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VAT EXPERT GROUP

VEG N° 071

Draft paper on topic for discussion
Possible VAT implications of Transfer Pricing

1. Introduction

The VEG welcomes Commission Paper VEG No. 65 and the opportunity to discuss the possible VAT implications of transfer pricing rules 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 it would, had the transactions under transfer pricing been performed by 3rd parties

Besides Transfer Pricing Adjustments between affiliated parties, the scope of Transfer Pricing Adjustment 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.

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, allocation of the taxing rights based on the destination principle.

Nevertheless, transfer pricing adjustments can also have VAT implications. Businesses across the EU have experienced in practice that Member States take 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 – adjustment is linked to a prior underlying taxable transaction for VAT purposes
3. Consideration for a separate service – separate taxable transaction for VAT purposes

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

The VAT neutrality principle should be recognized when defining the VAT treatment. Also, neither businesses nor tax administrations should suffer from negative consequences of the proposed treatment.

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), however, given that customs has its own specifics and complexities, we decided not to bring them into this assessment but instead we preferred to address and resolve the pure VAT complexities related to this topic.

2. The VAT Expert Group's Opinion

The Opinion of the VAT Expert Group is that Transfer Pricing Adjustments should be considered as "Outside scope of VAT" in case both parties have the full right to recover VAT.

Only if the simplification measure described in 2.2.1 is not applicable (as both parties do not have the full right to recover VAT) or the simplification measure is not applied by the Member States, we suggest to apply a process as described under 2.2.2.

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 the EU VAT Directive 2006/112/EU (“VAT Directive”). There are also no CJEU cases available which specifically deal with the VAT handling of Transfer Pricing Adjustments.

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

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 to the existence of a direct link, it is unclear whether transfer pricing adjustments would always meet this requirement.

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 ties.

Also, according to the CJEU¹, 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. 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.

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

¹ See CJEU Joined Cases C-621/10 and 129/11

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 arranges that “The chargeable event shall occur and VAT shall become chargeable when the goods are imported”. The chargeable event for Transfer Pricing Adjustments should be the moment when the decision is made to adjust the taxable amount for VAT purposes. At the same time, an adjusted document is issued. No adjustment needs to be made when the statutory limits expired.

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.

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 VAT². In line with the rules on chargeable event, VAT should be deductible at the moment when the decision is made to adjust the taxable amount for VAT purposes. The deduction of VAT should not be impacted by the expiry of statutory limits in case of Transfer Pricing Adjustments.

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. The Transfer Pricing Adjustment should be reported in the month the document adjusting the VAT liable/deductible is issued, there should be no retroactive adjustment and/or reporting in the period the initial transaction.

Link Direct and Indirect Taxation

Although the CJEU has never expressly dealt with this issue, it has in the past limited the potential correlation between a direct tax rule and the rules laid down in the VAT Directive, explicitly excluding the application of OECD convention related to Direct Tax within the EU.³

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

Based on the VAT Directive, it is not clear if Transfer Pricing Adjustments should be defined as Taxable Transactions. It can be argued that a Transfer Pricing Adjustments is an adjustment of a previous Taxable Transaction and therefore constitutes the same Taxable Transaction. One can also argue that the Transfer Pricing adjustment is generating a different Taxable Transaction or consider it even as outside scope of VAT.

The proposed VAT treatment aims to bring certainty, simplicity and clarity on Transfer Pricing Adjustments.

² See AG Opinion in CJEU Case C-8/17, point. 71 Conclusion and AG Opinion in CJEU Case C-533/16, point. 91 Conclusion

³ See CJEU C-210/04 Ministero dell’Economia e delle Finanze, Agenzia delle Entrate v FCE Bank plc, point 39 “It should be noted that the OECD Convention is irrelevant since it concerns direct taxation whereas VAT is an indirect tax.”

2.2.1. Transfer Pricing Adjustments Outside 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 (2.2.2.1.)
- Voluntary Prospective Compensating adjustments (2.2.2.2.)

