

# Intangible assets and customs valuation

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## Abstract

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This paper focuses on determining the customs value of intangible assets by using a transactional profit split method. In this paper we explain how to determine the customs value of related inter-company transactions; summarise the relationship between the arm's length principle and customs valuation; explain how the customs value of intangible assets can be determined by using a profit split method; and discuss the developments related to reconciliation of customs valuation with transfer pricing and the proposed solutions.

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## 1. Introduction

Academic studies show that the share of trade carried out by multinational corporations (MNC) is about 60–70 per cent of total trade volume. Today, most commercial goods are produced using intangible assets, such as patents, know-how, brands and designs, with intangible assets contributing as much as 75 per cent of consolidated profits (Frisch, 1989).

Intangible assets differentiate goods from others and add value to them. However, the intangible assets are generally unique, making it virtually impossible to use comparable goods at customs valuation. For this reason, there is a need to develop and standardise specific methods related to the valuation of goods produced using intangible assets.

The Organisation of Economic Co-operation and Development (OECD) adopted a transactional profit split method for valuation of intangible assets in 1994. In contrast, the General Agreement on Tariffs and Trade (GATT) agreement on customs valuation (ACV) deals with intangible assets within the scope of the sales price of the goods to which they relate, and therefore custom administrations examine whether these rights are included in the price paid or payable. In other words, the transactional profit split method for the valuation of intangible assets is not used to determine customs value, but the problem is reduced to the extent of determining whether or not the relationship between the seller and the buyer affects selling price.

Since the valuation of unique intangible assets is very difficult, MNCs can easily avoid taxation. Therefore, customs administrations must be equipped with means to accurately determine the value of the goods in question. For this reason, only looking at the transfer pricing documents will not be enough because tax administrations and customs administrations have different perspectives.

## 2. Determination of customs value of related party transactions

In foreign trade transactions, there should be no relationship between the buyer and the seller when accepting the sales price. However, in valuation law, the existence of a relationship between the buyer and the seller does not constitute sufficient reason to reject the application of the sales price method. If it is determined that the relationship between the buyer and the seller has not affected the price, it is possible to prescribe the sales price to the customs value of the goods.

To determine whether the selling price would be an acceptable basis for the transaction value, two tests are used: (1) the ‘circumstances of sale’ test to determine whether the relationship influences the price; and (2) the ‘test values’ test to determine whether the transaction value closely approximates one of three types of test values. The circumstances of the sale test, which is more commonly used, is broad and the provisions strikingly concise (Ping & Silberstein, 2007).

Under the sale test, relevant aspects of the transaction are analysed—such as the way in which the buyer and the seller organise their commercial relations, and the way in which the price in question is arrived at—in order to determine whether the relationship influences the price.

Under this test, the price will be accepted provided that:

- a. The price was settled in a manner consistent with the normal pricing practices of the industry in question (i.e. the industry that produces goods of the same class or kind). This test does not focus on the function performed by the parties, as transfer pricing rules do.
- b. The price was settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related to it. This test is equivalent to comparable uncontrolled price in transfer pricing rules.
- c. The price was adequate to ensure recovery of all costs plus a profit that is equivalent to the firm’s overall profit realised over a representative period of time in sales of merchandise of the same class or kind. This test is equivalent to the cost plus profit method in transfer pricing rules, but focuses on merchandise of the same class or kind, not in the functions performed by the parties.

The ‘test values’ test is met (and where met, the price declared is accepted as a basis for transaction value) when the price declared closely approximates one of the following values:

- a. the transaction value in sales to unrelated buyers of identical or similar goods for export to the same country of importation
- b. the deductive value of identical or similar goods
- c. the computed value of identical or similar goods occurring at or about the same time (or, in the United States, at the time of exportation) (Marsilla, 2008).

