

Determining the Place of Taxation of Transactions under VAT/GST:² Can Transfer Pricing Principles Help?³

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In this article, the authors consider how Transfer Pricing principles for corporate income taxes as set out under Articles 7 and 9 of the OECD Model Tax Convention may potentially be of some use for VAT/GST regimes in determining the place of taxation in connection with cross-border transactions. It contains a discussion of the differing approaches taken for corporate income tax and VAT/GST purposes in relation to intra-entity dealings. It then describes how price adjustments or reallocations of income may be required under the arm's length principle, and the impact these may have on ensuring that the correct place of taxation for VAT purposes may be achieved.

Introduction

Whilst value added taxes apply to transactions as a means of taxing household consumption and corporate income taxes apply to business profits, both share a common aim of avoiding double taxation or double non-taxation. This article identifies a level of interaction between VAT and transfer pricing aspects of corporate income taxes. The kind of “*economic*” analysis used under transfer pricing principles could help determine the place of taxation of transactions for VAT purposes and thus avoid double taxation or double non-taxation.

The determination of transfer prices or a transfer pricing adjustment initiated by the taxpayer or a tax administration may – and usually will – entail some VAT consequences, at least when it occurs between associated enterprises (Article 9 of the OECD Model Tax Convention). The changes in the cash position of the parties should normally be reflected for VAT purposes when these can be connected to specific transactions.

When transfer pricing principles are applied – by analogy – under Article 7 of the OECD Model Tax Convention – to “*dealings*” between different parts of a single legal entity, the conclusion is not as clear for VAT purposes. Many OECD jurisdictions determine that inter-

branch transactions should be ignored for VAT purposes. However, others do recognize such transactions as supplies for VAT purposes.

Why should transactions between branches be treated differently from transactions between subsidiaries for VAT purposes? If “*dealings*” can be recognized between different parts of a single legal entity when applying by analogy transfer pricing principles, why not apply a similar approach for VAT purposes?

The OECD is currently developing VAT/GST Guidelines for determining the place of taxation of internationally traded services and intangibles. If inter-branch transactions are to be within the scope of VAT then all VAT incurred in relation to a service purchased would be taxed in the jurisdiction of the branch that uses these services for the purpose of making onward supplies. This would result in branches and subsidiaries being treated equally for VAT purposes. This article considers how this might be achieved and some of the effects it would have, particularly for single legal entities providing exempt supplies.

Allocation of Profits vs. Determination of “One” Place of Taxation

In a domestic transaction, VAT normally applies unless the supply is zero-rated or exempt. However, in a cross-border supply, there is a need to determine where the transaction occurs for VAT purposes in order to determine where to account for any VAT. Because VAT taxes transactions, each transaction has to be identified as occurring in one, and only one, jurisdiction. To do this, VAT legislation uses proxies, or indicators. In the VAT world, there is no sharing of taxing rights.

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1. The views expressed in this article are those of the authors and should not be taken as representing the position of the OECD or its Member Countries.
2. Some countries cite their form of value added tax as a “*Goods and Services Tax*” (GST). For ease of reading we refer to all value added taxes as “VAT”.
3. This article does not explore issues concerning valuation or timing although it does recognize that these are important points to be borne in mind.

By contrast, corporate income tax regimes tax business profits in each country, and therefore require the determination of the profits taxable in the hands of each associated enterprise⁴ and permanent establishment in each country where they operate. Article 9 of the OECD Model Tax Convention provides that the conditions of cross-border transactions between associated enterprises should be comparable to those that would be agreed between independent parties, i.e. that they should be at “*arm’s length*”⁵. The arm’s length principle also applies under Article 7 of the OECD Model Tax Convention, which governs the attribution of profits to a permanent establishment that an enterprise which is resident of a country may have in another country under Article 5 of the OECD Model Tax Convention. Many countries have implemented the arm’s length principle in their domestic legislation.

Legal vs. an Economic Approach

Because VAT applies to transactions as a means of taxing household consumption whilst corporate income taxes apply to business profits, they rely on different approaches or methodologies. VAT systems tend to take a more legal approach to determining location, and other issues, compared with the more economic analysis approach taken in corporate income taxes.

VAT is not normally a tax on the business itself (except, of course, in the exempt sectors such as financial services) but it is applied at each stage within the supply chain. Because of the different practical features of transactions involving various types of supplies, there is normally a need to characterize supplies as falling into a defined category, such as a supply as a supply of goods or a supply of services (some jurisdictions have other categories)⁶ before applying the corresponding VAT treatment.⁷

By contrast, transfer pricing looks at the economic reality of a transaction in order to achieve an allocation of business profits between the parties that reflect the economic activity undertaken by each of them. An enterprise that transfers physical goods and intangible property or provides services to an associated enterprise sets a transfer price – that is a price, based on the arm’s length principle, comparable to what would be agreed between independent parties. Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions. When the valuation of the controlled transactions – i.e. the transfer price – is not fully accurate, associated enterprises usually undertake a year-end adjustment. Depending on whether the adjustment is positive or negative, this retroactive adjustment of the transfer prices usually takes the form of a credit or debit note or of a fee provided by one of the associated enterprise or the other. Tax administrations may also carry out primary adjustments of this transfer price during an examination. A corresponding adjustment may be made by another tax authority in order to eliminate the

economic or juridical⁸ double taxation that would otherwise result from a transfer pricing adjustment.⁹

VAT Consequences of a Transfer Pricing Adjustment between Associated Enterprises

A transfer pricing adjustment between associated enterprises would normally entail VAT consequences.

