods, there is, depending on the circumstances in each case, another available option. If the transfer price is lower than the acceptable customs value the taxpayer can modify its transfer pricing policy.²²³

If the transfer price is higher than acceptable customs value, the taxpayer has three options in order for the value to be justified for customs purposes; (i) to consider the scope of unbundling the transfer price (separate the different costs included in the price and divide into smaller posts), (ii) to modify the transfer pricing policy, or (iii) to submit valuation on the basis of an alternative CV method.²²⁴

²¹⁹ Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 208.

²²⁰ *International transfer pricing 2009*, PwC, p. 180.

²²¹ Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 207.

²²² *International transfer pricing 2009*, PwC, p. 179.

²²³ *Ibid*, p. 172.

²²⁴ *Ibid*, p. 173.

6.6 Problems with Adjustments

6.6.1 Mandatory Additions and Deductions

There are elements of costs, which are not included in a transaction value but are part of the arm's length principle for income tax purposes. There are also elements of costs that would be included in a transfer price, but not in the customs value; for example transport costs and incidental costs after goods reach their first destination in the EU's customs territory. The conclusion to be drawn from this is that transaction value and transfer price is not identical due to necessary legislative adjustments. Even so, Marsilla states in his article that it can be possible to establish what factors are different and from that point of view make the necessary adjustments to go from one to the other.²²⁵

6.6.2 Time Limit

One reason for potential adjustment problems is the issue of the time limit. If an adjustment is made on income tax, the symmetrical review of customs valuation is most likely impossible because of the time limit for an assessment probably has expired. In the EU, this time limit is only three years starting after the submission and acceptance on a customs declaration. Nevertheless, even if the importer manages to make a review within the time limit, the authorities could argue that such review has no merit, based on the differences in the valuation methods. Also, for customs purposes, after-importation discounts and rebates (called 'retroactive discounts') are irrelevant for valuation purposes.²²⁶

6.6.3 The Possibility of Arrear and Repayment of Duty

Customs authorities most certainly regard any post-importation amendments as directly applicable to the value declared at the time of importation. Any upward amendments on the customs value must, therefore, be declared and the additional duty paid. Downward amendments should lead to repayment of duty. However, downward amendments may, in some countries, be considered as retroactive discounts and, as a consequence, claims for repayment of duties are not accepted.²²⁷

If an adjustment to the transfer price has the effect of increasing the declared customs value, the customs authority claims that the previously declared value was too low. Depending upon national regulations, the customs authority may be able to recover substantial arrears of duty, i.e. the sum of unpaid duty, and to impose penalties. Conversely, even if the customs authority accepts that the current transfer prices are higher than commercial circumstances justify, there is probably no basis for claiming repayment of duties overpaid. It probably does not matter even if the seller credits the buyer with the difference between the existing and proposed prices on a historical sale.²²⁸

²²⁵ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, pp. 401 to 402.

²²⁶ *Ibid*, p. 406.

²²⁷ *International transfer pricing 2009*, PwC, pp. 180 to 181.

²²⁸ *Ibid*, p. 180.

A customs audit²²⁹ can lead to consequences for the importer in case of amendments to the customs value. If the importer has paid more duty than necessary, the Swedish Customs support repayments of duty to the importer. If the importer, reversibly, has not paid enough duty, the Swedish Customs wants to recover arrears of duty. The importer must pay additional duties and can also be liable to pay duty surcharges on 20 percent of the withheld sum. In the event a company has misused a customs certificate, the Swedish Customs can withdraw that certificate.²³⁰

6.6.4 Provisional Prices

6.6.4.1 Price Review Clause

A price review clause²³¹ is a clause in a contract establishing how the price of the goods should be set.²³² The price review clause can also be situated in a company's transfer pricing policy. The policy can then specifically provide for periodic reviews and retrospective price adjustments.²³³ The periodic reviews, usually conducted by the end of the fiscal year, are made to assess what the sale have resulted in and what costs the company has had. The review may result in pricing adjustments. The adjustment can be both downward and upward depending on what profit margins the importer has achieved through resale of the goods. The price review clauses, shall not in themselves, hinder the use of the TVM for customs purposes.²³⁴ When the price of the goods is provisional and subject to a review clause, the importer has the opportunity to delay the final determination of the customs value through incomplete customs declaration. This needs to be notified to the customs authority in advance.²³⁵