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

The second and third test values require previous determinations of value of identical or similar goods, which must have been accepted by the customs authority and are therefore acceptable under Article 1 of the ACV. The tests provide a basis for comparison of an actual customs value already accepted by customs. Consequently, if there is no parallel import into the same customs territory by buyers not related to the seller, the test values cannot be used.

Certain factors need to be taken into consideration to determine if the transaction value ‘closely approximates’ the test value. Such factors include the nature of the imported goods, the nature of the industry itself, the season in which the goods are imported and whether or not the difference in values is commercially significant (Malm, 2009).

It is clear from the foregoing explanations that test values must be found in the determination of the customs value of related party transactions. However, if traded goods are unique and transactions are carried out only between related parties, the use of test values is not possible.

### 3. Determination of customs value of related party transactions and arm's length principle

Enforced by revenue authorities, transfer pricing is grounded in Article 9 of the OECD and United Nations (UN) Model Tax Conventions, which establish the arm's length principle. All cross-border commercial and financial transactions between associated enterprises (goods, services, intangibles, financial transactions) are within the scope of transfer pricing.

The arm's length principle requires a comparison of the conditions of a taxpayer's controlled transactions with the conditions of comparable uncontrolled transactions. Two transactions are regarded as comparable where either there are no material differences between them or reasonably accurate adjustments can be made to eliminate the effect of any such differences (Ping & Silberstein, 2007).

The relationship between the seller and the buyer and international/cross-border transactions were managed separately in the past. This means that transfer pricing was, and still is, regarded as a matter of direct taxation. Customs, on the other hand, being a harmonised indirect tax, has been regarded as a matter of logistics. Today, the two situations are more commonly linked due to the increased expansion of multinational groups and cross-border transactions.

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

Even if the OECD transfer pricing guidelines explicitly discuss comparability, the ACV does not make any reference to a comparability analysis. The Interpretative Note to Article 1.2 states that '[w]here it can be shown that the buyer and seller, although related [...], buy from and sell to each other as if they were not related, this would demonstrate that the price had not been influenced by the relationship'. This statement indicates that there is a clear similarity between the comparability analysis for transfer pricing purposes and demonstration of correct prices for customs valuation purposes. The idea of comparability is clearly present in the provisions of the ACV, simply not explicitly stated (Malm, 2009, pp. 12–13).

The arm's length principle is applied, broadly speaking, by many customs administrations as a principle of comparison between the value attributable to goods imported by associated enterprises, which may be affected by the special relationship between them, and the value for similar goods imported by independent enterprises. Valuation methods for customs purposes, however, may not be aligned with the OECD's recognised transfer pricing methods. Nevertheless, customs valuations may be useful to tax administrations in evaluating the arm's length character of a controlled transaction transfer price and vice versa. In particular, customs officials may have contemporaneous information regarding the transaction that could be relevant for transfer pricing purposes, especially if prepared by the taxpayer, while tax authorities may have transfer pricing documentation, which provides detailed information on the circumstances of the transaction.

It has been pointed out that there are marked similarities between the World Trade Organization (WTO) and OECD methods for customs valuation and transfer pricing respectively. For example, the WTO deductive method (Article 5) is based on the resale price of the goods as is the OECD resale price method; the WTO computed value method (Article 6) is based on a value built up from materials and manufacturing costs, plus profit, similar to the OECD cost plus method. However, although this is of

interest, it is not directly relevant to the issue at hand; Customs' focus is on the transaction value method and whether or not the declared price has been influenced when the buyer and seller are related. Customs, therefore, will in the main be examining transfer pricing data in this context and not in relation to the use of other WTO methods (WCO, 2015).

#### **4. Customs valuation and intangibles**

The effect of intangible assets on customs valuation is to the extent of the amount of royalty and licence fees paid or to be paid. In other words, royalty or licence fees that are paid for the sale of the goods and are not included in the actual price paid or payable should be included in the customs value.

The source of such legal arrangements is based on the agreement on the application of Article VII of the GATT. This issue is regulated in Article 8 (c) of the Treaty.

