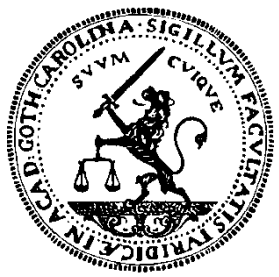


FACULTY OF LAW
Lund University

Anna Baranowska

Impact of transfer pricing adjustments on VAT liabilities

JAEM03 Master Thesis

European Business Law
30 higher education credits

Supervisor: Oskar Henkow

Term: Spring 2016

Contact: anna.k.baranowska@gmail.com

Contents

Summary

Transfer pricing and VAT represent two different areas of taxation: a specific branch of corporate income tax and indirect tax. On the surface they may seem as completely separate systems as they have different purpose, methodology or valuation methods. Yet, as they both regulate the treatment of transactions and supplies between companies in some cases they can start to interact with each other.

Transfer pricing uses objective criteria of valuation in order to achieve the price that will be in accordance with the Arm's Length and adjustments provide a mechanism that allows corrections if the Arm's Length is not achieved. There are however different types of adjustments: primary adjustments, compensating adjustments, secondary adjustments and corresponding adjustments. They all take different forms, which lead to different consequences from the VAT perspective.

VAT on the other hand focuses on the subjective value of a transaction and requires that a transaction will only be considered as a taxable transaction when supply of goods or services is affected by consideration and is provided by a taxable person acting as such. In that sense it is intended to be a tax on consumption. Therefore, any transfer pricing adjustment has to be assessed in the light of VAT requirements in order to determine whether or not it will impact VAT liabilities.

This research provides that although transfer pricing adjustments alone are rather unlikely to constitute a taxable transaction from the VAT perspective, they might nevertheless impact VAT due if adjustments are linked to a previously existing supply for consideration. Changes in the taxable amount in VAT have to be reported to relevant tax authorities as noncompliance may result in fees and penalties. This further depends whether adjustments were done between related enterprises or whether they were ordered and determined by tax authorities. Other factors such as legal relationship between the companies or membership in the VAT group can also alter the consequences from the VAT perspective.

Preface

I would like to thank my supervisor, Oskar Henkow, who kept challenging me throughout the entire process of writing this paper. Without his valuable comments and advisory I would not be able to complete this project. I am deeply thankful for all those questions that could not be answered and lead me through this academic journey.

I would also like to thank the staff working at EY Malmö as they turned those theoretical considerations into practical problems and made me realise that in practice all questions need to be answered.

Abbreviations

AG	Advocate General
AL	Arm's Length
ALP	Arm's Length Principle
APA	Advance Pricing Agreement
Art	Article
CJEU	Court of Justice of the European Union
ECJ	European Court of Justice
HMRC	Her Majesty's Revenue and Customs
IP	Intellectual Property
MNEs	Multinational Enterprises
OECD	Organisation for Economic Co-Operation and Development
OMV	Open Market Value
PE	Permanent Establishment
R&D	Research and Development
The Directive	The VAT Directive 2006/112/EC
UK	The United Kingdom
VAT	Value Added Tax

1. Introduction

1.1. Background

Although transfer pricing and VAT are both referred to as 'taxes' they represent entirely different systems.[1] While the former belongs to the field of direct taxation, the latter represents indirect taxation. This difference alone can raise doubts as to whether one system can have any significant impact on the other. Yet, upon a closer analysis one will realise that transfer pricing adjustments require thoughtful assessment from VAT perspective. As those adjustments might have impact on the taxable amount of goods or services traded, therefore the relationship to VAT should not be ignored. Moreover, as corporate structures and business models are constantly changing, legal framework regulating tax issues should not be assessed in isolation or classify specific elements as belonging exclusively to the sphere of direct or indirect taxation. This research shows that despite different concepts, principles and methodology both systems interact with each other.

The initial scepticism regarding the interrelationship between direct and indirect taxation is not irrational and it originates from the fact that transfer pricing is primarily concerned with corporate profit margins and its allocation between various jurisdictions while VAT focuses on individual transactions when a final customer bears the burden of the consumption tax. Additionally, the former concentrates on finding objective price comparison, while the latter, in principle, accepts the subjective valuation between the supplier and the recipient. Another difficulty comes from the lack of harmonisation and little clarification of interaction between legal principles governing transfer pricing and VAT. Yet, as cross-border transactions are not exclusive to either of the disciplines after a detailed analysis, it becomes more apparent when, and in what circumstances VAT liability might occur.

The introduction of Art 80 to the VAT Directive emphasised the growing importance of transfer pricing within the field of VAT in relation to trade and objective criteria of valuation of taxable amount between related enterprises. However, what is even more appealing, is to see when and more importantly why certain transfer pricing adjustments might give rise to VAT liability (that is when such adjustments should be treated as a taxable transaction from VAT perspective) or when they should be accompanied by a corresponding VAT

[1]Bakker A. and Obuoforibo B., *Transfer Pricing and Customs Valuation: Two worlds to tax as*

adjustment. As rightly pointed by academics,[2] the 'application of principles and valuation in each tax separately might be rather straightforward under review, however complications start when the two start to interact and need to be integrated'. As this new dimension to transfer pricing adjustments should no longer be denied as it might result in high compliance costs or penalties, it is therefore necessary to evaluate what consequences they have from the VAT perspective.

1.2. Subject and purpose

The subject of this research focuses on transfer pricing adjustments governed by the international OECD standards and their impact on VAT liabilities in the light of the European Union legal framework. Primary questions asked are whether there are any VAT liabilities resulting from transfer pricing adjustments, and if so, in which circumstances they arise.

As that impact is not always self-explanatory, it therefore requires that relevant concepts, methodologies and principles are explained and compared before the analysis can be conducted. As an emerging area of interest it needs further research that the author wants to contribute to in order to provide legal clarification.

1.3. Method and materials

This paper is divided into two sections. Firstly, it provides a theoretical background and an introduction to key concepts of transfer pricing and VAT. The second part presents an analytical assessment of the impact of transfer pricing adjustments over VAT liabilities and emphasises problematic areas from the international business perspective. It gives an overview of the legal situation as it stands today.

The traditional legal dogmatic method in the light of European Union law will be used[3] as it allows interpretation of legal norms as found in multiple legal sources in the context of the European Union law.

---

[2]Van Herksen M., Idsinga F., Van Slooten G., 'Dancing together', 17 *International Tax Review* (2006 nr 16) p 16.

[3]McConville M., and Hong Chui W., *Research Methods for Law* (Edinburgh University Press 2007) p 8.

For the purpose of interpretation of transfer pricing principles the OECD Model Tax Convention and Guidelines will be assessed. The primary sources of law for the VAT analysis are VAT Directive and the relevant case law from the CJEU. Furthermore, non-legally binding commentaries by Advocate Generals, academics and practitioners will be presented as they provide a valuable clarification and understanding of the issue.

Additionally, opinions and guidelines from relevant national bodies and tax authorities will also be introduced. Although domestic decisions are not binding on the European level they demonstrate how the problem is understood in a national context when there is no harmonised binding European approach.

1.4. Delimitation

The following delimitation applies. Firstly, this paper will not discuss whether the open market value should be understood as VAT implementation of arm's length principle.

Secondly, although the transfer pricing adjustments might have impact on another type of indirect taxes – customs – it will not be mentioned as this research focuses primarily on the interaction between the corporate income tax and VAT system. Additionally, as VAT represents a subjective valuation method it provides more contrast to the objective valuation represented by customs and therefore it results in more interesting reconciliation of the both concepts.

Thirdly, not all cases of the VAT grouping and relationship between parent companies, subsidiaries and fixed establishment will be analysed. As this paper provides as assessment based on the general principles it aims to present an overall guidelines rather than searching for exceptions or marginal situations.

1.5. Outline

This work has been divided into 4 chapters that provide both theoretical introduction and analytical assessment. Chapter 1 provides an overview of this research, its purpose and method used.

Chapter 2 provides an introduction to the transfer pricing mechanism, most important concepts such as arm's length principles and associated enterprises, various valuation methods and types of transfer pricing adjustments.

Chapter 3 focuses on the VAT as a system, explains key concepts of a taxable transaction and conditions that needs to be fulfilled in order for the transaction to be classified as taxable from the VAT perspective. Further, it provides comparative elements in relation to corporate income tax and how the field of direct and indirect taxes differ.

Chapter 4 presents the analytical part and assesses how different transfer pricing adjustments should be considered from the VAT perspective and whether they have any practical implications.

Finally, the last section provides final thoughts and remarks in relation to the research question and consequences that should be addressed in the future.

2. Transfer pricing

2.1. General information

Transfer pricing has been mostly associated with direct taxation as a more specific branch of corporate taxation between associated enterprises. For many years it has been named the most important tax issue for MNEs, especially when approximately 60% of the world trade takes place between MNEs.[4] In a very narrow meaning transfer price would only be *the amount charged between related parties when they transact*.[5]

However, this simple statement is further defined by a principle that prices agreed on between associated companies need to be calculated according to their open market value, using specific valuation methods depending on the circumstances of each transaction. Therefore, in a broader sense transfer pricing is an international standard that provides guidance on the application of the 'arm's length principle' (ALP) and its' valuation methods for direct tax purposes, of cross-border transactions between associated enterprises.[6]

Depending on the types of goods, services, debt or intangibles transfer pricing developed various valuation methods that allow appraising transactions to ensure that ALP is satisfied. As the internal trading contributes towards determination of expenses as well parts of income, transfer pricing is often used to ascertain profits of associated enterprises for functions they performed, including assets and risks involved.[7] As the transfer of goods and services covers cross-border activity it can be used to alter taxable base for income tax purposes.

In such situation multinational enterprises (MNE) can design their corporate structures (places of management, production, logistics centres, risks, tangible and intangible assets) to shift profits into countries with lower effective tax rates and create deductible expenses in jurisdictions with higher effective tax rates. Transfer pricing, despite providing international framework for pricing internal transactions, is still governed by national tax jurisdictions for the

[4] EY 2013 Global Transfer Pricing Survey, available at: www.ey.com/Publication/vwLUAssets/EY-2013_Global_Transfer_Pricing_Survey/$FILE/EY-2013-GTP-Survey.pdf

[5] Henshall J., *Global Transfer Pricing: Principles and Practice* (Bloomsbury 2013, 2nd ed.) p 1.

[6] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter OECD Guidelines), available online: http://www.oecd-ilibrary.org/docserver/download/2310091e.pdf?expires=1462778775&id=id&accname=oid012043&checksum=36CA25D40A2BBDCF2770969588C264C6 .

[7] Santoro E., 'Transfer Pricing and Value Added Tax in the European Community: Is There Room for Interaction and, If So, Where?', *International Transfer Pricing Journal* (2007 June/July) p 147.

income tax purposes where tax authorities have the power to reassess the transfer price to prevent under- or overstating value of transactions.[8] Nevertheless, if a transaction satisfies the conditions of being cross-border, between two related entities and could be connected to a good, service or any other thing of an economic value, then it must follow transfer pricing regulations.[9]

2.2. Associated enterprises

The very first requirement for the application and assessment of a transfer price is that a transaction must be done between associated enterprises. According to the OECD Model Convention Art 9(1) an associated enterprise can be defined as:

- an enterprise of a contracting state, participating directly or indirectly in the management, control or capital of an enterprise of the other contracting state, or
- when the same persons participate directly or indirectly in the management, control or capital of an enterprise of a contracting state and an enterprise of the other contracting state.

Although both definitions mention the aspect of control, neither specifies a minimum percentage to satisfy the threshold. This might occasionally prove to be troublesome as some countries exercise not only *de jure* relationship between enterprises (such as participation in capital or management) but additionally also *de facto* control situations.[10] MNEs are often made of multiple companies and legal entities and cross-border transactions between each affiliate from a company's perspective are considered to be internal, however from the direct tax purpose those constitute an international supply of goods, services or capital/finance instruments. For that reasons transfer pricing focuses on the economic reality that might go beyond a traditional legal form of an enterprise.

2.3. Arm's length principle

According to the efficiency argument for profit maximisation, companies seek to maximise their own profits as it leads to economic efficiencies and welfare

[8] Duff and Phelps ed., *Guide to International Transfer Pricing: Law, Tax Planning and Compliance Strategies* (Kluwer Law International 2014, 4th ed.), p 12.
[9] *Supra note* 6, OECD Guidelines, p 12.
[10] Dwarkasing R.S.J., 'The concept of associated enterprises', 41 *Intertax* (2013 issue 8/9) p 412.

maximising outcomes.[11] This statement however does not necessarily have to be true from the taxation perspective if there is a link between trading enterprises. The intention behind arm´s length is to ensure fairness of the price based on allocated risks, functions performed, used assets and compare those factors to the price that would be achieved between unrelated parties for similar goods or services. The concept behind ALP is to value transactions and tax profits between associated enterprises as if they were conducted between independent enterprises, taking into account conditions of the market, financial and commercial reality.[12]

It is important to remember that the search of a comparable data is not only related to the type of goods and services, but it also includes a 'functional analysis' of assets, risk and functions performed.[13]

The principle is endorsed by the OECD and applied in Art 9 (the Associated Enterprises) of the OECD Model Tax Convention on Income and Capital,[14] however it is introduced in more detail in Chapter 1 of the OECD Guidelines. As specified in the Guidelines, 'when associated enterprises transact with each other, their commercial and financial relations may not be directly affected in the same way by external forces (…), however there may be a genuine difficulty in accurately determining a market price in the absence of market forces or when adopting a particular commercial strategy. It is important to further adjustment to approximate arm's length, irrespective of any intention of the parties to minimise tax. Thus, tax adjustment may be appropriate even where there is no intent to minimize or avoid tax'.[15]

The underlying purpose therefore is to provide the parity of treatment between associated and independent enterprises as it makes them more equal for tax purposes. The application of the ALP faces difficulties and often requires adjustments, especially when:

- there are no comparable transactions available (e.g. when highly specialised or innovative goods are involved),
- when independent parties would not conclude transaction in question (e.g. licensing of intangibles is more probable to occur between related parties),
- when justification of the price is done many years after the actual transaction took place.

[11] Jensen M.C., 'Value Maximization, stakeholder theory and the corporate objective function', 14 Journal of Applied Corporate Finance (2001) p 8.
[12] *Supra note* 6, OECD Guidelines, p 33.
[13] *Supra note* 5, p 5.
[14] Usually referred as OECD Model Tax Convention.
[15] *Supra note* 6, OECD Guidelines, Chapter I, section A, para 1(2).