The importer can, with an incomplete customs declaration, avoid penalties for failing to declare a full value of imported goods and ensure that duty can be recovered in the event of a price reduction. Some customs authorities accept arrangements whereby provisional values are declared at the time of importation and subsequent adjustments are reported on a periodic basis, provided they are accompanied by the appropriate additional duties or claims for repayment.²³⁶

²²⁹ Chapter 6, Section 28 of the Swedish Customs Act.

²³⁰ Swedish Customs, TV 790.64, "Varför Tullrevision?", pp. 2 to 3, accessed 30 November 2009 from <http://www.tullverket.se/download/18.4ab1598c11632f3ba9280005564/tullrevision%2C+varf%C3%B6r+tv790.64.pdf>.

²³¹ The wording of 'price review clause' also includes pricing formulae.

²³² Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, p. 114.

²³³ *International transfer pricing 2009*, PwC, pp. 180 to 181.

²³⁴ Swedish Customs, TV 790.14, *Tullvärdehandledning*, p. 27.

²³⁵ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 406 and Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, p. 116.

²³⁶ *International transfer pricing 2009*, PwC, p. 181.

6.6.4.2 Contract without a Price Review Clause

If a contract or pricing policy do not include a review clause, or the clause is not properly notified to the customs, an adjustment of the price would have following consequences:

- a) 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 goods has been imported, the customs value would not be affected; or
- b) Where the modification of the price is agreed to after importation due to retrospective adjustments, the originally declared transaction value could be regarded as influenced by the relationship and, as a result, rejected as a basis of appraisal under Article 1 of the ACV.²³⁷ Due to that the transaction price can be adjusted at a later stage could indicate that the originally declared transaction price is influenced by the fact that the parties are related. This result for the related parties; unable to use the TVM, results in the situation that the arm's length pricing method used between related parties would effectively be useless for customs valuation purposes. In fact, the TP method used would trigger numerous customs valuation problems.²³⁸

There are other problems that can arise if the importer has not disclosed the detail of the price review clause. If the final price of the goods is a higher price, the importer is deemed to have represented a false price to the customs authority and may therefore be subject to a penalty. On the other hand, if the final price is a lower price, the customs authority is most likely denying a reconsideration of the customs value on the grounds that retroactive discounts are irrelevant for customs purposes.²³⁹ However, according to case C-468/03 *Overland Footwear*, a repayment of duty must be made if the conditions laid down by Article 236 of the CCC are fulfilled. In particular if there has been no manipulation by the taxpayer and the application for repayment has been submitted within the time limit, which in principle is three years.²⁴⁰

6.6.4.3 Contract with a Price Review Clause

A contract that, on the other hand, establishes a price review clause effective at the time of importation, the situation for the importer is radically different. Even if the actual price cannot be determined until later, the review clause enables the price for the imported goods to be established on the basis of the data specified in the contract. A cost plus contract, for example, should include such clause if the cost figures are not yet available at the time of importation. In this example, a transaction value is available and

²³⁷ Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, p. 114.

²³⁸ Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 208.

²³⁹ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 406.