Typical examples include the manufacture and/or sale for export of imported goods (e.g. patents, designs, models and manufacturing know-how, trademarks) and the use or resale of imported goods (in particular, copyright, manufacturing processes inseparably embodied in the imported goods). The manufacturing term in this definition means that materials are partly or completely altered, or processed by means of machines, devices, workbenches, tools or hand tools, or are a new product developed by loading a function to a product.

According to the definitions, royalty or licence fees are made on the basis of goods imported under the names of patent, design, know-how, trademark, model, registered design, copyright and manufacturing processes.

There are two basic conditions for the inclusion of royalty or licence fees in customs valuation. These are that the payment must be:

- a. related to the goods to be valued
- b. made on the condition of sale of these goods.

The royalty or licence fees bearing both of these conditions must be added to the customs value of the imported goods.

As can be understood from these provisions, the royalty and licence fees are evaluated only for inclusion in the customs value of the imported goods because of the usage price of intangible assets. The amount of royalty and licence fees are considered to be the cost of using these assets. However, in the ACV, there are no assessments of whether the royalty and licence fees paid for the imported goods are in accordance with the arm's length principle, and of what these payments should actually be if there is no comparable transaction. Unlike transfer pricing methods, the value of intangible assets in customs valuations is assessed in terms of whether those assets are included in the price actually paid or payable for the imported goods. This makes it nearly impossible to determine the customs value of the intangible assets used in the imported goods, especially in the case of incomparable transactions.

## 5. Profit split method in OECD transfer pricing guidelines

Both the transactional net margin method (TNMM) and profit split method in OECD transfer pricing guidelines were developed for income tax purposes, and even though the problem posed by intangible valuation is a growing concern in Customs, they have not been widely adopted outside the income tax context. Customs is resistant to them.

Intangibles are problematic because they have few (if any) comparable items and they are frequently subject to adjustments based on future events and commercial practice if they are non-routine. The impact of intangibles on customs is no less significant than their impact on income tax, but the valuation system is not designed to easily accommodate either voluntary or audit-based intangible adjustments.

This complicating factor makes applying traditional transfer pricing methods problematic. For example, if:

- a. the intangible is truly unique, then comparable uncontrolled price (CUP/CUT) methods (by definition) are not available (the intangible would not be unique if there was comparable)
- b. the intangible asset is not resold (and this would be the normal case with an intangible asset purchased by a bank, financial or insurance company), then resale price valuations cannot be performed (there are no resales)
- c. the cost of producing the intangible asset is not controlled by the purchaser, then cost plus (C+) methods are difficult to perform (because the data needed to perform analysis are under the seller's control, not the buyer's control).

Of all the traditional methods, only the C+ method can be realistically applied, and this would be a difficult application (Ainsworth, 2007).

To be understood, the presence of the intangible for one party or both parties in the trade between the related parties would make it very difficult to determine the customs value of the goods. In these situations, there will usually be no comparable item, and problems will become more complicated because the profit-based methods used in transfer pricing are not included in the customs valuation methods.

In transfer pricing, residual analysis (which is one of the profit split methods), is generally used in profit sharing between related entities. Under the residual analysis, the combined profits from the controlled transactions are allocated between the associated enterprises based on a two-step approach:

Step 1: allocation of sufficient profit to each enterprise to provide a basic compensation for routine contributions. This basic compensation does not include a return for possible valuable intangible assets owned by the associated enterprises. The basic compensation is determined based on the returns earned by comparable independent enterprises for comparable transactions or, more frequently, functions. In practice, TNMM is used to determine the appropriate return in step 1 of the residual analysis.

Step 2: allocation of residual profit (i.e. profit remaining after step 1) between the associated enterprises based on the facts and circumstances. If the residual profit is attributable to intangible property, then the allocation of this profit should be based on the relative value of each enterprise's contributions of intangible property (United Nations, 2001).