An increase or a decrease of the transfer price of a supply would obviously result in an additional consideration or a credit that should reflect the VAT treatment applied to the original supply.

However, this may not be the case where the transfer pricing adjustment is based on the application of a transfer pricing method that is applied in a transactional manner, i.e. which does not involve the determination of a price transaction by transaction. In particular, transactional profit methods (the transactional net margin method and the profit split method) typically lead to the

4. According to Article 9 of the OECD Model Tax Convention, two enterprises are “*associated*” if one of the enterprises participates directly or indirectly in the management, control or capital of the other or if the same persons participate directly or indirectly in the management, control or capital of both enterprises, i.e. if both enterprises are under common control.

5. According to Article 9 of the OECD Model Tax Convention, where 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.

6. In the VAT world, many jurisdictions have a residual definition of services according to which “*services*” are everything that is not goods or property. For instance, in the European Union, Article 24 of the VAT Directive 2006/112/EC of 28 November 2006 provides that “*Supply of services*” shall mean any transaction which does not constitute a supply of goods”. Most jurisdictions include services, rights and intangible property in the same category. However, there are some exceptions, notably in jurisdictions that have adopted a VAT more recently.

Some jurisdictions have categories other than goods or services. Australia, for instance, uses three different categories: goods, real property and “*anything else*”. “*Anything else*” comprises anything that is not included in the first two categories and hence includes supplies of services, rights and intangible property. Canada distinguishes between services and property. Property encompasses all movable or immovable property, including intangibles and rights with the exception of money.

7. In some jurisdictions, categories of services or intangibles are subdivided in subcategories that identify a specific type of service under a legal definition. These subcategories generally follow their own place of taxation rules. Thus restaurant services are generally treated differently in most countries than – say – intellectual services. Other jurisdictions, for instance Australia, Canada, New Zealand or South Africa, are more concerned with the connection between the supply and the jurisdiction where it is performed. They have implemented sets of rules that do not focus on systematically identifying the place of consumption of services. They normally exempt with credit (i.e. zero-rate) all supplies of services deemed to be consumed outside their jurisdiction without necessarily identifying the place of taxation of these supplies.

8. Juridical double taxation occurs when the profits in the hands of a same legal entity are taxed in two or more countries (i.e. when there is a dispute between two countries on the allocation of profits to a permanent establishment). Economic double taxation occurs when a country taxes the same profits in the hands of two or more legal entities.

9. A primary adjustment is an adjustment that a tax administration in a first jurisdiction makes to a company’s taxable profits as a result of applying the arm’s length principle to transactions involving an associated enterprise in a second tax jurisdiction. This may entail a corresponding adjustment by the tax administration of a second tax jurisdiction, so that the allocation of profits by the two jurisdictions is consistent. A corresponding adjustment is an adjustment to the tax liability of the associated enterprise in a second tax jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first jurisdiction.

determination of the profits of the associated enterprises participating in a transaction or series of aggregated transactions, and not to the determination of a price for each transaction.¹⁰

However, in this situation (i.e. when a transfer pricing adjustment is made, for instance, at the end of the year and does not take the form of an adjustment of existing prices for a transaction but is characterized as for instance a marketing fee), this reallocation of costs may be within the scope of VAT when a clear link between the consideration received and a supply (for instance, a marketing fee) can be established.¹¹

The two diagrams in the annex illustrate VAT issues that may arise from a transfer pricing adjustment between associated enterprises.

VAT and the Recognition of “Dealings” between Parts of a Single Legal Entity

In the context of the allocation of profits to a permanent establishment, transactions or “dealings” (as they are called in corporate income tax terminology) between different parts of a single legal entity may be recognized in appropriate circumstances.

The Authorised OECD Approach is based on a two-step approach. In order to allocate profits to a permanent establishment, the permanent establishment is, in the first step, hypothesized as a “separate” entity under Article 7 of the Model Tax Convention). In the second step, transfer pricing principles are applied by analogy to these “dealings”.¹²

Transfer pricing principles are therefore less bound by legal limitations than VAT analyses. In the European Union, inter-branch transactions are not recognized as a supply for VAT purposes. Therefore, an allocation of costs within a single entity for corporate income tax purposes would not entail a VAT levy. From a VAT point of view, EU Member States generally agree that a single entity cannot contract with itself in order to make supplies.¹³

At a global level, however, there are differing views as countries, like Australia, Canada, New Zealand, South Africa and Switzerland, normally treat cross-border inter-branch transactions as supplies for VAT purposes because they feel there is no good reason to treat a branch differently from a subsidiary. Presumably, these countries would normally draw VAT consequences from an allocation of costs made for transfer pricing purposes within a single entity (this is already the case in Australia, New Zealand and Switzerland and this seems to be contemplated in Canada and South Africa). This may, however, be dependent on this allocation entailing a change in the cash position of the related parties that can be linked to the provision of a service.