The list is not exhaustive and the above represents only few, most common examples. The first one, which focuses on the lack of comparability criterion, is crucial for the overall methodology used in transfer pricing. Regardless of valuation methods used or types of transaction, comparability is a lasting value for the entire transfer pricing system. It is argued that the comparability ensures the objective element in the valuation, while VAT (as will be explained in more detail in the further part) is based on the subjective valuation. The comparability covers multiple factors*, inter alia*, characteristics of types of transactions, whether they cover tangibles, intangibles or service transactions (quality, quantity), functional analysis, terms of the agreement, economic circumstances (overall economic conditions, labour costs, size of the market and competitiveness, etc.) or business strategies (expected expenses for the initial business developments, expectations of profits).[16]

Certain areas might be more difficult to identify and characterise than others, for instance when dealing with service transactions, as often there is no physical transfer that could prove the existence of a transaction (with an exception of travelling professionals) and even the OECD Guidelines definition of a service is not definitive and only specifies types of potential services (e.g. administrative, technical, financial, management, control functions).[17] This specific difficulty occurs also in VAT, as service has only a negative definition of being 'not-goods'.[18]

2.4. Valuation methods

As most tax authorities in the world would require compliance with the ALP, it is not an easy task to ensure the objectivity of the valuation as there are different types of transactions. Until 2010 there was a preference in the Guidelines to use one of the traditional transaction methods (the CUP method, resale price and cost-plus methods), however as in certain circumstances also transactional profit methods were preferred, any of the methods can be used as long as they satisfy the ALP. Another way of grouping valuation methods (rather than as traditional transactions methods and transactional profit methods) is to look who will be tested in the assessment analysis. In that regard we can distinguish one- and two-sided methods.

In most cases valuation methods in order to determine transfer prices would take into account internal and external comparisons when transactions between a taxpayer and an unrelated party take place (internal comparison) or when a

[16] *Supra note* 6, OECD Guidelines, section D.1.2, paras 1.38-1.63
[17] *Ibidem*, para 7.2.
[18] VAT Directive, Art. 24.

transaction is concluded between two independent parties (external comparison).

a) The CUP method

The comparable controlled price method[19] is often described as the simplest and the most accurate, when it is possible to apply. It compares the price in the controlled transaction with the price in a comparable uncontrolled transaction. One of the advantages of the CUP method is how direct it is and when the comparable data is available, it then always allows to set prices according to ALP. However, the method is only reliable when there are no differences in the circumstances of the transaction or when those alternations cannot influence the price (or if those differences could be corrected by means of adjustments).[20] It is not difficult to imagine that in the open market global economy the price can be influenced by a small change of circumstances and any of those changes must be reflected in the price itself. The CUP method is classified as two-sided as the price is dependent on both sides of the transaction.[21]

b) The RPM method

The resale price method measures the gross profit earned for the resale of goods, therefore it is mostly reliable for sales and marketing activities. Any controlled or uncontrolled transactions that might have an impact on the gross margin will later require adjustments. The requirement of comparability is less strict than in the CUP method because the gross margin of sale is for similar types of products. When conducting the RPM method it is important to take into account relevant functions to correctly address risks and undertaken by each entity. OECD strongly recommends that RPM should only be applied when a correct allocation of risks and functions is possible to asses as otherwise the correct evaluation of gross profit will not be possible as the transfer price will not represent the real nature of the transaction. If functions or risks between associated enterprises differ from comparable transactions between unrelated parties then gross margin will require further adjustments.

[19] *Supra note* 6, OECD Guidelines, Chapter II, para 2.13.
[20] See for instance HMRC clarification for the CUP method: http://www.hmrc.gov.uk/manuals/intmanual/intm421030.htm.
[21] UN Commentary on Transfer Pricing http://www.un.org/esa/ffd/tax/2011_TP/TP_Chapter5_Methods.pdf , p 13.

The RPM method is one-sided as only the buyer is assessed and the financial indicator is the resale margin.[22]

c) The Cost+ method

The cost+ method is typically preferred in situations when there is a value added to a product.[23] Often it can cover situations of a sale of semi-finished goods between connected parties (manufacturing and distribution affiliate), long-term buy-and-supply or when the controlled transaction is a provision of services.[24] Requirements for the assessment of controlled transaction in the cost+ method are similar to the RPM – functions and risks need to be addressed accordingly, although the gross profit is measured as a per cent of the costs of sales.

Therefore, the starting point for the assessment of costs incurred by a supplier and a 'plus' percentage is added to establish a profit appropriate to functions and risks carried out by a recipient. The profit is evaluated either based on the so called 'internal comparable' of a supplier in uncontrolled transactions or when the supplier does not enter into uncontrolled transactions then the mark of the profit will be based on the external comparable between independent enterprises in comparable transactions.[25] It is thus evident that the cost base is an important factor and taking into consideration all relevant functions and risks is a key for evaluation of the cost base; if entities have different costs bases then it will require an adjustment (e.g. direct production costs, indirect production costs and general and administrative expenses). The Cost+ method is one-sided and the seller remains the tested party with the financial indicator being the mark-up on the costs of the seller.[26]

d) The TNMM

The transactional net margin method together with the profit-split method represent transactional profit methods. In contrast to the above methods, those two are concerned with measuring the net profit rather than the gross profit margin. The net profit refers usually to a given base (sales, costs, assets) that a

[22] *Ibidem*, p 23.
[23] *Supra note* 7, p 77.
[24] *Supra note* 6, OECD Guidelines paras 2.39-2.55.
[25] HMRC Guidelines on Cost+ Method, available at:
http://www.hmrc.gov.uk/manuals/intmanual/intm421060.htm
[26] OECD Guidelines, http://www.oecd.org/ctp/transfer-pricing/45765701.pdf, p 13.

company earns from its transactions. The method should compare the net margin made from a controlled transaction with the net margin from uncontrolled transactions (internal comparable) or, if such data does not exist, then the net margin made between unrelated enterprises in comparable transactions (the external comparable) will be used as guidance.[27]

Although the TNMM might be less affected by differences in functions, the net result can vary due to factors other than the transfer price or the information needed might not be available at the time. The TNMM is mostly used in less complex transactions when entities do not contribute to unique intangible assets. The TNMM is a one-sided method and the tested party can be either a buyer or a seller. The financial indicator for the former will be the net profits on sales while for the latter it will be the net profit of costs or assets.[28]

e) The Profit Split

This method is also based on the transactional-based method. Some transactions might be so closely linked or integrated that enterprises that separate evaluation could face multiple difficulties in the assessment, therefore the method allocates profits to each entity based on the individual contribution towards overall profits earned in transactions. Profit split unlike other methods reflects two sides as it takes into account not only the return of one of the parties but also the results of the other party. OECD Guidelines emphasises that profits should be split on 'an economically valid basis', which reflects transactions made according to ALP.[29] The contribution analysis uses combined profits from controlled transactions (from all parties involved) and divides them according to the relative value of the functions carried out by each enterprise.

It is important to consider the economic relevance of each function, e.g. what contributed most to the successful sale of a product (innovative R&D, successful marketing, distribution effort, etc.). The second method, the residual analysis also allocates sufficient profits to allow a return for functions input (as compared to transactions between independent enterprises) but it will not take into account valuable intangibles or other contributions.

Then, any profit (or loss) left after basic return allocation would be again split between the parties as if it would have been between unrelated parties – at this stage valuable contributions are taken into account. The OECD suggests that objective criteria should be used rather than subjective ones, as they could be

[27] *Supra note* 6, OECD Guidelines, paras 2.58-2.107.
[28] *Supra note* 27, p 13.
[29] *Supra note* 6, OECD Guidelines, para 2.108.

relevant in the case of joint ventures between independent parties, e.g. assets and capital (operating assets, fixed assets, capital employed) or costs (relative spending, investments in engineering, marketing, R&D).[30] The profit split represents a two-sided method as the financial indicator (profits) is split between both parties to the transaction.[31]

2.5. Objective subjectivity or subjective objectivity?

Although each of valuation methods includes suggestions and guidance and the need for a comparable situation in order to achieve arm's length, there is no exhaustive list as to how the process should be conducted. Moreover, the mechanism of achieving the objectivity is dependent on multiple subjective elements, such as functions performed or risks attached.[32] The objectivity within the area of transfer pricing in therefore not rooted in the general meaning of objectivity, it is based on subjective characteristics of each transaction. However it is the element of comparability (or at least the attempt to find similar transactions between unrelated parties operating in an analogous environment and commercial conditions) that determines the objectivity of transfer pricing. This element should not be underestimated or omitted when assessing the relationship with VAT, because (as explained in more detail in the later part of this paper) the subjectivity of the consideration in a taxable transaction for VAT purpose forms one of its fundamental principles and characteristics.

2.6. Transfer Pricing adjustments

Income distortions between companies may take different forms when related parties' transactions fall outside the AL. However, as indicated by the OECD, transfer pricing is not 'an exact science', therefore it might be possible that more than one method could be applied or due to various elements the AL will not be an exact number, but will fall within a range of acceptable figures.[33] Corrections might be needed when prices specified in controlled transactions or corresponding margins fail to fall into the margins of selected comparables. Thus, should the declared profit be incorrect or fail the specific AL profit, Art 9(1) of the OECD Model allows tax authorities to adjust primary profit that

[30] *Supra note* 6, OECD Guidelines, para 2.135.
[31] *Supra note* 27, p 13.
[32] *Supra note* 7, p 150.
[33] *Supra note* 6, OECD Guidelines, section A.7.1, para 3.55.

serves as a taxable amount for the income tax purpose.[34] Those so-called primary adjustments might also require further application of secondary adjustments in the other contracting state as well as corresponding adjustments. Adjustments can also be voluntary in nature and be conducted by companies themselves when actual financial outcomes differ from the projected results.

The motivation behind compensating adjustments is usually to avoid an official investigation conducted by tax authorities and potential penalties related to it. As transfer pricing is focused on the factual attribution of profits between associated enterprises resulting from internal transactions, then adjustments in profits have to be done accordingly to the existing tax law norm, namely the valuation satisfying the AL.[35] In simple terms the process of adjustment is reciprocal and requires a distribution of profits between associated enterprises: while profits of one enterprise are increased, the counterparty to the transaction has to decrease his profits. As Wittendorff explains: *a transfer adjustment will result either in income or expenses being imputed if the transfer price is below the AL prince, or in income or expenses being reduced if the transfer price exceeds the AL price*.[36]

Despite the importance of transfer pricing adjustments and their potential consequences they have clearly received less attention, even in the professional literature, especially when compared to the guidance on determination of the AL prices and valuation models. Considering the current economic climate when most countries delegate more staff within tax authorities to work with transfer pricing a little guidance has been provided in relation to what happens when a price needs to be adjusted.[37] Such a situation is surprising as the direct consequence of an increased number of staff is also an increased number in adjustments. For instance, Danish tax authorities increased their number of adjustments, especially in relation to IP rights, intra-group royalties and loss-making companies. Adjustments in 2013 in 77 cases were worth approximately 17 billion DKK (comparing to 30 cases in 2008 which resulted in 8.7 billion DKK).

Several types of adjustments can be distinguished and overall description will be provided below. The interaction between specific types of adjustments and VAT will be provided later, after introducing characteristics of VAT.

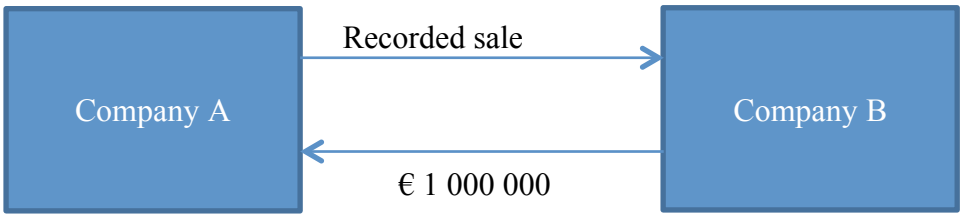
[34] Lasinski-Sulecki K., 'Impact of Transfer Pricing Adjustments for VAT and Customs Law Purposes', *International Transfer Pricing Journal* (2013 May/June) p 174.
[35] Wittendorff J., *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International 2010) pp 16-17.
[36] *Ibidem*, p 17.
[37] Practitioners commentary http://www.thetaxadviser.com/issues/2013/jun/hill-june2013.html.

a) Primary adjustments

Art 9(1) allows tax authorities in a first jurisdiction to make an adjustment of company's taxable profit in order to comply with the AL in transactions with an associated enterprise in a second jurisdiction. OECD Glossary specifies that a primary adjustment is an adjustment that tax administration in a first jurisdiction makes to a company's taxable profits as a result of applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction.[38] It is worth noting that the wording that refers to primary adjustments in OECD Guidelines allows tax authorities to re-assess the pricing of the transaction in order to reflect profits earned by independent parties in comparable uncontrolled transactions and it does not interfere with aspects of contract law specifying terms and conditions of agreements between related parties.

Therefore, if the transfer price is found not to satisfy the AL criteria, then tax authorities have a right to either increase or decrease the transfer price. The application of the primary adjustment can have various consequences, *inter alia*, the increased or decreased tax liability, an additional interest to be paid on the underpaid tax (or in reverse situation a tax payer might receive an interest on an overpaid tax) or an additional penalty for negligence or carelessness. It has been explained that not every primary adjustment has to result in additional penalties and in most cases negligence arises when a company 'does not present sufficient thought to establishing and supporting arm's length transfer pricing policy'.[39] If a business can demonstrate that it had made a reasonable attempt to comply with the ALP then the adjustment will not be followed by a penalty.

The mechanism of primary adjustments can be presented in the following graph:



Arm's length price: € 1.2M

[38] OECD Glossary, http://www.oecd.org/ctp/glossaryoftaxterms.htm.
[39] HMRC TP Manual, http://www.hmrc.gov.uk/manuals/intmanual/intm483120.htm.

