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Possible VAT implications due to voluntary and involuntary transfer pricing adjustments in the EU

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Summary

Value added tax and Transfer Pricing are two of the major areas of international tax law, as the former one uses a subjective price for the calculation of taxation and the latter one uses an objective price the two regimes seemingly lack interaction. There is however a possibility that an adjustment of the price used for Transfer Pricing purposes might have an effect on the VAT due.

VAT is a harmonized indirect tax applicable within the European Union, it is regressive in its nature and strives to achieve neutrality between both the Member State and the type of business one chooses to pursue your goals through. The tax is meant to be borne by the end consumer or business entities that for the purpose of VAT is categorized as end consumers. There is extensive compliance issues to regard when conducting cross-border business. If not enough diligence is paid there might be severe consequences through audits by the authorities or you might end up over paying VAT.

Transfer pricing is a valuable tool both for the MNEs and the tax authorities, it helps to distribute profits and mitigate losses whilst increasing tax transparency. Stemming from the model tax treaty of the OECD and now also incorporated in the UN model tax treaty the set of rules governing transfer pricing is close to being regarded as a general concept of international tax law. The mechanics of transfer pricing appear to be relatively straight forward but can quickly become more than a little complicated due to the complexity of certain transactions. Transactions that are deemed to deviate from the arm's length principle stipulated in both the UN and OECD treaties will be readjusted in order to reflect earnings. The prices used will be readjusted for taxation purposes, hence economic fiction will be stipulated by the authorities. This aims to simulate a relationship similar to those between non-related companies.

A transfer pricing adjustment instigated by the concerned multi national enterprise would most probably be subject to a corresponding retroactive change in the VAT due. In my opinion, this is strictly to be regarded as a part of the consideration given. If on the other hand, the adjustment is made by the authorities with the intention of distributing profits in order to reflect the true income in the respective countries, an adjustment of VAT should not be done.

Sammanfattning

Mervärdesskatt och Transfer Pricing är två av de stora områdena inom internationell skatterätt, då det förra är en indirekt skatt och baseras på det subjektiva priset och det senare området tillhör direkt beskattning och använder ett objektivt, fiktivt pris för beräkning kan de vid första anblick sakna anknytning. Det finns dock en risk att justeringar av det pris som använts för Transfer Pricing-ändamål kan påverka den mervärdeskatt som ska erläggas.

Mervärdesskatt är inom EU en harmoniserad indirekt skatt, den är regressiv och syftar till att åstadkomma neutralitet både mellan medlemsländerna samt vilken typ av bolagsform som används i rörelsen. Denna skatt är tänkt att bäras av slutkonsumenter eller de som i enlighet med momsdirektivet är att se som slutkonsumenter. Vid gränsöverskridande handel inom EU finns det komplicerade compliance-aspekter att ta hänsyn till. Om inte tillräcklig noggrannhet iakktas kan stora konsekvenser följa, antingen genom granskningar av myndigheterna alternativt att vissa momsinbetalningar kan bli svåra att få tillbaka.

Transfer pricing är ett viktigt verktyg både för multinationella företag och för skattemyndigheter, det underlättar distributionen av vinst mellan länder och kan mildra förluster samtidigt som det ökar den skattemässiga transparensen. Tekniken härleds ur OECD:s modellavtal för beskattning och finns numera även i FN:s modellavtal rörande beskattning, reglerna är idag enligt vissa att se som allmängiltiga inom internationell beskattning. Funktionen och reglerna kring Transfer Pricing kan vid första blick se okomplicerade ut men vid närmare granskning och ju mer komplicerad den underliggande transaktionen kan det snabbt bli svåröverskådligt. Transaktioner som sker i intressegemenskap och där priset anses avvika från armlängdsprincipen som styr Transfer Pricing kan komma att omvärderas av Skattemyndigheterna för att på ett bättre sätt skildra i vilka länder inkomsten har uppkommit. Detta nya pris som används bestäms av Skattemyndigheterna och är således en fiktiv prissättning som syftar till att härma verkligheten, att utsätta transaktionen för den fria marknaden.

En justering av det pris som använts för Transfer Pricing-ändamål som sker helt på det multinationella företagets eget bevåg bör medföra en motsvarande retroaktiv ändring av den mervärdesskatt som ska erläggas. I min mening bör en sådan justering inte ses som något annat än en del av den betalning som ges för transaktionen som helhet. Om å andra sidan en justering genomförs genom ett myndighetsförfarande som syftar till att distribuera vinsterna hos gruppen så att de speglar vart de uppkommit, bör inte någon justering av mervärdesskatten ske.

Abbreviations

AC	Arbitration Convention
ALP	Arm's length principle
B2B	Business to Business
B2C	Business to Customer
ECJ	Court of Justice of the European Union
EEA	European Economic Area
EU	European Union
MNE	Multi-National Enterprise
OECD	Organization for Economic Co-operation and Development
OMV	Open Market value
TP	Transfer Pricing
VAT	Value added tax

1 Introduction

Multi-national enterprises and their internal transactions today make up for a significant portion of all the international trade in goods and services and hence the importance of these transactions cannot be overstated. Given that a company could potentially choose in what country to accumulate their earnings the role of transfer pricing in regards to direct taxation is vital. Presumably, no country has any wish to neither lose all the tax revenue accumulated within their borders nor push the company out of the country with a much too rigid taxation. Hence, the effort to create an internationally applicable model which satisfies all the States in regards to the ration of tax revenue they are entitled to and at the same time does not limit nor deter the international trade is ongoing.

Transfer pricing and the Model Tax Convention of the OECD is something complicated for all involved parties, the tax authorities, custom authorities and the involved companies may all very well have a different view upon how certain transactions should be regarded.[1] While direct taxation of legal persons is, to a high extent, still a matter of national competence even within free trade areas such as the European Union, some indirect taxes are harmonized. Within the EU, indirect taxes, such as VAT, excises and customs duties are harmonized, and while national variations occur, the major part of the law is the same in all Member States.

These two areas of tax law, VAT and transfer pricing, are very technical, difficult to gain an overview over, extremely costly and at the same time they are too a large extent harmonized within the EU.[2] This is why a possibility of convergence between the two tax regimes deserves a closer investigation.

1.1 Purpose and aim of the thesis

This thesis will focus on the relationship of VAT in the EU/EEA area and deviations from transfer pricing regimes as formulated by OECD. The following questions will be investigated:

Is the VAT due affected when an MNE[3] deviates from the transfer pricing regime and suffers a transfer pricing adjustment through the tax authorities?

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[1] Organisation on Economic and Commercial Development have produced a number of model conventions, the referred to here is the Model Tax Convention on Income and on Capital, last updated in 2010.

[2] As concerns transfer pricing, the source is only harmonized if the Member States of the EU have chosen to contract tax treaties based on the OECD or UN model tax treaties.

[3] Multi National Enterprise.

Is the VAT due affected when the MNE itself seeks to address deviations by making adjustments without involving the authorities?

1.2 Method and material

The following thesis will employ the traditional legal dogmatic method, conducted mainly with the help of analysing primary sources of law such as the EU directives and the OECD model convention. Case law, doctrinal debates and methods of interpretation such as the official commentaries provided for have been employed in order to clarify or try to pin point a certain issue. Case law is limited concerning the joint problematic area. By contrast, it is abundant within the VAT area and concerning TP[4] sufficient. Cases where the two areas of law are activated at the same time are non-existent to this date. One should also remember that whilst cases concerning VAT lies within the jurisdiction of the EU the same is not true concerning TP which will be dealt with in national courts. To make up for this lack of cases I provide for a fictional, simplified case activating both types of adjustments later covered.

1.3 Delimitation

Due to the vastness of these two areas, the thesis will not provide for any extensive discourses concerning either of them, focus will lie within the joint area but some fundamentals regarding the two different systems will be present. The thesis will also remain confined within the borders of the EU, the reader is of this thesis is expected to have a working knowledge of both VAT and TP as well as the functions of the EU and also some knowledge regarding public and private international law.

1.4 Disposition

There are four parts of this thesis. The first part introduces the characteristics of VAT within the EU and describes its function. Basic principles such as who is liable to pay VAT and for what are covered in this here but also more intricate details such as the interpretation of certain provisions.

Part two covers transfer pricing, its function and the problems related to its application. As this particular area of law is vast and the theories regarding how to apply the law optimally differ not only from country to country but also between subjects, this portion serves only as a basic introduction.

[4] Transfer Pricing.

The third part links the two areas together and is meant to serve as the more theoretical and investigative part of the thesis in comparison to the two previous descriptive parts.

The fourth and last part contains the conclusions of this thesis, an example to highlight the problem and doctrinal statements on the question.

2 VAT

2.1 What is VAT?

VAT or value added tax is a general, regressive tax on consumption meant to be borne by the end consumers. As opposed to income tax or other direct forms of taxation, VAT is only levied when you choose to spend your money and due to this, you can yourself decide how much VAT you would like to pay, at least for so long. Due to the fact that similar goods are taxed with a similar rate the tax as such becomes regressive, in other words, the relative burden of the tax is simply smaller for a high-income purchaser than a low-income one. VAT is employed as a percentage added to the price, this rate deviates not only between Member States but also among internal products. Categories of commodities and services often considered either essential or worthy of extra protection such as groceries, culture in various forms and public transport are commonly taxed with a lower rate with the intention of keeping the prices down. There are three rates prescribed in the VAT directive[5] for the levy of the tax, the standard one at no less than 15% and two reduced rates no less than 5%.[6] The latter rates are optional for the Member States but if they choose to employ them, their application is firmly set out in the directive. There is arguably another rate, not classified as such by the directive but economically if would classify as such, namely the 0% for exempt goods and services.

