



The use of transfer pricing for customs valuation purposes:
what should be the criteria for a transfer price in order to meet
the customs valuation rules?

The two different systems explained from a customs perspective for determining a transfer price in order to be applicable for customs valuation purposes.

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Preface

As the icing on the cake of my IBTL studies, I had the pleasure of writing this master's thesis. During the academic year 2018-2019 I became interested in customs law. Even though it was not a separate course in itself at the time, I still got certain things from it with the existing courses including the subject of customs valuation. I decided to look for a thesis topic in this area. During the preliminary research I came across the mechanism of TP. In the literature there is and was a lot of discussion about using a transfer price as a customs value.

This subject attracted me so much that I wanted to research it further, but on the basis of an innovative way of thinking, i.e. the use of a transfer price as a starting point for customs valuation from customs perspective. However, I was bound to an alternative shortened timeline, which meant that I had to learn a lot of things in a very short time. This timeline was based on a period from October 2019 until January 2020.

I would like to thank my supervisor mr. R.G.A. Tusveld of Fiscal Institute Tilburg (Department of Tilburg Law School) of Tilburg University. He supervised me intensively and gave me very good feedback in detail during the writing process of the thesis. For this reason, I have therefore experienced the cooperation was very pleasant.

Finally, I would like to thank my girlfriend, parents and parents in law, brother and friends for their support and understanding in times when I said I wanted to drop out of university, because there were problems with my health and due to the fact that the level of university might have been too high for me. Thanks to them, I have made it to the bitter end.

Thank you for your support and understanding.

I hope you enjoy reading my thesis.

Vera Hendriksen

De Lutte, 15 January 2020

Abstract

Cross-border transactions between associated enterprises of an MNE have become more and more important, as has transfer pricing (TP) as a result of that. These transactions should be in accordance with the arm's length principle. If goods are sold from an associated enterprise to an associated enterprise and based upon that the goods are exported to and released for free circulation in the EU, then the framework of customs valuation becomes important.

In practice, a transfer price has been and is used as is as basis as the starting point for the customs value. This although based upon the main principles, only in specific cases the transfer price really reflects a price as aimed for under the customs valuation rules and the legal framework of customs valuation in the EU does not allow mechanisms as common under TP, such as advanced pricing agreements and retrospective price adjustments. As a consequence, there has been and is discussion about the use of transfer prices as a one-on-one basis for the customs value, looking to adjust the UCC in such way that this legal framework allows the use of these transfer prices for customs valuation purposes.

However, from a theoretical point of view, this way of thinking is fundamentally wrong. The mechanisms of TP and customs valuation originate from different areas of taxation. Both systems contain different key principles and starting points. This means that it is not possible to use a transfer price one-on-one as starting point for a customs value. In order to allow the use of a transfer price as customs value, this price has to meet criteria and include elements that are required for such price for it to be used as a customs value. Therefore, this thesis examines the issue from a customs valuation perspective.

List of abbreviations

Art.	Article
Arts.	Articles
APA	Advanced Pricing Agreement
CCC	Community Customs Code (Council Regulation (EEC) No 2913/92 of 12 October 1992 establishing the Community Customs Code)
CUP	Comparable Uncontrolled Price Method
EC	European Community
ECJ	European Court of Justice
EU	European Union
GATT	General Agreement on Tariffs and Trade 1947
MNE	Multinational Enterprise
OECD	Organisation for Economic Co-operation and Development
OECD Model	OECD Model Tax Convention on Income and on Capital 2017
OECD TP Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017
TEU	Treaty on the European Union (European Union, Treaty on European Union (Consolidated Version), Treaty of Maastricht , 7 February 1992)
TFEU	Treaty on the Functioning of the European Union (European Union, Consolidated version of the Treaty on the Functioning of the European Union, 13 December 2007)
TNMM	Transactional Net Margin Method
TP	Transfer Pricing
UCC	Union Customs Code (Regulation (EU) No 952/2013 of the European Parliament and of the Council of 9 October 2013 laying down the Union Customs Code)
UCC DA	Union Customs Code Delegated Act (Commission Delegated Regulation (EU) 2015/2446 of 28 July 2015 supplementing Regulation (EU) No 952/2013 of the European Parliament and of the Council with regard to detailed rules of specifying some of the provisions of the Union Customs Code)

UCC IA	Union Customs Code Implementing Act (Commission Implementing Regulation (EU) 2015/2447 of 24 November 2015 laying down detailed rules for implementing certain provisions of Regulation (EU) No 952/2013 of the European Parliament and of the Council laying down the Union)
UCC TA	Union Customs Code Transitional Act (Commission Delegated Regulation (EU) 2016/341 of 17 December 2015 supplementing Regulation (EU) No 952/2013 of the European Parliament and of the Council as regards transitional rules for certain provisions of the Union Customs Code where the relevant electronic systems are not yet operational and amending Delegated Regulation (EU) 2015/2446)
UN	United Nations
VAT	Value Added Tax
WCO	World Customs Organisation
WTO	World Trade Organisation
WTO CVA	World Trade Organisation Customs Valuation Agreement

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Chapter 1 Introduction

In this chapter, the motivation of study will be clarified first, followed by the research question with the associated sub-research questions. Then, the interrelationship with international business taxation, the relevance of the research and the delimitation of this thesis will be explained. Finally, the research methodologies used, and the outline will be given.

1.1 Motivation of study

In the past years, cross-border trade between associated enterprises of a Multinational Enterprise¹ (MNE) has become more and more important. According to the Organisation for Economic Co-operation and Development (OECD), around 60% of the global trade takes place between the associated enterprises which relates to Transfer Pricing (TP).²

When associated enterprises of an MNE transfer goods to each other and are located in different jurisdictions, mainly outside the European Union (EU), customs legislation comes into force. In such case the import and export of goods comes into play. In principle, the declarant (which can be anyone as long as established in the EU) is required by law to pay customs duties in case the goods are declared for free circulation of the EU.³ These duties are taxes on goods imported from outside the EU and should be paid when goods are declared for free circulation in the EU.⁴ At this point, the main problem to be discussed in this thesis arises: the pricing and valuation of the goods. TP and customs are completely different disciplines with their own legislation, pricing and valuation methods of the goods, their own documentation requirements and their own burden of proof.⁵ Actually, the only similarity is the use of an arm's length principle in both systems.⁶

Currently, the prices of the goods are determined independently for both customs and TP purposes by different authorities.⁷ Due to that circumstance, it can create an atmosphere of uncertainty and complexity for taxpayers. Therefore, the taxpayers could bare several risks of fines and an increase in their compliance and implementation costs.⁸ During the past years, MNEs have used transfer prices as the basis for customs valuation, and these prices could also be subject to retrospective price adjustments.⁹

¹ An MNE could be defined as follows: "two or more companies located in different countries under common control which have a common set of resources and common purposes." This definition comes from: Eden, L., *Taxing Multinationals: Transfer Pricing and Corporate Income Taxation in North America*, Toronto: University of Toronto Press, 1998, p. 6

² EY., *Tax steps into the light: Tax Risk and Controversy Survey Series 2017*, pp. 3&6

³ Art. 77(3) UCC

⁴ KVK., "Douane", Ondernemersplein.kvk.nl, <https://ondernemersplein.kvk.nl/douane/> (accessed December 14, 2019)

⁵ Bakker, A., *Transfer Pricing and Customs Valuation: Two worlds to tax as one*, Amsterdam: IBFD, 2009, pp. 13&14

⁶ Friedhoff, M. & Schippers M.L., "HvJ Hamamatsu: een abrupt einde aan de wisselwerking tussen verrekenprijzen en douanewaarde?" WFR 2018/132, para. 1

⁷ TP: Tax Authority, Customs: Customs Authority

⁸ Angelis, De, E & Elshof, T., "The Interplay between Transfer Pricing and Customs Valuation in Case of Retroactive Profit Adjustments: The Position of the ECJ in the Case Hamamatsu Photonics Deutschland GmbH (C-529/16)", *International Transfer Pricing Journal*, Volume 25, No 4 (2018), para. 1

⁹ Friedhoff, M. & Schippers M.L., "ECJ Judgement in Hamamatsu Case: An Abrupt End to Interaction Between Transfer Pricing and Customs Valuation?", *EC Tax Review 2019/1*, para. 1

It was therefore necessary to adjust the customs value, but retrospective adjustments for these purposes are not permitted within the customs valuation rules.¹⁰ Recently, the ECJ (European Court of Justice) ruled that it is not permitted to use a customs value without knowing whether the adjustment will be upwards or downwards at the end of the fiscal year.¹¹

Looking at TP and customs valuation from an EU perspective, TP is on an international level based on various sources of soft law¹², while customs valuation in the EU consist of several EU-regulations which are legally binding for EU Member States.¹³ Therefore, it is noteworthy that at an international level there is discussion focusses on how to adjust the customs valuation framework in such a way that a transfer price can be applied one-to-one as a starting point to establish a customs value.¹⁴ In fact, legally spoken, the opposite – i.e. taking the customs legislative framework as a starting point - would be a more logical view of the existing binding legal framework. As a result, the author of this thesis takes the customs valuation framework as a starting point in order to determine a transfer price that will be in line with the customs legislation.

The main problem in this discussion is the question whether a transfer price could serve as a basis for customs valuation. Due to the aforementioned differences in the systems, it is currently not automatically so that a transfer price can be used as the basis for customs valuation on a one-to-one basis. For this reason, a transfer price should take into account certain minimum criteria in order to be used for customs valuation purposes. In this thesis, all of these factors are discussed more in detail on the basis of a set research question and its associated sub-research questions.

¹⁰ Art 70(1) UCC jo. Art. 132 UCC IA

¹¹ ECJ EU 20 December 2017, C-529/16, ECLI:EU:C:2017:984 (*Hamamatsu*), para. 35

¹² Which lacks legal binding

¹³ These EU-regulations are called as the UCC Legal Package. The UCC Legal Package is based upon the WTO Customs Valuation Agreement (WTO CVA)

¹⁴ Angelis, De, E & Elshof, T., “The Interplay between Transfer Pricing and Customs Valuation in Case of Retroactive Profit Adjustments: The Position of the ECJ in the Case Hamamatsu Photonics Deutschland GmbH (C-529/16)”, *International Transfer Pricing Journal*, Volume 25, No 4 (2018), para. 1.2

1.2 Research Question

Based on the above, my main research question is:

“To what extent is it possible to determine a transfer price which takes into account the customs valuation rules and meets the criteria to be used for customs valuation purposes?”

By means of four sub-research questions, the main research question could be answered. These sub-research questions are as follows:

- What are the key principles and fundamental starting points of TP?
- What are the key principles and fundamental starting points of customs valuation?
- What are the similarities and differences between TP and customs valuation and which elements could play a role in a more combined approach?
- To what extent is the current practise of applying a TP based price as the basis a correct fundamental starting point for determining a customs value and what are the minimum criteria to be set, in order to make sure that such transfer price then can be used for customs valuation purposes?

Finally, the claim in the thesis is that a transfer price only can be used for customs valuation purposes if it meets several criteria in order to be in line with the customs valuation rules.

1.3 Interrelationship with International Business Taxation

Both the doctrines of TP and customs valuation are of importance when dealing with international trade between associated enterprises of MNEs. TP deals with pricing of the goods for taxation of the transaction whereas customs valuation deals with the valuation of the goods which is based upon the price of the goods. Taking both areas in account, it is important to decide what the best way is, to comply with the two set of rules and to avoid fines and penalties.¹⁵

In that respect it is important that:

- TP is a concept of direct taxation, which within cross-border intercompany trade is an essential concept for the allocation of profits within an MNE in the same way as it would be allocated between independent enterprises¹⁶, whereby
- Customs valuation deals with international trade of goods and relates to release into free circulation and importation of the goods.¹⁷

Therefore, these two different tax areas are very interesting to research because MNEs, tax authorities and customs authorities benefit from greater clarity when it comes to the pricing and valuation of goods. In addition, it ensures that enterprises comply with the rules of both systems in order to avoid the aforementioned penalties and fines.

¹⁵ Ping, L. (WCO) & Silberstein, C. (OECD), “Transfer Pricing, Customs Duties and VAT Rules: Can We Bridge the Gap?” WCR (2007), p. 36

¹⁶ Ibid

¹⁷ WTO, “Technical Information on Customs Valuation”, WTO.org, https://www.wto.org/english/tratop_e/cusval_e/cusval_info_e.htm (accessed October 29, 2019)

1.4 Relevance of the research

For practice, MNE's could benefit from the fact that there will be more clarity on how to price and value their goods in the light of customs purposes next to TP. Also, they can get more guidance and certainty about the accuracy of the pricing of goods when using them for customs. It ensures that MNE's will be compliant¹⁸ with the rules of the law.

In addition, the research contributes to the academic world, because the playing field between TP and customs valuation can be considered as a grey area. Moreover, taking customs valuation as the starting point for pricing and valuation is a way forward that has not been explored in depth so far.

The researches that have been done were always in the light of TP coming from the starting point that the customs legislation should be adjusted to TP's soft law. However, the research needs to be delimited, as not everything can be examined and treated in this thesis.

1.5 Delimitation

The delimitation of this thesis has been done to answer the research question as accurately and completely as possible in order to prevent the interference of irrelevant issues. Also, delimitations have been made because of the thesis' limited extent.

First, this thesis deals with TP in the sense of the transfer of goods¹⁹ and related intangibles between associated enterprises. This means that the treatment of the other elements²⁰ is excluded. In the light of customs valuation, the release into free circulation and importation of goods will be dealt with, but only to the extent that it contributes to the relationship between TP and customs valuation. Therefore, the relationship between customs valuation and Value Added Tax (VAT) is not taken into account in this thesis.

Second, the legal framework for TP only consists of the legislation used by the developed countries of the world, therefore the United Nations (UN) Models will fall out of the scope. As a result, only the OECD Model Tax Convention on Income and Capital (OECD Model)²¹ and OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines) will be dealt with. Moreover, only TP elements relevant to customs valuation rules are taken into account. In addition, the Union Customs Code²² with regard to the rules on customs valuation will be taken into account.

Finally, in order to be able to make a correct delimitation, it is important to use research methods in the research. The research method is therefore discussed in the next paragraph.

¹⁸ Water Integrity Network, "Tax compliance", waterintegritynetwork.net/2015/12/04/tax-compliance/ (accessed October 29, 2019)

¹⁹ Which means the transfer of goods and bringing the goods into free circulation

²⁰ For example: services

²¹ Especially Arts. 9 & 12 OECD Model

²² Which is implemented from the WTO Customs Valuation Agreement (WTO CVA)

1.6 Methodology

The purpose of this research is to critically analyse the use of transfer prices in the light of customs valuation. Therefore, a qualitative method of research will be used in order to analyse the theory, practical issues and a review of the relevant literature. For that reason, the author will conduct an overall review of the existing theoretical system. The research will be done by reviewing books²³, relevant tax law²⁴, tax journals²⁵, legal packages²⁶, tax treaties²⁷, ECJ case law²⁸, guidelines²⁹ and guidance³⁰. The sources used have been collected from Kluwer Law International, Kluwer Navigator (Dutch Only), NDFR³¹ (Dutch Only), IBFD³², Google Scholar and, online platforms of the WTO, WCO and EU and tax journals. Further, the research consists of both descriptive and analytical parts. The research will be done by the use of multidisciplinary interpretation methods and based upon that, key conclusions will be drawn which contain a conclusion and follow the insights of the author. However, more information about the structure of this thesis is discussed in the next paragraph.

1.7 Outline of the thesis

The outline of the thesis will be as follows:

- As described, chapter 1 gives an overall introduction to the topic. The prepared sub-questions from this chapter are dealt with separately in the next chapters.
- Chapter 2 and chapter 3 contain an explanation of TP respectively the customs valuation framework:
 - Chapter 2 gives an introduction to TP, followed by its background and history, its legal framework, its theoretical framework, TP in practice, adjustments to transfer prices, TP-documentation and the treatment of intangibles. Finally, a conclusion to this chapter will be given which provides an answer to the first sub-question.
 - Then, chapter 3 gives an introduction to customs valuation, followed by its concepts and history, legal framework, methods of customs valuation divided in the transaction value method with its specific issues and a brief explanation of the alternative methods. Finally, a conclusion to this chapter will be given which provides an answer to the second sub-question.

²³ The books used related to TP and Customs which can be found in the bibliography at the end of this thesis

²⁴ Agreement on Implementation of Article VII of The General Agreement on Tariffs and Trade (GATT) 1994

²⁵ The articles used related to TP and Customs which can be found in the bibliography at the end of this thesis

²⁶ UCC Legal Package which exists of: the Union Customs Code (Reg. 952/2013) (“UCC”), The Implementing Regulation of the UCC (Reg. 2015/2447) (Implementing Act: “UCC IA”), The Delegated Regulation of the UCC (reg. 2015/2446) (Delegated Act: “UCC DA”), The Commission Delegated Act on IT (Reg. 2016/341) (Transitional Act: “UCC TA”)

²⁷ OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017*, Paris: OECD Publishing (OECD Model)

²⁸ For example: ECJ EU 20 December 2017, C-529/16, ECLI:EU:C:2017:984 (*Hamamatsu*)

²⁹ OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, Paris: OECD Publishing (OECD TP Guidelines)

³⁰ WCO, *Guide to Customs Valuation and Transfer Pricing*, World Customs Organisation, Brussels, 2018

³¹ Nederlandse Documentatie Fiscaal Recht

³² International Bureau Fiscal Documentation

- In chapter 4 both systems of TP and customs valuation will be compared, and the similarities and differences will be discussed. Moreover, the valuable elements that could play a role in a more combined approach will be derived from this comparison which then provide the basis for the conclusion to this chapter. This conclusion provides an answer to the third sub-question.
- Chapter 5 will discuss possible solutions on how to connect TP and customs valuation. As in the previous chapters, this chapter will end with a conclusion. This conclusion provides an answer to the fourth sub-question.
- The last chapter contains the overall conclusion which answers the main research question and provides the opinion of the author related to the topic. Besides that, it contains recommendations and ideas for further research.

Chapter 2 Transfer Pricing

This chapter deals with the first sub-question of this thesis, i.e. “*what are the key principles and fundamental starting points of TP?*” The chapter will be structured as follows:

- An introduction to TP is clarified first in paragraph 2.1, followed by
- the background of TP in paragraph 2.2.
- In paragraph 2.3, the history will be given, whereas
- paragraph 2.4 will discuss the legal framework of TP.
- Paragraph 2.5 will discuss the theoretical framework consisting of an explanation of the arm’s length principle, the comparability analysis and the TP methods.
- The application of the elements as mentioned in paragraph 2.5 will be explained in paragraph 2.6.
- In paragraph 2.7, the adjustments to a transfer price will be given, whereas
- paragraph 2.8 sets out the documentation in connection with TP.
- Special attention will be given to intangibles in paragraph 2.9.
- Paragraph 2.10 will then give the overall conclusion on the first sub-question which contains the key elements and fundamental starting points of TP.

2.1 Introduction

As a consequence of the trade’s globalisation, a large number of trade transactions take place between enterprises³³ of the same MNE.^{34,35} These enterprises are associated to each other and often located in different jurisdictions all over the world. Their transactions can be classified as cross-border intercompany transactions which includes all³⁶ commercial and financial transactions. Because of the relationship between these enterprises, it is possible that the price, i.e. the transfer price of the goods is influenced by this relationship.³⁷ A background to this issue will be discussed more in detail in the next paragraph.

³³ Transactions between enterprises of the same MNE are the so-called “intercompany transactions”

³⁴ OECD, WTO, UNCTAD., *Implications of Global Value Chains for Trade, Investment, Development and Jobs, Prepared for submission to the G20 Trade Leaders’ Summit in Saint Petersburg (Russian Federation)*, September 2013, p.8

³⁵ Monsengo, J., *Introduction to Transfer Pricing*, Alphen aan den Rijn: Kluwer Law International, 2015, p.1

³⁶ Goods, services and intangibles

³⁷ WCO, *Guide to Customs Valuation and Transfer Pricing*, para. 3.1

2.2 Background

TP is a concept as applied within the framework of direct taxation, i.e. the corporate income tax which aims that prices charged between associated enterprises for the transfer of goods, services and intangibles are not influenced by their relationship.³⁸

It is possible that transactions between associated enterprises lead to an influenced price of the goods by the fact that these enterprises may not have to deal with the same market forces³⁹ as that will be in place for a transaction that takes place between independent enterprises. In addition, these prices can also influence the allocation of profits which leads to the circumstance⁴⁰ that it could have an impact on the corporate tax base.⁴¹ To eliminate these differences, the transfer prices models have introduced the so-called arm's length principle which ensures an uninfluenced price and a correct allocation of profits among the enterprises involved.⁴²

The starting point for the application of the arm's length principle is the comparison of the conditions in a transaction between associated enterprises with the conditions that would have been agreed between independent enterprises in a free market situation under comparable circumstances. This comparison is made using the comparability analysis.⁴³ After this comparison has been made, one of the five TP methods can be used to demonstrate that a price and the profits are at arm's length.⁴⁴

Based on the aforementioned issues, it is necessary to have rules which ensure that the price between associated enterprises is not influenced, i.e. that an arm's length price is established in the same way as it would have been established between independent companies. The history of these rules is explained in more detail in the next paragraph.