2.2.1.1. Non-voluntary Transfer Pricing Adjustments

Generally, there is only a taxable transaction in case 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 “Outside scope of VAT”. It is our understanding that Primary, Secondary and Corresponding Adjustments⁴ do not qualify as “consideration”, and as such do not lead to a “Taxable Transaction”. These adjustments are therefore considered as being “Outside scope of VAT”. Besides a lack 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 1 - Reallocation of costs as a result of TP-audit

- Costs have been paid by Company A in MS 1
- As a result of an audit, costs are from income tax perspective rejected in the hands of Company A
- Taking into account functions/risks, these costs are to be paid by Company B in MS 2

VAT issues – rejection of right of deduction of VAT in the hands of Company A in MS1, re-invoicing to Company B (qualification/ right of deduction in MS2?/ Statute of limitation?)

2.2.1.2. Voluntary Prospective Compensating adjustments

Compensating adjustments are defined⁵ 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”. These adjustments should be made for consideration

In case of “prospective” compensating adjustments, the Transfer Pricing Adjustment is included in the price of future supplies either via a price decrease/increase. The VAT treatment 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.

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.

⁴ See VEG no. 65, Possible VAT implications of Transfer Pricing, page 6-10, definitions of Primary, Secondary and Corresponding Adjustments

⁵ See VEG no. 65, Possible VAT implications of Transfer Pricing, page 10

2.2.2.1. Direct link with the initial supply

In case 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

In case there is no direct link with the initial supply and the Transfer Pricing Adjustment has not been clarified contractually, the assumption is that the adjustment aims to reach an agreed profit margin, which is not a taxable transaction and as such outside scope of VAT .

In case the contract would refer 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 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 - 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 transaction is a "Supply of Services" - Debit- or credit note to be issued
Contract defines the adjustment as a profit split	Adjustment relates to a "profit adjustment" - This is not a Taxable Transaction - No debit- or credit note to be issued

2.2.3. Simplification measure

Given the complexity on the treatment of Transfer Pricing Adjustments for VAT purposes, we recommend to treat all types of Transfer Pricing Adjustments as Outside Scope of VAT for B2B transactions whereby all parties have full right to deduct VAT.

Transfer Pricing Adjustments are Direct tax driven. Direct tax and VAT are conceptually totally different taxes, as also highlighted by the Commission in VEG Paper No 65 – VAT is a transaction based tax with business as tax collector only, VAT is borne by the final consumer, so in principle neutral for business, and the taxing rights are allocated based on the destination principle.

The preferred handling of Transfer Pricing Adjustments is to define them as being “Outside 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, even though the profit calculation can be seen as a result of purchased goods in relation to sold goods and other kind of costs.

Consequently, Transfer Pricing Adjustments do not lead to a “new” Taxable Transaction or they do not adjust a transaction of the past. Transfer Pricing Adjustment should not be and, in most cases, can not be directly linked to a previous transaction. Even in case a direct link would be possible, Transfer Pricing

Adjustments are to be defined as “Outside scope of VAT”, in case both parties are Taxable Persons with the full right to deduct VAT.

This approach is applied by Austria. The Austrian tax authorities state that usually no correction is necessary for VAT if the omission does not have an impact on the Austrian tax revenue and the VIES system, e.g. because the underlying transaction is a zero rated intracommunity supply of goods.

In case the scope of the above recommended simplification measure is not followed by the Member States we suggest to apply the following process when it comes to handling TP adjustments for VAT purposes:

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

Transfer Pricing Adjustments should not have adverse impacts on businesses. Therefore this should - where adjustments will also be made for VAT as required - not lead to the application of:

- Penalties
- Late payment interests
- The statute of limitations should be the same both for the payment and the right to refund/deduction of the VAT due on the amended taxable base further to the Transfer Pricing Adjustment (see also under 2.1. Principles).

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