Company A received € 1M, but the price according to the ALP has been increased by tax authorities by € 200 000. In consequence the total taxation for company A will be based on € 1M received and the additional € 200 000 while the deduction of company B is only based on € 1M paid (instead of € 1.2M) which results in economic double taxation on € 200 000. The economic double taxation occurs when at least two tax jurisdictions impose tax on the same taxable income.

b) Corresponding adjustments

Corresponding adjustments are mentioned in paragraph 2 of Art 9 as a corresponding mechanism for primary adjustments that is intended to eliminate double taxation that may result from application of primary adjustments. They have been defined as *adjustment to the tax liability of an associated enterprise in a second jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first tax jurisdiction, so that the allocation of profits by the two jurisdictions is consistent*.[40]

However, there has been certain inconsistency between the OECD Model Convention and the OECD Commentary of the Model Convention, namely the Art 9(2) states that if there has been a primary adjustment in the first contracting state, then '*that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits'*.[41] Yet, in the Commentary to the Model Convention it has been stated that '*an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length'*.[42] Further, it clarifies that the adjustment in the other state should only be accepted if tax authorities agree that the adjustment in the first state has been 'justified both in principle and as regards to the amount'.

Therefore, even though corresponding adjustments are aimed and designed to eliminate a potential double taxation, a consensus has not been achieved as to whether they are obligatory or not. In some cases in order to achieve consensus between tax authorities in both jurisdictions the Mutual Agreement Procedure (MAP) is used, based on Art 25 of the OECD Convention. Corresponding

[40] OECD Glossary, *supra note* 38.
[41] OECD Model Tax Convention, Art 9(2).
[42] OECD Commentary, www.oecd.org/berlin/publikationen/43324465.pdf, p 182.

adjustments have also been called 'correlative adjustments' as when they correlate to changes triggered by primary adjustments they will maintain the symmetry between transactions.

It appears that although they are supposed to mirror the relief for primary adjustments it is not certain that it will happen on an automatic basis. In practice corresponding adjustments are made either by 'recalculating the profits subject to tax for the associated enterprise in that country using the relevant revised price or by letting the calculation stand and giving the associate enterprise relief against its own tax paid in that State for the additional tax charged to the associated enterprise by the adjusting State as a consequence of the revised transfer price'.[43]

It is important to remember that primary adjustments together with corresponding adjustments (if allowed) only change the allocation of taxable profits of the MNE group, but they do not alter the fact that excess profits represented by the adjustment are not consistent with the result that would have arisen had the transaction been conducted according to the AL from the beginning. [44] Therefore another type of adjustment – secondary adjustments – might be triggered by the application of primary adjustment which is intended to account for the difference between re-determined taxable profits and originally declared profits.

Corresponding adjustment can be presented as following (example as in primary adjustment):

Arm's length price € 1.2M

Primary adjustment for Company A will be: + € 200 000
Corresponding adjustment for Company B will be: – € 200 000

[43] OECD Guidelines, *supra note* 6, OECD Guidelines, p 141.
[44] OECD Guidelines, *supra note* 6, p 151.

c) Secondary adjustments

Secondary adjustments are not explicitly mentioned in the OECD Model Treaty, however the Guidelines and Commentary both explain the purpose and reasoning behind such adjustments. Similarly to corresponding adjustments the status of secondary adjustments is not clear: neither does Article 9 require implementation of secondary adjustments, nor it forbids their application. Overall, the Guidelines state that 'tax authorities should implements adjustments that would minimise the possibility of double taxation'.[45]

As stated above, primary adjustments and corresponding adjustments only change the allocation of taxable profits of the group of companies for tax purposes. In order to pursue the actual allocation some countries would allow a constructive transaction (a secondary transaction) where excess profits resulting from primary adjustments are transferred in some form and therefore would be also taxed accordingly.

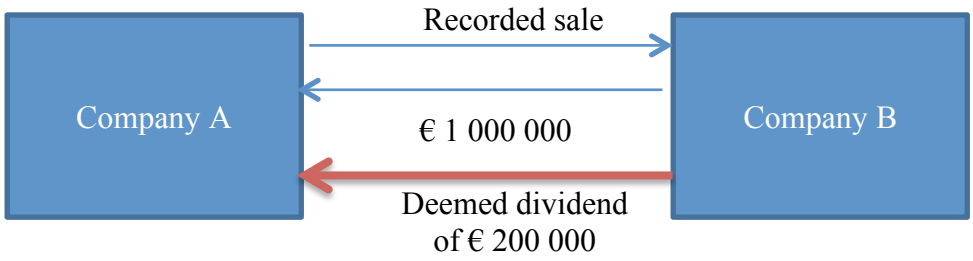
Therefore, secondary adjustments will arise from imposing tax on a secondary transaction in order to make the actual allocation of profits consistent with the primary adjustment. Secondary transactions can take forms of constructive dividends, constructive equity distributions or constructive loans.

As the purpose is to establish a situation as if transactions were conducted according to the AL, they treat the excess profit (that arises from the application of primary adjustment) as if it was transferred in some form and thus, resulting in a need for an additional taxation – which would be consistent with profit allocation from primary transfer pricing adjustments; if dividends are used to account for the secondary transaction they might be subject to a withholding tax or imputation of interest on a constructive loan.[46] EU Joint Transfer Pricing Forum in its latest report addressed the implications of secondary adjustments and urged Member States to recognise that on this type of adjustments no withholding tax should be applied over constrictive dividends or constructive capital distributions according to the EU Parent Subsidiary Directive.[47]

[45] *Ibidem*, para 4.71.
[46] Bakker, *supra note* 1, p 213.
[47] Council Directive 2011/96/EU of 30 November 2011 on the Common System of Taxation applicable in the case of parent companies and subsidiaries of different Member States, Art 4-5.

The mechanism of secondary adjustments can be presented as following:

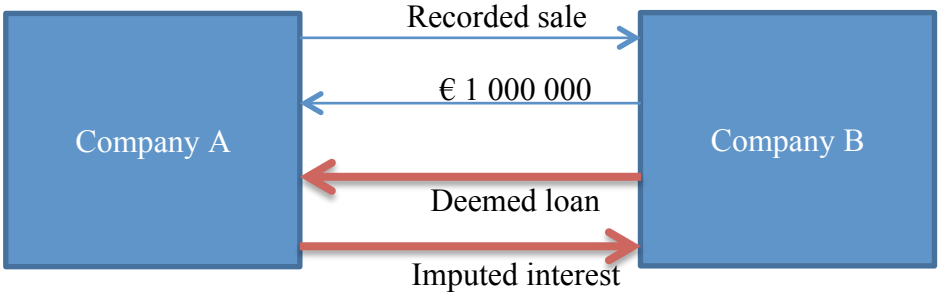
With a Constructive Dividend



Arm's length price: € 1.2M

In this case not only profits will be adjusted (and taxed accordingly) but also the actual transaction transferring the funds will be conducted, subject to withholding tax (e.g. 20%) therefore the adjustment will lead to additional € 40 000 in withholding tax on the constrictive dividend.

With a Constructive Loan



Arm's length price € 1.2M

In this scenario the constructive loan will also be taxed according to the amount received from the interest.
E.g. If the interest of the loan is 6% then € 200 000 x 6% = € 12 000
Tax: 33% x € 12 000 = € 3 960

d) Compensating adjustments

In the OECD Glossary those are characterised as '*adjustment in which the taxpayer reports a transfer price for tax purposes, that is in his opinion, an arm's length price for a controlled transaction, even though this price differs from the amount actually charged between associated enterprises. This adjustment would be made before the tax return is filed'*.[48] Although there is no direct reference in the Model Treaty, the methodology can be indirectly implied from the wording of Art 9(2), however the changes in the transfer price are done by taxpayers themselves instead of a review conducted by tax authorities. Nevertheless, not all OECD Members do in fact recognise compensating adjustments (to the extent that some countries ban the use of this method),[49] even though the possibility of exercising compensating adjustments does not preclude tax authorities from conducting an investigation or rejecting adjustments done by companies. Compensating adjustments have been considered as a 'self-help' measure that allows achieving the AL and minimising the risk of adjustments ordered by tax authorities (although as mentioned, the use of compensating adjustments does not exclude a possibility of further adjustments).[50]

For some types of transactions it might be difficult to establish an adequate transfer price that would satisfy the AL due to a little data available at the time, therefore companies should have a possibility to later adjust the price once they have sufficient information. This might lead to difficulties if one of the contracting states does recognise the procedure and local tax authorities would accept the amount of the adjustment, but the other contracting state does not allow it (or the local tax authorities disagree as to the amount). It might also limit the administrative burden, as they can be done monthly, quarterly or yearly before the tax return is filed.

Compensating adjustments can take different forms, e.g. in adjustments of operating expenses or an increase in transfer prices by means of a credit not or additional invoice.[51] By doing so it is not intended to change the cash position between involved enterprises, but only to establish their income according to the AL. However, the balancing payment between related enterprises might be required in order to fully reflect the cash effect (e.g. secondary adjustments). Additional payments in a form of balancing payment from the perspective of income tax can be treated as a capital contribution or a dividend.[52]

[48] OECD Glossary, http://www.oecd.org/ctp/glossaryoftaxterms.htm#c.
[49] OECD Guidelines*, supra note* 6, chapter III, para 4.39, p 143.
[50] Pfeiffer S., and Ursbrung-Stehdl M., *Global Trends in VAT/GST and Direct Taxation* (Linde 2015) p 301.
[51] Santoro, *supra note* 7, p 158.
[52] *Ibidem*, p 158.

3. VAT

3.1. The purpose of VAT versus corporate income tax

Thomas Hobbes already in XVII century argued in his *Leviathan* that consumption is a valid base for taxation as people should pay for the withdrawal of limited resources available to the society.[53] The modern understanding of the value added tax provides (in short) that it is 'a general, broadly based consumption tax assessed on the value added to goods and services, and which can be imposed on all commercial activities or at any stage of production process and to be borne by consumers.'[54]

The first definition of VAT in the First VAT Directive described it as 'involving the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged. On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components'.[55] A description provided by the European Commission specifies that VAT is applied 'to all transactions carried out in the EU for consideration by a taxable person that supplies goods or services in the course of business.'[56]

The introduction of the harmonised VAT helped in further development of the internal market where restrictions of cross-border trade should be abolished, based on the principles of free movement of goods, services and persons. This also gave the origin to yet another principle characterising VAT as neutral: that similar types of transactions, services and goods should carry the same tax burden.[57] Even from this short description one should be able to extract important characteristics of VAT, which at the same time can be also contrasted with corporate income tax used for the purpose of transfer pricing.

Firstly, VAT is a turnover tax and is applicable to each individual transaction, while the corporate tax that covers transfer pricing assesses overall profits and

[53] Schenk A., *Value Added Tax: A Comparative Approach* (Cambridge University Press 2015, 2nd ed.) p 8.
[54] Explanation of VAT, http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/index_en.htm
[55] First Council Directive of 11 April 1967 on the harmonization of legislation on member states concerning turnover taxes (67/227/EEC) now Art 1 of the VAT Directive.
[56] Commission report http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=URISERV%3Al31057.
[57] Lang M., Melz P., Kristoffersson E., *VAT and Direct Taxation: Similarities and Differences* (IBFD 2009) p 18.

losses, including all functions and risks borne. Secondly, VAT is a consumption tax paid by a final consumer but the tax is not collected directly from him. The process of collection usually involves the offsetting mechanism when successive taxpayers are able to deduct input VAT for purchases and account for the output VAT, while in transfer pricing companies are individually liable for profits taxation. Due to the mechanism of deductions and that the tax is essentially borne by the final consumer it is less prone to tax evasion strategies (although as it will be explained later it may differ when one of the related parties to the transaction does not have a full right to deduct, which is mostly present in financial sector due to the exempt nature of this type of transactions).[58] Thirdly, the valuation based on consideration agreed between parties makes VAT subjective in nature as opposed to objectivity based on comparability in assessment of the AL for transfer pricing purpose.

This can naturally be contrasted with conclusions reached in 2.5 that transfer pricing searches for objective criteria for the purpose of price valuation. Having said that, Art 80 considerably changed this approach since its introduction in 2006 when Member States were given a general permission to reassess the taxable amount using the open market value standard.

3.2. Key concepts of VAT

The main focus of this paper is to assess whether, and if so, under which circumstances transfer pricing adjustments could lead to VAT liabilities. 'The VAT liability' should be understood as a situation in which VAT becomes due, therefore a transaction is considered to be taxable or in other words it constitutes a supply for consideration. Art 2 provides specific criteria which establish that a transaction should be subject to VAT if it:

i) constitutes a supply of goods, services or importation of goods[59],
ii) is supplied for consideration, and
iii) is made by a taxable person acting as such.

Transactions that fall outside the scope of Art 2 will not be subject to VAT (which also means that costs incurred as input VAT will not be deductible). Although above elements create a general model for the assessment whether a transaction could be subject to VAT, the CJEU throughout the years has

[58] Art 135 VAT Directive.
[59] As mentioned in delimitation section, this paper does not deal with customs valuation, therefore this section will only refer to related parties transactions not qualifying as importations.

explained in more detail the legal character of the VAT system, its subject matter and the scope, concepts of the direct and immediate link between transaction and consideration received or the legal relationship between the activity and the payment. The evaluation of whether transaction is taxable is a multistage process in which elements are closely linked and are never assessed in isolation. It is not always easy or self-explanatory in which particular order various elements should be discussed due to multiple reasons: some of the concepts are not explicitly defined in the Directive and occur multiple times under various sections (e.g. consideration), additionally in relation to transfer pricing connections they can arise at different stages. For clarity purposes the assessment will follow the chronological order of the Directive, however certain cross-references might be made also in relation to the case law development and comparison elements of transfer pricing.