2.3 History

With regard to the topic in this thesis, it is only important to highlight - in brief - the development towards the current legal framework of TP. TP originated in the US, where they feared that profits would be shifted to low-tax jurisdictions. This idea was (and is) also present at the OECD. The OECD is an alliance of 36 countries, mainly from the Western world. This means that their policy is based on the Western way of thinking. As a result, their policy on TP can be at odds with other parts of the world.⁴⁵

³⁸ WCO, *Guide to Customs Valuation and Transfer Pricing*, para. 3.1

³⁹ These market forces are the forces of supply and demand without governmental control

⁴⁰ This circumstance is profit shifting from high tax jurisdictions to low tax jurisdictions

⁴¹ Friedhoff, M. & Schippers M.L. "ECJ Judgement in Hamamatsu Case: An Abrupt End to Interaction Between Transfer Pricing and Customs Valuation? EC Tax Review 2019/1, para. 2.1

⁴² Ubachs, S., "Verrekenprijeregels: Het arm's-lengthbeginsel en de OESO-richtlijnen staan centraal bij het vaststellen van een zakelijke verrekenprijs." *Fiscale Thema's*. Kluwer Navigator (online)

⁴³ OECD TP Guidelines, para. 1.36

⁴⁴ Tuominen, J., "The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened? ", *International Transfer Pricing Journal* (2018), para. 2.1

⁴⁵ OECD, "About", [OECD.org/about/](http://www.oecd.org/about/), <http://www.oecd.org/about/> (accessed December 16, 2019)

In 1963, the OECD introduced its Model Tax Convention on Income and on Capital (OECD Model).⁴⁶ The OECD Model served and still serves as the basis for the developments in the field of the previous and current edition(s) of OECD TP Guidelines. The first TP Guideline i.e. report provided an explanation of the use of the arm's length principle and introduced three TP methods. These methods are currently known as the traditional transaction methods and consist of the comparable uncontrolled price method (CUP), the cost-plus method and the resale-minus method.

In the 1980s, there were important developments in the US. The US was afraid that foreign MNEs would want to reduce their tax burden by means of transfer pricing. These MNEs began to use tax planning schemes to reduce their tax burden as much as possible. In response to this, the US introduced two additional methods in its regulations in 1994. These methods were the profit-split method and the comparable profit method⁴⁷. Several OECD countries also expressed similar concerns, which led the OECD to introduce the transactional profit methods, i.e. the transactional net margin method (TNMM) and the profit-split method.⁴⁸ Since then, there has been a trend to apply the profit methods instead of applying the traditional methods. This as in practice it proved very difficult to apply the traditional methods and organisations became more profit driven, i.e. the profits were shifted to low-tax jurisdictions with the aim of paying as low taxes as possible.⁴⁹

The Guidelines have been expanded over the years to be able to meet developments in society to reflect economic reality. Finally, these developments in the field of TP have led to the legal framework as it is known nowadays, namely the OECD TP Guidelines 2017 in conjunction with the OECD Model 2017. The legal framework will be discussed in the next paragraph.

2.4 Legal framework

The OECD Model uses a number of rules with regard to international business and aims to eliminate double taxation of corporate income tax.⁵⁰ This framework consists of various elements, including one element that is decisive for TP. This element is Art. 9 of the OECD Model which provides for a definition of "associated enterprises" and deals with the situation in which a transaction between these enterprises should be at arm's length. If transactions are not at arm's length, the transfer prices must be adjusted by the tax authorities to an at arm's length price.⁵¹ The OECD TP Guidelines are a result of Art. 9 OECD Model which serves as a basis for the elements of the Guidelines.

⁴⁶ Hamaekers, H., "Arm's length – How long?", *International Transfer Pricing Journal* (2001), IBFD, p.30

⁴⁷ The comparable profit method is based on the operating profit level of independent enterprises involved in similar business transactions under similar circumstances

⁴⁸ Hamaekers, H., "Arm's length – How long?", *International Transfer Pricing Journal* (2001), IBFD, p.31

⁴⁹ Monsenego, J., *Introduction to Transfer Pricing*, Alphen aan den Rijn: Kluwer Law International, 2015, para. 2.3

⁵⁰ Hamaekers, H., "Arm's length – How long?", *International Transfer Pricing Journal* (2001), IBFD, p.30

⁵¹ Art. 9 OECD Model

However, both the OECD Model and the OECD TP Guidelines are soft law which means that they are not legally binding. Therefore, OECD countries had to implement the provisions of TP in their domestic legislation and bilateral tax treaties.⁵² Now that the legal framework has been explained, a step can be taken towards the theoretical framework in which the core elements from the OECD TP Guidelines are explained in more detail. These main elements are the theoretical approach of the arm's length principle, the comparability analysis and the TP methods.

2.5 Theoretical framework

As has been said, this paragraph explains the three elements which are important in order to reach an arm's length price. These elements are discussed in subparagraphs.

2.5.1 Arm's length principle

The arm's length principle can be classified as a key element in TP, because associated enterprises are obliged to, in situations of intercompany transactions, charge the same price as they would charge to independent enterprises in comparable circumstances.⁵³ The arm's length principle is established based upon market forces.⁵⁴ These market forces are the supply and demand which means that in a competitive market the price of a good is determined by the actions of buyers and sellers.⁵⁵

The starting point for the application of the arm's length principle is the comparison of the conditions, i.e. price or profit margin, of a transaction between associated enterprises with the conditions that would have been agreed between independent enterprises in a free market situation under comparable circumstances. This comparison is made on the basis of the comparability analysis as discussed in the next subparagraph.⁵⁶ As an outcome of the arm's length principle, there would be an acceptable price or profit margin to every enterprise involved.⁵⁷ The purpose of TP is to ensure that no profit shifting⁵⁸ of taxable profits and tax revenues takes place.⁵⁹ In cases of non-arm's length prices, they have the right to adjust the profits of an MNE if situated in their territory.⁶⁰

⁵² Bakker, A., *Transfer Pricing and Customs Valuation: Two worlds to tax as one*, Amsterdam: IBFD, 2009, p.34

⁵³ OECD TP Guidelines, para. 1.35

⁵⁴ Tuominen, J., "The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?", *International Transfer Pricing Journal* (2018), para. 1.1

⁵⁵ Universiteit Leiden, "Hoofdstuk 2: Vraag en aanbod", [Let.leidenuniv.nl](http://www.let.leidenuniv.nl).

<http://www.let.leidenuniv.nl/history/RES/Eco/hoofdstuk02/evhw02.html> (accessed December 17, 2019)

⁵⁶ Pötgens, F.P.G., *Het at arm's length-beginsel*, IBR 3.4.2.C.c, Cursus Belastingrecht, Kluwer Navigator (online), p. 1

⁵⁷ Monsenego, J., *Introduction to Transfer Pricing*, Alphen aan den Rijn: Kluwer Law International, 2015, p.16

⁵⁸ Profit shifting means the movement of profits from high-tax regimes to low-tax regimes. This will be done to avoid taxation in the jurisdiction where a higher tax rate is levied.

⁵⁹ Monsenego, J., *Introduction to Transfer Pricing*, Alphen aan den Rijn: Kluwer Law International, 2015, p.3&4

⁶⁰ Art. 9(1) &(2) OECD Model

2.5.2 Comparability analysis

As described in the previous subparagraph, the comparability analysis is the starting point for the application of the arm's length principle. By making this comparison it can be made clear that the price has not been influenced by the relationship of associated enterprises. The comparability analysis requires an examination of the factors affecting the transactions between associated enterprises, i.e. internal comparables and the examination of the factors affecting the transactions between independent enterprises, i.e. external comparables.⁶¹

Internal comparables can be easily found and are more reliable, complete and less costly to document, because the information required is available within the MNE. In contrast, in the context of external comparables, the usable information is limited to public information which leads to information of the whole enterprise instead of information on the price of goods.⁶² As an outcome, it is important that the comparison is made under comparable facts and circumstances. These facts and circumstances lead to five comparability factors that can affect the comparability and need to be assessed in order to determine whether a price has not been influenced.⁶³

These comparability factors are as follows which can be applied to both internal and external comparables:

- the contractual terms of the transaction;
- the functional analysis;
- the characteristics of property or services;
- the economic circumstances;
- the business strategies.⁶⁴

These factors will be explained briefly in the next subparagraphs. In the paragraph on the application of the elements of TP (paragraph 2.6), it will also be indicated for which TP method which comparability factor(s) is (are) specifically relevant.

⁶¹ OECD TP Guidelines, paras. 1.33-1.35

⁶² European Commission, *EU Joint Transfer Pricing Forum, Draft Report on Compensating/Year-end adjustments*, Taxud D1, May 2013, pp. 7-14

⁶³ OECD TP Guidelines, paras. 1.36, 1.39-1.63

⁶⁴ OECD TP Guidelines, para. 1.36

2.5.2.1 Contractual terms of the transaction

The contractual terms of the transaction usually give a valuable illustration of the distribution of risks, functions and profits between enterprises. The search for the contractual terms is therefore part of the functional analysis as discussed in the next subparagraph. The OECD TP Guidelines therefore include a definition covering a wide range of conditions.

In addition to contractual terms, other forms of written communication between enterprises which are normally used between enterprises or in the specific sector fall within this definition. The conduct of the enterprises involved should be compared with the contractual terms. This will show whether the terms have been followed or not, i.e. that the price has not been influenced which means that the arm's length principle is applied correctly.⁶⁵

2.5.2.2 Functional analysis

The functional analysis can be considered as the key element in the comparability analysis. In the case of transactions between two independent enterprises, the transfer price and, by extension, the profit received will reflect the functions performed by each enterprise, taking into account the functions performed, assets used, and the risks assumed. A functional analysis is therefore necessary to determine whether the transactions between associated enterprises and the transactions between independent enterprises are comparable. This functional analysis seeks to identify the economic activities and responsibilities, the assets used, and the risks assumed in order to identify these factors within the transactions between the enterprises involved.⁶⁶

With regard to the functions performed, this performance includes management, R&D, purchasing, production, sales, marketing, transport and financing. In addition, it observes at which assets the group enterprises involved use to perform their functions. This includes both intangible⁶⁷ and tangible assets⁶⁸. It should also be borne in mind that one enterprise may perform a wide range of functions as compared to the other enterprise in the transaction, but it is the economic significance of these functions⁶⁹ that is most important.⁷⁰ With regard to the assets used, it is necessary to identify, inter alia; machinery, plants, intangible and financial assets in order to ensure a proper comparison between the transactions between associated enterprises and the transactions between independent enterprises. The nature of the assets used; which could be the age, the market price, the location and property rights, should also be included.⁷¹

⁶⁵ OECD TP Guidelines, paras. 1.42-1.50

⁶⁶ Ibid, para. 1.51

⁶⁷ For example, patents, R&D, know-how and trademarks

⁶⁸ For example, plants, offices, machines

⁶⁹ In terms of their frequency, nature and value of the respective enterprises to the transactions

⁷⁰ OECD TP Guidelines, para. 1.55

⁷¹ Ibid, para. 1.54

With regard to the risks assumed⁷², transactions between associated and independent enterprises are not comparable if there are significant differences in the risks assumed with the transaction. The functional analysis would therefore be incomplete if the risks faced by each enterprise were not identified. This is because it is likely that each enterprise involved in the transaction will take into account the allocation of risks, as they may influence the price and the profit of the transactions between the associated enterprises.⁷³ After the determination of the functions performed, assets used and risks assumed, it is important to determine the differences in specific characteristics of goods and/or services.⁷⁴ This factor is discussed in the next subparagraph.

2.5.2.3 Characteristics of property or services

Differences in the specific characteristics of goods or services are often partly or entirely responsible for differences in value between goods or services transactions between independent enterprises. Therefore, the comparison of these characteristics is useful in determining the comparability between the transactions between associated enterprises and transactions between independent enterprises. Since this thesis focuses on goods, it is not important to further discuss the aspects on the characteristics of services.

In the context of goods, a division can be made between tangible goods and intangibles. In case of tangible goods, the physical characteristics, the quality, the reliability and the extent of the supply are important factors to consider. In case of intangibles, the form of the transaction (e.g. granting or selling licences), the type of property (e.g. patents, trademarks or know-how), the duration and extent of the possible protection and the anticipated benefit are important factors to consider.⁷⁵ Once this factor has been determined, it is possible to determine the economic circumstances of the transaction.

⁷² The types of risks that may be market risks (such as input costs and output price fluctuations), liability risks, stock risks, capacity risks and debtor risks

⁷³ OECD TP Guidelines, paras. 1.56-1.58

⁷⁴ Ibid, para. 1.107

⁷⁵ Ibid

2.5.2.4 Economic circumstances

The at arm's length price can vary depending on the market, even for transactions with the comparable characteristics. Therefore, in order to obtain comparability, it is necessary that the markets in which the associated enterprises and independent enterprises operate are comparable and that any differences do not materially affect the price or that appropriate adjustments can be made.

Economic conditions that may be relevant in establishing market comparability are the geographic location, the size of the markets, the degree of competition in the markets and the relative competitive position of buyers and sellers. Also relevant are the availability of substitute goods and services, the levels of supply and demand in the market as a whole and in particular regions.⁷⁶

The last step of the comparability analysis is the examination of the business strategies which will be explained in the next subparagraph.

2.5.2.5 Business strategies

Business strategies should also be examined for reasons of comparability. This factor takes into account the many aspects of a company such as innovation and development of new products, diversification, attracting or disposing of risks, assessment of political changes, existing or new labour legislation as well as other aspects such as market penetration strategies, which can be important in the day-to-day running of the enterprise and therefore influence the comparability of the transactions.⁷⁷

2.5.2.6 Final remarks on the comparability analysis

As indicated earlier in paragraph 2.5, the comparability analysis is used to assess whether transactions between associated enterprises are in accordance with the arm's-length principle. Table 1.1 in the Appendix contains a typical process of the OECD which describes nine steps in order to carry out a comparability analysis. The use of this process is not mandatory. As a result, the use of this process does not guarantee that the outcome will be at arm's length, nor that the outcome by definition will not be arm's length if the typical process is not used.⁷⁸ Finally, the information collected through the comparability analysis serves as a basis for determining the at arm's length price by applying a TP method.⁷⁹ An explanation of the TP methods is included in the next paragraph.

⁷⁶ OECD TP Guidelines, para. 1.110

⁷⁷ Ibid, paras. 1.114&1.115

⁷⁸ Ibid, para. 3.4

⁷⁹ Ibid para. 3.2

2.5.3 TP methods

The selection of a TP method is an important step in the comparability analysis to reach an at arm's length price or profit margin. This means that the selection of a TP method is a tool and not just a means to reach an optimum at arm's length price or profit margin. In order to prove that intercompany transactions have been administered as if they take place between independent enterprises, and that the circumstances surrounding the transactions did not influence the prices or profit margins, the OECD recognises five TP methods to demonstrate that a transfer price or profit margin is at arm's length.⁸⁰ These methods can be divided in "traditional transaction methods" and "transactional profit methods".⁸¹ In cases that none of the TP methods are appropriate, it is allowed to use other methods with the condition that the method used is in line with the arm's length principle.⁸²

Moreover, the OECD allows the use of more than one method in order to determine a transfer price because, without this possibility, there is a risk that there will be a significant tax burden on the enterprise involved.⁸³ In addition, the enterprise has a free choice in its selection⁸⁴ of the TP method, because the aim is to find the most appropriate method.⁸⁵ This selection is always done on a case-by-case basis and it is not restricted by the provisions of the OECD TP Guidelines.⁸⁶ Finally, the aforementioned distinction in TP methods will be explained in the next two subparagraphs.

2.5.3.1 *Traditional transaction methods*

The traditional transaction methods are considered as the most direct methods which examine and determine the price of transactions.⁸⁷ This category of methods consists of the comparable uncontrolled price (CUP) method, resale-minus method, and the cost-plus method which will be described separately in the next subparagraphs.

2.5.3.1.1 Comparable uncontrolled price method

The CUP method is described as a method of determining a transfer price in which the price for goods transferred (or services provided) in transactions between associated enterprises is compared with the price charged in comparable circumstances for goods transferred or services provided in a transaction between independent enterprises.⁸⁸ Besides that, the CUP method contains both internal and external comparables which have already been discussed in paragraph 2.5.2.⁸⁹

⁸⁰ Tuominen, J., "The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?", *International Transfer Pricing Journal* (2018), para. 2.1

⁸¹ OECD TP Guidelines, paras. 3.2-3.4

⁸² *Ibid*, paras. 2.1 & 2.9

⁸³ *Ibid*, para. 2.12

⁸⁴ The selection should be determined in view of the appropriateness of the method in view of the nature of the transaction determined in particular through a functional analysis, the advantages and disadvantages of the method. Availability of reliable information and the degree of comparability

⁸⁵ OECD TP Guidelines, para. 2.2

⁸⁶ *Ibid*, paras. 2.1&2.2

⁸⁷ Tuominen, J., "The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?", *International Transfer Pricing Journal* (2018), para. 2.1.1

⁸⁸ OECD TP Guidelines, para. 2.14

⁸⁹ *Ibid*, para. 3.24

2.5.3.1.2 Resale minus method

The resale-minus method is also known as the resale price method which takes the price at which the associated enterprise that is part of the intercompany transaction resells the good to an independent enterprise as the basis for establishing the transfer price. This price is known as the resale price. The resale price is then reduced with the resale price margin (gross margin), which is determined by comparing gross margins in transactions between independent enterprises.

Then, the costs associated with the purchase of the good, like customs duties, are subtracted. The amount remaining can be considered as an at arm's length price for the transaction between associated enterprises.⁹⁰ This method can be considered as a gross margin method, i.e. the comparison is made on the basis of a profit indicator that takes into account the relationship between the transaction and the gross profit of the transaction. The resale-minus method is particularly applicable to marketing activities and distributorship.⁹¹

2.5.3.1.3 Cost-plus method

The cost-plus method can be defined as a method to determine a transfer price based on the direct costs incurred by the supplier of goods (or services) in a transaction between associated enterprises. An appropriate cost-plus mark-up shall be added to those costs to reach an appropriate profit, taking into account the functional analysis. The amount resulting after the addition of the cost-plus mark-up to the costs can be considered as an at arm's length price for the original transaction between associated enterprises.⁹² The cost-plus method is most appropriate for transactions involving semi-finished goods sold between associated enterprises.⁹³

2.5.3.1.4 Final remarks on the traditional transactional methods

Both the resale minus and cost-plus method review the price of the transaction in an indirect way, but their principles are contrary to each other. The traditional transaction methods provide direct (CUP) or indirect linkages (resale-minus & cost-plus) to the price. As a result, these methods are considered as the most appropriate methods to determine whether the conditions between associated enterprises have been applied in such the same nature as between non-associated enterprises. The OECD advises to use these methods in situations where it is possible.⁹⁴

It however should be mentioned that, in practice, enterprises often do not know the prices of the individual goods in case they use the resale-minus or the cost-plus. This as there in practice often actually only one margin defined downwards or upwards on the basis of overall factors.⁹⁵

⁹⁰ OECD TP Guidelines, para. 2.27

⁹¹ Ibid, para. 2.35

⁹² Ibid, para. 2.45

⁹³ Ibid

⁹⁴ Ibid, para. 2.3

⁹⁵ Transfer Pricing Asia, "The Cost Plus Method With Example", Transferpricingasia.com, <https://transferpricingasia.com/2017/02/24/cost-plus-method-with-example/> (accessed on November 25, 2019)

2.5.3.2 Transactional profit methods

The transactional net margin method (TNMM) and the profit-split method are part of the transactional profit methods. In situations where no comparable prices can be determined directly, the transactional profit methods can be used.⁹⁶ The transactional profit methods will be described per subparagraph.

