

Transfer pricing adjustment and VAT 2/13/22



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Our customers often ask us if transfer pricing adjustments affect VAT. This is an issue that remains unresolved by [the VAT directive](#), [the Latvian VAT Act](#), the Cabinet of Ministers' rules, or guidelines issued by the State Revenue Service (SRS). Even the Court of Justice of the European Union (CJEU) has never dealt with this issue in its rulings. This article explores an opinion expressed by the European Commission's VAT committee.

What is transfer pricing (TP)?

This is the price (value) of goods or services, or another type of value, or terms applied in a controlled transaction or present in a financial or commercial relationship between connected persons. The TP concept provides that the terms of transactions between related parties must not be different from what independent parties would apply in similar transactions under similar circumstances (the so-called arm's length principle).

Thus, if under conditions that are present between two related companies in their financial or commercial relationship, one company's revenues or expenses are different from those of comparable independent companies, the difference must be included in the company's corporate income tax base.

Applying the arm's length principle involves conducting a benchmarking study to assess key aspects, such as the financial or commercial relationship between the related companies, and any economically relevant facts and circumstances of transactions between related and independent companies. For this purpose, we need to consider the functions performed, assets used and risks taken by the parties to the transaction, as well as their business strategy, industry specifics, and other factors. Once we have established the facts and circumstances of the controlled transaction, we need to check whether its price is arm's length. There are various methods to choose from for comparison. The TP analysis leads us to a particular market price (value) and a corresponding range of prices or profit indicators.

If the price (value) of the transaction is not arm's length, a TP adjustment has to be made. The taxpayer can make it voluntarily, or the tax authority can do this. The TP adjustment may or may not be followed by a balancing payment. It is important to bear in mind that the idea of adjusting TP has been adopted for direct taxation purposes, so a TP adjustment has no direct correlation with VAT.

Things to consider in assessing whether a TP adjustment is subject to VAT

The requirement for charging VAT arises from the scope of taxable transactions – VAT is charged on a supply of goods or services for a consideration.

Thus, if a TP adjustment is made for direct tax purposes only and a balancing payment does not follow, then VAT does not come into play because no consideration has been received in exchange for goods or services. Even where the TP adjustment is followed by a balancing payment, we do not always have a taxable supply to speak about.

We need to establish that the payment is made to adjust the agreed price of goods or services supplied earlier. The CJEU case law states that a supply of goods or services for a consideration means there must be a direct link between the goods or services supplied and the consideration received. A direct link can be identified if a legal relationship exists between the supplier and the customer that involves counter-performance, and the consideration received by the supplier represents the actual value of the goods or services supplied to the customer. Accordingly, if it is not possible to identify a direct link between the goods/services and the consideration received for them under the agreement between the parties, then it is not possible to identify a supply for VAT purposes.

The CJEU case law also states that in a supply of goods or services, VAT is charged on the consideration actually received and not on any fee computed according to some objective criteria, and it is not relevant that the value of a legitimate transaction is higher or lower than its open market price. [The anti-avoidance rule in section 34\(9\) of the Latvian VAT Act](#) provides that in related-party transactions VAT is not charged on the consideration received, but rather on the market price, which is to be used only if one of the parties has limited input tax deduction rights. This means that using the market price for VAT purposes is an exceptional measure and not every TP adjustment is subject to VAT.

In summary, a TP adjustment will affect VAT only where a payment is actually made and can be directly linked to a supply of goods or services made earlier (it is the consideration received for an earlier supply that is being adjusted). The agreed price of a supply of goods or services may be adjusted if the parties have agreed on this based on objective reasons, for instance, a substantial rise in the price of raw materials, or additional costs incurred in the provision of services. So each case should be assessed on its merits and there is no saying in general whether a TP adjustment affects VAT. What matters is the contract between the parties, in particular whether it provides for a need in certain circumstances to adjust the value of the transaction (the consideration) agreed originally.

If the TP adjustment invoice/payment reduces or increases the consideration received for identifiable goods or services supplied earlier, the VAT due should also be adjusted.

In its report of 28 February 2017, the European Commission's VAT committee states that if, for instance, a TP adjustment made by the tax authority results in the company making a balancing payment, this may be treated as an additional consideration for any previous supply of goods or services only if we can establish a direct link between the payment to an identifiable supply made earlier. A payment that represents anything other than counter-performance for a supply of specified goods or services has no VAT implications. If a balancing payment for the TP adjustment is determined according to the customer's income or profit indicators, then it is unlikely to have any VAT impact.

In their report of 18 April 2018, the VAT group of experts has even recommended treating a TP adjustment as one that falls outside the scope of VAT, unless one of the parties has limited input tax deduction rights and the market price is to be used for VAT purposes.

If the parties have agreed that a TP adjustment will reduce or increase the consideration for the goods or services supplied earlier, a credit note must be issued at the same time, specifying the goods or services whose value is being adjusted.