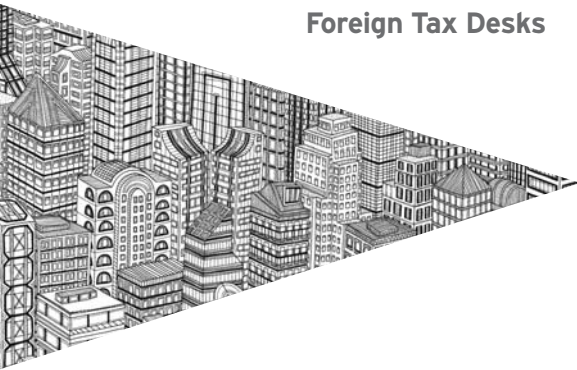


International Tax Alert

News and views from
Foreign Tax Desks



Tax authorities focus on increased transfer pricing-related VAT and customs issues

Introduction

There has been an increased focus in recent years from taxing authorities on the indirect tax implications of transfer pricing and customs duties and whether, in particular, the price used for direct tax purposes is appropriate for customs purposes.

It may come as a surprise to some that the same tax authorities (in a significant number of countries that have a value added tax, goods and services tax or consumption tax (hereafter, the generic term, VAT, will be used to cover all these taxes)) are also taking a look at whether additional VAT may be due on post-transaction adjustments to the pricing of goods and services transactions between related entities in different jurisdictions. This focus by the tax authorities is taking place even in situations where any additional VAT that may be due is fully deductible by the importer of such goods and services and even where the imported goods are not subject to customs duties.

In our alert, we consider the implications of the increased interaction between transfer pricing and VAT and focus, in particular, on post-transaction transfer pricing adjustments. We also highlight the risks of penalties and interest that can be levied by tax authorities where such retrospective adjustments between related entities (resulting in an increase of VAT payable) have not been reported.

Transfer pricing

Why the need for transfer pricing adjustments?

Transfer pricing legislation and practices differ by country. Although some countries have adopted similar transfer pricing frameworks or principles (e.g., the arm's-length principle and the OECD (Organisation of Economic Co-

operation and Development) Transfer Pricing Guidelines), there still exists significant variation in transfer pricing treatments by tax authorities around the world. Further, transfer pricing implications are attached to a wide variety of intra-group transactions, including:

- ▶ Tangible property
- ▶ Services
- ▶ Intangible property
- ▶ Rents
- ▶ Loans and guarantees

To comply with the complex web of local country transfer pricing legislation, it is often necessary to make transfer pricing adjustments after the initial transaction has been recorded.

Types of transfer pricing adjustments

Certain transfer pricing adjustments may occur for goods and services transactions between related entities. These are as follows:

- ▶ US- or foreign-initiated primary adjustments are imposed by the tax authority to ensure that the appropriate amount of tax is reported in the taxpayer's country.
- ▶ Taxpayer-initiated primary adjustments are made without the involvement of the tax authority to ensure that transfer prices are at arm's length. These adjustments are typically made to ensure that prices and income are consistent with the relevant local country guidance. Taxpayer-initiated

primary adjustments may be performed before or after the closing of the statutory accounts.

- ▶ Correlative adjustments are made to ensure that no double taxation arises in the related party's country as a result of the primary adjustment. Thus, if a primary adjustment is made to increase the taxable income of a member of a group, a corresponding decreasing adjustment is made to decrease the taxable income of any other member of the group involved in the transaction. A correlative adjustment is, by its nature, one that is made after the taxable year has ended and is usually made based on treaty provisions and use of the competent authority process, to avoid double taxation.

VAT treatment for prospective adjustments

No action is generally required, as an increased transfer price for future sales will be reflected on future invoices and the normal VAT accounting practices will apply. However, could countries attempt to apply retrospectively if there is a material effect on either the seller's or the purchaser's earlier input tax deduction as opposed to a current position?