The Question of the Need for a Much Broader Link

To summarize, corporate income tax regimes tax profits and therefore require the determination of the profits of each enterprise and of the parts of each enterprise where they are located in different jurisdictions. This may entail, among other things, the determination of an arm's length remuneration for cross-border transactions with associated enterprises and for cross-border “dealings” between different parts of a single entity.

In the VAT world, a business cannot generally contract with itself. The question arises whether, and if so under what conditions, should the recognition of “dealings” between different parts of a single legal entity entail a corresponding VAT adjustment in terms of input or output tax.

10. Traditional transaction methods (the comparable uncontrolled price method, the resale price method and the cost plus method) normally involve the determination of a price transaction per transaction. Transactional profit methods (the transactional net margin method and the transactional profit split method) examine the profits that arise from particular controlled transactions.

11. For a European Union perspective, see for instance the *Société thermale d'Eugénie-les-Bains* case where the European Court of Justice (ECJ) decided that: “a sum paid as a deposit, in the context of a contract relating to the supply of hotel services which is subject to value added tax, is to be regarded, where the client exercises the cancellation option available to him and that sum is retained by the hotelier, as a fixed cancellation charge paid as compensation for the loss suffered as a result of client default and which has no direct connection with the supply of any service for consideration and, as such, is not subject to that tax” (ECJ, *Société thermale d'Eugénie-les-Bains*, 18 July 2007, Case C-277/05).

12. “Transactions” or “dealings” between a branch that would qualify as a PE in one country and its head office in another country are not in the scope of Article 9 of the OECD Model. Article 9 has its scope expressly limited to transactions between associated enterprises, i.e. legally separate enterprises, such as a parent and a subsidiary or two companies under common control (see paragraph 1 of the OECD Commentary on Article 9).

Article 7 of the OECD Model deals with the attribution of profits to a PE, in particular in the context of the relationship between this PE and the rest of the enterprise to which it belongs. This is conducted on the basis of an economic analysis. The “Authorised OECD Approach” (AOA) under the new Commentary on Article 7 of the OECD Model (updated in July 2010) describes a two-step approach. Paragraphs 15 et seq. of the Commentary acknowledge that the profits to be attributed to a permanent establishment are those “that the permanent establishment might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions”. The PE is therefore first hypothesized as a functionally separate entity from the rest of the enterprise of which it is a part (paragraph 20 of the Commentary). This is done by attributing “functions”, “risks”, “assets” and “capital” to the PE and then by recognizing “dealings” between the PE and the rest of the enterprise (a threshold needs to be passed to ensure that the dealing at stake can be recognized). Thus, profits may be attributed to a PE when this PE is dealing with the rest of the enterprise of which it is part. This means that the branch may be attributed profits even if the entity as a whole is making a loss. The determination of the profits attributed to this PE will account for all transactions with other independent enterprises and associated enterprises that may be allocated to the PE, and also for “dealings” between the PE and other parts of the enterprise – i.e. internal “transactions” within the same legal entity (see para. 24 et seq. of the Commentary on Article 7 of the OECD Model). In the second step of the approach, the profits of the permanent establishment are determined by applying the arm's length principle and Transfer Pricing Guidelines by analogy, including the guidance on comparability analysis described in the latter, to recognized dealings between the permanent establishment and the rest of the enterprise.

13. According to the European Court of Justice, “a fixed establishment, which is not a legal entity distinct from the company of which it forms part, established in another Member State and to which the company supplies services, should not be treated as a taxable person by reason of the costs imputed to it in respect of those supplies” (*FCE Bank plc*, 23 March 2006, Case C-210/04).

The OECD has been leading the discussions on corporate income taxes, starting with the Model Tax Convention more than 50 years ago and, more recently, developing Transfer Pricing Guidelines for transactions between associated enterprises and guidance to attribute profits within the same enterprise.¹⁴ The OECD is now putting a stronger focus on VAT in its programme of work.

In February 2010 the OECD released the draft VAT/GST Guidelines on the determination of the place of taxation of services and intangibles for public consultation.¹⁵ These draft VAT/GST Guidelines focus on the place of taxation for cross-border supplies of services and intangibles but will be expanded later.¹⁶ The initial draft VAT/GST Guidelines, which apply to single location entities only, assert that the appropriate proxy for determining the place of taxation of supplies of services or intangibles is the location of the business customer. This is similar to the place of the recipient rule defined by the EU VAT Directive.