## 5.1 Application Example<sup>1</sup>

Company A manufactures product X in Country A, and sells it to Company B in Country B. Company B sells a value-added product to local consumers after it has been involved in various manufacturing activities for this product. Both A and B companies are involved in research and development (R&D) activities for the development of this product. Also, Company B has valuable intangible assets developed in its home country for the marketing of products. In this case, we can explain how the customs value of the goods can be determined by using residual analysis and the data in Table 1.

### a) Companies A and B Profit & Loss

Table 1: Income and expenses for companies A and B

	Company A <sup>b</sup>	Company B <sup>b</sup>
Sales	80 CU	150 CU
Raw materials	(10) CU	(80) CU
Production costs	(25) CU	(20) CU
Gross profit	45 CU	50 CU
R&D costs <sup>a</sup>	(30) CU	(10) CU
Marketing expenses <sup>a</sup>	—	(20) CU
Other operation expenses	(15) CU	(10) CU
<b>Net profit</b>	<b>0 CU</b>	<b>10 CU</b>

<sup>a</sup> It is assumed that all costs are due to intangible assets

<sup>b</sup> CU denotes currency units

As can be seen in Table 1 above, the sales (80 CU) of Company A constitute the costs of Company B. The total profit of the company A and B is 10 CU.

### b) Determining the routine profit in the productions of companies A and B and calculating the total residual profit

Suppose Company A and Company B will each make a profit of 10 per cent (ratio of net profit to direct and indirect production costs) of their production costs (except for the raw materials) if they do not have any unique intangible assets (10% profitability is assumed to be the average routine profit of the industry). Since Company A's production cost is 25 CU, the return on production cost of Company A will be 2.5 CU. Since Company B's production cost is 20 CU, the return on production cost of company B will be 2.0 CU. In this case, the residual profit will be calculated as 5.5 CU [ $10 - (2.5 + 2.0) = \text{CU } 5.5$ ].

### c) Splitting the residual profit

In the first allocation, 2.5 CU is given to Company A and 2.0 CU to the Company B because of the production function. However, the relative contribution of intangible assets related to R&D and marketing was not taken into account in this allocation. For this reason, 5.5 CU residual profit will be distributed according to the relative contributions of the research and development expenses and the marketing

expenses of the Company A and Company B. Here, it is assumed that the companies contributed to the technological innovation and marketing of the products, to the extent of the expenses they have made. According to this explanation: the share of A is  $5.5 \times 30/60 = 2.75$  CU, the share of B is  $5.5 \times (10 + 20) / 60 = 2.75$  CU.

#### d) Recalculation of the profit

The net profit of A will be  $2.5 + 2.75 = 5.25$  CU and the net profit of B will be  $2.0 + 2.75 = 4.75$  CU. This recalculation is shown in Table 2. Accordingly, the profit of Company A will be 5.25 CU and the profit of Company B will be 4.75 CU. In other words, by using intangible assets, company B's net profit decreases from 10 CU to 4.75, CU while company A's net profit increases from 0 CU to 5.2 CU.

Table 2. Rearranged income and expenses table for companies A and B

	Company A	Company B
Sales	85.25 CU	150.00 CU
Raw materials	(10) CU	(85.25) CU
Production costs	(25) CU	(20) CU
Gross profit	50.25 CU	44.75 CU
R&D costs	(30) CU	(10) CU
Marketing expenses	–	(20) CU
Other operation expenses	(15) CU	(10) CU
<b>Net profit</b>	<b>5.25 CU</b>	<b>4.75 CU</b>

In the absence of any royalty or licence payments in accordance with Table 2, the value of the goods in Company B rose from 80 CU to 85.25 CU. For this reason, the sale price of the good should be accepted as 85.25 CU.

