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VAT EXPERT GROUP

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Paper on topic for discussion

Possible VAT implications of Transfer Pricing

1. EXECUTIVE SUMMARY - THE VAT EXPERT GROUP'S OPINION

The VEG welcomes the opportunity to discuss the possible VAT implications of transfer pricing rules laid down for the purposes of direct taxation.

It is important to note that Transfer Pricing Adjustments are direct tax driven and direct tax and VAT are conceptually totally different taxes. As such, a Transfer Pricing Adjustment does not usually result in an adjustment in the consideration for any supply, even though the profit adjustment may be an indirect consequence of goods being bought or sold and other kinds of costs being incurred.

When defining the VAT treatment of a Transfer Pricing Adjustment, the VAT neutrality principle should be recognized, meaning that neither businesses nor tax administrations should suffer negative consequences from the proposed treatment.

An exception to this would be where Article 80 of Directive 2006/112/EC applies or when there is an abuse of law (e.g. through artificially low pricing to reduce non-recoverable VAT followed by a relatively large Transfer Pricing Adjustment) or a member state has a derogation under Article 395.

The Opinion of the VAT Expert Group is that Transfer Pricing Adjustments should be considered as "Outside scope of VAT" where both parties have a full right to recover VAT, in accordance with the simplification practice that we suggest to be adopted by the Member States (see 2.2.3). It is only when one of the traders does not have a full right of recovery, that Transfer Pricing Adjustments might require a VAT adjustment if there is a sufficiently direct link between any payments resulting from an adjustment and specific supplies. Transfer Pricing Adjustments resulting from a tax audit should always be treated as outside of the scope of VAT (see 2.2.1.1) unless the parties agree to change the consideration accordingly.

2. INTRODUCTION

The VEG welcomes Commission Paper VEG No. 65 and the opportunity to discuss the possible VAT implications of Transfer Pricing Adjustments as laid down for the purposes of direct taxation.

The direct tax transfer pricing rules are aimed at ensuring that the conditions of the transactions within a multinational enterprise group ("MNE group"), including the price, match comparable market conditions and that, as a result, profits and losses are divided between the jurisdictions in which the multinational enterprise ("MNE") operates as they would have been, had the transactions under transfer pricing been performed between unrelated 3rd parties

Besides Transfer Pricing Adjustments between affiliated parties, the scope of Transfer Pricing Adjustments needs to be expanded to adjustments executed between 3rd parties due to contractual arrangements. This may be the case for instance in case of guaranteed profit margins for 3rd party distribution, toll and contract manufacturing arrangements.

The aforementioned aim (proper allocation of income between related and unrelated parties) clearly differs from the aim of the VAT system, i.e. taxation of consumption, with the allocation of taxing rights based on the destination principle.

Nevertheless, Transfer Pricing Adjustments can also have VAT implications. Businesses across the EU have, in practice, experienced Member States taking different approaches on how to treat Transfer Pricing Adjustments for VAT purposes, such as:

1. Outside the scope of VAT – no taxable transaction for VAT purposes
2. Price adjustments – the adjustment is linked to a prior underlying taxable transaction for VAT purposes (retroactive adjustment)
3. Further consideration for a subsequent supply (prospective adjustment)
4. Consideration for a separate service – separate taxable transaction for VAT purposes

Annex 1 refers to a couple of real-life examples of issues in business practices on Transfer Pricing Adjustments. The examples clearly show the lack of clarity on how to deal with Transfer Pricing Adjustments from a VAT perspective. This uncertainty may cause a significant monetary risk and a high administrative burden on businesses operating in the European Union.

It is therefore important to examine this topic in further detail to provide legal certainty for businesses and tax administrations.

This document deals with the VAT aspects only. We recognize that when it comes to TP adjustments there is also a linkage to customs with potential VAT consequences[1]. However, the specificity of the rules[2] applicable to customs transactions justifies a separate treatment of this topic. Also, this document does not consider the impact of Transfer Pricing Adjustments on Direct Tax.