According to the draft VAT/GST Guidelines, the customer is identified by a business agreement, something that is in essence a non-legal concept. It consists of all the elements of the agreement (including, but not limited to, written contracts). Other elements can include invoices, accounting records and the actions of the parties to a supply. The business agreement identifies the parties to a supply and the rights and obligations with respect to that supply. If the customer has one location only then it follows that the location is identified once the customer's identity is determined. There are some similarities with transfer pricing documentation, which is normally supported by contractual arrangements.

Of course, because the draft VAT/GST Guidelines apply at this stage to single location entities only, this leaves open the issue of multiple location entities, i.e. entities that have branches located in different jurisdictions.

For multiple location entities, it can be more difficult to identify which of the establishments of the multiple location entity is the customer. This is an area where transfer pricing analytical frameworks could help because they would allow, at least to some extent, the identification of the jurisdiction in which the costs are borne.

In the European Union, Working Paper No. 634 of the VAT Committee dated 12 November 2009¹⁷ says that, according to a majority of member countries, the taxable person receiving a supply is normally responsible for determining where the services are supplied. It goes on to say that when services are supplied under a global contract and are to be used in several places, these services should be taxable at the place where the customer has established its business. It is unclear whether this position will be maintained in the future as presumably not all Member States may share this approach. However, in France, for instance, notice 3 A-1-10 dated 4 January 2010 confirms that the place of business (place of central administration, place where the management meets or place where the general policy of the business is determined) should be the primary factor where this business has several establishments to which services are rendered.

This does not acknowledge that, under corporate income taxes, each associated enterprise or permanent establishment should generally bear the costs in relation with the services provided to it, subject to such costs being arm's length. Thus, the arm's length principle typically requires that the head office recharges to its affiliates and permanent establishments their respective shares of the costs of a service purchased under a global contract. This may entail, among other things, the identification of the services rendered and of their actual beneficiary(ies) and the determination of an arm's length charge for the services or of an arm's length allocation of the costs incurred by the head office to the benefit of several entities so that such costs be borne effectively by the right associated enterprise or permanent establishment (rather than residing with one location only)

Would an Economic Analysis Help Identify the Place of Taxation for VAT Purposes?

Because transfer pricing analyses seek to identify the enterprise or permanent establishment which benefits from the services received, they may potentially help identify the right place of taxation for VAT purposes. If a branch is incurring costs for corporate income tax

14. The Council for European Economic Co-operation (OEEC) adopted its first Recommendation concerning double taxation on 25 February 1955. The OEEC was the forerunner of the OECD. It was formed in 1947 to administer American and Canadian aid under the Marshall Plan for the reconstruction of Europe after World War II. OECD took over from OEEC in 1961. The Fiscal Committee of the OECD submitted in 1963 a "Draft Convention on Income and Capital" and the Council of the OECD adopted on 30 July 1963 a Recommendation concerning the avoidance of double taxation and called upon the Governments of OECD member countries to conform to this draft convention. The Transfer Pricing Guidelines started with a report published in 1979 entitled "Transfer Pricing and Multinational Enterprises". Both the Model Tax Convention and Transfer Pricing Guidelines are reviewed periodically. The last updates to the Model Tax Convention and Transfer Pricing Guidelines were issued in July 2010.

15. At its meeting in January 2010, the Committee on Fiscal Affairs (CFA) approved publication for public consultation of the draft OECD VAT/GST Guidelines on the place of taxation of internationally traded services or intangibles (www.oecd.org/ctp/ct). These draft Guidelines propose that the place of taxation of internationally traded services and intangibles be the location of the customer. The draft VAT/GST Guidelines have been developed by Working Party 9 on Consumption Taxes of the OECD's Committee on Fiscal Affairs. Working Party 9 comprises senior VAT policy officials from OECD member countries. It is assisted by a Technical Advisory Group consisting of government, academics and business representatives. The draft VAT/GST Guidelines were released for the purposes of inviting comments from interested parties but do not necessarily reflect the final views of the OECD and its member countries. The draft VAT/GST Guidelines, when final, should be considered as "soft law". Although not having legal force, they include principles that should be followed by the OECD's members. The VAT/GST Guidelines should persuade governments to make changes in their legislation as necessary. They should be limited to invoice-credit VAT/GST systems and should not relate to other types of consumption taxes. It is hoped that the Guidelines will influence the development of VAT/GST legislation in non-OECD economies.

16. For supplies of goods it is generally agreed that they should be taxed at import where customs controls ensure collection and control. For supplies of services or intangibles where there are no such controls, the situation is more difficult.

17. The VAT Committee is set up by Article 398 of the VAT Directive 2006/112/EC of 28 November 2006. This is an advisory committee on VAT which consists of representatives of the EU Member States and of the European Commission. Working Paper No. 634 of the VAT Committee dated 12 November 2009 provides guidelines for the application of the VAT package modifying the provisions of the VAT Directive regarding the place of taxation of the customer rules (Council Directive 2008/8/EC of 12 February 2009 amending Directive 2006/112/EC as regards the place of supply of services).

purposes, why should these costs not entail a VAT consequence? In Canada, a country that recognizes cross-border inter-branch transactions as supplies, an anti-avoidance provision taxes to GST the costs incurred by a foreign branch in support of a business carried out through a branch or head office of the same legal entity in Canada. This applies when (1) this Canadian branch or head office is a financial institution that is carrying out an exempt activity and (2) these costs relate to the Canadian activity and are deducted by the latter for Canadian income tax purposes.