However, associates, who usually use intangible assets in the present, pay royalty and licence fees to the parent company to which they are entitled. If it is required to determine the profitability appropriately for the residual profit distribution, according to Table 1, the royalty and licence fees to be paid to Company A by Company B will have to be 5.25 CU. Thus, the profit of Company A will increase to 5.25 CU while the profit of Company B will decrease to 4.75 CU.

Multinational companies can separately determine both the amount of royalty and licence fees to be paid and the resources of these fees as part of their tax planning activities in their contracts. For example, the royalties amount to be paid in the above example can be set as 1.00 CU or 8.00 CU instead of 5.25 CU. In this case, it will not be possible to determine the royalty and licence fees that must actually be paid unless the profit split method is used. On the other hand, the inclusion of royalty and licence fees to the customs value requires that such a payment be related to the goods to be assessed and this payment be made on the condition of sale. Customs valuation methods do not make any determination as to what 'actually paid' should be. In the existence of intangible assets in both companies, the relative contribution of these intangible assets and consequently the profits of each company can only be determined by the

profit split method. Only if the intangible asset was found in Company A, the customs value of imported goods of the company B could be determined by the reduction method. In this situation, the customs administration would be able to determine the customs value of the goods, taking into account the profitability rate and the overall costs of an independent operator similar to Company B.

In some cases, the MNCs may license their intangible assets related to the marketing of their brand to their subsidiaries operating in another country, and in return, the subsidiary may pay royalty and licence fees to the parent company. For example, while a famous mobile phone company exports its products under its own brand to its subsidiary in another country, the parent company also may give some marketing rights (such as store design, employee training, product presentation) to introduce products under the licence. Here, the customs valuation methods are insufficient because there is no comparable transaction in determining how much of the payment is related to the brand and how much of the payment is related to marketing. In this case, the only solution would be to use the profit split method. Knowing whether the relationship influences the price or not would not be beneficial to the customs authorities. Even if there is a transfer pricing report that shows that the royalties paid are consistent with the arm's length principle, this information will not show us how much of the licence fee is for the brand and how much for the marketing intangibles (royalties for marketing is not included in the customs value). The tax administration will just look at the total amount paid, not to whether the royalties paid are related to marketing or branding.

For example, suppose that in the above example, Company A licenses only intellectual property for marketing to Company B, and Company B does not have a R&D facility. In this case, Company A has only intangible assets related to R&D, and marketing rights given under its own licence to Company B (expenses incurred for activities related to intangible asset related to marketing are 20 CU). So, the profit of Company B in Table 1 will increase to 20 CU and the residual profit will be 15.5 CU [ $20 - (2.0 + 2.5)$ ]. Since total 50 CU ( $30 + 20$ ) intangible assets belong to Company A, all residual profit will be the profit of Company A. The remaining 9.3 CU [ $15.5 * (30/50)$ ] of the residual profit will be related to the share of the R&D expenditure, while the remaining 6.2 CU of the residual profit will be related to the marketing licence. If Company B pays a royalty and licence fee of 15.5 CU, royalty and licence fees for R&D expenses of Company A will be 9.3 CU, and royalty and licence fees for marketing expenses of Company A will be 6.2 CU. For this reason, royalty and licence fees to be added to the customs value will be 9.3 CU instead of 15.5 CU. As can be seen from this example, the amount of royalties on marketing would only be confirmed by the profit split method. While it is sufficient to pay royalties of 15.5 CU for tax administration, it is more important for the customs administration to know how much of this payment is related to R&D expenditures.

## 6. Attempts to reconcile values/prices

Valuation of related party transactions for transfer pricing, customs and VAT purposes was the subject of two major conferences organised jointly by the World Customs Organization (WCO) and the OECD in May 2006 and May 2007 (Ping & Silberztein, 2007).

Specialists from customs and tax administrations and the private sector presented and discussed various viewpoints and proposals regarding issues such as the scope for greater alignment and other technical aspects. Following the second conference in 2007, a focus group was established (again comprising customs and tax officials and business representatives) to consider the key themes that emerged during the conferences. The focus group has met once to date, on 26 October 2007 (WCO, 2015, p. 56).