2.5.3.2.1 Transactional Net Margin Method

The TNMM determines the net profit margin of transactions between associated enterprises. Then this net profit is compared to the net profit margin of an independent enterprise's comparable transaction. The net profit margin can also be calculated based on the net profit margin of independent enterprises that would have been achieved in transactions between non-associated enterprises.⁹⁷

This method has become almost the standard method to be used, because it often provides publicly available data on the net profits that comparable independent enterprises derive from operating in comparable markets with other independent enterprises.⁹⁸ As a result, the TNMM is often easier to use than, for example, the resale-minus method and the cost-plus method, because for the latter two it is more difficult to find public information under these methods.⁹⁹

2.5.3.2.2 Profit-split method

The profit-split method focuses on the conditions for the distribution of the profit that have been laid down in transactions between related parties. The profit distribution that would have been agreed in transactions between independent enterprises is taken into account. The more an enterprise contributes to the profit, the higher its entitlement to part of the profit.¹⁰⁰ First, the overall profit in the associated enterprises' transaction is determined. This method can be divided in two categories which are the contribution profit-split method and the residual profit-split method.¹⁰¹

Under the contribution profit-split method, the profit is divided between two associated enterprises based on the functional analysis.¹⁰² Under the residual profit-split method, the general total profit will be determined first, and the profit generated by routine functions will be calculated. Then, the remaining profit will be distributed between the associated enterprises.¹⁰³ Besides that, the profit-split method offers a solution primarily in situations where few or no comparable transactions can be found, such as when both enterprises contribute intangibles.¹⁰⁴

⁹⁶ OECD TP Guidelines, paras. 2.3 & 2.6

⁹⁷ *Ibid*, para. 2.64

⁹⁸ Tax journal, "The different methods of TP: pros and cons", Taxjournal.com, <https://www.taxjournal.com/articles/different-methods-tp-pros-and-cons> (accessed on September 29, 2019)

⁹⁹ *Ibid*

¹⁰⁰ OECD TP Guidelines, para. 2.140

¹⁰¹ *Ibid*, para. 2.124

¹⁰² *Ibid* paras. 2.125&2.126

¹⁰³ *Ibid*, paras. 2.127-2.129

¹⁰⁴ *Ibid*, para. 2.141

2.5.3.2.3 Final remarks on the transactional profit methods

The transactional profit methods can be seen as less direct methods, due to the fact that these methods consider the net profit realised from transactions between associated enterprises. This net profit will be compared to the net profit of the independent enterprise which performs comparable transactions.¹⁰⁵

2.5.4 Final remarks on the theoretical framework

Paragraph 2.5 explained the main elements for establishing a TP. This concerned a general description of the arm's length principle, the comparability analysis and the various TP methods. The theoretical side of TP is important, but perhaps it is even more important to know how enterprises should deal with it in practice. The functioning of the aforementioned key elements of TP in practice will be discussed in the next paragraph.

2.6 Application of TP's elements

This paragraph explains the relationship between the arm's length principle, the comparability analysis and the various TP methods in order to show how a substantiated transfer price or profit margin can be established in practice.

2.6.1 Coherence between the elements of TP

As described in paragraph 2.5, the starting point for determining an arm's length transfer price is to compare the conditions of transactions between associated enterprises and transactions between independent enterprises under comparable circumstances. This comparison is made on the basis of the aforementioned comparability analysis, which consists of the contractual terms of a transaction, the functional analysis, characteristics of the property or services, the economic circumstances and the business strategies.

At the end of the analysis, relevant information is often available to determine an arm's length price or profit margin. As described, this determination can be made using various methods, depending on the facts and circumstances. Besides that, the following describes which step of the comparability analysis is important for the different TP methods. The comparability of goods, i.e. the characteristics of the goods, is the most important comparability factor in applying the CUP method, because the differences in goods will lead to differences in prices.

¹⁰⁵ Transfer Pricing Asia, "The Resale Price Method with Example", [Transferpricingasia.com](https://transferpricingasia.com), <https://transferpricingasia.com/2017/02/20/resale-price-method-with-example/> (accessed on November 25, 2019). Transfer Pricing Asia, "The Profit Split Method With Example", [Transferpricingasia.com](https://transferpricingasia.com), <https://transferpricingasia.com/2017/04/11/profit-split-method-with-example/> (accessed on November 25, 2019)

However, the contractual terms and economic circumstances are also important comparability factors, because it also reflects the comparability of the goods concerned.¹⁰⁶ The focus of both the resale-minus method and cost-plus method are less on the exact comparability of goods as is the case with the CUP method. The most important factor with these methods is the functional analysis, since differences in functions, which are reflected in differences in operating costs, can lead to a wide range of gross margins.¹⁰⁷

In the case of the TNMM, the comparability of goods is less important than under the traditional methods, because net margins are less influenced by differences in goods. The TNMM focuses more on the functional analysis, because the main function of the TNMM is the determination of a net profit margin.¹⁰⁸ Although, the net profit margin can be influenced by factors that have almost no impact on the gross margin or prices, as operating expenses differ between enterprises. As a result, economic circumstances and business strategies must also be considered.¹⁰⁹

Finally, the profit-split method begins with identifying the profits which should be divided between the associated enterprises. Then the profit of the associated enterprises is split according to the contribution to the profit of each enterprise involved. This contribution shall relate to the functions performed, assets used and the risks assumed, i.e. the functional analysis comes into force. To determine this contribution, external data¹¹⁰ can be used to examine if the division of the profits is in line with the division which would have taken place between two independent enterprises.¹¹¹

2.6.2 Arm's length range

Since transfer pricing as such is not an exact science, it works with a range. If the profit margin applied in these transactions with an associated enterprise falls within that range, then it is an at arm's length price. Otherwise, the price should be adjusted until the margin falls within the range.¹¹² As a result, this means that a transfer price is not set on individual transactions, but that it is based on an aggregated¹¹³ level.¹¹⁴ MNE's can use a TP Study in order to reach an at arm's length price in transactions between associated enterprises. This will be discussed in the next subparagraph.

¹⁰⁶ OECD TP Guidelines, paras. 2.14-2.20

¹⁰⁷ UN., *Agenda Item 5. Working Draft for the October 2011 Geneva meeting*, 2011, p. 49

¹⁰⁸ Belastingdienst., *Handboek Douane (HDU)*(valid as from 1 May 2016), Chapter 9.00.00, para. 13.6

¹⁰⁹ UN., *Agenda Item 5. Working Draft for the October 2011 Geneva meeting*, 2011, p. 49

¹¹⁰ This external data can be profit-split percentages of transactions between independent enterprises which performs comparable functions.

¹¹¹ OECD TP Guidelines, para. 2.122

¹¹² Ubachs, S. "Verrekenprijeregels: Het arm's-lengthbeginsel en de OESO-richtlijnen staan centraal bij het vaststellen van een zakelijke verrekenprijs." *Fiscale Thema's*. Kluwer Navigator (online)

¹¹³ Which means based on a product line or divisional basis

¹¹⁴ WCO, *Guide to Customs Valuation and Transfer Pricing*, para. 3.6.5

2.6.3 TP Study

As described in subparagraph 2.5.1, transactions between associated enterprises should be made at arm's length prices, i.e. the prices that would be charged by independent enterprises. Therefore, to determine arm's length prices for transactions between associated enterprises, a study must be conducted to determine the price that would be charged if such transactions had taken place between independent enterprises. The process of performing this study is called a TP Study.¹¹⁵

In this TP Study, the comparability analysis is carried out on the basis of the five factors as explained in subparagraph 2.5.2. The results of this TP study then will reflect the most appropriate TP method to arrive at an arm's length price in a given transaction between associated enterprises.¹¹⁶ After carrying out the TP Study, its application needs to be implemented in practice. This is often done on the basis of a TP Policy. This will be discussed in the next subparagraph.

2.6.4 TP Policy

In practice, a so-called TP policy is often used to determine the price to be charged for goods between associated enterprises of an MNE. This policy reflects the approach used in order to reach an at arm's length price. This policy describes how the comparability analysis and the selection of the most appropriate TP method to determine an arm's length price are applied in practice.

The TP Policy must be integrated into the financial policy of the MNE.¹¹⁷ Such a TP policy is often drawn up when new transactions of goods take place within the MNE or when new business relations will be set up with associated enterprises.¹¹⁸

2.6.5 Final remarks on TP Study and TP Policy

Both the TP Study and the TP Policy can be considered as the TP Model of an MNE, because both elements show how a certain transfer price or profit margin is established. Besides that, these parts can be an important tool for the different departments of an MNE to collect specific TP documentation. The documentation of the TP Study and TP Policy will be discussed in paragraph 2.8.¹¹⁹

¹¹⁵ iTechPath, "Transfer Pricing Study", itechpath.com, <http://itechpath.com/transfer-pricing-study/> (accessed on December 30, 2019)

¹¹⁶ IMF, OECD, UN & World Bank Group, *Practical Toolkit to Support the Successful Implementation by Developing Countries of Effective Transfer Pricing Documentation Requirements, Draft Version*, p.37

¹¹⁷ PwC, *International Transfer Pricing Guide*, 2015/16, p.65

¹¹⁸ Taxonity, "Transfer pricing policy", Taxonity.pl, <http://www.taxonity.pl/en/services/transfer-pricing-policy/> (accessed on December 31, 2019)

¹¹⁹ Ibid

2.6.6 Advanced Pricing Agreements

By using TP models, legal certainty and a reduction in the administrative burden is created both on the side of the enterprise and on the side of the tax authorities. However, such models have no legal basis, and are not mentioned in the OECD TP Guidelines.¹²⁰ The TP model can be used in practice to conclude an Advanced Pricing Agreement (APA) between the MNE and the tax authorities of a certain country or the tax authorities of multiple countries involved.

An APA can be considered as an agreement in which the tax administration approves in advance the determination of an at arm's length price for cross-border transactions between associated enterprises or between parts of the same MNE. In these APAs, agreements can be made on various elements that provide certainty about, for example, the nature and terms of the transactions, the TP method, the comparables to be used, critical assumptions, reporting requirements of the enterprise and the use of compensating adjustments.¹²¹ These adjustments will be discussed in paragraph 2.7.2. Finally, the APAs are usually concluded for a period of three to five years.¹²²

It may also be the case that by means of the comparability analysis and applying a certain TP method it appears that this price is not at arm's length and shall therefore be adjusted. The adjustments will be discussed in the next paragraph.

2.7 Adjustments

The objective of a transfer price adjustment is to create a price which is at arm's length.¹²³ Adjustments to a transfer price can be made by the enterprises involved or by the tax authorities. There are five categories of adjustments, namely: primary adjustments, secondary adjustments, corresponding adjustments, compensating, i.e. retrospective, adjustments and prospective adjustments. A distinction is made between the adjustments made by the tax authorities and the adjustments made by the enterprise itself. Of importance is to note that the enterprise involved can only make both compensating adjustments and prospective adjustments, while the tax authorities can make the other types of adjustments.¹²⁴ The different types of adjustments will be discussed in the next subparagraphs.

¹²⁰ Monsenego, J., *Introduction to Transfer Pricing*, Alphen aan den Rijn: Kluwer Law International, 2015, para. 3.1&3.2

¹²¹ WCO, *Guide to Customs Valuation and Transfer Pricing*, para. 3.5.1

¹²² Poelmann, E., *Advance Price Agreements*, FBR.4.9.4.B, Cursus Belastingrecht, Kluwer Navigator (online)

¹²³ Gulati, K. "Transfer Pricing Adjustments" Google Scholar, p.3

¹²⁴ WCO, *Guide to Customs Valuation and Transfer Pricing*, para. 3.4.7

2.7.1 Adjustments made by the tax authorities

A primary adjustment will be made to the profits of the enterprise by the tax authority in order to get a transaction at arm's length.¹²⁵ This adjustment is the first adjustment made by the tax authority of a country which states the difference between the price of the transaction as determined by the taxable enterprise and the price of the transaction that is in line with the arm's length principle by the local tax authority.¹²⁶ Depending on the direction of the primary adjustment, the consequences for the enterprise are clear. The tax liability will be higher or lower due to the primary adjustment.

The primary adjustment is also the reason for establishing a secondary transaction (with the possible consequence of a secondary adjustment) and will also lead to a corresponding adjustment.¹²⁷ Further explained: if the local tax authority does not agree with a particular transfer price used in a transaction, given the terms of that transaction, they will correct this price (primary transaction). The correction of this price is called a primary adjustment. A primary adjustment is therefore a tax adjustment on the transfer price used by the enterprise in which it is determined that a cash flow should have taken place between two associated enterprises.

By carrying out a secondary transaction it can be shown how the correction has been processed in the profit and loss account and the balance of the enterprise involved.¹²⁸ This secondary transaction is a transaction which aim is to reconcile the actual profit distribution with the primary adjustment.¹²⁹ Taxation on a secondary transaction is called a secondary adjustment.¹³⁰ This adjustment eliminates the imbalance between the cash book and the actual profit of the associated enterprise.¹³¹ The secondary transaction is usually made by the tax authority of the country that has also imposed the primary adjustment. However, this does not always have to be the case since both states can make secondary transactions. If both countries agree on the tax consequences of a transfer price correction, the secondary transactions applied by both countries will be consistent with each other. Although, it is possible that both countries apply different secondary transactions. This can result in double taxation.¹³² After the primary adjustments and the possible secondary adjustments have been made, a corresponding adjustment is then made.

Corresponding adjustments are adjustments made by the tax authority of the other country which is in line to the primary adjustment made by the first country.¹³³ With these corresponding adjustments, the administrations of enterprises involved are aligned again.¹³⁴

¹²⁵ OECD TP Guidelines, glossary

¹²⁶ Ibid

¹²⁷ OECD TP Guidelines, para. 4.68

¹²⁸ OECD TP Guidelines, glossary

¹²⁹ European Commission, *EU Joint Transfer Pricing Forum, Draft Report on Compensating/Year-end adjustment*, Taxud D1, May 2013, p.3

¹³⁰ OECD TP Guidelines, glossary

¹³¹ European Commission, *EU Joint Transfer Pricing Forum, Draft Report on Compensating/Year-end adjustments*, Taxud D1, May 2013, p. 3

¹³² Teixeira, R.R., "Tax Treaty Consequences of Secondary Pricing Adjustments", 37 *Intertax Issue* 8/9 (2009), Kluwer Law International, paras. 2.1, 2.2 & 4.1.

¹³³ OECD TP Guidelines, glossary

¹³⁴ Gulati, K. "Transfer Pricing Adjustments" Google Scholar, p. 5

2.7.2 Adjustments made by the enterprise

Now the adjustments that can be applied by the tax authorities have been discussed, it is time to discuss the adjustment that an enterprise can make. This adjustment is the compensating adjustment which is, in general, an adjustment to the transfer price before the tax return is filed.¹³⁵ In these situations, a comparison will be made between the results of a comparable transaction between independent enterprises which occurred during the same period of time as the transaction made between associated enterprises.¹³⁶ In principle, the compensating adjustments take place after the end of the relevant fiscal year which means on a retrospective basis. These compensating adjustments are also called year-end adjustments.

As mentioned in paragraph 2.6.6, in APAs often an agreement is reached between the tax authority/authorities on the pricing and profit levels and thus are often the basis for this category of adjustments. Transfer pricing adjustments can also be made prospectively to already adjust the price based upon the anticipated outcome for that fiscal period. These adjustments therefore are called prospective adjustments. The transfer price based upon this can be adjusted both upwards and downwards. This adjustment can be made during the fiscal year as well as in anticipation of the next fiscal year. Prospective adjustments are usually made if the actual sales and costs are not that much different from the calculated sales and costs.¹³⁷

2.7.3 Final remarks on TP adjustments

The corresponding adjustment can mitigate or eliminate the effect of double taxation. In contrast to primary and secondary adjustments, these adjustments can lead to double taxation. This is because the other country may not allow the corresponding adjustment which arises due to the primary and, eventually, secondary adjustments made by the first country.¹³⁸ Moreover, the enterprise is allowed to make price adjustments which can be done on a prospective basis or on a retrospective basis. The adjustments to transfer prices also contain a link with customs valuation. However, this will be discussed in chapter 4. In the next paragraph, the TP's documentation obligations will be discussed first.

¹³⁵ OECD TP Guidelines, glossary

¹³⁶ Bakker, A. *Transfer Pricing and Customs Valuation: Two worlds to tax as one*, Amsterdam: IBFD, 2009, p.52

¹³⁷ European Commission, *EU Joint Transfer Pricing Forum, Draft Report on Compensating/Year-end adjustments*, Taxud D1, May 2013, pp. 4&9

¹³⁸ Gulati, K. "Transfer Pricing Adjustments" Google Scholar, p. 4&5

2.8 TP documentation

An MNE group should include in their records data showing how the transfer prices of intercompany transactions were established and from which it can be derived whether the transfer prices used are at arm's length. This means that the elements of the TP Study and the TP Policy, i.e. the comparability analysis, the TP method(s) used, the results of the application of the comparability analysis and the most appropriate TP method(s) which lead to at arm's length transfer price(s) set, should be well documented.¹³⁹

The OECD TP Guidelines set out three purposes for TP documentation, i.e. *“to make sure that taxpayers fully consider transfer pricing requirements when determining prices and other conditions for transactions between associates, and when reporting income from such transactions in their tax returns”*, *“provide tax authorities with the necessary information to conduct an informed transfer price risk assessment”* and *“provide tax administrations with useful information for a thorough review of transfer pricing practices of taxable entities in their jurisdictions.”*¹⁴⁰

To achieve these purposes, countries should adopt a standardised approach to TP documentation.¹⁴¹ This approach can be seen as a three-tiered structure which consists of a master file, a local file and a Country-by-Country Report.¹⁴² These categories will be discussed per subparagraph.

2.8.1 Master file

The master file contains standardised information relevant for all associated enterprises of an MNE in order to provide the tax authorities of a high-level overview of the MNE's transfer pricing practices.¹⁴³ This type of file can be divided in five categories. These categories are the organisational structure of the MNE involved, a description of its business(es), its intangibles, its intercompany financial activities and its financial and tax positions.¹⁴⁴

2.8.2 Local file

The local file contains more detailed information and analysis which relates to specific local intercompany transactions in order to demonstrate that TP Policies of the MNE's associated enterprises are in line with the arm's length principle. This file is similar to the local TP documentation of an associated enterprise of an MNE and should be submitted to the local tax authority. The relevant information in the local file should include financial information related to the specific transactions, the comparability analysis, the selection and application of the most appropriate TP method.¹⁴⁵

¹³⁹ Belastingdienst, “Notitie Verrekenprijzen (‘transfer pricing’)”, 16 December 2016, p.5

¹⁴⁰ OECD TP Guidelines, para. 5.5

¹⁴¹ Ibid, para. 5.16

¹⁴² Ibid

¹⁴³ OECD TP Guidelines, para. 5.18

¹⁴⁴ Ibid, paras. 5.18&5.19

¹⁴⁵ Ibid, para. 5.22

2.8.3 Final remarks on the master file and local file

As described, the aforementioned TP Study and TP Policy should be documented in the systems of an MNE in order to be compliant with the laws of a particular country. Both the TP Study and TP Policy include the master file and local file, because the elements of these files, such as the comparability analysis, the selection and application of the most appropriate TP method, are required for the creation of the TP Study and the TP Policy.¹⁴⁶

2.8.4 Country-by-country report

MNE's with a consolidated group revenue of more than 750 million euros per year should prepare a Country-by-Country report. This report provides information on sales, profit before tax, paid and accrued income tax, overall profit, number of employees and tangible assets for each country in which the MNE operates. In addition, the location and the nature of the main activity are determined for each participating enterprise. The Country-by-Country report will help tax authorities to carry out the risk selection of transfer pricing more efficiently. When the report shows that there is a high risk of profit shifting, the authorities may request further information to conduct further investigations.¹⁴⁷

2.8.5 Final remarks on TP documentation

The underlying idea behind these documentation requirements is that MNE's should be more transparent about their allocation of profits worldwide. This change required associated enterprises of MNE's to use compliant TP documentation to demonstrate that their transfer prices and the policy on these are at arm's length.¹⁴⁸ Finally, a special treatment to intangibles will be given in the next paragraph, because intangibles are very important to enterprises.