2.2 History of VAT

The application of modern VAT and the system used to employ it originated in France and was introduced more than 50 years ago.[7] However, the roots of this tax go back more than a century and VAT is said to have been engineered in today's Germany. The introduction of the "original" VAT in Germany was due to a necessity to raise funds for the on-going war efforts. The first attempts of introducing a harmonized turn-over tax within the area today known as the EU started in 1957 and resulted in a proposal for the first VAT directive in 1962.[8]

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[5] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax. Recast through multiple directives and will be referred to as the RVD – Recast VAT directive.
[6] Article 96 and 99 RVD.
[7] Ben Terra, Julie Kajus, Commentary – A Guide to The Recast VAT Directive – Chapter 1 – Subject Matter and Scope, 1.2.1, 2013.
[8] Ben Terra, Julie Kajus, Commentary – A Guide to The Recast VAT Directive – Chapter 1 – Subject Matter and Scope, 1.2.1, 2013.

2.3 General function and application of VAT

When companies that are not related to each other, neither by theoretical nor factual control buy goods from each other they are liable to pay VAT. This VAT will in most cases be refunded later from the tax authorities, if the business/transaction is one that is considered taxable.[9] Financial services, insurance services and certain other transactions that have been deemed too complicated to tax with the help of VAT are considered exempt.[10] This means that the exempt company acts like the end consumer and lacks any right to deduct the VAT, much like when a natural person buys a good or service for private consumption. By this, the good or service bought can be considered "contaminated" since there is no right to deduct that specific VAT for the company who buys this good/service in the next stage. This is a natural consequence due to being regarded as non-taxable and thusly they are outside the scope of VAT.

The nature of VAT, a value added tax, and its regressive character makes the pricing of the traded good crucial and a fundamental part in calculating how much VAT one should pay/deduct.[11] It also ensures neutrality in regards to what the of business one chooses to pursue. Following this, everything that is not exempt is taxed. This approach, with an aim to achieve neutrality would of course be more easily understood if everything was taxed at the same rate with an all-encompassing right to deduction for taxable persons. All of the exceptions for non-taxable transactions and the different rates applicable to certain commodities/services complicates the area and might due to compliance issues discourage certain types of businesses.

2.4 Who is a taxable person?

The European approach is found in article 9(1) of the Recast VAT directive, stating that a "taxable person" is a person, legal or natural, who independently carries out economic activity in any place, irrespective of the purpose or any profit of that activity. By result of this legislation, the street vendor in Bangkok as well as the provider of security services in the Middle East are subject to the European VAT directive. Naturally, these transactions are not within the scope of any of the Member States right to tax. Not only legal entities and natural persons serve as taxable persons but also cooperation's and partnerships that lack a specific legal persona are taxable. Their classification in respect to direct taxation is not interesting but instead the fact that they are acting as one single unit is the relevant factor for VAT purposes. This latter part is highly relevant when it comes to large

[9] Article 2 RVD.
[10] Article 135 RVD.
[11] Article 1.2 RVD.

or complicated constructions, often within the area of public transport, such as the Öresund Bridge. Symptomatic for these types of ventures are that no one party would be willing to assume all the financial responsibility, and that procurement rules often place requirements on the financial stability of the winning bid. Thusly large companies whilst maintaining their individual legal persona can create partnerships. Placing these types of ventures outside of the scope of VAT would severely hamper their competitiveness, and place further strains on the concept of VAT being an all-encompassing tax.

Taxable persons who register for VAT purposes receive a VAT identification number.[12] This number is used when conducting business in order to simplify the procedure and to limit risks of compliance deviations. These unique numbers can be validated using the VIES system, which also serves as a database providing information for the tax authorities of the Member States.[13]

2.5 Those that are exempt are taxed and those that are taxed are exempt

Being exempt from taxation is something that probably a lot of both individuals and company owners fantasise about, and while it might drastically increase your revenue in what concerns direct taxation but the same is not true when in regards to VAT. The consequence of being exempt when it comes to VAT is traditionally not viewed as an advantage in comparison to other business operators. The fact that you cannot deduct the VAT due means that you act as an end consumer and need to raise the prices considerably to recover the tax, due to this you lose some of your competitiveness. If an exempt company sells something to a non-exempt company the VAT paid by company number two cannot be deducted, so in order to recover its losses it must raise the prices. This quickly escalates the prices down to the consumer.

The aim of the VAT directive is to have as harmonized rules and rates as possible, not only between the Member States but also between different types of businesses.[14] A uniform approach of VAT would minimize the cost of both business operators in their compliance work but also for the tax collectors of the different Member States.[15] Furthermore, if everyone is taxed at the same rate and by the same rules, fair competition can be assured. Naturally there are exceptions, and there are certain more beneficial

[12] VAT identification number – VAT number for short - are unique serial numbers allocated by the national tax authorities. Depending on what country issues them the format may differ, they do however always contain the issuing Member States country code.
[13] VAT information exchange system.
[14] VAT directive preamble (4) and (7).
[15] VAT directive preamble (48).

rules for certain type of start-up businesses or those businesses with a beneath threshold turnover or number of employees.[16]

The taxable amount when it concerns intra-Community acquisitions goods are to be dealt with the same way as if the goods were supplied in the same member state.[17] Hence, the taxable amount to use is the purchase price and in the lack of such the cost incurred by the seller to provide the good. In order to make sure that VAT is collected when goods travel across the borders or when services are performed abroad, there are some peculiar rules to be aware of. Some of these rules will be covered further down in the thesis.

2.6 Where is VAT due?

2.6.1 Goods

Where should one pay VAT when selling abroad to another business, or to a non-taxable person? It depends both on whether or not the purchaser provides its VAT-number and on whether the goods are intended to be transported "home" or onwards.

The leading thought is that VAT should only be paid in the member state where the acquisition is made, this agrees with the structure of VAT being a tax on consumption. However, according to the VAT directive, the acquisition is made in the member state where the goods are finally located if there is any transportation involved in the purchase. The two separate approaches are:

- Tax is due in the member state that issued the VAT identification number used in the acquisition;
- Tax is due in the member state to which the goods will be transported.

Where no VAT identification number is present, such as the case when consumers purchase goods the transaction will be taxed in the State of origin.[18]

If a Czech company buys goods in Germany, supplies their German VAT identification number to the seller, and uses the goods for refinement in their factory in Germany, only German VAT is due. Had they however supplied the VAT identification number issued in the Czech Republic and transported the goods "home", VAT would have been due there.[19]

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[16] Article 282 – 292 RVD.
[17] Article 83 RVD – Despite the fact that we no longer have a European Community but rather a Union, the term has not been updated.
[18] Article 50 RVD.
[19] Article 40, 41 RVD.

If goods are bought from Spain with the Czech VAT identification number but in fact are sent to a factory in Germany, VAT is due in Germany and the amount paid will later be used to reduce the VAT paid in Czech Republic. In this case the same transaction is taxable at two places at the same time and instead of instantly reliving the tax subject, presumably due to the immensely complicated work for the tax authorities, the VAT is recovered the year after.[20]

The above follows from the idea that VAT is due where consumption is taking place, if goods are transported out of the country of acquisition, no consumption has taken place. In practice, the buyer supplies the seller with his VAT identification number and then the seller refrains from charging the VAT. There are some issues to consider regarding these transactions, especially regarding the principal responsibility for the tax being collected.

The Court has tried whether or not the seller should bear the responsibility in cases where the goods never left the country, despite the buyer expressing to the seller that they would. In the Teleos and others case,[21] the Court specifically tried the concept of good faith when the transport of the goods was to be arranged by the buyer. The conclusions was that it lies upon the Member States to determine the rules applicable for not levying VAT, as long as they respect the principles of rule of law and proportionality. In the relevant case, the seller had been provided with a false VAT identification number, but according to the Court, the seller had no reason to doubt the validity and could as such not be responsible for the missing VAT. The Court stated that one should take the measures expected of one to ensure that one is not part of fraudulent behaviour If this has been done the seller cannot be held liable even if it is later revealed that the rules were abused. In another case, the buyer provided export documents to reassure the seller that the goods had been exported and that VAT was not due.[22] These documents later proved to be forged and the goods had been resold within the country without any VAT being levied. The Court stated that the seller could not be liable to reimburse the VAT if he had acted in good faith and taken every reasonable measure to ensure that he was not unwillingly participating in fraud.

It seems to me as if you have no reason to doubt, or should have had reason to doubt the transaction and the documents related to it you are acting in good faith and cannot be held liable.