VAT treatment for retrospective adjustments

In this situation, a seller should issue credit notes or amending invoices, which are cross-referenced to the original invoices showing the amended value of the goods previously sold to and imported by related entities. Summary invoices

may be possible, but some countries may limit them to specific periods, months or quarters.

Some EU countries require VAT returns on which original transactions were recorded to be adjusted. If an adjustment relates to intra-Community transactions involving goods, the seller and purchaser may be required to adjust Intrastat declarations and EC Sales Lists. If the adjustments are not recorded on these amended statistical reports, there could be penalties applied by the EU VAT authorities.

Related sellers and purchasers should check whether there will be a need to make any formal disclosures to the authorities in their respective jurisdictions.

Key messages

There is an ever-increasing importance of transfer pricing planning and compliance.

There is no single standard for the treatment of transfer pricing issues worldwide.

There is a need for an integrated approach to direct and indirect tax aspects of related party transactions.

Business model changes need to be examined carefully, as these can typically lead to transfer pricing implications with consequential affect on indirect tax, e.g.:

- ▶ Supply chain optimizations
- ▶ Intellectual property planning and management strategies
- ▶ Procurement strategies

Companies should be reviewing their transfer prices mid-year in this uncertain global economy to try and avoid year-end transfer pricing adjustments.

How do the VAT and customs valuation rules differ?

Generally, the customs value will be:

- ▶ Everything [monetary or non-monetary] which constitutes the consideration from the purchaser, customer or a third party, including subsidies directly linked to the price; plus
- ▶ Taxes, duties, levies and charges (excluding VAT itself), and incidental expenses, such as commission, packaging, transport and insurance, paid by the seller to the buyer
- ▶ Less discounts for early payment, discounts and rebates allowed at time of supply and disbursements

For VAT purposes, the taxable value on the importation of goods will be the customs value.

Ernst & Young survey of whether additional VAT due on retrospective adjustments

In a recent survey of over 60 countries that have a VAT (and there are over 135 of them!), it was found that the tax authorities in more than 80% of the countries surveyed require that local customs authorities

should be notified of retrospective transfer pricing adjustments, where the adjustment leads to an increase in the value of the goods previously imported and that additional payments of VAT should be made. Clearly, this makes sense where the goods are subject to customs duties, or where the importer cannot claim a full deduction of the VAT paid on imports, but the survey referred to situations where the goods are subject to VAT **only** and where any additional VAT is **fully deductible** by the importing entity. The survey also revealed that if the customs administrations discover that adjustments have not been notified, they could issue penalty and interest assessments of between 2% and 200% of the additional VAT due, again irrespective of whether the additional VAT due is deductible.

What should you do now?

Due to the developing levels of understanding of customs on transfer pricing principles, it is not currently realistic to have an immediate “one-size-fits-all” approach. The aim should therefore be to implement the applicable best practice in each country.

A strategy needs to focus on implementing a provisional value at the time of import, where this is possible, and implementing current best practices in those countries where this is not possible. This

will reduce penalties and provide the greatest chance of obtaining a refund of the VAT paid at import.

Customs authorities are increasingly aware of, and ask specifically for, transfer pricing documentation upon audit. Customs authorities, like any other tax administrations around the globe, are under increasing pressure to generate greater revenue for their respective governments. Taking proactive action will help establish better relations with customs authorities around the globe. The answer should be to make retrospective value adjustment notifications as needed. If the local customs authority will allow this, agree to a method in advance, i.e., import using an estimated value for a later true up. These strategies will reduce the risk of surprises, interest and penalties.

Conclusion

Transfer pricing-related VAT and customs issues are intensifying. Accordingly, it is becoming increasingly necessary to manage these issues. The best way to manage these issues is to consistently and pro-actively engage with the customs authorities. The approach needs to be on a country-by-country basis, but should be coordinated across the globe based on organizational and technical factors.

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