¹⁴⁶ IMF, OECD, UN & World Bank Group, *Practical Toolkit to Support the Successful Implementation by Developing Countries of Effective Transfer Pricing Documentation Requirements, Draft Version*, p.36

¹⁴⁷ OECD TP Guidelines, paras. 5.24&5.25

¹⁴⁸ KPMG, "Transfer Pricing Documentation", 2019, p. 1-3

2.9 Intangibles

As described, for many enterprises, intangibles are the actual value creators and the profit generators within the enterprise. Because intangibles are closely related to value creation (and therefore revenue and taxation), intangibles should be taken into account when establishing a transfer price.¹⁴⁹ This means that for TP purposes it is mainly important to know what value the intangibles contribute to the profits of a particular enterprise.

According to the OECD TP Guidelines, an intangible is “*something capable of owning or controlling non-physical or financial assets used for commercial activities, whose use or transfer will be offset if it occurs in a comparable situation between transactions between independent parties.*”¹⁵⁰

So, in fact, anything that is not tangible and that has added value to the goods will be considered as intangibles. If intangibles have been sold, the owner or developer receives a compensation at fair market value. This compensation is often in the form of a royalty¹⁵¹.¹⁵² In determining the royalty, it is important to know who is entitled to the payment, the amount of the payment and to assess whether the royalty arose in a reasonable manner.¹⁵³

Besides that, many enterprises that are part of an MNE have to deal with R&D activities. Research & Development (R&D) is the entire process that takes place within a company with regard to the research and development of new products and technological solutions. As described, R&D covers the entire process, which makes it important to determine the value of R&D at the enterprise-wide level, as a result, often not necessary to focus this activity on individual goods or product lines. In addition, there is a risk that R&D activities may not succeed as well as planned, so it is important to determine who bears the risks and in which country this is done as part of the allocation of R&D.¹⁵⁴ Under TP, intangibles have a broad scope and can be recharged in different ways. This is of relevance in relation with customs valuation which will be discussed in chapter 3.¹⁵⁵

¹⁴⁹ Monsenego, J., *Introduction to Transfer Pricing*, Alphen aan den Rijn: Kluwer Law International, 2015, para. 3.3

¹⁵⁰ OECD TP Guidelines, para. 6.6

¹⁵¹ For the definition of a royalty, reference is made to Art. 12(2) OECD Model

¹⁵² PwC, *International Transfer Pricing Guide*, 2015/16, p.79

¹⁵³ Egdome, van, J.T., *Verrekenprijzen; de verdeling van de winst van een multinational*, Fiscale Monografieën nr. 115, Deventer: Wolters Kluwer, 2017, pp. 230&231

¹⁵⁴ Geertsma, P., “Wat is research & development en Onderzoek & Ontwikkeling waarom is dit belangrijk?”, Technischwerken.nl. <http://www.technischwerken.nl/kennisbank/techniek-kennis/wat-is-research-development-en-onderzoek-ontwikkeling-waarom-is-dit-belangrijk/> (accessed on December 20, 2019)

¹⁵⁵ OECD TP Guidelines, para. 6.88

2.10 Conclusion

Based on what is described in this chapter, it can be concluded that TP is a mechanism that deals with direct taxation in the context of corporate income tax which takes into account several factors in order to reach an appropriate taxability of the profits in a given jurisdiction. This therefore concerns the allocation of profits in a given fiscal year. In particular, TP focuses on the net profit of an enterprise which often makes the individual value of the goods irrelevant. Moreover, TP concerns cross-border trade in goods between associated enterprises of an MNE.

The key elements of TP are the arm's length principle, comparability analysis and the selection of the most appropriate TP method. The aim of these elements is to reach a correct transfer price or profit margin in order to be at arm's length. In practice, a TP Study and TP Policy are used to determine an at arm's length transfer price or profit margin. In addition, in order to obtain more legal certainty about the correctness of a transfer price or profit margin used, an MNE or its associated enterprises can conclude an APA with the tax authorities. In the area of TP, there are a number of mechanisms to adjust a transfer price or profit margin. Enterprises, in particular, have the opportunity to adjust their transfer prices retrospectively. Furthermore, the TP mechanism has a mandatory documentation structure and a broad economic approach to determine intangibles.

Finally, it can be mentioned that all these aspects are important for the subsequent comparison with the customs value in chapter 4.

Chapter 3 Customs Valuation

This chapter deals with the second sub-question of this thesis, i.e. “*what are the key principles and fundamental starting points of customs valuation?*” The chapter will be structured as follows:

- An introduction to customs valuation is clarified first in paragraph 3.1,
- followed by the concepts of customs valuation in paragraph 3.2.
- The history will be explained in paragraph 3.3, whereas
- paragraph 3.4, will discuss the legal framework of customs valuation.
- In paragraph 3.5 until paragraph 3.9, the methods of customs valuation will be explained.
- Paragraph 3.10 will then give the overall conclusion on the second sub-question which contains the key elements and fundamental starting point of customs valuation.

3.1 Introduction

In the area of customs and international trade there is a framework of rules which covers the cross-border movement of goods which can be divided in fiscal measures¹⁵⁶ and non-fiscal measures¹⁵⁷. For this thesis, only the fiscal customs legislation is of relevance, more specifically the levy of customs duties of bringing goods into free circulation of - in this case – the EU.¹⁵⁸

Cross-border movement of goods can lead to the levy of import duties and the application of non-fiscal measures. In the EU, for customs purposes, bringing goods into free circulation leads to the payment of customs duties¹⁵⁹ (which is a definitive payment).¹⁶⁰ In situations where goods will be brought into free circulation, duties will become due based upon the applicable tariff for these goods which is either an ad valorem tariff (a percentage to be applied to the value of the goods (the so-called customs value¹⁶¹) or a specific right (e.g. an amount of furies per kilograms, litres etc.).¹⁶²

Additionally, customs values are determined transaction-based which means that for each individual good a specific customs value needs to be established. In other words, to value goods for customs purposes, transactions need to be separately identified. However, there is not a documentary requirement for customs valuation which is based upon global standards.¹⁶³ Finally, there are basically two concepts for determining a customs value. These concepts are discussed in the next paragraph.

¹⁵⁶ The purpose is to levy duties on the cross-border movement of goods into a customs territory

¹⁵⁷ Rules regarding trade policy: protection of domestic market, safety/health regulations

¹⁵⁸ Vliet, van, D.G., *Douanerecht*, Fiscale Monografieën nr. 90 (Tweede (herziene) druk), Deventer: Wolters Kluwer Nederland B.V, 2019, para. 1.1.1.

¹⁵⁹ The calculation of a customs duty is as follows: tariff (%) * value (€)

¹⁶⁰ European Commission, “What is importation?” Ec.europa.eu, https://ec.europa.eu/taxation_customs/business/customs-procedures/what-is-importation_en (accessed November 8, 2019)

¹⁶¹ Hereto belong the preferential origin (grants certain customs gains (access to a reduced rate of duty or zero duty) to goods traded between countries.) and tariff classification (determination of subtitles or other subdivisions of the Harmonized Commodity Description and Coding System (HS) of the WCO in order to classify the goods) which are the other essentials in the establishment of a duty liability

¹⁶² WTO, “Technical Information on Customs Valuation”, WTO.org, https://www.wto.org/english/tratop_e/cusval_e/cusval_info_e.htm (accessed October 29, 2019)

¹⁶³ Bakker, A. *Transfer Pricing and Customs Valuation: Two worlds to tax as one*, Amsterdam: IBFD, 2009, p. 85

3.2 Concepts of customs valuation

As described, there are traditionally two concepts for determining the customs value, namely the positive concept and the theoretical concept of valuation. Both of the concepts will be explained in this paragraph.

The first concept is based on the fact that goods are usually imported in the context of a purchase and the idea that this price is exactly the same as the market price of the good. The starting point is then that the current price should in principle apply as a customs value (positive customs value). The value is called positive because the importer does not have to prove that the actual invoice price is normal (in contrast to the application of the theoretical value). As a result, the customs authority must show that the invoiced price is so extraordinary¹⁶⁴ that it cannot serve as a customs value.¹⁶⁵

The second concept is based on the economic market value of the goods at the time the goods are imported, regardless of the actual purchase price for which the importer purchased the goods (theoretical customs value). The theoretical customs value is determined on the basis of the objective market value, i.e. the normal price. This is the price at which a good could be bought or sold on the free market.¹⁶⁶ Thereby, criteria¹⁶⁷ are set-up in order to determine whether a price could be considered as normal.¹⁶⁸ In the next paragraph these concepts will be discussed in more detail, against the background of the history of the concept of customs valuation.

3.3 History

In this paragraph, the history of customs valuation and the relevant institutions will be explained. The Brussels Definition of Value will be discussed in subparagraph 3.3.1 whereas the GATT (General Agreement on Tariffs and Trade) and the WTO (World Trade Organisation) will be discussed in subparagraph 3.3.2. The WCO (World Customs Organisation) and the EU (European Union) will be explained in subparagraph 3.3.3 and subparagraph 3.3.4.

¹⁶⁴ Not a real invoice price

¹⁶⁵ Vliet, van, D.G., *Douanerecht*, Fiscale Monografieën nr. 90 (Tweede (herziene) druk), Deventer: Wolters Kluwer Nederland B.V, 2019, para. 6.2.2

¹⁶⁶ Ibid, para. 6.2.2.1

¹⁶⁷ These criteria are for example, the price used is equal to a price used between independent parties agreed at a certain level of trade, place of supply which relates to the allocation of costs, the time at which the agreement was concluded, the quantity of goods

¹⁶⁸ Vliet, van, D.G., *Douanerecht*, Fiscale Monografieën nr. 90 (Tweede (herziene) druk), Deventer: Wolters Kluwer Nederland B.V, 2019, para. 6.2.1.1

3.3.1 Brussels Definition of Value

The theoretical valuation concept is the basis for the definition of the customs valuation as laid down in the Brussels Value Convention of 15 December 1950¹⁶⁹.¹⁷⁰ The purpose of the Brussels Definition of Value was the harmonisation of the customs valuation definition.¹⁷¹ This Convention was in fact an early EC-concept, but it also had a global effect, i.e. many countries around the world used the Brussels Definition of Value.¹⁷²

The main advantage of the Brussels Definition of Value is that the value, on which customs duties are levied, is not dependent on what a seller and buyer agree upon as the price in a particular case but is the same for all goods of certain type and quality. A disadvantage is that the outcome of the assessment whether a price deviates from the normal price or value often turned out to be arbitrary, in particular in transactions between related parties. This was partly due to the fact that the provisions in definition were broadly defined, which led to different interpretations by many countries.¹⁷³ As a result, it became necessary that a more adaptable and unified valuation methodology was needed to coordinate the systems of the countries. This is further explained in the next subparagraph.

3.3.2 GATT & WTO

In 1947, the GATT was signed. In Art. VII GATT regarding the customs value, it was stated that the import value of goods should be based on the actual value, i.e. Brussels Definition of Value, of the goods from which the duty is levied. However, it could be difficult to determine the actual value because the value of a good is influenced by several¹⁷⁴ factors.¹⁷⁵ Therefore, the GATT Uruguay Round resulted in the adoption of the positive value concept in the *Agreement on Implementation of Art. VII of the General Agreement on Tariffs and Trade* which provided for a basis of the current system, i.e. the WTO Customs Valuation Agreement..

¹⁶⁹ This convention entered into force in 1953

¹⁷⁰ Vliet, van, D.G. *Douanerecht*, Fiscale Monografieën nr. 90 (Tweede (herziene) druk), Deventer: Wolters Kluwer Nederland B.V., 2019, para. 6.2.1.3

¹⁷¹ Bakker, A. *Transfer Pricing and Customs Valuation: Two worlds to tax as one*, Amsterdam: IBFD, 2009, p. 64

¹⁷² WTO, "Technical Information on Customs Valuation", WTO.org, https://www.wto.org/english/tratop_e/cusval_e/cusval_info_e.htm (accessed October 29, 2019)

¹⁷³ Vliet, van, D.G. *Douanerecht*, Fiscale Monografieën nr. 90 (Tweede (herziene) druk), Deventer: Wolters Kluwer Nederland B.V., 2019, para. 6.2.1.3

¹⁷⁴ These factors could be time, place, scarcity, level of trade, competition et cetera

¹⁷⁵ Vliet, van, D.G. *Douanerecht*, Fiscale Monografieën nr. 90 (Tweede (herziene) druk), Deventer: Wolters Kluwer Nederland B.V., 2019, para. 6.2.1.1

As a result, the GATT Agreement was no longer based on the Brussels Definition of Value, but on the price actually paid or payable by the importer (positive concept of value).¹⁷⁶ This change has taken place as the Brussels Definition of Value had led to different interpretations requiring a neutral and uniform customs valuation system.¹⁷⁷ In 1995, the organisation behind the GATT was replaced by the WTO.¹⁷⁸ As a result of the Tokyo Round, in 1995, the WTO CVA¹⁷⁹ has become mandatory for the WTO-Members.

3.3.3 WCO

In order to improve the effectiveness and efficiency of customs administrations, in 1952 the WCO was established as an independent intergovernmental¹⁸⁰ organisation.¹⁸¹ An important body of the WCO is The Technical Committee on Customs Valuation who manages and explains the WTO CVA. This Committee has several tasks and responsibilities¹⁸², including writing Advisory Opinions, Commentaries and Case Studies.¹⁸³

In 2019, the WCO consists of 183 Member Countries of which three quarters are developing countries. The Member Countries represent more than 98% of the world trade.¹⁸⁴ This is in contrast to the OECD, which consists mainly of 36 Western countries that can lead to different policies, interests and practices, as developing countries are characterised, inter alia, by low economic development.¹⁸⁵

3.3.4 European Union

The EU is an economic and political cooperation of 28¹⁸⁶ European countries (Member States).¹⁸⁷ It established, among others¹⁸⁸, an “internal market”.¹⁸⁹ The internal market is the area without internal frontiers in which the free movement of goods, persons, services and capital in the EU is guaranteed.¹⁹⁰

¹⁷⁶ Vliet, van, D.G. *Douanerecht*, Fiscale Monografieën nr. 90 (Tweede (herziene) druk), Deventer: Wolters Kluwer Nederland B.V., 2019, para. 6.2.2

¹⁷⁷ Bakker, A. *Transfer Pricing and Customs Valuation: Two worlds to tax as one*, Amsterdam: IBFD, 2009, p. 65

¹⁷⁸ Vliet, van, D.G. *Douanerecht*, Fiscale Monografieën nr. 90 (Tweede (herziene) druk), Deventer: Wolters Kluwer Nederland B.V., 2019, para. 1.6.1.1

¹⁷⁹ WTO, “Technical Information on Customs Valuation”, WTO.org, https://www.wto.org/english/tratop_e/cusval_e/cusval_info_e.htm (accessed October 29, 2019)

¹⁸⁰ Member States are bound by the international organisation treaty if they have explicitly agreed

¹⁸¹ WCO, “Customs Valuation: Background to The Agreement”, June 2015

¹⁸² Their responsibilities are as follows: guarantee the consistency of the treatment, test numerous technical problems, research laws, procedures and assessment methods and provide technical assistance

¹⁸³ WCO, “Customs Valuation: Background to The Agreement”, June 2015

¹⁸⁴ WCO, “WCO in brief”, Wcoomd.org, <http://www.wcoomd.org/-/media/wco/public/global/pdf/about-us/wco-members/list-of-members-with-membership-date.pdf?db=web> (accessed December 16, 2019)

¹⁸⁵ Nuffic academy, “Welke problemen komen we tegen in ontwikkelingslanden”, Internationalisering.nl.

<https://www.internationalisering.nl/modules/capaciteitsopbouw-in-ontwikkelingssamenwerking/lessen/1-welke-problemen-komen-we-tegen-in-ontwikkelingslanden/> (accessed December 16, 2019)

¹⁸⁶ At time of writing this thesis

¹⁸⁷ Rijksoverheid, “Wat is de Europese Unie?”, Rijksoverheids.nl, <https://www.rijksoverheid.nl/onderwerpen/europese-unie/vraag-en-antwoord/wat-is-de-europese-unie> (accessed December 16, 2019)

¹⁸⁸ Also, “an economic and monetary union whose currency is the euro”

¹⁸⁹ Arts. 3(3) & (4) TEU (Treaty on the European Union)

¹⁹⁰ Art. 26(2) TFEU (Treaty on the Functioning of the European Union)

Before the internal market¹⁹¹ was established, the EU Customs Union¹⁹² was already in place. Since the establishment of the Customs Union, import duties between the EU MS are no longer levied. In addition, a common customs tariff applies to goods from third countries throughout the EU.¹⁹³ As a result of the Customs Union, it became necessary to search for a more uniform customs legislation within the European Community (EC). First, several customs processes and procedures were laid down in Regulations and Directives. At the time the internal market was to be established (1993), a common customs code was required.

As a result, in 1992, the Community Customs Code¹⁹⁴ (CCC) was published. From that moment on, the CCC¹⁹⁵ has been the basic piece of customs legislation in EC/EU customs.¹⁹⁶ However, over time, it became necessary to remodel the CCC which resulted in the Union Customs Code¹⁹⁷ (UCC). The UCC is applied in the EU since 1st May 2016.¹⁹⁸

3.4 Legal framework

As described in paragraph 3.3, the legal framework of customs valuation can be found in the WTO CVA Agreement which is binding for its members. However, this Agreement has, in principle, no direct effect. The WTO Member States, including the EU, have to implement the CVA in their own legislation which has taken place in an EU context, at present in the form of the Union Customs Code¹⁹⁹ (UCC), the Delegated Act (UCC DA) and the Implementing Act (UCC IA).

In this respect, the main purpose of the UCC is “*to introduce a fair, uniform and neutral system excluding the use of arbitrary or fictitious²⁰⁰ customs values*”. This means that the customs value should show the real economic value²⁰¹ of a good. All of the elements should be taken into account which have real economic value.²⁰² The rules on customs valuation have been implemented²⁰³ in Arts. 69 until 76 UCC, Art. 71 UCC DA, Arts. 127 until 146 UCC IA, Annexes 23-01 & 23-02 UCC IA and Art. 6 and Annex 8 UCC TA.

¹⁹¹ Which entered into force on 1 January 1993

¹⁹² Europa Nu, “Interne Markt”, Europa-nu.nl, https://www.europa-nu.nl/id/vh7doti6loy3/interne_markt (accessed December 16, 2019)

¹⁹³ Europa Nu, “Douane Unie”, Europa-nu.nl, https://www.europa-nu.nl/id/vh7dosr8loxq/douane_unie (accessed December 16, 2019)

¹⁹⁴ Legal package of the Community Customs Code (Reg. 2913/92) consisted of: Implementing Act of the CCC (Reg.2454/93), Tariff Regulation (Reg. 2658/87) and Definitive reliefs at import (Reg 1186/2009)

¹⁹⁵ Which is directly binding for EU Member States, in contrast to Directives (which has to be implemented in the national legislation of EU Member States)

¹⁹⁶ Tusveld, R., *Basic Principles of EU Customs Law*, Rotterdam: RSM, 2019, Chapter 2

¹⁹⁷ Legal package of the Union Customs Code (Reg. 952/2013): “The UCC”, the Implementing Regulation of the UCC (Reg. 2015/2447): “Implementing Act”, the Delegated Regulation of the UCC (Reg. 2015/2446): “Delegated Act” and the Commission Delegated Act on IT (Reg. 2016/341): “Transitional Act”. Remark: The Tariff Regulation and Definitive Reliefs Regulation of the former CCC are still in force within the UCC.

¹⁹⁸ Tusveld, R., *Basic Principles of EU Customs Law*, Rotterdam: RSM, 2019, paras. 4.1.1-4.1.3

¹⁹⁹ Legal package of the Community Customs Code (Reg. 2913/92), Implementing Act of the CCC (Reg.2454/93), Tariff Regulation (Reg. 2658/87) and Definitive reliefs at import (Reg 1186/2009)

²⁰⁰ Arbitrary or fictitious values could arise in cases of aggregate ranges instead of the value of individual goods

²⁰¹ This means the actual price paid or payable in cases when the transaction value method being used

²⁰² ECJ EC 12 June 1986, C-183/85, ECLI:EU:C:1986:247 (*Hauptzollamt Itzehoe v.Repenning*), para. 16; ECJ EU 19 March 2009, C-256/07, ECLI:EU:C:2009:167 (*Mitsui & Co. Deutschland*), para. 24; ECJ EU 12 December 2013, C-116/12, ECLI:EU:C:2013:825, (*Christodoulou and Others*), para. 39; ECJ EU 16 June 2016, C-291/15, ECLI:EU:C:2016:455 (*EURO 2004. Hungary*), para. 25.