²⁴⁰ Case C-468/03 *Overland Footwear Ltd v Commissioners of Customs & Excise*, 20 October 2005, "Summary of the Judgment", para. 2.

the price review clause cannot be regarded as constituting a condition or consideration for which such value cannot be determined.²⁴¹

The ACV recommends that the transaction value, as far as possible, should serve as the basis of valuation.²⁴² Together with Article 13 of the ACV²⁴³, which provides for the possibility to delay the determination of customs value, price review clauses should not by themselves prevent valuation under Article 1 of the ACV. Compensating adjustments are often necessary for the importer to ensure that the price of the related parties is at arm's length. The use of a price review clause makes it possible to conduct such adjustments to the transaction value without affecting the acceptability of such value for a related party.²⁴⁴

It may, nonetheless, in some specific cases be in the importer's interests to decide not to declare a transaction value because the price for the goods cannot be determined at the time of the importation. In that event, the importer could instead of a review clause seek valuation under one of the alternative CV methods.²⁴⁵

The compliance of incomplete declarations is in practice considered to be a tremendous burden for companies. Not only is the importer required monitoring incomplete declarations filed, an incomplete declaration also postpones the statute of limitations for the assessment of customs duties, which in the EU normally is three years after the submission and acceptance on a customs declaration.²⁴⁶

6.7 Strategies for Solving the Problem

A cautious company should implement the same record keeping and documentation matching system and framework for customs purposes as for transfer pricing. It can generally be argued if an importer only relies on a transfer pricing analysis; it would likely be insufficient to support the customs valuation. If this is not understood, the importer runs the risk of being subjected to fines, penalties and/or forced to use an alternative CV method that may be difficult and costly to implement and sustain. If the taxpayer has done a transfer pricing study, it is not advisable to believe that the customs value on the imported goods must also be correct. However, a transfer pricing analysis and a TPD can provide a basis from which a customs value may be derived and supported. Mandatory adjustments must be applied and other relevant considerations have to be regarded.²⁴⁷

²⁴¹ Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, pp. 114 to 115.

²⁴² “General Introduction Commentary” para. 1 of the ACV.

²⁴³ See Article 253 of the CCIP.

²⁴⁴ Martín Jovanovich, Juan, *Customs Valuation and Transfer Pricing – Is It Possible to Harmonize Customs and Tax Rules?*, p. 115.

²⁴⁵ *International transfer pricing 2009*, PwC, p. 181.

²⁴⁶ Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, pp. 208 to 209.

²⁴⁷ *International transfer pricing 2009*, PwC, p. 183.

Marsilla argues that if a tax authority accepts the price as being an arm's length price, this should be evidence enough for the transaction value to be sufficient (after mandatory additions and deductions) for customs purposes. When a transfer price is set in accordance with an APA, that price should be accepted as the proper basis for the transaction value for customs purposes.²⁴⁸ Marsilla argues that there should be a common position in the EU concerning the use of APA-consistent prices. The agreement should state under which circumstances the declaration for customs valuation would be considered as sufficient indication that the relationship has not influence the price.²⁴⁹

Ainsworth states in his working paper that the inconsistent rules concerning transfer pricing and custom valuation (and VAT) need to be harmonised. This harmonisation of one set of pricing rules applicable regardless of the tax involved (income tax or indirect tax) would ease the domestic compliance.²⁵⁰ Ainsworth's solution to a successful harmonisation is by introducing a certified automated system; an information technology advanced pricing agreement (IT APA). This IT APA share the same purpose as a traditional APA but being an integrated software programme that can offer more than accounting procedures and price review clauses.²⁵¹

Three issues concerning the way to minimise the gap between transfer pricing and customs duties were discussed at conferences in May 2006 and May 2007 by the WTO and WCO.²⁵² The first issue discussed was the usefulness of TPD for customs purposes. A company's TPD could be useful for the customs authority since it often provides extensive information about the company's transfer pricing compliance requirements and could serve as dual purpose, especially if the TPD addresses the company's customs valuation requirements. The second issue was the development of a joint ACVA and APA. This possible development was seen, at the conference, as promising, despite limited and contrasting experiences in countries so far. The use of a ruling involving both the revenue and customs authorities opens up the prospects for an effective, coordinated dispute prevention mechanism. The third issue discussed at the conference was the possible development of joint customs and transfer pricing audits. The objectives are that it would reduce the time and effort spent in audits by the taxpayer and the authorities, and to arrive to the extent possible at a common determination of the valuation of related party transactions that would be acceptable for both customs and tax authorities.²⁵³

²⁴⁸ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 407.

