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Transfer Pricing in European Union VAT Law

What is the open market value in EU VAT and how is it determined?

Masters Thesis

15 Credits (15 ECTS)

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Master's Programme in European and International Tax Law

Course: HARN60

2012-2013

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Summary

The aim of the thesis is to analyse the transfer pricing rules in the VAT system, namely Articles 72 and 80 of the Recast VAT directive. The thesis specifically aims to investigate the application of the open market value to improperly valued transactions between related parties, what the open market value in the VAT system is and how it is determined.

The second chapter of the thesis presents an analysis of transfer pricing in European Union law and international tax law. In line with the aim of the thesis, the chapters main focus is on the transfer pricing provision of Article 80. It presents an analysis of the provision and puts it into the context of the common system of VAT, specifically by looking at how it relates to the general principles of the taxable amount being based on a subjective valuation based on the actual consideration paid for a transaction, and especially how it relates to the general principle of fiscal neutrality inherent in the VAT system. The chapter then briefly looks at transfer pricing rules in, on the one hand European Union customs law, and on the other hand international corporate income tax law.

The third chapter presents an analysis of the concept of open market value as it is provided in Article 72 of the Recast VAT Directive. The concept is compared to the rules on re-valuation of the customs value in transactions between related parties in customs law. The concept of open market value is then compared to that of the arm's length principle used in international corporate income tax law. Lastly, the chapter asks the question whether customs valuation methods would be accepted as a basis for calculating the open market value in VAT before the European Court of Justice, and attempts to answer it.

Finally, in the fourth chapter, the main conclusions of the thesis are summed up. The main findings of the thesis are that the transfer pricing provisions may be too far reaching, and possibly go against the principle of proportionality, harming the neutrality of the VAT system unnecessarily when a re-valuation to the cost or purchase price would similarly prevent tax evasion and avoidance. The provisions the thesis set out to examine are both lacking in clarity due to definitions of key concepts being too general. The corresponding concepts in the Community Customs Code don't suffer from this lack of clarity and it could be worthwhile looking in that direction for clarification of the VAT transfer pricing rules.

Abbreviations

AG	Advocate General
CCC	Community Customs Code
ECJ	European Court of Justice
EESC	European Economic and Social Committee
EU	European Union
GATT	General Agreement on Tariffs and Trade
OECD	Organization for Economic Co-operation and Development
OMV	Open Market Value
RVD	Recast VAT Directive
SPV	Special Purpose Vehicle
TFEU	Treaty on the Functioning of the European Union
VAT	Value Added Tax
WTO	World Trade Organisation

1. Introduction

1.1 Subject

In today's marketplace multinational enterprises play a large role. These international groups are made up of legally independent entities, parent companies and their subsidiaries, and their dependent branches. The parties all share a common economic interest, so minimizing the total taxes of the group becomes everyone's interest. Because the group members have a common financial interest, the value of transactions between members of the group won't necessarily be best determined by market forces. It might be in the group's best interest to trade at artificially low or high prices in order to allocate profits to the jurisdiction with the lowest taxes or deductible losses to the jurisdiction with the highest taxes.¹ In direct tax terms the parties to these multinational enterprises are known as associated enterprises.

While these entities do of course do business with third parties, an extremely large portion of their transactions is with related parties. In fact cross-border transactions between related parties account for almost 50% of trade in today's international marketplace.² In order to properly assess where to attribute profits and losses for tax purposes, these transactions are treated as being carried out at arm's length, that is, as if the individual group members were not related and the transaction was being carried out at normal market prices.³ This leads to the problem of transfer pricing. Transfer prices are the prices that are attributed to the transfer of goods and services between associated enterprises.⁴ For the proper determination of transfer prices between associated enterprises with regard to corporate income tax, the Organization for Economic Co-operation and Development⁵ has set out in its Model Tax Convention on income and capital⁶ the arm's length principle⁷ as well as issued detailed guidelines for the application of that principle and the methods to determine the correct transfer pricing, the OECD Transfer pricing guidelines for Multinational enterprises and Tax administrations.⁸

The issue of transfer pricing has mainly been an issue for income tax law but due to the ever increasing number of transactions between related parties in international trade, there has been

¹ Marjaana Helminen (2012), pg. 237.

² Mayra O. Lucas Mas (2010), pg. 190.

³ OECD, *Transfer Pricing Guidelines for multinational enterprises and tax administrations*, (1995), pg. 18.

⁴ OECD, *Transfer Pricing Guidelines for multinational enterprises and tax administrations*, (1995), pg. 19.

⁵ Hereafter OECD

⁶ Hereafter the Model Tax Convention.

⁷ OECD, *Model Tax Convention on income and capital*. (2010) Article 9.

⁸ Hereafter the Transfer pricing guidelines.

an increased interest in the VAT treatment of related parties transactions. This is especially so since the lack of specific transfer pricing rules in VAT would open up the potential for artificial arrangements involving parties who don't have a full right of input tax deduction being set up to gain advantages for VAT purposes.⁹ The general principle in the EU VAT system is that the taxable amount is a subjective value, the value that the parties have agreed upon as being the price of the good or service. However Member States have grown aware that using the subjective value as a general valuation rule can encourage the aforementioned artificial arrangements being set up.¹⁰ This increased focus on transfer pricing with regards to VAT lead to the adoption of Council Directive 2006/69/EC. The Directive introduced a new provision, now Article 80 of the RVD which enables member states to deal with VAT avoidance schemes involving price manipulation in transactions between related parties by adjusting the valuation of improperly valued transactions to the open market value.¹¹ The definition of open market value is laid out in article 72 of the RVD. The definition is however not sufficiently clear, and there are no international or european guidelines on how to determine the open market value when dealing with transfer prices in VAT. This lack of clarity of the concept can lead to legal uncertainty for businesses and can potentially cause Member States loss of tax revenues.¹²

1.2 Purpose

In this thesis it is the author's aim to look at the transfer pricing rules in the VAT system, mainly the concept of open market value as it stands in Article 72 of the RVD and to try to clarify what the open market value in related party transactions is when it comes to the EU VAT system, as well as how the open market value is determined. As stated above, there is a certain lack of clarity on the concept and it's application. In order to attempt to clarify the issue, it makes sense to look on the one hand to do so in the context of international tax law, i.e. the OECD Model tax convention and the OECD Transfer pricing guidelines, and on the other hand in the context of EU law, i.e. by looking to the valuation methods for related parties transactions set out in the Community Customs Code¹³.

Certain countries, both within and outside of the EU have tried to clear up the lack of clarity by making express references to income tax rules on transfer pricing in their domestic

⁹ Mayra O. Lucas Mas (2010), pg. 190.

¹⁰ Mayra O. Lucas Mas (2010), pg. 193.

¹¹ Mayra O. Lucas Mas (2010), pg. 195.

¹² Mayra O. Lucas Mas (2010), pg. 190.

¹³ Hereafter CCC.

legislation.¹⁴ Scholars have similarly investigated whether there is scope for interaction between transfer pricing rules in income tax law and VAT, which seems logical in many ways due to transfer pricing originally being an income tax law issue and having well established rules on how to deal with transactions between related parties and guidelines on how to correctly determine the correct transfer price in the form of the OECD Model Tax Convention and the OECD Transfer pricing guidelines. Therefore this thesis will look at the possibility of using the well established arm's length principle and the accompanying valuation methods for determining the appropriate transfer price in VAT. The main focus of this part of the thesis will however be on the possible interaction between transfer pricing in VAT, and more specifically, the concept of open market value in VAT, and the customs valuation rules in the CCC as they relate to transactions between related parties. This seems to be a logical and worthwhile investigation, considering, firstly that there is a direct link between the two systems through Article 85 of the RVD as the article states that when it comes to the importation of goods, the taxable amount shall be the customs value determined in accordance with the Community provisions in force, i.e. the CCC valuation methods, and secondly, the CCC rules on valuation of related parties transactions are the closest thing in EU law to a definition of the concept of open market value. The thesis will therefore attempt to analyse the current transfer pricing rules in the VAT system, and answer the questions of what the open market value in the EU VAT system is and more specifically, how the open market value is determined.