3.3. Taxable person

Art 2 provides that supplies made by 'a taxable person acting as such' will be subject to VAT. Further Art 9 defines that 'taxable person' means *any person who independently carries out in any place any economic activity whatever the purpose or the result of that activity*.[60] The definition covers not only individuals carrying out business activities or self-employed but also legal persons: private and public companies, joint ventures, partnerships, etc.; additionally for VAT purpose it is irrelevant what status does an entity have for income tax purposes.[61]

On the other hand, the second part of the definition 'acting as such' has never been defined either in legislation or by the Court. It might lead to difficulties in situations when certain forms of economic activities are conducted but it is questionable whether they were done in a capacity of a taxable person acting as such. For instance, in principle public bodies are not taxable persons (Art 13) but only if they carry out activities in their capacity as public authorities. If a local authority is involved in a private sector activity with characteristics of a private investor then it will be regarded as a taxable person for those activities as non-taxation could lead to distortion of competition.[62]

Economic activities *comprise any activity of producers, traders or persons supplying services, including mining and agricultural activities or activities of*

[60] Art 9(1) VAT Directive.
[61] Terra B. and Kajus J., *A Guide to the European VAT Directives: Introduction to European VAT vol.1* (IBFD 2013) p 369.
[62] EU Commission, http://ec.europa.eu/taxation_customs/taxation/vat/topics/taxable_persons_en.htm

the professions.[63] Although the definition is rather broad, the CJEU had to provide that it also requires a certain degree of interference in management, therefore so called 'pure' holding companies whose only activity concerns holding of shares are not taxable persons for VAT purpose.[64]

Moreover, according to AG Kokott in a Geemente Borgese there is a certain link between the level of remuneration and the existence of economic activity.[65] Her subsequent analysis concludes that '*after all, an activity which, under normal system of VAT, can give rise only to tax refunds, on account of the structure of the unit costs and prices connected with that activity, does not lead to any taxation of 'added value' because, structurally, no such added value can be generated'*. The comment regarding the 'added value' is especially important as it emphasises the nature of VAT as a consumption tax when a positive value is created in the course of the economic activity. This yet again emphasises the difference between income tax and indirect taxation. Further comments evaluating this implication are discussed in chapter 4 under subsection Transfer Pricing as a distribution of wealth.

Although Art 9 specifies that persons who act independently should be considered as taxable persons, Art 11 gives discretion to Member States to treat related parties, established within the territory of a given Member State as a single taxable entity even though they are legally independent, provided that they are *closely bound to one another by financial, economic and organizational links*.[66]

3.4. Taxable transaction

a) Supply of goods or services

As mentioned in 3.2.(i), subject to VAT are supplies of goods (Articles 14-19), certain intra-Community acquisitions (Articles 20-23), supplies of services (Articles 24-29) and importations. From the VAT perspective it is important to distinguish the difference between goods and services because different rules might apply, for instance rules in relation to establishing the place of supply, VAT rate, chargeable event, which set of rules needs to be used to determine the right of deduction.

[63] Art 9(1) VAT Directive.
[64] Judgment in *Polysar*, C-60/90, ECLI:EU:C:1991:268.
[65] AG Opinion in *Gemeente Borsele*, C-520/14, ECLI:EU:C:2015:855, para 66. See also Judgment in *Commission v Finland*, C-246/08, ECLI:EU:C:2009:671, para 50 and judgement in *Hotel Scandic*, C-412/03, ECLI:EU:C:2005:47, paras 22 to 24.
[66] Art 11 VAT Directive.

Art 14 specifies that 'supply of goods' means the *transfer of the right to dispose of tangible property as an owner*.[67] Tangible property should be understood as any physical good, furthermore Art 15(1) establishes that gas, heat, cooling energy and the like should also be treated as tangible property.

Art 24 defines supply of services as 'any transaction which does not constitute a supply of goods'. Although Art 25 provides examples of services (the assignment of intangible property, the obligation to refrain from an act or to tolerate an act or situation), the definition of a service is nevertheless not self-explanatory as it is presented in the form of a negative definition – a service might be anything that is not a good, for instance providing goods to someone or producing goods from someone else's materials will also be considered as a supply of a service. The Directive does not provide further distinguishing qualities or features, however, based on the case law, the meaning of a service should be understood extensively in order to assure the broad application of the Directive.

b) Consideration

The notion of consideration is one of the most crucial concepts in the VAT directive (for the purpose of taxable transaction as well as for the determination of taxable amount). Yet, there is no definition of consideration in the Directive. The Second EC VAT Directive Annex A13 provided the explanation that '*the expression consideration' means everything received in return for the supply of goods or the provision of services, including incidental expenses (packing, transport, insurance, etc.), that is to say not only the cash amounts charged but also, for example, the value of goods received in the exchange or, in the case of goods or services supplied by order of a public authority, the amount of compensation received'*. Although the Second Directive is no longer in force, the CJEU seems to be following this definition, for instance in a recent decision in *Grattan plc v HMRC*.[68]

In general terms consideration can be therefore understood as a form of payment for the supply of goods or services. Although in most cases it will be a monetary payment, consideration can also have a non-monetary nature, for instance when another service or a good is supplied in return (consideration paid 'in-kind'), or consideration will be only partially expressed in money.

Already in *Goldsmiths*, the Court expressly held that transactions in money and in kind are similar from the VAT perspective and are subject to the same

[67] Art 14 VAT Directive.
[68] Judgment in *Grattan v HMRC*, C-310/11, ECLI:EU:C:2012:822, paras 6 and 21.

rules.[69] Moreover, in *Serebryannay*[70] the Court ruled that the supply of services consisting of fitting and furnishing an apartment (done by a taxable person) in exchange for the right to use that apartment should be regarded as a supply for consideration in the light of Art 2(1)(c). In cases concerning barter exchange the consideration in kind should be capable of being expressed in monetary terms.[71]

It is important to realise that a taxable transaction, as explained in Art 2(1), is not barely a supply of goods or services, but in order to fall within the scope of VAT it has to be affected by consideration. The following situations will further explain the role and the meaning of consideration in the VAT system. Subsections below regarding various assessment of consideration follow the methodology suggested by Ben Terra and Julie Kajus.[72]

i) Transactions without consideration

In *Hong Kong Trade Development* case[73], the Court decided whether providing information and advice without a charge could be considered a taxable transaction. The Council was partly financed by the government and partly from import levies on products imported into Hong Kong. However, no fees were charged on bodies receiving the advice. The Court decided that *'if an activity consists exclusively in providing services for no direct consideration, there is no basis of assessment and the free services in question are not subject to VAT (...). In those circumstances services provided free of charge are different in character from taxable transaction, which presuppose the stipulation of a price or consideration'*.[74]

ii) Payments, distribution of profits and other financial transactions

Hong Kong case considered a situation when a service is provided without receiving a direct payment from the beneficiary of that service. It is worth considering what the position in a mirror situation is when a payment is received without providing an expressly linked service. Such situation has been often considered by the CJEU in relation to the issue of shares or dividend

[69] Judgment in *Goldsmiths*, C-330/95, ECLI:EU:C:1997:339.
[70] Judgment in *Serebrannay*, Case C-283/12, ECLI:EU:C:2013:599.
[71] Judgment in *Bertelsmann*, C-380/99, ECLI:EU:C:2001:372, para 17.
[72] Terra, Kajus, *supra note* 61, pp 350-361.
[73] Judgement in *Hong Kong Trade Development*, 89/81, ECLI:EU:C:1982:121.
[74] *Ibidem*, para 10.

payments. *Polysar*[75] was one of the first cases that started the discussion over the status of dividends for VAT purposes (although those type of dispute usually concerned the question whether payment of dividends should be considered as a taxable transaction in order to obtain the right to deduct input VAT).

Polysar BV was established in the Netherlands and hold shares in multiple companies. It received dividends and paid out dividends to the parent company in Canada. The Dutch Polysar deducted input VAT which was questioned by the Dutch tax authorities. The Court ruled that holding shares cannot constitute an economic activity and therefore a holding company cannot be considered a taxable person. Additionally, it was noted that as transactions without payments are not subject to VAT, therefore payments without transactions are to be treated in a similar manner. However, in para 14 the Court concluded that 'it is otherwise where the holding is accompanied by a direct or indirect involvement in the management', which later gave rise to several cases discussing the status of dividends.

In *SATAM*, it was decided that dividends did not represent consideration for any supply within the meaning of the Sixth Directive, and therefore dividends should be excluded from the calculation of the deductible proportion.[76] *Flordienne*[77] brought up a problem of dividends paid in relation to management services, and specifically the comment from para 14 , whether an involvement can make a holding company a taxable person and therefore whether a payment of dividends can constitute a consideration for supply of services. The Court decided that the receipt of a dividend is not a consideration for a taxable supply. Other cases, e.g. *Welthgrove*,[78] *EDM*[79] also dealt with similar issues.

One of the more important cases discussing the relationship between consideration, supply and the understanding of dividends was *Kretztechnik*.[80] The company wanted to increase its capital by issuing additional shares for which it incurred certain costs including VAT, which Kretztechnik wanted to deduct. The question referred was whether the issue of new shares could be considered as a supply for consideration. Firstly, the Court rejected the possibility that issuing of shares could fall within supply of goods (now Art 14) as the issue of new shares represents transfer of ownership of an intangible property, while supply of goods is only concerned with the disposal of ownership of a tangible property. Then the question remained whether it could

[75] *Polysar*, *supra note* 64.
[76] Judgment in *SATAM*, C-333/91, ECLI:EU:C:1993:261, paras 13-14.
[77] Judgment in *Floridienne and Berginvest*, C-142/99, ECLI:EU:C:2000:623.
[78] Judgment in *Welthgrov*e, C-102/00, ECLI:EU:C:2001:416.
[79] Judgment in *EDM*, C-77/01, ECLI:EU:C:2004:243.
[80] Judgment in *Kretztechnik*, C-465/03, ECLI:EU:C:2005:320.

be considered as a supply of service. The Court explained that the issue of shares has its primary objective in raising capital, rather than to provide a service. A company receiving payment has a primary objective raising capital and not providing a service, which also corresponds to the conclusion that payment for shares is not a consideration but an investment.[81] The decision cleared that, in this specific case, it was not relevant whether the payment constituted consideration because, at the first place, there was no taxable transaction within the meaning of Art 2(1).

It can be summarised that a payment will only be classified as consideration if it is received for a taxable transaction resulting from economic activities. This is generally not the case of payments arising simply from the ownership of an asset.[82] Additionally, consideration should not be confused with the concept of profit – even the notion of the economic activity does not require an entity to make a profit in order to fall within the scope of VAT Directive. If a transaction does not generate profit it does not mean that there was no consideration. Furthermore, when turning into the nature of VAT of being a tax on consumption it may seem more apparent why distribution of dividends should not be considered as a taxable transaction. Dividends, similarly to savings can be seen as distribution of wealth. But certainly they are not consumption. If VAT was to be included as tax on redistribution of wealth it would turn into tax on income (see chapter 4.5).[83]

iii) Transactions for consideration: direct and immediate link

The direct link is not explicitly mentioned in the VAT Directive, rather, it has been often emphasised by the Court that Art 2(1) presupposes that the supply is effected for consideration only if there is a direct link between goods and services delivered and payment received (in money or in kind). One of the first cases that evaluated on the relationship between the consideration and supply was so-called the Dutch potato case (*Cooperative*).[84] It involved a co-operative that offered cold storage facilities to its members. The possibility to use the facility was a result of the share that every member had in the co-operative. Normally, a fixed annual charge applied for the use of the storage, however for 2 years the co-operative did not charge any fees, which resulted in a lower value of shares. Dutch tax authorities reassessed VAT arguing that the lower

[81] Terra, Kajus, *supra note* 61, p 1209.
[82] Judgment in *Empresa de Desenvolvimento Mineiro*, C-77/01, ECLI:EU:C:2004:243, para 49.
[83] Terra, Kajus, *supra note* 61, p 352.
[84] Judgment in *Cooperative*, 154/80, ECLI:EU:C:1981:38.

value of shares was effectively the consideration for the storage facilities as no extra fee was applied.

The Court disagreed with such reasoning and stated that there was no direct link between the service of storage and the alleged consideration, namely the lower value of shares. It stated in para 13 that *there must be a direct link between the service provided and the consideration received, which does not occur in a case where the consideration consists of an unascertained reduction in the value of the shares possessed by the members of the cooperative and such a loss of value may not be regarded as a payment received by the cooperative providing the service*.[85] Furthermore, the Court added that consideration should be capable of being expressed in monetary value and that it is a subjective value as *the basis of assessment is the consideration actually received and not the value assessed according to objective criteria*.[86]

Apple & Pear Development[87] and *Kennemer Golf*[88] both considered the status of fixed membership fees and potential benefits obtained, however their outcomes were different. The former involved a fixed membership fee for a statutory body established to promote the sale of apples and pears. The annual fee was based on the size of the land. HMRC ruled that the body should not be entitled to VAT deduction as it did not conducted a business service in the meaning of the VAT Directive. The Court agreed by stating that there was no direct link between consideration and the service as: 1) the payment was a mandatory charge imposed on farmers and 2) it was impossible to assess the level of benefits resulting from the promoting of sale for each individual member based on the annual fees paid.

The second case might appear to have a similar scenario, yet the outcome was opposite to the decision reached in the *Apple & Pear* case. Kennemer's dispute arose around a golf country club that was charging its member a fixed annual fee for a possibility of using its sport facilities. However, not every member was using facilities, therefore it should be in a similar position to an individual apples' grower who could not assess his individual benefit resulting from fees paid to the promotion association. However, the Court took the stand that the fact that not every member of the country club exercised his option did not change the reciprocal performance between members and the association. The possibility of using facilities was considered to be a supply of a service on a permanent basis and not only upon a specific request. Therefore there was a direct link between the supply of a service and consideration paid.

[85] *Cooperative*, *supra note* 84, para 13.
[86] *Ibidem*, para 13.
[87] Judgment in *Apple & Pear Development Council*, 102/86, ECLI:EU:C:1988:120.
[88] Judgment in *Kennemer Golf & Country Club*, C-174/00, ECLI:EU:C:2002:200.

The notion of a direct link additionally highlights the subjective value of consideration. In *BAZ Bausystem*[89] German tax authorities wanted to account VAT on a payment for a supply and 5% interest that was awarded by the local court as a compensation for the late payment. The CJEU disagreed and stated that the payment interest has no connection to the supply of service and should not be assessed as a consideration for a commercial transaction as it merely represented the form of compensation for the late payment. As the interest payment was awarded by a national court it was only remotely connected to the taxably transaction and the supply as agreed between the parties. Additionally, in *Midland Bank*[90] it was further evaluated that the adjective 'direct' means *there cannot be the appropriate link between two transactions where a third transaction takes places between them breaking the casual chain, or where the link between two transactions is very distant in time*.[91]

iv) Legal relationship

In order to satisfy the direct link criterion there must be a legal relationship between parties to the transaction. The legal relationship criterion presupposes that there must be reciprocity of performance between supplier and recipient of goods or services. The indication that the legal relationship is essential for consideration to be corresponding to a supply is also a reason why fees and penalties awarded by courts are not acknowledge as part of consideration for the VAT purpose.