2.6.2 Services

When selling services across borders there are two distinct set of rules used to distinguish where the tax liability is located. These are separated as business-to-business (B2B) or business-to-customer (B2C) rules. The main

[20] Article 40 RVD.
[21] C-409/04 Teleos and others.
[22] C-271/06 Netto Supermarkt.

rule within the B2B system is that the place of supply is where the customer has the fixed place of establishment.[23] This means that if you sell across borders it is the recipients VAT rate that applies. This rule is called the reverse charge mechanism. A simple example to demonstrate the importance of the fixed establishment:

A Dutch company sells tax advisory services to a branch of a business in Slovakia. The business fixed establishment is however located in Portugal. Portuguese VAT rates are applicable.[24] Hence the concept of fixed establishment bears the highest of importance. Unfortunately the term is not easily interpreted and there is extensive case law on the matter.[25]

When selling B2C, the rules are a bit simpler as you only need to charge and pay the VAT applicable in the State from where you are selling.[26] This is however not true when the total amount you are selling for exceeds a certain threshold, currently 35 000 €.[27]

The set of rules for the two groups are harmonized when it concerns immovable property. In this case, the rate applicable is determined by the Member State where the property is located.[28]

2.7 Which transactions are taxable?

The supply of goods,[29] certain intra-Community acquisitions,[30] supplies of services[31] and importation[32] are all taxable events if they are provided by a taxable person. Consumers may however also be liable to pay VAT directly to the authorities, just as if they were taxable persons. This occurs upon importation from jurisdictions, factually or legally considered to be outside of the EU, or upon purchasing a new means of transport.[33] The transactions need to be given for consideration in order to fall within the scope of VAT[34]. It is irrelevant whether this is given in legal tender or in other goods and services, as long as the consideration can be expressed in monetary value.[35]

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[23] Article 44 RVD.
[24] See also http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/vat_on_services/ available as of 2013-11-21.
[25] See C-318/11 Daimler AG and C-319/11 Widex A/S.
[26] Article 45 RVD.
[27] Article 34.2 RVD.
[28] Article 47 RVD.
[29] Article 14 – 19 RVD.
[30] Article 20 – 23 RVD.
[31] Article 24 – 29 RVD.
[32] Article 30 RVD.
[33] Article 2.1 (b) (ii) and Article 2.1 (d) RVD.
[34] Article 2(1) RVD.
[35] C-154/80 Coöperatieve Aardappelenbewaarplaats.

A supply of goods occurs when a transfer of legal ownership of property occurs within one of the Member States. Intra-Community acquisitions are those where ownership is transferred over the borders of Member States. The supply of services, such as the sales of management and consulting services, is treated the same irrespective if they are boundary crossing or not. Importation of goods occurs when a good is brought into the EU from a third territory. This might be from a country not forming a part of the EU or a territory within the EU which for VAT purposes does count as a third territory, such as the Canary Islands or Mount Athos in Greece. Upon importation into the EU, the importer must, if it is an end consumer, pay VAT on the product if its value reaches a certain threshold. For business operators the variations on how to treat imported goods are many, sometimes the goods are held in a customs warehouse until the day that they are sold within the Union. Only at this latter event, a liability to pay VAT arises. There might be instances when the goods are only meant to be processed for further exportation, such as car parts coming from Russia into Poland, where they are treated with anti-corrosion solutions and then sent back to Russia for assembly. In cases like this, where no consumption of the product is intended within the EU, VAT is not due.

2.8 What is the taxable amount?

Following the concept of VAT being calculated as a percentage of the given consideration for the good or service, knowing the price which to base the calculations on is crucial in order both to pay the tax and in order to predict and asses risks connected to VAT. The basic approach is that the taxable amount is ”everything which constitutes consideration which has been or is to be obtained by the supplier from the purchaser, customer or third party”.[36] Two important conclusions can be drawn from this article:

1. It is irrelevant from whom the payment is actually done, if it is partially paid by multiple parties or paid by subsidies. The joint sum is the taxable amount
2. Everything received should be used as the basis for calculation. If a business operator agrees to provide a computer to another business operator and receives cleaning services in return, this latter service should be converted to a monetary sum for VAT purposes.[37]

While this may sound simple enough there are some complications. Goods and services offered in bundles that include non-taxable transactions such as a car sold with an insurance policy cannot be charged with one VAT rate for the whole consideration.[38] The ECJ[39] gave no definite answer to when it is

[36] Article 11(1)(a) RVD.

[37] Folkert Idsinga, Bart-Jan Kalshoven and Monique van Herksen, Let’s Tango! The Dance between VAT, Customs and Transfer Pricing, International Transfer Pricing Journal, Sep/Oct 2005 P. 202.

[38] C-349/96 Card Protection Plan para 28-30.

[39] European Court of Justice.

to be considered as one supply or multiple supplies when it comes to bundles. The Court gave a few pointers but left it up to the national courts to decide whether a certain bundle is multiple supplies or not. These pointers are as follows: A supply of a service should be regarded independently and whether or not the service/good is exempt must be determined in the light of all relevant factors and not only derived from primary law. Transactions should not be split up by the courts if this would create an artificial basis for assessment; when one part of the bundle is considered an ancillary service, something that will make the consumer enjoy the product more, this should generally be considered one supply.

Similar situations occur when a real estate owner houses non-taxable activities and taxable activities in the same building, such as an accounting firm next to a bank.

How should one treat/calculate consideration when it is not purely monetary or if the price set by the seller does not seem to be in relation with what other suppliers in the same position could afford to offer their goods/services for? The directive states that open market value in regards to VAT means the full amount that a customer at the same stage in the supply chain would have to pay, at fair competition, at an arms-length price and within the same member state. [40]

VAT as such is aimed only to tax private expenditure and should accordingly be formed as a subjective tax, only applicable to the sum, which one has actually paid to acquire the goods or service. Even though the tax is aimed to be borne only by those excluded from VAT, end-consumers or other institutions, the mechanism for levying the tax is the same irrespective of how many parties have held the good.

Production stage	Price	VAT due	VAT deductible	VAT paid
Lumber mill	100 €	20 €	0 €	20 €
Carpenter	200 €	40 €	20 €	20 €
Grosser	300 €	60 €	40 €	20 €
Retailer	400 €	80 €	60 €	20 €
Consumer	0	80 €	0	80 €

In the left column you find the selling price of each party, and since the consumer here is presumed to be the end-consumer and is buying the good solely for consumption he or she does not act as a taxable person and can thusly not deduct the VAT. The 80 € that the customer is in fact paying to the retailer constitutes the entire VAT payment, but due to the temptation of fraud and the possibility of very quick accumulation of large sums of VAT payments the system of VAT charges the producers at an earlier stage. Naturally, it is no cost of the producers/retailers but the levy is included in

[40] Article 72 RVD.

the price and forces the retailer to claim it back from the consumers. The 80 € which is due has already been collected and paid to the State on a previous stage, the consumer however has to bear the burden of this indirect tax since the price is raised to cover the tax expenses of the producers.

VAT is meant to be a general tax on consumption that knows no discrepancy between products, the reasoning behind this is not only a sense of justice among the salespersons but also the theory of price elasticity. Having a common tax rate does not give or take away any advantages of the market forces, instead, it allows them to compete on equal terms. Having the market operate with the least amount of government involvement, tax vice, is meant to increase the effectiveness and allows it to supply the goods demanded at the equilibrium price.

The VAT paid by the lumber mill will eventually be reclaimed or deducted against other goods and services that the company buys; the intention is never for the company to bear the cost of the VAT, if they are not exempt.

2.9 Open market value

The general method of calculating VAT is simply to use the consideration given for the product and add the relevant percentage for that type of good. There are however circumstances where the price used between two parties does not reflect the intention of the transaction. A mechanism to adjust the price used for determining the VAT liability is prescribed in the VAT.[41] As the revenue collected by the State is based on the size of the consideration given for the good/service, lowering the consideration given/received has an immediate adverse effect on the VAT part of the tax base. Corrections only take place when one of the subjects is a non-taxable person for VAT purposes as these are the ones primarily interested in paying as low VAT as possible per transaction. For a taxable person, the VAT due is largely of minor importance since it in most cases will be offset against the VAT obtained at a later transaction stage. In the case C-621/10 Provadinvest OOD the ECJ stated that prices set too high or low between two related parties enjoying a full right to deduction never can be adjusted due to the lack of risk for tax avoidance.[42]

The price will be adjusted up to a price equivalent to what another business at the same stage in the production chain would pay to a non-related party under conditions of full competition. There is however no method provided for in the directive in order to find this ideal price. Whilst it might be a trivial task to find and compare the prices of bulk purchases of eggs or labour hours at a belt, other transactions offer a bit more resistance. Purchases of complex management services or one-of-a-kind pieces of scientific machines that lack any comparability will prove harder to

[41] Article 72 and 80 RVD, see also further down.
[42] C-621/10 Provadinvest OOD para. 42-48.

examine. Providing an arbitrarily chosen price in order to punish the parties would serve the purpose of the articles, which is to counter tax avoidance, but offers little as to the protection of legitimate expectations and would arguably not fulfil the maxim of *nulla poena sine lege.*

The relationship between price adjustments for VAT purposes and adjustments for TP purposes will be covered in a larger extent further down.

2.10 Later reduction/increase of the price

Different types of marketing schemes might have a big impact on the total VAT liability arising from a certain group of transactions. For example some retailers offer a retroactive discount on an invoice not yet due if you place another order. In order to be able to efficiently calculate the VAT it is important to know both when the liability arises and what happens if the price changes after that period.

The point where the legal conditions necessary to charge the VAT is present is referred to in the directive as the chargeable event.[43] In contrast to this point we have a point referred to as the chargeability of VAT. The former of these two represent the point where businesses can charge VAT on their sales and the latter point is the de facto taxing point, where the tax authorities can claim the VAT.[44]

VAT, being built on a system of duality with the liability to pay on one end and the right to deduct on the other hand, can only function if the two events are synchronized. VAT must be due before being deductible since what you deduct against is your own VAT liability.

