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Reducing VAT Transfer Pricing Abuse

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Direct taxation practitioners have dealt with transfer pricing issues for a long time. Corporate tax authorities, all over the world, have long elected transfer pricing as the "enfant terrible" of tax evasion.

Strangely, the theme of transfer pricing has been more or less ignored, until recently, by indirect tax authorities. Perhaps this was because in the majority of the countries the same government entity, at federal level, controls the administration of direct and indirect taxes, so there was the perception that dealing with transfer price issues at direct taxes level would be sufficient – not quite.

As Value Added Tax (VAT) is the consumption tax most widely adopted in the world this article intends to illustrate some transfer price issues as they apply in VAT environments. The article focuses on the abuse that leads to tax evasion as well as the growing attention these issues are receiving from the tax authorities. Finally, the article considers recent measures introduced to combat such abuse.

I. What is “Transfer Pricing”?

Transfer pricing is the doctrine behind the price of transference of goods and/or services between related parties. According to such doctrine, such transfers, be they inter or intra-jurisdictional, must occur at prices that would be comparable to prices in the "open market", for transactions between unrelated parties.

There are many methods available to calculate fair transfer pricing but they are irrelevant for the purpose of this article. What is relevant is the notion of related parties trading as if they were unrelated.

Although very complex in some cases, it is not terribly difficult to determine the fairness of pricing for operations between related parties. The crux of the matter is when related parties appear to be unrelated. This is the real challenge in cross-border transactions.

II. VAT Background

To a lay person, perhaps the most striking difference between VAT and a Retail Tax, such as the one adopted in the United States, is the fact that in a Retail Tax environment a registered business that buys merchandise, for the purpose of re-selling it, will pay no tax on such acquisition.

Contrary to this, the same acquisition in a VAT scenario will be subject to tax, with the characteristic that the tax paid on the purchase will become a credit (input credit) in the purchaser’s ledgers; to be offset by the debit (output debit) of the tax collected on the ongoing sale, presumably at a higher price or, in other words, with value added. The tax liability in that single operation is therefore the delta between the tax paid on the purchase and the tax collected on the sale.

Since the purchase and the sale will be supported by a corresponding invoice, this system of calculating VAT is called the “credit invoice” system and is certainly the most broadly adopted method of calculating VAT.

The inevitable conclusion is a necessary reliance on invoices as they are the supporting evidence for debits and credits that generate final tax obligations.

III. The Invitation for Abuse

The transfer pricing doctrine was born out of the fear tax authorities had that related parties could feel inclined to under-invoice or over-invoice their transactions with each other, thus creating artificial prices of transference to suit particular needs of shifting profits from a high-tax jurisdiction to a low(er) tax jurisdiction, in the realm of direct taxation, or simply pay less transaction tax, in the realm of indirect taxation, or both.

In some VAT systems this need would not be felt as many jurisdictions harbour the concept of "VAT Groups" according to which transactions between registered taxpayers in the same "group" (made out of companies with substantial ownership ties between them) are ignored, or made neutral, for VAT purposes.

However, two corporations may be related and, yet, not reach the legal criteria for the formation of a VAT Group or simply do not want to reveal that they are related.

Against this backdrop, the invitation for abuse comes precisely from the excessive, and sometimes blind, formalism modelled by the “credit invoice” system.

IV. Form Over Substance

Let us consider the European Union.

The European Union is the supra-national entity aiming, inter alia, to harmonise the legislation, including tax law, of (so far)
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25 member states, as a tool to achieve their common goal of unity.

In this context, the European Union VAT system is perhaps the most sophisticated and advanced VAT system in the world, with the Sixth EU VAT Directive serving as the blueprint for the adoption and implementation of the unified VAT system, in each of the member states' national statutes.

The Sixth EU VAT Directive, in Article 11(1)(a), clearly states that the taxable amount is "... everything which constitutes the consideration which has been or is to be obtained by the supplier from the purchaser, the customer or a third party for such supplies ..." (emphasis added).

So, apart from a little nod to the self-supply of services (op. cit., Art. 11(1)(d)), for which member states may or may not use the open market value as the taxable amount, the taxable amount in European VAT is consideration.

And what is consideration? Anything one cares to write on one's own invoice, as the price for goods and/or services supplied. Remember, these are related parties dealing with each other; maybe even controlled by the same parent corporation, a fact that is sometimes not disclosed to authorities. The determination of price between these parties may become totally arbitrary, not to say whimsical.

V. Inter-Jurisdictional Abuse

Please consider the following example:

Example 1

A corporation in country B buys goods from a corporation in country A for $200, with a 25 percent import duty and a 25 percent (import) VAT, calculated on price + import duty, with a total cost of $312.50, cleared Customs.

If the corporation in country B decides to establish a company in country C, commonly described as a "tax haven", and less humorously called "countries with harmful tax practices" by the OECD (Organisation for Economic Co-operation and Development) we could have:

In this example, the corporation in country C (controlled by the corporation in country B, but not seemingly so) buys the same goods for $200 and sells them for $100. This is irrelevant in country C as most of the countries with harmful tax practices do not require accounting books (or at least very few records) from their non-established, foreign-controlled, corporations.

Likewise, there are no import duties and import VAT as the goods do not go anywhere near country C, being dispatched directly from country A to country B.

The only unorthodox move is that the corporation in country B has to arrange for an unofficial (in country B) payment of $100 since goods are being officially imported for $100 from country C, but the actual cost in country A is $200.