The meaning of legal relationship has been evaluated on in the case of a local barrel organ player and donations he received from passers-by. Mr Tolsma was charged with VAT by local tax authorities for the supply of service. He appealed the decision and argued that his activity was not covered by the scope of VAT. The CJEU in a referred question stated that *a supply of services is effected for consideration within the meaning of Art 2(1), only if there is a legal relationship between the provider of the service and the recipient pursuant to which there is reciprocal performance, the remuneration received by the provider of the service constituting the value actually given in return for the service supplied to the recipient*.[92]

The legal relationship represents therefore a form of a contractual performance, where both parties feel obliged to execute their obligations. In this case the Court was of the opinion that performance by Mr Tolsma was not guaranteed

[89] Judgment in *BAZ Bausystems*, C-222/81, ECLI:EU:C:1982:256.
[90] Judgment in *Midland Bank*, C-98/98, ECLI:EU:C:2000:300.
[91] *Midland Bank, supra note* 90, para 29.
[92] Judgment in *Tolsma*, C-16/93, ECLI:EU:C:1994:80, para 14.

to receive anything in return, and also that payments contributed were not necessarily dependent on the music service, therefore there was no link between donations and music played.

The need for existence of legal relationship between parties has been challenged in the *FCE Bank* case.[93] The case examined whether services supplied by the head office to its branches fall within the scope of Art 2(1) as a taxable supply for consideration. As a bank, FCE performed mostly financial services, which are VAT-exempt, but it supplied its branches with several services, such as management, personal training, IT services, etc. Costs were split between various branches. Although at first the Italian branch applied the reverse charge and consequently paid the VAT it later claimed it back arguing that there should be no VAT applicable as there is no separate legal personality between the head office and its branch.

According to the Court it was essential to establish whether there was a legal relationship between FCE Italy and the head office. In order to determine whether there is a legal relationship between the head office and its branch it was necessary to assess whether a branch was capable of carrying an independent economic activity. The elements that were taken into consideration were *inter alia* the capability of bearing economic and financial risks, independence of decision making and the need for supervision. It was examined that as a branch, FCE Italy was dependent on FCE Bank, it did not have any endowment capital and all risks associated with carrying out an economic activity were placed upon the head office.[94]

Interestingly, the Court disregarded the OECD guidance on permanent establishment and economic activity by saying that OECD Convention was irrelevant, since it is concerned with direct taxation whereas VAT is an indirect tax.[95] Therefore, for the purpose of VAT, fixed establishment (branch) is not a separate legal entity as it merely forms a part of another establishment and in consequence should not be treated as a taxable person in the light of Art 2(1) and 9(1). Therefore, according to the *FCE* ruling, transactions between head offices and branches are not subject to VAT as they do not fulfil the requirement of legal relationship.

Due to the ruling in *FCE Bank,* for quite some time services supplied between heads offices and their fixed establishments were considered to fall outside the scope of VAT as the Court consistently held that it is not possible to make a taxable transaction between two bodies that belong to the same legal entity. Yet, when in September 2014 the CJEU handed its ruling in *Skandia* case, many have thought that FCE Bank decision was overruled.

[93] Judgement in *FCE Bank*, C-210/04, ECLI:EU:C:2006:196.
[94] *FCE Bank, supra note* 93, para 37.
[95] *Ibidem*, para 39.

The facts of *Skandia* were to a large extend similar to the situation in *FCE Bank*, with the difference that the head office was located in the U.S. and the Swedish branch was a member of a VAT group, subject to Art 11. One of the main questions was whether the membership in the VAT group made the branch an independent entity from its head office and therefore a supply of services could be considered as a taxable transaction (supply for consideration). Advocate General Wathelet in his opinion followed the reasoning established in the *FCE Bank* case, namely that a branch cannot belong to a VAT group independently, without the primary establishment and consequently cannot become a separate legal person, independent from the company it belongs to, and therefore is not capable of being a part of a VAT group on its own.[96]

Nevertheless, the Court despite the initial reference to the *FCE Bank* case and repetition that as a branch, *Skandia Sverige* could not operate independently from its head office, has recognised that Skandia Sverige was a member of the VAT group and therefore together with other members formed a single taxable person for the VAT purpose. Consequently, when the head office located in a third country supplied a service to a branch, the supply has to be regarded as a supply to the VAT group. In that regard the supply of services between the head office and a branch that belongs to a VAT group constitutes a taxable transaction in the meaning of Art 2(1) of the VAT Directive. The Court unfortunately did not go much into depth to provide a clear explanation for its reasoning. A main conclusion from Skandia is that a branch by joining a VAT group, dissociate itself from its head office and other branches.[97]

For some it might be surprising that economic factors taken into account in *FCE Bank* case which were supposed to determine the dependency status between a branch and head office were of less importance in Skandia in comparison to the membership in the VAT group. The *FCE Bank* case essentially referred bank to Tolsma test and the question whether the dependent nature between the head office and its fixed establishment can amount to reciprocal performance was answered in negative. It appears that in Skandia the existence of the VAT group altered the conditions for determination of the independence status and opened the possibility for the reciprocal performance criterion.

As mentioned, consideration is a comprehensive concept that is consisted of several elements that are strictly connected to each other. From the presented case law one can distinguish three main principles governing the notion of consideration: 1) that there must be a direct link between the supply provided

[96] Cornielje S., and Bondarev I., 'Scanning the Scope of Skandia', *International VAT Monitor* (2015 January/February) p 19.
[97] Terra B., Kajus J., Henkow O*., Commentary on Skandia Sverige* (available at IBFD database) p 8.

and consideration receives, 2) consideration must be capable of being expressed in money, 3) consideration is a subjective value as the basis for it is payment actually received (in money or in kind).[98] Moreover, consideration serves as a basis for establishing a taxable amount to which specific VAT rates are applied as a percentage of the taxable amount.

3.5. Taxable amount

Although this work is intended to assess VAT liabilities in a situation of transfer pricing adjustment, it is necessary to introduce key aspects of a taxable amount due to its importance for the notion of consideration. Rules and principles on the taxable amount can be found in Title VI of the VAT Directive. The opening chapter 1 provides in Art 72 the definition of the open market value (OMV) as *the amount that a customer at the same marketing stage 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*.

This introduction to the taxable amount might be somehow misleading, because in VAT (in principle) not an objective but a subjective value is applied.[99] It can be found in Art 73 that the taxable amount *shall include everything which constitutes consideration obtained by the supplier in return for the supply, including subsidies directly linked to the price of the supply*. Therefore, other taxes, duties, levies, charges (but excluding VAT itself) incidental expenses such as commission, packing, transport and insurance cost charged by the supplier to the customer are also included in the taxable amount.[100] The Directive provides also a guidance what should not be included in the taxable amount, *inter alia,* price reductions by way of early payment, price discount and rebates offered at the time of supply and also disbursements.[101]

Establishing what constitutes consideration and what should be seen as taxable amount is not always straightforward. An interesting example can be seen in *Naturally Yours*.[102] The company was selling cosmetics at wholesale prices to its consultants who later sold products at a recommended retail price during home parties. Hostesses of those parties could purchase specific cream at a price £1.50 while the recommended high-street price was £10.14. The

[98] *Cooperative, supra note* 84.
[99] *Terra, Kajus, supra note* 61, p 679.
[100] Art 78 VAT Direcetive.
[101] Art 79 VAT Directive.
[102] Judgment in *Naturally Yours Cosmetics*, 230/87, ECLI:EU:C:1988:508.

company accounted for VAT based on the discounted value of the product, however British tax authorities argued that the taxable amount was £10.14. As it was explained above, consideration is represented by a subjective valuation between the parties. Yet, at the same time the taxable amount should include everything that was received in the exchange for the supply. Moreover, consideration can be expressed in money, in kind as a barter exchange or both in money and in kind. The CJEU agreed with HMRC and stated that the taxable amount was £10.14 as the consideration was expressed in money (£1.50) and in the service of hosting a party that was valued at £8.64 (£10.14 - £1.50). The Court pointed out that the reduction in price was only available if the home party took place, therefore the hosting event had its value to Naturally Yours. Consequently there was a direct link between the supply of the cream at a reduced price and the service provided by the consultant.

The crucial role of the subjectivity in relation to consideration and in turn also to the taxable amount has been emphasised by the Court on multiple occasions, however it has to be remembered that it has its justification in the principle of neutrality, which is fundamental for the VAT as a system. Art 1(2) of the Directive gives the basis for the principle of fiscal neutrality by stating that, as far as possible, VAT should be neutral to competition and the tax should only be borne by the final consumer. This can be achieved thanks to two mechanisms; firstly, full passing-on of the VAT at each step of the production and distribution and secondly, the production and distribution chain must be entitled to deduction of the input VAT. In consequence, at the end of the process of passing-on (end-consumer) the taxable amount is calculated based on the consideration actually obtained.[103] This is one of the reasons why VAT is less prone to the need of re-valuation (in contrast to transfer pricing) and, according to the general principle, any re-evaluation of the taxable amount would be contrary to the VAT system as it would undermine the principle of fiscal neutrality. Even between related parties the VAT aspect of transaction would be less problematic as the tax burden is passed on the final consumer.

The VAT system allows to change and adjust the taxable amount to fully represent the subjective value concluded between the parties. Art 79 of the Directive provides *that price reductions by means of early payments, discounts and rebates should be included in the taxable amount*. This allows to adjust the correct VAT amount in case of downwards corrections.

Yet, it does not mean that VAT is free from the tax abuse. Specific types of transactions between related parties, most commonly when one of the parties does not have a full right of deduction (or when the right is limited) are more probable to be under- or overvalued (in comparison to OMV). This was the reason why in 2006 the VAT Directive was amended and introduced an

[103] Lang, Meltz, Kristoffersson, *supra note* 57, pp. 880-881.

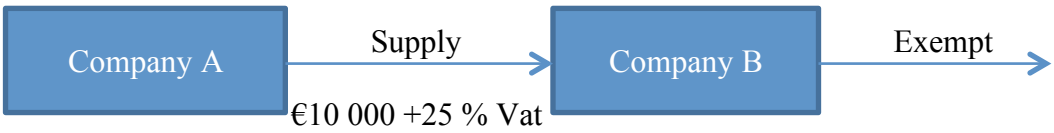
optional transfer pricing provision in Art 80. In short, Art 80 allows Member States to re-evaluate the taxable amount in sales between related parties in a number of specifically listed situations:

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;
b) Where the consideration is lower than the open market value and the supplier does not have a full right of deduction;
c) Where the consideration is higher than the open market value and the supplier does not have a full right of deduction.[104]

The Court in *Balkan and Sea Properties* reminded that Art 80 constitutes an exception to the general rule, therefore must be applied strictly and only according to the specified criteria. Member States cannot apply it outside the specified conditions, however they are allowed to use other methods to address the problem of tax evasion.[105] Despite the possibility to re-evaluate the taxable amount by tax authorities the general rule remains that *the taxable amount for taxable transactions must include everything which constitutes consideration actually obtained, and not a value calculated by the tax authorities in accordance with objective criteria*.[106]

Graphs below present situations in which the general mechanism of VAT deductions might be abused and therefore Art 80 might be applied together with the OMV instead of the subjective valuation[107].

Ad. a)

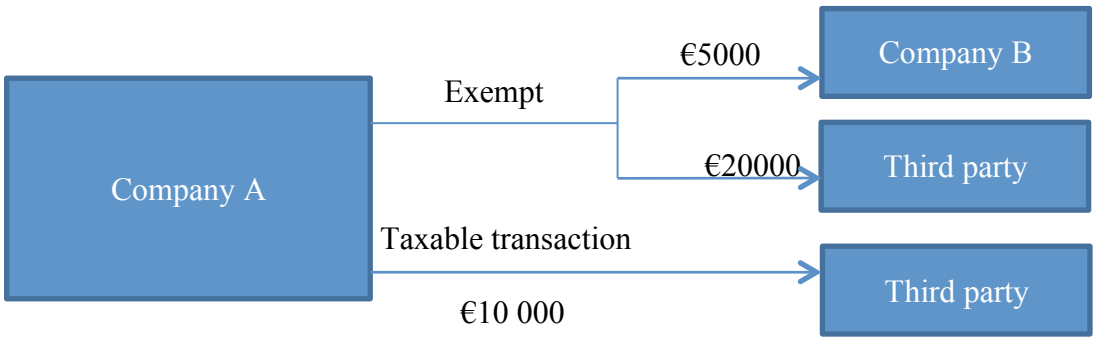


If companies A and B are related and they operate in the building and real estate sector when A builds and B rents out the premises (which is an exempt activity according to Art 135(l)) then B is not entitled to deduct input VAT on

[104] Art 80(1)(a)(b)(c) VAT Directive.
[105] See for instance judgment in *Balkan and Sea Properties,* C-621/10, ECLI:EU:C:1988:508, para 52.
[106] Judgment in *Elida Gibbs*, C-317/94, ECLI:EU:C:1996:400, paras 18-24.
[107] Following the examples provided in Bakker, *supra note* 1, pp. 199-201.

costs incurred. In specific cases the tax authorities will be entitled to evaluate whether the price of €10 000 was appropriate according to the OMV as it impact the amount of the unrecoverable VAT included in the transaction between A and B (in the given example it would be €2500). However, if for instance the value of the supply was €50 000 then the unrecoverable VAT would be €12 500.

Ad. b)



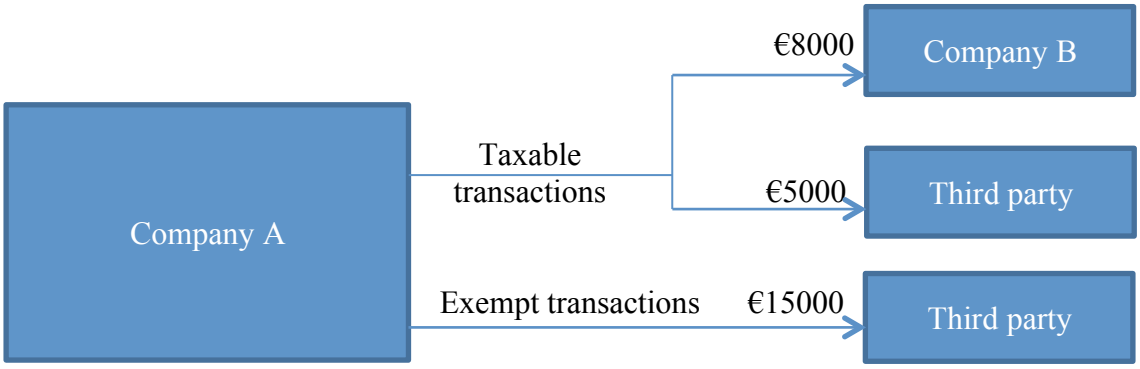
The illustration shows that Company A carries out both taxable and exempt supplies. According to the general principle the VAT will be recoverable only in a proportion of costs that are attributable to the taxable supplies. The value of taxable transactions here is € 10 000 while the value of exempt activities is € 25 000. Based on this the right to deduct would equal to:

10 000/ 35 000= 29%

We can notice however that that exempt supplies provided to a related company B and an independent third party have significant difference in price. If the value of the supply to B was purposely lowered in order to increase the VAT recovery ratio then tax authorities might be allowed to investigate the taxable amount and adjust it. For instance, assuming that the value of the exempt supply to B should be € 12 000 instead of € 5000 then the recovery ration would equal to:

10 000/ 42 000= 24%

Ad. c)



In the given scenario, the situation is reverse comparing to B – the supplier artificially raises the value of taxable transactions in order to increase the VAT recoverable ratio.