Considering the extremely large part transactions between related parties plays in today's international marketplace, the issue of transfer pricing in VAT seems worthy of further discussion. This is especially so, considering the lack of a clear definition of key concepts. Neither the concept of „related parties“ nor the concept of open market value is clearly defined in the RVD. Despite the high level of harmonization in EU VAT, the VAT systems are still national and the further definition of related parties is subject to domestic legislation, which can have the effect of preventing the uniform application of the VAT transfer pricing rules.¹⁵ Similarly there is no clear definition of open market value, or any valuation guidelines to determine what the open market value is for any given transaction. Some countries, both within and outside of the EU have attempted to solve this problem by introducing an express reference to transfer pricing methods used in corporate income tax legislation.¹⁶ This thesis

¹⁴ Mayra O. Lucas Mas (2010), pg. 206.

¹⁵ Mayra O. Lucas Mas (2010), pg. 202-3.

¹⁶ Mayra O. Lucas Mas (2010), pg. 206.

will try to look at it from the perspective of whether it is possible to look to either international tax law methods of establishing transfer pricing, or existing EU law in the CCC in order to determine what the open market value is, and how it should be determined.

1.3 Method and material

The main method used for writing this thesis will be the dogmatic legal method. The thesis will analyze what the current rules (*de lege lata*) are as regards transfer pricing and the use of open market value in VAT in the European Union. This will entail analyzing the relevant EU law provisions. From the standpoint of the legal framework of the EU with regard to transfer pricing in VAT and customs, the discussion will mostly be based on secondary legislation, namely the Recast VAT directive and the Community customs code. In addition to the EU sources of law, I will also use OECD publications, namely the Model Tax Convention and the Transfer Pricing Guidelines. Lastly I will rely on material written by experts that has been published on the subject as a basis for further discussion.

The aforementioned sources are necessary for this thesis to be able to determine whether there is a basis for interaction between the concept of open market value in VAT and either OECD transfer pricing rules or customs rules for valuation of related parties transactions.

1.4 Delimitations

For the purposes of keeping this thesis concise and focused on its main points, its contents will be subject to a few parameters and certain assumptions will be made about the reader's background knowledge. It will be assumed that the reader has some general background knowledge of the EU VAT system and therefore the thesis will not go into detail about the deduction system or the rules about taxable persons. There will however obviously be some discussion of the general principles of the VAT system, mainly as regards the taxable amount and the principle of neutrality, as the application of the provisions this thesis focuses on, Article 72 and Article 80 of the RVD constitutes an exception from these principles. The thesis will focus on transactions of goods for consideration between related parties and will therefore not deal with the open market value re-valuation provision of Article 77 that deals with internal supply of services.

Furthermore the reader will be assumed to have a basic knowledge of international tax law, so while the thesis will inevitably touch on certain aspects of international corporate income tax

law, mostly related to OECD rules and guidelines, that discussion will be limited to issues related to the main topic of open market value in VAT.

Given that there is a certain link with transfer pricing rules in income tax law in the definition of open market value in Article 72 through the arm's length principle, and how developed and established transfer pricing rules are in income tax law, there will be certain discussions of income tax rules on the subject of transfer pricing. These will however not be very detailed and only used to support and frame the discussion about the main topic of the thesis. For instance, no mention will be made of the various methods used in income tax law to determine the proper transfer price.

Furthermore, since the aim of the thesis is to focus mainly on the open market value aspect of transfer pricing in the EU VAT system and its potential interaction with customs law and international tax law, it will not go into detail about the different types of transfer pricing adjustments and their application.

1.5 Disposition

The thesis will be structured into four chapters, this introductory chapter and three chapters dealing with the framework for the main topic and the main topic itself and the eventual conclusion.

In chapter two there will be a definition of what transfer pricing is, this discussion will inevitably draw from income tax rules in order to clearly define the concept of transfer pricing. The concept of related parties will also be defined in this chapter. The interaction between the two systems, direct and indirect tax, with regards to transfer pricing, will be shortly discussed in this chapter as well. This will be followed by an overview of the relevant provisions of EU law regarding transfer pricing in VAT and customs, that is, the relevant articles of the Recast VAT Directive and the Community Customs Code.

In chapter three the concept of open market value will be analyzed in the context of the rules on customs valuation, as the definition in article 72 of the RVD is neither particularly clear nor conclusive. Under this chapter the concept of customs valuation will be defined, as well as the methods used for determining the customs value. Later in the chapter there will be a comparison of the open market value concept in VAT and the customs valuation rules in the

Community customs code. Finally, chapter four will summarize the main conclusions of the thesis.

2. Transfer pricing in EU and international tax law

2.1 Transfer pricing in EU VAT law.

The problem of transfer pricing used to be primarily an issue of corporate income tax law, and less of a focus of VAT law. This can mainly be attributed to two causes, the VAT system's inherent principle of fiscal neutrality and the fact that transactions between related parties had not been seen as a pressing concern. This has changed in recent years, and related parties transactions have received increased attention in the field of VAT law, leading to the adoption of an optional transfer pricing provision, which is now found in Article 80 of the RVD.¹⁷ The provision allows Member States to re-value transactions between related parties to the open market value of comparable supplies, which is defined in Article 72 of the RVD. Such re-valuation presents an exception from the general principles of the VAT system, that the value of a transaction should be subjective rather than an objective one¹⁸, and the aforementioned principle of neutrality. Therefore it is appropriate, following an analysis of the transfer pricing provision of Article 80, to present a short overview of these principles, i.e. the taxable amount as it is set out in Article 73 and the principle of neutrality, and how Article 80 derogates from them.

2.1.1 Open market value

For the purposes of the following discussion on the general transfer pricing provision in Article 80 of the RVD it is necessary to give a broad definition of the term open market value here. A more detailed discussion of the term will follow in chapter 3. The term open market value refers to the value of a sale of goods or services in the open market, that is, the full amount a customer would have to pay in a transaction with an independent, unrelated party under conditions of fair competition, that is, at arm's length. The term is defined in Article 72 of the RVD, which will be discussed in detail in a later chapter.

¹⁷ Dennis Ramsdahl Jensen (2009), pg. 878-880.

¹⁸ See Article 73 RVD.

2.2 Article 80 RVD – A transfer pricing provision

In 2006, Council Directive 2006/69/EC¹⁹ (the „*rationalisation directive*“) was adopted to, amongst other goals, combat VAT avoidance and evasion that had become a very real issue. Before the rationalisation directive was adopted, Member States‘ only recourse to introduce their own special measures in order to combat those issues was to apply to the Commission for a derogation according to what was then Article 27 of the Sixth VAT Directive²⁰ (now Article 395 of the Recast VAT directive). At the time of the proposal for the rationalisation directive, Member States had been allowed to apply over 140 derogations, and as the EU had recently been enlarged by the accession of ten new Member States, that number was expected to grow in the near future. The proposal aimed at making available to all Member States, through an amendment of the Sixth Directive, the derogations that had already proven themselves to be effective and which dealt with problems that were shared by more than one Member State.²¹ One of the areas which the proposal focused on was the valuation of supplies. Since the valuation of supplies directly affects the amount of tax that is charged, there was a possibility for avoidance through over- or undervaluation of supplies made between related parties or persons where either recipient or seller is not entitled to a full right of deduction of input VAT. The result of the commission‘ s proposal was the transfer pricing rule of Article 80 of the RVD:

- 1. In order to prevent tax evasion or avoidance, Member States may in any of the following cases take measures to ensure that, in respect of the supply of goods or services involving family or other close personal ties, management, ownership, membership, financial or legal ties as defined by the Member State, the taxable amount is to be the open market value:*

¹⁹ Council Directive 2006/69/EC amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion or avoidance, and repealing certain Decisions granting derogations.

²⁰ Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment (77/388/EEC).

²¹ COM(2005)89 final, Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations, pg. 2-3.

- a) *Where the consideration is lower than the open market value and the recipient of the supply does not have a full right of deduction under Articles 167 to 171 and Articles 173 to 177;*
- b) *Where the consideration is lower than the open market value and the supplier does not have a full right of deduction under Articles 167 to 171 and Articles 173 to 177 and the supply is subject to an exemption under Articles 132, 135, 136, 371, 375, 376, 377, 378(2), 379(2) or Articles 380 to 390b;*
- c) *Where the consideration is higher than the open market value and the supplier does not have a full right of deduction under Articles 167 to 171 and Articles 173 to 177.*

For the purposes of the first subparagraph, legal ties may include the relationship between an employer and employee or the employee's family, or any other closely connected persons.