The final result is that the goods that cost $312.50 in a deal with an unrelated party could be bought for $286.25 by introducing a friendlier country in the equation. That is a saving of $66.25 in a $200 purchase. This is difficult to ignore.

We are obviously not advocating that readers engage in such practices. Quite the opposite. We are merely recounting a morally debatable, if not outright illegal, choice that is available to corporations worldwide.

VI. Intra-Jurisdictional Abuse

Abuse has many forms and can also occur in intra-jurisdictional transactions.

Please consider this further example:

Example 2

A bank purchases a car from a car dealership in a VAT jurisdiction with a 20 percent standard-rate. The base price of the car is €10,000, plus €2,000 VAT, for a total of €12,000 (in some jurisdictions the VAT is part of its own taxable amount and in those cases the total price would have been €12,500).

The said bank will not be able to recover any of the VAT paid on the purchase of the car (the "input credit" referred above) for two, theoretically independent, reasons:

(i) The bank is the final consumer of the car and VAT is a consumption tax ultimately borne by the final user of goods and services, with a withholding mechanism along the economic chain of commercialisation, unknown in Retail Tax environments;

(ii) Even if our bank were not the final consumer, banks' main merchandise is money and money (i.e., banking, financing etc.) is not "vatable".

The consequence is that in the overwhelming majority of VAT jurisdictions, banks (and their supplies) are exempt (proper exemption or "exemption without credit") and therefore unable to recover their VAT input credits, or the tax portion on their purchases.

There is one remedy.
Our bank may establish a leasing company, as a separate legal entity, in the same VAT jurisdiction. The leasing company would purchase the car and lease it to the bank.

This changes everything. To the leasing company, that car is inventory and not a fixed asset. This means that the whole
VAT portion of the total purchase price of that car is recoverable by the leasing company, controlled by the bank. Only the VAT paid on the monthly lease the bank pays to the leasing company would be lost, or not recoverable, but that is a much lesser amount.

This is not abuse. This is legitimate tax planning by the bank.

**Example 2**

The abuse would occur if the bank were to lease the car from the leasing company at an artificially low monthly lease:

<table>
<thead>
<tr>
<th>Car Manufacturer</th>
<th>Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pays €10,000</td>
<td>Pays 24-month lease of €60 (€50 + €10 VAT) per month, VAT paid €80, VAT recoverable €0.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Leasing Co.</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Pays €12,000</td>
<td>VAT recoverable €2,000.</td>
</tr>
</tbody>
</table>

In this case we would have a monthly lease payment of €60 when a more realistic figure would be three times that amount.

**VII. Combating Abuse**

In order to combat these types of abuse, some E.U. member states (including Cyprus, The Netherlands, Portugal and Lithuania) are scrambling to ask the European Commission for authorization to derogate from (op. cit. Sixth Directive) Article 11A(1)(a) and/or introducing national legislation to adopt open market prices, rather than consideration, as the taxable amount for operations involving perceived low prices between related parties.

In doing so, E.U. member states are following the example of some non-E.U. countries that have already adopted such standards in their national legislation as, for instance, Iceland, whose VAT Code (Value Added Tax Act no. 50/1988) declares

"Article 9 – In transactions between related parties the tax price shall be passed upon the general selling price in similar transactions between unrelated parties".

As we have said, the real challenge is combating inter-jurisdictional abuse.

This particular type of abuse was so pervasive that direct taxation authorities in many countries simply assumed, and the assumption was built into law, that if companies in their jurisdiction were dealing in intangibles with companies in countries with harmful tax practices, both companies were related, and assessed at a higher withholding rate for those transactions.

Things are not so easy in indirect taxation as countries cannot appear to be discriminating against goods and services originating from certain other countries, simply because they exist, as this would likely give rise to sanctions at the World Trade Organisation level. This is especially true when one considers that depending on the criterion one adopts to classify a country as having harmful tax practices (and there are many criteria), it could result in Switzerland, for example, being classified as a tax rogue nation, as indeed the OECD once did.

One of the ways authorities are fighting transfer pricing transgressions in cross-border trade is to determine, at administrative level, prices of reference to be used as taxable amounts for import duty and import VAT. This way is fraught with difficulties because:

- It is not always easy to establish prices of reference due to the endless, in practical terms, nature of different goods and services;
- Taxpayers can easily challenge reference prices in Court as the fact they are set administratively allows authorities great latitude for arbitrary, and potentially illegal, behaviour.

We would argue that countries will eventually move to apply comparison with open market prices to determine the fairness of taxable amounts in transaction taxes, whenever there is suspected abuse, in all transactions and not only transactions involving related parties.

**Note:** At the time this article was written, the European Union was gestating an initiative (details unknown) to modify the application of VAT rules to financial services in order to void the inability of financial institutions to recover input credits. This would prevent such credits translating into higher costs of borrowing, an obstacle to investments in the region.

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He graduated as Jusis Doctor by the Sao Paulo (Brazil) University and specialised in Private Internal Law. Camilo speaks five languages and worked in corporate matters and international direct and indirect taxation in England, France, Venezuela, Hungary and Brazil. He used to lecture in Brazil for a think-tank in international trade and for candidates to the Brazilian IRS. Camilo is admitted to the Brazilian Bar Association, as Attorney-at-Law and to the Massachusetts Bar Association, as Foreign Legal Consultant.