²⁴⁹ *Ibid*, p. 409.

²⁵⁰ Ainsworth, Richard Thompson, *IT-APA:s Harmonizing Inconsistent Transfer Pricing Rules in Income Tax – Customs – VAT*, pp. 1 to 2.

²⁵¹ *Ibid*, p. 3.

²⁵² Ping, Liu and Silberztein, Caroline, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 38.

²⁵³ *Ibid*, p. 38.

6.8 Concluding Comments

It can be concluded that the issue of adjustments and after-importation amendments are problematic. Due to the close and often conflicting relationship between arm's length pricing for tax and customs purposes, multinational companies with significant import/export operations are strongly encouraged to ensure that they can meet the respective standards of both the revenue and customs authorities.

Importance of transfer pricing and the determination of a fair and correct allocation of profits between countries, are well-known subjects. However, the aspects of transfer pricing and its impact on indirect taxes has not yet benefited from full and appropriate attention.²⁵⁴ In order to minimise the complications, Ping and Silberztein want to encourage the dialogue between customs and tax authorities and between authorities and companies, and establish better mechanism for liaison. They also believe that better co-operation between and customs and tax authorities would benefit all parties involved.²⁵⁵

The best strategy, according to Marsilla, is to act before the problem arises. If the importer is interested in having consistent values for both customs duties and income tax purposes, the importer should try not to avoid the transaction value method. Price review clauses should be disclosed to the customs authority at the time of importation in order to delay the final determination of the customs value. This way, the importer avoids losing repayments of duty in the case of an overvaluation and cannot be charged with potential penalties for undervaluation. The customs authority should, if possible, be invited when an APA is discussed. An adequate APA is the best method available for the importer to avoid conflicting valuations.²⁵⁶ Customs legislation should provide procedures enabling importers to file provisional declarations. Subsequently, once adjustments have been made pursuant to a review clause, the importer files the complementary declaration on which final appraisal should be based.

The conclusion is that, in the case of a review clause, which is advisable to have in order to make price adjustments, it is the use of an incomplete declaration that makes it possible for related parties to use the transaction value for customs purposes. An incomplete declaration can be used when the value is provisional and the deadline can be set to the time absolutely necessary to establish a final customs value. It is not obligatory to use this possibility, but if the importer does not, the transaction value cannot be established and instead an alternative CV method must be used. The declared customs value is then the final value and, as a consequence thereof, a potential claim of repayment of duty will not be approved.²⁵⁷

²⁵⁴ Idsinga, Folkert, Bart-Jan Kalshoven and Monique van Herksen, *Let's Tango! The Dance between VAT, Customs and Transfer Pricing*, p. 209.

²⁵⁵ Ping, Liu and Caroline Silberztein, *Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?*, p. 38.

²⁵⁶ Ibáñez Marsilla, Santiago, *Customs valuation and transfer pricing*, p. 411.

²⁵⁷ Swedish Customs, TV 790.14, *Tullvärdehandling*, p. 27.

7 Analysis

7.1 Introduction

This chapter contains the concluding analysis and it is focusing on fulfilment of the purpose of this thesis. Information being analysed is based on previous chapters and references made therein.

7.2 An Obvious Connection

It is evident that there is an important connection between customs valuation and transfer pricing. To begin with, they both share the concept of the arm's length principle where the price of the goods should be the same as an open market price. Nonetheless, it cannot be argued that a transfer price is equal to a customs value, even if both fulfil the arm's length standard. This fact has to be taken into consideration discussing harmonisation of the rules and co-operation between involved parties. There are mandatory elements of costs to add and deduct from the value for both customs and transfer pricing purposes. See section 4.2.2 for examples on such elements. Even so, if the elements can be identified and separated from the price, the core value should be an arm's length price and identical for both customs and transfer pricing.