Member states are not required to implement the article as it is an optional provision. The objective of the article, to combat tax evasion and avoidance, is stated in recital 26 of the preamble to the RVD, where it says: *„To prevent loss of tax revenues through the use of connected parties to derive tax benefits, it should, in specific limited circumstances, be possible for Member States to intervene as regards the taxable amount of supplies of goods or services and intra-Community acquisitions of goods.“* The stated objective can also be seen clearly from the wording of the first paragraph.

Rather than providing for all related party transactions to be subject to re-valuation to the open market value, the article sets out certain circumstances where re-valuation is allowed. This is due to the nature of the VAT system. Because the system is intended to tax final consumption and be neutral for sellers and producers, they are able to deduct their input VAT against their output VAT.²² Therefore there will be no loss of tax revenue in the case of related parties that have a full right of input VAT deduction, as AG Sharpston says in his opinion in joined cases C-621/10 and C-129/11 (Balkan and Proviadinvest): *„When goods or services are supplied at an artificially low or high price between parties who both enjoy a full right of deduction in connection with the transaction – that is to say, when both supplier and customer make only taxable outputs – there is no evasion or avoidance of tax at that stage. As far as the transaction in question is concerned, the tax is entirely neutral for both parties, and*

²² See Article 168 RVD.

*will remain so whatever the price charged. Nor can any tax be 'lost' at that stage. It is only when the supply chain comes to an end with the final consumer – or to a partial end with a 'mixed' taxable person enjoying a proportional right of deduction – that an artificially low or high price can lead to a loss of tax revenue.*²³ However, since the VAT system is full of derogations and exemptions, there are certain circumstances where manipulation of the price between related parties can lead to a lower tax burden for them. These are the circumstances that the article is intended to deal with and are listed in detail in sub-paragraphs a)-c). Further discussion of these circumstances follows in chapter 2.2.1. The article also sets out a framework for what should constitute related parties, although the actual definition of each term is left to the Member States.

The ECJ has dealt with the question of whether Member States are allowed to apply the open market value to transactions between connected persons in circumstances other than those listed in the sub-paragraphs a)-c) in the aforementioned joined cases C-621/10 and C-129/11 (Balkan and Provadiinvest). The cases concerned the sales of immovable property and land between related parties. National legislation in Bulgaria provided that the taxable amount in transactions between related parties should be the open market value. The open market value was determined by experts on a case by case basis. In the case of both transactions the open market value was deemed to differ from the actual consideration paid between the parties, in one case it was lower and in the other it was higher. In the case where the open market value was deemed to be lower than the actual sale price, the tax authorities considered the excess VAT to have been unlawfully invoiced and therefore it could not be deducted. In the other case, the tax authorities laid claim to payment of VAT on the higher open market value rather than the actual sales price. The question before the Court was whether the conditions for application of Article 80(1) as listed in that article are exhaustive or whether it may be accepted that the taxable amount is the open market value of the transaction between connected persons in cases other than those expressly provided for in that provision, in particular where the taxable person has a full right of deduction.²⁴ The Court found that by allowing the open market value of the transaction, Article 80(1) laid down an exception to the general rule stated in Article 73 of the RVD, and as such it had to be interpreted strictly. Since the objective of the provision was to prevent tax evasion and avoidance, and those issues could not arise from related party transactions between parties with full right of deduction but

²³ Advocate General's Opinion, joined cases C-621/10 and C-129/11, para. 30. See also para. 47 in the Court's judgement.

²⁴ Joined cases ECJ C-621/10 and C-129/11 *Balkan and Provadiinvest*, para. 42.

only from transactions involving final consumers or taxable persons with a limited right of deduction, it was only those circumstances which are listed in the provision that the article is intended to deal with.²⁵ The Court therefore found that the conditions laid out in Article 80(1) are exhaustive and consequently, that national legislation cannot on the basis of the provision provide that the taxable amount in related parties transaction be the open market value in circumstances other than those listed in the article, particularly where the taxable person has a full right of deduction.²⁶

In the explanatory memorandum to the proposal for the rationalisation directive, the Commission explained that tax authorities should not interfere in the taxable amount of a supply as a matter of course, but rather in certain specified circumstances only.²⁷ As there is no loss of tax revenue in transactions between two fully taxable persons, related or not, since the tax on the supply can be reclaimed and the valuation of the supply does not impact the suppliers ability to recover input VAT, transfer pricing rules with regard to VAT naturally focus solely on situations where there is a possibility for exploitation of the deduction system²⁸ and therefore the scope of the transfer pricing provision of Article 80 of the VAT directive is limited to certain specifically described circumstances relating to the valuation of the supplies and the VAT status of the buyer or seller.²⁹ The article explicitly states that it aims at preventing tax evasion and avoidance, and not, as already stated, at allowing interference in all transactions between related parties. Whether the provision is only applicable in cases of intended tax avoidance or evasion is however unclear. There can be situations where an abnormal valuation of a transaction between related parties can be justified by commercial factors. An example of this is canteen sales to employees that are below the open market value. Such a transaction will lead to lessening the parties VAT burden, but could still be borne out of a legitimate aim of caring for the employees. In the Commission's proposal for the rationalisation directive, it stated that transfer pricing corrections could not be made where the supplier can demonstrate a commercial reason for

²⁵ ECJ C-621/10 and C-129/11 *Balkan and Provadiinvest*, para. 45-48.

²⁶ ECJ C-621/10 and C-129/11 *Balkan and Provadiinvest*, para. 51-52.

²⁷ COM(2005)89 final, Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations, pg. 6.

²⁸ COM(2005)89 final, Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations, pg. 6.

²⁹ Dennis Ramsdahl Jensen (2009), pg. 886.

the valuation of the goods or services. This part did not make it into the final directive, but is, according to Dennis Ramsdahl Jensen nevertheless assumed to express the applicable law.³⁰

2.2.1 Transactions above or below open market value

Transactions made at below the open market value can be used to exploit the deduction system in cases where the seller has a full right of deduction but the buyer has no such right. An example of this is a transaction between related parties, such as a bank (no ability to recover VAT on investments) and an affiliated special purpose vehicle (SPV). If the SPV purchases equipment and leases it to the bank at below open market value, that leads to VAT savings for the bank. The SPV recovers the VAT on the investment, and while the bank still can't recover VAT on the lease, the lower price leads to a lower VAT burden for the bank (and loss of tax revenue for the state).³¹ Article 80(1)(a) deals with this type of transaction.

Another example of transactions below open market value exploiting the deduction system is when the seller does not have a full right of deduction because he deals in both transactions that are VAT deductible and transactions that are not VAT deductible³², and the sale in question is exempt from VAT. As the partial right to deduction is determined by the proportion of the turnover stemming from non-exempt taxable transactions divided by the sellers total turnover,³³ selling supplies below the open market value leads to the optimization of the seller's right to proportional VAT deduction and a reduction of the related parties overall VAT burden (and loss of tax revenue for the state).³⁴ Article 80(1)(b) deals with this type of transaction.

Conversely, the deduction system can also be exploited by valuing supplies between related parties at above the open market value. When the supplier has a partial right of deduction according to Article 173 of the RVD, he can increase the deductible proportion by selling supplies to related parties that have a full right of deduction at above the open market value and thereby increasing the part of his turnover that is subject to VAT. Since the percentage of his partial right of deduction is determined by his turnover subject to VAT divided by his total turnover, this leads to a higher proportion of deduction and lowered VAT burden for the

³⁰ COM(2005)89 final, Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations, pg. 16. See also footnote 40 in Dennis Ramsdahl Jensen, *Transfer pricing principles VAT/GST v. Direct taxation*, pg. 888.

³¹ F. Idsinga, B. Kalshoven and M. van Herksen (2005), pg. 202-203.

³² See Article 173 RVD

³³ See Article 174(1) RVD

³⁴ Dennis Ramsdahl Jensen (2009), pg. 894.

parties (and loss of tax revenue for the state).³⁵ Article 80(1)(c) deals with this type of transaction.