2.1. Principles

Transfer Pricing Adjustments, while mainly related to the "Taxable Amount", have a much broader impact.

The notion "Transfer Pricing Adjustments" is not mentioned in VAT Directive 2006/112/EC ("VAT Directive"). There are also no CJEU cases available which specifically deal with the handling for VAT purposes of Transfer Pricing Adjustments.

Below is an overview of the provisions in the VAT Directive which may have an impact to define the correct VAT treatment of Transfer Pricing Adjustments.

[1] See CJEU C-529/16, Hamamatsu, para. 26: "Furthermore, the Court has already stated that the customs value had to be determined primarily according to the 'transaction value' method under Article 29 of the Customs Code. It is only if the price actually paid or payable for the goods when they are sold for export cannot be determined that it is appropriate to use the alternative methods laid down in Articles 30 and 31 thereof (see, in particular, judgments of 12 December 2013, *Christodoulou and Others*, C-116/12, EU:C:2013:825, paragraphs 38, 41, 42 and 44, and of 16 June 2016, *EURO 2004. Hungary*, C-291/15, EU:C:2016:455, paragraphs 24 and 27 to 30).".

[2] See Article 70 et seq. of REG EU (Recast) no. 952/2013.

Taxable transaction

A supply of goods or services is subject to VAT when made for consideration by a taxable person acting as such, pursuant to Article 2(1) of the VAT Directive.

Concerning the existence of consideration, from the settled case-law of the Court of Justice of the European Union (CJEU), it is clear that a supply of services is effected for consideration within the meaning of Article 2(1)(c) of the VAT Directive, and hence is taxable, only if there is a direct link between the services supplied and the consideration received.

Such a direct link is established if there is a legal relationship between the provider of the service and the recipient pursuant to which there is reciprocal performance, the remuneration received by the provider of the service constituting the actual consideration given in return for the service supplied to the recipient.

Based on the existing case-law of the CJEU concerning the existence of a direct link, it can be argued that Transfer Pricing Adjustments do not meet this requirement[3].

Taxable person

A taxable person is defined as any person carrying out an economic activity, whatever the purpose or results of that activity under Article 9 of the VAT Directive.

Taxable amount

The anti-avoidance rule in Article 80 of the VAT Directive is only applicable in the case of transactions between persons with close (family, financial or legal etc) ties.

Also, according to the CJEU[4], the conditions of application of Article 80 of the VAT Directive are exhaustive and, consequently, national legislation cannot - on the basis of that provision - provide that the taxable amount is to be the open market value of the transaction in cases other than those listed in that provision, except if a Member State has a derogation under article 395.

This is different from the direct tax concept and application of transfer pricing for intra-group transactions.

Article 83 of the VAT Directive does not provide for a specific Transfer Pricing provision either, as the taxable amount of an intra-Community acquisition of goods is determined in the same way as that of supplies of goods or services.

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[3] See CJEU C-285/10, Campsa Estaciones de Servicio SA vs. Administración del Estado para. 27: " It follows that, where consideration has been agreed and actually paid to the taxable person in direct exchange for the goods he has delivered or the service he has provided, that transaction must be classified as a transaction for consideration, regardless of whether it is effected between connected parties and the price agreed and actually paid is patently lower than the open market price. The taxable amount of such a transaction must, therefore, be determined in accordance with the general rule stated in Article 11A(1)(a) of the Sixth Directive." (emphasis added).

[4] See CJEU Joined Cases C-621/10 and 129/11

Article 85 of the VAT Directive establishes the taxable amount for an importation of goods by reference to the corresponding customs value.

Article 90 of the VAT Directive deals with Transfer Pricing Adjustments: "where the price is reduced after the supply takes place, the taxable amount shall be reduced accordingly under conditions which shall be determined by the Member States".