13 000/ 28 000 = 46%

However, the value of the transaction between a third party and Company B is significantly different and assuming that the supply provided does not differ much then the taxable amount of the transaction between A and B should be adjusted to the OMV:

10 000/ 25 000= 40%

Above examples provide a simplified model of situations when tax authorities might be entitled to use mechanisms provided under Art 80 and 72. Even then, the number of situations when the taxable amount should be adjusted is significantly lower than in cases of income taxation because only entities involved in exempt activities or those who have limited VAT recovery rate may be investigated. Although this mechanism has been designed to only target VAT fraud and can be used independently from any transfer pricing issues, in specific situation adjustments for income tax purposes might indicate that the valuation used for VAT purpose has been applied incorrectly.

Art 80 combined with Art 72 is not the only anti-avoidance measures in the VAT directive. Art 16 and 26 provide that self-supply of goods or services also need to account for the output VAT in situations when goods or services were taken away permanently from the business or were used for a private purpose even if there was no consideration received. When a consideration is received in a monetary form then VAT is due according to the correct rate of the amount

received. If the consideration received was in kind the value of that good or service has to be determined in order to apply the correct VAT rate. If however no consideration was received then VAT is still due based on the estimated value of the supplied good or service. The mechanism works similar to the OMV, for instance if the value has to be determined based on the age and condition at the time of supply.

4. VAT treatment of transfer pricing adjustments

This part provides an analytical assessment of whether transfer pricing adjustments might result in any VAT liabilities. Despite multiple differences between both systems, the problem of potential VAT consequences resulting from transfer pricing adjustments recently began to receive an increased attention.[108] Yet, despite this growing interest there are hardly any official commentaries or guidelines published by public bodies or tax authorities regarding the treatment of adjustments, which is why one might argue that any suggestions as to the universal approach might be, at the best-case scenario, only highly speculative. In the author's understanding it will be impossible to find a universal principle, as 'one-size-fits-all' solution to this problem does not exist. However the following assessment might serve as an indication as to how specific types of adjustments might be considered from the VAT perspective and perhaps it will encourage a future debate on the issue.

It will be beneficial to companies as well as to public authorities to raise awareness about potential consequences of transfer pricing adjustments. In a recent survey conducted by EY penalties and interest assessment for lack of notification in VAT adjustments varied between 2% to 200% of the additional VAT due, regardless of whether the additional VAT was deductible.[109]

4.1. Primary adjustments

As explained in chapter 2, primary adjustments are re-assessments of internal prices by tax authorities for the purpose of determining and allocating actual profits achieved between related enterprises. Often the allocation of profit would require also a constructive transaction (a constructive dividend, loan or equity) to reflect not only the cash position but also the actual profit – in that cases often a constructive dividend, a constructive loan or a constructive equity contribution might be ordered (see section 2.6.c on secondary adjustments). In VAT the supply of goods or services for consideration is considered a taxable transaction. The form in which adjustments are made cannot be classified as a supply of goods. As the definition of supply of services is only a negative

[108] This conclusion can be drawn from the fact that 10-15 years ago there has been hardly any commentaries on the topic, however in the past few years few articles have been published alongside tax authorities manuals.

[109] EY Tax Insights, http://taxinsights.ey-vx.com/archive/archive-articles/vat-and-transfer-pricing-perils.aspx

explanation that a service might be anything that is not a good. From the VAT perspective the adjustment could therefore be considered as:

- a separate taxable transaction, or
- a further consideration for services already supplied, or
- no VAT consequences will arise.

The above list includes scenarios for upward adjustments because although downward adjustments conducted by tax authorities are possible in theory, in practice they are not that common, as they do not result in revenue losses.

a) Separate taxable transaction

The hypothesis that a primary adjustment by tax authorities could constitute a separate taxable transaction might be based on the broad definition of a service provided in Art 6 of the Directive. Several separate issues should be assessed.

Firstly, the concept of 'transfer pricing adjustment' is not mentioned in the VAT Directive. However, despite the broad definition of 'service' the nature of the adjustment provided without a regard to any specific service, the payment will be rather considered as a financial settlement or transfer of funds, which is not itself subject to VAT (similar to capital contributions into the equity in monetary form).[110]

Secondly, as already indicated the primary transfer pricing adjustment could not be considered as consideration because there is no separate supply provided, namely the entity receiving the adjustment does not supply any additional service resulting from its economic activity. Martin Kopecky is his article provides that the service (or supply of goods) has to actually take place; it cannot be only a possibility of supplying a service or *a mere will or ability to exercise a certain activity*.[111] However, it has been previously demonstrated that from the VAT point of view a possibility to use a right or to supply a right to use an immovable property with exclusions of others or the right to use immovable property.[112]

The line of cases involving a right to exercise a specific function or an activity has been recently reviewed again by the CJEU in *KLM/ Air-France* case. The Court decided that VAT was chargeable on unused and non-refundable flight

[110] *Kretztechnik, supra note* 80, para 18.
[111] Kopecky M., 'VAT Treatment of Transfer Pricing Adjustments in the Czech Republic', *Global Transfer Pricing* Solutions (WorldTrade Executive 2008 5th ed.) p 233.
[112] Bijl J., *Air France/KLM: The SAFE equivalent for services?*, International VAT Monitor (2016 vol. 27 no 2).

tickets as there was a direct link between the sums paid for the tickets and the service that was performed. Interestingly, the consideration for the supply of service was not the physical presence of a passenger but the right to benefit from the performance, regardless of whether the person showed up for the flight.[113] The case law indicates therefore that a distinction must be made between a mere will or an ability to exercise a certain activity and the right to voluntarily use the service, however at this stage it is difficult to provide a clear guidance and cases have to be assessed on individual basis. Often this will be done on case-by-case analysis.

While in the *KLM* case the benefit from the performance was identifiable, in a situation when a company merely has an ability to exercise certain activity when transfer pricing adjustments are done there *is 'no benefit capable of being regarded as a cost component of the activity of another person in the commercial chain*' as the funds would have been obtained even when no services or activities were performed.[114] In the author's opinion the conclusion reached by Martin Kopecky regarding the mere ability to exercise a function is not sufficient to amount to a taxable transaction because adjustments occur irrespective of the service provided as their purpose in this scenario (e.g. when done by tax authorities) is to correct corporate income tax rather that to provide consideration for the supply. In that sense there would be no direct link between the adjustment and a service.

Another relevant point in relation to adjustments being potentially treated as consideration reflects back to the *Cooperative* case where the Court specified that consideration cannot be unspecified. However, in a situation when tax authorities are determining the amount of the adjustment the consideration is in fact unknown and cannot be determined by associated enterprises.[115] Moreover, in the *Apple & Pear Development*[116] it was stated that 'a mandatory charge' could not be considered as a consideration if it results from a statutory obligation rather than from a contractual agreement. This once again emphasises that consideration in the VAT system represents a subjective value and if the amount of primary adjustments is determined by tax authorities it cannot be seen as consideration. This reflects back to the nature of adjustments.

An interesting aspect of primary adjustment arises in relation to the requirement of the legal relationship (as specified in *Tolsma* case) when the money received did not fulfil the test as consideration was not specified because it was received 'entirely voluntarily'. In case of primary adjustment the situation would be completely opposite.

---

[113] Judgment in *KLM/ Air-France*, C-250/14, ECLI:EU:C:2015:841, paras 28 and 46.
[114] Judgment in *Landboden-Agrardientste GmbH*, C-384/95, ECLI:EU:C:1997:627, para 23.
[115] *Cooperative, supra note* 84.
[116] *Apple & Pear, supra note* 87.

Therefore, in the light of all those elements it is author's opinion that primary adjustments should be considered as a transfer of money (or for instance distribution of wealth) and therefore not subject to VAT.

b) Further consideration for a previous supply

The second possibility is to treat primary adjustments as a further consideration for services already provided (or as a part of consideration for services/goods supplied). Firstly, in this situation when a transfer price needs to be altered because the already existing supply was below (or above) arm's length then the adjustment should not be considered as a financial help or simply a money transfer but as a further (or adjusted) consideration for goods or services already supplied.

However, the problem arises from the nature of primary adjustments: the parties themselves do not determine their amount and therefore the consideration can hardly be considered as subjective. In the section 3.4.(b)(iii) the nature of consideration in the case of *BAZ Bausystem* was mentioned. The Court explained that although the amount of consideration can be altered in a situation when a judge determines additional costs, those costs cannot be considered as a part of consideration. The procedure of primary adjustments being determined by tax authorities would be analogical to the conditions mentioned in *BAZ Bausystem*.

It can therefore be concluded that primary adjustments (and also any following secondary transactions and secondary adjustments) due to their nature will not be considered as an additional consideration but rather as a separate cost decided by the public authority and not by the parties. Under those circumstances, primary adjustments will not have any VAT consequences.

The situation can be also examined from a different angle: when tax authorities conduct transfer pricing investigation they are primarily focused on assessing whether a taxable base for income tax purposes was determined according to the AL based on the declared functions performed, risks assumed and assets used. Although in principle transfer pricing should regulate the process of setting of the prices between associated enterprises in practice it is used to regulate taxable profits.[117] Therefore although it would be possible to examine each transfer price individually it would not be efficient if overall profits of an entity are effected by functions it performed. Thus, the majority of investigations only focus on the taxable base or possibility of profits shifting. For that reason any adjustments required by the tax authorities *will only*

[117] Van Hersen, *supra note* 2, p 16.

represent a modification of the initial taxable base but they do not alter consideration agreed upon parties themselves (for the VAT purpose).[118] In contrast, as VAT is a consumption tax, any alternations to the taxable amount would have to be assessed for each transaction individually. However, as some European tax agencies indicate, in a very limited number of cases adjustments for direct tax purpose might be an indicator of an incorrect valuation of VAT purpose which could require assessment under Art 72 and Art 80.[119] Yet, as any exception to the general rule, Art 80 has to be applied strictly and Member States cannot expand the list of situation specified in the Directive.[120]

4.2. Compensating adjustments

As explained, compensating adjustments are made by taxpayers themselves in order to settle the transfer price to the arm's length in controlled transactions, even though the amount might differ from what was initially specified in the agreement between associated parties. In most cases, compensating adjustments will be done once a year before the submission of the tax return. This characteristic is relevant when contrasted with primary adjustment as the value of taxable transactions for VAT purpose is subjective in nature.

The main difficulty in assessing compensating adjustments is that there is no universal approach as to how they are treated in different countries. For instance, not all countries give companies the possibility to self-correct, some don't even provide an official guidance whether such practice is acceptable, and some even ban it, while others allow it under a condition of submitting a detailed transfer pricing documentation.[121]

In practice, compensating adjustments can be done by issuing an additional invoice in order to increase or reduce the transfer price to adjust and correct the taxable income as also accounting practice needs a proof for any transfers or transaction. Not always will this process imply a change in the cash position. Depending whether any balancing payments or constructive transactions follow compensating adjustments then different approaches can be adapted from the VAT perspective. One of important factors is to determine whether compensating adjustments were made with or without balancing payments.

[118] Matesanz F.,'Transfer Pricing Adjustments and VAT', *International VAT Monitor* (2015) p 298.
[119] V1-12 HMRC Valuation Manual, Transfer Pricing interaction with VAT (also available at: https://www.gov.uk/hmrc-internal-manuals/vat-valuation/vatval15000) p 134.
[120] *Balkan Sea Properties, supra note* 105.
[121] Bakker, *supra note* 1, p 210.

Then, if a balancing payment was made similarly to primary adjustments one can assess whether compensating adjustments have any VAT consequences as:

- a separate taxable transaction,
- a further consideration for an already existing supply,
- do not have any VAT consequences.

a) When no balancing payments are made

If no balancing payment is involved then a compensating adjustment has to be assessed in the light of Art 2 (scope of application) and Art 73 (taxable amount) of the Directive whether it can qualify as a supply of goods or services for consideration. If the adjustment is treated as a supply it is rather unconvincing that there is any consideration received in return. Therefore this adjustment will not have any VAT consequences.

However, an adjustment is always an indication that the transaction was not taken within the arms' length and implies changes of the taxable base for the income tax purpose (as mentioned on the page 45). From the VAT perspective, this normally should not matter as the general rule adapts the subjective valuation. Yet, taking into account changes introduced in Art 80 (when read in conjunction with Art 72) it might be possible that changes conducted for the valuation for income tax purposes might indicate that also from the VAT perspective the transaction was undervalued or overvalued. Nevertheless, situations in which tax authorities might be allowed to investigate under Art 80 are very limited and constitute only exemptions to the general rule (see page 44).

