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Compared to the global focus on BEPS, indirect tax issues relating to transfer pricing have received little attention, but businesses are as vulnerable to the VAT and GST implications of cross-border transactions as to transfer pricing adjustments themselves. The following article considers this in more detail.

Transfer Price Adjustments—what you need to Consider from an Indirect Tax Perspective

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The International VAT/GST Guidelines of the OECD, published in 2014, qualify the overarching purpose of a value added tax (VAT) as a broad-based tax on consumption, primarily targeting final household consumption. Consequently, the burden of VAT should not rest on the businesses.

However, VAT and similar multi-stage taxes, known by other names such as GST, are levied not only on the supply to households upon final consumption, but also on business transactions throughout the supply chain, and are paid by the businesses involved. In general, a business can recover local VAT payable on its purchases, including VAT on intra-group transactions. However, there is a risk that treating business transactions incorrectly, including—among others—related party transactions, will lead to indirect tax shortfalls. Even if VAT can be charged further in the supply chain and recovered by the other party, the assessed penalties could still significantly affect the financial results of the group.

Although the current worldwide debate around BEPS focuses primarily on direct taxes and on the fair distribution of taxes amongst the jurisdictions involved, in practice, related-party transactions are challenged from an indirect tax perspective time and time again by various tax authorities. Besides the VAT qualification, for the cross-border transfer of goods the customs treatment is also frequently challenged.

In order to generate additional revenues, assessing an indirect tax shortfall might be the easier approach for many tax authorities in the present environment. Due to a lower level of harmonization and the fact that indirect tax issues rarely get resolved across borders, businesses are much more at the mercy of local tax authorities. So, even if incorrectly handled related-party transactions do not result in a loss of indirect tax revenue for the treasury, non-compliance with formal requirements can still be penalized heavily.

I. Key Indirect Tax Issues to be Clarified in Relation to Transfer Price Adjustments

As a precaution, tax managers and transfer pricing specialists alike should be aware of the indirect tax implications of transfer price (TP) adjustments. Take a common scenario in which a company has to make a TP correction for transactions performed with a related party in the previous year. All of the following aspects need to be analyzed:

- Is the retroactive TP adjustment subject to value added tax (VAT) or a similar multi-stage consumption tax in a given country?
- If yes, the adjustment may have to be invoiced and the way this is done can be critical for the indirect tax assessment.
- In which reporting period should the adjustment be taken into account?
- In case of cross-border trade of goods, the customs value may also be impacted. What are the possibilities of modifying customs declarations, and are there any related risks?

In some cases, the answers might be straightforward; but investigating those questions for a given jurisdiction might necessitate a thorough review, where international tax treaties cannot provide any guidance.

To give a real-life example: during a tax audit, a multinational client of ours was challenged for a VAT shortfall of several million U.S. dollars with regard to a TP adjustment made for only one business year, with a linearly proportionate risk for a further five years open for future tax audits. The reason was a dispute the client had had with the tax authority as to whether or not a downward TP adjustment should have been subject to VAT in this given country. Instead of charging VAT, which the company had done, the tax authority argued that the client must credit the invoices and rebill the customer without VAT. Even if the client's customer in turn could also correct its VAT liabilities, the interest and penalties related to this dispute could still have a significant impact on the client's P&L.

II. The Relevant Indirect Tax Principles

In the following, we would like to provide you with some food for thought about how TP adjustments can affect your indirect tax liabilities. Tax practitioners should be able to recognize that implementing the results of a TP analysis in practice could lead to differing indirect tax treatments depending on the applicable consumption tax (VAT/GST) and customs regimes. If the prices are modified retroactively, either upwards or downwards, the indirect tax implications of these changes should be taken into account.

From an indirect tax point of view, a TP adjustment may be treated in various ways. It may be treated (1) as part of the previous supply, modifying its value, (2) as consideration for a different supply (usually a type of service), (3) as an indemnity that is not subject to VAT, or even (4) as a payment without an underlying supply that should be fully disregarded. Even when the TP adjustment relates to previous supplies, there are still various questions that need to be answered to identify the correct tax treatment.

From an indirect tax perspective, in order to illustrate potential pitfalls at a very high level, three basic scenarios need to be analyzed, depending on where the underlying transaction to which the TP adjustments relate is deemed to have taken take place. For the supply of goods, the location will be determined based on the physical route of delivery, i.e. the question is whether or not the goods are sold and delivered to another country. In the case of services, however, the location of either of the contracting parties will most likely be relevant.

III. Scenario 1: Local Supplies Within the Same Jurisdiction

In order to determine where a transaction takes place from a VAT perspective, specific local rules should be taken into account. It should not be forgotten that even transactions between two related parties that are located in different countries might qualify as local transactions within one country for indirect tax purposes. For example, a US company supplying goods in a European country could be registered for VAT there, and the supplies to its related party subject to local VAT. Consequently, even if the TP adjustment takes place between companies from two countries, for VAT purposes, the local rules of the European country in which the supply takes place would apply.