Chargeable event and chargeability of VAT

Following Article 63 of the VAT Directive, the chargeable event shall occur, and VAT shall become chargeable, when the goods or the services are supplied. Some subsequent articles allow for derogations. Article 70 of the VAT Directive dealing with the chargeable event for the Importation of Goods provides that "The chargeable event shall occur and VAT shall become chargeable when the goods are imported".

The chargeable event for Transfer Pricing Adjustments should in our opinion be the moment when the decision is made to voluntarily adjust the taxable amount for VAT purposes. At the same time, a debit/credit note is issued.

Invoicing, concept of an invoice – Deduction of VAT

Transfer Pricing Adjustments also have an impact on invoicing and deduction of VAT.

Article 219 of the VAT Directive mentions that "Any document or message that amends and refers specifically and unambiguously to the initial invoice shall be treated as an invoice". Typically, a taxable person only has the right to deduct the VAT in case he possesses an invoice or an import document in case goods are imported in the EU.

In our opinion, the deduction is a fundamental right of the VAT mechanism (neutrality principle). A correction of the amount of deductible VAT via an adjusted invoice should not result in a retro-active adjustment of the deductible VAT[5]. In line with the rules on chargeable event, VAT should be deductible at the moment when the obligation or the right to adjust the taxable amount for VAT purposes arises. The deduction of VAT should not be impacted by the expiry of statutory limits in case of Transfer Pricing Adjustments.[6]

Reporting requirements

Impact of Transfer Pricing Adjustments on VAT reporting such as the monthly/quarterly/annual VAT return and the recapitulative statements should be carefully considered to avoid a burdensome, complex and time-consuming process, particularly as transfer pricing is typically a B2B transaction that, in most cases, will see its VAT impact neutralized. Where unavoidable, the Transfer Pricing Adjustment should be reported in the month the document adjusting the VAT liable/deductible is issued, there should be no requirement for retroactive adjustment and/or reporting in the period the initial transaction.

[5] See AG Opinion in CJEU Case C-8/17, point. 71 Conclusion and AG Opinion in CJEU Case C-533/16, point. 91 Conclusion

[6] See Ecotrade C-95/07 and C-96/07 and Case C-85/97 SFI

2.2. Considerations to define Transfer Pricing Adjustments as Taxable transactions in/outside the scope of VAT

Based on the VAT Directive, it is not clear when a Transfer Pricing Adjustment is a taxable transaction within- or outside the scope of VAT. In some cases it might be argued that a Transfer Pricing Adjustment is an adjustment of a previous Taxable Transaction and therefore constitutes additional consideration for the same Taxable Transaction. It may also be arguable that the Transfer Pricing adjustment is consideration for a different Taxable Transaction or alternatively is outside the scope of VAT.

In the absence of a specific provision to this effect, the proposed VAT treatment in this document aims to bring certainty, simplicity and clarity on Transfer Pricing Adjustments.

2.2.1. Transfer Pricing Adjustments Outside the scope of VAT

Following Transfer Pricing Adjustments are not considered as taxable transactions and are consequently defined as being outside scope of VAT:

- Non-voluntary adjustments (2.2.1.1.)
- Voluntary Prospective Compensating adjustments (2.2.1.2.)

2.2.1.1. Non-voluntary Transfer Pricing Adjustments

Generally, there is only a taxable transaction where there is “consideration” (which can go beyond cash settlement). If there is no “consideration”, there is no taxable transaction and the Transfer Pricing Adjustment is clearly “Outside the scope of VAT”. It is our understanding that Primary, Secondary and Corresponding Adjustments[7] do not qualify as “consideration”, and as such do not lead to a “Taxable Transaction”. These adjustments are therefore considered as being “Outside the scope of VAT”. In addition to the absence of Taxable Transactions, there is no “reciprocal” performance.

These non-voluntary adjustments also typically occur after the tax return has been filed.