This assessment is consistent with the Guidelines issued by the HRMC, which indicated that normally transfer pricing adjustments without any balancing payment normally should not have any consequences in respect of those adjustments for the VAT purpose.[122] Yet, as the HMRC simply represents a national legal interpretation it does not have any binding powers from the European law perspective.

b) When balancing payments are made

Compensating adjustments involving balancing payments are more likely to have implications for VAT. In that case the balancing payment would be

[122] V1-12 HMRC Valuation Manual, *supra note* 119, p 134.

considered as a consideration for either a new supply or as an additional consideration to an already existing supply. Supply for consideration in order to be taxable requires also a direct and immediate link and a legal relationship between parties to the transaction.

i) Separate taxable transaction

The first possibility is to consider compensating adjustments as a separate taxable transaction, similarly to the assessment of primary adjustments. In a recent debate regarding the VAT treatment of transfer pricing adjustments Czech Ministry of Finance, tax authorities and practitioners discussed a general approach (without making distinctions between primary or compensating adjustments) when parent companies provided transfer pricing adjustments to Czech subsidiaries responsible for providing services in the shared service centres.[123]

In that scenario a balancing payment was made without any additional provision of services. It can therefore be compared to a payment without transaction (e.g. similar to *Polysar* case and other in line with it, see page 29), which as such will not be treated as a taxable transaction for VAT purpose. The conclusion reached by Czech officials was that, when a company provides financial funds with no further condition and with no relation to additional services provided by the related entity, then the payment will be treated as a transfer of money, which according to the Directive is not subject to VAT. Such a payment or a financial contribution will not be treated as consideration because the adjustment would have occurred regardless of whether any supply was provided or not.[124] It might be missing the direct link as discussed on pages 42-43.

It is worth noting that Czech authorities considered that a future supply in return for balancing payment could be sufficient to treat it as a taxable transaction, which is in line with commentaries prepared by the HMRC in the UK and which suggested that balancing payment conditional for further supply may be considered as a part or whole as a non-monetary consideration.[125]

This leads back to the discussion started in the section assessing primary adjustments on pages 42-44 and how to treat a mere ability to exercise economic activity and what could be considered a supply for the VAT purpose. As already mentioned, Martin Kopecky in his article also emphasised that an entity receiving a balancing payment should exercise some sort of separate

[123] Kopecky, *supra note* 111, p 232.
[124] *Ibidem*, p 233.
[125] Valuation Manual, *supra note* 119, p 134.

economic activity in exchange for the balancing payment (or the transfer pricing adjustment) as the 'sole ability to provide shared services within the group cannot be considered as economic activity within the meaning of the VAT Directive' (based on the example that the subsidiary's role was already to provide specific services within the group).[126] The statement that a company should 'exercise some sort of separate economic activity' might be misleading and requires an additional clarification. It does not mean that a subsidiary participating in shared service centre or cost sharing agreement need to begin a different types of services. Rather, the statement reflects back to the discussion when economic activity will be classified as a taxable transaction for the VAT purpose. It is worth mentioning again AG's Kokott comment in *Gemeente Borsele* case that 'extra added value' can be an indicator of the existence of an economic activity.[127]

Additionally, in a recent domestic case in the UK in *Norseman Gold v HMRC*[128] the Upper Tribunal found that a charge for management services did not result in consideration as the company could not prove that at the relevant time there was an intention to provide supply for consideration that would lead to a taxable transaction. The Upper Tribunal decided that management services by a holding company to its overseas subsidiaries should not be considered as an economic activity as there was no agreement between the company and subsidiaries that they would pay for services; there was no indication as to the agreed value of the supply and no understanding when the payment should have occurred. The Tribunal emphasised that 'a vague intention to levy an unspecified charge at some undefined time in the future'[129] cannot result in a taxable transaction. Such situation will lack the presence of the direct and immediate link between services provided and remuneration received. Future transfer pricing adjustments would have similar nature – at the moment of supply there is no indication that the adjustment will occur. However, as this decision only represents a domestic interpretation it can be hardly considered as influential or binding on the European level.

Moreover, this line of cases has to be distinguished from for instance *KLM/ Air-France* or *Kennemer Golfclub,* when the Court decided that the direct and immediate link exists even when the service provided is optional and recipient of it does not have any obligation to actually exercise the right (or in the KLM scenario when passengers benefited from the performance regardless whether they physically attended the flight, see pages 42-43). In the scenario involving cost sharing centres specific services are provided regardless of whether

[126] Kopecky, *supra note* 111, p 233.
[127] AG Kokott in *Gemeente Borsele, supra note* 65, para 66.
[128] (2016) UKUT 69. Even though it was a domestic UK case it analyses the VAT taxable transaction in the light of European legislation.
[129] *Norseman Gold v HMRC, supra note* 123, para 94.

transfer pricing adjustments occur or whether any additional payment is provided. In terms of the *Kennerman Golfclub* situation, the services were offered only after specific payment was made; members of the club can later decide whether to use the premises or not.

The possibility of a voluntary option to exercise a supply will therefore usually suggest an existence of a separate taxable transaction. This view seems to be also confirmed in *Wojskowa Agencja*.[130] The case concerned renting of an immovable property and related service charges and whether it constituted a single or multiple supplies for VAT purpose. The Court decided that in a situation when there is an option to choose whether to use a specific service or not (or the amount or level of supply provided) then there is a strong indication of a separate taxable transaction. From the perspective of transfer pricing adjustments, we can see that it lacks the possibility of using the service in a sense that services are already provided, regardless of any future adjustments.

ii) Further consideration for a previous supply

To be classified as an additional consideration for services or goods already supplied there is a prerequisite of the direct and immediate between the balancing payment and the previous supply. One of the indicators of such link can be for instance the existence of earlier agreements that would allow a price variation. This would be in line with Art 73 that the *taxable amount shall include everything which constitutes consideration obtained or to be obtained*. It is also relevant that the modification of the consideration (or the taxable amount for VAT purpose) is done voluntarily by the parties themselves and not by an external body such as tax authorities or a judge. It has been pointed that depending on the precise circumstances and whether the first supply was already a taxable transaction from VAT point of view then balancing payments might be considered as a further consideration.[131]

From the VAT perspective the conditions specified in Art 2 thus seem to be satisfied, namely the presence of the supply of goods or services in return for consideration (which is later altered by means of balancing payment in compensating adjustments). Another important point is to determine whether there is a direct and immediate link between supply and consideration received or any other commercial justification for the transaction. If that also can be determined the last step would be to verify the legal relationship between parties to the transaction.

[130]Judgment in *Wojskowa Agencja*, C-42/14, ECLI:EU:C:2015:229.
[131] Valuation Manual, *supra note* 119, p 134.

This step can again emphasise differences between direct and indirect taxation. While from the income tax perspective it does not matter whether the adjustment is done between a parent company and a subsidiary or a parent company and a permanent establishment or even a subsidiary and a permanent establishment for VAT such determination is important. As explained in *FCE Bank* case and later challenged in *Skandia*, transactions between parent companies and fixed establishment will not be taxable as there is no legal relationship between them. Unless, as specified in *Skandia* the parent company supplies services to its branch that is a member of a VAT group, then the membership in the VAT group would prevail over the corporate relationship. This is however a simplified conclusion as the recognition and treatment of VAT group members differ between Member States and this statement might have different application for instance in the UK, the Netherlands, Sweden and Poland (due to different rules governing VAT grouping). Providing more details as to the consequences of VAT grouping and transfer pricing adjustments is outside the scope of this paper. Additionally, transactions between members in the VAT group are not taxable transactions for VAT purpose either.

When a compensating adjustment is made with a balancing payment and which is connected to a previous supply an additional invoice would have to be issued for an upward adjustment or a credit note for a downward adjustment. As the amount of the deducted input VAT should always be modified in case of adjustments of the taxable amount any changes resulting from the transfer pricing adjustments should be reflected later, after receiving invoices or credit notes. Therefore, in the case of downward adjustments the supplier would recover the excess VAT while the recipient would have to return the deducted excess of input VAT.[132]

It has been previously stressed by tax authorities that balancing payments (in a monetary or non-monetary form) can be only treated as such only if they are made for the sole purpose of the transfer pricing adjustments. Related parties cannot make a supply for consideration and decide themselves to treat it as a balancing payment as not in all circumstances it will then have VAT consequences.[133]

It is important to remember that in most cases an individual assessment will be needed. British tax authorities provided an example where a balancing payment was made additionally to a previously existing monetary payment for the management services.[134] Before the balancing payment was made there had already been an existing taxable supply. In the author's opinion if it is possible

[132] Bakker, *supra note 1,* p 211.
[133] HMRC Manual, http://www.hmrc.gov.uk/manuals/intmanual/intm486010.htm
[134] Valuation Manual, *supra note* 119, p 144.

to find a direct and immediate link and commercial justification for making the balancing payment then it would result in altering the amount of consideration paid due to change in economic situation. The new basis for the VAT assessment will be the first monetary payment and the subsequent balancing payment.

4.3. Secondary adjustments

As mentioned earlier, secondary adjustments arise from imposing tax on a secondary transaction that some countries might require in order to make the actual allocation of profits consistent with the primary or compensating adjustment. Secondary transactions usually take form of constructive dividends, constructive equity contributions or constrictive loans.[135]

It follows from the Court's case law that transactions that involve distribution of dividends or capital are not subject to VAT (see cases: *Polysar, Wellcome Trust, KapHag, Emperesa, Kretztechnik*[136]) as operations involving holding of shares or issuing of share are non-economic activity and therefore are outside the scope of VAT.

In respect to constrictive loans VAT consequences will have to be evaluated individually in each case as loans as financial transactions constitute an exempt activity[137] and therefore they limit the right to deduct VAT.

4.4. Corresponding adjustments

Corresponding adjustments arise in relation to the tax liability of the associate enterprise in the other tax jurisdiction as a result of primary or compensating adjustments in order to avoid double taxation and can be achieved by means of the Mutual Dispute Agreement and Tax Treaties between countries (in practice it should constitute a *mirror relief*).[138]

They involve recalculating profits that should be correctly assigned to an enterprise in the second contracting state resulting from a change in taxable base in the first country by for instance providing a relief against its own tax already paid. As they only intend to change the allocation of the taxable profit there would be no effects for VAT.

---

[135] OECD Guidelines, *supra note* 6.
[136] C-60/90 Polysar, C-77/01 Empresa, C-465/03 Kretztechnik, C-442/01 KapHag, C-155/94 Wellcome Trust.
[137] Art 135(1)(b) VAT Directive.
[138] Bakker, *supra note* 1, p 215.

4.5. Transfer pricing adjustments as a distribution of wealth

From the above analysis, it is possible to notice that certain types of adjustments are more likely to have VAT consequences than others. Transfer pricing and VAT have different conceptual framework, they are governed by different legal rules and principles, documentation rules, scope and application of companies' grouping, valuation methodology, but most importantly they have different aims. As transfer pricing is aimed at establishing the proper income allocation based on the economic reality of entities involved, VAT is focused at taxing the consumption of goods and services. This somehow obvious statement might serve as an additional explanation why specific types of transfer pricing adjustments will not be treated as taxable supplies for VAT purpose.

Financial activities for a long time have been debated as to whether they should be subject to VAT and due to the uncertainty in assessing the taxable amount and a difficulty in separating financial services from pure redistributions of wealth.[139] Essentially, this discussion aims at determining which activities should be classified as a distribution of wealth as those are not VAT taxable as they do not constitute consumption. Although it is not directly subject of this paper, it is worth to briefly look how transfer pricing adjustments should be seen from this perspective.

The problem of VAT treatment of value produced by capital and redistribution of wealth has already been subject to the CJEU case law. The application of VAT to savings, gifts, dividends, emission of shares have been assessed as not being subject to VAT as those activities do not constitute production or consumption.[140] The VAT Directive clearly defines that only activities resulting from the economic capacity of undertakings (taxable persons) could be considered as a consumption and therefore subject to VAT. *In passive financial investment activity, no value is created by the activity itself*,[141] and therefore as redistribution of wealth will fall outside of the scope of the VAT Directive. This approach differs from the income tax perspective as it aims as taxing any form of income received, regardless of its source. For that reason, certain gifts or inheritance might also be subject to income tax.

It is important therefore to examine whether transfer pricing adjustments' function should be seen purely as a wealth distribution or whether they could possibly lead to the consumption and therefore lead to VAT liabilities. Although much has been said that VAT is a tax on consumption and even Art 1

[139] Henkow O., 'Income from Financial Activities and the Treatment in the Value Added Taxation and Corporate Income Taxation' (IBFD 2009) p 660.
[140] *Ibidem*, p 666.
[141] *Ibidem*, p 666.

of the Directive explicitly refers to it, there is no definition of what amounts to consumption. The meaning can be however derived from Art 2 that it is a supply for consideration. As stated earlier, the consumption indicates creating the 'added value', however, on the other hand, refraining from an act can also constitute a supply in the light of VAT Directive.[142] In *Mohr*[143] and *Landboden*[144] the Court examined whether refraining from producing milk in a return for a financial compensation could be a supply for consideration. In both cases it was decided that it fall outside the scope of VAT because there was no consumption since there was no identifiable benefit that could be considered as a necessary component for another consumer in a commercial chain. The compensation paid was *not to acquire goods or services for a personal use but for the general act of promoting a proper functioning of the EU market*.[145] Existence of consumption is therefore a crucial element for the VAT system.

From a more economic perspective consumption should lead to a direct benefit that a person would receive. In the case law that has already been mentioned (inter alia *Kreuztechnik, Polysar, Floridienne*[146]) that distribution of dividends does not constitute economic activity as it only distributes wealth. Ben Terra commented that if VAT aimed at taxing savings and pure redistribution of wealth it would no longer be a tax on consumption but would turn into income tax.[147]

As observed, transfer pricing adjustments if not linked to a previously existing supply they do not create any value or consumption from VAT perspective. They only re-allocate income for the income tax purpose and similarly to dividends they would redistribute wealth. This reasoning is in line with commentaries issued by tax authorities in whose opinion adjustments themselves do not constitute a taxable transaction as no new goods or services are created as a result of such adjustments and for that reason they should fall outside the scope of VAT. The situation differs however if an adjustment is linked to a previous supply. In those circumstances we can observe the alternation of the taxable amount if the adjustment is done voluntarily, in order to emphasise the subjective nature due to changes in economic conditions of a transaction.

[142] Art 25 VAT Directive.
[143] Judgment in *Mohr*, C-215/94, ECLI:EU:C:1996:72.
[144] Judgment in *Landbroended*, C-384/95, ECLI:EU:C:1997:627.
[145] *Mohr*, paras 19-21, *Landbronded* para 22-23.
[146] *Supra note* 136.
[147] Terra, Kajus*, supra note*, p 342.

4.6. Final thoughts and remarks

Due to dynamic changes in the modern supply chain structures we can observe that multinational companies challenge the way in which we perceive global business models. Those developments however to a large extend are not followed by a legal framework and guidance that would reflect contemporary corporate structures and business models. Among some of the most important changes we can undoubtedly notice departing from a traditional one-to-one business model when companies trade directly between themselves or supply products to customers. Rather, the specific elements of the supply chain are located in various countries and the physical flow of goods does not necessarily coincide with legal or economic flows.[148] Decision-making centres are separated from manufacturing and distribution lines and cost-sharing centres are providing services to the entire group.