Without a cross-border element in the transaction, you might think that risks and potential challenges would be limited. However, even if the transactions occur within one country, you should consider whether or not TP adjustments are taxable at all under the local consumption tax regime.

- In case of a retroactive TP correction, do any of the parties need to issue invoices, credit or debit notes and;
- what are the exact rules governing the contents of these documents?

In many countries, issuing/obtaining formally incorrect invoices could lead to a denial of VAT recovery. This risk, combined with ever-increasing consumption tax rates, could result in tax costs higher than the associated direct tax effect of the whole TP adjustment. We should also not forget that transactions within one country, but between different federal states, may be subject to different indirect tax rules.

For related-party transactions, there is a further risk if one of the parties is not entitled to a full recovery of input taxes according to the applicable indirect tax regime (e.g. in the case of financial institutions). In such cases, when the applied prices are not at arm's length, they will not only affect the corporate tax liabilities, but also the indirect tax liabilities of the parties involved. This may lead to a situation in which one of the parties would have to increase its total indirect tax liabilities—for example its output VAT—without the other party realizing a corresponding reduction of its tax liabilities by increasing the input VAT. This situation would increase the tax-related costs of the corporate group to which the related parties belong.

At this point, it should be mentioned that in indirect taxation, the principles determining the price to be applied between related parties may differ from those in a direct tax approach. Modification of the price and the taxable base for VAT might be required by law only if one of the parties is not fully entitled to VAT recovery.

IV. Scenario 2: Transactions Within one Customs Territory, but Between Differing VAT Regimes

If related-party transactions are made across national borders, the easier scenario is for the underlying transactions to still take place in a single market within one customs territory, such as within the EU. In this case, customs considerations are not relevant for TP issues concerning the trading of goods. Only the two countries' regulations relating to VAT (or other similar consumption taxes) are relevant.

Most likely, cross-border trading of goods will be taxed in the country of destination and be exempt from taxes in the country of supply. Services are usually taxed at the customer's location. Provided that the parties, being taxable businesses, can recover the payable indirect taxes, the questions which arise are rather of an administrative nature, such as:

- How should the TP adjustment for cross-border transactions in the respective countries be reported?
- Besides the relevant indirect tax aspects, tax professionals should not forget that TP adjustments may affect other reporting requirements. For example, regarding the trade of goods, other statistical reporting requirements, such as Intrastat reporting in the EU, may arise.

With regard to TP adjustments, it is worth mentioning the theoretical “challenge” that prices may only be modified within the EU VAT regime if the modifications can be directly linked to the original transactions. Most likely, this requirement would be fulfilled by most TP adjustments, because the modifications affect prices of the supply of goods and services in previous periods, such as in a preceding fiscal year or quarter—but the direct link to the original transaction could still be difficult to establish.

If transfer prices are modified based on functions or profitability and not on comparable third-party prices of specific products, they cannot be necessarily linked or allocated to specific transactions in the past. Even if we accept that a TP adjustment would be subject to VAT, as it is applied in most EU countries, the question remains as to what the correction invoice would look like:

- Is summary invoicing for such a modification viable at all in a given jurisdiction?
- If countries with differing interpretations are involved, how could we fulfil these contradictory requirements?

V. Scenario 3: Transactions Across Customs Borders

Customs duties are generally imposed on the importation of goods from other customs territories. However, we should also consider the customs implications for other types of intercompany transactions, since trademarks and royalties could affect the customs value of goods as well. In order to identify and act on such customs implications, the responsible departments within a multinational organisation must maintain the necessary internal connections and communication.

In contrast to the rather long-term approach of transfer pricing, customs focuses on individual transactions at a specific time. In principle, import duties and taxes are assessed at the very moment the goods cross customs borders. Even in cases, where customs clearances may be modified retroactively, this is a rather cumbersome administrative exercise in many jurisdictions and is usually not well received by the authorities.

Customs focuses on the transaction value, i.e., the price actually paid or payable for the goods (with certain adjustments). This encompasses everything (both monetary and non-monetary) that constitutes the consideration from the purchaser when the goods are sold for export to the country of importation. If this originally assessed value was not correct and the importing entity subsequently states that the TP assessment will influence this customs value, the customs authorities of some countries could even consider this change as fraud. By increasing the value (and related duties) retroactively, the importer of goods risks incurring high penalties or even criminal prosecution.

Furthermore, it is not simply a question of whether or not it is necessary to retroactively modify the import value; such a modification may not even be possible, particularly if a price adjustment results in a reduction of customs duties. Such cases may lead to an overpayment of duties, which would result in additional costs.

VI. Conclusion

We suggest that you identify and analyze these indirect tax-related risks thoroughly in connection with TP adjustments. Involving indirect tax specialists with a thorough understanding of local regulations early on might be a well-founded approach. In order to ensure that intra-group prices are not challenged by local authorities, preparing a defendable TP documentation is not enough; it is equally crucial to clarify the invoicing of the necessary price adjustments.

Especially with regard to possible customs implications, it is essential to build strong internal channels of communication with all other stakeholders within the organization, especially with those who sit outside of the tax function, such as in the logistics or supply chain departments.

For More Information

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