For instance, adjustments to the price of transactions or taxable basis upon audit of a taxable person. This can happen if the profit margin is not correctly applied if goods or services are invoiced on a cost+ basis. Typically, the taxable basis of the person under audit is increased while there is no corresponding decrease in the taxable basis of the counterparty.

Example - Reallocation of costs upon TP-audit

- Costs have been paid by Company A in MS 1
- During an audit, costs are from an income tax perspective rejected in the hands of Company A
- Following audit report, considering account functions/risks, these costs are to be paid by Company B in MS 2

[7] See VEG no. 65, Possible VAT implications of Transfer Pricing, page 6-10, definitions of Primary, Secondary and Corresponding Adjustments

- There is compensation paid by Company B to Company A for the costs incurred by Company A and rejected by the auditor

Potential VAT issues:

- Rejection of right of deduction of VAT in the hands of Company A in MS1
- Is there a requirement to re-invoice the rejected costs to Company B or a credit note to be issued by Company B.
- What is the qualification of the taxable transaction?
- Will Company B have the right to deduct VAT in MS2?
- Can an invoice/CN still be issued considering Statute of limitations?

2.2.1.2. Voluntary Prospective Compensating adjustments

Compensating adjustments are defined[8] as "*An adjustment in which the taxpayer reports a transfer price for tax purposes that is, in the taxpayer's opinion, an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between the associated enterprises. This adjustment would be made before the tax return is filed".*

In case of "prospective" compensating adjustments, the Transfer Pricing Adjustment is included in the price of future supplies of the same (identical) products via a price decrease/increase. The VAT treatment of the "prospective adjustment" would logically follow the treatment of the "future" supplies. There is no impact on VAT at the moment the Transfer Pricing Adjustment has been calculated, only at the time the invoice of the future supply which includes the Transfer Pricing Adjustment is issued.

2.2.2. Impact of the link with the initial supply

The correct VAT treatment depends on whether there is a direct link with the initial supply.

2.2.2.1. Direct link with the initial supply

Where the Transfer Pricing Adjustment can be linked to the initial supply, the VAT treatment of the adjustment is the same as the initial supply. The "link" requires that the Transfer Pricing Adjustment can be split so as to link (part of) the adjustment to each single good being sold or service being provided. For goods, the price of each product can be adjusted for each supply being made. For services, the cost of each service provided can be adjusted.

2.2.2.2. No direct link with the initial supply

Where there is no direct link with the initial supply and no contractual obligation to make a Transfer Pricing Adjustment payment, the assumption is that the adjusting payment aims to reach an agreed profit margin, which is not a taxable transaction or taxable consideration, and as such outside scope of VAT.

[8] See VEG no. 65, Possible VAT implications of Transfer Pricing, page 10

Where the contract refers to the treatment of Transfer Pricing Adjustments, the agreed treatment as per the contract should be followed. Following options are possible:

Definition Transfer Pricing Adjustment as per the contract	**VAT treatment**
Contract defines adjustments to reach guaranteed profit margin	Adjustment relates to a "profit adjustment" - This is not a Taxable Transaction - No debit or credit note or any other document for VAT purposes to be issued
Contract defines adjustment for previous supplies - - reference is made to a period during which transactions happened, list of invoices numbers attached, breakdown of the adjustment to each supply	Taxable transaction - Supply of Goods (or services) – Debit or credit note to be issued - same VAT treatment as initial transaction
Contract defines the adjustment as billing of variances between actual and budgeted cost of marketing or administrative expenses	Taxable amount is adjusted, ie further (less) consideration for a "Supply of Services" - Debit or credit note to be issued
Contract defines the adjustment as a profit split (e.g. in case of a joint venture)	Adjustment relates to a "profit adjustment" - This is not a Taxable Transaction - No debit or credit note to be issued

Documents may be desired for direct tax purposes to evidence payments that are made between the parties but which are outside the scope of VAT. If such documents are described as “invoices”, it is possible that tax authorities will assume that VAT must be due. The VAT Expert group therefore considers that it would be helpful to both tax authorities and business if there were an agreed description, such as “Transfer Pricing Payment Request”, for documents requesting payments relating to transfer pricing adjustments that are outside the scope of VAT.