Both customs and transfer pricing have valuation methods to assist in establishing correct prices. The valuation, however, can differ significantly between the two valuation systems. Transfer pricing, regarded as a matter of direct taxation, is often evaluated on an aggregated basis, while customs is a transaction-based duty. When determining the correct value different bases are therefore usually used. Both tax authorities and customs authorities are government bodies and have as their objective to collect as much tax and duty as possible. This, however, leads to different expectations on the transaction value. A tax authority wants a low value on the transaction since it would lead to a maximised amount of taxable income. A customs authority is, unfortunately, pulling the importer to the opposite side with a similar duty collection purpose. The customs authority wants the value of the transaction to be high, in order to maximise the collectable customs duty. Naturally, the taxpayer or importer generally wants to pay the lowest possible tax. Despite this natural inclination, there is a conflict of interests from the taxpayer point of view regarding the value of the transaction. To be able to pay a low amount of customs duty, the customs value should also be low. But in order to pay a low amount of income tax, the value for transfer pricing purposes should be high.

7.3 Solutions to Minimise the Problems

Transfer pricing becomes an international issue in cross-border transactions between related parties. Because of the mentioned conflict between the tax and the customs authorities, the issue can also be a domestic problem, a fact that most often is disregarded. Even if customs valuation and transfer pricing, essentially, share the same pricing principle, the tax authority, the customs authority and the importer have different interests. These differences lead to problematic and costly conflicts for all parties involved. Customs valuation cannot be seen as a fair, uniform and neutral system, as the ACV is aiming at, due to existing problems in the area. A possible way to solve, or at least ease, the situation would be if there were a better harmonisation of the two sets of rules regarding customs valuation and transfer pricing. All parties would, as suggested in the TPG, benefit from a better co-operation between the customs and tax authorities. Tools that

could help assist authorities and taxpayers resolve the problem are for instance APAs and ACVAs. If one of the competent authorities accepts the value, it should be accepted by the other as well. Instead of having separate pricing agreements the authorities could use a shared advanced price agreement concerning both transfer pricing and customs valuation. The taxpayer could then proactively seek advance approval on the subject. The agreement should state under which circumstances the customs declaration would be considered as sufficient indication that the relationship has not influence the price. A shared agreement would lessen the burden on the taxpayer and ease the work for the authorities.

Another solution could be to require a documentation requirement, not only for income tax purposes, but for customs as well. Article 1.2 (a) of the ACV already contains a possibility for the customs authority to request information from the importer when doubts about the acceptability of the price exist. A requirement of documentation is, therefore, not something completely new for neither the Swedish Customs nor the importer. It would be even better if there could only be one documentation requirement that would cover both systems, which the tax and customs authorities equally would have access to.

A third solution would be if the Swedish Customs and the Swedish Tax Agency could have joint audits. It would reduce the time and effort spent in audits both by the taxpayer and by the competent authorities. It would also provide, to the extent possible, a common determination of the valuation of related party transactions that would be acceptable for both customs and tax authorities.

7.4 Method Comparison

When making a comparison between the CV and TP methods it becomes clear that there are some similarities between the methods. There is in addition a similarity regarding the comparability analysis since both type of valuation systems require some form of comparables in order for the price to be seen as upholding the arm's length standard. Some authors suggest when one method is used to set a price; it should be possible to match it with the corresponding method of the other system. This is, however, not as easy as it may appear, nor is it always the solution desired to the importer. The CV methods are used strictly hierarchical, while the use of a TP method is less so and primarily focuses on the division of risk, asset and function between the parties to the transaction in order to establish the most appropriate method. Another problem is to determine what valuation system is prior the other. Since a group's budget process and the establishment of a pricing policy is, in general, made before the time of importation, the transfer prices are set before calculating the customs value. This leads to the situation where a TP method is applied first, only after which an attempt is made to match this method with the correct hierarchical CV method. The possibility of matching methods under current set of rules seems, therefore, achievable only in theory.