2.2.2 Taxable amount

Since VAT is a tax on expenditure on consumption, the taxable amount is generally a subjective value, the consideration actually paid for the supply.³⁶ According to Article 73 of the RVD, the taxable amount includes everything which constitutes consideration obtained or to be obtained by the supplier, in return for the supply, from the customer.³⁷

The taxable amount in the VAT system is, as a principle according to Article 73, a subjective value, that is, what the parties to the transaction have decided as the price. The European Court of Justice³⁸, in its ruling in case 154/80, said: „...*that such consideration is a subjective value since the basis of assessment for the provision of services is the consideration actually received and not a value assessed according to objective criteria.*“³⁹ In its ruling in the joined cases C-621/10 and C-129/11 (Balkan and Provadiinvest) the ECJ said that Article 73 is the „...*expression of a fundamental principle, the corollary of which is that the tax authorities may not collect as VAT an amount exceeding the tax paid to the taxable person.*“⁴⁰ However, as countries became aware that using the subjective value as a basis for the taxable amount opened up possibilities of artificial arrangements being set up in order to obtain a tax advantage,⁴¹ leading to the loss of tax revenue for member states, the Commission put forth a proposal to deal with that issue. The result of that proposal was, amongst other provisions, the aforementioned transfer pricing provision, currently Article 80 of the RVD. That provision provides for the option of an adjustment of improperly valued transactions between related parties to the open market value of those transactions. The introduction of that provision presented an exception from the normal principle of the taxable amount being based on the subjective value of the transaction.⁴²

2.2.3 Principle of fiscal neutrality

The principle of fiscal neutrality is stated in the preamble to the RVD where it says in the fifth recital: „*A VAT system achieves the highest degree of simplicity and of neutrality when the tax*

³⁵ Dennis Ramsdahl Jensen (2009), pg. 884.

³⁶ Ben Terra (2011), pg. 738.

³⁷ See Article 73 RVD

³⁸ Here after ECJ.

³⁹ ECJ 154/80 *Staatssecretaris van Financiën v Coöperatieve Aardappelenbewaarplaats*, para. 13. See also joined cases C-621/10 and C-129/11 *Balkan and Provadiinvest*, para. 43.

⁴⁰ ECJ joined cases C-621/10 and C-129/11 *Balkan and Provadiinvest*, para. 44.

⁴¹ Mayra O. Lucas Mas (2010), pg. 193.

⁴² Ben Terra (2011), pg. 739.

is levied in as general a manner as possible and when its scope covers all stages of production and distribution, as well as the supply of services. It is therefore in the interest of the internal market and of Member States to adopt a common system which also applies to the retail trade.“ And in the seventh recital: *„The common system of VAT should, even if rates and exemptions are not fully harmonised, result in neutrality in competition, such that within the territory of each Member State similar goods and services bear the same tax burden, whatever the length of the production and distribution chain.*“ Furthermore, it says in the 25th recital that *„the taxable amount should be harmonised so that the application of VAT to taxable transactions leads to comparable results in all the Member States.*“ The principle, which the ECJ has claimed to be inherent in the VAT system⁴³ is codified in Article 1(2) of the RVD:

Article 1(2)

The principle of the common system entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged.

On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components.

According to the article, VAT is only intended to tax final consumption. It is therefore not intended to impose a tax on the various stages of production or distribution. In order for the tax to fall solely on the end user, two conditions must be met. Firstly, there has to be a full passing on of the VAT at each stage of the production and distribution chain, and secondly, each taxable person in the chain must have a right to deduct the VAT which is paid to the prior producer/distributor.⁴⁴ For the VAT to be fully passed on to the final consumer, the taxable amount at each stage of the chain must be calculated on the basis of the consideration actually paid. If the taxable amount was calculated on the basis of a higher value than the consideration actually received, such as in the case of a re-valuation to the open market value according to Article 80, then the VAT would constitute a cost for the seller, as he'd be paying

⁴³ See for example ECJ case C-481/98 *Commission vs France*, para. 21.

⁴⁴ See Article 168 RVD.

the VAT on the excess valuation that would not be recovered from the buyer.⁴⁵ Therefore, in order for the system to maintain its neutrality, the taxable amount needs to be based on a subjective value, the consideration actually received, rather than an objective one. The re-valuation option provided for in Article 80 therefore constitutes conscious breach of this principle of fiscal neutrality. It is not the only such breach in the RVD, and it stems from the need to prevent tax evasion and avoidance in order to protect the tax revenues of the Member States, which has been deemed more important than maintaining absolute neutrality of the system. However, as Dennis Ramsdahl Jensen points out in his article, *Transfer pricing principles VAT/GST v. Direct taxation* it would be preferable if the transfer pricing rules were framed in such a way that they showed due respect to the principle of proportionality^{46, 47}.

If the purpose of the transfer pricing rules in VAT is only to prevent tax evasion and avoidance, it is not necessary for the taxable amount to be re-valued in connection with transactions at below market value, but rather only when the transaction price is below purchase or cost price. If the price is at least equal to the purchase or cost price of the transaction, a transaction between related parties will not lead to misuse of the deduction rules of the VAT system, as the seller will not obtain a greater VAT deduction than the VAT that is passed on to the buyer. In such an example the transaction is neutral from a VAT standpoint, and as such can't be said to constitute tax evasion or avoidance. It follows from this that in cases of transactions between related parties being below cost or purchase price, it should be sufficient to re-value the transaction to the cost or purchase price rather than the open market value.⁴⁸ This would maintain the neutrality of the system and seems to align better with the principle of proportionality. This, however only holds true for transactions that are made below the open market value. Transactions that are made above the open market value and subsequently re-valued to the cost or purchase price lead to a disadvantage for the party that is liable to tax and is therefore contrary to the principle of proportionality. Re-valuing the transaction to the open market value is therefore better in accordance with the principle of fiscal neutrality and the principle of proportionality in such cases.⁴⁹ They are however rarer,

⁴⁵ Dennis Ramsdahl Jensen (2009), pg. 880-881.

⁴⁶ See Art. 5(4) TFEU which lays down the principle of proportionality.

⁴⁷ Dennis Ramsdahl Jensen (2009), pg. 881-882.

⁴⁸ Dennis Ramsdahl Jensen (2009), pg. 897.

⁴⁹ See Dennis Ramsdahl Jensen (2009), footnote 53. Pg. 896.

the primary area for transfer pricing corrections in VAT concerns transactions below open market value.⁵⁰

In the explanatory memorandum to the proposal for the VAT transfer pricing rules, the Commission explains that it considered both options for re-valuation, the cost or purchase price and the open market value. It states that it found the open market value the most appropriate method. The Commission's reasoning is that the cost or purchase price would only have the effect of enabling Member States to neutralise the tax loss suffered through the low value, whilst the open market value would allow tax authorities the possibility to protect some of the tax on the value added. Acknowledging the difficulties of calculating the correct value, using either method, the Commission stated that the open market value would give the Member States „the greatest scope to collect something approximating to the tax which would otherwise be due.“⁵¹ Judging by the Commission's reasoning for choosing the open market value method ahead of the cost or purchase price, which as has been demonstrated above is more in line with the general principles of the VAT system, it must be doubted whether the sole intention of the provision is to combat tax evasion and avoidance. Rather, it seems that it is also intended to increase the Member States potential tax revenue.

One other example that further demonstrates how the transfer pricing rules have possibly gone unnecessarily far is a comparison to the RVD's self-supply rule in Article 16. A transfer of goods between related parties without consideration would be covered by the self supply rule rather than the transfer pricing rules. Article 74 of the RVD provides that such a supply should be re-valued to the transaction's cost or purchase price. If the parties however put a nominal price on the transaction, such as one euro, this should in theory trigger the transfer pricing rule of Article 80, in which case the re-valuation would be to the open market value rather than the cost price. If we consider that the aim of the self supply rules is much the same as that of the transfer pricing rules, i.e. to prevent taxable persons from obtaining unjustified advantages from their right to deduct input VAT, it seems like this difference in application is not justified by the stated purpose of the transfer pricing rules, to combat tax evasion and avoidance. Dennis Ramsdahl Jensen comes to the conclusion that transfer pricing rules relating to underpriced sales should only deal with cases where the transaction price is below cost or purchase price, and then the re-valuation should be to the cost or purchase price rather

⁵⁰ Dennis Ramsdahl Jensen (2009), pg. 896.