As the main rule, the point of chargeability follows the commitment of the transaction and is met when either the good is delivered or the service is performed. [45] If the right to deduct would be linked only by the sending of an invoice from the seller, the state revenue would be faced with covering for the tax until it is finally paid by the buyer. If the monetary commitment is performed before the good/service is delivered, the receipt of that payment makes the VAT chargeable, unless there is an option to step out of the contract and retrieve the amount.[46] With deposits such as those often posted when booking a hotel room, the Court held that if the payee never consumes the booking and hence never fulfils the payment, there is no VAT due on this portion. But if the booking is used and the amount paid in full the entire sum becomes subject to VAT.[47] At first this might appear to the reader as somewhat disturbing but considering that the room has never been

[43] Article 62 RVD.
[44] Article 65 RVD.
[45] Article 63 RVD.
[46] Article 65 RVD.
[47] Case C-277/05 Société thermale d´Eugénie-les-Bains, ruling.

of service to the payee, no good or service has been consumed and hence no VAT is due.

With schemes of retroactive price reductions or even increases due to failure to oblige with the terms stated in the transaction the VAT must be adjusted correspondingly. A later increase of the price would render a larger liability towards the tax authorities and a reduction of the price would mean that your liability has been reduced; the two alternatives have two quite clear differences of interest. There is however, a clear need for business operators to be wary; one cannot reclaim "overpaid" VAT if the time passed between the claim and the payment is too long.[48] In this case, the UK had implemented national legislation curtailing any objections related to the amount of VAT paid from six to three years, Marks & Spencer argued that this was not in compliance with the VAT directive and subsequently won the case. ECJ states that for the protection of legitimate expectations the Member States cannot make it excessively difficult or virtually impossible to recover unduly paid VAT. The problem here was not the time limit as such being set to three years but the fact that the time limit had retroactive effect, rendering the claims useless.

Seeming that there is a possibility to retroactively change the consideration and thusly affect the VAT liability, either increasing or lowering it, the question remains whether or not this mechanism is applicable in regards to TP adjustments instigated by the authorities. As will be later covered more thoroughly, the price of a transaction for TP purposes can be changed by the tax authorities. This is meant to address disproportionalities within the direct tax area, but could it possibly have a spill-over effect on VAT liability?

2.11 Risk and avoidance of VAT

Within the EU there has for a long time existed forms of tax frauds, some more complicated than others, but their main goal has been to minimize tax liability either of a person or of a company. With a harmonized VAT system but un-harmonized tax authorities/control functions, a possibility for the morally flexible has been created. As ingoing/outgoing VAT accounts are settled relatively few times during the year, a series of transactions with high value commodities can quickly amass significant portions of VAT. The larger these amounts get, the larger is the temptation to withhold it from the State. This is meant to be neutralized as taxable persons pay VAT "upwards" the chain and through this, more often struggle with a deficit to be corrected rather than a surplus of VAT.

There are however certain loopholes that can be exploited by those seeking to profit on the States expense. In one form or the other they usually contain small goods of high value, transactions over at least one Member State, involved unknowing taxable persons and a so called "missing trader". The fact that the fraud can be undertaken so swiftly and have an almost

[48] Case C-62/00 Marks & Spencer para 43-45.

unlimited potential as to the value defrauded, makes it a very damaging practice.

This is probably the most publicly known form of VAT abuse. I would however differentiate between the carousel type of fraud and other tax avoidance scheme. Not only due to the difference in nature between the taxes being avoided but mainly due to the nature of the person/business executing the scheme. It seems to me as those conducting VAT fraud are more aggressive in their conduct and lack any intention of running their businesses legally. Frauds related to the under/overpricing of goods and service are not unheard of but they are not a prioritized matter due to their lack of significance in comparison to the aforementioned type of fraud. A more unrefined way of abusing the system of VAT is to hijack and employ someone else's VAT identification number. By doing this you can purchase goods "VAT-free" as you simply ignore to pay the VAT due. This method must employ another EU trader who preferably should act in good faith.

For those interested in examining the topic closer I recommend studying the case law of the ECJ.[49] It should also be mentioned that an organization has been built up within the EU to provide for assistance between Member States and for the Commission in matters dealing specifically with VAT fraud, the EUROFISC.[50] It is made up of represents from the tax authorities of all the Member States and works in the form of a Council. Representatives from the Commission are present in matters not concerning cases where individual taxpayers can be identified.

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[49] Joined cases Optigen, Fulcrum and Bond House C-354/03, C-355/03 and C-484/03, Axel Kittel C-439/04, Euro Tyre C-430/09.

[50] Council Regulation (EU) No 904/2010 on administrative co-operation and combating fraud in the field of VAT.

3 Transfer Pricing

3.1 What is Transfer Pricing?

The practice of transfer pricing and its effects on tax revenue has long been subject to controversy. Media have written full articles on what they refer to as "tax avoidance" by employing a tool known as transfer pricing. In the UK, MNEs such as Amazon, [51] Google and Starbucks have all been targeted in the newspapers and accused of using "transfer pricing".[52] The accusation as such is rather absurd to write an article on but I would guess that the general public does neither knows nor cares that the strategy employed is perhaps not morally justifiable but none the less legal.

Since companies that are related, either via control of shares or otherwise, do not operate on the open market when they buy or sell goods or services from each other, a transfer price must be artificially determined. This price is intended to be determined by the MNE itself and it is expected to have some form of transfer pricing protocol or an internal purchasing mechanism in order to comply with various transfer pricing guidelines. There are multiple obstacles to overcome when determining the transfer price, such as: discrepancies between views of the tax authorities of two jurisdictions, one may find the price too low the other one too high; the lack of data to employ when comparing the prices set; risks of double taxation.

One possible reason for the confusion of the media in regards to transfer pricing might be the fact that even when the companies apply it in accordance with the rules set out by the authorities the tax liability decreases. The fact that the operator still contributes to the growth of the economy and the tax base via employment and the taxes drawn from these sources might be disregarded in favour of the more exciting headlines screaming out: Tax fraud.

In a survey conducted by Ernest & Young in 2003 in over 600 MNEs and their subsidiaries, a bit over 80 % of them identified transfer pricing as the most important international tax issue they are facing.[53] The survey also concluded that one third of the audits resulted in an adjustment, one third of these adjusted audits involved threats of penalties and in half of these a penalty was actually enforced. Whilst the numbers might be hard to grasp at first, they do tell the importance of transfer pricing when scrutinized. The

[51] http://www.bbc.co.uk/news/business-20580545 available as of 2013-11-04.
[52] http://www.reuters.com/article/2012/12/06/us-tax-amazon-idUSBRE8B50AR20121206 available as of 2013-11-04.
[53] Oosterhoff, D., Multinational organizations face transfer pricing audits across the globe ; transfer pricing trends, practices and perceptions, International Transfer Pricing Journal, 2004 (Volume 11), No. 2.

cases where the authorities have found deviations from the ALP[54] and therefore choose to adjust the profits should not be compared to a situation where tax avoidance has been discovered. Whilst it might very well be the case of a deliberate attempt to withhold profits from taxation, it is also possible that the transaction was highly complicated and that the price chosen might reflect an honest attempt to comply with the rules. This is possibly reflected in the authorities' use of the penalties: deviations with good faith awards an adjustment and deviations lacking good faith also come with a penalty.

3.2 Short introduction to transfer pricing

"[Where] conditions are made or imposed between the two [associated] 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." – Article 9.1 OECD Model tax Convention

Transfer pricing adjustments is for the tax authorities a tool to spread the gains of MNEs to better reflect where their income is actually accrued.[55] What happens is that the authorities in one of the two States raises the taxable amount accrued in that State and thusly the tax liability is raised. This occurs despite the fact that the transferred asset will be taxed in the other State. There are no guarantees of relief for the MNE, but depending on if the two States have concluded a tax treaty based on the OECD model there might be some mechanisms to employ. The aim is not double taxation, but a far taxation based on where the values actually have been created.

It should also be noted that the United Nations Model Double Taxation Convention between Developed and Developing Countries in Article 9 on associated enterprises contains a very much similar function in order to distribute profits. This means that a majority of the world's States are contracting parties to conventions containing forms of transfer pricing, which even further highlights its importance.

According to some, since this mechanism is present in so many jurisdictions, one could talk of the arm's length principle as a general principle of international tax law.[56]

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[54] Arm's length principle, reflected in both the OECD and UN model tax treaties.
[55] OECD Commentaries to the Model Tax Convention 1.2.
[56] Krzysztof Lasiński-Sulecki, Impact of Transfer Pricing Adjustments for VAT and Customs Law Purposes, International Transfer Pricing Journal, 2013 (Volume 20), No. 3, 10 May 2013.

3.3 Why is transfer pricing needed?

In an increasingly global world with fewer and fewer natural obstacles to business, the concept of transfer pricing is argued to be an effective tool to combat hazardous tax competition and to promote trade and growth.[57] Transfer pricing was in its youth mainly employed by MNEs in order to determine the margins of the management and other centralized services, and for tax planning.[58] The theory of tax competition is that countries would lower their tax rates in order to attract businesses, making a move that would be countered by other countries by lowering their own tax rates for the same reasons. The end result would be a severely decreased income from tax rates for all countries; no country would be a winner but they would all be losers. Both the EU and the OECD have put efforts into minimizing the risks of harmful tax competition and procedures. There is yet no legislation on the area within the EU but a code of conduct has been adopted and has gained importance.[59] In accordance with this, the Member States have agreed to abstain from continuing applying or adopting new procedures identified as harmful. The OECD has established a special forum to tackle the issue under the name "Forum on Harmful Tax Practices", this followed after a report published in 1998.[60]

Countries with a low tax rate combined with a legislation containing very low requirements for what is considered a legal person could easily attract the attention of MNEs. The possibility to set up a shell corporation with the sole purpose of owning the shares and receiving the profits accrued from the actual operation in other locations of the world would please both the corporate leaders and their shareholders.