The CV method to be used to the greatest extent possible, i.e. the first method in the hierarchy, is the transaction value method. This method can, however, only be used by related parties if it is established that the relationship does not influence the price. When there are doubts about the acceptability of the price, the Swedish Customs bears the primary burden to show if the relationship between the related parties has influenced the price. The Swedish Customs can then communicate its grounds to the importer and request for additional information. There are two types of tests which can verify that the price is acceptable despite a relationship. The first is a relationship test where the cir-

cumstances of the sale are examined. The other provides an opportunity for the importer to demonstrate that the value at hand closely approximates to one of three test values. If one of these tests is sufficiently attained, or if the Customs already has satisfactory information, the transaction value shall be used as the customs value. The circumstance of sale test has similarities with the comparability analysis for transfer pricing purposes and the test value tests have similarities with certain TP methods such as the CUP and the CPM. It must be regarded as positive when a requirement of examination only can take place if doubt about the acceptability of the price and not only because the parties are related. Additionally, it is positive that the ACV and its Interpretative Notes provide tests and examples of how a taxpayer can demonstrate an acceptable price. Even so, it must be concluded that the available information should, in order to facilitate for the importer, be more elaborated and include more examples. When the transaction value method is not possible to use, the importer must instead apply a subsequently applicable CV method.

7.5 Adjustments and Amendments

The main purpose of this thesis concerns transfer pricing adjustments and how they affect the customs value. Especially retrospective adjustments are analysed. There are three categories of adjustments; primary, corresponding and compensating adjustments. It is, foremost, primarily and compensating adjustments that have an effect on the customs value. The primary adjustment on the transfer price is imposed by the tax authority, most likely as a result of a tax audit. In practice, however, it is only in the country of importation that a primary adjustment has an effect on the customs value. It is not likely that the importer, after an audit in the country of exportation would declare amendments to the declared customs value. The reason is the lack of co-operation between authorities, not only in the same country but also internationally. This provides another example why the co-operation between authorities must be improved. A compensating adjustment is made on the taxpayer's own initiative and is most often made at the end of the fiscal year in connection with a review of an annual profit and loss statement. To be able to make adjustments to the price is a necessity in order for transfer pricing to function correctly. It can be very difficult to set a correct transfer price on the transaction beforehand if necessary information is not yet available, or because of other problems that could not be foreseen. Swedish Customs has the right to make a primary amendment on the customs value that may have the impact of a price adjustment on transfer prices. It is also possible for the importer (taxpayer) to make a compensating amendment to the customs value.

A transfer pricing adjustment can be either upward or downward, i.e. if the price is either lower or higher than the acceptable value. If an adjustment is made on the transfer price, a corresponding amendment should be made on the customs value. A primary transfer pricing adjustment leads only, in principle, to an upward adjustment on the price. It is highly unlikely that the tax authority would want to make a voluntary downward adjustment on the price and, as a result, lose taxable income. If the customs authority imposes a primary amendment on the customs value, it is most logical that most of the authorities would, in principle, never suggest a downward adjustment on the price. This since a customs authority wants to collect as much duty as possible. Another reason is also that the authority, generally, wants to avoid repayments of customs duty.

A compensating transfer pricing adjustment can be made both downwards and upwards depending on the arm's length return to be received. Since the taxpayer does not necessarily want to pay more tax, the compensating adjustment is therefore most often made as a downward adjustment. A compensating amendment for customs purposes can also take place both ways. An upward amendment could be necessary if the company at hand has special customs certificates which regulate these types of routines and the importer does not want to risk causing problems with the Swedish Customs. An AEO is a certificate that simplifies the customs procedure for a company. For that reason, an importer probably does not want to risk losing such certificate due to wrongful customs procedures. The Swedish Customs can therefore use the AEO and other customs certificates as a management control measure to put pressure on companies to set correct customs values, forcing them to make both upwards and downwards amendments to the customs value. An upward amendment of the customs value results in the payment of additional duty. If the compensating amendment leads to a price reduction, the company wants to recover as much as possible of the overpaid duty and should claim repayment. If the importer has not paid enough duty, the Swedish Customs, naturally, will recover the debts of duty not being paid. In this case, the importer may also be liable to pay duty surcharges. The surcharge is normally 20 percent of the withheld sum of duty. The Swedish Customs does not, besides the duty surcharge, impose other penalties due to an underpayment of duty in Sweden. The repayment of duty can be a delicate issue since it can, for example, be seen as a non-refundable retroactive discount. The conclusion is that the best way for the Swedish Customs to address this problem is to handle such issues on a case-by-case basis and use fair judgment.