Three issues concerning the way to minimise the gap between transfer pricing for tax and customs purposes were discussed at the conferences. The first issue was the usefulness of transfer pricing documents (TPDs) for customs purposes. A company's TPDs could be useful for the customs authority since it often

provides extensive information about the company's transfer pricing compliance requirements and could serve a dual purpose, especially if the TPDs address the company's customs valuation requirements. The second issue was the development of a joint advance customs valuation agreement (ACVA) and advance price agreement (APA). This possible development was seen at the conference as promising, despite limited and contrasting experiences in countries so far. The use of a ruling involving both the revenue and customs authorities opens up the prospect of an effective, coordinated dispute-prevention mechanism. The third issue was the possible development of joint customs and transfer pricing audits. The objectives are that it would reduce the time and effort spent on audits by the taxpayer and the authorities, and to arrive to the extent possible at a common determination of the valuation of related party transactions that would be acceptable for both customs and tax authorities (Malm, 2009).

Some commentators have suggested that there should be a formal alignment or merger of the two methodologies. It became clear following the joint conferences and focus group meeting, however, that such harmonisation was not a realistic proposition, particularly as the application of the methodology contained in the WTO valuation agreement is an obligation for a WTO member country and it is not expected to be amended/updated in the short to medium term. Therefore, the challenge is to consider what is possible within the constraints of the existing WTO agreement provisions.

It was recognised that the test values option in Article 1.2 (b) and (c) for examining related party transactions was not likely to be useful for MNCs that typically sell unique goods. In other words, it is unlikely that such test values, based on the strict criteria of identical or similar goods provided in the agreement, will be available, and so the focus was on the analysis of the circumstances surrounding the sale provision.

The key progress made to date has been the adoption of Commentary 23.1, an instrument of the Technical Committee on Customs Valuation (TCCV) that acknowledges that a transfer pricing study may be of use in the examination of related party transactions for customs value purposes, on a case-by-case basis. This instrument confirms the principle that transfer pricing studies are a source of information that can be considered by customs and so provides an important first step (WCO, 2015, pp. 56–57). However, neither the WCO nor the OECD has proposed concrete instructions or guidelines thus far (Kim, 2009).

## 7. Conclusion

In a world where MNCs have increasing transaction volumes and intangible assets make a huge contribution to the profitability of the company, valuation of intangible assets is at the top of the debate on taxation. The valuation of intangible assets has been standardised within transfer pricing methods to some extent, although some subjective assessments are required.

Although the provisions of the ACV for related party transactions are quite similar to the arm's length principle, the methods based on profit are not included in the customs valuation methods. In the absence of comparable goods due to the use of intangible assets, customs valuation methods do not provide an explicit solution to the issue of related party transactions. The only solution proposed by the ACV is to investigate the conditions for sale.

In this regard, the recommended way to investigate the conditions for sale was to use the transfer pricing documentation to determine whether the relationship affected the price. The TPDs are often said to provide comprehensive information about the company's compliance with transfer pricing and to serve both tax and customs purposes. However, royalty and licence fees related to intangible assets to be included in the customs value should be related to the imported goods and should be made subject to sales conditions. For these reasons, it is considered that the usefulness of these documents is significantly limited.

TPDs are not sufficient for customs purposes, especially when intangible assets exist for marketing activities. In other words, the profit in compliance with the arm's length principle does not provide sufficient guidance to the customs authorities on whether the price is influenced by relationship. For this reason, the author believes that it is important to update the valuation agreement to add profit-based methods to the existing methods.

In the case of adopting profit-based methods, the declared value during import would be provisional, and the customs value under the profit split method would be subsequently adjusted.

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### Notes

- 1 In the development of the application example, the OECD's 2015 publication, *BEPS action 10: Discussion draft on the use of profit splits in the context of global value chains*, (pp. 24–30), was used.

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