3.4 Source and applicability

Irrespective of whether a State is a Member of the OECD or not the application of the model treaty can only take place if the tax treaties the State has concluded with other States follows the model. If so, the tax treaty is enforced and interpreted with the help of the Vienna Convention from 1969 provided that the States are parties to it.[61] The leading provision would be Article 31, providing that treaties should be interpreted within their *ordinary meaning*. This is referred to as the objective method of interpretation and means that the purpose and context of the treaty should be used to provide clarity.[62]

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[57] OECD Commentaries to the Model Tax Convention 1.8.
[58] Folkert Idsinga, Bart-Jan Kalshoven and Monique van Herksen, Let's Tango! The Dance between VAT, Customs and Transfer Pricing, International Transfer Pricing Journal, Sep/Oct 2005 P. 199.
[59] Conclusions of the ECOFIN Council Meeting on 1 December 1997 (98/C 2/01).
[60] Harmful Tax Competition: An Emerging Global Issue, OECD Publications 1998.
[61] Vienna Convention on the Law of Treaties 1969.
[62] Mattias Dahlberg, Internationell Beskattning, 3rd edition, Studentlitteratur, 2012, ISBN 978-91-44-07734-5 p. 237.

Some states have chosen to adopt a monistic view and others a dualistic view when it comes to international treaties. The difference is that while the former acknowledges treaties as internal law upon contracting the latter requires transcription into the national laws before it is recognized as law.

If the text is effectively adopted as national legislation, what principles should be used for interpretation when it comes to national matters? Within the Model Treaty there is a recommendation from the OECD Council that the Member States should use the commentaries for the interpretation of the Treaty. As the commentaries on the model treaty as such and the more specific commentaries related only to each article lack any definite relevance in relation to national law the situation is uncertain. According to Dahlberg the commentaries should not be the sole source of interpretation as they lack constitutional legitimacy and hence lack status of public law.[63] In his opinion, some of the longer-standing commentaries might however have gained the status of *ordinary meaning* referred to in the Vienna convention and thusly are binding.

3.5 What is transfer pricing used for?

Large and widespread MNEs often have the infrastructure to provide most of their subsidiaries with the services required themselves, they might have an accounting subsidiary based in Belgium, tax consultancy services based in the Netherlands, marketing services in the US whilst producing their actual products all over Europe and selling them from subsidiaries all over the world. This integration might provide a streamlined approach to business in all their divisions or it might be employed to safe guard vital know-how, or it can simply be a means of control for the mother company. While a cynic might argue that all of this sets up the perfect environment for avoiding tax liability, the system of transfer pricing should rather be viewed as an essential part of business and a way to improve cross border relations and commerce.[64] Not being able to buy/sell or being constantly hindered by overly complicated legislation would severely impede the global trade and most probably reduce the amount of work opportunities. On the other hand, we face the harsh reality of MNEs reducing the tax revenue globally by creating artificial transactions with the sole purpose of avoiding tax liability.

3.6 Transfer pricing exemplified

See supplement A for an illustration of the following example.

Let us assume there is a small company in Sweden that has discovered a Chinese product for which the demand within the European Union is very high. Instead of administrating all their sales in Sweden, they would perhaps

[63] Dahlberg, Mattias Internationell Beskattning p. 241.
[64] OECD Commentaries to the Model Tax Convention 1.5.

rather form companies in the other Member States who would handle the sales and customer contact. To do this, they form subsidiaries that subsequently buy the product from the mother company located in Sweden. If we assume the unit price from China to be 10€, is it then this price that the subsidiaries should pay to the mother when they purchase? The subsidiaries, lacking many of the costs such as coordination, board and legal fees of the mother will accrue a larger profit provided that the retailing price is the same in all of the Union. Let us assume that the cost for Company A is 13€ per unit when all the costs are included compared to Company B's cost of 10€ per unit.

If both entities sold the good at a price of 15€, and if they both sold an equal amount of the good Company B would earn 40 % more before taxation. While buying the product from A for a price of 10€ indeed reflects the price of the good as such it does not reflect the price a non-related party would have used when selling. As seen above, the minimum selling price would be 13€, but even at that price Company A is presumably selling "too cheap". Non-related parties of commerce operate under a pressure to produce revenue, in order to do this you need to sell with a profit when possible. Following this, those who sell to related companies without a profit margin do not act at an arms-length.

Had the business operator not chosen to separate the businesses but instead operated through a web shop with tax liability in the country of origin the taxable amount generated would be significantly larger. From the MNEs perspective, here follows the most useful part of transfer pricing. It can be employed to reduce tax liability in countries with high corporate taxation and concentrate its earning in low tax jurisdictions. Naturally, less taxation means more revenue, but the possibility to mitigate costs to a high tax country also serves as an incentive for MNEs.

In the example above, the open value market price is 15€ but the subsidiaries get to buy the good for 10€ and by doing so the MNE is concentrating revenue outside of the jurisdiction of the parent company. When applying the arm's length principle, the price would have to be adjusted by the tax authorities up to at least 15€, provided that the national laws of the State in which Company A resides allows for this. This is referred to as a profit adjustment, which will raise the taxable amount accrued by Company A. However, the subsidiary is still being taxed in Country B, resulting in economical double taxation. While this example might appear clear, the same is not true for most of the TP disputes.

3.7 Relief from double taxation

If the two countries have signed a bilateral tax treaty modelled after the OECD´s recommendation, Article 9.2 can be active in the seek for relief. This is not something that is provided for automatically and as far as the cooperation between the two countries goes the treaty only states that they

should, when necessary, communicate with each other.[65] In order to receive any relief however, the tax authorities in Country B must agree with those in Country A upon the validity of the adjustment and its size.[66] Meaning that if the profits after the adjustments still are lower than what Country B believes they should be according to the ALP, paragraph 9.2 cannot be invoked. Furthermore, there are no prescribed methods for the adjustments, meaning that problems of comparability and lack of clarity of what the adjustment accomplished are existent.[67] Hence there are no automated guarantees for relief.

Taxpayers subject to double taxation have expressed worries regarding the settlement of accounts between the two states.[68] If the states disregard the economic health of tax subjects not operating within their borders, there is a risk that they fail to treat each petition for relief as a separated procedure and instead view it as a part of an account balance maintained with the other state.

In the lack of a tax treaty what so ever, the MNE must most likely suit itself with being taxed twice. Considering the various fines and administrative proceedings that can follow and attempt to withhold funds in the form of tax avoidance in different countries, this has to be regarded as very mild.

3.8 How to determine the transfer price?

In order to simplify the use of transfer pricing and to increase the openness of business the OECD has provided for a range of tools to use when determining the correct transfer price. Depending on what commodity is the object of the transaction the preferred method will change. Especially complicated are intangibles such as licences to use software, produce a specific good or use a trademark. The five methods supplied are:

1. Comparable uncontrolled price
2. Resale price method
3. Transactional net margin method
4. Transaction profit split
5. Cost plus method

Some transactions occurring between related parties might not have any comparable counterpart, this means that market forces have never been applied and that there exists no market price.[69] None the less the transaction must be concluded and a price must be set. How does one go about this?

[65] Article 9.2 OECD Model Tax Convention.
[66] OECD Commentaries to article 9 Paragraph 2 p. 6, 8th edition ISBN 9789264175181.
[67] Dahlberg, Mattias Internationell Beskattning p. 274.
[68] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations p. 4.40.
[69] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations para. 1.11.

The five methods provided for are split into two distinct groups where 3-4 are called the traditional transaction based methods and 1-2 plus 5 are based on the profit. These methods may sound very elementary, but add to these the concept of functional, residual, contribution and comparability analysis, and it quickly becomes complicated. All of these forms of analysis have their place depending upon witch method is used. Transactions involving more than two countries might need further analysis to find the correct price, different methods and calculation might be needed depending on what type of business is concerned. All of this makes for a jungle, for the legislators, judicators, tax authorities, business operators as well as the tax practitioners.[70]

For further reading upon the subject and on how the methods interact, I recommend studying some of the comprehensive documents published by the OECD themselves.[71]

3.9 Transfer pricing in the EU

Within the EU there exists a multilateral treaty which is meant to address and if not solve, at least to minimize, many of the problematic issues related to international groups and their taxation. This document, called the Arbitration Convention,[72] contains relief for double taxation brought on due to transfer pricing adjustments. The legal basis for the Convention can be found in Treaty of Rome[73] and in short, it states that Member States should, where necessary, enter negotiations to eliminate double taxation within the Union. Interestingly enough, this article is written so that the Member State is supposed to protect its own nationals against what other Member States want for tax revenue. How well this fits the idea of a common market without internal borders nor discrimination between different nationalities within the EU is up for discussion. The lack of "supranational" character achieved by choosing to conclude treaties with each other instead of adopting an EU directive on the matter means that the ECJ is put on the side-line and that Member States remain in fiscal power of their transfer pricing procedures.