Pricing adjustment can be made at the time of the importation or as a retrospective adjustment sometime after the importation. One of the most significant issues discussed in this thesis is the use of a retrospective adjustment when the parties are related. As previously discussed in chapter 5, the fact that parties are related should not influence the price, otherwise there is no possibility to use the transaction value method for customs purposes. When the parties are related and they make a retrospective adjustment to the transfer price, resulting in a customs value amendment, this adjustment can in itself provide evidence of a relationship influence on the price. If it is proven that the relationship has affected the price, the transaction value cannot be used as a method to determine the customs value, which is the preferred method. In this case, the importer has different options depending on the type of adjustment. All solutions are costly and time-consuming and should be avoided if possible. If the importer must use another CV method, this can also cause problems concerning the applied TP method, since the applied CV and TP methods may no longer be consistent with each other. Another option would be to adjust the company's transfer pricing policy, for example unbundling the transfer price (separate the different costs included in the price and divide them into smaller posts). The importer should then use the smaller post and add them as required to the customs value, which could explain why the customs value is in fact correct. This too can, however, be a very costly and time-consuming process for the company.

Another issue is when an adjustment is made on the transfer price due to a primary adjustment by the Swedish Tax Agency. These types of adjustments can be made up to five years after the assessment year. The problem is that the assessment of customs duties can only be made up to three years after the submission and acceptance on a customs declaration. If the time limit of three years has passed, the importer does not have the possibility to recover overpaid duty if the tax audit results in a downward amend-

ment on the customs value. This provides another evidence of the problems inherent in the lack of harmonisation between transfer pricing and customs valuation.

7.6 Solutions for Related Parties

A better harmonisation of the rules in the area and better co-operation between the relevant authorities would decrease the current problems with adjustments. However, it is impossible for many companies to wait for legislative amendments or changed authority procedures. Adjustments are necessary and a change in a company's transfer pricing policy affects the customs value and, subsequently, also the payable amount of customs duty. In order for related parties to be able to make adjustments at any time (within the allowed time limit) there is a solution to the problem. The importing company should make the transfer price provisional by using a price review clause (or pricing formula) in the company's contract or pricing policy. The clause should state that price reviews are to be made on regularly basis (yearly, monthly, etc.) and adjustments are made when necessary. This review clause constitutes the legal basis in case of an adjustment. The fact that the price is provisional needs to be notified to the Swedish Customs on entry and the importer must fill in an incomplete customs declaration. When necessary information is available, the importer can establish the final customs value and files a complementary declaration to the Swedish Customs. By delaying the final declaration of the customs value, the importer shows that the price is not influenced by the fact that the seller and buyer are related and the importer can use the transaction value as the customs value. The review clause also facilitates the request of repayment of overpaid duty in case the provisional price is higher than acceptable value. Another similar solution would be if the importer declares an open claim on how the customs value has been set or requests a review of the price. In the case of an open claim the Swedish Customs can at the time of the importation understand and approve the value without asking for further information. In order for a request of a review of the price to be granted, the importer must prove that the new information could not have been foreseen to affect the price at the time of importation.

8 Conclusions and Recommendations

8.1 Conclusions

This thesis describes the different valuation methods for both customs and transfer pricing purposes. The customs value for related parties is, to the greatest extent possible, the transaction value in Article 1 of the ACV. If there are doubts whether the relationship has influenced the price, it must be shown using one of two tests that the relationship has not influenced the price. If the transaction value cannot be used, a CV method next in the hierarchical application is used and so forth. For income tax purposes, the applicable TP method depends on the situation at hand and what types of risks, assets and functions the company is connected with; the transfer price is set using the most appropriate method stated in the TPG.