⁵¹ COM(2005)89 final, Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations, pg. 6.

than the open market value, as this would both align the transfer pricing rules with the self supply rules, and better take into account the principle of fiscal neutrality and the principle of proportionality.⁵² This seems to be in line with what it says in recitals of the preamble to the RVD mentioned at the start of the chapter, especially the fifth recital. The system achieves the highest degree of neutrality when the tax is levied in as general a manner as possible.

2.2.4 VAT transfer pricing rules – Arm’s length

Transfer pricing rules in relation to VAT have a different purpose from transfer pricing rules with regards to income tax. With regards to income taxes, when associated enterprises carry out transactions between themselves at abnormally low or high prices, they are doing so with a view to distribute the income and expenditure in such a way that the parties pay the least tax. The way this is done is by placing the taxable income in the tax jurisdiction with the lowest tax or, conversely, by placing the deductible expenses in the jurisdiction with the highest tax. When it comes to VAT, transactions between related parties at abnormally high or low prices aim at exploiting the rules of the VAT system for making input VAT deductions.⁵³ Nevertheless, there are certain similarities in the definition of the open market value in the VAT system and the arm’s length principle that is used as the transfer pricing standard in corporate income tax, e.g. Article 72 refers to transactions at arm’s length.

2.3 Transfer pricing – The arm’s length principle

For corporate income tax purposes, the OECD member countries have agreed upon the arm’s length principle as the transfer pricing standard to be used for tax purposes by multi-national enterprises and tax administrations internationally.⁵⁴ The arm’s length principle is set forth in Article 9 of the OECD Model Tax Convention:

Where

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or*
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,*

⁵² Dennis Ramsdahl Jensen (2009), pg. 898.

⁵³ Dennis Ramsdahl Jensen (2009), pg. 882-883.

⁵⁴ OECD, *Transfer Pricing Guidelines for multinational enterprises and tax administrations*, (1995), pg. 23.

*and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.*⁵⁵

The article sets out the arm's length principle and states that in cases where the price of a transaction between associated enterprises is different from what it would have been between unrelated parties the profits of the enterprise can be adjusted as if the transaction had been made at arm's length. Transfer pricing in corporate income tax is not solely aimed at combating tax fraud and avoidance. In transactions between associated enterprises there can arise genuine difficulties in determining the market price and therefore tax administrations should not automatically assume that the reason for the incorrect price is a result of intended tax avoidance. The transfer pricing adjustments are made irrespective of any intention to commit fraud or avoid tax.⁵⁶ This is different from the transfer pricing rules in VAT, where the main focus is on combating tax avoidance and evasion.

2.4 Customs value – Related parties transactions

Article 29(1)(d) of the CCC states that the customs value shall be the transaction value as long as the parties aren't related. However it also states that in cases where the buyer and seller are related, the customs value shall still be the transaction value as long as it is acceptable for customs purposes.

Article 29

- 1. The customs value of imported goods shall be the transaction value, that is, the price actually paid or payable for the goods when sold for export to the customs territory of the Community, adjusted, where necessary, in accordance with Articles 32 and 33, provided:*

[...]

(d) that the buyer and seller are not related, or, where the buyer and seller are related, that the transaction value is acceptable for customs purposes under paragraph 2.

⁵⁵ OECD, *Model Tax Convention on income and capital*. (2010) Article 9.

⁵⁶ OECD, *Transfer Pricing Guidelines for multinational enterprises and tax administrations*, (1995), pg. 33.

Paragraph 2 of Article 29 lays out the rules for transactions between related parties. Unlike transfer pricing rules in corporate income tax, the fact that parties are related is in and of itself not enough for the transaction value to be deemed unacceptable. Where a transaction gives rise to examination, the transaction value is to be accepted as long as it is found that the relationship between the parties did not influence the price.

2.5 Transfer pricing rules in different systems

Transfer pricing rules apply to transactions between related parties, regardless of whether it is in the field of corporate income tax, VAT or customs, what differs between the systems is who are considered related parties and which transactions are subject to transfer pricing examination and potential adjustments. Transfer pricing rules only come into play with regard to cross-border transactions when it comes to corporate income tax, since transactions between related parties within the same jurisdiction don't involve different tax rules and as such don't offer the opportunity for minimizing the tax burden through over- or undervaluation. Transfer pricing rules with regard to customs naturally will necessarily involve cross-border transactions as well. VAT transfer pricing rules however can involve any transaction between related parties, either internal or cross border, as long as it fulfills the conditions of improperly valued supplies and the VAT status of the seller/buyer set out in Article 80 RVD.

Any cross-border transaction between associated enterprises is subject to transfer pricing rules with regard to corporate income tax. When it comes to VAT however, only those transactions where it can be established that the related parties have a joint interest are subject to the transfer pricing rules of Article 80 of the RVD.⁵⁷

2.5.1 Related parties: Corporate income tax

In corporate income tax the term „associated enterprises“ is used for related parties. Article 9 of the OECD Model Tax Convention provides the definition of associated enterprises for transfer pricing purposes. Two enterprises are considered to be associated enterprises with respect to each other if one of the enterprises participates directly or indirectly in the management, control or capital of an enterprise of the other enterprise or if the same persons participate directly or indirectly in the management, control or capital of both enterprises.⁵⁸

⁵⁷ Dennis Ramsdahl Jensen (2009), pg. 889.

⁵⁸ OECD, *Transfer Pricing Guidelines for multinational enterprises and tax administrations*, (1995), pg. 23.

2.5.2 Related parties: VAT

According to article 80 of the RVD, related parties are considered to be those with familial or other close personal ties, ties through management, ownership, membership or financial or legal ties. The definition of those ties is left to the member states. Furthermore, legal ties may include „the relationship between an employer and employee or the employee’s family, or any other closely connected persons.“⁵⁹ The scope of the concept of related parties is therefore much wider than it is in regards to corporate income taxes.

2.5.3 Related parties: Customs

Article 29(1)(d) of the CCC states that the customs value of imported goods shall be the transaction value, provided that the buyer and seller are not related. Article 143 of the implementing regulation of the CCC⁶⁰ provides a definition of the term related parties as it is used in Article 29 of the CCC. According to the article, persons are deemed to be related if: (i) they are officers or directors of one another's businesses; (ii) they are legally recognized partners in business; (iii) they are employer and employee; (iv) any person directly or indirectly owns, controls or holds 5 % or more of the outstanding voting stock or shares of both of them; (v) one of them directly or indirectly controls the other; (vi) both of them are directly or indirectly controlled by a third person; (vii)) together they directly or indirectly control a third person; or (viii) they are members of the same family. Familial ties are considered to be husband and wife, children, brothers and sisters, grandparents and grandchildren, uncles, aunts, nephews and nieces, parents in law, son or daughter in law and brother and sister in law.

Much like the the definition of related parties in VAT, the term is much wider in customs than when it comes to corporate income tax. The definition of related parties is somewhat similar to that in VAT in fact, covering those with familial ties, working relationship or links through management, ownership, membership or financial or legal ties. There is however also a clear difference between the definitions of related parties in the VAT transfer pricing rules and the CCC in that while the general framework is very similar, the CCC definition is very specific and a lot more clearly defined, while the VAT definition is very general and leaves the detailed definition to the Member States. The CCC is of course a regulation, and as such is binding for Member States in it’s entirety and therefore ensures a uniform definition across all

⁵⁹ See Article 80, RVD.

⁶⁰ Commission Regulation (EEC) No. 2454/93 laying down provisions for the implementation of Council Regulation (EEC) No. 2913/92 establishing the Community Customs Code.

Member states, while the RVD is a directive, so the implementation is left to the Member States.⁶¹

⁶¹ See Article 288 TFEU.

3. VAT, customs and transfer pricing: Open market value

3.1 Article 72 – Open market value

Article 72 of the RVD contains the definition of the open market value referred to in Article 80. It was first introduced in its current form in the Sixth directive through the adoption of Council Directive 2006/69/EC. In the explanatory memorandum it says that there was a choice between two options, revaluing transactions between related parties at the cost price or the open market value. The Commission felt that, since the cost price would only have had the effect of enabling Member States to neutralize the tax loss suffered through the incorrectly valued transaction, while the open market value allowed tax authorities the possibility to protect some of the tax on the value added, the open market value was the most appropriate.⁶²

„Article 72:

For the purposes of this directive, ‘open market value’ shall mean the full amount that, in order to obtain the goods or services in question at that time, a customer at the same marketing stage at which the supply of goods or services takes place, would have to pay, under conditions of fair competition, to a supplier at arm’s length within the territory of the Member State in which the supply is subject to tax.