[70] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations para. 1.13.
[71] Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, see also the Model Tax Convention and the commentaries published with it.
[72] Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises – AC.
[73] Art. 220 Treaty Establishing the European Economic Community.

3.10 Risks and avoidance with transfer pricing

The potential risk for tax avoidance with the use of TP is in my opinion rather low due to the joint work of the OECD and its Members. The demands on documentation and a common set of rules provides for openness, just treatment and satisfies the demands of legal expectations. There is however a great risk of very aggressive tax planning which, whilst being legal, might cause significant tax base erosions. The difficulty of assessing non-comparable goods as well as intangibles such as trade mark-use and minor patents might provide for an impenetrable wall for the authorities. The OECD is continuously working on combating this with the help of for example the EU, for the year 2014-2015 a so called action plan is proposed. This action plan might bring about considerable changes in the Model treaty as well as in the implementation of TP regimes into national legislation.[74] Within the EU, the Action Plan of 2012[75] contains measures on combating tax fraud and tax evasion.[76] This plan put its focus on a good and justifiable tax strategy, aiming to provide more clarity and foreseeability.[77] To limit cost of compliance both for authorities and for businesses and to encourage tax compliance the Commission has set out to compile a list of good administrative practices which among others, aim to increase clarity and service approach of the authorities.[78]

3.11 Final remarks on transfer pricing

The very concept of reassessing the price of a good/service from an external point violates pricing itself if one disregards the theory of social costs, which are meant to be borne by excises. Nothing is worth more than what it sells for under optimal market forces. At a first glance, it might appear that the function of transfer pricing adjustments is to actually correct the prices used, but the transaction as such is uninteresting. There is no correction of the transaction and any reasoning of such is strictly fictional. The sole purpose is to protect a healthy tax base. While this may be a sound goal and most probably a matter, which is best tackled by joint efforts such as those undertaken by the OECD, there are perhaps better methods to distribute the revenue of MNEs.

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[74] M. Nouwen, *The Gathering Momentum of International and Supranational Action against Aggressive Tax Planning and Harmful Tax Competition: The State of Play of Recent Work of the OECD and European Union*, 53 Eur. Taxn. 10 (2013), Journals IBFD (accessed 4 Jan. 2014). P. 2.2.

[75] Commission Decision C(2013)2236 of 23 April 2013.

[76] COM (2012) 722.

[77] D. Barmentlo ,P. Valente. Voluntary Payment of Taxes and Voluntary Adjustments of Transfer Prices from an EU Perspective, International Transfer Pricing Journal, 2013 (Volume 20), No. 4, 10 July 2013.

[78]See http://ec.europa.eu/taxation_customs/common/consultations/tax/2013_tpcode_en.htm.

The complexity for the MNE of setting prices so that it can avoid any adjustments can sometimes be enormous, and all of the time and money spent on this has one sole purpose: avoiding adjustments. Naturally, this is a decision for the business operators and shareholders to take, but aggressive tax planning and especially too much of it offers very little returns for the society as such. These funds might have been employed more efficiently promoting more growth and further investments. Seen from the perspective of the State and considering its interest to protect its source of income this procedure might serve as a good deterrent for those business operators who are tempted to siphon the revenue from one State to another. Regarding the economic impact, I am not so certain however that instigating a lengthy investigation full of both technical and legal difficulties is the best choice. It would be very interesting to see a report produced by a third party investigating how much tax revenue is actually saved.

In my opinion, it is rather absurd to talk about adjusting the transaction price seen from an economical point of view. Naturally, the flow of funds is related to the pricing of the good/service and for a matter of convenience, I do see the appeal for the States to employ this terminology. However, as shown above the VAT due/deductible in these cases does not follow the adjustment and hence I would argue that the transaction is left intact. Moreover, if the transaction is left intact, there has been no adjustment as to the price employed between the parties, there has only been a decision to allow double taxation provided that the other state does not allow a corresponding adjustment.

4 Transfer pricing and VAT

4.1 Transfer pricing and VAT in harmony

As covered above, when related companies sell/buy from each other using the ALP no complications are met, VAT is deductible in the selling country and respectively added in the buyers' country. This is dependent on that the tax authorities in both countries agree that the price set is in fact the correct one.

Both the taxable amount used for VAT purposes and the price used for transfer pricing might be retroactively changed. The former may be changed by the parties concerned in the transaction and with the tax agencies involved only in paying out or demanding a higher sum. The latter situation is instigated by either of the two tax authorities of the two countries or by the MNE itself, and can potentially result in a profit adjustment, effectively reallocating earnings of the MNE. Transfer pricing adjustments done by the MNE serve to protect the company itself from any potential administrative measures if it, at a point later than the transfer have discovered or realized that there is a more fitting price to use for the transaction. Do we have a factual change in the consideration given for the service/good in this situation?

4.2 Sources of law

The backbone of the legislation on transfer pricing in the Member States derives from the model treaty but its implementation into national legislation will most certainly differ. Discrepancies in translations as well as in the methods for enforcing and applying the rules would call for tedious studies. As the rules of what punishment or administrative fees, a company might face if it actively deviate from the ALP differs in the Member States it would be an immensely cumbersome task to try to for provide a satisfying overview and any attempt of such will not be found in this thesis. Instead, this segment will focus on the relationship between the VAT directive and the suggested rules on transfer pricing as formulated by the OECD implemented in the AC and clarified by the JTPF.[79]

Neither does the VAT directive contain the concept of transfer pricing nor does the rules on transfer pricing in the OECD model treaty contain any reference to VAT. The two issues, one relating to indirect and the other to direct taxation seem to lack any convergence.

[79] Joint Transfer Pricing Forum.

4.3 The Joint Transfer Pricing Forum

Not with the expressed intention to harmonize but rather to provide a feasible overview for business operators the Joint Transfer Pricing Forum was established. The forum thankfully operates with the treaties provided by the OECD as its core and aims to provide non-legislative measures to resolve some of the problems concerning transfer pricing within the EU. It was set up formally in June 2006 and effective as of 1 of March 2007. [80] The document sets up a group of specialists tasked with creating a platform for business and tax authorities to discuss transfer pricing, advising the Commission of tax issues related to transfer pricing and to assist the Commission in finding practical ways of complying with the OECD rules in an effort of more uniform application. They now also provide sets of rules meant to be used when interpreting the AC and through this have gained influence on the application of the transfer pricing rules. The forum is not strictly based on assisting the authorities to protect revenue, but also aims to promote legal certainty for the business concerned by the legislation. Risk assessments are made with both parties interest in mind, involving practitioners and auditors aims to make sure that both parties can allocate their resources as effectively as possible.[81]

4.4 VAT and deviations from the ALP in the EU

If the price set by the MNE when selling/buying a good or service is considered by the authorities to be too low/high, and the price is voluntarily adjusted, the consideration given has de facto changed. With a change in the monetary value paid or received for a service/good, the VAT must also be adjusted. This might come across as peculiar regarding intra-Community acquisitions since the VAT is fully deductible for the MNE. There is however a need to treat the buyer and seller as two separate entities as the deduction and addition of the VAT takes place within two different tax jurisdictions. There might also be incentives for the operators in different countries to produce the best "individual" result possible, such as bonus programmes based on EBITDA. This would promote them to minimize their tax liability despite the fact that it might increase the sister companies liability. VAT is harmonized within the EU, and the legal basis for transfer pricing within the EU is also harmonized through the work of OECD. The implementation of both of the regimes into national law of the Member States do however have discrepancies. These discrepancies within VAT can be addressed by the EU through either the Commission starting an

[80] Decision 2007/75/EC setting up an expert group on transfer pricing.
[81] COM(2005) 543 final -COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN PARLIAMENT AND THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE on the work of the EU Joint Transfer Pricing Forum on transfer pricing documentation for associated enterprises in the EU. Para. 3.2.14-18.

infringement procedure against the concerned Member State or by the national courts of the Member States who can refer matters of interpretation to the ECJ.

4.4.1 Voluntary transfer pricing adjustments

These adjustments are most probably not undertaken in order to secure tax revenue for either of the States. The idea that they are undertaken to avoid a full investigation from the authorities is more feasible. Another possible reason might be to balance out any previously incurred misrepresentations of the earnings in two states. This could be undertaken by writing off debts or increasing the interest connected with such. It could also be accomplished by now doing the opposite, to deviate from the ALP again but in the other direction this time.

Between the two options only the former one would be of interest for VAT purposes, provided that both parties have a full right of deduction and due to this cannot be subject to a price adjustment for VAT purposes. As the mechanism of TP has not been activated as such, but rather a recommended model in order to avoid adjustments has been used the consideration given has been changed. This would activate the VAT directive and demand changes to be made to the taxable amounts and in extension the VAT deducted/added in the two States.

If it is not this way, this opens up for a practice of selling for price beneath the ALP, perform documented research about the pricing of the good sold and then upon “realizing” that you have used a too low price, correct it with another strictly monetary transaction. This would lower the VAT due in the recipient state. Allowing this under the pretence of companies correcting their TP practices and not taking into account this consideration for the good/service could potentially be very harmful.

4.4.2 Forced transfer pricing adjustments

The cases where the authorities intervene and determines another price than the one by the companies should not be subject to any VAT implications. The consideration given has not changed and the remedy for this risk of tax avoidance, from the tax authority’s perspective, would be fees or only the adjustment as such. VAT is essentially based upon the subjective value of the transaction, meaning that it is based upon what was actually negotiated and paid. For TP purposes the transaction adopts a objective value, the price should be what one would usually pay.