See Annex 1, Example 1.

2.2.3. Simplification practice

Unless it has been otherwise contractually agreed, given the complexity of the treatment of Transfer Pricing Adjustments for VAT purposes, we recommend treating all types of Transfer Pricing Adjustments as Outside the Scope of VAT for B2B transactions where all parties have a full right to deduct VAT.

Transfer Pricing Adjustments are Direct tax driven. Direct taxes and VAT are conceptually totally different. This is correctly highlighted by the Commission in VEG Paper No 65, which observes that VAT is a transaction based tax with businesses just acting as tax collector and the VAT being borne by the final consumer. In principle, the tax should therefore be neutral for businesses.

The VAT Expert Group’s preferred approach to Transfer Pricing Adjustments is to treat them as being “Outside the scope of VAT’. Transfer Pricing Adjustments are executed to determine the Taxable Basis for Direct Tax purposes. A Transfer Pricing Adjustment should not necessarily result in a price adjustment for VAT purposes, even though the

profit adjustment may be an indirect consequence of goods being bought or sold and other kinds of costs being incurred.

Consequently, Transfer Pricing Adjustments do not lead to a “new” Taxable Transaction nor do they adjust a past transaction. Transfer Pricing Adjustments should not be and, generally, can’t be directly linked to a previous transaction. Unless there is a contractual provision requiring a modification in the consideration originally due, even where a direct link can arguably be established, Transfer Pricing Adjustments should in practice be considered to be “Outside scope of VAT”, where both parties are Taxable Persons with the full right to deduct VAT.

This approach is applied by at least one of the Member States. A tax authority states that usually no correction is necessary for VAT if the omission does not have an impact on the tax revenue and the VIES system, e.g. because the underlying transaction is a zero-rated (exempt with credit) intracommunity supply of goods.

2.3. No negative consequences where the taxable basis for VAT should be amended

Transfer Pricing Adjustments should not have adverse VAT impacts on businesses. Even if adjustments are required for VAT purposes these should not lead to the application of:

- penalties;
- late payment interest; and
- If the adjustment is within the scope of VAT, the statute of limitations should be the same for the payment of VAT and the right to refund/or deduct VAT due that arises from the adjustment (see also under 2.1. Principles).

ANNEX 1

Real-life examples of issues in business practices on Transfer Pricing Adjustments

Example 1:

- X is a multinational group operating worldwide in the confectionary market.
- Under the “Principal Operating Model” of the group:
  - Local plants (TMs) operate on a toll manufacturing basis, e.g. without acquiring the ownership of the input materials that belong to the “Principal”;
  - Local distributor (LRDs) purchases finished goods from one single counterpart, e.g. the Principal; being entrusted with typical limited risk distribution functions, the LRDs are only responsible for the promotion of the products within their local market.
- For direct tax purposes, the transfer price applied by the Principal to the LRDs (located in different Member States) for the finished goods is set by applying a transactional net margin method (TNMM) return on sales (ROS) basis, e.g. the “Principal Operating Model” ensures that the LRDs receive an “arm’s length” remuneration for the functions performed in the local market in accordance with OECD Guidelines.
- Considering that the LRDs have a limited functional profile, the latter recharge (through the issuing of separately invoices) to the Principal the costs of advertising and promotion exceeding a certain “threshold”.
- At the beginning of each fiscal year the price of the finished goods sold by the Principal to the LRDs, as well as their budget costs, are approved by the Principal.
- The parties agree that such a price does not change during the fiscal year.
- As LRDs are remunerated based on a TNMM method, the determination of LRDs budget costs is of great importance. Thus, by the end of each fiscal year it is verified if the actual remuneration of the LRDs (and the corresponding profit) is in line with the “arm’s length” TNMM (ROS) established for transfer pricing purposes.
- To target the “arm’s length” remuneration of the LRDs, by the end of each fiscal year it is also possible that a “compensating adjustment”, is to be paid by the Principal to the LRDs if their profit is lower than expected (also considering the mentioned recharge of extra-costs). Even if the “compensating adjustment” is reflected in the accounts of both parties of the transaction (in both Member States involved), it could not be seen as consideration given in exchange for the taxable supply of goods already made.