This thesis also discusses the differences in valuation such as different expectations of the outcome of the valuation, time limit differences and conflicting interests on the valuation. It is clear that, despite the theoretically shared arm's length principle, there are problems that need to be addressed by authorities, governments as well as international organisations. A conclusion is that customs valuation and transfer pricing definitely can be described as "the two opposing and necessary sides of the same 'coin', whose respective values unavoidably affect the whole balance of a system of closely connected valuation".

There are three categories of transfer pricing adjustment depending on who is taking the initiative. Primary adjustment with the initiative from the authority, the taxpayer initiates a compensating adjustment and corresponding adjustments that has the purpose to resolve double taxation issues. It is, in principle, primary and compensating adjustments that have an effect on the customs value. An adjustment can be either downward, if the price is higher than acceptable value, or upward, if the price is lower than acceptable.

If the adjustment is necessary due to the transfer price being too low, the importer most likely has to make an upward amendment to the customs value and pay more duty to the Swedish Customs. The importer can also be liable to pay duty surcharges in the case of an underpayment. If the transfer price is too high, the importer must make a downward amendment of the transaction value and a downward adjustment on the transfer price. In this case, the importer should claim for repayment of overpaid duty from the Swedish Customs but the repayment has to be submitted within the allowed assessment time of three years.

The main conclusion of this thesis is that related parties should, in order to minimise the risks connected with adjustments, include a price review clause in their contract or pricing policy. The company should also notify the Swedish Customs about the provisional price and make an incomplete declaration. When required information is available, the importer should file a complementary declaration and pay additional customs duty. As an alternative, the importer should instead declare an open claim to the Swedish Customs, very similar to open claims for income tax procedures. The importer should argue that the transaction value cannot be applied and, as a consequence thereof, explain in the customs value declaration why the applied customs value is correct.

8.2 Recommendations

This section has the objective to provide recommendations to the problem with conflicting interests of the outcome of the valuation. There are three recommendations that provide a solution for minimising the burden for all parties involved.

The first recommendation is that the rules and recommendations surrounding transfer pricing and customs valuation should, to the extent possible, be harmonised. Preferably, the effort to harmonise rules and recommendations should start at an international level such as the OECD, the World Customs Organisation (WCO) and the EC. Thankfully, this work has already started by conferences, where the OECD and the WCO have been discussing valuation of related party transactions for transfer pricing, customs and VAT, for example in May 2006 and May 2007.

The second recommendation is that the co-operation between the Swedish Tax Agency and the Swedish Customs must improve. This could be achieved through issuing APAs and ACVAs or an agreement for both customs and transfer pricing. The Swedish Customs could also take an advantage of the related party's TPD, which is a requirement to hand in if requested by the Tax Agency. It would be even better if a documentation requirement also existed for customs purposes. Preferably, the same documentation requirement should cover both systems. It would facilitate for both taxpayers and the authorities in question, especially due to the administrative benefit, if a price that is accepted to uphold the arm's length principle by one authority, for example the Swedish Tax Agency, would also be accepted by the corresponding authority, in this example the Swedish Customs, and vice-versa. The price should, however, be accepted after adjusted for mandatory additions and deductions since elements to exclude and include differs from transfer pricing in comparison to customs valuation. The co-operation could possibly also take place through the development of joint customs and transfer pricing audits.

The third, and final recommendation, is that all companies having cross-border transactions should establish a TPD for their business. For those companies also affected by customs regulations, it is recommended they take important customs issues into account, which may arise as a consequence of their transfer pricing policy. Importing companies should implement a price review clause in their contract before the importation and declare an incomplete declaration. This way, in case of an adjustment, the importer can be able to go back and change the price with minimum of complications. It also provides the possibility for the related party to use the preferred transaction value for customs purposes, if that is desirable. Finally, it is also advisable to document the process of arising at a customs value. The importer can then more easily respond to informational requests from the Swedish Customs and has the possibility to declare an adequate open claim.

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