A monetary transaction containing no obligations to either perform, abstain from performing or delivering a good/service, is not given for consideration. This means that it under no circumstances can be subject to VAT. These types of transactions are most probably not very common and the reasons

for performing them are very few. Examples of such could be group contributions or covert sponsorships.

4.5 Cases

The selection of cases concerning TP are rather slim in comparison to the amount of interest the topic is awarded in both the academic debate and within business. It seems as the countries previously categorized as emerging economies are the most active ones when it comes to choosing court proceedings as a tool to enforce the TP framework. At least if one studies the collection of tax treaty cases provided by the IBFD.

Cases where the issue of VAT and TP is being raised within the same proceeding are very rare to come by. In one case, the defendant argued that the shift from paying an IPT[82] on insurances to partially applying VAT to the product motivated setting a price deviating from the ALP. [83] This argument did however not hold up and the Special Commission favoured the tax authorities' interpretation of the TP model. As the case concerned activities exempt from VAT, insurance and reinsurance, it had a potential to involve the OMV[84] mechanism in the VAT directive but the matter was not raised.

4.6 Hypothetical case

To illustrate where an actualisation of both sets of rules might be applicable I will produce a fictive scenario taking place within the EU. For matters of simplicity, the situation will be quite uncomplicated and should rather be viewed as school book example than an actual business decision.

The concerned MNE operates in all the Member States of the EU and was founded as a producer of transmissions for heavy industry apparatus but has made most of its earnings selling larger motorized garden tools to end consumers. In each of the Member States at least one division of the MNE is present, the MoGaT Ltd. which acts as retailer. Apart from this, the MNE operates accounting houses in England, insurance services in France, tax services in the Netherlands and a R&D department in Hungary. The mother company is located in the Republic of Ireland from where it finances the other divisions via high interest loans.

Recently the MNE has broken its previous agreement with one of the larger European insurance companies in order to set up its own operation in order to internalize profits further. Today they sell an extended warranty as an extra service connected to the vehicles, the service contract is not covered in

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[82] Insurance Premium Tax– Non deductible.

[83] United Kingdom – DSG Retail Ltd v. Her Majesty's Revenue and Customs, 31 March 2009.

[84] Open Market Value.

the price of the initial deal. The warranty is constructed as a service due to having fixed dates/running hours after which the warranty should be employed. The price of the warranty when sold to a customer is 15€ including 25% VAT.

The service contract is shortly after sold from the retailing division in respective MS to the centralized MNE insurer located in France, effectively assuming the responsibility but will be providing the service via outsourcing when called upon.

Recap: Here we have MoGat Ltd. a company with full right to deduction, selling warranties to a related company, the FraInsur, a company lacking any right to deduction. The two companies are in this example located in different Member States. The price paid by the customer was 15€ including 25% VAT, meaning 12€ without VAT. As the warranty is neither a good nor a non-taxable service it is liable for VAT.[85] Let us assume that the contract is worth 10€ as the liabilities assumed are quite small. Let us also assume that the insurance division pays the highest amount of company tax of all the bodies of the MNE. Hence, it would be "ideal" to shift the profits to this division and only accrue losses as far as possible in the higher tax jurisdictions. The selling price is therefore set to 5€ excluding VAT. Not only does this mitigate earnings but it also serves to lower the amount on unrecoverable VAT accrued by the exempt insurance business.

The following will outline what happens with the transaction before any corrective measures are taken:

1. MoGat deducts the VAT in respective Member State when selling the warranty.
2. As the place of establishment of the purchaser is in France, French VAT is applicable in accordance with the reverse charge mechanism.[86] This liability belongs to the French company.
3. As a company dealing only with otherwise non-taxable activity, FraInsur lacks a general right of deduction.[87] It is however not the type of business that determines if you are exempt or not but the types of supplies you make. Therefore, they are accumulating input VAT but they lack any output VAT to offset it, effectively making them end consumers.

Analysis: FraInsur has accrued non-insurance warranties for half of their price and worth, this concentrates wealth in a wrongful way not reflecting the earnings of the MNE. At the same time, they have in an unlawful manner effectively limited their liability to pay VAT by 50%.

[85] Article 24 RVD.
[86] Article 44 RVD.
[87] Article 135 1. (a) RVD.

To address this matter we would need to apply both the Model Tax Treaty to address the price used for TP purposes but also the VAT directive to correct the price in order to obtain the lacking VAT.

As the price has deviated violently from what we previously assumed that the service was worth (100%) it is quite clear that the transactions have not been carried out at an arm's length basis. What should happen is that the tax authorities of the Member States where the retail end is located (not in France) should instigate an investigation and ultimately raise the taxable amount of the companies involved. They have sold services too cheap and through this withheld tax base from the States. This would activate the mechanism of open market value and correct the consideration given for VAT up to 10€ as well.[88]

Uncorrected tax liability of the retailing division: X-5y
Corrected tax liability of the retailing division: X

Uncorrected VAT liability of FraInsur: X+ (5y*VAT rate)
Corrected VAT liability of Frainsur: X+ (10y*VAT rate)

Had the FraInsur had a full right of deduction, the correction for VAT purposes would have been redundant since the deviation between ingoing and outgoing VAT forms a liability that ultimately rests with the company. If they had a right of deduction and still actively chose to manipulate the consideration given, there will be no direct VAT consequences since the company will have to settle their accounts with the tax authorities in the end of the year.

4.7 Main differences between TP and VAT

The most significant difference between the two concepts is that while TP concerns the direct taxation of entities, VAT is an indirect tax focused on each transaction individually. The VAT liability of a taxable person stands in perfect relation to how many and how big transactions they perform, provided that they have a full right of deduction. TP can incur or reduce tax liability depending on its usage and is thusly under more control from the MNEs than VAT.

If the two systems operate as intended, they lack significant similarities, but due to tax avoidance schemes, the two have been prepared with very similar tools in order to combat potential erosion of tax base. In TP, we have the concept of the arm's length principle and in regards to VAT we find something referred to as the open market value. While the former has been around for a significant amount of time, the latter was introduced in the VAT directive in 2006 as a special measure to specifically combat tax

[88] Article 80 1 (a) RVD.

avoidance.[89] It has since then formed part of today's directive and is defined as follows:

Article 72 RVD

"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.

Where no comparable supply of goods or services can be ascertained, 'open market value' shall mean the following:

(1) in respect of goods, an amount that is not less than the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, determined at the time of supply;

(2) in respect of services, an amount that is not less than the full cost to the taxable person of providing the service. "

The terminology of the provision seems to imply a relationship to the OECDs model treaty and the concept of the ALP. Whether or not the interpretations employed by the national Courts of the Member States and the ECJ in regards to what are prices set at ALP for transfer pricing purposes still applies is not certain. The provision is only applicable when there is a company involved in businesses lacking full deductibility interacting with one who has it. This follows, as it is only the companies who lack full deductibility that would be interested in obtaining as low input VAT as possible and thusly have an incentive to meddle with the openly stated prices.

Article 80 RVD

"1. In order to prevent tax evasion or avoidance, Member States may in any of the following cases 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 as defined by the Member State, the taxable amount is to be the open market value:

(a) where the consideration is lower than the open market value and the recipient of the supply does not have a full right of deduction under Articles 167 to 171 and Articles 173 to 177;

(b) where the consideration is lower than the open market value and the

[89] Council Directive 2006/69/EC of 24 July 2006.

supplier does not have a full right of deduction under Articles 167 to 171 and Articles 173 to 177 and the supply is subject to an exemption under Articles 132, 135, 136, 371, 375, 376, 377, 378(2), 379(2) or ►M7 Articles 380 to 390b ◄;

(c) where the consideration is higher than the open market value and the supplier does not have a full right of deduction under Articles 167 to 171 and Articles 173 to 177.

For the purposes of the first subparagraph, legal ties may include the relationship between an employer and employee or the employee's family, or any other closely connected persons.

2. Where Member States exercise the option provided for in paragraph 1, they may restrict the categories of suppliers or recipients to whom the measures shall apply.

3. Member States shall inform the VAT Committee of national legislative measures adopted pursuant to paragraph 1 in so far as these are not measures authorised by the Council prior to 13 August 2006 in accordance with Article 27 (1) to (4) of Directive 77/388/EEC, and which are continued under paragraph 1 of this Article."

In this article the terminology is even more similar to that of the OECD and the UN but the article in its entirety seems to address the situations when individuals receive benefits or goods from a company whilst paying a rebated price.

The most significant difference between the two forms of price corrections is that whilst both aim to protect tax revenue one is economic fiction and the other one is real. With transfer pricing adjustments you seek to reallocate the earnings of the MNE to better reflect reality, whilst with adjustments of the taxable amount used for calculating VAT you aim to correct a specific transaction. The underlying commodity or service is no longer of any interest and neither is the actual transaction for TP purposes. If you sell goods/services extremely overpriced in the beginning of the year and later you sell goods/services extremely under-priced during the same year and end up correctly reflecting the earnings of each division of the MNE, there is no need for any transfer pricing adjustments. The tax base will remain intact. Whilst not confirmed by any higher instance of law this was the reasoning of the highest instance on tax law in Sweden and ought to reflect the intention of the OECD.[90] The fact that the court recognized OECD's work on the topic and applied some of its methods of interpretation provided for was of the highest importance in this case.

[90] RÅ 1991 ref. 107 "Shell-målet".