²⁰³ Implemented from: Arts. 1 until 17 WTO CVA. These articles deal with the rules on customs valuation, whereby Arts. 1 until 8 determine six customs valuation methods

Besides that, there are other provisions of the UCC which influences the customs value used in specific cases. These provisions could be divided in three categories. Namely, the provisions relating to customs formalities²⁰⁴, the general rules on customs procedures²⁰⁵ and the release for free circulation and special procedures²⁰⁶. The UCC (as based upon the WTO CVA) contains six methods for determining the value of the goods for customs purposes. These methods are explained in paragraphs 3.5 to 3.9.

3.5 Methods of Customs Valuation

As mentioned in paragraph 3.4, the WTO CVA contains six methods of customs valuation.²⁰⁷ These methods are therefore also part of the UCC of the EU.²⁰⁸ The transaction value method of Art. 70(1) UCC²⁰⁹ is the primary method in order to determine the customs value. Between 90% and 95% of the cases, the transaction value is being used in order to determine the value of the imported goods.²¹⁰ In situations where it is not possible to determine the customs value on the basis of the transaction value, the next method in the hierarchy has to be applied in the order as listed.²¹¹ The transaction value method and its elements will be explained in paragraph 3.6 until paragraph 3.8 while the alternative methods will be discussed in paragraph 3.9.

3.6 Transaction value method

According to Art. 70(1) UCC, the transaction value should be used for the goods being valued. The transaction value means *the “price actually paid for the goods or the price to be paid when sold for export to the customs territory of the EU, adjusted where necessary”*.²¹² The price actually paid or payable is the total payment to be made by the buyer to the seller²¹³ for the imported goods, and includes all payments made as a condition for the sale of the imported goods.²¹⁴ Therefore, the transaction value is the sales price for export to the EU.²¹⁵

²⁰⁴ Arts. 5, 15, 18, 22-30, 51, 53, 77-80, 85-87 and 127 UCC

²⁰⁵ Arts. 162, 163, 166, 167 and 172 UCC

²⁰⁶ Arts. 201, 226, 240, 250, 254, 256 and 259 UCC

²⁰⁷ Transaction value method (Art. 1 WTO CVA), transaction value of identical goods (Art. 2 WTO CVA), transaction value of similar goods (Art. 3 WTO CVA) deductive value method (Art. 5 WTO CVA), computed value method (Art. 6 WTO CVA) and the fall-back method (Art. 7 WTO CVA). In contrast, Art. 7 is not a valuation method, but it defines the options and limitations for determining CV when the previous method cannot be used. This can be considered as one exception related to the hierarchical order (Art. 4 WTO CVA)

²⁰⁸ Which is based on the WTO CVA

²⁰⁹ Which is based on Art. 1 WTO CVA

²¹⁰ WCO, *Guide to Customs Valuation and Transfer Pricing*, para. 2.1

²¹¹ This could be the situation that a customs value does not reach the conditions set in Art.70 UCC to determine the transaction value, the customs authority has doubts about the truth or accuracy of the declared value or in situations that no sale took place

²¹² Art. 70 UCC

²¹³ According to Art. 129 UCC IA, *“The price actually paid or payable within the meaning of Article 70(1) and (2) of the Code shall include all payments made or to be made as a condition of sale of the imported goods by the buyer to any of the following persons”: “the seller”, “a third party for the benefit of the seller”, “a third party to the seller”, “a third party where the payment to that party is made in order to satisfy an obligation of the seller.”*

²¹⁴ Art. 70(2) UCC (implemented from Interpretative Note 1 of the WTO CVA); ECJ EU 22 June 2006, C-419/04 (*Conseil general de la Vienne*), ECLI:EU:C:2006:419 (*concl. Tizzano*)

²¹⁵ ECJ EU 15 July 2010, C-354/09, ECLI:EU:C:2010:439 (*Gaston Schul BV*), BNB 2011/15 (*note De Wit*), para. 29

There are five elements of the transaction value's definition which should be examined. These elements are:

- “the price actually paid or payable” (already referred to above),
- the condition of “sale”, which should be
- “sold for export to the EU”,
- the four conditions to be fulfilled (the last condition will be discussed in detail), and
- the adjustments to the customs value.

These elements will be discussed in subparagraphs 3.6.1 to 3.6.4, except for the adjustments to the price actually paid or payable. These adjustments are discussed in more detail in paragraph 3.8.

3.6.1 Sale

A sale should take place prior to the clearance of the goods for free circulation because, for customs valuation purposes, it is not possible to determine the transaction value in situations where no sale has taken place.²¹⁶ It is noteworthy that neither the WTO nor the EU have included a definition of a sale in the CVA and in the UCC. There have been some indications of what is meant by a sale.

For example, the WCO has stated in its Advisory Opinion 1.1 that the definition of sale should be interpreted broadly.²¹⁷ This remains a vague explanation, which means that it remains unclear what is meant by a sale for customs purposes (this contrary to TP where the existence of a sale is not relevant because the way in which a transfer price is structured between two associated enterprises is relevant there). Finally, the existence of a sale is not the only element for determining the transaction value. The sale must be for goods exported to the EU. This is the second element to be tested and will be discussed in the next subparagraph.

3.6.2 Sale for export to the EU

As mentioned, the sale prior to the importation must qualify as a sale for export to the country of importation.²¹⁸ According to the WCO, this type of sale should be considered as an actual transfer of goods which took place internationally.²¹⁹ In situations of more sales, series of sales²²⁰, the WCO explained in its Commentary 22.1 that the price paid on the last sale before launching the goods in the importing country should be taken into account as the sale for export.²²¹ The WCO Commentary 22.1 was the basis for the EU to move to a system which is laid down in the current EU UCC, i.e. Art. 128 UCC IA.

²¹⁶ Bakker, A., *Transfer Pricing and Customs Valuation: Two worlds to tax as one*, Amsterdam: IBFD, 2009, p. 69

²¹⁷ WCO, Advisory Opinion 1.1

²¹⁸ WCO, Commentary 22.1

²¹⁹ WCO, Advisory Opinion 14.1

²²⁰ Two or more following contracts

²²¹ WCO, Commentary 22.1

The EU have further tightened the condition of the “last sale”, which has led to the fact that the legislation now states that “*the transaction value of the goods sold for export to the customs territory of the Union shall be determined at the time of acceptance of the customs declaration on the basis of the sale occurring immediately before the goods were brought into that customs territory.*”²²² Since this provision came into force, there has been some uncertainty about this as well. However, this condition is not required under TP is and therefore does not create a direct issue in comparing TP to customs valuation. As a result, it is not further explained in this thesis.

3.6.3 Four conditions

As described, the transaction value must reflect the actual price paid or payable, i.e. real economic value of a good imported which shall take into account all elements of that good which represent the real economic value. The transaction value may be accepted provided that it has not been significantly influenced. A price is deemed not to have been influenced if “*the price at which such or like merchandise is sold or offered for sale in the ordinary course of trade under fully competitive conditions*”.²²³ In this respect, Article 70(3) UCC provides that the transaction value applies if the following four conditions are met:

1. There are no restrictions on the transfer or use of the goods by the purchaser (except in the cases referred to in Art. 70(3)(a) UCC);
2. The sale or price is not subject to any condition or performance in respect of goods whose value is to be determined cannot be established;
3. No part of the proceeds of the subsequent resale or transfer or subsequent use of the goods by the buyer shall directly or indirectly benefit the seller, unless an applicable adjustment can be made; and
4. The buyer and seller are not related, or their relationship is not such that it influences the price.

In respect of this thesis, the fourth condition regarding to the relationship between the buyer and seller plays an important role in the question whether the transaction value in such stage can be used in determining the customs value. If the buyer and seller are related, the transaction value can be used if the relationship has not influenced the price of the goods.²²⁴ Art. 127 UCC IA ²²⁵ defines the concept of being “related”.²²⁶

²²² Art. 128(1) UCC IA

²²³ Art. VII(2)(a) GATT 1994

²²⁴ WTO Art. 1(2)(a) CVA

²²⁵ Art. 127 UCC IA (based on Art. 15(4) WTO CVA)

²²⁶ According to Art. 127 UCC IA, This can be in the following situations: “*officers or directors of one another’s business*”, “*legally recognised partners in business*”, “*employer and employee*”, “*a third party directly or indirectly owns, controls or holds 5% or more of the outstanding voting stock or shares of both of them*”, “*one of them directly or indirectly controls the other*”, “*both of them are directly or indirectly controlled by a third person*”, “*together they directly or indirectly control a third person*”, “*members of the same family.*”

In case a sale has been influenced does not automatically mean that that sale cannot serve as a basis for the customs value, because these sales could have been made in the ordinary course of business under competitive conditions.²²⁷ However, a transaction value established between two related parties can still be rejected by the customs authorities on the basis of Art. 140 UCC IA if they have doubts about the extent to which this value is influenced. This procedure allows the customs authorities to request additional information from the declarant.

If doubts persist, before a final decision is made, the declarant in question must have the opportunity to respond to these doubts.²²⁸ In this context, a link must be established on how to determine whether or not the relationship between the buyer and the seller has influenced the price. This will be further discussed in the next subparagraph.

3.6.4 Transactions between related parties

In order to determine whether or not the price established in a sale between two related parties has been influenced, two criteria need to be tested. These are the "circumstances surrounding the sale" and the "test values".

3.6.4.1 *Circumstances surrounding the sale*

In order to determine if the transaction value used is acceptable, the circumstances surrounding the sale should be taken in to account.²²⁹ The circumstances surrounding the sale are as follows²³⁰: “*the way the buyer and seller organise their commercial relations*” and “*the way in which the price in question was arrived at*”.²³¹ The review of the circumstances surrounding the sale takes only place in cases of doubts about the price acceptability. If the customs authority is unable to accept the price, the importer should supply the data required.²³²

²²⁷ Art. VII(2)(a) GATT 1994

²²⁸ Written on request.

²²⁹ Art. 1(2)(a) WTO CVA

²³⁰ Interpretative Note to Art. 1 WTO CVA, para. 2

²³¹ Interpretative Note to Art. 1 WTO CVA, para. 2

²³² Bakker, A., *Transfer Pricing and Customs Valuation: Two worlds to tax as one*, Amsterdam: IBFD, 2009, p. 72

3.6.4.2 Test values

A test value can be used to support the declared value to determine whether a transaction value based upon a sale (price) between related parties has been influenced.²³³ The transaction value should be accepted if the declared value “closely approximates”²³⁴ to one of the next test values which are in fact the alternative methods, namely: the transaction value of identical or similar goods, the deductive value method and the computed value method.²³⁵ Test values are not allowed as replacement values, but only for comparison purposes.²³⁶

3.6.4.3 Final remarks on transactions between related parties

If it shows that the relevant data concerning the "circumstances surrounding the sale" and the "test values" have been influenced by the relationship between two related parties, such means that the transaction value cannot be used to determine the customs value. As a result, the customs value shall be determined on one of the alternative methods as applied in a strict hierarchical order.²³⁷

3.7 Adjustments to the price actually paid or payable

As described, the transaction value is the price actually paid or payable for the goods when sold to the EU and can be adjusted where necessary.²³⁸ In some cases, other amounts are paid which have been established on the basis of the same transaction and have not yet been included in the price.

Based upon the WTO CVA, these elements should actually be added to the price. On the other hand, elements which do not belong to the price as determined for customs valuation purposes should be deducted from the customs value.²³⁹ The adjustments can therefore be divided in additions to and deductions from the customs value.²⁴⁰ Besides that, as a result of a recent ECJ ruling²⁴¹ and its consequences, it will be discussed whether or not year-end adjustments are allowed for customs purposes. This type of adjustments will be discussed in paragraph 3.8.

²³³ Art. 1(2)(b) WTO CVA

²³⁴ According to Interpretative Note to Art. 1 WTO CVA, para. 2(b), “closely approximates” includes the following factors: the “*nature of the imported goods*”, the “*nature of the industry itself, the season in which the goods are imported*”, and, “*whether the difference in values is commercially significant*.” These factors differ from case to case which means that it is hopeless to apply a consistent guideline.

²³⁵ Art. 1(2)(b) WTO CVA

²³⁶ Art. 1(2)(b) WTO CVA

²³⁷ Bakker, A., *Transfer Pricing and Customs Valuation: Two worlds to tax as one*, Amsterdam: IBFD, 2009, p. 73

²³⁸ Art. 70(1) UCC

²³⁹ ECJ EC 28 March 1990, C-219/88 (*Malt*), ECLI:EU:C:1990:146 (*concl. Tesouro*)

²⁴⁰ Art. 71 & 72 UCC

²⁴¹ ECJ EU 20 December 2017, C-529/16, ECLI:EU:C:2017:984 (*Hamamatsu*)

3.7.1 Additions

In some cases the customs value must be increased by the amounts paid by the buyer that were not included as such in the invoice price of the goods.²⁴² These elements include commissions, brokerage fees, assists, packaging costs, royalty and license fees, as well as freight and insurance costs up to the point of entry into the customs territory of the EU.²⁴³ In the context of this thesis, assists, royalties and license fees are explained in more detail.

3.7.1.1 Assists

Assists is the collective term for the elements listed in Art. 71(1)(b) UCC. These elements are the goods and/or services provided by the buyer to the seller for free or at a reduced price for the production and sale for export of the goods imported in case they are not yet included in the price actually paid or payable.²⁴⁴ The assist containing the design and development costs necessary for the production of the goods imported are important to mention, because here is a link between TP and customs valuation.²⁴⁵ If the design and development costs are related to the goods imported and the work on this development has taken place outside of the EU, then it should be added to the customs value.²⁴⁶ If this condition is met, the design and development costs may be allocated pro rata to the individual goods being imported.²⁴⁷

Nevertheless, according to Art. 135(5) UCC IA the costs of general research and preliminary design sketches do not have to be added to the customs value.²⁴⁸ This is due to the fact that both the WTO CVA and the UCC refer to design and development costs.²⁴⁹ In the context of customs valuation, there are specific rules whether or not elements should be added. However, in a number of cases, in fact, efforts on intellectual property rights are recharged to the other party in the form of royalties or license fees.²⁵⁰ Therefore, under the principles of the WTO CVA royalties and licenses may have to be added to the price (if not yet included in the price).²⁵¹ This will be discussed in the next subparagraph.

²⁴² Chin-Oldenziel, M., *Aanpassingen van de douanewaarde*. EBR 7.2.7. B, Cursus Belastingrecht, Kluwer Navigator (online), p.1

²⁴³ Art. 71 UCC

²⁴⁴ Art. 71(1)(b) UCC

²⁴⁵ Art. 71(1)(b)(iv) UCC

²⁴⁶ Simmons & Simmons, "Outsourcing manufacturing: customs duties, intellectual property and R&D", 2006, p.1

²⁴⁷ Art. 135 UCC IA

²⁴⁸ Art. 135(5) UCC IA

²⁴⁹ Art. 8(1)(b)(iv) WTO CVA jo. Art. 71(1)(b)(iv) UCC

²⁵⁰ Simmons & Simmons, "Outsourcing manufacturing: customs duties, intellectual property and R&D", 2006, p.1

²⁵¹ Art. 71(1)(c) UCC

3.7.1.2 Royalties & license fees

With regard to the royalty and license fees, the UCC provides in a specific provision. It states that royalties and license fees are dutiable only if they are related to the imported goods and payment is a condition of sale.²⁵² Some particularities apply here, such as Art.136 UCC which defines the term “condition of sale”²⁵³ and the WCO Commentary 25.1 which is also important for the UCC.²⁵⁴ In this Commentary, the WCO Technical Committee on Customs Valuation sets out several factors²⁵⁵ that should be taken into account in order to determine whether a royalty payment or a license fee is a condition of sale.²⁵⁶ However, in the context of this thesis, no further explanation will be given. On the other hand, it may also be the case that elements are already included in the customs value that actually don't belong in the price as determined for customs valuation purposes. As a result, these elements should be deducted from the customs value. This will be discussed in the next subparagraph.

3.7.2 Deductions

It may also happen that payments are made by the seller in the context of a sale, i.e. the costs related to the elements which play a role after release into free circulation of the goods.²⁵⁷ Article 72 UCC lists the elements that are not included in the customs value, such as costs of transport after entry into the customs territory of the Union, costs of construction work, installation, assembly, maintenance and technical assistance related to the imported goods after entry into the customs territory of the Union, purchase commissions, import duties and other taxes to be paid in the Union as a result of the importation or sale of goods.²⁵⁸

²⁵² Art. 71(1)(c) UCC as implemented from Art. 8(1)(c) WTO CVA

²⁵³ Art. 136 UCC IA

²⁵⁴ Art. 136 UCC IA

²⁵⁵ According to WCO Commentary 25.1(9), these factors are as follows: “Royalties or license fees are mentioned in the sales agreement or related documentation;” “The sale of goods is mentioned in royalties or license agreements;” “Depending on the terms of the sales agreement or royalties or license agreement, the sales agreement may be terminated due to a violation of the royalties or license agreement as the buyer does not pay the licensor a royalty or license fee. This would indicate a link between the payment of royalties or license fees and the sale of the valued goods;” “The license agreement states that the manufacturer may not manufacture and sell the products unless royalties or royalties are paid. Incorporation of the licensor's intellectual property into the importer;” “The terms contained in the royalties or license agreement allow the licensor to manage the production or sale between the manufacturer and the importer (export to the importing country), which is outside the scope of quality control.”

²⁵⁶ WCO, Commentary 25.1(9)

²⁵⁷ Chin-Oldenzel, M. *Aanpassingen van de douanewaarde*. EBR 7.2.7. B, Cursus Belastingrecht, Kluwer Navigator (online), p.2

²⁵⁸ Art. 72 UCC

3.8 Year-end adjustments

Another interesting question is to what extent year-end adjustments in the context of TP can reduce the customs value. This question arose in ECJ *Hamamatsu*.²⁵⁹ The facts of this case are placed in the footnote.²⁶⁰

The ECJ has ruled in this case that acceptance of retrospective adjustment of the transaction value is limited to specific situations that, in particular, are related to a lack of quality of the good or defects that come to light after goods have been cleared through customs.²⁶¹

Besides that, the CCC did not impose an obligation on importing enterprises to request corrections of the transaction value when it is subsequently adjusted upwards. Neither did the CCC contain a provision based on the basis of which the customs authorities can hedge against the risk that those enterprises will only request downwards adjustments.²⁶² Therefore, the transaction value cannot be used if price is adjusted at the end of the fiscal year. The customs value must be determined based on one of the alternative methods.

The significance of this judgement of the ECJ for practice has been far-reaching as in the customs authorities of several EU Member States in daily routine have developed policies on how to deal with these year-end adjustments and how they (retrospectively) could be incorporated into the customs value. After the judgement of the ECJ doubts have arisen as to the use of transfer prices subject to year-end adjustments for customs valuation purposes. In Chapter 5 of this thesis, a number of solutions are proposed in the context of this issue.

As already indicated, in certain situations there is no transaction value, or the transaction value may not be acceptable for the customs authorities. In those case alternative methods are provided for in the customs valuation agreement. These alternative methods of customs valuation will be explained in the next paragraph.

²⁵⁹ ECJ EU 20 December 2017, C-529/16, ECLI:EU:C:2017:984 (*Hamamatsu*)

²⁶⁰ *Hamamatsu* Germany has purchased goods from its Japanese parent company Hamamatsu Photonics. As the claimant, Hamamatsu Germany acquired various goods from Hamamatsu Photonics, which were released for free circulation in Germany at different customs rates (partly duty-free and partly with a customs rate between 1.4% and 6.7%). The customs value was the price invoiced during the year (calculated on the basis of a prior pricing agreement). The intercompany prices are based on a closed APA with the German tax authorities. The amounts charged to Hamamatsu are adjusted based on the TP method “Residual Profit Split Method.” This method consists of two steps. In the first step, a profit is allocated to each party that is sufficient to record a certain minimum return. The residual profit is then distributed proportionally based on certain factors. In the second step, a target range for the operating margin is determined for Hamamatsu. If the actual operating result achieved falls outside the target range, the result is corrected to the upper or lower range of the target range and it receives an additional claim or credit. Because the operating margin was below the target range, the transfer prices were adjusted. As a result, Hamamatsu received a discount in the form of a credit from Hamamatsu Photonics. Therefore, Hamamatsu asked the German customs authorities for a refund of customs duties. The correction amount was not broken down into individual goods. However, the final total price for the same product in every transaction was not determined for every transaction. The German customs authority rejected the request because the method used by Hamamatsu was incompatible with Art. 29 CCC. The German court asked two preliminary questions.