Where no comparable supply of goods or services can be ascertained, ‘open market value’ shall mean the following:

- (1) In respect of goods, an amount that is not less than the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, determined at the time of supply;*
- (2) In respect of services, an amount that is not less than the full cost to the taxable person of providing the service.“*

The term open market value has multiple meanings for the application of the transfer pricing rules of VAT. Firstly, a transaction between related parties that meets the criteria for the application of Article 80 is measured against the open market value to determine whether it has been under- or overvalued. Then, if a transaction covered by Article 80 is found to be

⁶² COM(2005)89 final, Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations, pg. 6.

improperly valued, its valuation is adjusted to the open market value.⁶³ While Article 72 is said to provide the definition of the concept of open market value as it is referred to in Article 80, the definition is not particularly clear. It lacks a clear definition of what the open market is and how it should be determined. Whereas customs law has clear and well established valuation methods, Article 72 only makes reference to re-valuation to a comparable supply of goods and services. Much like in the case of the definition of related parties discussed earlier, the VAT definition of open market value is extremely general and lacks specificity, leaving the interpretation to the Member states, which leads to a lack of uniformity in the common system of VAT. This is, like in the case of the definition of related parties, in stark contrast to the valuation methods in the CCC, which are far more specific.

That the definition of the concept of open market value lacks clarity is an opinion shared by experts as well as the European Economic and Social Committee⁶⁴ The EESC, in its opinion on the proposal for the Rationalisation Directive, raised its concern that there was no clear definition of the open market value. In its opinion it said: *„The EESC recognises that in a few cases, where there is suspicion of tax evasion by over- or undervaluing transactions, the taxable amount should be set at the open market value. Difficulties may arise in practice, however, in determining a significant difference between the value of the transaction and the open market value, as there is no clear definition of either open market value, which depends on the assessment of the parties involved, or of a significant difference of value. The EESC is concerned that lack of clarity could cause uncertainty for businesses. The use of the instrument in the legislation of Member States should, therefore, be conditional upon a precise definition of open market value and quantification of what is deemed a significant difference.“*⁶⁵ Alain Charlet and Dimitra Koulouri concur with the opinion of the EESC, saying that the open market value as a re-valuation measure has prompted concerns about the additional uncertainties created by the lack of guidance to the methods to be used to determine the open market value.⁶⁶

The lack of clear guidelines on how to determine the open market value, means that it is left to the Member states to decide how it should be determined which leads to legal uncertainty

⁶³ Dennis Ramsdahl Jensen (2009), pg. 890.

⁶⁴ Hereafter EESC.

⁶⁵ Opinion of the European Economic and Social Committee on the „Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations“ COM(2005) 89 final, para. 3.5.

⁶⁶ Alain Charlet & Dimitra Koulouri (2009), pg. 732. See also Mayra O. Lucas Mas, *Value added tax*, pg. 204-205.

and goes against the aim of the common system of VAT. It isn't just the determination of the open market value that is left to the Member States. The definition of related parties is also mostly left to the Member States, as Article 80 only contains a short list of criteria for related parties, which leaves a broad discretionary power to the Member States to define the concept of related parties. This prevents the uniform application of the VAT transfer pricing rules among Member States.⁶⁷

Article 72 of the RVD defines the open market value as being the full amount a customer would have to pay at arm's length, while there is no reason to believe that this is an express reference to the arm's length principle, it is nevertheless natural in light of this wording to examine a potential interaction with OECD transfer pricing rules. This will be done in a later part of this chapter.

The article provides no guidelines for the determination of the open market value. In order to properly define the concept it makes sense to try to do so in the context of EU law by looking at another harmonized tax system in EU law, customs law. There is a clear link between the two systems, as Article 85 of the RVD provides that in respect of importation of goods, the taxable amount shall be the customs value. While the Community Customs Code makes no reference to the term open market value, it contains detailed rules and methods for assessing the validity of transactions between related parties and for re-valuing them in case the price has been affected by the relationship, much like what the VAT transfer pricing rules in Articles 72 and 80 aim to do. These re-valuation methods are all similar in nature to open market value, as they all use transactions between non related parties or at least transactions that have not been affected by a relationship between buyer and seller as a yardstick.

3.2 Re-valuation of related parties transactions in Customs law

As already stated earlier in chapter 2.4, Article 29(1)(d) and 29(2) contain the relevant provisions with regard to transfer pricing in EU customs law. These provisions are identical to the provisions of the Agreement on the implementation of Article VII of the GATT⁶⁸⁶⁹. Since the EU is a signatory to the agreement and they are identical, and the Agreement provides interpretative notes to its provisions, the agreement will be the basis of this discussion. The general rule is that the customs value is the transaction value. However, in order for the transaction value to be accepted as the customs value, four conditions have to be satisfied, one

⁶⁷ Mayra O. Lucas Mas (2010), pg. 202-203.

⁶⁸ General Agreement on Tariffs and Trade.

⁶⁹ Hereafter „the Agreement“

of which is that the buyer and seller are not related, or where they are related, that the transaction value is acceptable under the provisions of paragraph 2 of Article 1 of the Agreement.⁷⁰ Paragraph 2 provides that the transaction value can be acceptable where the buyer and seller are related, as long as the relationship doesn't influence the price. The question then becomes how do we determine whether or not the relationship influenced the price. Two options are provided in Article 1(2)(a) and (b). Paragraph 2(a) provides that the circumstances surrounding the sale should be examined to determine whether the relationship influenced the price. Paragraph 2(b) provides that the importer may demonstrate that the price closely approximates to one of three test values.⁷¹

When examining the circumstances surrounding the sale according to Article 1(2)(a) two aspects of the of sale should be examined, the way the buyer and seller organize their commercial relations and the way in which the price was arrived at. The interpretative note to Article 1 provides examples of such circumstances that would demonstrate that the relationship had not influenced the price: „Where it can be shown that the buyer and seller, although related under the provisions of Article 15⁷², buy from and sell to each other as if they were not related, this would demonstrate that the price had not been influenced by the relationship. As an example of this, if the price had been settled in a manner consistent with the normal pricing practices of the industry in question or with the way the seller settles prices for sales to buyers who are not related to the seller, this would demonstrate that the price had not been influenced by the relationship. As a further example, where it is shown that the price is adequate to ensure recovery of all costs plus a profit which is representative of the firm's overall profit realized over a representative period of time (e.g. on an annual basis) in sales of goods of the same class or kind, this would demonstrate that the price had not been influenced.“⁷³

3.2.1 Test values

The Agreement provides for three test values that the buyer can compare the transaction price to to demonstrate that it is acceptable as the customs value. They are: The transaction value in sales to unrelated buyers of identical or similar goods for export to the same country of importation; the customs value of identical or similar goods as determined under the

⁷⁰ Article 1.1(d) of the Agreement.

⁷¹ Article 1.2(a) and (b) of the Agreement. See also Ian Cremer and Maki Kitaura, *Customs Value*, pg. 71.

⁷² Article 15 of the Agreement provides the definition of related parties. It is similar to the corresponding article 143 of the CCIP.

⁷³ Paragraph 2(3) of the interpretative note to Article 1 of the Agreement.

provisions of Article 5 (the deductive value method) and the customs value of identical or similar goods as determined under the provisions of Article 6 (the computed value method).

According to Article 1(2)(b) when applying the tests, due account shall be taken of demonstrated differences in commercial levels, quantity levels, the elements enumerated in Article 8 (which are additions to the price actually paid or payable, such as commissions, cost of containers, cost of packing and more) and costs incurred by the seller in sales in which the seller and the buyer are not related that are not incurred by the seller in sales in which the seller and the buyer are related.⁷⁴ If the buyer demonstrates that the transaction price closely approximates with one of the test values, examining the circumstances of the sale in accordance with Article 1(2)(a) is not necessary.⁷⁵ In cases where the value of the goods does not closely approximate to a test value, and the examination of the circumstances surrounding the sale reveals that the price was influenced by the relationship between the buyer and seller, the test value can not be used as a substitute value, but rather the next available method in the hierarchy of alternative valuation methods should determine the customs value.⁷⁶

3.3 Five methods of establishing the customs value

3.3.1 Transaction value

The general rule in Article 29 of the CCC is that the customs value is based on the transaction value, i.e. the price actually paid or payable. It applies to all transactions provided four conditions are met: that there are no restrictions as to the disposal or use of the goods by the buyer; that the sale or price is not subject to some condition or consideration for which a value cannot be determined with respect to the goods being valued; that no part of the proceeds of any subsequent resale, disposal or use of the goods by the buyer will accrue directly or indirectly to the seller, unless an appropriate adjustment can be made in accordance with Article 32; and that the buyer and seller are not related, or, where the buyer and seller are related, that the transaction value is acceptable for customs purposes.⁷⁷ When the customs value cannot be determined by the transaction value, it is to be determined by the alternative measures provided for in Article 30 of the CCC. The alternative measures are hierarchical in nature, that is, each of them can only be applied if the prior one proves inadequate.⁷⁸

⁷⁴ Article 1(2)(b) of the Agreement.