All of those changes in corporate structures are designed to meet the needs of modern trade and to increase financial turnovers, but at the same time they increase the need of legal compliance across various jurisdictions. For companies that trade in the European Union internal transactions will require compliance both from the perspective of transfer pricing (and therefore corporate income tax) and VAT. Although for a long time it has been thought that due to different purposes and structures the two should remain separate, recent trends prove that this ambiguous liaison can have significant consequences. Practitioners working with transfer pricing should become more aware about potential implications from VAT perspective that may occur due to transfer pricing adjustments.

Another issue arises when the adjustment of the transfer price is a part of a contractual agreement between related companies. It is possible and not uncommon in practice to include a term in the agreement that would allow a transfer price to be changed over the year to be in line with the ALP. Recently the Hungarian court dealt with the situation when domestic tax authorities challenged the assessment of the transfer pricing adjustment.[149] The case involved a production and distribution of apples by a Hungarian company to its parent company in Austria. At the beginning of the year parties decided on the price and the volume of goods and included a condition that if the parent company would purchase less goods than initially agreed then they would pay an additional monetary compensation. By the end of the year only half of the

[148] Lucas Mas M.O., 'Value Added Tax' in Bakker A. and Obuoforibo B., Transfer Pricing and Customs Valuation: Two Worlds to tax as one (IBFD 2013) pp. 216-217.
[149] Details of the case can be found on: http://www.lawandnumbers.eu/news-tax.php?id=152 . As the case was examined by the Hungarian court there is no official transcript of the case in English.

agreed volume was purchased and the Hungarian company received the additional payment and no VAT was accounted on that money. Hungarian tax authorities were of the opinion that the money paid should not be considered as a transfer price adjustment but as a separate taxable transaction for services supplied (the right to produce less).

However, the court disagreed and noticed it was important to look at the transaction as a whole and that the compensation paid was by its nature a year-end adjustment. It was concluded that the Austrian company did not pay for a separate service but it merely increased the price of the goods supplied, therefore the adjustment shared the same characteristics as the original transactions and should be treated in the same way. It is important that the court looked into the economic circumstances of the transaction and the nature of the VAT system rather than at the formalities connected to invoices.

At the same time it is necessary to distinguish adjustment of the transfer price from the transfer pricing adjustment when sums received or paid do not correspond to the chosen value based on the agreed method (e.g. invoiced are too low or too high) and actual figures do not match with the estimated value (or when the method or the value of the method was chosen incorrectly). In that case the adjustment is required so that the actual invoiced costs would correspond to the estimated income of the companies.

The ruling in *Skandia* resulted in the new focus for the supply of services to the VAT group from a company that does not belong to that group. Previously VAT-exempt supplies of services between related companies might now lead to new tax consequences based on the Member State's treatment of the VAT grouping. When a company is involved in the IT sector or if it has centralised intangibles any transfer pricing adjustment might need to be also evaluated from the VAT perspective as it can amount to a taxable supply of services for which the place of taxable supply has to be determined based on the VAT rules.[150]

Finally, it is important to consider how the company group is financed – inserting own financial institutions might lead to unrecoverable input VAT that in consequence becomes a cost to the entire chain.

[150] Lucas Mas, *supra note* 139, pp. 218-220.

5. Conclusions

This thesis aimed at assessing whether transfer pricing adjustments have impact on VAT liabilities. The answer to this question is complex and heavily depended on the individual facts of each case, however main findings are presented below.

Primary adjustments could be considered either as a separate taxable transaction or as a further consideration for a supply already provided, however due to their nature they are not likely to result in VAT liabilities. As they are conducted by tax authorities any liabilities due will result in an involuntary nature of adjustments, which is contrary to the subjective valuation needed from the VAT perspective. Consequently, alternations done by tax authorities will be considered as falling under *BAZ Bausystems* circumstances, namely when an amount is determined by official authorities and not parties themselves. This precludes also VAT liability in the form of alternation of the taxable amount. The only situation that could implicate VAT consequences is the assessment under Articles 80 and 72 in a much-narrowed scenario under anti-abuse provision when OMV should be applied instead of the subjective valuation.

Compensating adjustments might be more complicated as they are done by parties themselves, therefore from the beginning the emphasis is put on the subjective nature of the adjustment. Due to the voluntary nature they are also more likely to trigger VAT liabilities. If no balancing payments are made it is rather unlikely that any consideration in return for the supply. If balancing payments are made then, similarly to primary adjustments, compensating adjustments can be considered either as a separate taxable transaction or as a further consideration for an existing supply. As the analysis showed, payments received will rather be classified as financial contribution rather than consideration as normally they occur without a requirement of providing services. Even if a supply of service is found in the possibility of exercising economic activity (as in the case of cost sharing centres) it might be difficult to prove the direct and immediate link between the adjustment and the supply as the primary purpose of adjustment is to avoid tax authorities investigation and penalties related to it. If the compensating adjustment is however linked to a previously existing supply it is likely to impact the taxable amount for the VAT purpose that requires adjustment of the VAT due (upward or downward).

As secondary adjustment arise from the actual allocation of profits to reflect the primary adjustment, usually in the form of a constructive dividend, constructive equity contributions or a constructive loan. As dividends are not subject to VAT therefore those forms would be outside the scope of the VAT

Directive. Constructive loans as exempt financial transactions might limit the right to deduct the input VAT.

Corresponding adjustments are not likely to result in VAT liabilities as they only mirror the change of taxable base for income tax purposes resulting from primary or compensating adjustments, in order to avoid double taxation of profits.

From the VAT perspective it is therefore relevant to assess how transfer pricing adjustments are conducted, by whom, between who and even in which form they are done. Therefore the assessment of the economic substance becomes the key when analysing the relationship between transfer pricing adjustments and VAT adjustments. Especially in the situation when it is impossible to provide a universal guidelines or one-fits-all solution. As mentioned, the modern corporate structures and relationship in the global supply chain models create increasing amount of challenges for professionals from both transfer pricing and VAT area. Special attention should be given to inter alia compliance or registration deadlines (for VAT purpose) as it might make it more difficult to claim any deductible expenses.

As the secondary purpose of this research was to clarify the legal position of transfer pricing adjustments and their potential impact on VAT liabilities and to contribute to the research in this field one could ask whether there is in fact the need for further harmonisation on the European Union level. It has been mentioned that tax authorities in some Member States and other relevant public bodies start to issue guidelines on treatment of transfer pricing adjustment. Yet, there have been no statements of such nature at the European level. It could be for the benefit of taxpayers if The European Commission provided official communication document or if VAT Committee issued commentary on VAT treatment of various transfer pricing adjustment as a form of reply to communication provided by the European Union Transfer Pricing Forum.

Bibliography

Articles

Cornielje S., and Bondarev I., 'Scanning the Scope of Skandia', 26 *International VAT Monitor* (2015 issue 1), pp. 17- 21.

Dwarkasing R.S.J., 'The concept of associated enterprises', 41 *Intertax* (2013 issue 8/9), pp. 412-429.

Henkow O., 'Income from Financial Activities and the Treatment in the Value Added Taxation and Corporate Income Taxation' in Lang M., Melz P. and Kristoffersson E., Value Added Tax and Direct Taxation: Similarities and Differences (IBFD 2009), pp. 659-672.

Idsinga F., Kalshoven B-J., Van Herksen M., 'Let's Tango! The Dance between VAT, Customs and Transfer Pricing', International Transfer Pricing Journal (2005 issue 12), pp. 199-209.

Jensen M.C., 'Value Maximization, stakeholder theory and the corporate objective function', 14 Journal of Applied Corporate Finance (2001) pp. 8-21.

Kopecky M., 'VAT Treatment of Transfer Pricing Adjustments in the Czech Republic' in Dinmancescu K., Global Transfer Pricing Solutions (WorldTrade Executive 2008 5th ed.), pp 231- 237.

Lasinski-Sulecki K., 'Impact of Transfer Pricing Adjustments for VAT and Customs Law Purposes', International Transfer Pricing Journal (2013), pp. 173-181.

Lucas Mas M.O., 'Value Added Tax' in Bakker A. and Obuoforibo B., Transfer Pricing and Customs Valuation: Two Worlds to tax as one (IBFD 2013), pp 189-221.

Matesanz F., 'Transfer Pricing Adjustments and VAT', International VAT Monitor (2015), pp. 295-299.

Santoro E., 'Transfer Pricing and Value Added Tax in the European Community: Is there Room for Interaction and, If So, Where?', International Transfer Pricing Journal (2007), pp. 147-164.

Van Herksen M., Idsinga F., Van Slooten G., 'Dancing together', 17 International Tax Review (2006, no 16) pp. 16-19.

Books

Bakker A. and Obuoforibo B., Transfer Pricing and Customs Valuation: Two Worlds to tax as one (IBFD 2013).

Henshall J., Global Transfer Pricing: Principles and Practice (Bloomsbury 2013, 2nd ed.).

Lang M., Melz P. and Kristoffersson E., Value Added Tax and Direct Taxation: Similarities and Differences (IBFD 2009).

McConville M. and and Hong Chui W., Research Methods for Law (Edinburgh University Press 2007).

Monsenego J., Introduction to Transfer Pricing (Studentlitaratur AB 2013).

Pffeiffer S., and Ursbrung-Stehdl M., Global Trends in VAT/GST and Direct Taxation (Linde 2015).

Schenk A., *Value Added Tax: A Comparative Approach* (Cambridge University Press 2015, 2nd ed.).

Terra B. and Kajus J., A Guide to the European VAT Directives: Introduction to European VAT vol.1 (IBFD 2013).

Wittendorff J., *Transfer Pricing and the Arm's Length Principle in International Tax Law* (Kluwer Law International 2010).

Legal sources and preparatory work

Council Directive 2006/69/EC of 24 July 2006.

Model Tax Convention on Income and on Capital 2010.

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.

Online resources

www.ey.com/Publication/vwLUAssets/EY-2013_Global_Transfer_Pricing_Survey/$FILE/EY-2013-GTP-Survey.pdf, (EY Global Transfer Pricing Survey, accessed between 20th February and 15th April 2016).

http://www.oecd-ilibrary.org/docserver/download/2310091e.pdf?expires=1462778775&id=id&accname=oid012043&checksum=36CA25D40A2BBDCF2770969588C264C6
(OECD Guidelines, accessed between 1st February and 10th May 2016).

http://www.hmrc.gov.uk/manuals/intmanual/intm421030.htm
(HMRC Manual, accessed on 25th March 2016).

http://www.hmrc.gov.uk/manuals/intmanual/intm421060.htm
(HMRC Manual on Cost+ method, accessed 22nd February 2016).

http://www.hmrc.gov.uk/manuals/intmanual/intm483120.htm
(HMRC Manual on transfer pricing penalties, accessed 3rd March 2016).

http://www.un.org/esa/ffd/tax/2011_TP/TP_Chapter5_Methods.pdf
(UN Report on Transfer Pricing Methods, accessed 17th February 2016).

http://www.oecd.org/ctp/transfer-pricing/45765701.pdf
(Transfer Pricing Methods, accessed 27th February 2016).

http://www.thetaxadviser.com/issues/2013/jun/hill-june2013.html
(Secondary Transfer Pricing Adjustments, accessed 29th February 2016).

http://www.oecd.org/ctp/glossaryoftaxterms.htm
(OECD Glossary accessed 29th February 2016).

www.oecd.org/berlin/publikationen/43324465.pdf
(OECD Commentary, accessed 5th May 2016).

http://ec.europa.eu/taxation_customs/taxation/vat/how_vat_works/index_en.htm
*(*European Commission overview of VAT, accessed 12th March).

http://taxinsights.ey-vx.com/archive/archive-articles/vat-and-transfer-pricing-perils.aspx
(EY report on VAT and Transfer Pricing, accessed 5th April 2016).

https://www.gov.uk/hmrc-internal-manuals/vat-valuation/vatval15000
(HMRC Manual on Valuation, Interaction between transfer pricing and VAT, accessed 5th May 2016).

Table of Cases

CJEU Judgements

154/80, ECLI:EU:C:1981:38, Cooperative.
89/81, ECLI:EU:C:1982:121, Hong Kong Trade Development Council.
222/81, ECLI:EU:C:1982:256, BAZ Bausystem.
102/86, ECLI:EU:C:1988:120, Apple & Pear Development Council.
230/87, ECLI:EU:C:1988:508, Naturally Yours Cosmetics.
C-60/90, ECLI:EU:C:1991:268, Polysar Investments.
C-333/91, ECLI:EU:C:1993:261,SATAM.
C-16/93, ECLI:EU:C:1994:80, Tolsma.
C-215/94, ECLI:EU:C:1996:72, Mohr
C-317/94, ECLI:EU:C:1996:400, Elida Gibbs.
C-330/95, ECLI:EU:C:1997:339,Goldsmiths.
C-384/95, ECLI:EU:C:1997:627, Lanbroended
C-98/98, ECLI:EU:C:2000:300, Midland Bank.
C-142/99, ECLI:EU:C:2000:623, Floridienne and Berginvest.
C-380/99, ECLI:EU:C:2001:372, Bertelsmann.
C-102/00, ECLI:EU:C:2001:416, Welthgrove.
C-174/00, ECLI:EU:C:2002:200, Kennemer Golf & Country Club.
C-77/01, ECLI:EU:C:2004:243, Empresa de Desenvolvimento Mineiro (EDM).
C-412/03, ECLI:EU:C:2005:47, Hotel Scandic.
C-465/03, ECLI:EU:C:2005:320, Kretztechnik.
C-210/04, ECLI:EU:C:2006:196, FCE Bank.
C-246/08, ECLI:EU:C:2009:671, Comission v Finland.
C-621/10, ECLI:EU:C:1988:508, Balkan and Sea Properties.
C-310/11, ECLI:EU:C:2012:822, Grattan v HMRC.
C-283/12 ECLI:EU:C:2013:599, Serebryannay.
C-7/13, ECLI:EU:C:2014:2225, Skandia America.
C-42/14, ECLI:EU:C:2015:229, Wojskowa Agencja.
C-250/14, ECLI:EU:C:2015:84, KLM/ Air-France.

Advocate General's Opinion

C-520/14, ECLI:EU:C:2015:855, Gemeente Borsele.