²⁶¹ ECJ EU 20 December 2017, C-529/16, ECLI:EU:C:2017:984 (*Hamamatsu*), paras. 31&32

²⁶² *Ibid.*, paras. 33&35

3.9 Alternative methods

In cases where it is not possible to determine the customs value on the transaction value of Art. 70 UCC, it is required to determine the customs value on one of the five alternative methods which should be applied in a strict hierarchical order. An important remark is that under application of Art. 74(1) UCC,²⁶³ it is possible to reverse the order of application of the customs valuation methods. This is only possible in situations when the importer requests to reverse the deductive value method and the computed value method. In this case, the application of Art. 74(2)(c) UCC goes above the application of 74(2)(b) UCC.²⁶⁴ In the next subparagraphs, the alternative methods will be explained.

3.9.1 Transaction value of identical and similar goods

The second and third method to be applied in the hierarchical order are the transaction value of identical and the transaction value of similar goods.

3.9.1.1 Identical goods

The transaction value of identical goods can be found in Art. 74(2)(a) UCC. These goods are goods which are produced in the same country and which are identical in all respects to goods imported and exported from the third country in question at the same or nearly the same time as goods for which the value must be determined. This is the case when the goods are identical with regard to their external characteristics, material characteristics, quality and reputation.²⁶⁵ In practice, it appears to be difficult to use this method, since "identical" must also be really identical in all aspects. For example, a radio can be identical even though it has a different colour. But it must have the same (volume) buttons, the same price, the same options, trademark and so on.²⁶⁶ It is therefore very difficult to use this method.

3.9.1.2 Similar goods

The transaction value of similar goods can be found in Art. 74(2)(b) UCC. These goods are goods that are produced in the same country of the goods to be imported and are therefore replaceable with the trade. Besides that, these goods are not identical in all respects (but have the same characteristics and contain similar components) and should be exported at almost the same time. The existence of product quality, reputation and registered trademarks are important factors to consider when evaluating product similarities.²⁶⁷

²⁶³ Based on Art. 4 WTO CVA

²⁶⁴ Art. 4 WTO CVA

²⁶⁵ Art. 74(2)(a) UCC & Art. 15(2)(a) WTO CVA

²⁶⁶ PwC, *Six degrees of valuation - Is there madness in the methods?*, Trade Intelligence Asia Pacific, August/September 2017, p.6

²⁶⁷ Art. 74(2)(b) UCC & Art. 15(2)(b) WTO CVA

In practice, it appears to be difficult to use this method because, despite the fact that a good should be commercially replaceable, there are still several conditions to be fulfilled. For example, the existence of a trademark, the commercial level, the quantities, the quality of the goods and the exporting country are factors that should be taken into account. This means that it is almost impossible to make a good comparison with similar goods.²⁶⁸

3.9.1.3 Final remarks on the transaction value of identical and similar goods

Due to the conditions set, the transaction value of identical and similar goods is hardly applied in practice. Furthermore the necessary information is not available at the importer and the customs authorities are not in a position to provide it due to their professional secrecy.²⁶⁹ If another alternative method is applied, it is often the deductive value method or the computed value method which are the fourth and fifth method in the hierarchical order. These methods are explained in more detail in the next subparagraphs.

3.9.2 Deductive value method

The deductive value method can be found in Art.74(2)(c) UCC.²⁷⁰ This method takes as a starting point the value of the goods when sold in the EU to independent customers at or around the time of importation. This price can be reduced by the usual commissions or additional payments for profit and general costs, the usual costs of transport and insurance and related costs in the EU and the import duties and taxes levied on import or sale in the EU.²⁷¹

In practice, the deductive value method is easier to apply than the transaction value of identical and similar goods. However, this method requires the gross profit margin of a competing enterprise. For the importer in question, this information is often difficult to obtain or to verify. The gross profit margin should fall within the normal margins of similar goods. Because enterprises import many goods at the same time, it is almost impossible to find a margin comparable at production level.

In addition, the burden of proof that a gross profit margin is acceptable lies with the importing enterprise.²⁷² However, this enterprise does not know the gross margins of other enterprises and this method is not applicable in sales between two related enterprises.²⁷³ On the other hand, in a customs dispute it is an important factor because this method provides insight into the figures on how a price is built up.²⁷⁴

²⁶⁸ PwC, *Six degrees of valuation - Is there madness in the methods?*, Trade Intelligence Asia Pacific, August/September 2017, p.6

²⁶⁹ Chin-Oldenziel, M., *Aanpassingen van de douanewaarde*. EBR 7.2.7. B, Cursus Belastingrecht, Kluwer Navigator (online), p.1

²⁷⁰ Based on Art. 5 WTO CVA

²⁷¹ Art. 74(2)(c) UCC

²⁷² PwC, *Six degrees of valuation - Is there madness in the methods?*, Trade Intelligence Asia Pacific, August/September 2017, p.6

²⁷³ Art. 142(4) UCC IA jo. Art. 74(2)(c) UCC

²⁷⁴ PwC, *Six degrees of valuation - Is there madness in the methods?*, Trade Intelligence Asia Pacific, August/September 2017, p.6

3.9.3 Computed value method

The computed value method can be found in Art. 74(2)(d) UCC.²⁷⁵ Under this method the customs value is determined on the basis of the sum of production costs incurred in the exporting country, an amount for profit and operating costs and the costs of transport and insurance of the goods up to the point of entry into the Union.²⁷⁶ In practice, the computed value method faces the same issues to be applicable as the deductive value method. However, the computed value method is more difficult to apply than the deductive value method, because the computed costs are incurred outside the EU.²⁷⁷ As a result, customs authorities are reluctant to rely on information that cannot be verified on their own territory. They must therefore rely only on the information provided by the exporter.²⁷⁸

3.9.4 Final remarks on the deductive value method and the computed value method

Both the deductive value method and the computed value method require that the amounts of general expenses and profits should be taken into account together. In practice, many enterprises never consider them together, but include them in their accounts separately.²⁷⁹

3.9.5 Fall-back method

In cases where it is not possible to determine the customs value on Arts. 70, 74(2)(a), 74(2)(b) 74(2)(c) or 74(2)(d) UCC, it is required to determine the customs value on the basis of the fall-back method of Art. 74(3) UCC.²⁸⁰ In general, the fall-back method is not a specific method, but it describes the ability to create a customs value if the aforementioned methods cannot be used.²⁸¹

When applying the fall-back method, the other four alternative methods will be reviewed again and the conditions that apply to these methods are used less strictly.²⁸² By abandoning the strict conditions, these methods may be easier to apply.

The value of the goods determined under the fall-back method should represent a fair market value and commercial reality which means, among others, arbitrary and fictional values may not be used.²⁸³ In practice, this method is often used in sales between related parties, i.e. intercompany transactions in which it is not possible to use to transaction value because their relationship has influenced the price or there has no sale for export taken place.²⁸⁴ Finally, in the next paragraph a conclusion is given on the second sub-question that was dealt with in this chapter.

²⁷⁵ Based on Art. 6 WTO CVA

²⁷⁶ Art. 74(2)(d) UCC

²⁷⁷ Maisto, G., "Cross-Border Valuation for Income Tax, Customs Duties and VAT", Bulletin March 2001, IBFD, pp. 111&112

²⁷⁸ PwC. "Six degrees of valuation - Is there madness in the methods?" Trade Intelligence Asia Pacific, August/September 2017, p.7

²⁷⁹ Ibid, p.7

²⁸⁰ Based on Art. 7 WTO CVA

²⁸¹ WCO, *Guide to Customs Valuation and Transfer Pricing*, para. 2.5

²⁸² Art. 144(1) UCC IA based on Interpretative Note to Art. 7 of the WTO CVA

²⁸³ Art. 144(2) UCC IA jo. Art. 74(3) UCC

²⁸⁴ TechAmerica, *Customs Valuation Benchmarking Survey: Outside the Comfort of Transaction Value*, June 2013, pp. 4&5

3.10 Conclusion

Based on the above, it can be concluded that the value of the goods is determined at the moment they are cleared for free circulation in the EU, i.e. at that moment customs duties are levied. Different to TP, the taxable event is bringing the goods into free circulation. The rules of customs valuation are legally binding for Member States of the EU.

Key element of customs valuation is that the value of individual goods as customs duties are levied per individual transaction. This value includes the costs of the goods and an amount of profit attributable to these goods. Unlike TP, the customs value should be determined using six specific customs valuation methods to be applied in a strict hierarchical order. The transaction value is to be used as the primary method. Further, where the application of the alternative methods is required, such is perceived as complex in practice. The customs value can only be adjusted if there are elements which are not included in the price or which are already included in the price but do not actually belong to it as listed for customs purposes.

Finally, it can be concluded that customs valuation is based on a very different kind of framework with different purposes, elements and backgrounds. It can be said that the framework of customs valuation is constructed in a different way compared to TP. To explain this in more detail, an extensive comparison between TP and customs valuation will take place in the next chapter.

Chapter 4 Comparison Transfer Pricing & Customs Valuation

This chapter deals with the third sub-question of the thesis, i.e. “*what are the similarities and differences between TP and customs valuation and which elements could play a role in a more combined approach?*” The chapter will be structured as follows:

- The similarities will be explained in paragraph 4.1, whereas
- Paragraph 4.2 discusses the differences per subparagraph.
- In paragraph 4.3, the similarities and differences are listed in a table to clarify the comparison.
- Finally, paragraph 4.4 will then give the overall conclusion on the third sub-question which contains the similarities, differences and the elements which can play a role in a more combined approach.

From various points of view, it is difficult to say that a transfer price can serve as a basis for customs valuation because it is based upon different principles. This will be discussed in detail in the next two paragraphs where a distinction is made between the similarities and differences.

4.1 Similarities

The main similarity is that both transfer prices and customs values are determined on the basis of an arm's length principle which aims to establish a price that would have been determined under free competition between independent enterprises (unrelated parties). This means that the existence of such a relationship should not influence the price.²⁸⁵ The need to determine a transfer price is related to the existence of associated enterprises²⁸⁶ whereas the test criterium to use of that transfer price for customs valuation is subject to an analysis whether the price has been influenced based upon the existence of related parties²⁸⁷. This shows, therefore, that the similarities can be found in "not being influenced", i.e. the establishment of an arm's length price.

In TP, a TP Study is used to arrive at a most appropriate TP method by means of a comparability analysis. On the basis of this outcome an arm's length price or profit margin is established. After this theoretical determination, the results of the TP study are implemented in practice as a TP Policy. In terms of customs valuation, the as such established arm's length price i.e. the price on the invoice in the related party transaction is tested whether that the price has not been influenced and whether the other conditions of Art. 70 UCC are met. However, the test is different to arrive at an at arm's length price.

²⁸⁵ Schippers, M.L., “Retroactieve interne verrekenprijsaanpassingen en de douanewaarde”, NTFR Beschouwingen 2017/32, para. 3.1

²⁸⁶ Art. 9 OECD Model

²⁸⁷ Art. 70(3) UCC

As described, in TP, a TP Study is used in advance to arrive at an arm's length price, while in the area of customs valuation, questions can be asked afterwards by the relevant customs authority about the same price. In other words, the same price is tested in two different ways.

On that point it is important to mention that, when companies are viewed as associated under the TP rules, this also will be the case under the specific customs valuation rules (in other words: under customs valuation rules they then will be viewed as related parties).²⁸⁸ Therefore, despite some differences, with regard to the arm's length principle a very similar starting point exists, i.e. the price may not have been influenced. However, it is difficult to align TP and customs valuation due to substantial differences as explained in the next paragraph.

4.2 Differences

As described, cross-border transactions between associated enterprises should be determined and/or tested in accordance with the arm's length principle which can be considered as the main similarity between TP and customs valuation. However, there are also differences between TP and customs valuation of which only the main differences will be mentioned that are in line with the perspective of this thesis. These main differences consist of the following elements and will be discussed per subparagraph:

- Objective and legal framework,
- the scope,
- the subject,
- the taxable and dutiable event,
- the taxable and dutiable object,
- the tax and duty rate,
- the period, the methods,
- the adjustments,
- the documentation requirements and
- the treatment of intangibles.

²⁸⁸ Bakker, A., *Transfer Pricing and Customs Valuation: Two worlds to tax as one*, Amsterdam: IBFD, 2009, p.12

4.2.1 Objective & legal framework

As described in paragraph 2.2, the objective of TP is the allocation of profits between associated enterprises of an MNE (or within the entire group) in the same way as between independent enterprises. This is because otherwise transactions between associated enterprises would not be exposed to the same market conditions as independent companies, i.e. free market conditions. To ensure this, the OECD has developed a legal framework for this purpose.

The legal framework of TP on an international level can be found in the OECD Model and in the OECD TP Guidelines. Both the OECD frameworks can be considered as soft law. Only if members of the OECD have implemented it in their national legislation, it can be considered as legally binding, i.e. hard law.

In contrast, the objective of customs valuation is primarily to determine the value of the goods declared for release for free circulation in the EU. This value provides a basis for the dutiable amount on which the duty rate is applied for the goods declared and thus to establish the customs duties due. The legal framework of customs valuation can be found in the EU UCC²⁸⁹ which is established on several EU-regulations. Because EU-regulations are legally binding for EU Member States, this means that the UCC is legally binding as well, i.e. it can be considered as hard law.²⁹⁰

4.2.2 Scope

In the context of transactions between associated enterprises, TP and customs valuation have different scopes. The scope of TP covers all cross-border intra-group transactions, i.e. the trade in goods, intangibles, services and financing activities. This is because each of these elements can be important for a correct allocation of profits within the associated enterprises, i.e. to determine who is entitled to which part of the profit. In contrast, the scope of customs valuation is, in this context, the cross-border movement of goods released for free circulation in the EU.²⁹¹ This is because customs duties can only be levied when goods physically cross the border to be released for free circulation.²⁹² In the context of the scope of TP and customs valuation, it can therefore be said that TP has a broader scope than customs valuation.²⁹³

²⁸⁹ Which is based upon the WTO CVA

²⁹⁰ Tuominen, J., "The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?", *International Transfer Pricing Journal* (2018), p. 441

²⁹¹ Goods are products which can be valued in currency accepted as exchange the goods and which are capable of being traded. (ECJ EC 10 December 1968, C-7/68, EU:C:1968:51 (*Commission v. Italy*) p.428)

²⁹² WTO, "Technical Information on Customs Valuation", WTO.org. https://www.wto.org/english/tratop_e/cusval_e/cusval_info_e.htm (accessed October 29, 2019)

²⁹³ Tuominen, J., "The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?", *International Transfer Pricing Journal* (2018), p. 441

4.2.3 Subject

As may have become clear from subparagraphs 4.2.1 and 4.2.2, the subject of TP is limited to associated enterprises only. This is because transactions between associated enterprises should take place in the same way as between independent enterprises, i.e. under free market conditions. The framework of TP provides in this aim due to the arm's length principle.

On the other hand, the subject of customs valuation is completely different. In principle, the declarant is required by law to pay customs duties in case the goods are declared for free circulation in the EU. The declarant can be anyone as long as established in the EU. This is because the UCC is a legal framework of the EU which, among other things, covers goods brought into the EU.

In the context of the subject matter in this thesis, the declarant of the goods is an associated enterprise that must be established in the EU or, if such is not the case be represented by an agent established in the EU.

4.2.4 Taxable & dutiable object

As described in subparagraph 2.6.2, a transfer price is determined on an aggregated level in order to arrive at a correct allocation of profits. This is because TP works with a range. If the profit margin applied in these transactions with an associated enterprise falls within that range, then it is an at arm's length price. The profits of an enterprise should be taxed under the corporate income tax system. In this context, the taxable profit is the taxable object.

In contrast, customs valuation is transaction-based which takes into account the individual value of the goods for released free circulation. Therefore, this value serves as a starting point for the duty due, i.e. the individual value of the goods is the dutiable basis for customs valuation purposes.²⁹⁴ It follows from the above that TP's taxable object is the taxpayer's profits, whereas the dutiable object of customs valuation represents the value of the individual goods. Before a tax or duty can be levied, a taxable or dutiable event must take place. This will be discussed in the next subparagraph.

4.2.5 Taxable & dutiable event

As described in paragraph 2.1, for the purpose of TP, a taxable event arises when a transfer of goods (among others) takes place from one associated enterprise to another associated enterprise. This is because, normally between independent enterprises, by this act a transaction takes place in return for a consideration. For example, one enterprise sells a good and the other enterprise pays for this good. In this situation, the arm's length principle comes up. It has the aim that inter-company transactions should take place in the same way as if that transaction takes place between independent enterprises. Therefore, the transaction then qualifies as the taxable event.

²⁹⁴ Tuominen, J., "The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?", *International Transfer Pricing Journal* (2018), p. 442

In contrast, for customs valuation purposes, the release for free circulation of goods in the EU is the dutiable event. The individual value of the goods is necessary to levy the correct amount of import duties when clearing the goods for free circulation.²⁹⁵ The good must be released for free circulation in order to qualify as a dutiable event. From the above it can therefore be noted that the taxable event and the dutiable event are very different from each other. Now that the differences between the taxable and dutiable event have been further explained, the differences in tax and duty rate can be explained.

4.2.6 Tax & duty rate

For TP purposes, a tax rate becomes due on the total amount of profits by means of a fixed percentage of that amount. It is possible that the amount of this percentage is linked to a certain maximum amount. If this amount is exceeded, the percentage will also increase. In contrast, for the purpose of customs valuation an ad valorem duty rate becomes due on the individual goods released for free circulation. Ad valorem means that the duty is expressed in a certain percentage of the value.²⁹⁶ In other words, in case of TP a percentage is levied on the profit and in the case of customs valuation, a percentage is levied on the value of the goods.

This difference is mainly explained by the fact that tax authorities are interested in the correctness and allocation of profits and customs authorities are interested in the individual value of the goods.²⁹⁷ In addition, there is a timing difference in determining the corporate income tax and the import duty due. This will be discussed in the next subparagraph.

4.2.7 Period

As mentioned, there is a timing difference in determining the corporate income tax and the import duty due. The corporate income tax is determined annually because, in principle, the fiscal year covers the period from 1 January to 31 December.²⁹⁸ In contrast, the duty is determined per transaction because the value of the goods has to be determined separately when they are brought into free circulation.²⁹⁹ This shows therefore that the period of customs valuation does not depend on a fiscal year, i.e. fiscal year, but really depends on a transaction by transaction basis.

²⁹⁵ Tuominen, J., “The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?”, *International Transfer Pricing Journal* (2018), p. 442

²⁹⁶ Global negotiator, “Ad valorem duty”, Globalnegotiator.com, <https://www.globalnegotiator.com/international-trade/dictionary/ad-valorem-duty-2/> (accessed January 6, 2020)

²⁹⁷ Tuominen, J., “The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?”, *International Transfer Pricing Journal* (2018), pp. 441&442

²⁹⁸ Belastingdienst, “Belastbaar bedrag en boekjaar”, Belastingdienst.nl, https://www.belastingdienst.nl/wps/wcm/connect/bldcontentnl/belastingdienst/zakelijk/winst/vennootschapsbelasting/belastbaar_bedrag/belastbaar_bedrag_en_boekjaar (accessed on January 6, 2020)

²⁹⁹ Schippers, M.L., “Retroactieve interne verrekenprijsaanpassingen en de douanewaarde”, *NTFR Beschouwingen* 2017/32, para. 3.1

As described in subparagraph 2.5.3 and paragraphs 3.5 until 3.9, the methods which can be used to arrive at an arm's length price/profit margin or customs value are also of an undeniable difference. This is explained in more detail in the next subparagraph.

4.2.8 Methods

In order to determine a correct transfer price or profit margin, the OECD TP Guidelines consider five methods. In principle, associated enterprises can select the most appropriate method for their situation. This selection is often based on a TP Study and TP Policy which consists of the comparability analysis and the selection of the most appropriate TP method in order to prove that the transfer price or profit margin used is at arm's length.³⁰⁰ Where possible, the OECD advises the use of traditional transaction methods, i.e. the CUP, cost-plus or resale-minus method.