From a policy perspective, it is questionable whether imports of goods and cross-border supplies of services should be treated differently for VAT purposes than for corporate income tax purposes. If these costs are in relation to a transaction supplied by the head office, why should the lack of legal personality of the branch prevent the branch from accounting for VAT on this transaction as it would for VAT on any import of goods? Not doing so breaks the chain of input/output VAT when a branch is providing a supply (and accounting for input VAT) to another branch of the same company providing onward supplies (subject to output VAT). This would contradict a fundamental principle of VAT according to which, in order to deduct input tax, the goods and services purchased must have some links with subsequent taxable outputs.

In theory, this approach (recognizing inter-branch transactions as supplies), supported by a stronger link between corporate income tax principles and VAT, would seem to be a relatively straightforward way of ensuring that the tax ends up in the right place and is easy for tax administrations and business to understand.

However, this approach might be a bit more difficult to implement in practice. VAT and corporate income tax operate in two different ways or methodologies (“legal” vs. “economic” approach) to meet different ends (allocation of profits vs. determination of a place of taxation). The immediacy required in determining the application of VAT to a supply means the taxing decisions have to be made when the supply is made. Under VAT, services are normally chargeable when paid for or performed,¹⁸ whereas information on transfer pricing is not available to revenue authorities until year-end upon filing of a tax return or even later following audit.

Applying the sort of economic analysis required for the determination of profits for VAT purposes every time a supply is made may impose a significant compliance burden on business. This is, however, not unknown in VAT where, a business making both taxable and exempt supplies is required to make an annual adjustment of its VAT recovery ratio. Furthermore, some countries have harmonized the computation of VAT with transfer pricing rules by requiring that both be computed at the end of the year.¹⁹

Furthermore, there are also questions over the valuation of the supply. VAT is normally based on a subjective value whereas the arm’s length principle seeks to identify

an objective value. However, here also, some jurisdictions have implemented specific anti-avoidance provisions for VAT purposes to identify an open market value that should reflect the amount that would have been paid under conditions of fair competition.²⁰

Role of Contracts

An area where greater consistency between transfer pricing and VAT might be easier to achieve is the administrative side. VAT avoidance or fraud is an increasing concern for most jurisdictions. A study published recently by the European Commission has shown that substantial amounts of VAT revenues are lost in the European Union as a result of VAT non-compliance, legal avoidance and fraud (this amounts to more than 100 billions of Euros according to a report produced by Reckon LLP in September 2009, “*Study to quantify and analyse the VAT gap in the EU-25 Member States*”).²¹ There is a need

18. For instance, in the European Union, according to Article 63 et seq. of the VAT Directive 2006/112/EC of 28 November 2006, VAT becomes chargeable when goods are delivered or the services are paid for or performed, i.e. in practice normally at the time the supply is actually made.

19. Canada is one of those countries.

20. In most countries, VAT is calculated on a subjective value. The European Court of Justice (ECJ) held that “the consideration must be capable of being expressed in monetary terms and, secondly, that it is a subjective value, since the basis of assessment is the consideration actually received and not a value estimated according to objective criteria” (ECJ, 23 November 1988, Case C-230/87, *Naturally Yours Cosmetics Limited v. Commissioners of Customs and Excise* [1988] ECR 6365, §16). This was confirmed by the same Court in the *Empire Stores* case where it held that “the consideration taken as the taxable amount in respect of a supply of goods is a subjective value, since the taxable amount is the consideration actually received and not a value estimated according to objective criteria” (ECJ, 2 June 1994, Case C-33/93, *Empire Stores v. Commissioners of Customs and Excise* [1994] ECR I – 2329, §18) and in the *Scandic* case where the Court provided that the taxable amount for the supply of goods or services for consideration is the consideration actually received for them by the taxable person “even where that consideration is less than the cost price of the goods or services supplied” (ECJ, 20 January 2005, Case C-412/03, *Hotel Scandic Gasaback AB v. Riksskatteverket* [2005] ECR I – 743, §31). Some jurisdictions do require an objective value when specific circumstances are met, generally to discourage artificial constructions to be set up for the sole purpose of obtaining a VAT advantage. This was implemented in Canada (imports of services must be self-assessed to Canadian GST on the fair market value of the supplies when they are used to make exempt supplies) but also in the European Union where Article 80 of the VAT Directive 2006/112/EC of 28 November 2006 enables Member States to revalue certain supplies to an open market value in order to prevent tax evasion or avoidance where the supplier or the recipient does not have a full right of deduction. According to this article, Member States may, 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, the taxable amount is to be the open market value. According to Article 72 of the VAT Directive 2006/112/EC of 28 November 2006, “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”.