4.8 Efforts to limit tax avoidance

As countries strive to secure their tax revenue, they must not only abide to the national law but also to conventions or as in the Member States of the EU, the directives. Within the EU, there exists a framework upon which the idea of a Union was founded and which ranks higher than national constitutions, the regulations are *lex superior*. Hence, any attempts of securing tax revenue that might be in conflict with these regulations, most commonly the fundamental freedoms, can be put out of effect.[91] Helminen argues via arguments derived from case law of the ECJ that the willingness to allow tax protective measures in conflict with the fundamental freedoms has been very low.[92] It is not a valid reason for interfering with the fundamental freedoms that a Member States tax base is eroded, only if the measure by which it is so is to be regarded as tax avoidance. Harmonized legislation such as the VAT-directive does however provide a more powerful tool for the Member States and by extension for the Union as long as they remain diligent with the implementation. The same applies for those who have implemented transfer pricing regimes stemming from either the OECD or the UN. With the former of the two, the implementation of harmonized legislation there exists within the EU a loyalty principle.[93] This means that Member States are obliged to implement and fulfil obligations stemming from the legislation of the EU. Protecting your own tax base resulting in a lack of taxation for another Member State would probably not qualify. When it concerns the interpretation of international treaties the Vienna Convention and its *bona fide* provision will serve to deter countries from benefitting on the other ones loss.[94] This provision can only serve to this purpose if combined with the purpose of the OECD and UN treaties, to provide accurate taxable base for the contracting parties.

The amount lost each year due to fraudulent behaviour or avoidance within VAT or pricing deviating from the ALP is of course hard to estimate, but in 2009 the EU estimated to have lost approximately 12%, almost 107 billion Euros.[95] Some Member States have been harder hit than others, probably due to a lack of effective means to combat the evasion.

With the above in mind, a Member State can not act to counter tax avoidance if there is a risk that the action is prohibited by international treaties or by the existing EU legislation. A Member State employing a more strict interpretation than allowed by general principles of either legislation may face severe fines or might risk losing some of their good reputation. A too strict view on tax avoidance in general might also lower

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[91] Free movement of goods, free movement of capital, free movement of services and the freedom of establishment.
[92] M. Helminen, *EU Tax Law – Direct Taxation* (IBFD 2013), Online Books IBFD (accessed 3 Jan. 2014). 2.3.1.
[93] Art. 10 Treaty establishing the European Community.
[94] Article 31 Vienna Convention on the Law of Treaties 1969.
[95] http://europa.eu/rapid/press-release_MEMO-11-874_en.htm available 2013-12-29.

the incentives for companies to place their operations within that jurisdiction as the risks and cost of compliance will increase.

5 Conclusions

The two areas of tax law, VAT and TP, and their possible convergences are a highly complicated matter. Both areas are by themselves subject to rigorous scrutiny by professionals, academics and tax authorities. Neither of the two are understood and employed fully, hence creating a demand for experienced VAT and TP consultants. The two systems encompass vast amounts of tax, in 2009 the total VAT receipt within the EU amounted to 873 billion Euro.[96] Considering that some surveys state that more commerce takes place within MNEs than outside, the system of TP is monumental.[97] When these two topics are discussed to a great extent within committees hosted within the UN, and sub-committees are appointed in order to produce papers and reports in order to clarify the exact same questions posed in this thesis few would dare claim that the matter is resolved.[98] As to the doctrinal debate, any type of co-relation between VAT and TP is not promptly stated. Words of caution has been raised by some scholars as to the possible interaction but what interaction and how it would unfold is still uncertain.[99] Multiple tax consultancy bureaus have produced informational .pdfs and adverts for distribution warning their clients for possible interactions.[100] This latter addition though might be a way of further capitalizing on the uncertainty of the area and the information asymmetry in the relationship between the seller and the buyer of tax consultancy. Alain Charlet and Dimitra Koulouri writes that in this regard there are two schools of thought. One that views the interaction between the two areas to be desirable and the other that remains cautious as to whether or not they should interact. The relevant text does concern MNEs acting through a branch instead of a separate legal person, but the situation for goods crossing border are from a VAT point of view the same. As to whether or not one school should prevail over the other the article offers no leading other than stating that training tax assessors in both of these areas of law would be costly. In the article regarding the valuation of goods for TP/customs/VAT purposes referred to above, the conclusion is only that the three types of taxes could maybe be harmonized and may have an effect on each other not easily foreseeable if left un-harmonized.

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[96] http://europa.eu/rapid/press-release_MEMO-11-874_en.htm available 2013-12-29.

[97] See above 4.1.

[98] Paragraph (n), Eight Session of the UN committee of Experts on International Cooperation in Tax Matters, Report from Prof. Jan J.P. de Goede, IBFD Senior Principal Tax Knowledge Management, 23 October 2012.

[99] Relation between Head Offices and Permanent Establishments: VAT/GST v. Direct Taxation: The Two Faces of Janus, Alain Charlet, Dimitra Koulouri P. 733 - Value Added Tax and Direct Taxation: Similarities and Differences, Michael Lang, Peter Melz, Eleonor Kristofferson, 2009, IBFD.

[100] See https://www.kpmg.com/BE/en/IssuesAndInsights/ArticlesPublications/Documents/Transfer%20Pricing%20Synergy.pdf and http://www.bakermckenzie.com/files/Uploads/Documents/Amterdam/Ahead%20of%20Tax/pn_amsterdam_aheadoftax_tpdouaneenbtwpolkatangoofwals_mar10.pdf both available 2014-01-02.

The following conclusions are thusly not an expression of certainty but rather follows from logical deduction and interpretation of the legal provisions activated.

Whether or not a transfer pricing adjustment should affect the consideration given for VAT purposes boils down to two distinct issues:

1. Are the adjustment made voluntarily?
2. Are the adjustments enforced by the authorities?

In the case of a voluntary adjustment, no matter why this has come about, there is a *de facto* change in the consideration given for the good/service. VAT is calculated on all of the consideration received for a good, no matter when, by whom or in what form it is given. Not accounting for this shift in consideration can either be exploited by business operators or unjustly enrich the tax authorities. Thusly, I would argue that voluntary transfer pricing adjustments must have a VAT consequence. Irrespective of what one might call an extra payment it is in my opinion still to be regarded as consideration.

Example:

MegaCorp Sweden sells 100 units for 10€ each to MegaCorp Finland on the 1st of January. VAT rate in Finland is 24%, hence, 240€ in due in VAT in Finland.

MegaCorp Sweden changes the price of the units retroactively to 20€ on the 1st of December, MegaCorp Finland submits the payment.

In this case in my opinion it is apparent that the VAT due should be doubled as the consideration has doubled. Without a mechanism to correct this, VAT would no longer be effective as any two parties then could reach a mutually beneficial agreement with two separate payments, one smaller where VAT is due and a later, larger payment free of VAT.

With the adjustments enforced by authorities, which serve only to reallocate the earnings of the MNE, the new price determined should not affect the consideration given. Within TP an objective price is found and applied, this one should not affect the subjective price used for VAT purposes. Only if the mechanisms provided for within the VAT directive are simultaneously activated the consideration given should be affected, and as showed above this can only happen when the transaction involves a party lacking full right of deduction.

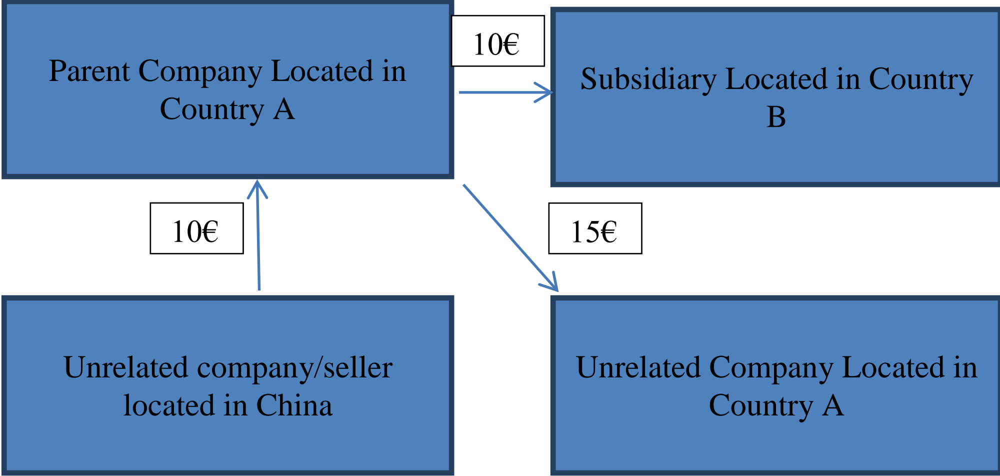
MegaCorp Sweden sells 100 units for 10€ each to MegaCorp Finland on the 1st of January. VAT rate in Finland is 24%, hence, 240€ in due in VAT in Finland.

The tax authorities in Sweden deems that the price is too low and raises it retroactively to 20€. No payment is received from MegaCorp Finland but MegaCorp Sweden still incurs a larger tax liability.

In this second example tax base is guaranteed, the consideration given has not changed and corrective measures have been enforced.

Thusly, in my opinion the VAT due should be adjusted to correspond with the total consideration given for a service/good when a voluntary adjustment of the price used for TP is done. The leading thought here is the voluntary aspect of the consideration given, and conversely, the VAT due should remain intact if the authorities carry out the adjustment.

Supplement A



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