In contrast, the customs value is primarily determined on the basis of the transaction value which considers the price actually paid or payable. The transaction value does not apply if there is no sale and/or if the price is subject to restrictions, depending on some conditions, or is influenced by the relationship between the buyer and seller. If it is demonstrated by the buyer and seller that the price has not been influenced by their relationship, the transaction value may still be used. This should be done on the basis of test values and/or circumstances surrounding the sale which compares the transaction to the extent of influence.

If it seems that the transaction has been influenced, the customs value must be determined on the basis of the strictly hierarchical alternative valuation methods. However, all of these methods have proved difficult to apply in practice.³⁰¹ It follows from the above that the application of a TP method creates an arm's length transfer price or profit margin and that by applying a customs valuation method, for the same price it should be shown that it has not been influenced.

In both systems, prices can be adjusted if they are not arm's length. However, they also contain substantial differences. This is further explained in the next subparagraph.

³⁰⁰ Tuominen, J., "The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?", *International Transfer Pricing Journal* (2018), p. 443

³⁰¹ *Ibid*

4.2.9 Adjustments

4.2.9.1 *In general*

As described in paragraph 2.7, in TP there are several mechanisms to adjust a transfer price. Most are subject to use by the tax authorities, whereas enterprises only can make compensating adjustments, i.e. retrospective adjustments and prospective adjustments on a voluntary basis. In contrast, the adjustments of a customs value are limited to the extent they are listed in both Arts. 71 (additions to the customs value) and Art. 72 UCC" (deductions from the customs value). This distinction can be explained as follows. The adjustments within TP relate in particular to the adjustment of the price in order to achieve an acceptable profit. In the context of the customs value, the adjustments relate to the elements which should be normally included in the price, i.e. the value of the export price to the EU.

4.2.9.2 *Retrospective adjustments*

An important remark shall be made in the context of retrospective adjustments. In TP, enterprises are allowed to make retrospective adjustments to the transfer price of the goods. This is because of the moment at which a transfer price can become final after the corporate income tax return is filed. A transfer price can still be adjusted years later after a transaction has taken place. In addition, it is possible for enterprises to conclude an APA with the tax authorities, among others, on this element in order to obtain legal certainty. In contrast, the customs valuation framework does not provide for a similar ruling with the customs authorities.

In customs valuation, retrospective adjustments are only allowed in cases of specific circumstances. These circumstances are in the situations of defective goods recognised at the time of the customs clearance as it influences the price actually paid or payable.³⁰² In addition, a customs value will become final at the time of customs clearance. This is because customs valuation takes into account only the value of the goods at the time they are released for free circulation.³⁰³ The element "release for free circulation" is one of the customs procedures included in Art. 5(16) UCC. This will be explained in the next subparagraph.

³⁰² Art. 70(1) UCC jo. Art. 132 UCC IA

³⁰³ Art. 77 UCC

4.2.9.3 *Customs declaration*

Goods may be placed under a customs procedure. In order to place these goods under a customs procedure, a declaration must be made to the customs authorities.³⁰⁴ The UCC defines this a customs declaration. This is the act by which the declarant indicates the intention to place goods under a certain customs procedure.³⁰⁵ Art. 5(16) UCC distinguishes the following customs procedures:

- Release for free circulation
- Special procedures (Explained more in detail in Art. 210 UCC)
- Export

In the context of this thesis, only the first customs procedure, i.e. release for free circulation, will be considered. The declarant provides data to the customs authority by means of the declaration. These data are used to calculate the customs duties, for example when the goods are released for free circulation.³⁰⁶ By making a declaration for a customs procedure, the declarant asks the customs authority for permission to use this customs procedure. The customs authority must be able to take this decision, which means that the form of the declaration and the associated information are subject to statutory regulations.³⁰⁷

Standard customs declarations for placing goods under a customs procedure shall therefore contain all the elements necessary for the application of the provisions governing the customs procedure for which the goods are declared.³⁰⁸ In addition, the declarant must be in possession of so-called (legally required) supporting documents when submitting the declaration. These are documents that are necessary to allow the requested customs procedure and documents that support and substantiate the information in the declaration.³⁰⁹

4.2.9.4 *Simplified declaration*

If, at the time of declaration, not all the information is known, or certain supporting documents are not in possession at the time when the declarant of the goods wishes to declare their entry under a customs procedure, there is the possibility of making a so-called simplified declaration.³¹⁰ This type of declaration is possible, for example, in the case of declarations relating to goods released for free circulation.³¹¹ The simplified declaration procedure involves placing goods under a customs procedure with the presentation of a commercial or administrative document, i.e. an invoice. At a later point in time, a written or electronic supplementary declaration is submitted.³¹²

³⁰⁴ Art. 5(16) UCC

³⁰⁵ Art. 5(12) UCC

³⁰⁶ Belastingdienst., *Handboek Douane (HDU)*(valid as from 1 May 2016), Chapter 12.00.00, para. 2.1

³⁰⁷ Art. 6(1) UCC

³⁰⁸ Art. 162 UCC

³⁰⁹ Belastingdienst., *Handboek Douane (HDU)*(valid as from 1 May 2016), Chapter 12.00.00, para. 1.2

³¹⁰ Art. 166 UCC

³¹¹ Art. 5(16) UCC

³¹² Art. 166 UCC jo. Art. 167 UCC

Currently, the supplementary declaration must be lodged within ten days of the release of the goods.³¹³ However, this option in practice has no value in resolving the issue of retrospective price adjustments because the period of 10 days is too short. All of the above elements in this chapter should be well documented. The documentation requirements are also substantially different. This will be discussed in the next subparagraph.

4.2.10 Documentation

As described in paragraph 2.8, TP includes mandatory documentation requirements set based upon global principles, i.e. the master file, local file and the Country-by-Country Report in order to prove that a transfer price or profit margin is at arm's length. In contrast, the framework of customs valuation does not know a specific requirement as such.³¹⁴ This distinction makes it difficult for enterprises to demonstrate, by means of TP documentation, that a price has not been influenced for customs valuation purposes. In addition, there is no obligation for customs authorities to take into account TP-documentation in order to demonstrate that this price has not been influenced.

However, the WCO has indicated in its Case Study 14.1 that this documentation (TP Study) may be useful as it may contain certain information on a price that may be relevant for the customs value. It is theoretically possible that two separate documentation systems will be set up to demonstrate that the price is arm's length on the one hand and that the same price is not influenced, i.e. not arbitrary or fictitious on the other hand. However, in practice it is not desirable to use two separate documentation systems next to each other, because this is time consuming and creates more paperwork.³¹⁵

As mentioned in paragraph 2.9, intangibles are the actual value creators of an enterprise. However, the intangibles are treated in a completely different way in both systems. This difference is further explained in the next subparagraph.

4.2.11 Intangibles

With regard to the allocation of intangibles, TP has a very broad approach. In principle, any element that represents a value that is not tangible can be allocated to the transfer price. This is because, for the purpose of TP, it is of main importance to determine who is entitled to which part of the profit.³¹⁶ In other words, it must reflect all the elements required that attribute to the profit gained. The intangibles relevant for TP are e.g. R&D costs and royalties.

³¹³ Art. 146 UCC DA jo. Art. 167(1) UCC

³¹⁴ Tuominen, J., "The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?", *International Transfer Pricing Journal* (2018), p. 442

³¹⁵ *Ibid*

³¹⁶ Lagarden, M., "Intangibles in a Transfer Pricing Context: Where Does the Road Lead?" *International Transfer Pricing Journal* September/October 2014, p. 346

Under the customs valuation rules, the allocation of intangibles is stricter. Their treatment is subject to the to specific rules as mentioned in the limited list of Art. 71 UCC. This shows that the allocation of e.g. R&D costs, royalties and license fees is under customs valuation principles not done in the same way as under TP principles. In this case, however, the costs for design and development work may be taken into account provided that they are related to the goods released for free circulation and that this work took place outside the EU. This does not include the costs for preliminary design sketches and general research.³¹⁷

The same applies to the treatment of royalties and license fees. These may only be added to the value if they are related to the goods released for free circulation and it is a condition of sale.³¹⁸ Therefore, the customs value shall include the price of certain intangibles to the extent that they relate to the goods released for free circulation, are listed in the aforementioned article and were not yet part of the price charged. This shows that the intangibles have a much broader reach and impact for TP purposes than under the customs valuation rules.³¹⁹

4.3 Final remarks on the comparison

The previous comparison can be further clarified by means of the table below. It follows from the above that the similarity does not outweigh the differences between TP and customs valuation.

	Transfer Pricing	Customs
<i>Similarity</i>		
Starting point	Searching for an arm's length price between associated enterprises. The price should be set as if the parties were not related and that the prices are agreed under normal business circumstances.	Whether the price as invoiced between related parties has been influenced or not. The price should be set as if the parties were not related and that the prices are agreed under normal business circumstances.
<i>Differences</i>		
Legal framework	OECD Model & OECD TP Guidelines Soft law.	EU UCC Legal Package (based upon the WTO Customs Valuation Agreement) EU package is hard law.
Objective	Allocation of profits between associated enterprises of an MNE (or within the entire group) in the same way as between independent enterprises.	To determine the value of the goods released for free circulation in order to be a basis for the dutiable amount regarding the customs duties due.
Scope	Cross-border intra-group trade.	Cross-border intra-group trade of goods released for free circulation in the EU.

³¹⁷ Art. 71(1)(b) UCC jo. Art. 135(5) UCC

³¹⁸ Art. 71(1)(c) UCC

³¹⁹ Lagarden, M., "Intangibles in a Transfer Pricing Context: Where Does the Road Lead?" International Transfer Pricing Journal September/October 2014, p. 346

	Transfer Pricing	Customs
Subject	Associated enterprises only.	In principle, the declarant (which can be anyone as long as established in the EU) is required by law to pay customs duties in case the goods are declared for free circulation in the EU. Delimitation thesis: associated enterprise is the declarant of the goods as long as established in the EU.
Taxable/dutiabale object	The profits of the taxpayer. Especially, the aggregated/annual range of goods which results in a limited interest of the tax authority in the value of the individual good.	The value of the individual goods released for free circulation in the EU in order to impose the right amount of the customs duty.
Taxable/dutiabale event	Transfer of goods, intangibles, services and financing activities.	Release for free circulation of goods in the EU.
Tax item or customs duty due Tax/duty rate	Tax rate becomes due on the total amount of profits by means of a fixed percentage of that amount.	Ad valorem duty rate which is levied on the individual goods released for free circulation by means of a fixed percentage of the value.
Period	Periodically.	Transaction-by-transaction.
Methods	Transfer Pricing Methods. Selection of the most appropriate method. Arm's length principle is applicable.	Customs valuation methods. Strict hierarchy. Legally, no arm's length principle applicable.
Moment at which a transfer price/customs value becomes final	A transfer price can become final after the corporate income tax return which could be years after event has taken place.	A customs value become final at the moment of customs clearance.
Legal basis for retrospective adjustments	Yes, enterprises can adjust transfer prices retrospectively on a voluntary basis.	No, only in cases of specific circumstances (defects).
Documentation	Documentation is required consisting of a three-tiered approach: master file, local file and a Country-by-Country report.	Customs clearance: no specific documentation requirements as set in TP
Intangibles	Broad economic approach (any element that is not tangible can be allocated to the transfer price, where and if appropriate).	The customs value shall include the price intangibles to the extent that they relate to the goods imported and are listed in Art. 71 UCC (limited approach).

4.4 Conclusion

The foregoing shows that the two systems as a whole do not match. The only element that in broad terms is very similar is the use of an “arm’s length-like”- principle, which however as stated, is supported by totally different principles. The major differences can be found in the objective, scope and principles of both TP and customs valuation. Therefore, the arm’s length principle should be adjusted to the objectives of the different systems.³²⁰

A transfer price can be used only for customs purposes if it consists of an appropriate mix of elements as would be required under both systems. However, the TP rules do not provide for a basis that takes into account the customs valuation rules, nor do the customs valuation rules provide for a basis that provides a legal solution to the mismatch with TP.

As can be concluded from the above, from a purely theoretical point of view, a TP cannot simply be used as a customs value. The fact that it has happened in practice is often due to pragmatic considerations and the fact that many customs agents may not oversee the matter due to its complexity at one hand and the lack of detailed background information available for them, at the other hand.

Nevertheless, in daily routine enterprises and customs authorities have to work with the two systems. As a result, although now appropriately aligned, transfer prices are currently still used by associated enterprises as a basis for the customs value.³²¹ The question is how to resolve this as, looking at efficiency, it is obvious to look for a solution that brings the systems closer together. Otherwise enterprises will have to support out double pricing of goods and multiple accounting ledgers. Therefore, in the opinion of the author of this thesis, a possible approach that should be analysed in this thesis is a more combined approach.

This more combined approach consists of two important elements of both systems. In this more combined approach, the customs value is used as a starting point for determining the transfer price in order to make that transfer price a more valid basis for customs valuation purposes, i.e. the issue is resolved by taking customs valuation as the starting point. In chapter 5, possible solutions will be given in order to create a bridge between the two different systems of TP and customs valuation.

³²⁰ Tuominen, J., “The Link between Transfer Pricing and EU Customs Valuation Law: Is There Any and How Could It Be Strengthened?”, *International Transfer Pricing Journal* (2018), p. 444

³²¹ See: ECJ EU 20 December 2017, C-529/16, ECLI:EU:C:2017:984 (*Hamamatsu*)

Chapter 5 Possible solutions

This chapter deals with the fourth sub-question of this thesis, i.e. *“to what extent is the current practise of applying a TP based price as the basis a correct fundamental starting point for determining a customs value and what are the minimum criteria to be set, in order to make sure that such transfer price then can be used for customs valuation purposes?”* The chapter will be structured as follows:

- The customs value as starting point will be explained in paragraph 5.1, whereas
- paragraph 5.2 discusses the implementation method of TP.
- In paragraph 5.3, a change in the burden of proof will be explained, whereas
- paragraph 5.4 will discuss the proposal to extend the deadline for supplementing a simplified declaration.
- Paragraph 5.5 will then give the overall conclusion on the fourth sub-question.

5.1 Customs value as starting point

The idea here is that it should be possible to determine a value for the goods based on the principles of customs valuation which is such that it then can also serve as a basis for TP. This innovative way of thinking can be underpinned by the organisations behind the frameworks of TP and customs valuation.

As described in subparagraph 3.3.3, the WCO consists of 183 Member Countries of which three quarters are developing countries. The Member Countries represent more than 98% of the world trade.³²² This is in contrast to the OECD, which consists mainly of 36 Member Countries mainly from the first world. This means that both organisations have different policies, interests and practices, as the disparities between developing countries and developed countries can be considered as major. For these reasons, it is quite strange that a transfer price is used one-to-one as starting point for customs valuation since the WCO represents many more countries which are mainly developing countries.³²³

As chapter 4 has shown, it is not possible to use a transfer price one-to-one as starting point for a customs value, because the differences between both systems are significantly. For this reason, in the author’s view, a model can be applied that takes the customs value as a starting point in order to arrive at a transfer price that can also be used as a customs value. This model will be explained in the next subparagraph.

³²² WCO, “WCO in brief”, Wcoomd.org, <http://www.wcoomd.org/-/media/wco/public/global/pdf/about-us/wco-members/list-of-members-with-membership-date.pdf?db=web> (accessed December 16, 2019)

³²³ European Commission, “UCC – Legislation”, Ec.europa.eu, https://ec.europa.eu/taxation_customs/business/union-customs-code/ucc-legislation_en (accessed on December 23, 2019)

5.1.1 The model of a price

In general, the price of goods consists essentially of three elements, namely the costs of production which leads to a production price³²⁴, overhead costs (general expenses)³²⁵ and a profit margin^{326, 327}. These elements can together create a model where the production price is the bottom of the model and the profit margin is the top of the model. Additionally, there is a grey area that consists of the determination of intangibles, since for TP it is of main importance to determine who is entitled to which part of the profit.³²⁸ Under the customs valuation rules, the allocation of intangibles is subject to specific rules as mentioned in the limited list of Art. 71 UCC. Therefore, the customs value shall include the price of certain intangibles to the extent that they relate to the goods released for free circulation, are listed in the aforementioned article and were not yet part of the price charged.³²⁹ The production price is important for the customs value, because it contains main elements to determine the actual price of the goods.³³⁰

In contrast, the profit margin is important in TP because the purpose of TP is the allocation of profits.³³¹ These two elements can be considered as the elements which are relevant in a more combined approach. From the customs point of view, next to the profit and the intangibles, the bottom of the model is of main importance and has particularly got to be taken into account. TP mainly focus on the profit and looks therefore more on the top of the model. If under this model, first the bottom of the model is determined, namely the price of the individual goods, then this price can be taken as the starting point for the remaining parts of the model. The allocation of the profit margin to the parties involved shall be based on the results of the TP Study (comparability analysis, the most important element of which is the functional analysis).³³² Then the determination of these profit margins could also be acceptable for customs valuation purposes. While there is no legal basis for that as yet, the WCO has provided in its Case Study 14.1 that these margins³³³ can demonstrate that the price has not been influenced by the relationship between the parties involved.³³⁴

³²⁴ The costs are directly related to the good

³²⁵ Overhead costs are indirectly related to the good which can be energy costs, staff costs, depreciation costs and transportation costs

³²⁶ KVK, “Kostprijs berekenen en productprijs bepalen”, Ondernemersplein.kvk.nl, <https://ondernemersplein.kvk.nl/productprijs-bepalen-info-en-tips/> (accessed on January 2, 2020)

³²⁷ Evofenedex, “Douanewaarde zo eenvoudig is het nog niet, Evofenedex.nl.

<https://www.evofenedex.nl/kennis/actualiteiten/douanewaarde-zo-eenvoudig-het-nog-niet> (accessed on January 2, 2020)

³²⁸ Lagarden, M., “Intangibles in a Transfer Pricing Context: Where Does the Road Lead?”, *International Transfer Pricing Journal* September/October 2014, p. 346

³²⁹ Art. 71(1)(c) UCC jo. Art. 136 UCC IA

³³⁰ Art. 70(1) and (2) UCC jo. Art. 129 UCC IA

³³¹ Angelis, De, E & Elshof, T., “The Interplay between Transfer Pricing and Customs Valuation in Case of Retroactive Profit Adjustments: The Position of the ECJ in the Case Hamamatsu Photonics Deutschland GmbH (C-529/16)”, *International Transfer Pricing Journal*, Volume 25, No 4 (2018), para. 1.2

³³² OECD TP Guidelines, para. 1.36

³³³ Which were based on the TNMM

³³⁴ WCO Case Study 14.1

When determining the transaction value with regard to transactions between two related parties, it should first become clear from which elements it is composed.³³⁵ As stated in subparagraph 3.6.4.2, this can be proven on the basis of test values, i.e. the mechanism under customs valuation rules that compares the transaction value to the outcome of a price for the goods established under one of the other methods (in such case, the transaction value cannot be replaced by the outcome of the test values).³³⁶ In order to calculate a price starting with the production costs to derive the customs value of the goods, the computed value method can be used as a test value. This is because the computed value method provides insight into how the price is built-up, i.e. this value method calculates the production price as well as an amount of profit.³³⁷

The computed value method determines the costs of production, the overhead costs (general expenses), the transportation and insurance costs, loading and handling charges related to the transport and an amount of profit. The production costs include all expenses for the creation, completion or substantial improvement of the goods, i.e. the costs of materials and fabrication. These last-mentioned elements exist of the costs of containers and packing,³³⁸ and the assists³³⁹ supplied by the buyer.³⁴⁰ The general expenses are the direct and indirect costs of producing and selling the goods for export if they are not already included in the costs of production.³⁴¹ For the determination of the amount of profit, the TP profit methods can be used, i.e. the TNMM or the profit-split method.³⁴² These methods work with a distribution key that expresses itself in a certain percentage in order to allocate the profit to the associated enterprises involved in a given transaction. As a result, once a transfer price has been built up in this way, it can provide a basis for determining the customs value as well as a transfer price.

There remains a grey area with how to include intangibles in the price. As stated, in the context of customs valuation, intangibles are included in the value under certain conditions. In case of TP, it is an aspect that is taken into account in determining who is entitled to which part of the profit. In order to be able to use a transfer price as basis for the customs value, only the intangibles allowed for customs value should be included. These are, for example, royalties and license fees that may be included in the price under certain conditions.³⁴³ For TP purposes, it is simply possible to join the broad concept of their own framework. In this context, if a transfer price consists of elements that are not dutiable for the customs value, i.e. the way of determining intangibles for TP, then these elements can always be removed in advance and included separately in the invoice.