21. “Fight against tax fraud: Commission publishes a study on the VAT gap in the EU”, IP/09/1655, 30 October 2009 (<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1655>); “Study to quantify and analyse the VAT gap in the EU-25 Member States”, 21 September 2009, report produced by Reckon LLP following a study commissioned by the European Commission (http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_cooperation/combating_tax_fraud/reckon_report_sep2009.pdf). The Reckon report provides estimates of the VAT gap, which is the difference between the theoretical net VAT liability for the economy as a whole and the actual accrued VAT receipts. The VAT gap is not due to VAT fraud only but may include VAT not paid as a result of legitimate tax planning, avoidance, errors and unpaid VAT liabilities due to insolvencies.

therefore to improve overall compliance while not increasing the compliance burden on business.

Documentation plays a significant role in transfer pricing in order to determine consistency with the arm's length principle of a cross-border transaction between associated enterprises or dealing within a single entity.

For transfer pricing purposes between associated enterprises (Article 9 of the Model Tax Convention), contractual terms (e.g. written contracts, but also correspondence and other communications between the seller and the purchaser) are the starting point of the analysis. They are generally respected to the extent that they conform to the actual behaviour of the parties, have economic substance and are arm's length. Furthermore, the transaction as it has been structured by the taxpayer is generally recognized, and only in exceptional cases disregarded.²² If contracts between associated enterprises were systematically disregarded, there would be too much uncertainty for business as well as for governments. There would also be risks of double taxation and it would not be workable in practice.

By contrast, when determining the profits attributable to a permanent establishment (Article 7 of the Model Tax Convention), there are no legal contracts between the permanent establishment and other parts of the same legal entity. Some other notions have therefore been developed in order to hypothesize the permanent establishment as a distinct enterprise. These are the notions of "economic ownership", of "significant people functions relevant to the ownership of assets", of "significant people functions relevant to the assumption of risks", and of "dealings".

For VAT purposes, there is a need, in most jurisdictions²³, to characterize a supply before applying the right VAT treatment. In many jurisdictions, specific types of services identified under a legal definition follow their own place of taxation rules. Therefore, contracts play a significant role for VAT purposes as they help to characterize the nature of a supply and thus the corresponding tax treatment.

There is however no such documentation in VAT as in transfer pricing. There is no rule that provides that the transaction structured by the taxpayer should be recognized and only disregarded under exceptional circumstances. This lack of clarity may create uncertainty for business as well as for governments.

A Right Balance To Be Found

Should documentation play a similar role for VAT purposes, this would mean that the concept of the business agreement as developed in the draft OECD VAT/GST Guidelines would play a much bigger role than in the current draft. The place of taxation would be the place of the customer as "supported" by the "business agreement". For multiple location entities, the "business agreement" would help identify the location of the customer and support recognition of inter-branch transactions as supplies for VAT purpose when, for instance, a head office recharges part of the telecommunication services it pur-

chased under a global contract to one of its branch beneficiaries from these services.

Of course, there would be a risk that this would allow manipulation of contracts under which supplies could be channelled through low (or no-) tax jurisdictions or – in the case of a group – through entities with a better VAT recovery ratio. In these circumstances businesses that make exempt supplies would, therefore, be relieved to a significant extent, from the burden of the tax and governments would lose tax revenue. This may also create distortion of competition. Many countries have implemented anti-abuse rules for corporate income tax purposes. These rules refer normally to the economic substance of the transaction. They generally apply to both international and domestic issues. In the VAT world, however, the notion of abuse of rights is – at least in the European Union – relatively new. The European Court of Justice held in 2006 that a tax arrangement set up with the essential aim of avoiding tax will not be effective for VAT purposes.²⁴

It is, of course, legitimate and essential that governments defend themselves from VAT channelling but, in doing so, there has to be a balance between legitimate defensive measures and clarity and certainty for businesses required to collect VAT for their governments. The challenge for Working Party 9 on Consumption Taxes of the

22. Under the OECD Transfer Pricing Guidelines, there are two exceptional circumstances in which it may be both appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance arises where the economic substance of a transaction differs from its form. In such a case the tax administration may disregard the parties' characterization of the transaction and re-characterize it in accordance with its substance. The second circumstance arises where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

23. See footnotes 7 and 8 for more information.

24. The European Court of Justice (ECJ) held in the *Halifax* case that a taxable person must be precluded any right to deduct input VAT "where the transactions from which that right derives constitutes an abusive practice". An abusive practice is found, first, where "the transactions concerned [...] result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those [VAT] provisions" and, secondly "it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage" (ECJ, 21 February 2006, Case C-255/02, *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v. Commissioners of Customs and Excise*, § 85 to 86). This was confirmed by the same Court in the *Part Service* case where it held that "there can be a finding of an abusive practice when the accrual of a tax advantage constitutes the principal aim of the transaction or transactions at issue" (ECJ, 21 February 2008, Case C-452/06, *Ministero dell'Economia e delle Finanze v. Part Service Srl*, § 45).