⁷⁵ Paragraph 2(4) of the interpretative note to Article 1 of the Agreement.

⁷⁶ Ian Cremer and Maki Kitaura (2010), pg. 73.

⁷⁷ See Article 29, CCC.

⁷⁸ See Article 29 CCC, see also Massimo Fabio, *Customs Law of the European Union*, Chapter 4, pg. 3.

3.3.2 Value of identical goods

Identical or similar goods means goods produced in the same country, which have like characteristics and similar component materials, which enable them to perform the same functions and be commercially interchangeable. The quality of the goods, as well as their reputation and the existence of a trademark are among the factors to be considered when determining if goods are similar.⁷⁹

3.3.3 Deductive value method

The deductive value is the value at which identical or similar goods are sold in the EU in the greatest quantity at about the same time of importation as the goods being valued, to buyers that are not related to the sellers, subject to the deduction for extra costs of marketing the goods.⁸⁰

3.3.4 Computed value method

The computed value is calculated on the basis of the production cost in the country of export, such as the cost of raw materials and semi-finished products, fabrication processing, profits and general expenses, as well as other factors such as royalties or other license fees.⁸¹

3.3.5 Value based on data available in the community

This method is called the reasonable method. Using this method, the customs value of goods is determined under the general provisions of the Geneva Agreement, which provides that the customs value is determined by using „reasonable means“ consistent with the principles of the Agreement and Article VII of GATT.⁸²

3.4 Comparison

In the absence of a clear definition of the concept of open market value and guidelines on how to determine the correct open market value in VAT, it makes sense to try to define it in the context of EU law. The closest EU law has to the concept of open market value is the re-valuation of customs duties in cases where the relationship between buyer and seller has influenced the price. The CCC however, makes no express reference to open market value, and the transfer pricing rules of the RVD make no reference to the CCC, so it can at least be

⁷⁹ See Article 30(2)(a) CCC, see also Massimo Fabio, *Customs Law of the European Union*, Chapter 4, pg. 4.

⁸⁰ See Article 30(2)(b) CCC, see also Massimo Fabio, *Customs Law of the European Union*, Chapter 4, pg. 4.

⁸¹ See Article 30(2)(c) CCC, see also Massimo Fabio, *Customs Law of the European Union*, Chapter 4, pg. 4.

⁸² See Article 30(2)(d) CCC, see also Massimo Fabio, *Customs Law of the European Union*, Chapter 4, pg. 4.

concluded that the concept is not expressly intended to be common for the two systems. As already discussed however, there is a clear link between the two systems in that according to Article 85 of the RVD, in respect of importation, the taxable amount shall be the customs value, determined in accordance with the provisions in force, i.e. the CCC.

There are many similarities between the transfer pricing rules in customs and VAT, so there could be good reason to make use of the more detailed rules of the transfer pricing rules in customs law as a basis for definition of the VAT transfer pricing rules. A key reason to do so would be to eliminate the legal uncertainty that comes with the lack of a clear definition of the open market value and related parties in Articles 72 and 80. If the optional provision of Article 80 were to be made obligatory, and the definitions of related parties used in customs law made applicable to VAT, as well as the customs valuation methods, it would alleviate the legal uncertainty.

As discussed earlier both systems use a somewhat similar definition of related parties, with the very important distinction that the CCC is more specific in its definitions, and the definitions are the same throughout the customs union. Both systems are also similar in that the mere fact that transacting parties are related is not enough to trigger the transfer pricing rules into action. In customs, it is only when there are doubts about the acceptability of the price that further examination is required. In VAT, only certain types of transactions, those between related parties where either party does not have a full right of deduction and where the price is either too low or too high, lead to the transaction value being adjusted to the open market value. Both the open market value and the customs re-valuation share the aim of applying the tax to the correct transaction value.

While there are a lot of similarities, there is also at least one key difference. The customs value always includes a profit element, as seen by the alternative methods of valuation. The methods are all based on transactions between unrelated parties, and it is safe to assume that independent parties dealing at arm's length will look out for their own best interests and deal accordingly, i.e. for profit. One method, the computed value method⁸³ even expressly references a profit element.

The open market value however, can be the cost price in the absence of a comparable supply of goods, or as it says in Article 72: „*Where no comparable supply of goods or services can be ascertained, open market value shall mean the following: (1) in respect of goods, an*

⁸³ See Article 30(2)(d) of the CCC.

amount that is not less than the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, determined at the time of supply.“ This difference may not be so great however, if we consider the wording of the provision, „not less than“ does seem to refer to the minimum allowable price, and seems to allow room for Member States to add a profit margin if they so choose. As already discussed in an earlier chapter, the Commission chose the open market value ahead of the cost or purchase price in its proposal for the transfer pricing rules. They seemed to do so not only to prevent tax evasion and avoidance, but also to maximize potential tax returns, as can be seen from the explanatory memorandum to the proposal.⁸⁴ Like the re-valuation of transactions below the open market value are contrary to the principle of neutrality, so would using the CCC valuation methods with their inevitable profit element be. Using them wouldn't do anything to increase the transfer pricing rules adherence to the principle of fiscal neutrality, but considering that they are already intended to include such an element in their current, less clear rules, it would still be an improvement.

All in all, the two systems seem to have a lot in common when it comes to dealing with transactions between related parties and both have the same aim in that regard. It would therefore seem like it would make sense to use the more developed rules and methods of the CCC as a basis for definition of how to apply the open market value. This is in fact already being done in Australia and New Zealand, where they have developed a parallel valuation system for GST purposes. The two countries have designed a flexible hybrid transfer pricing regime for GST that allows these jurisdictions to borrow methods from the income tax and customs valuation regimes for GST purposes. There for example, the deductive value method is rejected due to it being buyer-centric and relying on data that is hard for the seller to gather.⁸⁵ This holds true for EU VAT as well. However, the other test values the CCC and the Agreement use could however be used in VAT. The value of identical/similar goods is already included in Article 72, and the computed value method is calculated on the basis of information readily available to the seller, such as production cost, profits and license fees.

Then the question becomes whether the ECJ would accept the CCC valuation methods to determine the open market value in VAT. Looking at the provision using a combination of the purposive and contextual methods of interpretation, the stated purpose of the provision is to prevent tax evasion and tax avoidance, while the provision and it's purpose should be

⁸⁴ See COM(2005)89 Final, pg. 6 as well as earlier discussion in chapter 2.2.2 of this thesis.

⁸⁵ Mayra O. Lucas Mas (2010), pg. 206-207.

understood in the context of the VAT system and EU law. With regard to the VAT system, the provision should be looked at in the context of the principle of fiscal neutrality and the goal of the system for a uniform application across Member States. With regard to EU law, the provision should be considered in the context of the principle of proportionality and the principle of legal certainty. The common system of VAT aims for uniform application wherever possible, as can be seen from the fifth and the 25th recitals of the preamble to the RVD. The former is really an expression of the principle of fiscal neutrality and states that the VAT system achieves the highest degree of neutrality when the tax is levied in as general a manner as possible, and the latter states that the taxable amount should be harmonised so that the application of VAT to taxable transactions leads to comparable results in all the Member States. The 25th recital is especially relevant in this regard as the provision's lack of clarity prevents a uniform application of the taxable amount, due both to the provision being optional, and the definition of open market value and related persons being left to the Member States. This also goes against the principle of legal certainty.