³³⁵ Art. 70(1) and (2) UCC jo. Art. 129 UCC IA

³³⁶ Art. 1(2)(b) WTO CVA

³³⁷ Art. 74(2)(d) UCC jo. Art. 143 UCC IA

³³⁸ As stated in Art. 71(1)(a)(ii) + (iii) UCC

³³⁹ Art. 71(1)(b) UCC

³⁴⁰ Art. 143(2) + (3) UCC IA

³⁴¹ Art. 143(4) UCC IA

³⁴² OECD TP Guidelines, para. 2.63

³⁴³ Art. 71(1)(c) UCC jo. Art. 136 UCC IA

As a result, this transfer price is ultimately established that comes much closer to what is required for customs valuation. The table below illustrates this solution by using a numerical example.

+/+ Costs of production			
- Materials		€20	
- Fabrication		€15	
- Containers		€10	
- Packing		€5	
- Assists		<u>€25</u>	
			€75
+/+ General expenses			
- Fixed costs		€25	
- Variable costs		<u>€20</u>	
			€45
+/+ Profit margin		€24	
- Distributed according to the TP Study For example: 20% allocated (20% * (€75+€45))			
			€24
= TP starting value			€144
+/+ Intangibles allowed for customs		€30	
- Royalties/license fees			<u>€30</u>
= TP to be used for customs valuation			€174

5.1.2 Considerations regarding the model

In principle, this model can be considered as a solution to the problem. By using the computed value method, it is possible to see how a price is built up. This makes it possible to remove the disparities between the two systems and also the compliance issues. It is also in the interest of the WCO Member Countries, as they form the majority in the world when it comes to customs. It should therefore be self-evident that they should have a leading role on finding a solution on this issue.

However, it is true that today the area of direct taxes, which includes TP, is dominant in this world and with it the interests of the OECD Member Countries. This is because these countries in fact represent the economic power in the world and the fact that these countries are mainly interested in a correct allocation of profits, i.e. taxing MNEs' allocated profits.

The author of this thesis finds this very regrettable, since these countries do not see the other interests at stake in this world in terms of, for example, the customs valuation framework. Therefore, the author is of the opinion that when establishing a transfer price, the rules of the customs valuation framework must first be respected. This should then be done using the prescribed model. This will remove a large part of the differences between the two systems. Another possible solution can be found in the field of TP in practice. This possible solution will be discussed in the next paragraph.

5.2 Implementation method TP

In practice, the so-called implementation methods are often used to determine the actual pricing that is to be used as the transfer price on the invoice. The OECD TP Guidelines are taken as a starting point which can be implemented in the national law of a country. The implementation method is explained in more detail in the next subparagraph.

5.2.1 The explanation of the implementation method

In order to determine a correct transfer price of the goods and to gain insight into the elements of this price, a TP Study will be performed.³⁴⁴ However, this observation is of a conceptual nature, since it will be determined how this price should be established. Taking into account the results of this TP Study, profit margins are allocated to the parties involved in the value chain of a good. For example, there are three enterprises involved to which a part of the profit is allocated according to the TNMM or the profit-split method. These enterprises will obtain 50%, 30% and 20% of the profit. Based on this, a TP Policy is drawn up in practice, stating the conceptual basis for the transfer price. Subsequently, this TP Policy still needs to be implemented. The amount on which the profit margins may be allocated should also be determined.

What then seems to happen is that, for example, a cost-plus or resale-minus method³⁴⁵ is assumed. In doing so, the consumer price, the cost price and the profit of the goods sold are determined. For example, a pair of jeans is sold at the consumer price of €150. This price consists of the cost price of €100 which leads to a profit of €50. This profit is allocated based on the conceptual basis, i.e. on the basis of the three percentages aforementioned. This will lead to a distributed profit of €25, €15 and €10 to the enterprises involved. It follows from the conceptual basis what price should be used. The application of this basis can be done either upwards (cost-plus method) or downwards (resale-minus method). In practice, therefore, not all theoretical requirements of these methods are applied, but these methods can be used as a basic mechanism to arrive at the price in the previous link in the value chain from the consumer price. This way of working is permitted, since the objective of TP will be maintained, i.e. reaching arm's length transfer price.

³⁴⁴ OECD TP Guidelines, paras. 1.60&3.4

³⁴⁵ In other words: the resale price method

In addition, TP documentation will be available which shows how the conceptual basis has been implemented. This documentation can be used to demonstrate that the relationship between the associated enterprises involved has not influenced the price for determining the customs value^{346,347}. In the implementation phase, some material exists that actually goes into the price of the goods. It is very likely that this documentation includes material that can be used to make the connection with the customs value. It is inevitable that a piece of documentation can be found in the files with which an enterprise can make clear to the customs authorities that the price is correct.

In doing so, different TP methods are used. Both the TNMM and the profit-split method can be used for the conceptual basis of a transfer price in order to set the profit margins. In the context of the implementation method, the resale-minus or the cost-plus can be used. The implementation method is often based on the traditional methods, as comparable transactions are required for the comparability analysis.³⁴⁸ Then, a recalculation of the transfer price takes place on the basis of the percentages established in the conceptual basis. As a result, this outcome is used as an implementation method.

5.2.2 Considerations regarding the implementation method

By linking in to the implementation method as applied to implement the transfer price, the related TP documentation may give relevant substantiation for the use of the transfer price as a basis for the customs value. However, a transfer price is based on the market price, which means that there is still no insight into whether the basis of that price is actually correct in order to be used as a basis for the customs value.

In the author's view, this possibility does not provide for an overall solution, but it can help to demonstrate that a specific transfer price likely could be used as a basis for the customs value. In other words, the implementation method is only a supporting element which helps to demonstrate that a transfer price may serve as a basis for the customs value. Linking in to the implementation method applied for TP, documentation can be available that can be valuable for the customs value. This will be discussed in more detail in the next paragraph.

³⁴⁶ Art. 70 (3)(d) UCC jo. Arts. 134 (1) + (2) UCC IA

³⁴⁷ Schippers, M.L., "Retroactieve interne verrekenprijsaanpassingen en de douanewaarde", NTFR Beschouwingen 2017/32, para. 3.3

³⁴⁸ OECD TP Guidelines, para. 3.24

5.3 Burden of proof

It is currently the case that at request of the customs authorities an (associated) enterprise has to demonstrate that the price of the goods is not influenced by its relationship with the other enterprise.³⁴⁹ This can be considered as the burden of proof. In contrast, in TP the enterprise has always the burden of proof.³⁵⁰ As indicated earlier, this is not the case within the customs valuation framework.

5.3.1 Changing the burden of proof

A similar burden of proof could therefore be placed on the customs value. However, this should only apply to related parties in order to preserve as far as possible the positive customs valuation principle. If a burden of proof is imposed on the declarant of the goods, the declarant is forced to collect and/or obtain documentation justifying why the price is appropriate to be used as a basis for the customs value. As a result of this obligation, a documentation file is available showing how a price is established. This documentation file provides both the customs authorities and the enterprises involved with certainty as to the correctness of the price and limits the risk of compliance issues, fines and penalties. All in all, incorporating a change in the burden of proof may lead to consistent and standardised documentation within the customs valuation framework.

5.3.2 Considerations regarding the burden of proof

For many enterprises, adjusting the UCC regarding the burden of proof can offer a possible solution concerning the substantiation of the correctness of the prices used by them as basis for the customs value. If they can prove, by means of documentation, that the customs value as declared has not been influenced, this can provide that they are forced to align much more to the legal framework of customs valuation. In addition, this change in the burden of proof provides customs authorities with more clarity about how a price is built-up. This does require additional work, but that is inherent to a possible solution like this concerning the applicability of a transfer price to the customs value.

According to the author of this thesis, a change in the burden of proof can be perfectly combined with the model as described in paragraph 5.1. This model itself and its results should also be documented. By means of the change in the burden of proof, the declarant of the goods should always demonstrate mandatory, based on this documentation, that the price is correct for customs value purposes.

³⁴⁹ Art. 70 UCC jo. Art. 140 UCC IA

³⁵⁰ OECD TP Guidelines, paras. 5.7-5.9

5.4 Extending the deadline for supplementing a simplified declaration

As explained in subparagraph 4.2.9.3, the supplementary declaration must be lodged within ten days of the release of the goods.³⁵¹ Therefore, until now, this option in practice has no value in resolving the issue of retrospective price adjustments. However, the European Commission has proposed an amendment to the UCC that provides for an adjustment of this deadline.

This proposal seems to follow up the ruling of ECJ *Hamamatsu*, i.e. that it is not permitted to use a transaction value as a customs value consisting partly of an amount initially invoiced and declared and partly of a flat-rate adjustment to that amount after the end of the period, without it being possible to know whether this adjustment will be made upwards or downwards at the end of this period.³⁵² Therefore, the European Commission has proposed to extend the period for supplementing the simplified declaration to two years.³⁵³ In principle, this is a practical solution to resolve the issue of retrospective price adjustments as often applied within TP. However, one should bear in mind that this solution does not take away the fundamental problem. It only solves the problem of retrospective adjustments but does not result in the fact that the intrinsic transfer price is in line with the requirements from the customs valuation framework.

Regardless the fact that now a retrospective price adjustment could be taken into account, still the basic problem remains that a price established based upon TP principles often does not reflect the actual price of the specific goods being released for free circulation. Therefore, also with this change in place, it remains to be seen whether, within those two years, a transfer price has been established that in fact can be used as the basis for a customs value.

³⁵¹ Art. 146 UCC DA jo. Art. 167(1) UCC

³⁵² ECJ EU 20 December 2017, C-529/16, ECLI:EU:C:2017:984 (*Hamamatsu*), p.10

³⁵³ Such a proposal was adopted by the CEG/VAL group (EU Member State representatives of Commission's Customs Expert Group, Valuation Section)

5.5 Conclusion

The foregoing has shown some possible solutions from a customs perspective in order to be able to use a transfer price as a starting point for customs valuation purposes. In current practise, a transfer price is determined mainly for the purpose of a correct allocation of profits between associated enterprises arising from a particular transaction. These enterprises and tax authorities involved are often only interested in the value of the goods on an aggregated level. If it shows that the transfer price does not lead to the wished and/or agreed upon outcome, enterprises can adjust that price afterwards (retrospective adjustment) and still use it for direct tax purposes.

This way of determining a transfer price is however at odds with the fundamental starting points of customs valuation. The determination of the customs value should, as mentioned in Chapter 3, relate to the price actually paid or payable for an individual good. Therefore, a transfer price in its current form cannot automatically be used as a correct starting point for determining a customs value because it does in most cases not reflect the price actually paid or payable for individual goods. In order to arrive at a transfer price which can also be used as a basis for customs valuation, a transfer price should meet certain minimum criteria. These minimum criteria can be determined by means of the first recommended solution in paragraph 5.1, because the model put forward there first establishes the actual production price of the individual goods before determining the general expenses and the addition of a profit margin. Where these factors have been established, there may still be elements that may adjust the price both upwards and downwards, but not retrospectively. This can be considered as the grey area of both systems.

If it turns out that certain elements are not to be included in the customs value, it is possible to remove them in advance and invoice them separately. For the rest, a transfer price must meet the other conditions set for the transaction value, i.e. the existence of a sale in which a good should be sold for export to the EU and that the price has not been influenced by the existence of a relationship between the enterprises involved. If a transfer price fulfils the aforementioned conditions, it can be used as a starting point for the customs value.

As an extension of this possible solution, as stated in subparagraph 5.3, there could be an obliged burden of proof introduced also at the customs valuation side. Where now the customs authority has to raise concerns on the applicability of a price as set between related parties, here there would be a requirement for the declarant of the goods to submit substantiation on the acceptability of that price. For the purposes of this thesis, this will then be the enterprise (or its agent).

All in all, the author of this thesis sees opportunities, particularly in the area of the proposed model and the burden of proof, to enable a framework for determining a transfer price that can also provide as a starting point for the customs value. In the next chapter, which is also the last one, an answer will be given to the main research question addressed in this thesis.

Chapter 6 Conclusion

This thesis researched the following main research question: *“to what extent is it possible to determine a transfer price which takes into account the customs valuation rules and meets the criteria to be used for customs valuation purposes?”* The chapter will be structured as follows:

- In paragraph 6.1, the main conclusions of this thesis will be given, whereas
- in paragraph 6.2 several recommendations will be discussed.
- Paragraph 6.3 will then give several ideas for further research.

6.1 Main conclusions

Chapter 2 of this thesis dealt with the first sub question, i.e. *“what are the key principles and fundamental starting points of TP?”* This has shown that TP is a mechanism of corporate income tax that takes into account several factors in order to arrive at a correct allocation of profits established in cross-border transactions between associated enterprises. The key elements of TP are the arm’s length principle, comparability analysis and the selection of the most appropriate TP method. In practice, a TP Study and TP Policy are used to determine an at arm's length transfer price or profit margin. In order to obtain more certainty about this, enterprises can conclude an APA with the tax authorities. It is also possible for these enterprises to adjust their prices retrospectively. Furthermore, the TP mechanism has a mandatory documentation structure and a broad economic approach to determine intangibles. The aforementioned elements ensure that a correct transfer price and/or profit margin will be established that is in line with the arm's length principle.

Chapter 3 of this thesis dealt with the second sub question, i.e. *“what are the key principles and fundamental starting points of customs valuation?”* This has shown that customs valuation is a framework which determines the value of individual goods at the time when they are cleared for free circulation in the EU. Before the goods are released for free circulation, they must (physically) cross the border. Key element of customs valuation is that the value of individual goods as customs duties are levied per individual transaction. The customs value should be determined using six specific customs valuation methods to be applied in a strict hierarchical order. The customs value can only be adjusted if there are elements which are not included in the price or which are already included in the price but do not actually belong to it as listed for customs purposes. This also means that there is a only limited approach to intangibles within customs valuation. Goal of all these factors is to ensure that the price includes all elements that normally should be part of a price charged for the individual goods and that, if a sale of these goods has taken place between two related parties, this price has not been influenced.

Chapter 4 of this thesis dealt with the third sub question, *i.e.* “*what are the similarities and differences between TP and customs valuation and which elements could play a role in a more combined approach?*” This has shown that both systems overall do not match. There are a substantial number of differences that clearly outweigh the only main similarity, the search for an arm’s length price. In fact, a transfer price can only be used for customs purposes if it consists of an appropriate mix of elements as would be required under both systems. The systems of TP and customs valuation should therefore, in the author’s opinion, be used in a more combined approach, since enterprises are hindered by the large number of differences between the two systems. This is because enterprises bear the risks of being confronted with compliance issues, fines and conflicts with both the tax- and customs authorities.

In the author’s opinion, this makes it desirable to establish a transfer price in such a way that it complies with customs valuation rules. There are in fact many more possibilities at the OECD side to adapt the framework of TP, because the 36 member countries of the OECD are mainly first world countries and the WCO consists of 183 member countries - of which about three quarters are developing countries - where there is a clear different interest in the collection of customs duties as income for the state between the first world and the developing countries. However, this way of thinking is in contrast to the current approach in practice, because the framework of TP, and thus the OECD, is dominant in today's world. In the author’s opinion, from a theoretical perspective, there is no reason at all to take this framework as starting point.

Chapter 5 of this thesis dealt with the fourth sub question, *i.e.* “*to what extent is the current practise of applying a TP based price as the basis a correct fundamental starting point for determining a customs value, and what are the minimum criteria to be set, in order to make sure that such transfer price then can be used for customs valuation purposes?*” This has shown that the current practice of directly applying a TP based price as the basis for the customs value, is not a logic fundamental starting point for determining a correct customs value. A transfer price can only be used as a basis for the customs value if it meets certain minimum criteria.

In the author’s opinion, these criteria can be met if the model (as explained in paragraph 5.1) is used to establish a transfer price that takes main requirements from the side of customs valuation in to account in combination with a shift of the burden of proof to the declarant, *i.e.* the enterprise (as explained in paragraph 5.3). This is because, first of all, the model explained there provides insight into the way in which a price is established that is used as basis for the customs value and that, that the price has not been influenced.

In addition, a shift in the burden of proof provides that a declarant (an associated enterprise) must always demonstrate that a price has not been influenced by using test values. In this context the computed value method from the model, this price reflects the basic cost price of the goods. This will result in more documentation work on the side of TP. However, in practice it is already the case that in TP, a lot of information about a transfer price must be recorded.

In the author's opinion, this additional burden is easily compensated by the minimisation of the compliance risks that otherwise exists under these two legal systems.

What could be better than to work in accordance with the rules of both systems that leads to the result with none or hardly any compliance issues, fewer conflicts with tax and customs authorities and the creation of more legal certainty. This can all be achieved if enterprises take the customs rules as a starting point for determining a transfer price so that it can be used as a basis for the customs value.

6.2 Recommendations

Following the main conclusions, several recommendations can be made.

The first recommendation is as follows. Enterprises might consider approaching their way of setting transfer prices starting from the customs valuation requirements, as this appears to be possible as a result of this thesis. This should then be done on the basis of the proposed model in paragraph 5.1. In doing so, a better understanding of the actual production price is obtained and the least risk of acting contrary to the rules of both systems.

The second recommendation can be made in the field of customs. If the burden of proof is a standard condition for the declarant of goods in case of related parties, Customs will be informed by default on each customs declaration how a price, as included on the invoice, is constructed. This, in the end, could lead to a more efficient way for customs authorities to work as they would spend less time on compliance issues.

The final recommendation is made to the OECD. The issue of profit shifting, and the correct allocation of profits plays an important role in today's world. However, it should not be forgotten that there are more aspects of the tax system that have a major impact. Especially since the OECD consists of only 36 First World Member Countries, the interests and issues of the 183 Member Countries that are part of the WCO can best be taken into account. The latter Member Countries together account for 98% of world trade. For this reason, the OECD should pay more attention to the customs perspective and not just worry about taxation and more specifically, the allocation of profits.

6.3 Ideas for further research

Following the main conclusions and recommendations, some ideas for further research can be put forward. In this thesis it has been investigated to what extent a transfer price can be used that complies with the customs valuation rules and meets the criteria to be used for customs valuation purposes. In this context, several possible solutions have been put forward by the author that can contribute to a final solution. However, these possible solutions are of a general nature.

The first idea for further research relates to the grey area (the intangibles) of the model presented in paragraph 5.1. The differences in the treatment of these intangibles and their attribution have become clear. However, no detailed research has yet been done in the area of certain intangibles that, in principle, bear the same term, but which may turn out differently in practice. In this respect, also the alignment of the treatment of intangibles for tax and/or duty goals could be subject of further research. In other words, this perspective of intangibles in the grey area in particular can be further researched.

The second idea for further research is also related to the model as discussed in paragraph 5.1. The model presented there uses the computed value method as a basis to arrive at the actual production price. However, it has not been researched whether other test values, i.e. the identical, similar and deductive value method are sufficient to be used as a basis in this model. Therefore, it could still be researched to what extent and in which cases, these other test values could support the actual production price.

The last idea for further research is related to the use of TP-documentation in order to demonstrate that a customs valuation has not been influenced. This issue can be further researched in practice. At the moment there is quite some uncertainty about this. As a consequence, it may be possible to research in practice whether specifically the TP implementation documentation, using the cost-plus or resale-minus method, contains information that could be relevant for the customs value. This was considered as likely in this thesis but detailed research in this area is still lacking.

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Appendix

Table 1.1 Comparability Analysis in 9 steps³⁵⁴

Step	Activity
1	Determination of years to be covered.
2	Broad-based analysis of the taxpayer's circumstances.
3	Understanding the controlled transaction(s) under examination, based in particular on a functional analysis, in order to choose the tested party (where needed), the most appropriate TP method to the circumstances of the case, the financial indicators that will be tested (in case of a TPM), and to identify the significant comparability factors that should be taken into account.
4	Review of existing internal comparables, if any.
5	Determination of available sources of information on external comparables where such external comparables are needed taking into account their relative reliability.
6	Selection of the most appropriate TP method, and depending on the method, determination of the relevant financial indicator (e.g. determination of the relevant net profit indicator in case of a TNMM).
7	Identification of potential comparables: determining the key characteristics to be met by any uncontrolled transaction in order to be regarded as potentially comparable, based on the relevant factors identified in Step 3 and in accordance with the comparability factors. ³⁵⁵
8	Determination of and making comparability adjustments where appropriate.
9	Interpretation and use of data collected, determination of the ALP remuneration.

³⁵⁴ OECD TP Guidelines, paras. 3.4 & 3.5

³⁵⁵ OECD TP Guidelines, paras. 1.38-1.63