Proposed Assessment

- The recharge to the Principal of the costs for advertising and promotion exceeding the “threshold” is a taxable transaction for VAT purposes, e.g. a “Supply of Services” to be separately invoiced by the LRDs.
- On the contrary, the (additional, if any) “compensating adjustment” aimed to reach the agreed LRDs profit margin (ROS) is not a taxable transaction for VAT purposes, because:
  - it does not constitute consideration given in exchange for the previous supply of goods sold by the Principal to the LRDs (e.g. it is not an adjustment to the price already paid by the LRDs to the Principal);

  - there is no direct link with the supply of finished goods sold by the Principal to the LRDs.
- In such a scenario, the "compensating adjustment" is to be considered "Outside the scope of VAT".

Example 2:

- LRD adjustments – pricing adjustments between a non-EU principal and LRDs in Member States X, Y and Z.
- All Member States have the same perspective – treating them as a "pricing adjustment" – VAT relevant transaction.
- Practical issue – potential complication if there are more source countries or direct plant shipments. A possible handling is to have the TP Adjustments raised (debit/credit note) from each sourcing country, which would lead to a number of debit/credit notes of which the amount would be difficult to determine. Also, some adjustments may be insignificant.
- Some Member States also require the adjustments to be reported in the month that the initial supply has taken place. VAT returns of these periods needed to be adjusted retro-actively. Besides the administrative burden, there is a risk that a Member State starts claiming late payment interest and penalties.

- Regional Cost Sharing and other service sharing adjustment
- This service allocation model works on the base of actual cost and forecasted sales. So once forecasted sales deviate from the actual sales, a TP adjustment is required.
- Issue: Should such possible adjustment created at year-end be treated as TP adjustment or the normal service invoice/credit note?

Example 3:

- Export. Principal manufactures its products in 10 different EU countries. These goods are sold to 15 different affiliates outside EU (zero rated). The Principal needs to issue a TP adjustment for the year to each of its affiliates (amounts might vary greatly from one affiliate to another)
- In the current situation complexity, risk of error and extra work for all parties for no amount at stake
  - Principal needs to issue 15*10 = 150 credit notes
  - Each affiliate will potentially receive 10 credit notes from the same legal entity but from its different VAT numbers.
  - On these 150 credit notes, the Principal will need to show the list of all invoices for the TP adjustment (here an adjustment of the price of previous supplies) relate to i.e. all invoices by affiliates, by sourcing plant.
  - In some countries, the Principal will be required to refile all VAT returns for the periods of the initial supply i.e. the past 12 VAT returns.
- Considering the current lack of clarity and existing practice we would end up with 150 transactions to be managed by the various parties (within and outside of the EU) thus 300 bookings to be checked by the various tax authorities for no monetary impact, as we assume all parties have full right to deduct.

Example 4:

- TP adjustment between Principal and Distributor
- Principal is a non-EU established business. Principal ships from country A. Distributor is located in country B, a country with use and enjoyment rules on advertising services. TNMM is applied between the principal and the distributor. TP adjustment from the principal to the distributor via a credit note – intra community supply – Zero rated – reverse charge by distributor in B.
- The reason behind the adjustment is that the distributor, in agreement with its principal, spent more on media advertising than initially planned.
- Tax authorities took the view that the adjustment is not an adjustment of the price of previous supplies but in fact an extra service rendered by the distributor to the Principal and that VAT was due on that service.
- Issue: The principal might be unable to deduct the VAT.