This question will obviously not be fully answered until the ECJ deals with it directly. However it would seem that there are good grounds for the Court to consider accepting the CCC valuation methods as a definition or clarification of the open market value. Doing so would help maintain the neutrality of the system and increase its uniformity. It would also, as a consequence alleviate concerns about legal uncertainty. As has already been discussed in an earlier chapter, the VAT transfer pricing rules could go too far and be in breach of the principle of proportionality, and this would not change if the CCC valuation methods were used. However, for the sake of this discussion this is not important, as the same holds true, whether the VAT transfer pricing rules stand on their own or if they are clarified by the use of the CCC.

3.5 Open market value vs arm's length principle

The definition of open market value is found in Article 72 of the RVD. The article makes an express reference to transactions at arm's length so a comparison to the arm's length principle laid out in Article 9 of the OECD Model Tax Convention is inevitable. In fact, due to the lack of guidelines on how to determine the open market value, some member states have resorted to prescribing an alignment with income tax transfer pricing methodologies, based on the OECD guidelines⁸⁶ in their domestic VAT law.⁸⁷ There certainly are similarities between the

⁸⁶ OECD Transfer pricing guidelines for Multinational Enterprises and Tax administrations

concept of open market value and the arm's length principle, beyond the mere reference to arm's length in Article 72, at least on the face of it. Both aim to ensure that the taxable base reflects the price which would apply in a transaction between unrelated parties under fair market conditions. As already stated, some Member States have already aligned their transfer pricing rules in VAT with those of corporate income tax, and given the similarities, it might not seem unreasonable that it would be possible to rely on the arm's length principle as stated in the OECD Model Tax Convention.⁸⁸

Any perceived interaction between the transfer pricing rules of the VAT system and the transfer pricing rules of the OECD Model Tax Convention used in corporate income tax stems from the use of the term arm's length in the definition of the open market value in Article 72 of the RVD. Based on that wording, it is only natural to investigate whether there is potential for the less established transfer pricing rules of the VAT system to lean on the well established rules and valuation methods of the OECD Model. Spain has taken the step of interpreting the legal concept of related parties for VAT purposes in conformity with the interpretation set out in its corporate income tax law. Furthermore, in the absence of a valuation system for the VAT transfer pricing rules, the Spanish VAT law also makes reference to the corporate income tax law as a basis for re-valuation of improperly valued related parties transactions.⁸⁹

There are however also differences between the open market value and the arm's length principle. The open market value as a revaluation measure is far more limited in scope than the arm's length principle. Open market value is only applicable in very specific situations where there is clear potential for tax avoidance or evasion, while the arm's length principle is applicable to any transactions between associated enterprises, regardless of any abusive practice.⁹⁰ Most significantly, for the potential of applying OECD transfer pricing rules to VAT, the ECJ has been very clear on the issue of applying OECD rules to EU VAT. As Alain Charlet and Dimitra Kourkouri point out, the fact that the ECJ has, in its ruling in the FCE Bank case said on the subject of using the OECD Guidelines in relation to the EU VAT rules that: „It should be noted that the OECD Convention is irrelevant since it concerns direct taxation whereas VAT is an indirect tax“⁹¹ would seem to imply that the concept of corporate

⁸⁷ Mayra O. Lucas Mas (2010), pg. 206.

⁸⁸ Dennis Ramsdahl Jensen (2009), pg. 891.

⁸⁹ Mayra O. Lucas Mas (2008), pg. 42-44.

⁹⁰ Alain Charlet & Dimitra Koulouri (2009), pg. 732.

⁹¹ ECJ C-210/04 *FCE Bank*, para. 39.

income tax transfer pricing is of limited relevance for the VAT transfer pricing rules and the definition of open market value.⁹² It could however be said that since FCE Bank doesn't deal with transfer pricing rules, but rather supplies of services between a Head office and a fixed establishment that it doesn't apply but the Court's extremely strong wording makes it seem unlikely that it would accept the use of OECD transfer pricing rules to determine the open market value. Furthermore, the fact that there is another well established valuation system when it comes to transfer pricing in EU law in the form of the CCC, and that there is already a direct link between the VAT system and the CCC in the form of Article 85 of the RVD means that any interaction between the OECD transfer pricing rules and the VAT transfer pricing rules on a judicial level is highly unlikely.

4. Conclusion

In the first chapter of this thesis the stated aim of the thesis was declared to be to analyse the current transfer pricing rules in the EU VAT system, and to attempt to answer the question what the open market value is, and how it is determined. The transfer pricing rules in the VAT system are quite general, to the point of lacking clarity and specificity. Both articles of the RVD dealing with transfer pricing, Article 72 and Article 80 contain very general definitions of key concepts that means that they have been left to the Member States for detailed definitions. This has led to legal uncertainty for businesses, by inhibiting uniform application of the transfer pricing rules.

In the second chapter the thesis presented the transfer pricing rules in international tax law, both the EU and the OECD rules. The chapter went into detail about Article 80 of the RVD. Article 80 is borne out of the same aim as the other transfer pricing rules, to prevent taxable persons from obtaining an undeserved tax advantage. The article differs from the transfer pricing rules of income tax law in that it only triggers re-valuation in certain specific circumstances where either of the (related) transacting parties has a limited right of deduction. In the one ECJ case that the thesis looks at in any detail the Court has dealt with the issue of whether these circumstances are exhaustive and found that they are. In that sense, the article is very clear. Its definition of when the re-valuation is triggered is not lacking in clarity.

Looking at Article 80 in the context of the general principles of the VAT system, the principle of fiscal neutrality and the principle that the taxable amount should be based on a subjective

⁹² Alain Charlet & Dimitra Koulouri (2009), pg. 733.

value rather than an objective one, it seems that the provision may be too far reaching. The Commission's decision to go with the open market value rather than the cost or purchase price seems to only serve to harm the neutrality of the VAT system, since the majority of transfer pricing adjustments in VAT concern transactions at below open market value, and when they are re-valued to a higher value, it leads to a cost for the seller that he doesn't recover from the buyer. The decision to go with the open market value method rather than the cost or purchase price doesn't result in any additional protection from tax evasion or avoidance, as valuing the transaction at cost price leads to the transaction being completely neutral from a VAT standpoint so if that was the only purpose of the provision, re-valuing to the cost or purchase price would have been enough, as well as having the added benefit of maintaining the neutrality of the system. From the wording of the Commission's reasoning in its proposal it seems that part of the purpose is to maximize tax returns.

Article 80 is an optional provision, which does not help in trying to harmonize the transfer pricing rules across the Member States. What further increases the lack of clarity is that the definition of related persons in the Article is very general and not at all specific. While the framework of the related parties definition is much the same as the framework of the related parties definition in customs law, the customs law definition is a lot more specific. In addition to that, the customs law definition has a binding effect on all member states as the CCC is a regulation. Therefore there is no such lack of clarity in the transfer pricing provisions of the CCC.

In chapter three the open market value is presented and compared with the corresponding arm's length principle of the OECD transfer pricing rules and the customs valuation methods. The definition of the open market value in Article 72 is similarly lacking in clarity to the definition of related parties in Article 80.. Like the definition of related parties it is too general, and offers no details or guidelines for how to determine the open market value beyond comparing the transaction to „comparable supplies“. This means the definition is left to the Member States with the same consequences as discussed with regard to the definition of related parties.

The OECD rules on transfer pricing, while they have been used to define both related parties and open market value in the VAT law of at least one Member State, are in many ways different from those of the VAT system. In addition the ECJ has flat out rejected the application of OECD rules when it comes to VAT in the FCE Bank case.

The transfer pricing rules of the CCC, however are in many ways similar to the VAT rules. Looking for clarification or a definition of an EU law provision in EU law is also the more obvious way to go about it. There is a clear link between the RVD and CCC through Article 85 of the RVD, and there are many similarities between the rules. They're both only triggered in specific circumstances, rather than everytime there is a transaction between related parties like there is in OECD transfer pricing rules. Both aim to tax the correct transaction value. Even the VAT concepts that lack a clear definition, open market value and related parties, are quite similar to the corresponding concepts in the CCC, the difference being that the VAT concepts are very general frameworks with complete lack of detail, while the CCC has that detail. There do therefore seem to be positive signs for a possible interaction between the systems, and indeed, countries outside the EU have set up hybrid transfer pricing systems that allow VAT/GST to borrow from customs valuation regimes.

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