In a later case, the ECJ seemed to move slightly to a stricter definition of the principle of abuse of rights. In the *Amplificientifica Srl* Case, the Court does not require that the essential aim of the transaction is to obtain a tax advantage but that the sole aim of the transaction is to obtain a tax advantage. The Court held that "the principle prohibiting the abuse of rights is intended to ensure, particularly in the field of VAT, that Community legislation is not extended to cover abusive practices by economic operators, that is to say transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided by Community law" and that "The effect of that principle is therefore to prohibit wholly artificial arrangements which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage" (ECJ, 22 May 2008, Case C-162/07, *Amplificientifica Srl, Amplifin SpA v. Ministero dell'Economia e delle Finanze, Agenzia delle Entrate*, § 27 to 28).

OECD's Committee on Fiscal Affairs will be to find the most efficient and internationally consistent way of achieving that balance.

Examples of VAT Issues that May Arise from a Transfer Pricing Adjustment

In the following examples, a parent company A located in the USA has entered into a global framework agreement with a telecommunication company also based in the USA. A is bearing all the telecommunication costs for the group, including the cost corresponding to the consumption of its subsidiary, company B, located in the UK. B is in charge of selling consultancy services to customers.

From a transfer pricing point of view, there might be a range of different methods for organizing the invoicing between A, B and the customers and attributing to Affil-

iate B its arm's length share in the telecommunication costs. One possibility, described under "Method 1" below, would be to allocate these costs directly to B. Another possibility, described under "Method 2" below, would be to consider that company B is acting as an intermediary receiving a commission as a consideration for intermediary services supplied to its parent company A.

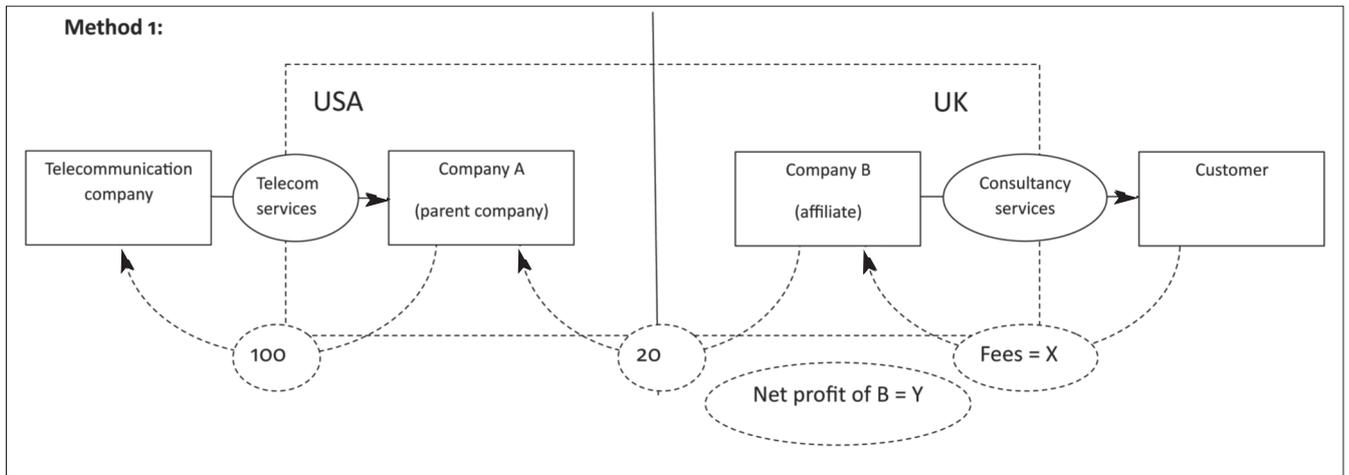
From a transfer pricing perspective, the choice among the various possibilities will depend on the facts and circumstances of the case and in particular on an examination of the functions performed by A and B, taking account of the assets used and risks assumed.

This raises the question of what the VAT implications are depending on the invoicing method chosen.

Valuation issues are not discussed here.

Diagram legend for the following examples:

Supply of services: —————>
 Flow of payment: - - - - ->

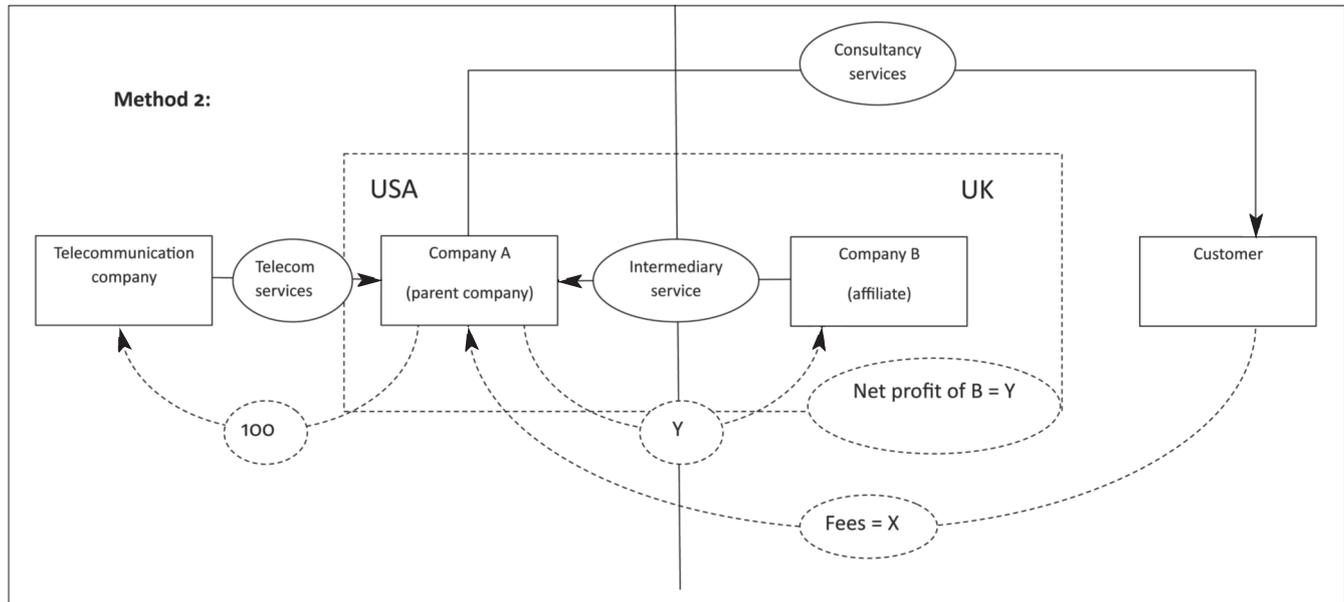


In this example, Company A bears all the telecommunication costs of the group. Of these costs, 20 are related to the telecommunication costs used specifically by Company B for its own activity. From a transfer pricing point of view, Company A should allocate 20 (with or without a mark up) to Company B.

From a VAT point of view, any consideration received is normally subject to VAT when there is a direct link between a service provided and the consideration received. This link is established if the service is rendered to a identifiable beneficiary and if there is a relationship between the level of benefits provided and the amount charged. In this example, the reallocation of a cost of 20 from A to B for transfer pricing purposes is in relation to the telecommunication services B is benefiting from A for the same value. Therefore, the 20 paid by B to A should be within the scope of VAT.

If later on, there is a transfer pricing adjustment (so that e.g. 25 instead of 20 are allocated by Company A to Company B) that entails a change in the cash position of

the associated enterprises A and B, this may also entail VAT consequences. Assuming that the supply has been treated as a supply within the scope of VAT according to the analysis in the previous paragraph, any price adjustment made to this existing supply should normally copy the same VAT treatment. This means that the additional consideration (e.g. 5) should be within the scope of VAT. Should the transfer pricing adjustment lead to a decrease of the original amount, e.g. 15 instead of 20, rectifying invoices would normally have to be issued from A to B so that the taxable VAT base is reduced by the corresponding amount of 5. For exempt businesses that cannot recover the amount of VAT reverse-charged, this may grant them with a VAT credit on the amount of the reduced taxable base. Where no reverse-charge is available the supplier has to register and account for the tax in the country of the customer. Any VAT adjustment may entail an additional credit for the supplier and a corresponding amount of VAT to reverse back to the tax administration for the customer.



Here, Company B is considered acting as an intermediary in charge of finding clients for company A. Company A itself is providing the consultancy services to these clients. Company B is remunerated by a commission.

From a transfer pricing point of view, the same profit is allocated to Company B under Method 1 and Method 2. Both methods may be acceptable depending on the facts and circumstances of the case.

From a VAT point of view, there is no doubt that the commission charged by the intermediary B to company A should be within the scope of VAT.

In this example, it is assumed that from a transfer pricing perspective this commission already takes account of the cost of 20 in relation with the telecommunication costs supported by A for the purpose of the activity of B.

From a VAT point of view, these costs can be related to the provision of a telecommunication service so that there would be an argument for saying that a direct link

exists between the telecommunication service and the cost incurred. Thus, there would be a reason for considering that A provided a service to B for a value of 20 and that this service should be within the scope of VAT.

The VAT analysis does not presume that a set-off happened between the intermediary service provided from B to A and the telecommunication service provided from A to B. Although any input VAT on the supply from A to B should be normally recoverable, there is a need to consider each supply separately from a VAT point of view as a set-off would not be neutral when the parties to a transaction do not have full VAT recovery rights.

Because VAT does not recognize this kind of set-off, the VAT adjustment on the “deemed” supply of telecommunication services from A to B for a value of 20 would entail a corresponding increase for transfer pricing purposes of the amount of the commission charged by B to A for the same amount of 20 (i.e. that would amount to $Y + 20$).